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# Structuring GRATs: Maximizing Estate Freeze Benefits, Avoiding Costly Errors With Specific Trust Drafting Tools

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Today's faculty features:

Eric M. Kramer, Partner, **Farrell Fritz**, Uniondale, N.Y.

Scott K. Tippett, Attorney, **The Tippett Law Firm**, Oak Ridge, N.C.

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# Structuring GRATs: Maximizing Estate Freezes

Scott K. Tippett  
The Tippett Law Firm,  
PLLC  
(336) 643-0044  
skt@sktlaw.com  
www.tippettlawfirm.com

Eric M. Kramer  
Farrell Fritz, P.C.  
1320 RXR Plaza  
Uniondale, New York  
11556-1320  
(516) 227-0738  
Ekramer@FarrellFritz.com  
www.farrellfritz.com

# Structuring GRATs: Maximizing Estate Freezes

- ▶ **Defined.** Irrevocable trust in which the grantor transfers assets and retains a right to receive annuity payments over a fixed term. The annuity payments can be expressed either as a fixed number or a fixed fraction or percentage of the initial fair market value of the property put into the GRAT. Treas. Reg. Sec. 25.2702-3(b)(1(ii)). The annuity payments need not be equal and probably should not be. The annuity payments can increase to up to 120% of the previous year's annuity payment, and they probably should be set up that way

# Structuring GRATs: Maximizing Estate Freezes

## ▶ Advantages

Can pass appreciation while retaining a cash stream

Can take advantage of IRC Sec. 7520 interest rate blips relative to current market rates

Permits leverage in calculation of gift tax

Great for working with gifts of partnership/LLC interests to leverage the applicable exemption amount through the additional use of valuation discounts

Expressly sanctioned in the Internal Revenue Code

S corporation stock can be placed in a GRAT because it is a grantor trust for income tax purposes since the grantor usually will be entitled to all of the trust income. IRC Sec. 675(2) and 675(4).

# Structuring GRATs: Maximizing Estate Freezes

## ▶ Disadvantages

Expense of set up, including valuation costs can be significant.

Mortality risk, *i.e.*, risk that the settlor will not survive the GRAT term, leading to some estate tax inclusion risk

Property must generate enough positive cash flow to pay the annuity amount, or the underlying property has to be sold (capital gain to grantor) or given back to the grantor (which defeats estate planning purpose), and not many assets do this. Cannot be promissory notes

Asset must grow at a rate faster than the IRC Sec. 7520 rate, or so-called "hurdle rate," in order for more wealth to pass onto the lower generation

Despite previously asserting includability under IRC Sec. 2039, IRS now says that the proper inclusion section is IRC Sec. 2036

# Structuring GRATs: Maximizing Estate Freezes

- ▶ **Disadvantages (cont.)**

Risk of GRAT failure to be tax qualified as gift of whole value of asset placed in GRAT. In other words, if the interest retained is not a “qualified interest” (as defined in IRC Sec. 2702(b)), then the value of the retained interest is zero

**Limited payout flexibility**, especially when compared to an installment note, which may be tailored to a particular situation with unequal payments of principal and interest

# Structuring GRATs: Maximizing Estate Freezes

## ▶ Disadvantages (cont.)

Inability to “zero out” (so said IRS. See, e.g., PLR 9239015; Treas. Reg. Sec. 25.2702-3(e), Example 5). However, the Tax Court did not agree, and it invalidated that regulation. *Walton v. Comr.*, 115 T.C. 589 (2000). IRS did not appeal *Walton* and has since acquiesced. Notice 2003-72.

Nevertheless, President Obama’s tax proposal would eliminate the right to zero out GRAT’s and would impose a ten year minimum term on the GRAT to eliminate the practice of “rolling GRATs”

Cannot safely use a GRAT for gifts to grandchildren for GST Tax purposes because of ETIP

# Structuring GRATs: Maximizing Estate Freezes

- ▶ **Gift tax consequences of a GRAT.**  
The value of the taxable gift on creation is a function of several factors:

- The value of the underlying property transferred to the GRAT

- The annuity amount

- The GRAT term

- The IRC Sec. 7520 rate

- The frequency of payment of annuity

- The time that the annuity amount is paid (beginning v. end of period).

# Structuring GRATs: Maximizing Estate Freezes

## ▶ Factors to consider in GRAT structuring

It is imperative to consider a client's remaining life expectancy in structuring the GRAT term. All other things being equal, the shorter the GRAT term is, (1) the larger the taxable gift will be, (2) the risk of the client dying during the GRAT term is smaller and (3) the likelihood and degree of appreciation in the value of GRAT assets is lower. Conversely, the longer a GRAT term is, (1) the smaller the taxable gift on GRAT creation will be, (2) the risk of the client dying during the GRAT term is greater and (3) the likelihood of appreciation in the value of GRAT assets is higher.

