



NORTHERN
TRUST

INNOVATIVE PASS-THROUGH STRUCTURES AND TECHNIQUES IN THE WAKE OF “TAX REFORM”

Paul S. Lee, J.D., LL.M.
Global Fiduciary Strategist
The Northern Trust Company
New York, New York
PSL6@ntrs.com

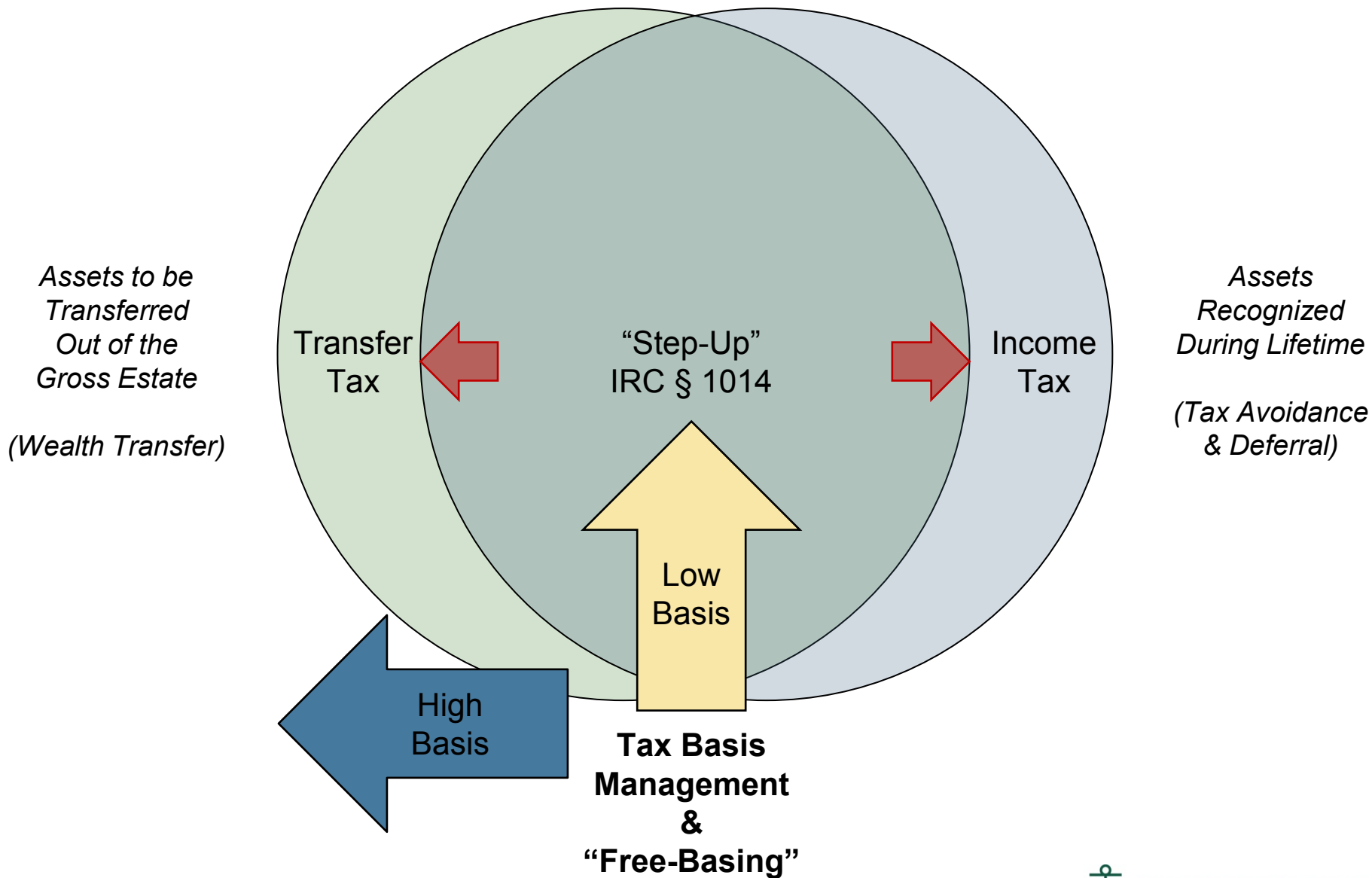
January 2019



The Tax COVF EFE and Jibberish Act



The Temporary TCJA Transfer Tax Landscape: Venn Diagram

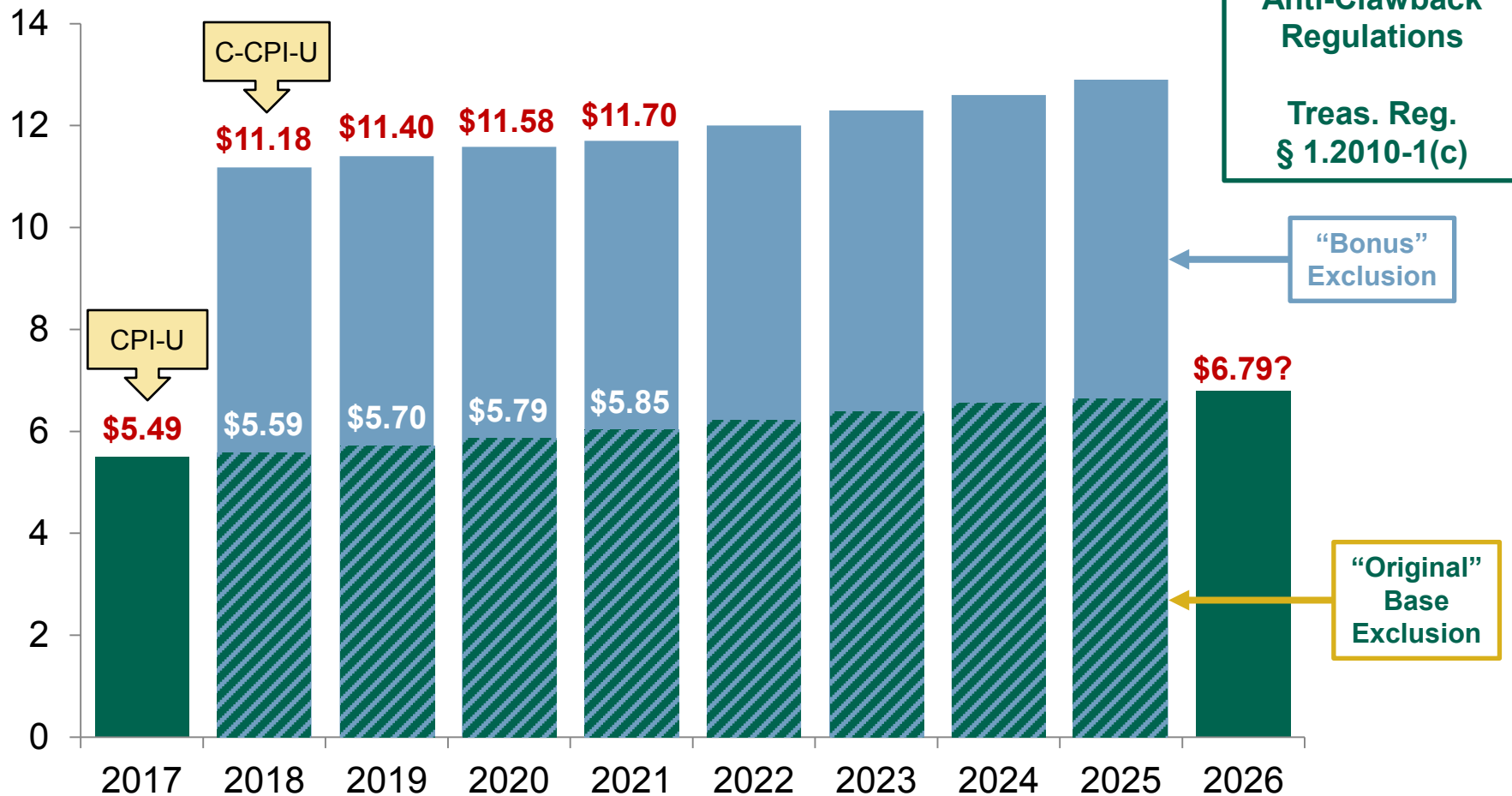




2012 All Over Again?

(\$ Mil.)

Applicable Exclusion Amount





To Gift or Not to Gift: That's the Question...

Up to Wealthy

\$0 to ~\$11.70 Mil.

- Limit taxable gifts
- Preserve Applicable Exclusion
- Take advantage of free “step-up” in basis
- Limit valuation discounts
- Transfers of wealth in excess of the Applicable Exclusion via “zeroed-out” techniques
- Transfer high basis assets to IDGTs with “swap” power

“Middle Class” Wealthy

~\$11.70 Mil. to ~\$50.0 Mil.

- Taxable gifts in excess of the “Original” Applicable Exclusion depend on whether taxpayer can afford to make such gift
- Careful consideration of “split-gift” election (or NOT) in certain years
- Spousal Lifetime Access Trusts
- Retained cash flow techniques (i.e., preferred partnership freezes)
- Trusts that provide maximum “flexibility”

Ultra-Wealthy

Above ~\$50.0 Mil.

- Large taxable gifts to use “Original” and “Bonus” Applicable Exclusion
- Transfer to IDGTs (with “swap” power”)
- Valuation discount planning
- “Zeroed-out” techniques, leveraging taxable gifts (i.e., installment sale)
- “Free-basing” with marital deduction and estate reduction planning with surviving spouse

Consider:

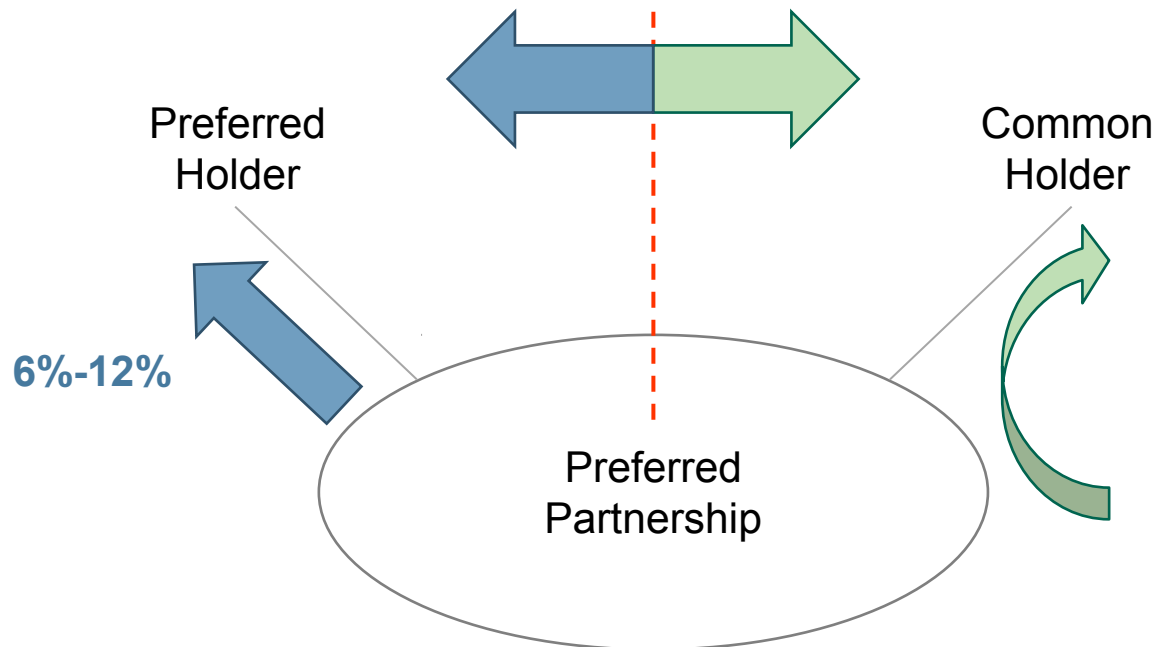
Applicable Exclusion gifts of cash (or marketable securities), and
Exercise of “swap” power in the future.



Preferred Partnership Structures: Forward, Reverse, and Non-Qualified



Preferred & Common: Retain or Transfer?

