

## ESTATE PLANNING ARBITRAGE STRATEGIES

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### OVERVIEW

- OVERVIEW OF TAX STRUCTURE
- INTEREST RATE FACTORS
- RELEVANT ECONOMIC CONSIDERATIONS
- EXAMPLES OF STRATEGIES



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### INCOME TAX RATES

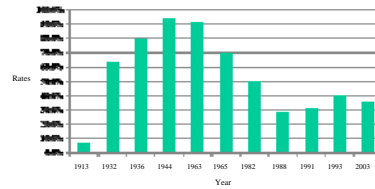
YEAR	RATE
1913	7.0%
1932	63.0%
1936	79.0%
1944	94.0%
1963	91.0%
1965	70.0%
1982	50.0%
1988	28.0%
1991	31.0%
1993	39.6%
2003	35.0%



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### INCOME TAX RATES



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### ESTATE TAX RATES

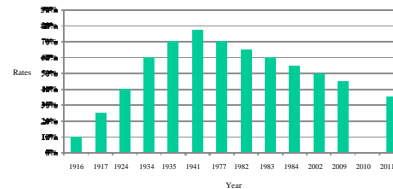
YEAR	RATE
1916	10%
1917	25%
1924	40%
1934	60%
1935	70%
1941	77%
1977	70%
1982	65%
1983	60%
1984	55%
2002	50%
2009	45%
2010	0%
2011	35%



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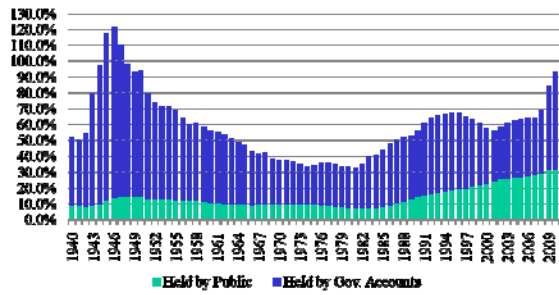
### ESTATE TAX RATES



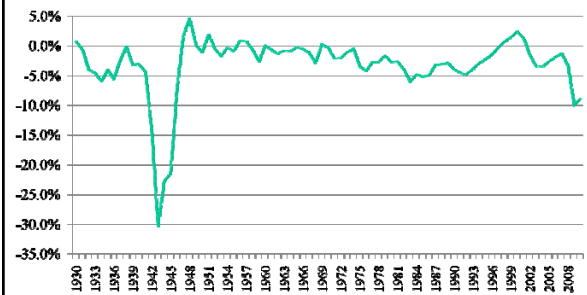
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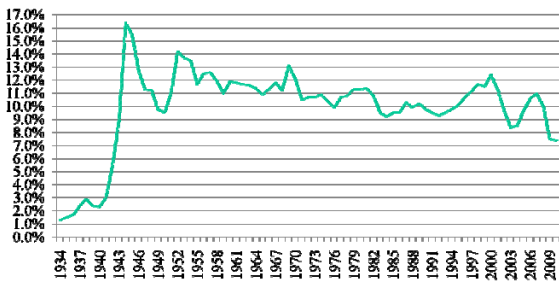
FEDERAL DEBT AS PERCENT OF GDP: 1940-2010



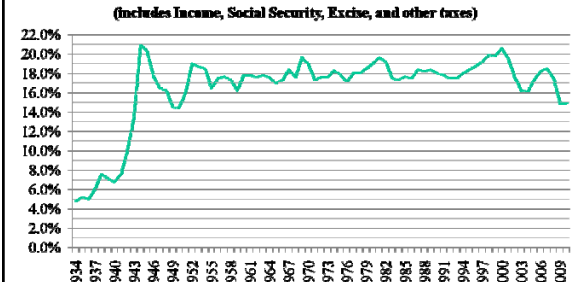
SURPLUS (DEFICIT) AS PERCENT OF GDP: 1930-2010



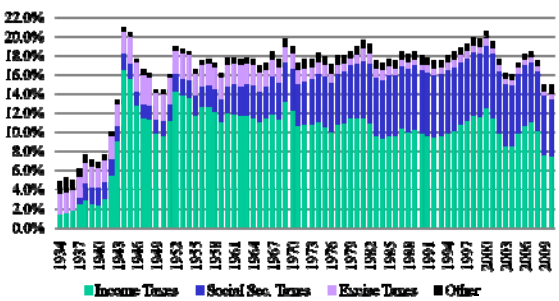
INCOME TAX RECEIPTS AS PERCENT OF GDP: 1934-2010



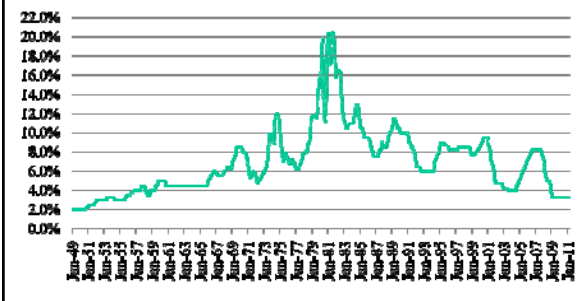
ALL TAX RECEIPTS AS PERCENT OF GDP: 1934-2010