# Structuring GRATs: Maximizing Estate Freezes

## ▶ Factors to consider in GRAT structuring

For example, IRS Table 2000CM tells us that a 65 year old has a remaining life expectancy of 17.7 years. Therefore, the estate planner probably should not suggest a 20 year GRAT term for a 65 year old. But how long should that the GRAT term be?

The answer to this question cannot be, and should not be given, with absolute certainty. However, the estate planner should make some inquiry as to mortality age patterns in the client's family. Then, the estate planner can also "play the percentages"

# Structuring GRATs: Maximizing Estate Freezes

- ▶ **Assets that could be good for usage in GRAT**  
**Appreciation Potential.** Property that will appreciate in value, and the more the better. The benchmark to consider is the IRC Sec. 7520 rate, or so-called “hurdle rate.” If the property produces combined income and appreciation in excess of the IRC Sec. 7520 rate, the balance will inure to the remainder beneficiaries free of transfer tax. Conversely, if the GRAT’ed property loses value, as in *Walton*, there may well end up in a deficit, meaning zero

# Structuring GRATs: Maximizing Estate Freezes

## ▶ Assets that could be good for usage in GRAT

**Cash Flow Is Also Essential.** It is imperative to analyze the potential cash flow that can be generated by the assets to be placed in the GRAT for several reasons.

- **First**, it is essential to be able to set the appropriate annuity amount so that there will be some appreciation to pass on.
- **Second**, IRS has invalidated some GRAT's in which it seemed very obvious that the assets were insufficient to throw off enough cash flow to satisfy the annuity amount, although this has not deterred aggressive estate planners from setting up short term GRAT's with very large payouts.

# Structuring GRATs: Maximizing Estate Freezes

- ▶ **Assets that could be good for usage in GRAT**

Cash Flow Is Also Essential. It is imperative to analyze the potential cash flow that can be generated by the assets to be placed in the GRAT for several reasons (cont.)

- **Third**, if the assets are expected to appreciate, and if cash flow is insufficient, then the GRAT trustee will be forced to redistribute GRAT assets back to the settlor, which could erode a substantial amount of the benefit. It is a good practice to run multiple cash flow scenarios using a “best case”–“worst case” scenario in order to identify the tension corridors. Would have to get new appraisals for assets coming out, if RP is in an entity, you will need two appraisals.

# Structuring GRATs: Maximizing Estate Freezes

## ▶ GRAT Compared to other tools

**Gift.** A Gift is a true, leak free appreciation pass through, while the GRAT is not; it offers a “leaky freeze.” The GRAT offers substantially more in the way of valuation leverage while, if structured as a fraction or percentage of the initial fair market value of the property put into the GRAT, giving more downside protection against subsequent gift revaluation on audit (unless the GRAT is invalidated), unless the gift is established as a defined value gift, as it should be

**Sale to Defective Grantor Trust.** In my opinion, the sale to an IDGT generally is more favorable across the board than a GRAT. However, there are those who disagree. One should model out both scenarios to see which technique works better in a particular situation. The issues are murkier from the specter of IRS challenge to a sale to an “intentionally defective” grantor trust

# Structuring GRATs: Maximizing Estate Freezes

- ▶ **GRAT Compared to other tools (cont.)**

**Straight Installment Sale/SCIN a/k/a DTIN.**

Generally, the GRAT beats these techniques if gain is recognized on the sale (of course, sale to a defective trust gets out of the gain event)

**Loan.** The loan is good for GST Tax planning, whereas the GRAT is not because of ETIP. The loan also can use a better AFR. However, the **GRAT can still outperform the loan in many scenarios**

# IDGT vs. GRAT

▶ With IDGT:

- No mortality risk.
- Can allocate GST exemption to seed gift.
- Mid-term AFR is less than Section 7520 rate.
- Back-loading (i.e., interest only with balloon payment vs. level annuity payment).
- Not a statutory technique.
- Possibility of unintended gift tax, which may be mitigated by using a “defined value” clause.

