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Estate Planning and Carried Interest:
Estate Tax Reduction Strategies for
Private Equity and Hedge Fund Founders

Strategies for Wealth Transfer and Asset Protection to Avoid Adverse Tax Consequences

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Introduction
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- General Wealth Transfer Planning

  - Transfer asset (typically via gift, sale or a combination) with appreciation potential in manner that removes it from grantor/parent’s gross estate and allows post-transfer appreciation to occur outside of estate in hands of next generation(s) or trusts for their benefit.

  - Ideally, select assets with greatest potential for future appreciation while having characteristics that would support current lower valuation (e.g., due to uncertain or speculative nature of asset, lack of controlling interest or lack of marketability).

  - Gift tax liability based on fair market value of asset on date of transfer, and not on subsequent appreciation.

    » Potential for future growth of asset is relevant factor in determining current fair market value.
Introduction (Cont’d)

• Estate “Freeze” Techniques

  - “Freeze” value of taxpayer’s estate by “locking-in” value of asset at its current value, while shifting future appreciation to recipient donee(s).

  - Generally effective from transfer tax (i.e., estate, gift and generation-skipping transfer tax) standpoint when actual rate of return on transferred assets exceeds “hurdle” rate (generally, § 7520 Rate or AFR, depending on technique used).

  - Potential opportunities:

    » Transfers of interests in closely-held businesses and private investment funds.

    » Structuring family operating businesses, FLPs, pre-liquidity event planning.
• Example: Transfer of Interests in General Partner of Private Investment Fund (the “GP”)

  - Significant potential for future appreciation associated with carried interest.

    » If 1% capital contribution by GP is entitled to allocation of 20% of profits (the “carried interest”), significant potential for value of GP interest to grow.

    » If growth occurs in estate planning vehicle excluded from transferor's ("Fund Principal's") estate, result is transfer-tax efficient shift of future appreciation to next generation, or better in a GST-exempt trust.

    » Even more powerful if leverage is applied to transaction, particularly when interest rates are near historic lows.
• Particular issues to consider with interests in private investment funds:

  - Gift tax valuation uncertainty;

  - Chapter 14 deemed gift issues under § 2701 and so-called “Vertical Slice" and “Non-Vertical Slice” planning alternatives;

  - Incomplete gift issues associated with vested and unvested interests and retained interests;

  - Estate tax inclusion risks under § 2036;

  - Trust and entity attribution rules under § 2701;

  - Valuation issues (ground floor investing; difficult to value assets);

  - Securities law issues; and

  - Coordination issues with planning techniques and related pressure points.
Fund Structures Generally
Fund Structures Generally

- Example of Typical Private Equity Fund Structure

- New Fund LP
  - General Partner (New Fund LLC)
    - Contributes 1% Capital
    - 1% General Partner
    - 20% Carried Interest

- Management Company
  - 2% Management Fee

- Investors

- Portfolio Companies
Fund Structures Generally (Cont’d)

- Common Hedge Fund Structure Known as “Master-Feeder”

- Non-U.S. Investors
- U.S. Tax-Exempt Investors
- U.S. Taxable Investors

Offshore Feeder Fund
(offshore corporation)
(PFIC; blocks UBTI)

U.S. Feeder Fund
(LP or LLC)
(tax flow-through)

Master Fund
(offshore partnership or corporation
that elects to be treated
as a tax partnership)
Chapter 14 Issues
Chapter 14 Issues

- Gift and estate tax issues may arise under Chapter 14 in connection with transfers of business interests or transfers in trust when family members involved.

  - Provisions designed to discourage certain transactions or arrangements entered into between family members.

  - Violating provisions can potentially cause unanticipated deemed gift or increase in value of estate, resulting in additional gift or estate tax liability.

  - Can unexpectedly apply even when transaction not intended to achieve wealth transfer or save estate or gift taxes.
Chapter 14 Issues (Cont’d)

• Chapter 14 Overview (§§ 2701-2704)

  - Attempts to prevent perceived transfer tax abuses in context of business or other interests held within family.

  - Treats certain transactions as deemed gifts.

  - Disregards certain agreements or restrictions that would otherwise affect valuation of transferred interests.
Chapter 14 Issues (Cont’d)

- § 2701 concern when planning for transfers of carried interests in funds.

  - Deemed gift provisions relating to “transfers” of subordinate equity interests to or for junior family member when senior family member continues to own another class of interest (typically a senior interest).

    - “Zero valuation” concept assigns value of zero to certain rights associated with equity interests held by senior family members.

    - Result is deemed gift of value of interests in connection with transfer of equity interest to junior family member under “Subtraction Method” of valuation.
Chapter 14 Issues (Cont’d)

• “Vertical Slice” to make transfer without running afoul of deemed gift issues under § 2701.

  - To qualify, Fund Principal transferring portion of carried interest to family members must transfer proportionate amount of other equity interests in fund.

  - Issue: Fund Principal wants to transfer all carried interest, but only some (or none) of LP interest or capital in GP, both for economic reasons (wants to retain portion of capital investment in fund) and gift tax reasons (does not want to make taxable transfer of high-value assets).

    » To comply with Vertical Slice safe harbor and avoid triggering deemed gift, Fund Principals frequently advised to transfer smaller percentage of carried interest.
Section 2701—Recapitalizations and Other “Transfers” of Business Interests
Section 2701—Recapitalizations and Other “Transfers” of Business Interests

• Section 2701 can cause deemed gift to occur in connection with “transfer” of subordinate equity interests in corporation, partnership or LLC to junior family member when certain discretionary rights retained by senior family member.

  - E.g., where parent who owns common and preferred stock in corporation (or preferred interest in partnership or LLC) transfers common stock to children while retaining preferred stock.