ALL TAX RECEIPTS AS PERCENT OF GDP: 1934-2010



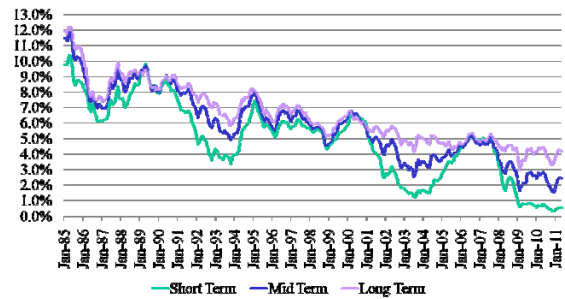
PRIME INTEREST RATE: JANUARY, 1949 - MARCH, 2011



**10 YR TREASURY RATE (NOMINAL): APRIL, 1954 – MARCH, 2011**



**HISTORICAL AFRS: JANUARY, 1095 – MAY, 2011**



**RELEVANT ECONOMIC CONSIDERATIONS**

- FUTURE DIRECTION OF INTEREST RATES
- US BUDGET DEFICIT
- S&P EARNINGS HAVE DOUBLED IN 10 YEARS BUT PUBLIC EQUITY MARKET IS FLAT
- INVERSE CORRELATION OF MARKET CAP RATES AND INTEREST RATES
- TAX POLICY CONSIDERATIONS
  - RATE INCREASES
  - LIMITATION ON DEDUCTIONS
  - "POTENTIAL" CHANGE IN GIFT/ESTATE TAX EXEMPTIONS
  - VALUATION ADJUSTMENTS

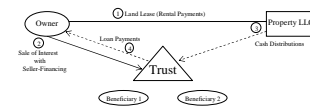
**STRATEGIES**

- REAL ESTATE STRIP
- CLT
- GRAT CONSIDERATIONS
- SPLIT INTEREST PURCHASE

**REAL ESTATE ARBITRAGE**

- FUNDAMENTAL INEFFICIENCY BETWEEN AFR AND CAP RATES.
- CREATE YOUNGER GENERATION TRUST FOR VEHICLE TO ACQUIRE/OWN INVESTMENT REAL ESTATE OR VACATION HOME ON LONG TERM LEASE.
- RENTAL PAYMENTS AND INTEREST PAYMENTS PROVIDE "MIRROR" STRUCTURE TO AVOID SECTION 2036 ISSUES.
- PURCHASE IS SELF-FUNDED OVER 8-12 YEAR PERIOD.
- AVOID GAIN THROUGH USE OF DGT OR SECTION 267 APPLICATION.
- LEASE TO RELATED PARTY IS SUBJECT TO LOSS LIMITATIONS.

**IMPLEMENTATION STEPS AND BENEFITS**



**IMPLEMENTATION STEPS:**

1. PROPERTY LLC IS FORMED.
2. OWNER ENTERS INTO 10-YEAR LEASE WITH PROPERTY LLC.
3. OWNER SELLS INTEREST IN PROPERTY LLC TO TRUST AND PROVIDES 100% SELLER FINANCING. FINANCING PROVIDED AT MID-TERM APPLICABLE FEDERAL RATE OF 2.44% (MARCH, 2011).
4. PROPERTY LLC DISTRIBUTES CASH FLOW TO TRUST.
5. TRUST USES CASH FROM DISTRIBUTIONS TO MAKE NOTE PAYMENTS TO OWNER.

**BENEFITS:**

- A. OWNER CONTINUES TO HAVE RIGHT TO USE PROPERTY.
- B. TRUST ACQUIRES INTEREST IN PROPERTY LLC:
  - i. CASH FLOW VALUE APPROACH BASED UPON LAND LEASE.
  - ii. NON-CONTROLLING INTEREST IN PROPERTY LLC.
- C. OWNER RECEIVES CASH FLOW VIA PAYMENTS ON NOTE.
- D. TRUST OBTAINS CARRYOVER BASIS IN PROPERTY.

## REAL ESTATE TRANSFER ECONOMIC ANALYSIS

REAL ESTATE TRANSFER ECONOMIC ANALYSIS  
Revised 10/11

FACTORS:

**I. SALE OF LLC INTEREST**  
 Net Proceeds from Sale: \$ 10,000,000  
 Yearly Cash Flow of Interest: \$ 1,000,000

**II. TERMS OF NOTES**  
 Loan Amount: \$ 8,000,000 (Loan amount of interest rate)  
 Interest Rate: 4.44% (Mid Term AFR, March 2011)  
 Amortization Period: 5 years (Amortization period based on equal and principal payments on an annual basis)  
 Term of Amortized Period: 5 year, interest only with all outstanding principal and accrued unpaid interest due at 5 years.