# Structuring GRATs: Maximizing Estate Freezes

- A GRAT (a grantor retained annuity trust) is an irrevocable trust to which the grantor transfers an asset in exchange for the right to receive a fixed amount annuity for a fixed number of fiscal years (the “Annuity Period”).
- When the trust term expires, any GRAT balance remaining is transferred tax-free to a designated remainder beneficiary (*e.g.*, the grantor’s issue or a “defective grantor trust” for the benefit of the issue).
- If a grantor makes a gift of property in trust to a member of the grantor’s family while retaining an interest in such property, the taxable gift generally equals the fair market value of the gifted property without reduction for the fair market value of the retained interest.
- However, I.R.C. Section 2702 provides that for a gift of the remainder of a GRAT in which the grantor retains a “qualified interest”, defined to include a guaranteed annuity, the taxable gift will be reduced by the present value of the qualified interest, as determined pursuant to a statutory rate determined under I.R.C. Section 7520(a)(2) (the “Statutory Rate”).

# Structuring GRATs: Maximizing Estate Freezes

- In general, the Statutory Rate requires an actuarial valuation under prescribed tables using an interest rate equal to 120 percent of the Federal midterm rate in effect for the month of the valuation.
- A grantor's ability to determine the size of the guaranteed annuity and the annuity period at the outset allows the GRAT to be constructed so that the present value of the grantor's retained interest approximately equals the value of the property placed in the GRAT, resulting in a "zeroed out" GRAT.
- Thus, a GRAT could be structured, where there is no, or a relatively modest, taxable gift.



# Structuring GRATs: Maximizing Estate Freezes

- There is no question that the GRAT is one of the most popular estate planning tools that the practitioner utilizes.
- While it is a very popular estate planning tool, it is probably a fair statement that it is not always an effective estate planning tool. Critical administrative issues exist with a GRAT that can lead to its failure.
- A GRAT will not succeed unless the asset that is held by the GRAT increases substantially in value.
- Generally, a GRAT is not a good tool for leveraging a client's generation-skipping tax exemption.
- The purpose of this talk is to offer the reader some suggested solutions, which should ameliorate or eliminate the above concerns and make the GRAT a more effective estate planning tool. This paper discusses some of the most creative structural techniques, financial leverage techniques and financial engineering techniques we see out there that are integrated with the GRAT estate planning technique.

# Structuring GRATs: Maximizing Estate Freezes

\$Valuation advantages – annuity automatically adjusts on asset revaluation

\$Grantor may pay for income taxes associated with GRAT gift tax-free

\$Grantor may substitute assets of the GRAT income tax-free

\$Synergy with other techniques

\$Comparatively low hurdle rate

\$High leverage

\$Non-recourse risk to remaindermen



# Structuring GRATs: Maximizing Estate Freezes

Financial reasons why a GRAT may not succeed:

We'll see below that a GRAT transfers value to the remainder beneficiaries when its assets are sufficiently volatile – that is, when the assets contributed have the potential for large swings in value.

When a client contributes an asset outright to a GRAT (financial engineers say the client is “long” the asset), the GRAT succeeds only if the asset appreciates above the 7520 rate. The pressure is on the client or the advisor to select just the right asset for the GRAT term.

Financial engineering expands the possibilities for successful GRAT.

If a GRAT is not administered properly, the retained interest by the grantor may not be deemed to be a qualified interest:



# Structuring GRATs: Maximizing Estate Freezes

The *Atkinson* worry: The U.S. Court of Appeals for the Eleventh Circuit (*see Atkinson*, 309 F.3<sup>rd</sup> 1290 (11<sup>th</sup> Cir. 2002), cert denied, 540 U.S. 945)), has held that an inter vivos charitable remainder annuity trust's (CRAT's) failure to comply with the required annual payment regulations during the donor's lifetime resulted in complete loss of the charitable deduction. The Court found that the trust in question was not properly operated as a CRAT from its creation. Even though the subject CRAT prohibited the offending acts of administration, the Court held that the CRAT fails.

In a similar fashion, the Internal Revenue Service could take the position that if the regulations under IRC Section 2702 are violated by the trustee of the GRAT's administrative practices, then the interest retained by the grantor will not be a qualified interest.

\$The annuity amount must be paid annually.

# Structuring GRATs: Maximizing Estate Freezes

\$Paying the grantor in satisfaction of his retained annuity interest with hard to value assets may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.

\$The contribution of assets to the GRAT must be made at the exact point of the creation of the GRAT.

\$The retained annuity interest is valued using the valuation principles under IRC Section 7520.

\$A successful GRAT could regress to the mean by the end of the term of the GRAT.

\$The GRAT may not satisfy a client's stewardship goals because the investments of the GRAT may have been too successful.

\$The GST tax exemption may be difficult to leverage through the use of a GRAT.

\$A GRAT will not be successful in transferring assets if the grantor does not survive until the end of the term of the GRAT.

