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Estate and Gift Tax Risks and Opportunities for Family Owned Entities: Impact of Recent Court Decisions and Legislation

THURSDAY, FEBRUARY 13, 2020, 1:00-2:50 pm Eastern

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February 13, 2020

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Prepared for a Strafford webinar

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Why Use a Closely Held Entity?

- Often the client or family will already have an entity used in a business context.
- Or, the client has investment assets but wants them held in an entity.
- There may be many reasons to use an entity, depending on context. Some examples:
  - Centralized management for family holdings, avoid fragmentation of illiquid assets
  - Continuity of investment philosophy (industry, economic outlook view, geographic focus, ethical concerns)
  - Continuity of investment management (economies of scale, most favored nation status for investments)
  - Continuity of operational active business management
  - Creditor protection, general and matrimonial (prenups are not impregnable)
  - Silo potential liability of specific lines of business, loans

What Should the Advisor be Asking?

- Start out by understanding what is important to the client
- There will likely be multiple goals, sometimes contradictory
- Advisors can get bogged down in focusing on the tax risks and opportunities, but that is putting the cart before the horse.
- Entities can have great benefits in estate planning, as long as there are sufficient other reasons to use them which will contribute towards decisions on structure and operations

Don’t Let the Tail Wag the Dog

- It is certainly true that using an entity structure will usually yield a lower tax value than holding assets directly, but that should be a consequence, not a reason or goal, for using entities
  - Nevertheless we assess the valuation impact of choices in entity design and operation at great length, after ascertaining the options available to meet the client’s goals
  - We also assess gift and estate tax and other tax risks and opportunities, and to the extent consistent with achieving the client’s other goals then the structure should be optimized from the tax perspective
  - When incorporated into a well-designed plan there can be considerable gift and estate tax savings as a result of transfers of interests in entities
    - Method of transfer will be critical: Gift vs. installment sale vs. GRAT
    - Formula clauses
    - GST planning

Choice of Type of Entity

What are the alternatives for structuring a family entity that may be used in estate planning transfers?

- The usual suspects:
  - Family Limited Partnerships ("FLPs")
  - Family Limited Liability Companies ("FLLCs")
  - Family S Corporations ("FSCs")
  - Combinations of the foregoing
  - Caveat on terminology: red flags
- State of Organization
  - Where will the entity be doing business?
  - Organize in, e.g., Delaware and qualify to do business in other states if necessary?
  - Note that investing a portfolio generally does not require state qualification unless and until a lawsuit is required.

Goals and Pitfalls

Avoid unnecessary complexity in creation and administration

- Reduce risk of a foul-up that can lead to IRS attack
- Reduce cost and time of lawyer, client and accountant
- Preference for transfers of disregarded entities to grantor trusts:
  - E.g., a partnership or LLC all of the economic interests of which (members, partners) are held by the client or grantor trusts as to the client
  - No separate income tax returns (possibly toggle relevant agreement provisions on or off depending on whether entity is disregarded in a particular year)
  - Bonus: No taxable income on loan interest, no taxable gain on sales
  - Recognition of gain on balance of installment note payments when grantor trust status ends, e.g. on death, plus taxable interest thereafter
  - Bonus: Leverage transfer value by having transferor pay transferee's taxes – not a taxable gift. Rev Rul 2004-64.
  - If owned solely by spouses as community property (including their grantor trusts), they may elect to treat it either as a disregarded entity or a partnership. Rev Proc 2002-69.

Goals and Pitfalls

- Preference for fewer entities
  - Organization of entities requires state filings at creation and annually, even for an entity disregarded for income tax purposes
  - Note that state filings for doing business may require entity to obtain an EIN even when not needed for income tax purposes
  - Fewer entities mean fewer state organizational and maintenance filings
- Don't Overdo It:
  - Beware 2704(b): disregard of governing instrument restrictions on liquidation of entity more restrictive than state law if transferor and family members can remove the restriction.
  - Does not apply to restrictions on transfer or withdrawal of transferee's interest (Estate of Jones v. Comm'r, 116 T.C. 121 (2001); Kerr v. Comm'r, 113 T.C. 449 (1999), aff'd 292 F.3d 490 (5th Cir. 2002)).
  - But see 2703(a): disregarding transfer restrictions; do the exceptions under 2703(b) apply?