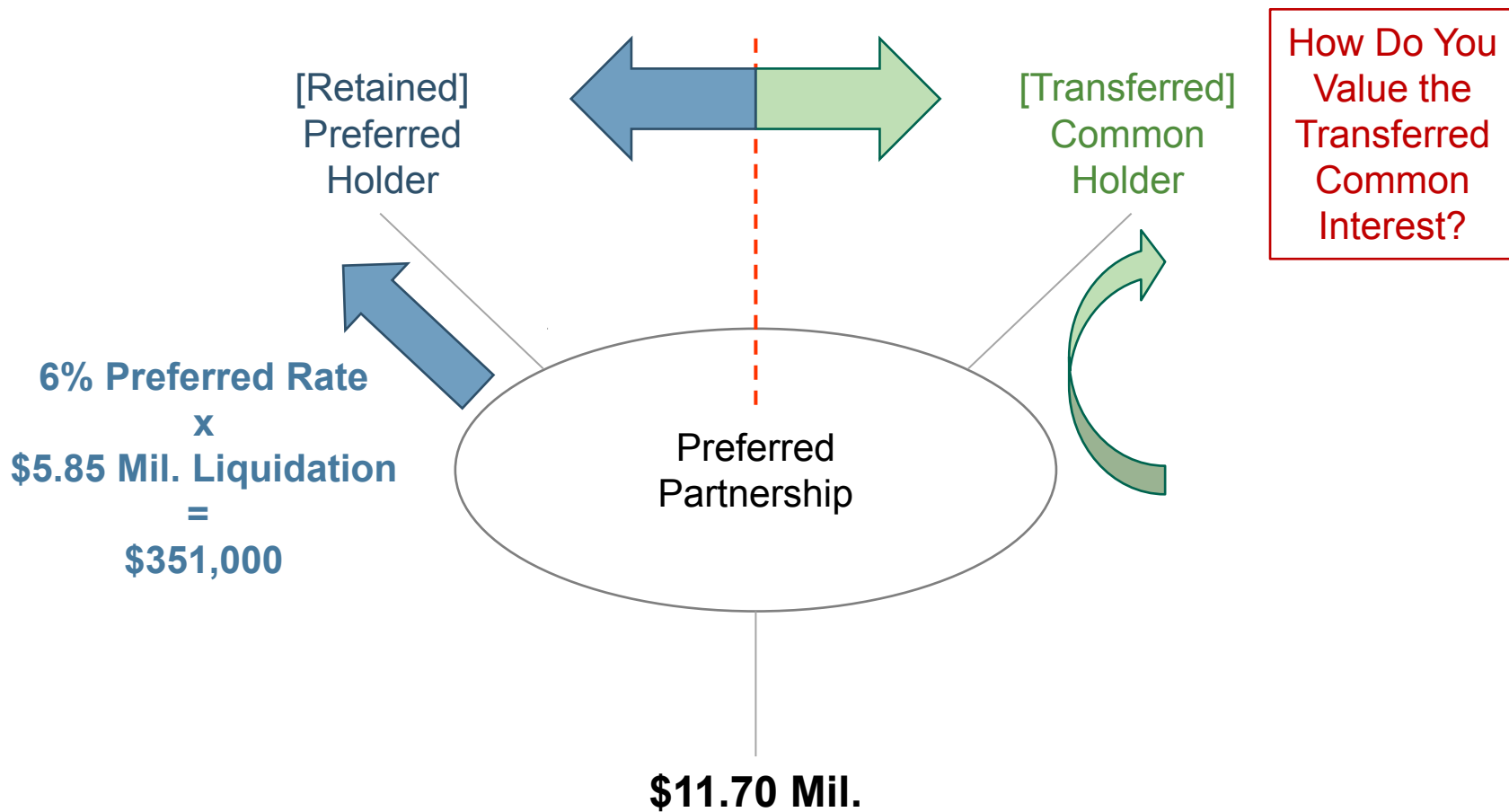


- Fixed Liquidation Value
- Annual Distribution at Fixed Rate/Amount
- Tax Items Preferentially Allocated
- Retain (Traditional), § 2701 Applies
- Transfer (Reverse), Normal Gift Tax Rules

- All Value in Excess of Preferred
- No Fixed Annual Distribution
- Residual Tax Items
- If Retain, Normal Gift Tax Rules
- If Transfer, § 2701 Applies



"Forward Freeze" Preferred Partnership Transaction





Forward Freeze: Subtraction Method (Valuing Common Interest)

- **Step 1: Determine**
 - ◆ Value of all family-held interests

- **Step 2: Subtract**
 - ◆ Value of senior equity interests

- **Step 3: Allocate**
 - ◆ Among the transferred interests

- **Step 4: Determine**
 - ◆ Value of the gift

Section 2701

Not liquidation value
No minority interest discount

Zero OR
Value of
“Qualified Payment” Interest

Minority interest discount
Lack of marketability discount
Subordination discount

Qualified Payment
Annual
Cumulative
Fixed Rate

Rev. Rul. 83-120

No ability to
inflate value above
liquidation



Retain Preferred/Transfer Common: Qualified or Non-Qualified

Estate Tax

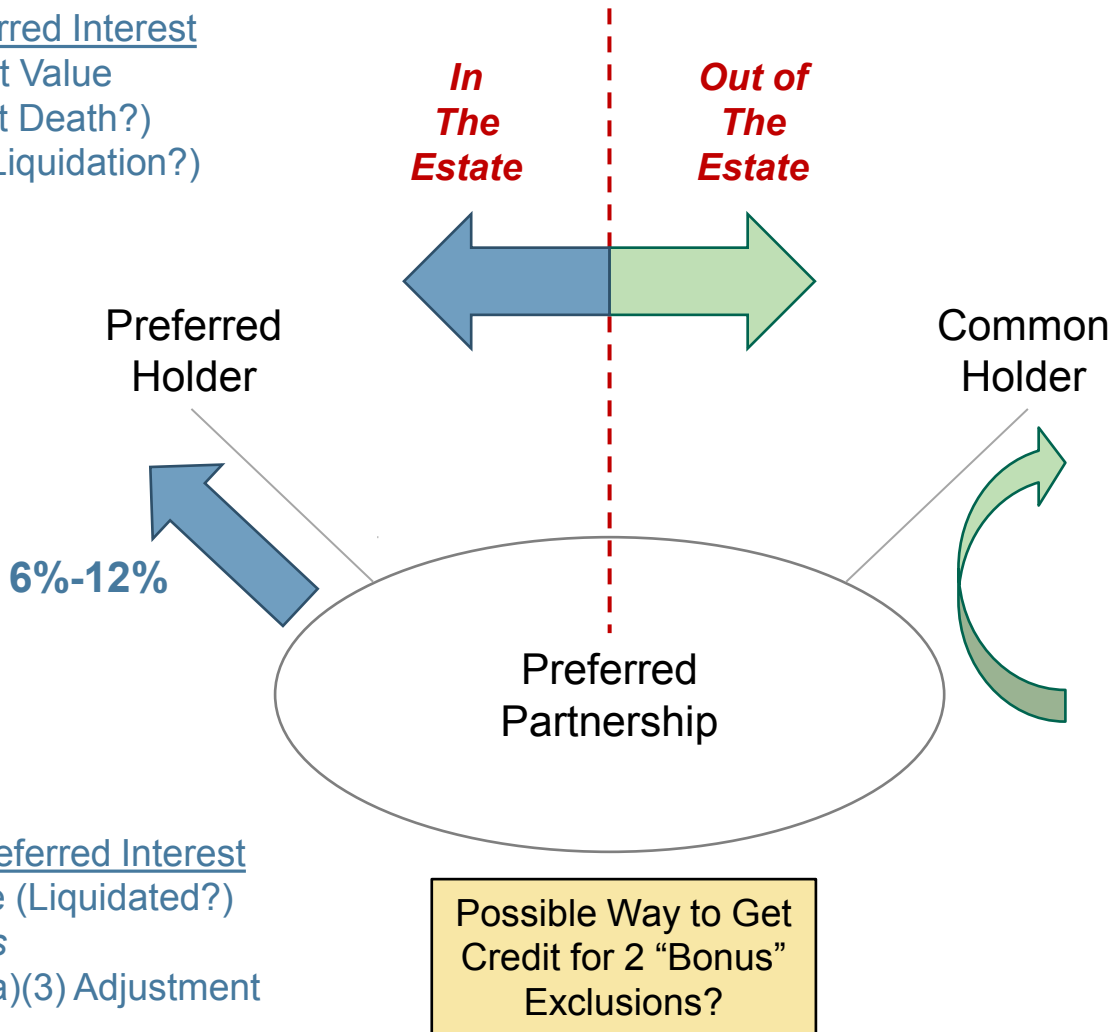
Qualified Preferred Interest

Fair Market Value
(Liquidated at Death?)
(Cost-of-Living Liquidation?)

Gift Tax

Common Interest

Family Interests
less
Qualified Interest
less
Discounts



Non-Qualified Preferred Interest

Fair Market Value (Liquidated?)
less
Reg. § 25.2701-5(a)(3) Adjustment

Common Interest

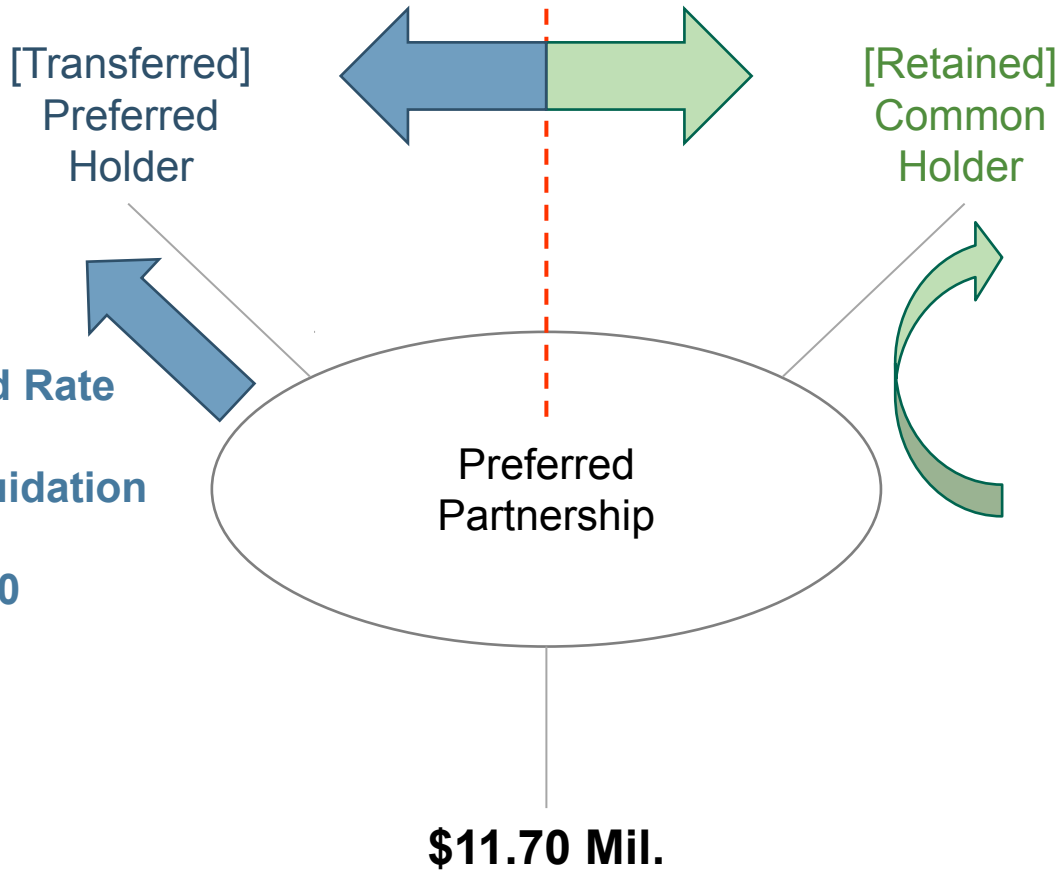
Family Interests
less
Zero



"Reverse Freeze" Preferred Partnership Transaction

How Do You Value the Transferred Preferred Interest?

$$\begin{aligned} &6\% \text{ Preferred Rate} \\ &\times \\ &\$5.85 \text{ Mil. Liquidation} \\ &= \\ &\$351,000 \end{aligned}$$





Reverse Freeze: Junior Equity Exception & Rev. Rul. 83-120

“Junior Equity Exception” to Section 2701

- Normal gift tax valuation rules apply
- Lack of marketability and minority interest discounts

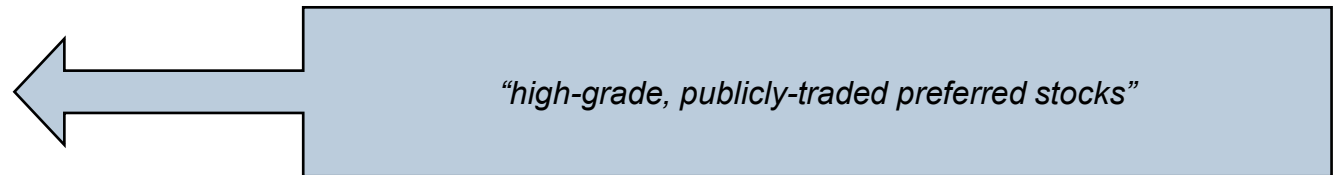
Rev. Rul. 83-120

■ Major Factors

- ◆ Yield
- ◆ Dividend Coverage
- ◆ Dissolution Protection

■ Minor Factors

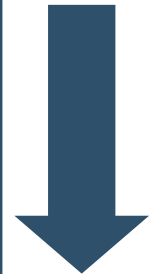
- ◆ Voting Rights
- ◆ Lack of Marketability