# Structuring GRATs: Maximizing Estate Freezes

- Structural solutions to prevent the inadvertent additional contribution of assets to a GRAT:

When creating the GRAT, the grantor may wish to consider a provision that prohibits any additional contributions to the GRAT and if any additional contribution is made, a new GRAT must be created specifically to hold that contribution.

The grantor of the GRAT may wish to consider initially making the trust revocable. Once all assignments to the trust have been completed, the grantor could amend the trust to make it an irrevocable GRAT.

- Structural solutions to ensure that the annuity amount is always deemed to be paid on a timely basis:

The grantor of the GRAT may wish to consider a provision in the trust document that provides (pursuant to a formula) a portion of the trust that is equal to the Annuity Amount due to the grantor shall not be subject to the trust.

# Structuring GRATs: Maximizing Estate Freezes

§If that portion remains in the hands of the trustee after the annuity payment date, the trustee shall hold such property only as a nominee or agent for the grantor.

§Structural solutions to limit the amount that is received by the remainderman of the GRAT:

§A structural solution is to put a cap on the amount left in the trust for the benefit of his descendants at the end of the annuity term.

§To the extent that the value of the assets of the GRAT on its termination exceeds that cap, there could be a provision that requires that excess to revert back to the donor.

§Spouse could be named as a discretionary beneficiary and the spouse could be given a special power of appointment.

# Structuring GRATs: Maximizing Estate Freezes

- Solutions to reduce the mortality risk in GRATs:
  - The grantor could sell her retained annuity interest.
  - The grantor could create and fund an insurance trust that would have an “estate planning windfall” if the grantor dies before the GRAT term terminates.
  - The grantor could contribute mortgaged property to the GRAT and the leverage from the note payable to the grantor may not have the same IRC Section 2036 issue.
  - The grantor could purchase the remainder interest in a profitable GRAT from the remainder beneficiaries.
  - The GRAT could be created by the grantor in consideration of full and adequate consideration:
    - If the remainder interest of a GRAT is not created by gift, but is created for full consideration, IRC Section 2036 should not apply to the GRAT assets, if the grantor dies before the end of the term of the trust.

# Structuring GRATs: Maximizing Estate Freezes

- Treas. Reg. Section 26.2632-1(c)(2) contains the regulatory definition of ETIP and then provides an exception, as follows:

For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is too remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate.

- For a short term GRAT (e.g., two years), except for a grantor who is above 70 years of age, the 5% exception noted above would apply.
- At least one way of reading the exception for a short term GRAT is that the ETIP rules will not apply to an allocation of GST exemption, because there is less than a 5% chance that the grantor will die during the GRAT term.
- Thus, can a grantor, age 70 or younger create a GRAT in which the remainderman is GST trust, if the exception applies, make an allocation of the GST exemption that is equal to the amount of the taxable gift of the GRAT remainder, and produce a zero inclusion ratio for generation skipping tax purposes?
- There is not any definitive authority on this subject, but most commentators believe the IRS will resist this result.

# Structuring GRATs: Maximizing Estate Freezes

- See private letter ruling 20010705. The private letter ruling's basic holding can be viewed as uniquely applicable to the charitable lead annuity trust. However, it is clear that the IRS will look for other opportunities to apply equitable doctrines in similar contexts. Stated differently, the ruling's reasoning could apply just as easily to a GRAT, if the reader substituted the phrase "ETIP rules" for "I.R.C. Section 2642(e)."
- Using the same logic, the Service could find that a gift by a GRAT remainderman is avoidance of the Congressional intent in enacting the ETIP rules. However, would the equitable doctrines inherent in the ruling apply to a sale by Betsy? It would appear that the answer should be no.
- In using a sale for full and adequate consideration, the issue is not whether Granny or Betsy is the transferor of the property that moves from the GRAT to the dynasty trust. The issue is whether there is an addition to the dynasty trust for GST purposes. There should not be an addition to the dynasty trust for GST purposes when Betsy transfers the remainder interest to the GST trust for full and adequate consideration and when Betsy buys the remainder interest back for full and adequate consideration.

# Structuring GRATs: Maximizing Estate Freezes

- The results are obviously very significant. Will this work? An argument can certainly be made that the creation of the split purchase GRAT is not subject to the ETIP rules and the creation of the GRAT does not constitute a transfer to the GST trust. If Lenny died during the 20 year term of the GRAT, the GRAT property will not be includible in his gross estate, only the value of the remaining annuity payments would be included. Alternatively, the GRAT annuity period could be set for the shorter of 20 years or the death of Lenny. Obviously, the GRAT annuity payment would have to be set at a higher amount in order to provide adequate and full consideration to Lenny. If Lenny died earlier than 20 years there would be significant income tax and estate tax advantages in structuring the GRAT term in that manner.
- There could be abusive situations where the remainder interest is very small and the logic of the *Wheeler*, *D'Ambrosio* and *Magnin* cases would not be applied.
- However, under the facts assumed under this case, the remainder interest is significant and would seem to be analogous to the remainderman values considered in the above Circuit Court cases.