  - For gift tax valuation purposes of transferred common interest, parent would want retained preferred interest to have highest possible value (to claim value of transferred interest had minimal value under "Subtraction Method").
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

• Perceived Abuse Prior to § 2701

  - To artificially increase value of retained preferred interests, preferred interests might have had certain discretionary rights (e.g., rights to non-cumulative dividends and redemption or conversion rights).

  - Discretionary rights not expected to be exercised, but still increased value of parent’s retained preferred interest (and reduced value of gift of common interest).

  - Section 2701 ignores such discretionary rights and assigns zero value to them in determining how much “credit” senior family member should get for gift tax purposes under Subtraction Method.

    » Under § 2701, only specific non-discretionary rights within narrow exceptions to zero valuation rule considered when determining value of senior family member’s retained preferred interest.
Perceived Abuse– Valuation Before Gift

**Preferred**
(Discretionary Rights – Inflated Value)

**Common**
(Deflated Value)

**Parent**
Retained
Preferred

Common
Gifted to **Kids**
(at depressed value)

Partnership Agreement Provisions
Perceived Abuse – Valuation After Gift

- Preferred (Deflated Value)
- Common (Inflated Value)

Value shifted to Common when discretionary rights not exercised
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

• Narrow Exceptions to Zero Valuation Rule

  - When parent’s preferred interest structured within certain parameters designed to ensure that parent's retained rights are both mandatory and quantifiable.

    » If parent must receive certain quantifiable value, should not be valued at zero for gift tax valuation purposes.
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

• Application of § 2701- Overview

  - Generally, § 2701 can cause deemed gift to occur when senior generation family member holds “Applicable Retained Interest” after “transfer” to “Member of the Family.”
    » "Transfer" includes traditional gift transfer, contribution to capital of new or existing entity, redemption, recapitalization or other change in capital structure of entity.
    » No intent to make gift required.
    » Two types of Applicable Retained Interests: “Extraordinary Payment Rights” and “Distribution Rights.”

  - If § 2701 applies and retained interest is not “Qualified Payment Right” or other right to which statute does not apply, certain rights associated with retained interest valued at zero in applying Subtraction Method.
    » Result: Some or all of family-held interests attributed to transferred interest.
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

Application of § 2701- General Definitions

• **Transfer.** Broadly defined and includes traditional transfer, capital contribution to new or existing entity, redemption, recapitalization or other change in capital structure of entity.

• **Applicable Family Member.** Includes Transferor’s spouse, any ancestor of Transferor or his or her spouse, and spouse of any such ancestor.

• **Member of the Family.** Includes Transferor’s spouse, any lineal descendant of Transferor or his or her spouse, and spouse of any such descendant.

• **Subtraction Method.** If § 2701 applies, value of interest transferred to junior family member determined by subtracting from value of entire family-held interests the value of interest retained by senior family member.
Application of § 2701- Applicable Retained Interests

- **Section 2701** applies to transfer to Member of the Family if Transferor or Applicable Family Member holds “Applicable Retained Interest” *immediately after* transfer.

  - **Extraordinary Payment Rights**
    
    » Given value of zero in determining worth of retained preferred interest for gift tax purposes because assumed they would not be exercised by senior family member.

  - **Distribution Rights**
    
    » *Control Requirement*: Distribution Right will be considered Applicable Retained Interest only if “control” of entity exists in family (*i.e.*, if Transferor and family members "control" entity immediately before transfer).
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

Application of § 2701—LLC Recapitalization

• In CCA 201442053, IRS determined § 2701 triggered in connection with recapitalization of LLC.

• LLC created by mother as single class LLC; subsequently, gifts of LLC interests to two sons and grandchildren, all sharing capital, profits and losses in proportion to percentages interests.

• LLC later recapitalized, with result that all future profits or gains would be allocated to sons only, as consideration for sons agreeing to manage LLC.

• Following recapitalization, mother’s only interest was right to return of capital account based on membership interest immediately prior to recapitalization.

• IRS determined that recapitalization was § 2701 “transfer.”
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

• Exception to Distribution Right – “Qualified Payment Right”

  - Any dividend payable on periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at fixed rate;

  - Any other cumulative distribution payable on periodic basis (at least annually) with respect to equity interest, to the extent determined at fixed rate or as fixed amount; or

  - Any Distribution Right for which election has been made to be treated as Qualified Payment.

• Because Qualified Payments are mandatory, and no discretion of family controlled entity to make or not make distributions exists, perceived opportunity to manipulate value does not exist; therefore, zero valuation rule will not apply.
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

• “Lower Of” Rule for Valuing Qualified Payment Right Held in Conjunction with Extraordinary Payment Right

- *Example:* Dad, the 100% stockholder of corporation, transfers common stock to Child and retains preferred stock which provides (1) Qualified Payment Right having value of $1,000,000 and (2) right to put all preferred stock to corporation at any time for $900,000 (Extraordinary Payment Right).

- At time of transfer, corporation’s value is $1,500,000.

- Under “Lower of” rule, value of Dad’s retained interest is $900,000, even though he retains Qualified Payment Right worth $1,000,000

  » Retained interests are valued under assumption that Dad exercises Extraordinary Payment Right (put right) in manner resulting in lowest value being determined for all retained rights.

- Result: Dad made gift of $600,000 ($1,500,000 - $900,000) rather than $500,000 (if value of preferred interest was based on the $1,000,000 value of Qualified Payment Right).
• Minimum Value of Junior Equity Interest

  - If § 2701 applies, in the case of transfer of junior equity interest, such interest shall not be valued at amount less than 10% of sum of (1) total value of all equity interests, plus (2) total indebtedness of entity to Transferor or Applicable Family Member.
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

- Rights that Are Not Extraordinary Payment Rights or Distribution Rights (i.e., rights that do not trigger application of § 2701):
  - Mandatory payment rights.
  - Liquidation participation rights.
  - Guaranteed payment rights.
  - Non-lapsing conversion rights.
Section 2701—Recapitalizations and Other “Transfers” of Business Interests (Cont’d)

- Circumstances Where § 2701 Inapplicable
  
  - **Same Class.** Where retained interest and transferred interest are of “same class” (i.e., rights associated with retained interests are identical (or proportional) to rights associated with transferred interests, except for non-lapsing differences in voting rights).