Based on
structure
of the
partnership

Preferred Stock Sectors

- Financial Services
- Oil & Gas
- Real Estate



Preferred Stock Yields

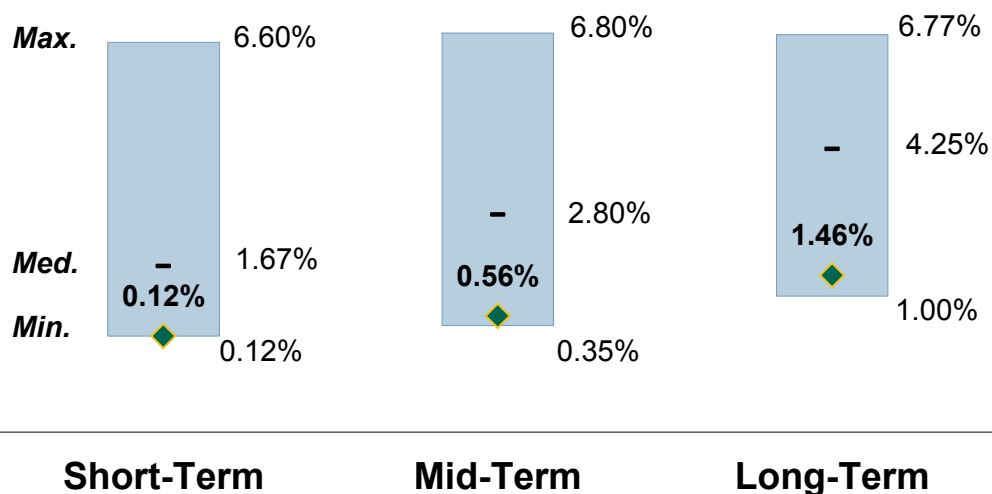
8% to 14%



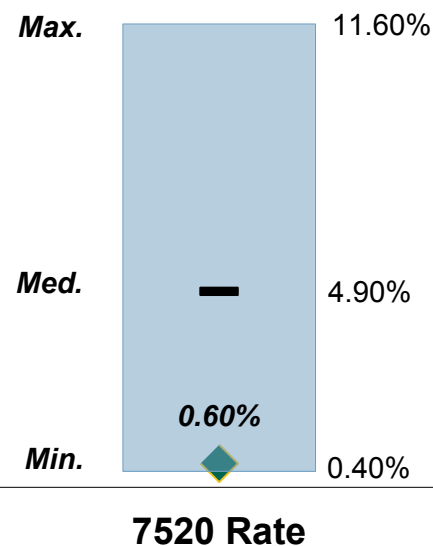


At a Time When AFR and Section 7520 Rates Are Very Low

Applicable Federal Rates Jan. 1998 – Feb. 2021



Section 7520 Rate (Since Inception) Mar. 1989 – Feb. 2021



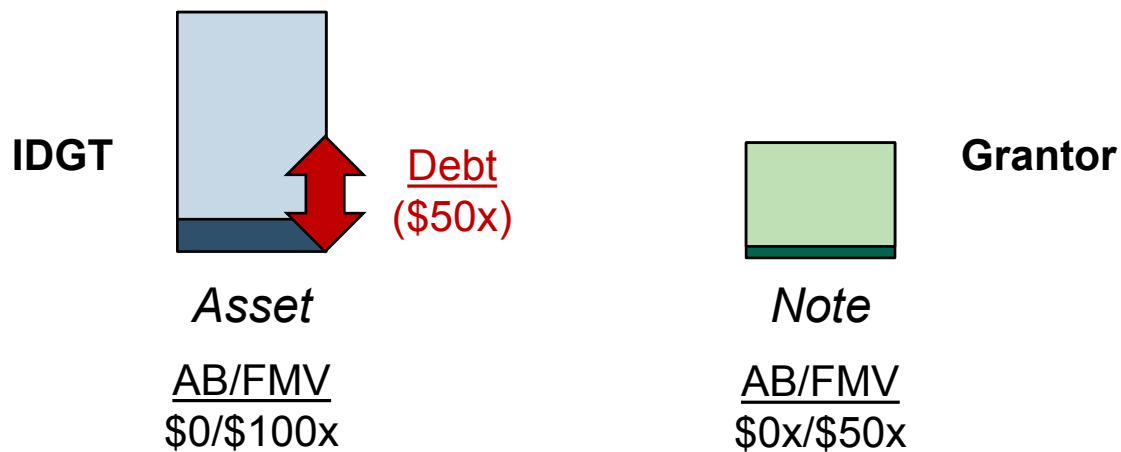
Feb. 2021



Eliminating Outstanding Installment Notes, Avoiding Gain At Death, And Getting A “Step-Up” On The IDGT Property



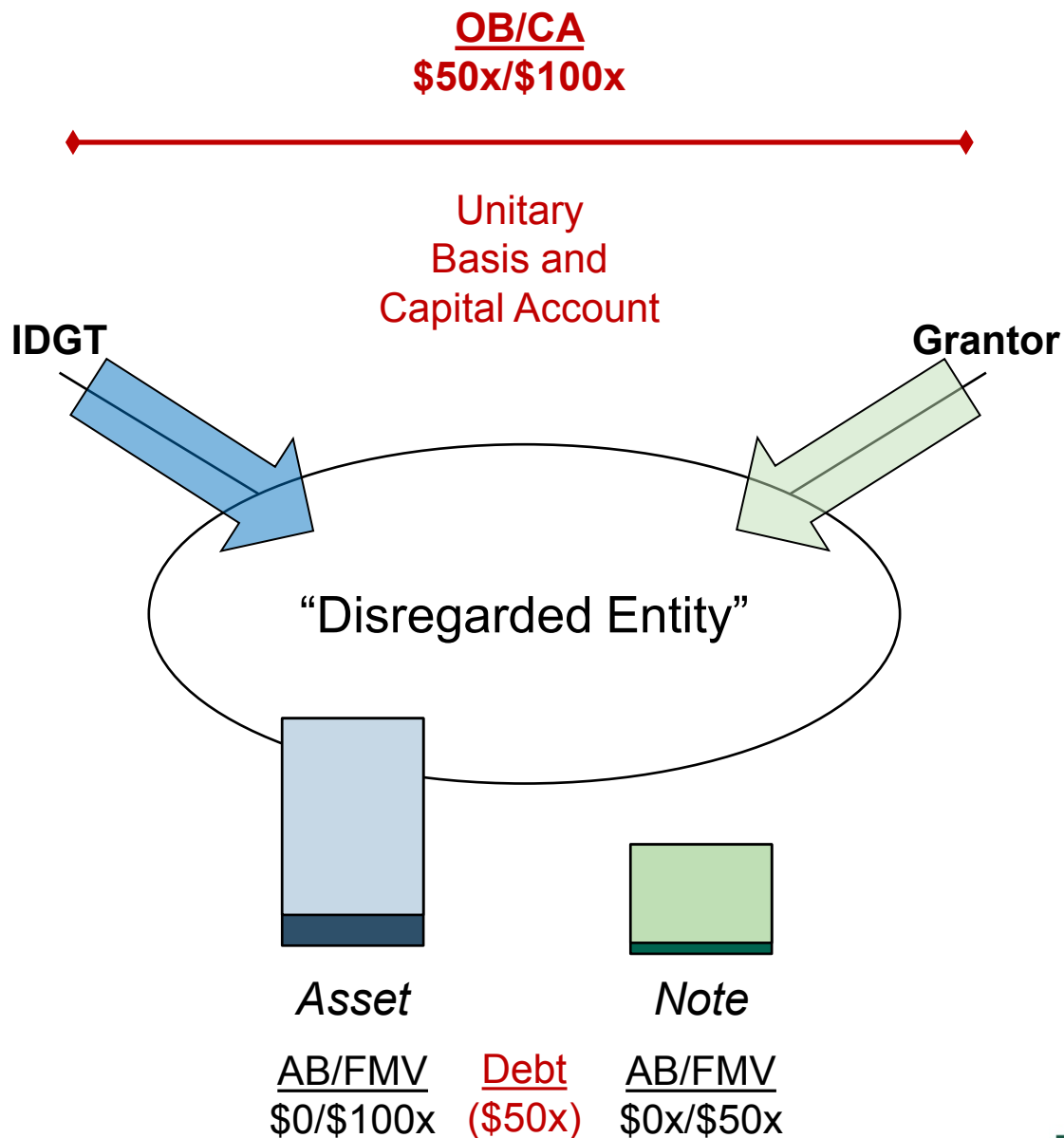
Installment Sale to IDGT and Outstanding Note



*Potential \$50x Taxable Gain
Upon Conversion of
Grantor Trust to Non-Grantor Trust*