Less Common Tax Risks

- Avoid control premium at death for retained controlling interest
  - May affect both control and non-control retained interests (Ahmanson Foundation v. U.S., 674 F.2d 761 (9th Cir. 1981); Estate of Curry v. U.S., 706 F.2d 1424 (7th Cir. 1983).)
  - Size of premium may be computed on entire enterprise, including part not owned by decedent (Simplot v. Comm'r, 112 T.C. 130 (1999), rev'd on other grounds 249 F.3d 1191 (9th Cir. 2001).
- Avoid imputed gift under 2701
  - Use safe harbor of strictly proportionate economic interests (except for control and limitations on liability) (2701(a)(2)(C)).

Valuation

- Approaches to valuation of a closely held entity
  - Asset approach
  - Market approach
  - Income approach
- Yes, discounts are real – even in family-owned entities. Rev. Rul. 93-12
- Discounts for lack of control
- Discounts for lack of marketability
- Other, less common discounts
  - Tiered
  - Blockage
  - Key person

Potential IRS Challenges

- Section 2036 estate tax inclusion
- Gift (and possibly GST) resulting from undervaluation
  - Deemed gift under chapter 14

Contexts:

- Installment sales to “intentionally defective” grantor trusts
- Formula clauses
- GRATs
- S corporation valuation
- Penalties

Section 2036 - Most Litigated Issue

- **Section 2036 provides that:**

  General Rule —The value of the gross estate shall include the value of all property to the extent of any interest therein of which *the decedent has at any time made a transfer* (except in case of *a bona fide sale for an adequate and full consideration* in money or money's worth), by trust or otherwise, *under which he has retained . . .*

  (1) *the possession or enjoyment of, or the right to the income from, the property*, or

  (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom

- **Ramifications — If IRS successful, all assets of entity might be brought back into estate**
  - Even if interests in partnership transferred during life (*Harper*, *Korb*y)
  - Marital or charitable deduction may not be applicable (*Turner*)

Bona Fide Sale for Adequate and Full Consideration Exception

- **Two part test:**

  (1) Adequate and Full Consideration — Interests proportionate and value of contributed property credited to capital accounts

  (2) Bona fide Sale — "Significant and legitimate non-tax reason" for creating the entity

  Case-by-case analysis (citations on last slides):

  – Centralized asset management (*Stone*, *Kimbell*, *Mirowski*, *Black*)

  – Involving next generation in management (*Stone*, *Mirowski*, *Murphy*)

  – Protect from creditors/failed marriage (*Kimbell*, *Black*, *Murphy*, *Shurtz*)

  – Preservation of investment philosophy (*Schutt*, *Murphy*, *Miller*)

  – Avoiding fractionalization of assets (*Church*, *Kimbell*, *Murphy*)

  – Avoiding imprudent expenditures by future generations (*Murphy*, *Black*)

2036(a)(1) — Retained Right to Possess or Enjoy Assets Contributed or Income From Assets

- **Case-by-case analysis**
- **Factors considered by courts:**
  - Non pro-rata distributions (*Harper*, *Korby*, *Thompson*)
  - Personal expenditures with partnership funds (*Strangi*, *Hurford*, *Rector*)
  - Personal use assets in partnership (*Strangi*)
  - Payment of estate tax and expense when assets transferred to partnership close to death (*Miller*, *Strangi*, *Erikson*)
  - Accurate books and records not kept (*Harper*)
  - Insufficient assets outside of partnership (*Thompson*, *Miller*, *Strangi*, *Rector*)
  - **It's not enough to recite these reasons – they have to be real!**