  - **Market Quotations.** If readily available market quotations exist on established securities market for either transferred interest or retained interest.

  - **Proportionate Transfers** (also known as “Vertical Slice”). Where transfer results in proportionate reduction of each class of equity interest held by senior and junior family members.
Section 2701 Attribution Rules
Section 2701 Attribution Rules

- Entity Attribution Rules

  - Generally attributes ownership of equity interest owned by entity as owned by owner of the entity to the extent of his or her percentage ownership in the entity.
    - If individual holds directly and indirectly in multiple capacities, rules are applied in manner that results in individual being treated as having largest possible total ownership.
    - “Tiered” attribution approach for entities holding interests in other entities.

- Example:
  - A, an individual, holds 25% by value of each class of stock of Y Corporation.
  - Y holds 50% of stock of Corporation X.
  - Y’s interests in X attributable proportionately to shareholders of Y. Accordingly, A considered to hold 12.5% (25% x 50%) interest in X.
Section 2701 Attribution Rules (Cont'd)

- Trust Attribution Rules—“Basic" Trust Rules

  - Generally provide that person has beneficial interest in a trust whenever he or she may receive trust distributions in exchange for less than full and adequate consideration.

  » Attribute trust's equity interests among its beneficial owners to the extent they may each receive trust distributions, and based on presumption that trustee discretion will be exercised in their favor to maximum extent permitted.

  » Exception: Equity interest held by trust will not be attributed to beneficiary who cannot receive distributions with respect to such equity interest.
Trust Attribution Rules—Grantor Trust Attribution Rules

- Attribute ownership of equity interest held by or for a “grantor trust” to the substantial owner(s) (or “grantor(s)”) of such grantor trust.

- Thus, a grantor of a grantor trust will also be considered the owner of any equity interest held by such trust.
Section 2701 Attribution Rules (Cont'd)

Trust Attribution Rules—Multiple Attribution Rules

- If “basic” and “grantor trust” attribution rules both applied, ownership of equity interest in entity owned by trust may be attributable to grantor and one or more beneficiaries of same trust.

- “Tie-breaker” or “multiple attribution” rules to resolve such situations.
  - Orders the interests held and determines how ownership should be attributed between the grantor, other persons and/or different beneficiaries.
  - Way ordering rule is applied varies depending on (1) whether equity interest at issue is senior or subordinate and (2) status of particular persons in relation to Transferor.
  - Distinction between two sets of ordering rules motivated by two goals:
    - (1) Maximizing chance that ownership of Applicable Retained Interest will be attributed to Transferor (or related parties grouped with Transferor for § 2701 purposes); and
    - (2) Maximizing chance that ownership of subordinate equity interest will be attributed to transferee (or younger generations of Transferor’s family).
Section 2701 in Context of Carried Interest Planning – the “Vertical Slice”
Section 2701 in Context of Carried Interest Planning – the “Vertical Slice”

• The “Vertical Slice”

  - Requires Fund Principal who wishes to transfer portion of carried interest to family members to proportionately transfer all other equity interests in fund in order to avoid triggering a deemed gift.

  - For purposes of Vertical Slice exception, interests transferred by Transferor are aggregated with interests transferred simultaneously by Transferor’s spouse, any ancestors of Transferor or Transferor’s spouse, and spouses of such ancestors.

  - “Safe harbor" approach often prevents client from fully achieving wealth transfer objectives.
Section 2701 in Context of Carried Interest Planning – the “Vertical Slice” (Cont'd)

• Achieving “Verticality”

  - **Individual Slices.** Make transfer of proportionate interest of each interest that client has in fund and related entities.

  - **Holding Entity to Achieve Verticality.** Implement holding vehicle such as LP or LLC (“Vertical Slice Holding Entity”) and transfer percentage ownership interest in holding entity.
Section 2701 in Context of Carried Interest Planning – the “Vertical Slice” (Cont'd)

- Section 2036 Implications with Vertical Slice Holding Entity Approaches

  - **Vertical Slice Holding Entity.** IRS has challenged funding and subsequent transfer of interests in family limited partnerships.
    - Under § 2036(a)(1) as a transfer with retained interest.
    - Under § 2036(a)(2) as a transfer with retained control.

  - **Bona Fide Sale Exception.** Avoid application of § 2036(a)(1) and § 2036(a)(2) by satisfying “bona fide sale” exception.
    - If Fund Principal's initial capital contribution to entity is considered a “bona fide sale” for “adequate and full consideration,” § 2036 not applicable.
    - A legitimate business purpose and/or substantial non-tax purpose is required to establish that “bona fide sale” existed.
Section 2701 in Context of Carried Interest Planning – the “Vertical Slice” (Cont'd)

• Section 2036– General Application
  
  - Pursuant to § 2036(a)(1), value of gross estate includes value of all property to the extent decedent has made a transfer but has retained possession or enjoyment of, or right to income from, the property.
  
  - IRS has successfully argued that § 2036(a)(1) applied to cause inclusion of assets decedent contributed to FLP, on theory that decedent transferred assets subject to implied understanding that he would continue to have enjoyment of assets.
Section 2701 Exceptions: Other Options than Vertical Slice—“Non-Vertical” Holding Entity Approaches
Section 2701 Exceptions: Other Options than Vertical Slice - “Non-Vertical” Holding Entity Approaches

- Non-Vertical Holding Entities
  - Involves creation of family holding entity (e.g., LLC or LP) into which parent first contributes all Fund interests—both GP and LP interests.