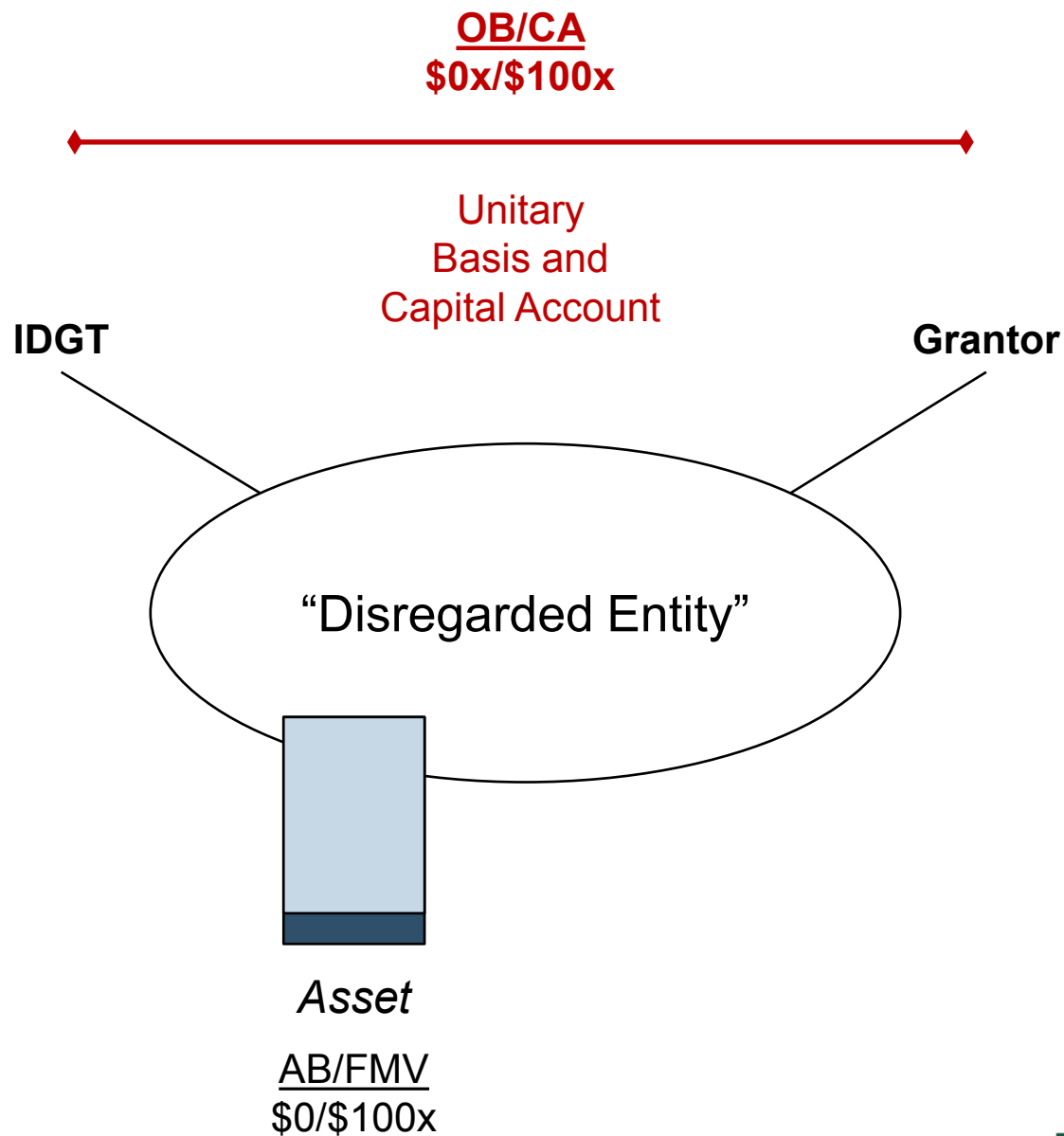


Contribution to Disregarded Entity



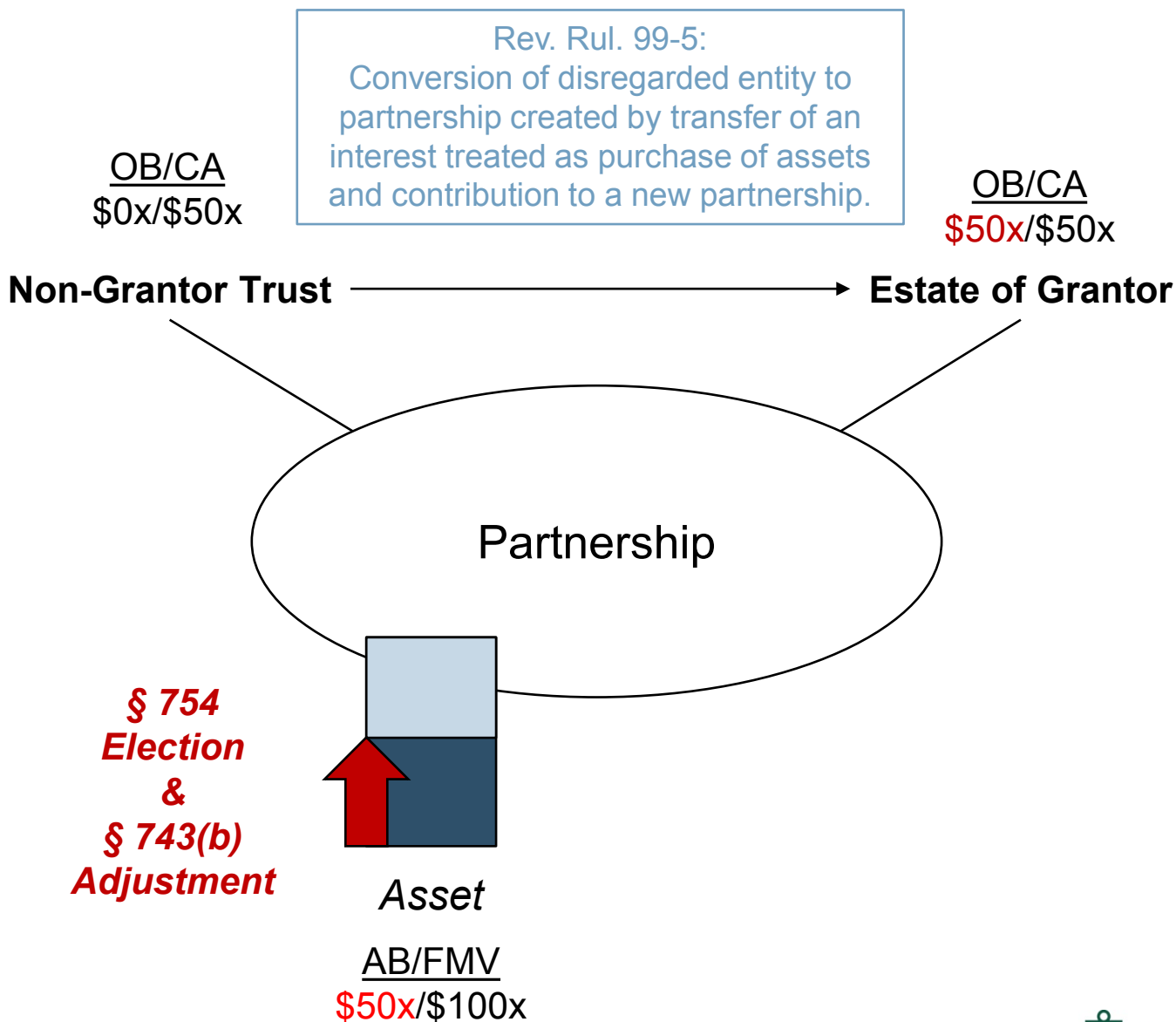


Debt Merges and Disappears





Conversion to Non-Grantor Trust & Partnership at Death

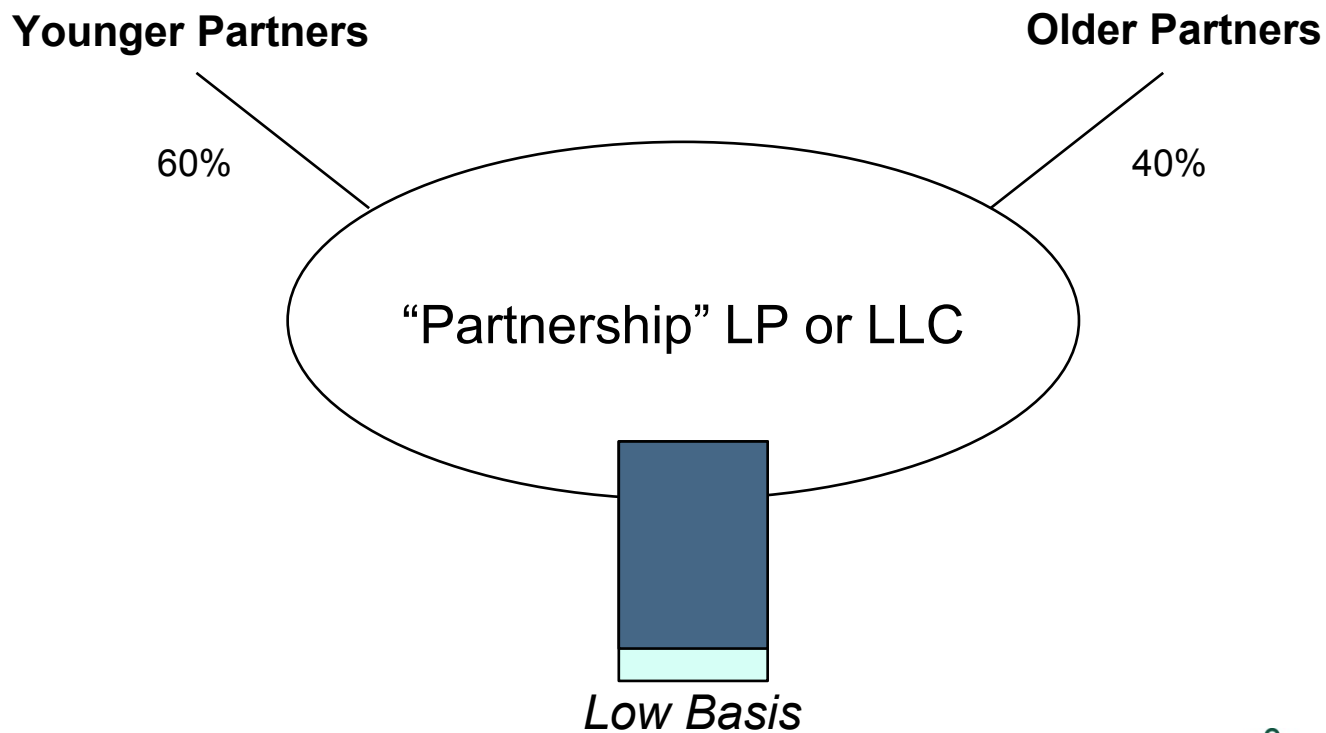




Eliminating Valuation Discounts On Pre-Existing FLP Interests Included in the Gross Estate



Eliminating Valuation Discounts on Pre-Existing FLPs





Eliminating Valuation Discounts on Pre-Existing FLPs

Younger Partners

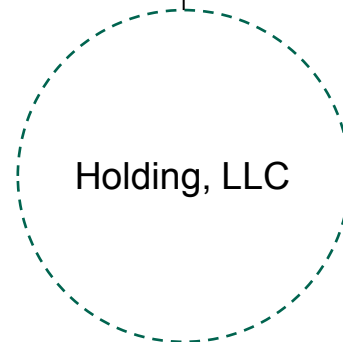
100%



Holding, LLC

Older Partners

100%

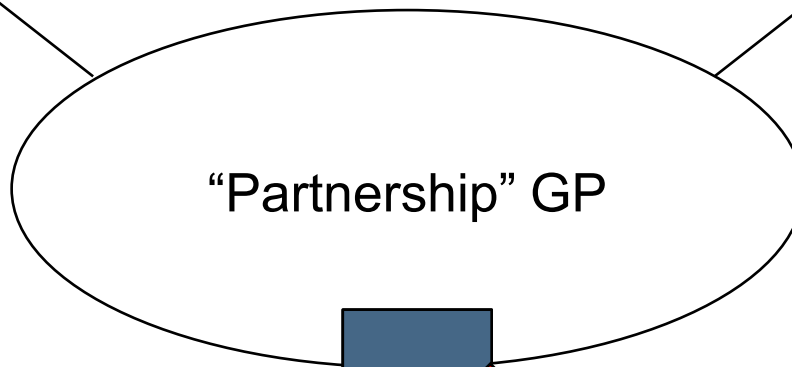


Holding, LLC

Disregarded Entities

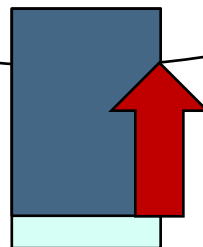
60%

40%



"Partnership" GP

*"Convert" to
General Partnership*



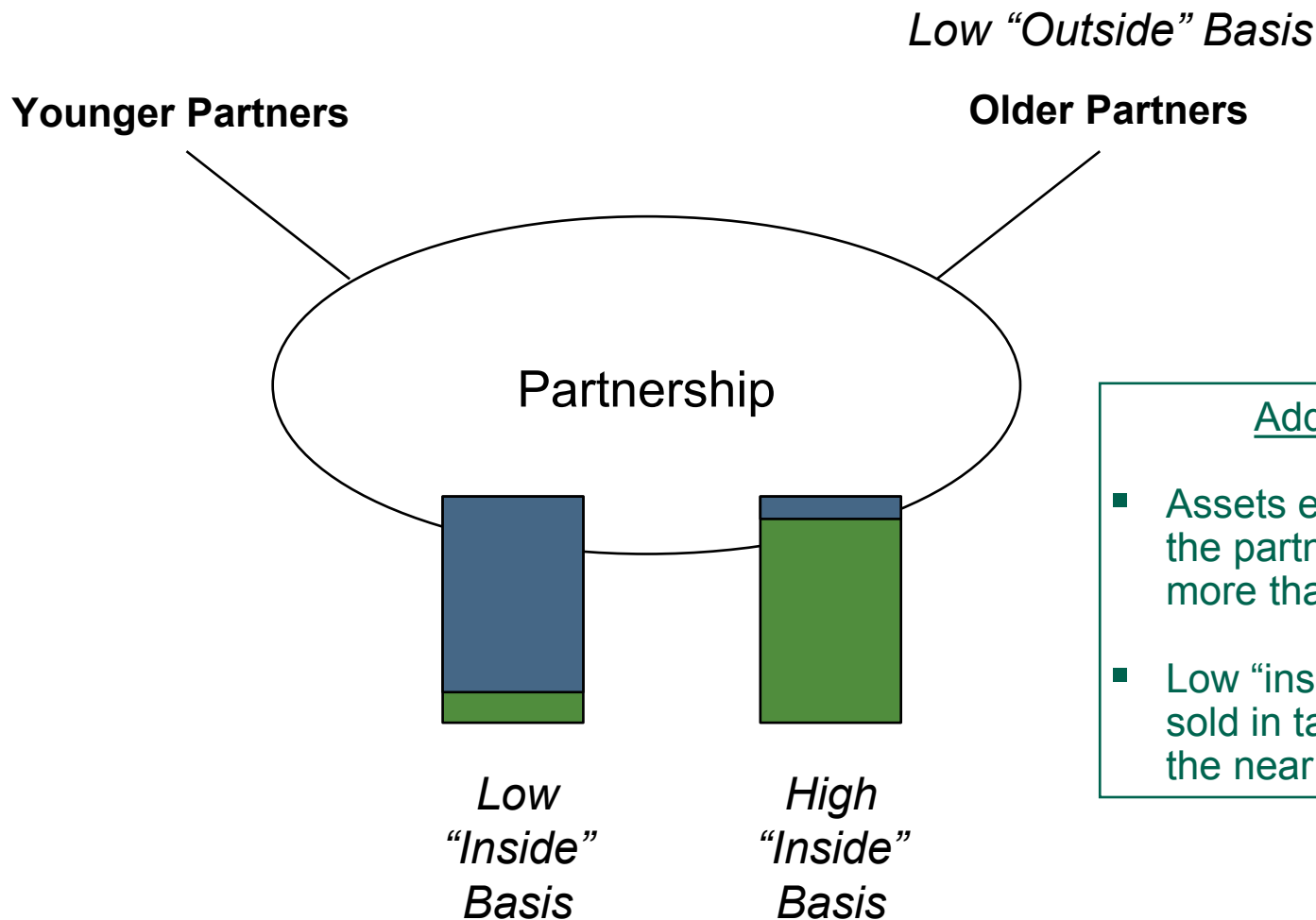
Low Basis

**Section
754
Election**

*The Basics of Basis
Stripping, Shifting, and Swapping*



Importance of Partnerships in Tax Basis Management

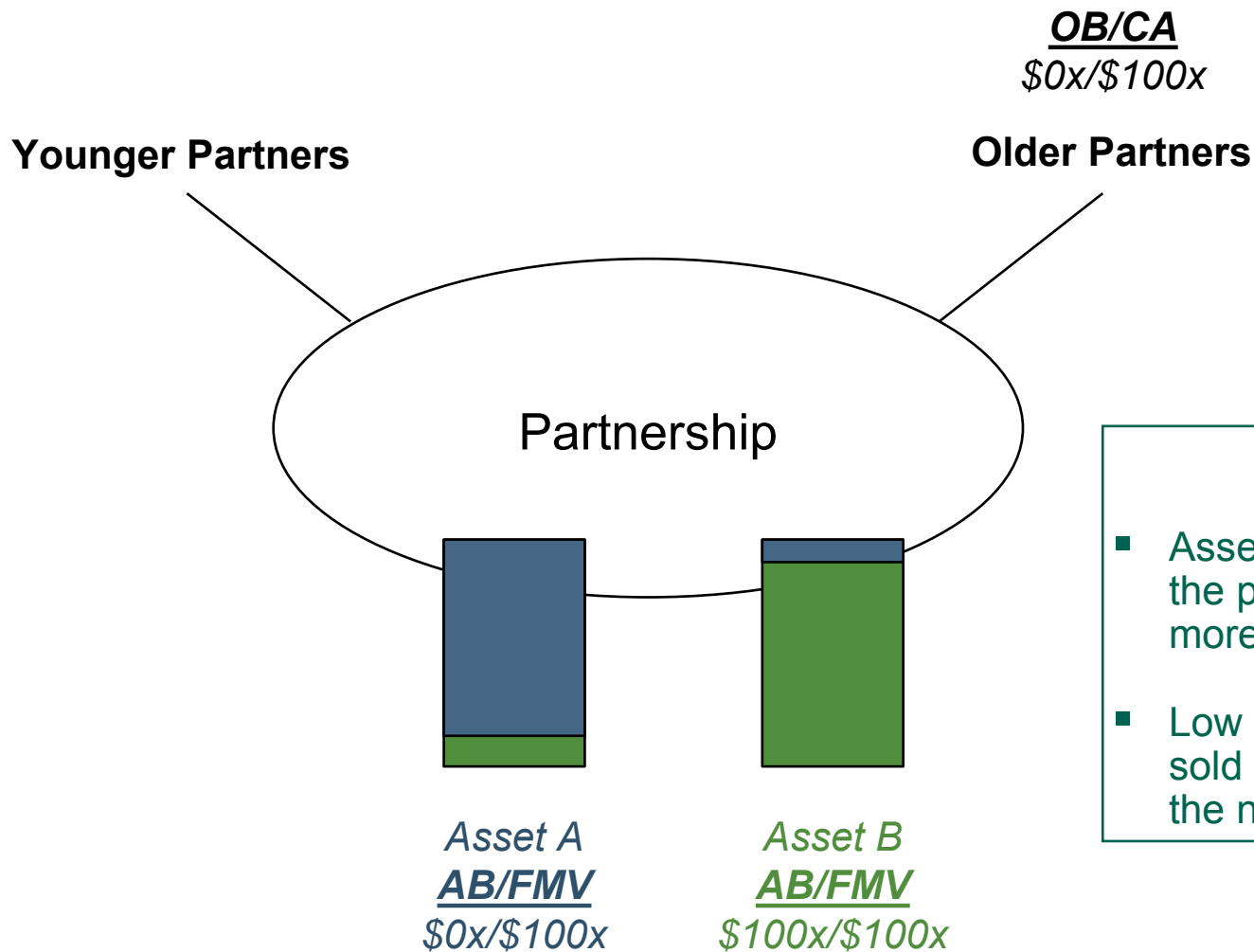


Additional Facts:

- Assets either purchased by the partnership or contributed more than 7 years ago.
- Low "inside" basis asset to be sold in taxable exchange in the near future.