2036(a)(2) - Retained Right to Designate Persons Who Will Possess or Enjoy Assets Contributed or Income From Assets

- ***Strangi, Turner, Cohen***
- **Investment powers not subject to 2036(a)(2) (*Byrum v. U.S., 408 U.S. 125 (1972)*)**
- **Distribution powers?**
  - *Cohen/Byrum* — "If the agreement may be said to give the trustees unlimited discretion . . . , so that dividends could be arbitrarily and capriciously withheld or declared, then the dividend power would constitute a 'right' under section 2036(a)(2); if, on the other hand, the power is circumscribed by cognizable limits on the exercise of discretion, then no such 'rights' exists."
- **Should senior family member be general partner?**
  - How about co-general partner?

Sample Distribution Provision

1.01 No Other Distributions. Except as provided in this Article, the Partnership shall make no distributions of cash or other property to any Partner until its liquidation.

1.02 Distributable Cash. Distributable Cash includes only that cash held by the Partnership at the end of a Fiscal Year after reasonable reserves of cash have been set aside by the Partnership Management, subject to the duties imposed by this agreement, for working capital and other cash requirements, including current and reasonably projected expenses, current and reasonably projected investment opportunities, and reasonably anticipated contingencies. For purposes of this Section, any of the Partnership Assets that are contributed to the Partnership by the Partners, any borrowed funds, and any cash generated upon the sale of any of the Partnership Assets, including Partnership Assets that are purchased with borrowed funds and including the cash attributable to appreciation in value, shall be considered as necessary for investment purposes.

Sample Distribution Provision

1.03 Operating Distributions.

(a) From time to time during each Fiscal Year, the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute any part or all of the Distributable Cash proportionately to each of the Partners based on their Percentage Interests.

(b) During the course of a Fiscal Year, in lieu of making any determinations or distributions under Sections 1.02 and 1.03(a), the Partnership Management may, in the exercise of reasonable discretion, cause the Partnership to distribute cash or other Partnership Assets proportionately to the Partners based on their Percentage Interests; provided that the total amount of distributions under this Section 1.03(b) in any Fiscal Year may not exceed five percent (5%) of the fair market value of the Partnership Assets (net of liabilities) as of the beginning of that Fiscal Year.

(c) No distributions under Section 1.03(a) or 1.03(b) shall have the effect of changing any of the Percentage Interests.

Sample Distribution Provision

1.04 Income Tax Distributions. Regardless of the amount of Distributable Cash and in addition to any distributions under Section 1.03, the Partnership may distribute during the course of each Fiscal Year an amount of cash that would be sufficient for each Partner to pay the Partner's federal and state income taxes attributable to profit and loss allocations by the Partnership at the highest marginal income tax rate, including quarterly estimated tax payments. Any distributions under this Section 1.04 shall be made proportionately to the Partners

2036(a)(2) - *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017)

- Partnership created by son under a power of attorney nine days before decedent's death
- Sons received 1% GP interest, decedent received 99% LP interest
- Son, using power of attorney, contributed 99% LP interest to CLAT
  - Tax Court concluded power of attorney did not authorize contribution
- **2036(a)(2) holding:**
  - Majority and concurring opinions opine that § 2036(a)(2) applied because (1) the decedent, in conjunction with the other partners, could dissolve the partnership, and (2) the decedent, through her son as the GP and as her agent, could control the timing and amount of distributions

Potential Ways to Avoid *Powell* § 2026(a)(2) Argument

Creation of new entity:

1. Satisfy bona fide sale test
2. Create two classes of interests
   - One with vote on dissolution/amendment
   - One without vote on dissolution/amendment

Faced with existing entity:

1. Retrofit structure into multiple classes
2. Senior family member disposes of all interests in entity more than three years before death
3. Terminate entity more than three years before death (potential income tax issues)

A Sophisticated and Flexible Variation to Avoid *Powell*: Slicing and Dicing Powers

Consider having three classes of members or partners (at inception or retrofitted):