- Types of Non-Vertical Holding Entities
  - Mandatory Payment Right holding entity.
  - Qualified Payment Right holding entity.
Parent’s Retained Preferred Interests Structured as Qualified Payment Right or Mandatory Payment Right

Step 1
Parent

- Common and Preferred (with Mandatory Payment Right) LLC Interests
- Contribute GP and LP Fund Interests

Step 2
Parent

- Gift of Common “Growth” Interests in LLC
- Preferred
- Common

Diagram:
- Delaware Dynasty Trust
- LLC
- FUND
- GP
- LP
Structuring the Non-Vertical Holding Entity and Valuation Issues

- Approaches rely on creation of some form of preferred partnership holding vehicle.

Even if Parent’s preferred interest is properly structured to avoid application of § 2701, could be partial gift under traditional valuation principals if Fund Principal’s retained preferred coupon is less than what it would have been in arm’s-length situation.

- Vital to retain qualified appraiser to prepare valuation appraisal to determine preferred coupon required for parent to receive value equal to par value for capital contribution.

- Factors set forth by IRS in Revenue Ruling 83-120:
  > Comparable preferred interest returns on high quality publicly-traded securities.
  > Security of the preferred coupon.
  > Size and stability of the partnership’s earnings.
  > Asset coverage.
  > Management expertise.
  > Business and regulatory environment and other relevant facts or features of preferred partnership.
Other Non-Vertical Approaches (Other than Holding Companies)
Other Non-Vertical Approaches (Other than Holding Companies)

• Parallel trust transfers

• Trusts for other beneficiaries

• Master-feeder funds

• Carry derivative
Parallel Trust Transfer

- Involves creation of side-by-side complete and incomplete gift trusts.
- In order for transfer to work, incomplete gift trust can only be for the benefit of the grantor’s descendants (but not the grantor).

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Parent

GP Interest

Complete Gift Dynasty Trust for the Benefit of Descendants (grantor trust)

LP Interest

Incomplete Gift Trust for the Benefit of Descendants (non-grantor trust)
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Trust for Other Beneficiaries

- Parent transfers all or some of his carried interest into irrevocable trust created for the benefit of older generations with a limited power of appointment.
Vesting and Incomplete Gift Issues
Vesting and Incomplete Gift Issues

• Parting with Dominion and Control

  – For gift tax purposes, donor will have retained dominion and control over transferred property if he retains limited power to appoint that property to others.

  – Donor will likely have made incomplete gift if he reserves power to either name new beneficiaries or change interests of beneficiaries as between themselves, unless power is fiduciary power limited by fixed or ascertainable standard.
Vesting and Incomplete Gift Issues (Cont'd)

• Vesting
  - Typically, fund will grant special profits allocation (carried interest) to GP (typically, entity such as LLC) and GP entity will divide profits among members (i.e., the Fund Principals).
  - GP entity often contains vesting schedule, under which profits interests allocated to Fund Principals “vest” over time in stages.

• “Unvested” nature of non-controlling Fund Principal’s interest in carry vehicle could present risk that attempted transfer of interest in GP entity deemed “incomplete” (Rev. Rul. 98-21 involving an unvested stock option).
  - Concern that no enforceable property right exists until vesting occurs and gift of right prior to vesting is incomplete.
  - Address by applying concept of independent significance and distinction that an unvested partnership interest still has currently enjoyable rights (in contrast to an unvested stock option).
Ground Floor Investing by Trust – Capital Contribution or Gift of an Opportunity?
Ground Floor Investing by Trust – Capital Contribution or Gift of an Opportunity?

- Investment vs. Gift

  - If trust created by Fund Principal for descendants is initial investor in GP and receives carried interest, argument that carried interest is gift from Fund Principal rather than investment by trust.

    » Risk of indirect gift even though Fund Principal never owned capital or carried interest.

    » Did trust acquire interest for full and adequate consideration?

    » Did Fund Principal merely facilitate opportunity for trust to invest (but not actually transfer property)?

  - Conservative approach: Treat carried interest as property right transferred by Fund Principal.
Disclosure and Statute of Limitations

- Under “investment approach,” could disclose investment on gift tax return to start 3-year statute of limitations period, during which IRS could challenge transaction as gift.

- Gift tax return must “adequately apprise” IRS of nature and amount of property interest.

- Amount of disclosure required is uncertain, but Tax Court has stated it must be sufficiently detailed that decision whether to select return for audit may be reasonably informed.

- Special disclosure rules for transfers under § 2701:

  » Must provide (1) description of transaction (including description of transferred and retained interests and method used to value each); and (2) identity of, and relationship between, Transferor, transferee, all other persons participating in transaction, and all parties related to Transferor holding equity interest in any entity involved in transaction.
Leveraged Transfer Planning Techniques
Leveraged Transfer Planning Techniques

- Grantor Retained Annuity Trusts ("GRATs")
  - Statutorily blessed vehicle under § 2702.
  - Assets transferred to irrevocable trust that provides stream of annuity payments to grantor for selected term of years.
  - If grantor survives GRAT term, upon termination of annuity stream, remaining assets pass to remainder beneficiaries (outright or in further trust), without imposition of additional gift tax.
  - Value of gift determined on GRAT's creation by calculating present value of remainder interest.
  - If GRAT is “zeroed-out”, present value of annuity stream is structured to equal value of assets transferred to GRAT, resulting in gift of "zero" for gift tax purposes.
  - If grantor survives GRAT term and assets in GRAT invested to grow in excess of annuity stream, excess growth passes to remainder beneficiaries free of gift taxes (i.e., provides gift-tax-free transfer of future appreciation).
  - GRATs generally considered relatively conservative planning vehicles because specifically authorized under § 2702.
  - Most significant downside: Mortality risk.
    » Can be reduced by using short-term "rolling" GRATs.
Leveraged Transfer Planning Techniques (Cont'd)