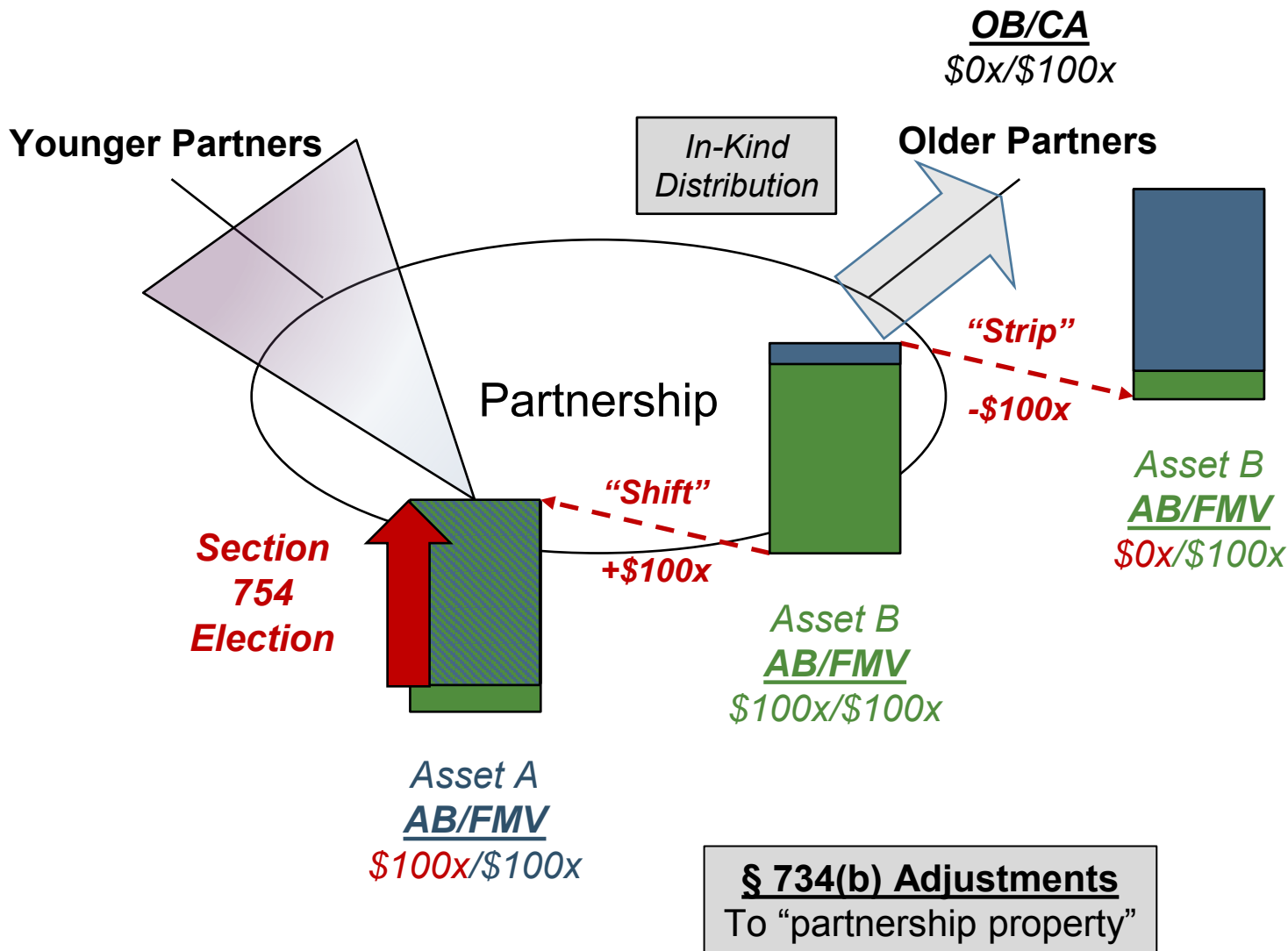
Importance of Partnerships in Tax Basis Management



- Additional Facts:
- Assets either purchased by the partnership or contributed more than 7 years ago.
 - Low "inside" basis asset to be sold in taxable exchange in the near future.



Importance of Partnerships in Tax Basis Management





***Creating, Stripping, and
Shifting Basis
(Even with Marketable Securities)***



“Old and Cold” Investment Partnership

G2 Partners

G1 Partners



Investment Partnership under § 731(c)(3)(C) of the Code:

- Never engaged in a trade business.
- “Substantially all” (e.g., 90%) assets are (have been):
 - Money
 - Stock in a corporation (including pre-IPO shares)
 - Notes, bonds, debentures, or other debt
 - Derivative financial instruments (e.g., options, futures, short positions)

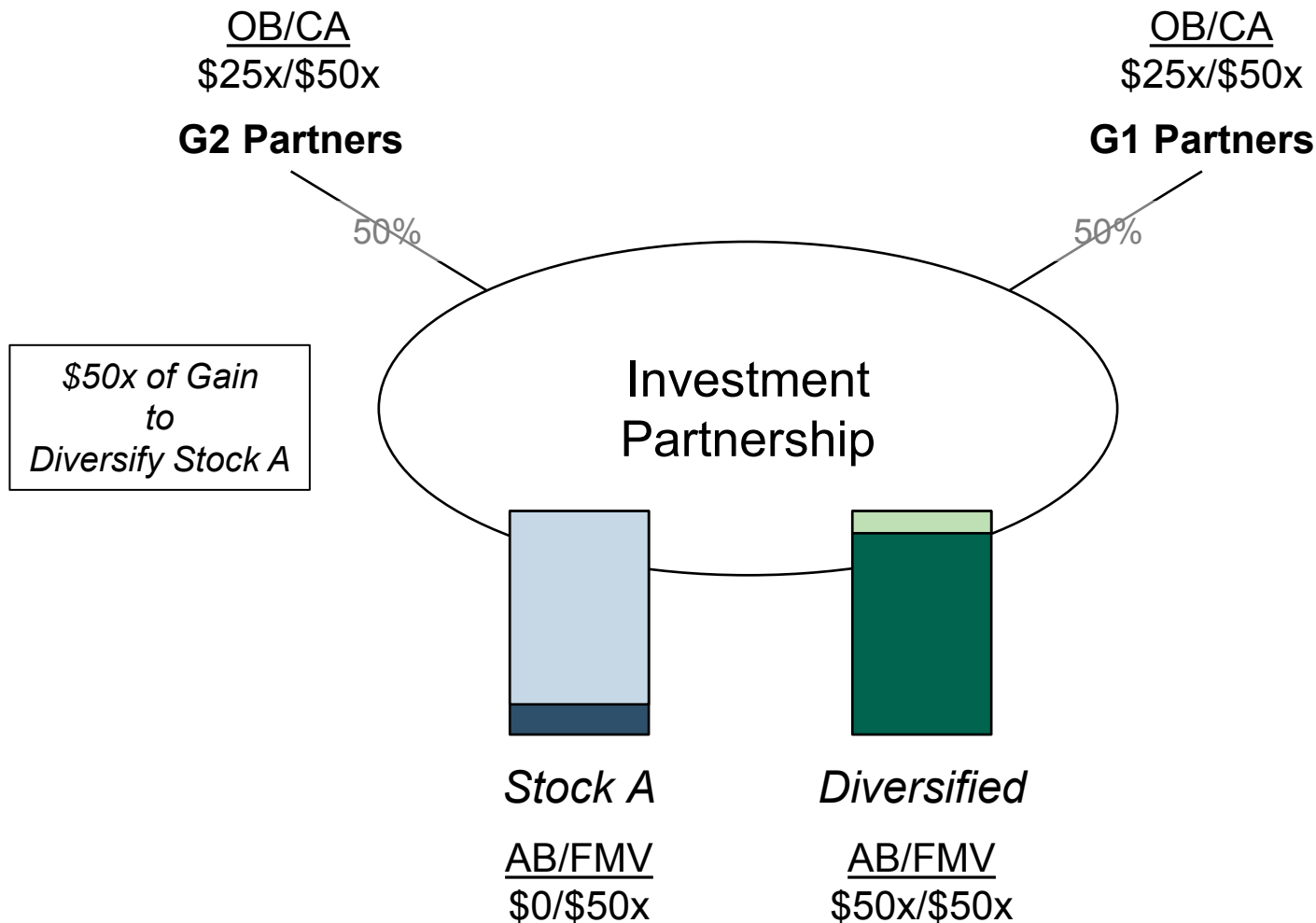
- All distributions to “eligible partners.”