- One class with all of the economics and no vote on anything.
  - Retained by transferor on creation; transferred to one or more grantor trusts (sale, gift or GRAT) as the discounted estate planning transaction
- One class with no economics and full investment control – fiduciary duties
  - Retained and used by transferor – the most control that is safe to retain
  - If transferor wants to retain an economic interest, do so outside this entity!
- One class with no economics and all other control including dissolution/amendment
  - Held by third party (can be spouse or relative at inception) designated by transferor, can be removed and replaced by the transferor as long as the replacement is not related or subordinate (*Wall)*

Installment Sales – Gift Tax Issues

- FMV of interest sold
  - Discounts
  - Step transaction/*Pierre* issue
- FMV of consideration received
  - Valuation of note
  - 2702?
- Deemed gift under 2701?
  - Readily avoided if all economic interests in transferred entity are proportionate
  - Differences in vote and control are OK

Installment Sales – Estate Tax Issues

- 2036/2038 with respect to interest sold
  - *Pierre* issue: adequate and full consideration?
  - Payment of note
- Retained note as retained equity interest?

Formula Transfers

- **Potential Benefit — Allows transferor to define the dollar value (or amount of consideration) for hard-to-value assets passing to taxable transferees**
- **Types of formula clauses:**
  - Formula clause based on values "as finally determined for estate/gift tax purposes" (*Christiansen*, *Petter*, *Wandry*)
  - Defined value clause (*McCord*, *Hendrix*)
    - Need somewhere for the excess value to go
  - Defined price clauses (*King*)
    - The only alterative if 100% of the economics of the entity are being transferred
    - Best call it a price correction rather than adjustment
  - Reversion clauses don't work (*Procter)*

Potential Donees of the "Excess Amount" Under Defined Value Clause

1) **Public Charity/Donor Advised Fund**
   - Independent fiduciary obligation
   - Subject to private inurement and excess benefit rules
   - *McCord*, *Hendrix*, *Petter*
2) **Private Foundation**
   - Self-dealing, excess business holdings and other rules make it difficult
3) **Lifetime QTIP**
4) **GRAT**
5) **None? — *Wandry***
6) **Consideration Adjustment/Correction? — *King***

Formula Language – It Matters!

- ***Wandry*** – "I hereby transfer to _____ that number of shares of ABC Company with a fair market value as finally determined for federal gift tax purposes equal to $ [X] ."
- ***Petter*** – "I hereby transfer X shares of XYZ Company to [taxable transferee] and [charity/QTIP/GRAT] to be allocated between the transferees as follows: (1) that number of shares with a fair market value as finally determined for federal gift tax purposes equal to $ [X] to [taxable transferee]; and (2) the remainder of the shares to [charity/QTIP/GRAT]
- ***King*** – "I hereby sell X shares of XYZ Company in exchange for a promissory note with a principal amount of $ [X] (which the parties believe to be equal to the fair market value of the shares). The term of the promissory note shall be [add note terms/interest]. If the fair market value of the shares as finally determined for federal gift tax purposes is greater or less than $[X], the principal amount of the note shall be adjusted to the finally determined value effective as of the date of the transfer. The parties intend for the sale to be at fair market value and that no gift result from the sale."

Formula Transfers - Gift Tax Reporting

- **Starts the statute of limitations**
  - Need to file to obtain "as finally determined value"
- **Report consistent with formula**
  - Avoid *Knight v. Comm'r* problem
  - Reflect formula in gift tax return schedule
  - Units initially allocated based on formula and appraisal
  - Attach formula transfer documents and appraisal
  - Satisfy adequate disclosure rules to start limitations running including Qualified Appraisal of underlying assets and particular interest in entity being transferred