- Sale to Intentionally Defective Grantor Trust
  - Grantor sells asset to irrevocable grantor trust created for benefit of family in exchange for promissory note.
  - Typically, grantor makes initial contribution to trust in amount equal to at least 10% of total value of assets to be transferred (the “seed gift”), which is taxable gift.
  - Transaction not recognized for income tax purposes because sale made to grantor trust.
  - Grantor responsible for payment of all income taxes attributable to assets in trust.
    » Dual benefit: (1) Passes assets to beneficiaries on after-tax basis and (2) reduces grantor's taxable estate by amount of income taxes paid.
  - After seed gift contributed to trust, grantor sells asset to trust in exchange for promissory note (typically, for term of 9 years), bearing interest at AFR.
  - Promissory note is asset of grantor's estate and unpaid balance is subject to estate taxation at death; however, transferred asset should not be included in grantor's estate.
    » If asset appreciates in value after sale, all appreciation occurs outside of grantor's estate (and possibly outside of descendants' estates).
Leveraged Transfer Planning Techniques (Cont'd)

Section 2701 Applied to Sales to Intentionally Defective Grantor Trusts

- In *Karmazin v. Comm'r*, IRS argued § 2701 applied to sale of FLP interests to IDGT, where taxpayer sold LP interests to IDGT in exchange for promissory note.

- IRS argument: promissory note was not debt, but rather disguised equity.

  » IRS argued that taxpayer made transfer of subordinate interests (LP interests) to IDGT and retained senior interest (promissory note).

  » IRS result: Gift of entire FLP interest with no offset for promissory note (i.e., entire transfer is taxable gift).

- Matter ultimately settled, but § 2701 argument remains a threat.
Section 2702 Applied to Sales to IDGTs

- In *Karmazin*, IRS also argued § 2702 applied.
  
  - Sale of LP interest by taxpayer constituted a “transfer in trust” within meaning of § 2702; value of retained interest was zero.

- IRS also attacked sale transaction in *Estate of Woelbing* (pending in Tax Court) under § 2702.
  
  - Transferor sold interest in family business to grantor trust in exchange for promissory note.
  
  - Pivotal issue is whether sale of LP interest to trust could be considered a “transfer in trust.”
  
  - Prior to *Karmazin*, assumed that “transfer” did not include a sale.
Valuation Issues
Valuation Issues

- Valuation Issues Generally

  - Challenging to value fund and related entities, as well as non-controlling interests therein for gift tax purposes.
    
    » Inherent risk that transfer of fund interests intended to fall within Fund Principal's available gift tax exemption may ultimately be determined for gift tax purposes to exceed that exemption and cause gift tax liability.
    
    » In case of sale or partial sale of fund interests, also risk that sale price may ultimately be determined to be for less than fair market value, also causing gift tax liability.
    
  - Common view that carried interest in start-up or early stage fund is “worth nothing” or of negligible value, due to speculative nature of fund.
    
    » However, generally does not hold up under “willing buyer/willing seller” framework.
    
    » Valuation appraiser would typically approach valuation of carried interest by applying discounted cash-flow method or option, calculated on several factual assumptions (e.g., fund's committed capital or anticipated assets under management, expected return, nature of investments, expenses, and anticipated timing and amount of carried interest distributions).
    
    » Would likely conclude that value of carried interest is significantly greater than zero but substantially less than Fund Principal's anticipated cash receipts over time.
    
  - Valuation discounts (e.g., for lack of control and lack of marketability).
Valuation Issues (Cont'd)

- Section 2704(b)– General Overview

  - Generally, § 2704(b) causes certain restrictions on dissolution (“Applicable Restrictions”) to be ignored for transfer tax purposes with respect to family controlled entities.
    - E.g., restriction in partnership agreement restricting partner from dissolving partnership, which would otherwise lower value of partnership interest.
    - § 2704(b) would ignore restriction for valuation purposes and treat partnership interest as containing dissolution right otherwise provided under state law.

  - “Applicable Restriction”: Restriction which effectively limits ability of corporation or partnership to liquidate, and with respect to which either:
    - (1) Restriction lapses, in whole or in part, after transfer; or
    - (2) Transferor or any member of Transferor’s family, alone or collectively, has right after transfer to remove the restriction.
Valuation Issues (Cont'd)

- Possible Expansion of Section 2704(b)

  - Obama Administration has targeted valuation discounts by proposing to:

    » (1) Eliminate discounts for valuation of entities other than those conducting active trades or businesses; or

    » (2) Eliminate discounts through implementation of aggregation rules.

- Section 2704(b) and accompanying Regulations may also impact valuation discounts for FLPs and LLCs.

  » Statute appears to give IRS broad authority to issue new Regulations listing additional restrictions that should be ignored when determining value of interest in closely-held business.

66
Proposed Expansion of § 2704(b)

Proposals for expansion of § 2704(b) appeared in Obama Administration’s Greenbook for each of fiscal years 2010-2013.

IRS has indicated informally that it intends to issue proposed regulations under § 2704(b)(4) that are similar to those in Greenbook proposals.

Greenbook proposals expand current scope of § 2704(b) by:

1. creating additional category of restrictions (“Disregarded Restrictions”) that would be ignored in valuing interests in transferred entity; and

2. Replacing provisions of state law with certain default assumptions that would be used in valuing such interests.
Difficult to Value Assets
Difficult to Value Assets

- Gifts Subject to Condition Subsequent

  - In *Commissioner v. Procter*, Taxpayer conveyed property in trust and parties believed full consideration was received. Trust agreement provided if transfer was subject to gift tax, property subject to gift tax would be deemed excluded from transfer (i.e., treated as if never transferred to trust).

    » Fourth Circuit determined provision violated public policy and thus was not given effect.

  - In *Ward v. Commissioner*, Tax Court held that "gift adjustment agreement" requiring reconveyance by donees of stock to the extent the value of transferred stock exceeded stated value for gift tax purposes was ineffective to avoid gift tax.

  - In *King v. Commissioner*, Tax Court upheld a bargained for price adjustment clause in connection with the sale of shares.