“Mixing Bowl” and “Disguised Sale” Rules Do Not Apply

- All assets purchased by partnership or contributed more than 7-years ago

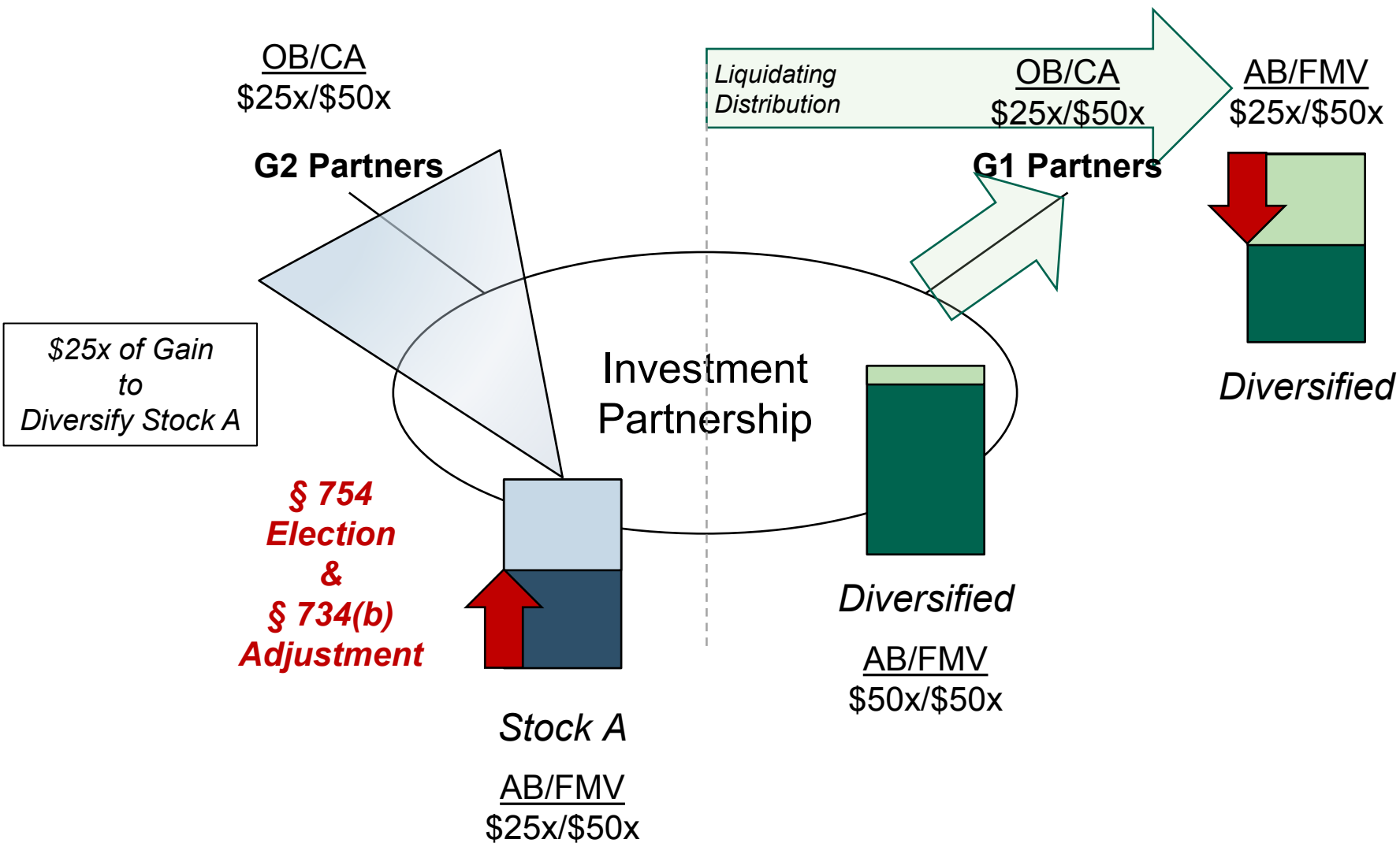


Basis Shift From Diversified to Concentrated



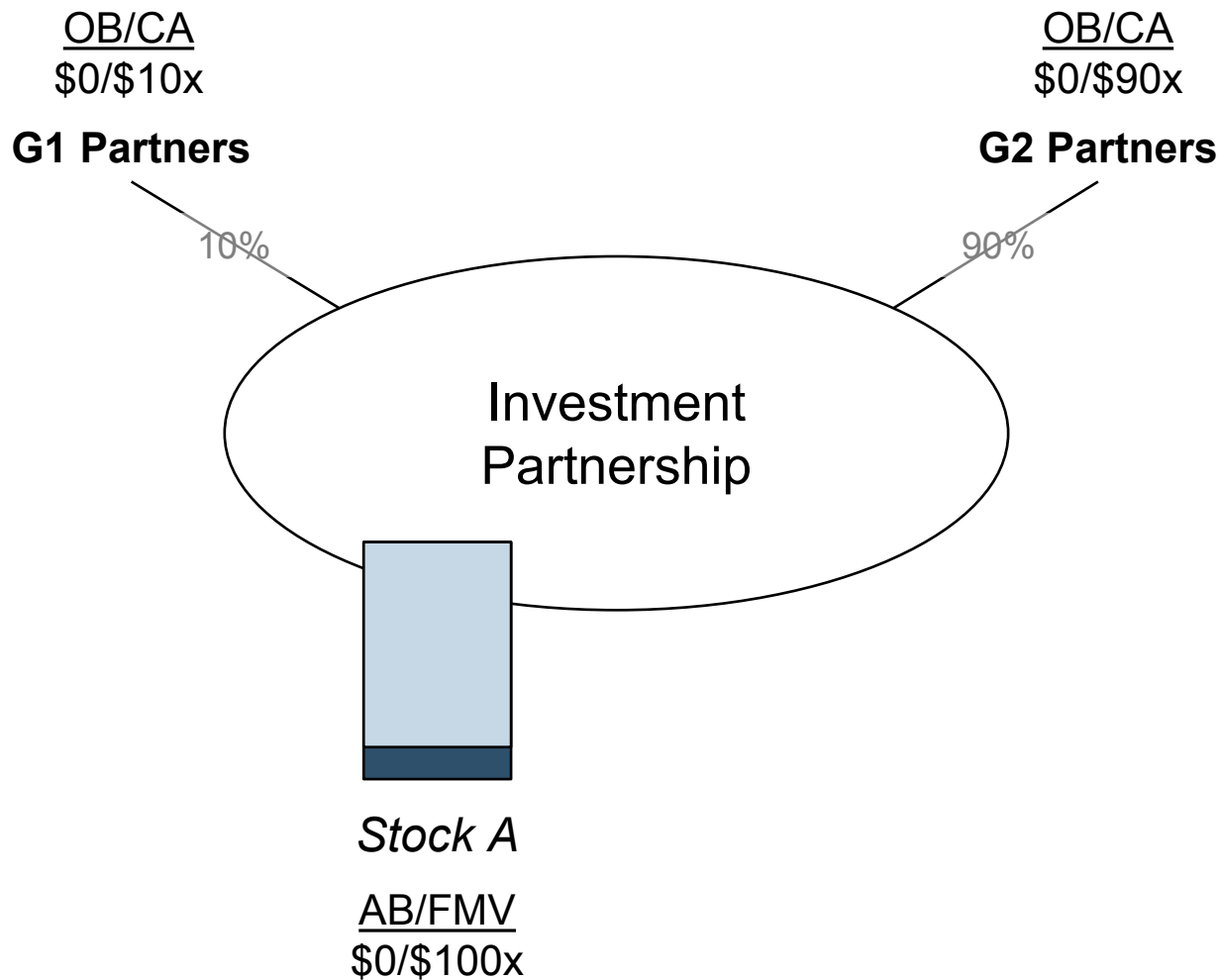


Basis Shift From Diversified to Concentrated



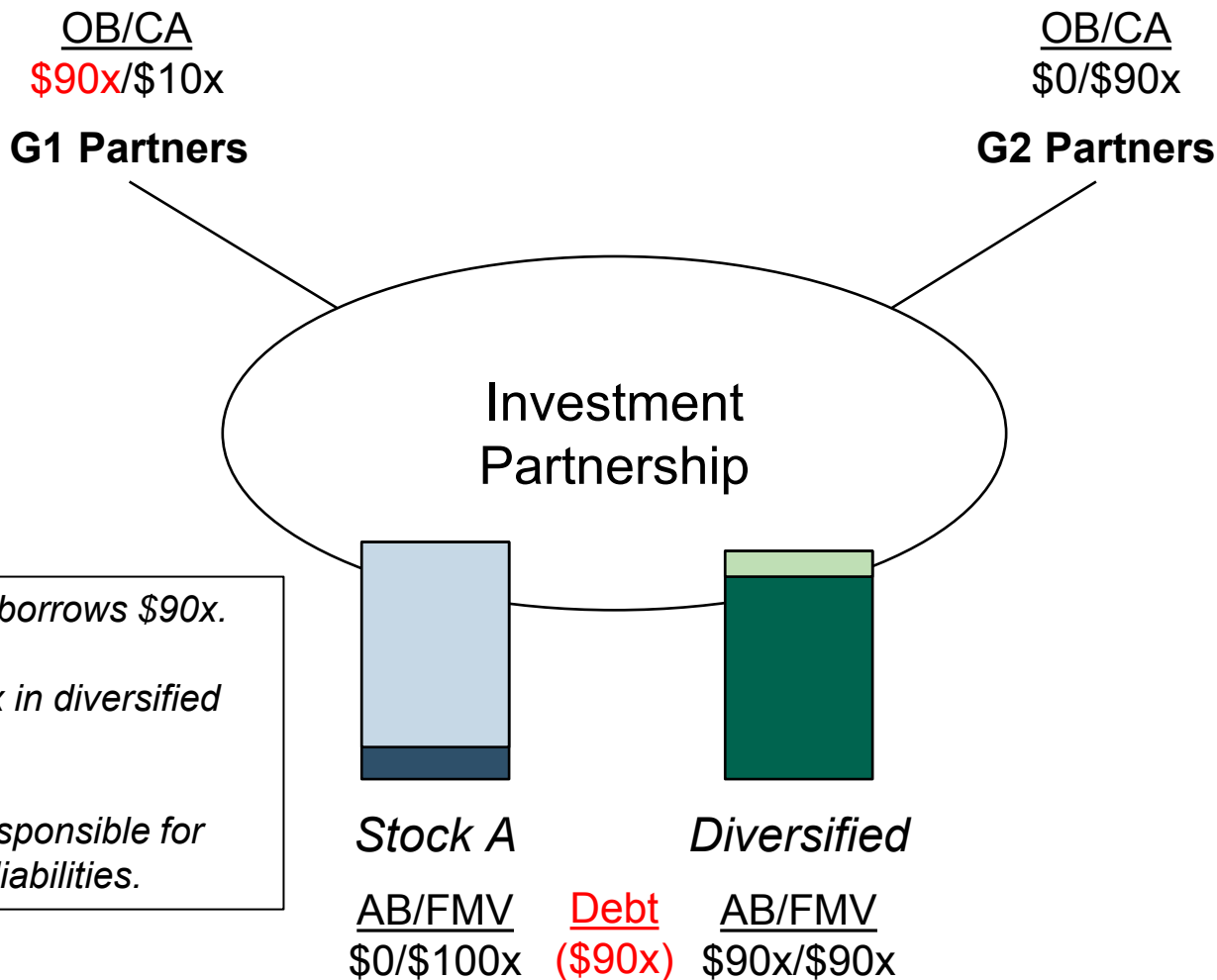


Debt to Exchange Concentrated for Diversified Position





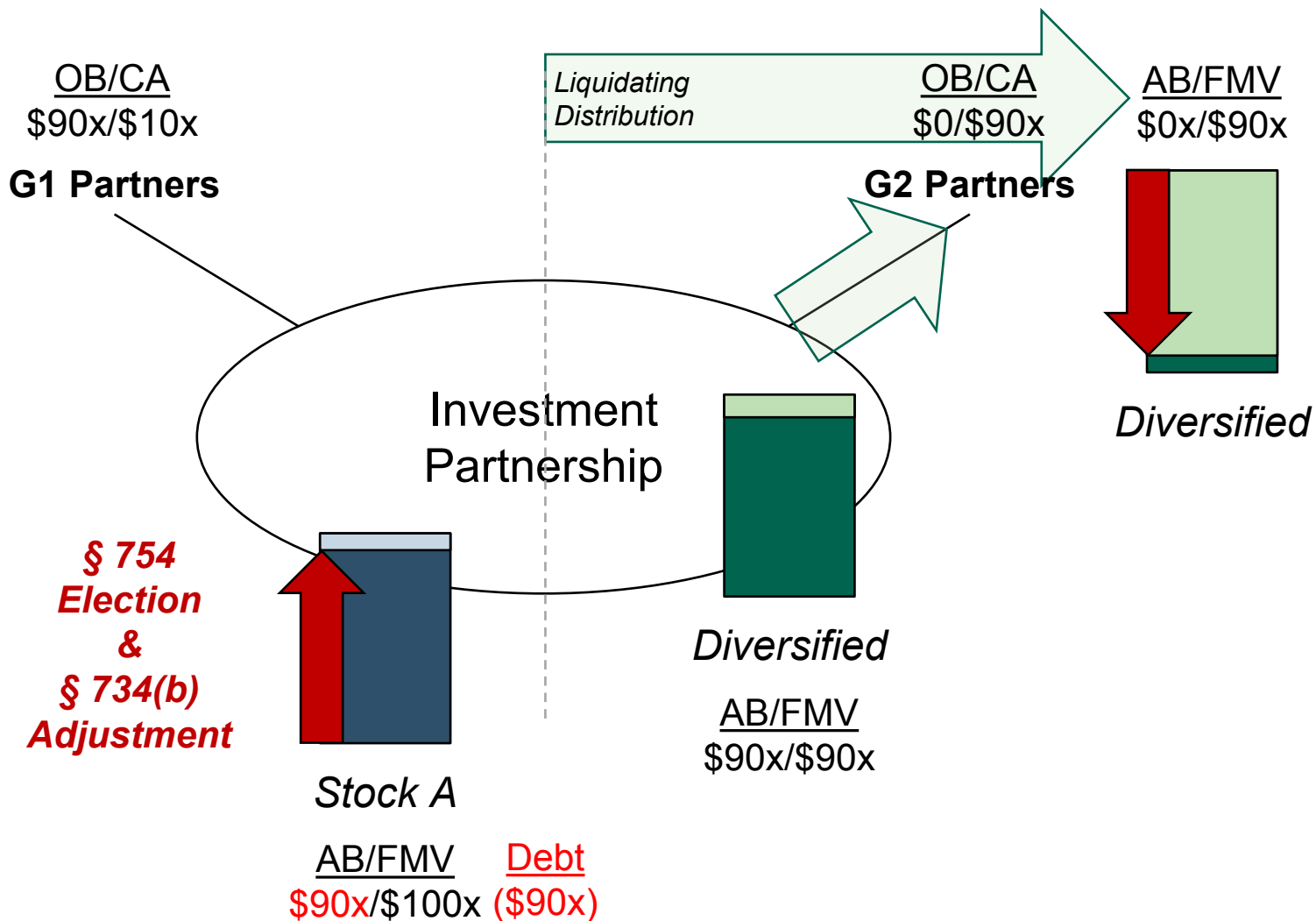
Debt to Exchange Concentrated for Diversified Position



1. Partnership borrows \$90x.
2. Invests \$90x in diversified portfolio.
3. G1 solely responsible for partnership liabilities.



Debt to Exchange Concentrated for Diversified Position

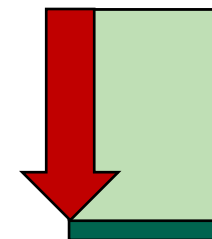
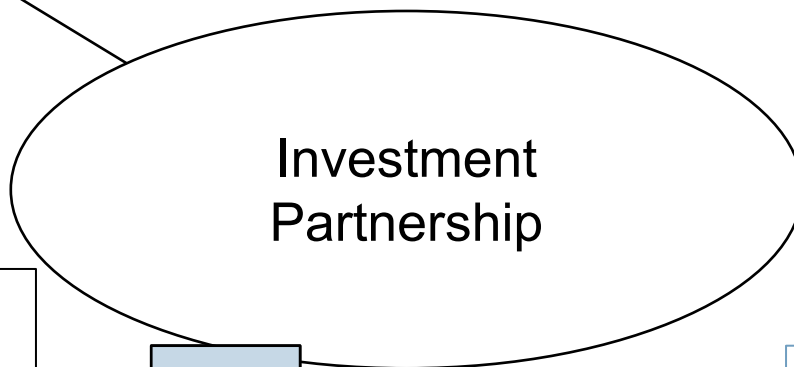




Debt to Exchange Concentrated for Diversified Position

OB/CA
\$9x/\$10x
G1 Partners

AB/FMV
\$0x/\$90x
Former G2 Partners



Diversified

1. Sells 90x of Stock A (\$81x of AB).
2. Recognizes \$9x of gain (+9x OB of G1=\$99x).
3. Repays \$90x to lender (-\$90x OB of G1=\$9x).