GRATS

- **Terms Comply with § 2702 Regs?**
- **GRAT operated in accordance with terms?**
    1) Substantiation of annuity payments
    2) *Atkinson* analysis
    3) Plan in advance for shortfall in cash flow – pay annuity in kind or GRAT can borrow from a third party (not grantor)
- **Valuation**
    1) Initial transfer of assets
    2) Exercise of power of substitution
    3) Use of hard to value asset to pay annuity
    4) Consider *Wandry* type formula for 2 & 3

Tax Affecting S Corporation Cash Flows

- Should S Corporation cash flows be reduced by corporate level taxes in a discounted cash flow ("DCF") analysis?
- Numerous cases say no, unless taxpayer can demonstrate the fact that shareholder level taxes affect the value of the shares. *See*, *e.g.*, *Gross v. Comm'r*, 78 T.C.M. (CCH) 201 (1999)
- S Corporation Job Aid for IRS Valuation Analysts says "absent a compelling showing that unrelated parties dealing at arms-length would reduce the projected cash flows by a hypothetical entity level tax, no entity level tax should be applied in determining the cash flows of an electing S Corporation"
- If tax affecting cash flows of an S Corp, appraisal needs address reasons for adjusting for taxes and any benefit/detriment to S Corp status
- Research demonstrates that shareholder level taxes affect the value of the shares. *See,* N. Fannon and K. Sellers, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle*
- Tax affecting allowed in *Estate of Jones v. Comm'r*, T.C. Memo. 2019-101 and *Kress v. United States,* 16-C-795, 2019 WL 1352944 (E.D. Wisc. 2019)

Substantial Estate or Gift Tax Valuation Understatement Penalties (§ 6662(g) & (h))

- Substantial valuation understatement – value of item reported is 65% or less of value as finally determined (20% penalty)
- Gross valuation understatement – value of item reported is 40% or less than value as finally determined (40% penalty)
- Reasonable cause exception § 6664 (c) requires taxpayer to act in "good faith" and "with reasonable cause" in reporting the value
  - Reasonable reliance on professional advice qualifies. Treas. Reg. § 1.6664
  - Relying on appraisal may or may not be "reasonable." Compare *Estate of Richmond v. Comm'r,* T.C. Memo. 2014-26 (February 11, 2014) and *Litman et. al. v. United States*, 326 F.3d 1268 (Fed. Ct. 2008)

Effect of Tax Reform

- With larger estate and gift tax exemptions, the Merely Rich have less incentive to make completed transfers
  - Designed to save estate taxes that may not be relevant to a particular client at the expense of forfeiting a still-valuable step-up in basis
- The Really Rich will still want to minimize transfer taxes (estate, gift and GST) including using entities as vehicles for lifetime transfers.
  - Follow all of the existing rules and recommendations to minimize transfer taxes
  - Ameliorate the loss of basis step-up through careful planning and administration:
  - For example:
    - Use of disregarded entities and grantor trusts permits lifetime repurchase of low-basis assets by client for cash without recognizing gain (putting low-basis assets back into the estate where step-up is available but with no increase in estate tax)
    - Creative use of older-generation powers of appointment or upstream transfers can also provide a step-up without transfer tax
    - Deliberately trigger *Powell* inclusion in estate of senior generation in the right cases

Prepare for Audit

- **Anticipate your potential audience at the planning stage**
- **IRS issues broad requests**
  - "All documents relating to the creation of the entity from any attorney, accountant or firm involved in recommending the creation of the entity."
- **Understand and preserve all privileges**
  - Attorney-client privilege
  - Work product immunity
  - Tax practitioner's privilege
- **Your files could be subpoenaed — including emails**
- **You might have to testify about reasons for creating entity**
- **Help your client — best evidence of non-tax reasons comes from contemporaneous correspondence (*see Stone*, *Schutt*)**
- **Okay to discuss tax attributes, but talk about non-tax attributes and reasons too (*see Stone*, *Schutt*, *Mirowski*)**

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- Wall v. Comm'r, 101 T.C. 300 (1993), Rev. Rul. 95-58
- Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (2012)

Dance like no one is watching; email like it may one day be read aloud in a deposition.