  - These clauses would eliminate incentive to audit gift tax return.
• Traditional Strategies Structured Other than as Condition Subsequent (i.e., other strategies to minimize valuation risk):

  − Marital Formulas

    » Trust to which property transferred contains formula allocating to a Marital Trust the amount by which the value (as finally determined for gift tax purposes) exceeds stated value (usually, value reported on gift tax return).

    » Alternatively, instrument of conveyance contains similar formula to allocate property.

    » Downsides:

      > In event of divorce, former spouse would remain trust beneficiary.

      > Reduces ability to shift property to descendants prior to spouse’s death.

      > To qualify for marital deduction, QTIP election must be made each time property is transferred to trust on timely filed gift tax return. But ordinarily, no QTIP election would be made for gifts using marital formula because assets not expected to end up in Marital Trust. Result: No deduction may be allowed because election would not have been made.
Difficult to Value Assets (Cont'd)

- Charitable Formulas

  » Same concept as marital formula, except "excess" property allocated to charity.

  » Alternatively, instrument of conveyance could contain similar formula to allocate property between trust and charity.
Difficult to Value Assets (Cont'd)

- Formula Gifts

  » Amount transferred is expressed in terms of formula (e.g., “that number of shares of ABC stock equal in value to $1,000,000 for federal gift tax purposes”).

  » Theory: “Excess” property transferred was never effectively transferred; donor effectively retains the "extra" property.

  » Formula gift differs from clause in Procter because formula actually defines amount being transferred. In Procter, clause attempted to undo part of original deal.
Difficult To Value Assets (Cont'd)

- Formula Definition Approach after *Wandry*
  
  - In *Wandry v. Comm'r*, gift of defined dollar amount worth of units in entity; at time of gift, actual number of transferred shares unknown.
  
  - IRS may challenge this approach.
    
    » Would likely argue that original number of shares estimated to be transferred was actually transferred at adjusted gift tax value.
Qualified Purchaser and Accredited Investor Issues
Qualified Purchaser and Accredited Investor Issues

- Investor Status

  - In order for Fund to be exempt from registration under Securities Act of 1933 and Investment Company Act of 1940, it must qualify for exemption.

  - Most common exemption limits type of investors Fund can accept to "Accredited Investors" and "Qualified purchasers."
Qualified Purchaser and Accredited Investor Issues (Cont'd)

• Accredited Investor Issues
  - Generally, transfer of interest in Fund to a trust by gift or intra-family sale will not trigger registration under 1933 Act.
  - However, if trust assumes Fund Principal’s obligation to make additional contributions to Fund, trust must qualify as Accredited Investor when it makes such additional contributions.
  - To qualify as Accredited Investor, trust must (1) have net worth in excess of $5 million, (2) not have been formed for specific purpose of acquiring interests in Fund and (3) have “sophisticated person” directing trust’s purchase of securities.
Qualified Purchaser and Accredited Investor Issues (Cont'd)

- Qualified Purchaser Issues

  - Generally, gift of interest in Fund to a trust will not trigger registration under 1940 Act unless trust is obligated to fund future capital calls using assets other than those received as a gift and earmarked for such purpose.

  - Otherwise, trust must qualify as Qualified Purchaser by meeting at least one of four requirements:

    » Trust must have at least $5 million of investments and be for benefit of certain family members;

    » Trustee (or other person authorized to make decisions with respect to the trust) and each settlor (or other person who has contributed assets to the trust) must be Qualified Purchasers;

    » Trust must own or manage, for its own account or the accounts of other Qualified Purchasers, in aggregate, at least $25 million in investments; or

    » Trust's grantor (or trust’s source of funds) and trustee (or person who makes all decisions with respect to the trust’s investments) must be “knowledgeable employees.”
Buy-Sell Agreements
Buy-Sell Agreements

- Commonly used to provide certainty as to how shareholder or partner’s business interests will be disposed of and valued in the event of death (or other triggering events).

- At minimum, should establish certainty as to exactly what will happen to party’s shares or equity interests at death and provide clear means to determine value of interests and funding mechanism for buy-out.
  - Important to keep up to date.
  - Should be coordinated with estate planning documents.
  - Failure to do so can result in mismatches (funding, valuation, marital deduction) and unexpected consequences.

- Section 2703 Concerns:
  - If applicable, § 2703 will cause rights, restrictions or other provisions included in agreement (typically, a buy-sell agreement) to be ignored for purposes of determining value of assets subject to the agreement for transfer tax purposes.
  - § 2703 does not affect contractual obligation of decedent’s estate to sell stock at the agreed price.
    - Result: Parent’s estate could be obligated to sell parent’s stock for lower price set in buy-sell agreement, while required to pay estate tax based on much higher fair market value for estate tax purposes.
The Internationally Connected Client
The Internationally Connected Client

- Increasing investment by foreign persons in U.S. assets
- International families with cross-border connections, including spouses, children and businesses
- Non-resident non-citizens (otherwise known as “non-resident aliens” or “NRAs”) increasingly look to the U.S. as a safe haven
  - Correct U.S. structuring can minimize tax and provide legitimacy
- Knowledge of the rules can avoid traps for the unwary
- Increased international financial transparency mandates correct U.S. and non-U.S. structuring
Who is Subject to the Estate, Gift, and GST Taxes?