Stock A
AB/FMV
\$9x/\$10x

Isn't this just an exchange fund?
Can this be used with tangible personal property in lieu of a "like-kind" exchange?



Basis Shifting With Grantors And Grantor Trusts



Making a Trust a “Grantor Trust” as to Another Trust?

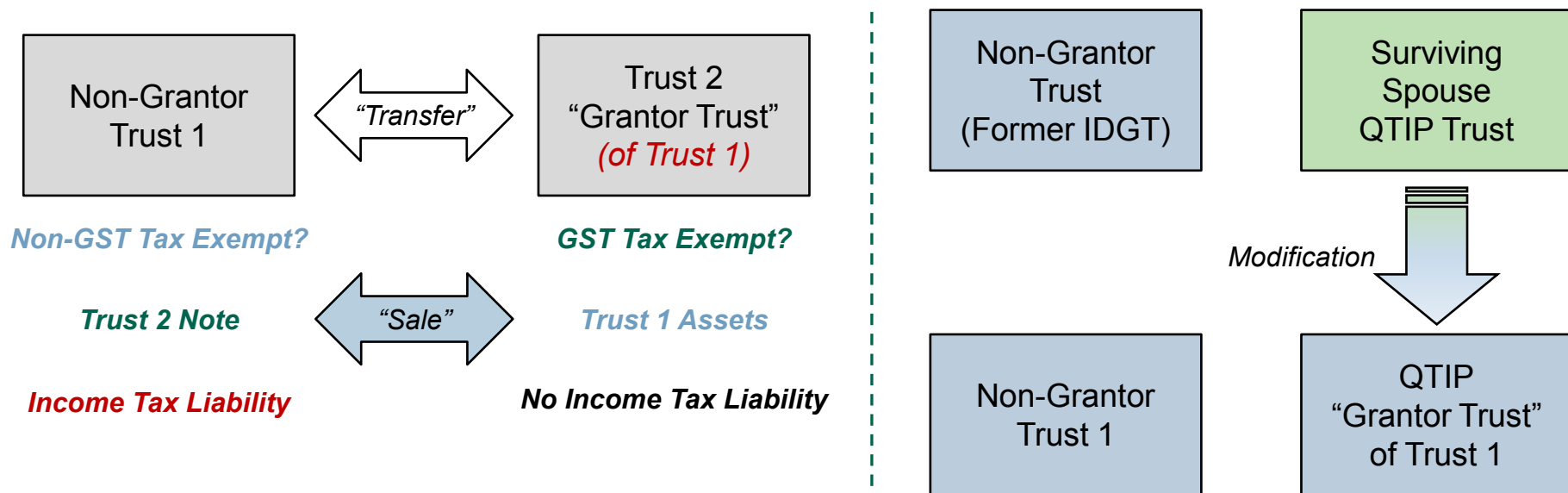
■ PLR 201633021

◆ Trust 1

- ▶ Grantor deceased.
- ▶ F/B/O children, spouse, and issue.
- ▶ Trustee proposes to transfer assets to Trust 2.

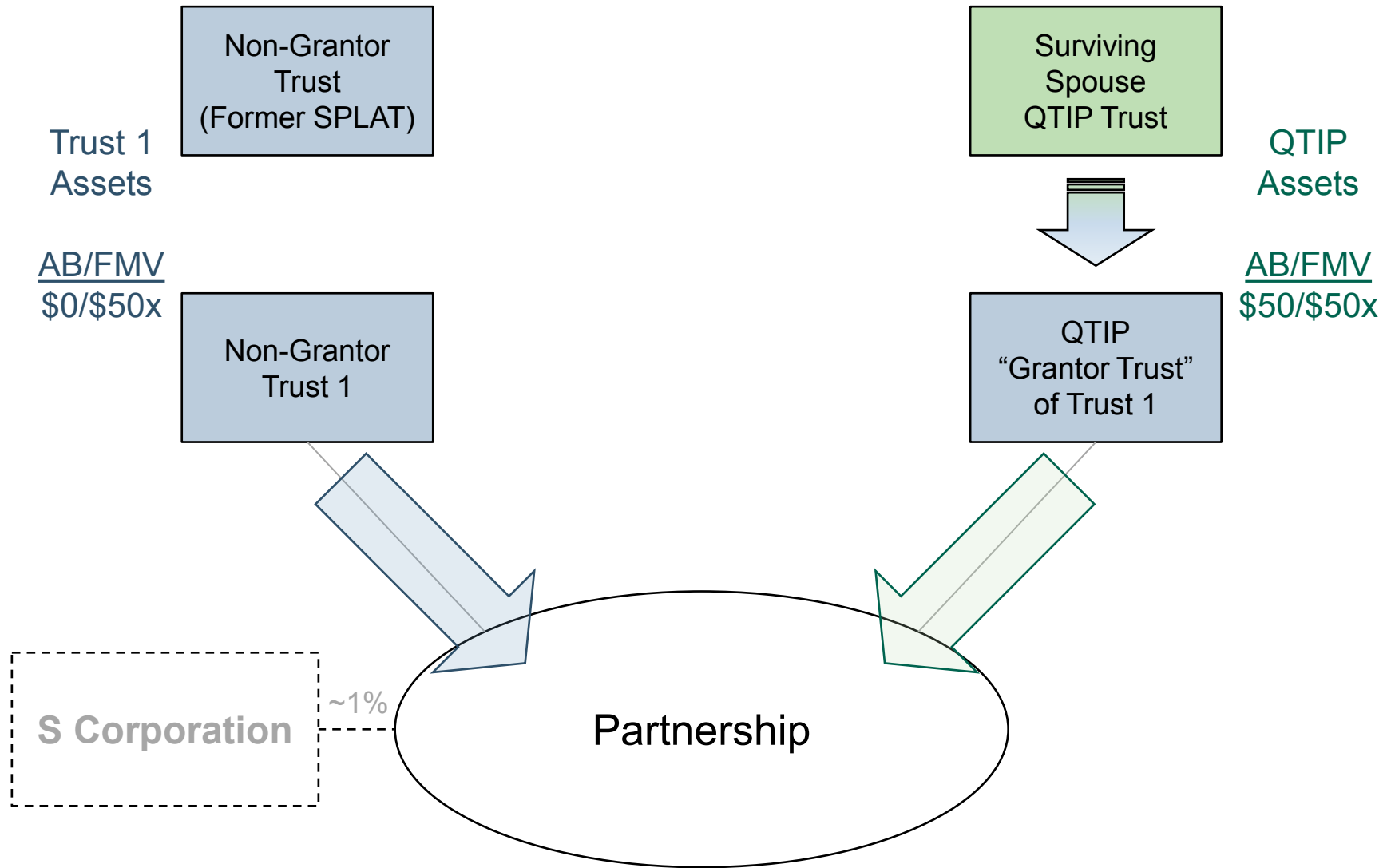
◆ Trust 2

- ▶ F/B/O children, spouse, and issue.
- ▶ Trust 1 retains sole power to revest net income of Trust 2.
- ▶ Lapses on the last day of the calendar year.
- ▶ “Net income” includes income under § 643(b) and capital gain.