# Structuring GRATs: Maximizing Estate Freezes

Use of a leveraged reverse freeze – consider the following example, which illustrates the potential of contributing a high yielding preferred partnership interest to a GRAT:

John and Jane Doe Wish to Transfer \$30,000,000  
of Their Financial Assets to Their Children in the  
Most Efficient Transfer Tax Manner Possible

John and Jane Doe own significant financial assets, \$103,000,000. They want to minimize gift taxes. John and Jane want their lawyer to devise a plan in which their consumption needs are addressed and in which their stewardship goals are met. Their stewardship goals are to give, within 10 years, \$30,000,000 to trusts for their children and eventually give the rest of their estate to their favorite charitable causes.

John and Jane tell their lawyer that they are both in excellent health. John and Jane ask their lawyer to assume that the assets will earn 6% pre-tax, with 3% of the 6% being taxed at ordinary income rates and 3% being taxed at capital gains rates, with a 30% turnover in capital gains investments.

John and Jane want their lawyer to develop a plan in which there are minimum gift tax consequences and, which eliminates, as much as possible, their gift and/or estate taxes on their planned \$30,000,000 gift to their children.

# Structuring GRATs: Maximizing Estate Freezes

\$IRC Section 2036 advantage of a multi-economic class partnership: Strong legislative history suggests IRC Section 2036 should not apply to partnerships with significant preferred interests.

\$The valuation rules of IRC Section 2701 should not apply, if one generation transfers the preferred partnership interests to the second generation.

\$What is the comparative outcome under the proposed plan?

If John and Jane create 10 year GRATs with the payouts described above, the gift will be \$2,135,460, assuming the IRC Section 7520 rate is 3.2%, even though trusts for their children will receive \$30,000,000 of preferred partnership interests at the end of 10 years.

If the term of the GRAT is 11 years, assuming the IRC Section 7520 rate is 3.2%, the gift will be zero.

# Structuring GRATs: Maximizing Estate Freezes

If the appraisers find that the rate of return on the preferred interests should be equal to 11.843% in order to support par value of the preferred interests, and the 10 year GRATs are created with \$30,000,000 of preferred interest paying all of that coupon in satisfaction of the retained annuity, the GRATs will be near zeroed out GRATs.

Thus, in each of these scenarios, John and Jane could be in the position to receive substantial cash flows for a 10 year or 11 year period, and assuming the gift tax exemption that they each have is \$1,000,000, they will each transfer preferred interests that are equal in value to over \$30,000,000 to trusts for the benefit of their children by paying little or no gift taxes.

All of this is accomplished, even though their investment portfolio only earns 4% to 5% annually, after taxes.

# Structuring GRATs: Maximizing Estate Freezes

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- ▶ *Example: Alan creates and gifts to a GRAT real property valued at \$1,000,000. Bill retains an annuity of \$100,000 dollars per year for nine (9) years. At the end of the 9 year term, the GRAT continues for the benefit of Jason, Amanda and Neil, for their lifetime. Based upon the IRC §7520 rate in effect for September 2016, the gift is \$159,900.*

# Structuring GRATs: Maximizing Estate Freezes

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*Example: Alan is considering gifting a 45% percent interest in his business (an “S” Corp.) which is worth \$10,000,000, as a whole. After taking 35% in valuation discounts, the interest Alan is ultimately transferring to his daughter, Amanda, is valued at \$2,925,000 dollars. The “S” Corp earns \$2,000,000 per year. However, if Alan gifts the 45% interest to a GRAT and retains an annuity of approximately \$389,000 per year for eight (8) years. The gift will be \$1.82. At the end of the term, the GRAT continues for the benefit of Amanda, for her lifetime.*

# Structuring GRATs: Maximizing Estate Freezes

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*(Example Continued)*

*Based upon the September 2016 IRC §7520 rate and estimated five (5%) annual growth of the asset, Alan has effectively made no taxable gift. However, he has transferred an asset worth \$4,500,000 (before discounts), as well as all future income and growth of the transferred asset to Amanda, in exchange for \$3,112,000 in annuity payments.*

# Structuring GRATs: Maximizing Estate Freezes

- ▶ Audit Risk for GRATs
- ▶ Shareholder Agreement is a Must.