- These three types of taxes can be imposed on gratuitous transfers of property

- But they only apply if the testator or donor:
  - Is a US *citizen*;
  - Is a US *domiciliary* for estate, gift, and GST tax purposes (different than “residency” for Federal income tax purposes); OR
  - Is a non-citizen/non-domiciliary who transfers certain *assets* that are situated in the US
Domiciliaries – Subject to U.S. Transfer Taxes

Two requirements for domicile, Treas. Reg. 25.2501-1(b):

- Living in a place, even for a brief period of time
- No definite present intention of leaving the place

Difficulty in determining intent

Courts look to many factors (highly subjective):

- Location of residences, other dwelling places, expensive possessions and investments
- Relative amount of time spent at claimed domicile and in other countries
- Location of family and friends
- Location of church, business activities and club memberships
- Jurisdiction of voter’s registration and driver’s license
- Declarations or statements of residence or intent (visa applications, wills, trusts, letters, oral statements, tax returns, etc.)
Citizens – Subject to U.S. **Transfer** Taxes and **Income** Tax

Typical ways to obtain U.S. citizenship (*no passport needed*):

- Birth within the U.S.
- Birth outside of the U.S. to at least one U.S. parent (subject to certain additional requirements depending on DOB)
- Naturalization

Important to ask clients about their citizenship and the citizenship of their family members
Residents – Subject to U.S. **Income** Taxes

Ways to be a resident:

- Green card holder (determinative)
- First year election to be treated as a resident under §7701(b)(4)
- Spousal election under § 6013(g)
- Satisfaction of the Substantial Presence Test
Residents – Subject to U.S. Income Taxes

Substantial Presence Test, § 7701(b)(3)

- Presence in the U.S. for at least 31 days in the test year, and
- Day count: current year days + 1/3 of prior year days + 1/6 of second prior year days >= 183 days

Certain days do not count

“Closer Connection” exception under § 7701(b)(3)(B)
Estate Taxation of NRAs – Gross Estate

Gross estate of an NRA includes only assets situated in the U.S., §2103

Transfers where §§ 2035 – 2038 are applicable will trigger inclusion in the NRA’s gross estate if the assets are U.S. situs assets at the time of the transfer or at the NRA’s death, § 2104(b)

• Planning note: Do not mix U.S. situs assets with non-U.S. situs assets, and consider carefully retaining “strings” in trusts

Jointly Owned Property – based on actual contributions of joint owners
Estate Taxation of NRAs – Situs Rules

Real Property

Real Property Interests

Tangible Personal Property – situated where located

- Includes currency, jewelry, furnishings, clothing, collectibles
- Exceptions for certain artwork on loan to a public facility, on exhibition or in transit to or from an exhibition
- Exception for “in transit” tangibles, Delaney v. Murchie, 177 F.2d 444 (1st Cir., 1949)
Estate Taxation of NRAs – Situs Rules (continued)

Intangible Personal Property

- Domestic corporate stock
- Partnership interests
- LLC interests (?)
- Interests in trusts
- Life insurance proceeds
- Debt obligations
- Mutual funds
Foreign Trusts - Overview

- Foreign Non-Grantor Trusts
- Foreign Grantor Trusts with Foreign Grantors
- Foreign Grantor Trusts with U.S. Grantors
- Taxation of trust and beneficiaries is dependent on both characterizations
A trust is a “Foreign Trust” (§7701(a)(31)) unless:

- A Court within US exercises primary supervision over administration of the trust (the “Court Test”); and

- One or more US persons have authority to control all substantial decisions of the trust (the “Control Test”)
  - Watch special power of appointment holders, protectors

* If you fail either test then have a Foreign Trust
Grantor Trust Status for Foreign Grantors

Section 672(f) - special grantor trust rules apply to trusts with non-US grantors

For non-U.S. grantors, there are generally two ways to create “Grantor Trust” status:

- The grantor has the power to revest the property in himself – can require the consent of a related or subordinate party subservient to grantor (power of revocation), or

- Distribution of income or principal can only be made during the grantor’s lifetime to the grantor or the grantor’s spouse
Taxation of Foreign Grantor Trusts - Planning Opportunities

If Section 672(f) requirements are satisfied, substantial opportunities for efficient income tax planning for foreign grantors of trusts with US beneficiaries

All income is deemed taxable income of foreign grantor – US beneficiaries can receive distributions free of tax

Foreign grantor only taxed on ECI or US source FDAP, so trust can invest in the US and generate capital gains (excluding FIRPTA gains) and interest income, as well as non-US income, without incurring an income tax burden in the US

Can be US transfer tax free if properly structured

Planning necessary with respect to estate and income tax consequences following grantor’s death

Need to understand taxation of grantor in grantor’s jurisdiction
Planning when Foreign Grantor Dies

Benefits of Foreign Grantor Trust cease when Grantor dies; trust becomes a Foreign Non-Grantor Trust

Plan to avoid the Throwback Rules and reporting requirements

- Purge DNI each year (outright or to a “mirror” foreign or U.S. trust)
- Domesticate the foreign trust
Typical Structure – During Grantor’s Life

- Foreign holding company avoids U.S. estate tax
- Foreign grantor trust (with a foreign grantor) avoids PFIC and CFC issues
Typical Structure – After Grantor’s Death

- **Foreign holding company may be treated as a PFIC or CFC**
- **Use of check-the-box elections after the death of the NRA foreign grantor**
  - Can be used retroactively up to at least 75 days before filing date
  - Careful of U.S. situs assets
- **Foreign Non-Grantor Trust may be subject to Throwback rules**
- **Purge trust of DNI each year or domesticate the trust**
Speaker Biographies
Lawrence M. Lipoff, CPA, TEP, CEBS, is a Director in CohnReznick LLP’s tax practice and is based in the Firm’s New York office. With more than 30 years of experience, Larry specializes in the delivery of domestic and international private client services to enable high net worth individuals and families to maximize their new or generational wealth. Larry provides strategic advice to his clients and their closely-held businesses in the areas of income tax planning and compliance, estate planning and administration services, consultation regarding formation of family trusts and philanthropic structures. Through his many years in practice, he is able to synthesize the work of various related professionals and their firms and integrate several planning strategies into solutions that maximize value.

He is a frequent lecturer and author of articles published through The New York State Society of Public Accountants and other professional forums on topics that include preparation of 1040/1041 & 706/709 returns, IRA/pension distribution, domestic and international asset protection, business succession, generation-skipping transfers, S corporation and fiduciary taxation including foreign trusts, alternative minimum tax, Chapter 14, family limited partnerships, international estate planning and administration, grantor charitable lead trusts, captive insurance companies, private placement life insurance and carried interest estate planning for private equity and hedge fund principals.