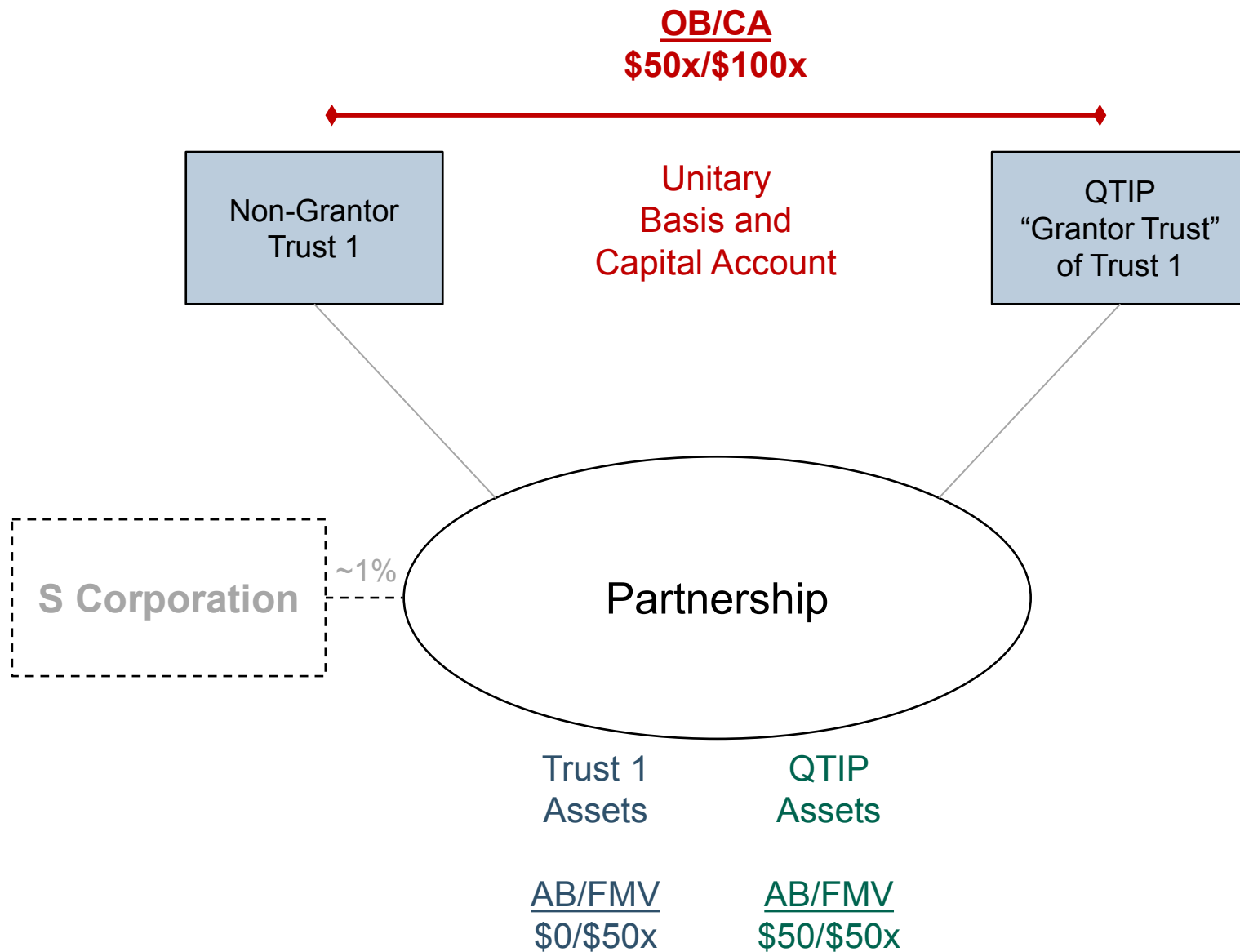


Sharing Basis Between Non-Grantor Trusts



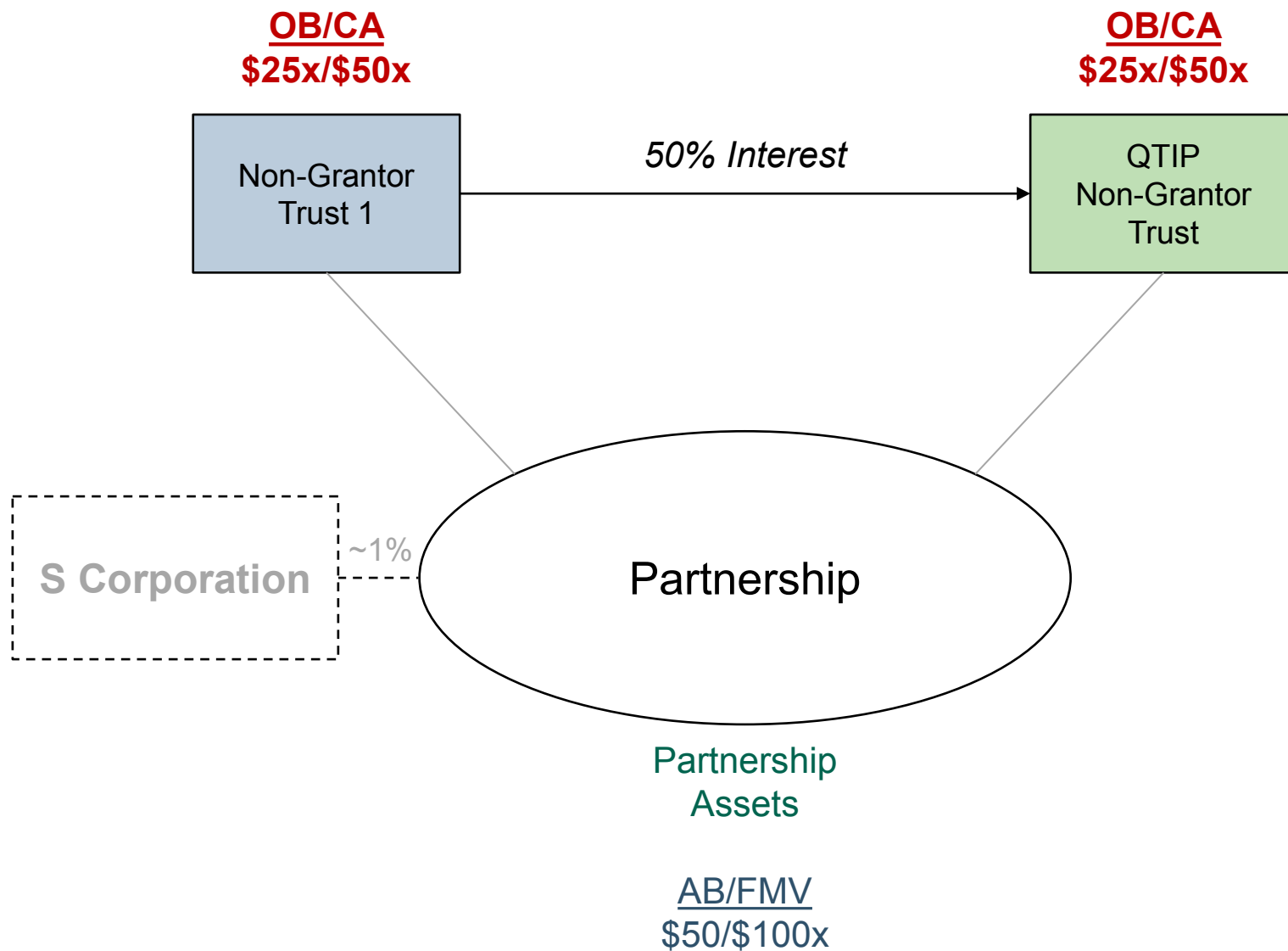


Sharing Basis Between Non-Grantor Trusts



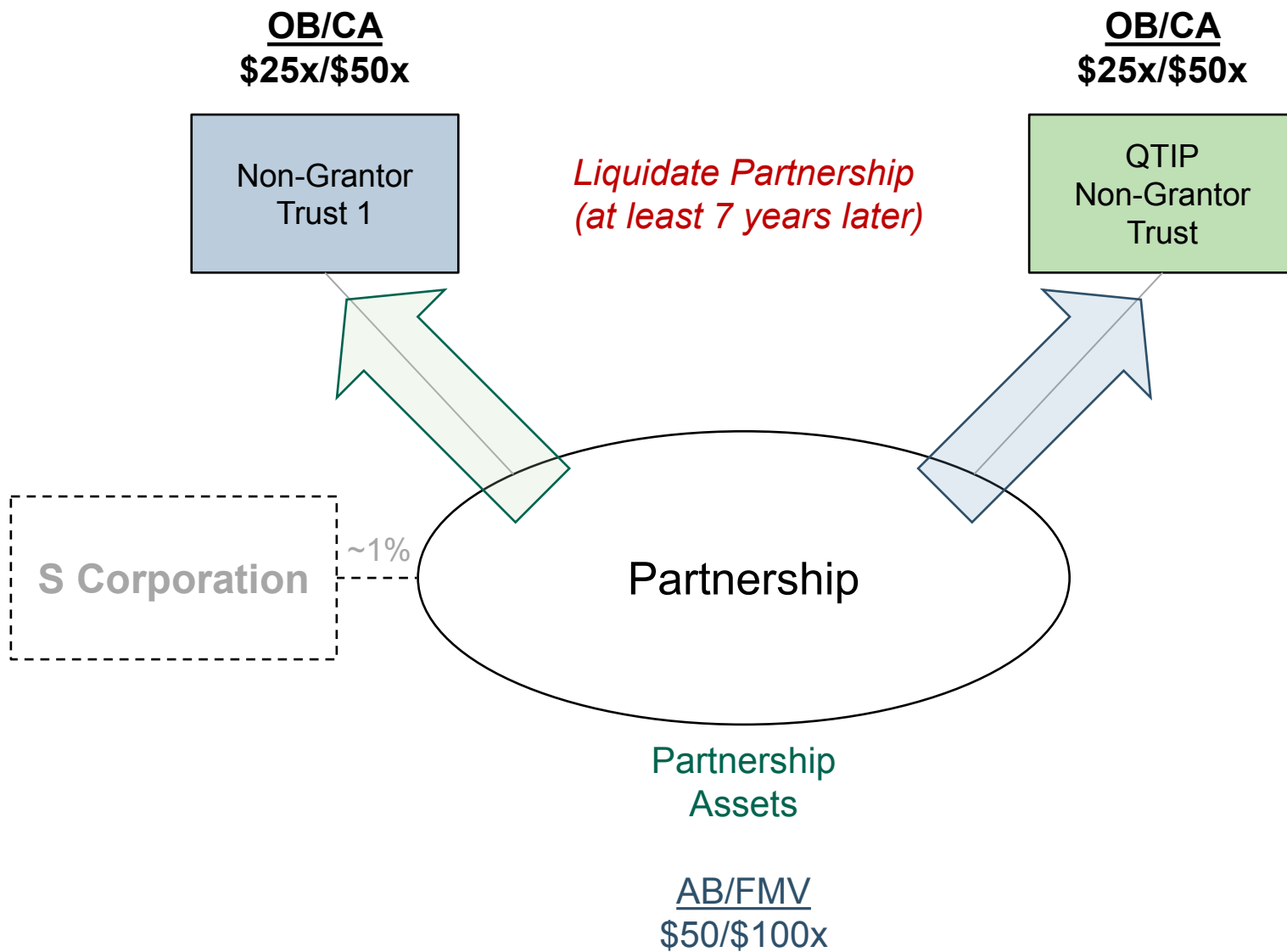


Sharing Basis Between Non-Grantor Trusts





Sharing Basis Between Non-Grantor Trusts





Sharing Basis Between Non-Grantor Trusts

Non-Grantor
Trust 1

Trust 1
Assets

AB/FMV
\$25/\$50x

QTIP
Non-Grantor
Trust

QTIP
Assets

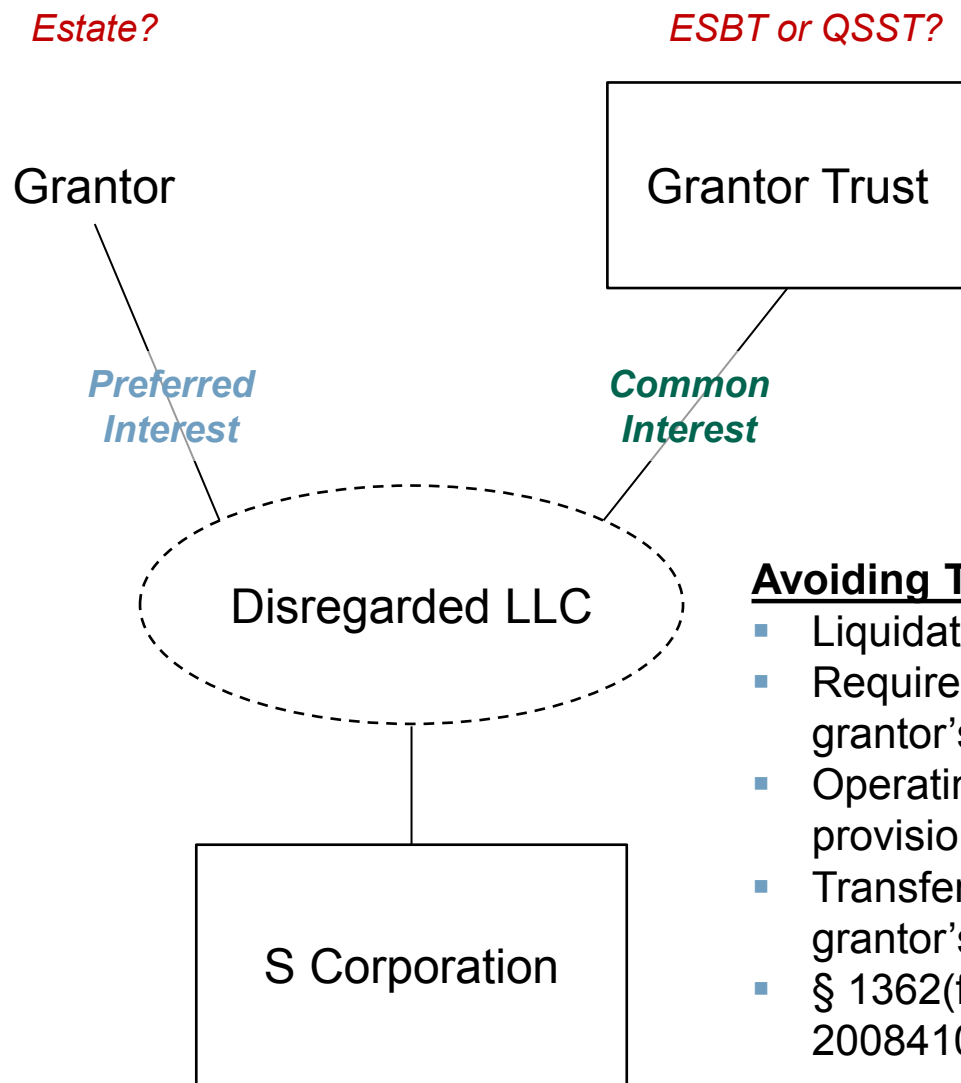
AB/FMV
\$25/\$50x



Disregarded Entities



Preferred Freeze with S Corporation: Disregarded Entities



Avoiding Termination of S Election

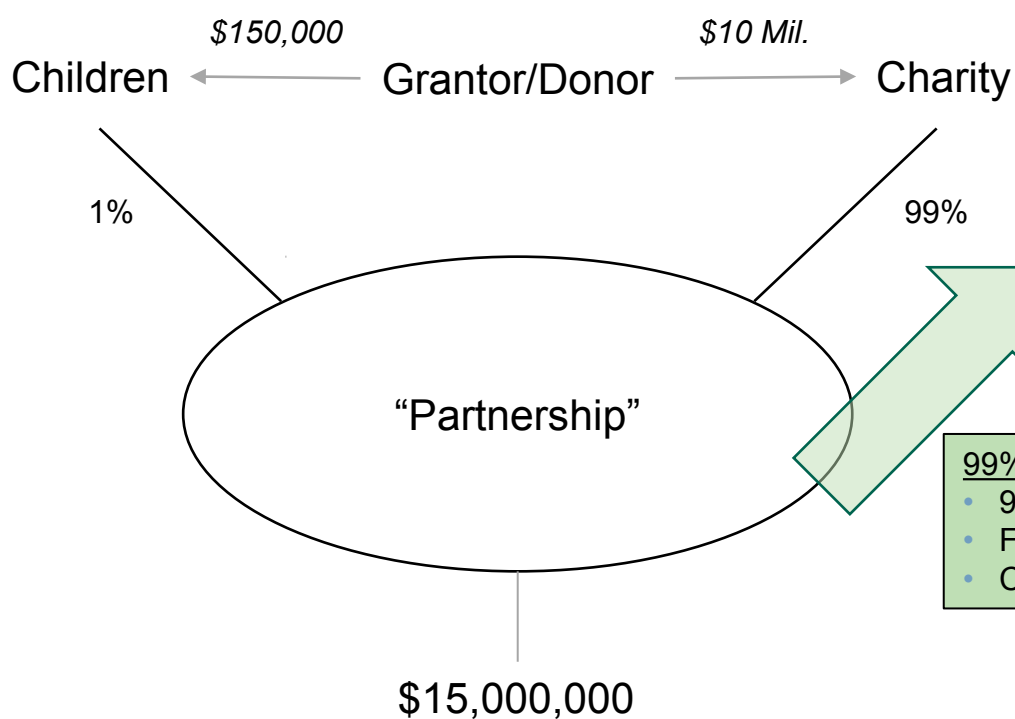
- Liquidation of LLC before grantor's death
- Required liquidation/termination of LLC at grantor's death
- Operating agreement "Transfer On Death" provision to trust
- Transfer provision in revocable trust of grantor's interest to trust
- § 1362(f) relief (PLRs 20173002 & 200841007)



Charitable Planning with Partnerships



Charitable FLP Redemption



Form 8282 (Donee Information Return)

- Disposition of nonmarketable asset
- Within 3 years of contribution
- Filed within 125 days

99% Limited Partnership

- 99% of Tax Items
- FMV upon redemption (\$10 Mil.)
- Children retain Partnership (\$5 Mil.)

2001 EO CPE: G (Control and Power : Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions)

- “[T]his year’s favorite charity scam superseding the charitable split-dollar transaction”
- “Key point is control” by the donor
- Sale of appreciated asset and keeping partnership through term of 40 years
- Partnership has right to sell property to donor or family at a specified price (like a put option)
- Depending on facts, it may “cross over into the area of clear tax abuse”
- Identified issues: private inurement & benefit, § 511 (Unrelated Business Income), § 4958 (Excess Benefit Transaction)
- If private foundation, § 4941 (Self-Dealing), and § 4943 (Excess Business Holdings)

Planning Considerations

- Transfer GP interest to family trust contemporaneously or soon after contribution to charity
- Distribute net income annually
- Allow charity to sell LP interest (if can find a buyer)
- Do not grant an option to charity
- Do not sell property to donor or donor’s family
- No compensation to GP



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