**III. TERMS OF LEASE AGREEMENT**  
 Lease Commitment on 3/30/11: \$66,667 (Lease commitment on 3/30/11)  
 Lease Rate: \$66,667 (Lease rate)  
 Amortization Period: 5 years (Amortization period based on equal and principal payments on an annual basis)  
 Option to Buy for 5 years: 5 years (Option to Buy for 5 years)  
 Fair Market Value of Property: \$1,000,000 (Fair Market Value of Property)

**CASH FLOW ANALYSIS (All cash flow to be used to pay down notes.)**

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	TOTAL
Rental Income	\$ 800,000	\$ 800,000	\$ 800,000	\$ 800,000	\$ 800,000	\$ 800,000	\$ 800,000	\$ 800,000	\$ 800,000	\$ 7,200,000
Interest Expense	(800,000)	(800,000)	(800,000)	(800,000)	(800,000)	(800,000)	(800,000)	(800,000)	(800,000)	(7,200,000)
<b>NET CASH FLOW</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 0</b>
BEGINNING NOTE BALANCE	\$ 8,000,000	\$ 5,346,488	\$ 4,076,952	\$ 3,066,247	\$ 2,248,247	\$ 1,613,251	\$ 1,175,939	\$ 842,762	\$ 599,000	\$ 0
Principal Payment	(800,000)	(889,298)	(988,080)	(1,096,298)	(1,214,298)	(1,342,298)	(1,480,298)	(1,628,298)	(1,786,298)	(10,000,000)
<b>ENDING NOTE BALANCE</b>	<b>\$ 8,000,000</b>	<b>\$ 5,346,488</b>	<b>\$ 4,076,952</b>	<b>\$ 3,066,247</b>	<b>\$ 2,248,247</b>	<b>\$ 1,613,251</b>	<b>\$ 1,175,939</b>	<b>\$ 842,762</b>	<b>\$ 599,000</b>	<b>\$ 0</b>

## RECENT CASES

- LUDWICK
- MITCHELL

## CLT ISSUES

- AVOID SECTION 2036 AND SECTION 2038 ISSUES
- NO CHARITABLE CONTRIBUTION LIMITATION
- ESCALATING PAYOUTS
- INVESTMENT/INCOME TAX COORDINATION
- GST PLANNING

## CLT CALCULATIONS

ASSUMPTIONS  
 100% Contribution: 10,000,000  
 Applicable Sec. 7520 Rate: 3.0% (April, 2011)

	REMAINDER VALUES OF "ZEROED OUT" CLAT (5% ANNUAL PAYOUT INCREASE)	
	Remainder Values	5% Growth
Total to Charity	11,443,143.40	1,895,085.88
20 year term	14,506,861.75	2,742,004.81
25 year term	15,305,777.30	3,013,855.45
30 year term	15,925,071.30	3,212,274.77

	REMAINDER VALUES OF "ZEROED OUT" CLAT (20% ANNUAL PAYOUT INCREASE)	
	Remainder Values	5% Growth
Total to Charity	11,443,143.40	1,895,085.88
20 year term	14,506,861.75	2,742,004.81
25 year term	15,305,777.30	3,013,855.45
30 year term	15,925,071.30	3,212,274.77

	DIFFERENCE IN REMAINDER VALUES IF ANNUITY PAYOUT/CLAT WITHIN 5% INCREASING ANNUITY	
	Remainder Values	5% Growth
Total to Charity	11,443,143.40	1,895,085.88
20 year term	14,506,861.75	2,742,004.81
25 year term	15,305,777.30	3,013,855.45
30 year term	15,925,071.30	3,212,274.77

## GRAT ISSUES

- DURATION OF TRUSTS
- LADDERED APPROACH
- INVESTMENT LAYERING
- RIGHT OF SUBSTITUTION
- HEDGING STRATEGIES
- USE OF ENTITY STRUCTURES (FLPS) AND IMPLICATIONS

## SPLIT INTEREST PURCHASES

- MID TERM AFR RATE APPLIED FOR VALUING INTERESTS
- SECTION 2702 APPLIES WITH ATTRIBUTION BASED UPON SECTION 267
- LIFE TENANT RETAINS ALL INCOME FROM THE PROPERTY
- LIFE TENANT IS ENTITLED TO AN AMORTIZATION DEDUCTION FOR ENTIRE ACQUISITION COST (SECTION 167(a)(2); REG. 1.1084-5(c); REV. RUL. 62-132)



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•California Society of CPAs  
•American Bar Association  
•California State Bar Association  
•San Francisco Estate Planning Council  
•San Francisco Tax Club

**Mark L. Wornatz**

Managing Director - Client Foundation

Mark Wornatz is a senior advisor and partner in the Client Foundation, a leading national organization of family business owners and their families. He has advised numerous family businesses on a wide range of issues, including estate planning, business succession, and family governance. He is also a frequent speaker at industry conferences and seminars.

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