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- Annual Estate Administration Conference - Chair
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Museum of Modern Art – Planned Giving Advisory Board
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N. Todd Angkatavanich is a partner at Withers Bergman, LLP, in the firm’s Greenwich, New Haven and New York offices. He serves as Regional Practice Group Co-Leader of the firm’s US Trust, Estate and Charities Practice Group. Todd is a Fellow of the American College of Trust and Estate Counsel and is a member of the Society of Trusts & Estates Practitioners. Todd has published articles in publications such as Trusts & Estates, ACTEC Law Journal, Estate Planning, BNA Tax Management, Probate & Property and other publications. He serves as Co-Chair of the Estate Planning & Taxation Committee of the Editorial Advisory Board of Trusts & Estates magazine, as well as a member of the Advisory Board for BNA/Tax Management Estates, Gifts and Trusts Journal. Todd is co-author of the pending BNA/Tax Management Portfolio No. 875, entitled “Wealth Planning with Hedge Fund and Private Equity Fund Interests.” A frequent speaker, Todd has given presentations for a number of organizations including the Heckerling Institute on Estate Planning, the Federal Tax Institute of New England, the Notre Dame Tax and Estate Planning Institute, the Washington State Bar Association Annual Estate Planning Seminar, the ABA Real Property, Trusts and Estates Section (Spring Symposia, Fall Joint Meetings and the joint ABA/New York Law School Skills Training Programs), BNA/Tax Management, as well as numerous estate planning councils, CPA societies and family office groups. Todd has been quoted in articles that have appeared in Barron’s, Bloomberg Businessweek, The Boston Globe, The Philadelphia Inquirer, The Chicago Tribune, The Miami Herald, Forbes, MSN Money and other publications. Todd is Co-Chair of the ABA/RPTE Business Planning Group – Business Investment Entities, Partnerships, LLC’s and Corporations Committee and serves as a member of the ABA/RPTE Diversity Committee. He is a member of the Executive Committee of the Connecticut Bar Association, Estates and Probate Section, and on behalf of the Section also serves on the Planning Committee for the Federal Tax Institute of New England. He is the 2012 recipient of the award for “Private Client Lawyer of the Year” from Family Office Review. Todd has been included in The Best Lawyers in America® (for New York City, Greenwich and New Haven, Connecticut) and is also the recipient of the Best Lawyers® 2015 Trusts & Estates “Lawyer of the Year” award for New Haven, Connecticut. He has been rated AV Preeminent® by Martindale-Hubbell® Peer Review Ratings™ and has been listed in Who’s Who Legal: Private Client. Todd received his B.A., in Economics, magna cum laude, from Fairleigh Dickinson University, his J.D., Tax Law Honors, from Rutgers University School of Law, Camden, his M.B.A. from Rutgers University Graduate School of Management, and his LL.M, in Taxation, from New York University School of Law.
Julie Miraglia Kwon is a partner based in Silicon Valley with the law firm of McDermott Will & Emery LLP. She advises clients regarding estate, gift and generation-skipping transfer tax issues; charitable planning and exempt organization compliance; trust and estate administration; and contested trust and tax matters. Julie formerly was the Philanthropic Advisor for Stanford University, a National Director with Bernstein Global Wealth Management, and fiduciary counsel and Legacy Planner for the Midwest Region for Bessemer Trust Company.

Julie is co-author of the tax treatise, “Generation-Skipping Transfer Tax” (by Harrington, Plaine, Zaritsky & Kwon, for Warren Gorham & Lamont), and the Tax Management Portfolio titled “Generation-Skipping Transfer Tax” (by Harrington & Kwon, for Bureau of National Affairs). She is a frequent speaker and author for professional organizations and publications, which have included the Wall Street Journal, Forbes, Dow Jones, Journal of Taxation, Trusts & Estates, the Heckerling Institute on Estate Planning, the Internal Revenue Service, the American Bar Association, the American Law Institute, and numerous regional organizations.

Chambers USA has individually ranked Julie nationally as a leading wealth management lawyer. She is a Fellow elected to the American College of Trusts & Estates Counsel. She also is a current Supervisory Council Member for the Real Property, Trust & Estate Section of the American Bar Association, and past Chair of the Income & Transfer Tax Planning Group and Estate & Gift Tax Committee, and past co-chair of the GST Tax Committee, of the Section. Julie is also a member of the Executive Committee of the Trusts & Estates Section of the State Bar of California which reviews and develops state legislation in her practice area. She also serves as a member of the Board of Directors of the Silicon Valley Community Foundation, the largest community foundation in the country. Julie received her J.D. from Yale Law School, where she was Executive Editor of the Yale Journal of Law & the Humanities, and her B.A., with distinction, from Stanford University. She is admitted to practice in California and Illinois.
Christine R. W. Quigley is a partner in the Private Clients, Trusts and Estates group of Schiff Hardin LLP. Christine advises affluent individuals and families in wealth transfer planning, tax planning, estate and trust administration, and business succession planning. Her clients include principals of private equity, hedge fund, and venture capital firms; owners of closely-held businesses; and executives of public corporations.

Christine is a vice chair of the Business Investment Entities, Partnerships, LLCs and Corporations Committee of the American Bar Association's Real Property, Trust and Estate Law Section. She has been quoted in The Wall Street Journal and has written and lectured on a variety of topics that impact her clients, including carried interest planning, family partnerships, tax traps involved in closely held business transactions and business succession issues. She has been named a "Rising Star" by Illinois Super Lawyers magazine each year since 2012 and was named an “Emerging Lawyer” in Leading Lawyers in 2015. Christine received her B.A. from Dartmouth College and her J.D. from Loyola University Chicago School of Law, summa cum laude.