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Things That Go Bump in the Night for Family Office Estate Planners: But in the Light of Day... They're Still Scary!

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Tips to Chase Away the Tax Boogie Man



Current Estate “Snapshot” – Dry Run

- Review/summary of plan, trusts, entities
 - “Dual hats” fresh evaluation post-Levine
- “Family Map” illustration
- Identify areas requiring immediate attention for “Stress Testing” and/or Fortification
- Promissory Notes – administration and challenges
- Flow-chart illustration – first death, second death summary
 - Flow of assets upon a “triggering event” into different “buckets”
 - Buy-outs (mandatory vs optional)
 - Valuation “mismatch” and/or funding concerns
- Establishing “spending protocol” out of different trusts/vehicles

Don't Forget to Read The Owner's Manual (and The Fine Print!) For Your Sophisticated Estate Planning Vehicle

- Like a high-end sports car, sophisticated estate planning vehicles can be quite powerful but can also be quite temperamental and require lots of attention.
- It is critical that the owner/client reads the owner's manual, and importantly the fine print, in order to avoid potentially severe complications from failing to operate the vehicle correctly.
- A number of complications that can arise as a result of the failure to properly operate and/or structure popular estate planning vehicles, including Family Limited Partnerships, GRATs, Sales to Defective Grantor Trusts, Preferred Partnerships, Buy-Sell Agreements and Carried Interest Transfer structures.
- Best practices in the operation and routine maintenance of a sophisticated vehicle can go a long way to preserve it properly.
- Caveat – there are a number of potholes in the road that can potentially damage even the most finely tuned vehicle, so defensive driving tips are always helpful.

How safe an estate planning “golf shot” do you have?

- Various techniques are like golf shots.
- While the tax savings can potentially be significant with certain techniques — *they are only successful if the shot goes as planned (and does not land in a “tax hazard”)*.
- Which estate planning “shot” to take depends on how aggressive or conservative the client wants to be, their appetite for uncertainty and risk (*and how good a “shot” they, and their advisors, have*).
- *Very often clients do not fully appreciate whether their structure is a “fairway shot” or a “risky shot” as they’ve only been sold on the planning advantages but not the nuances, risks, and where their transaction lies on the risk-reward continuum.*

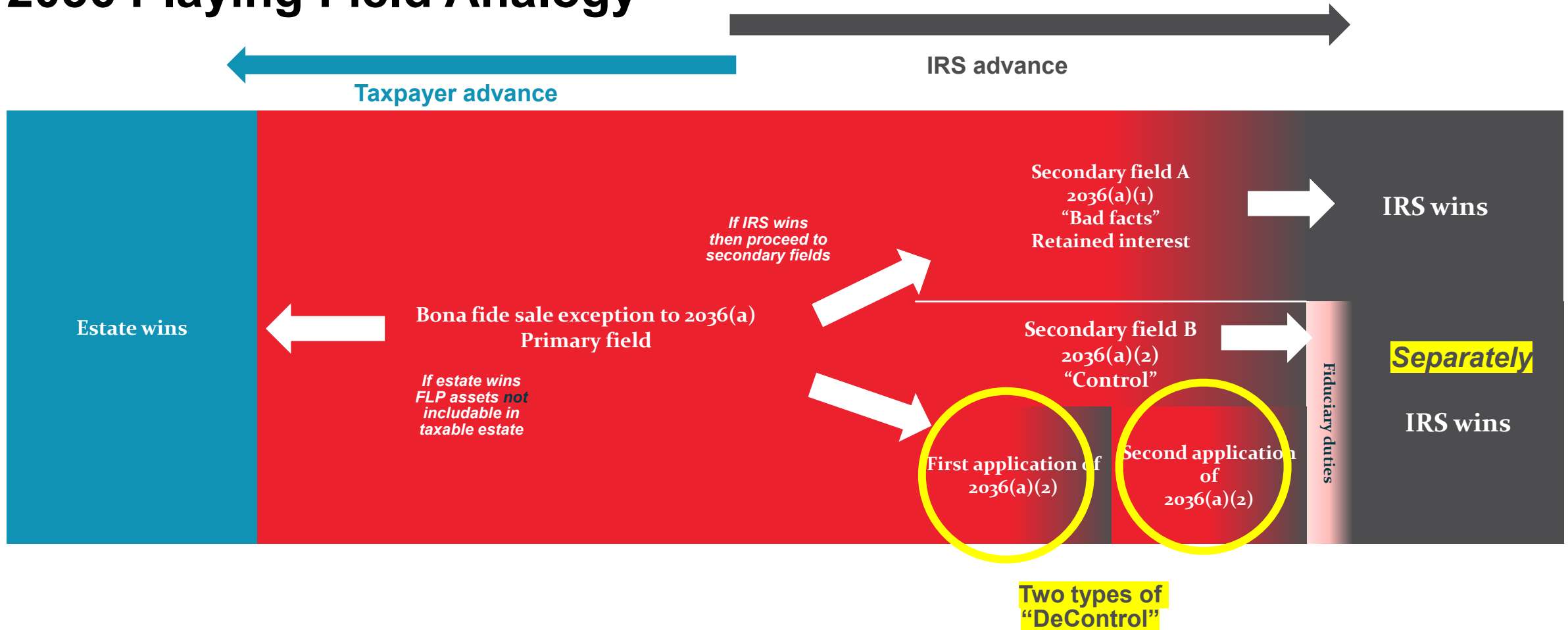


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Lifetime Diagnostic Stress Test of an FLP



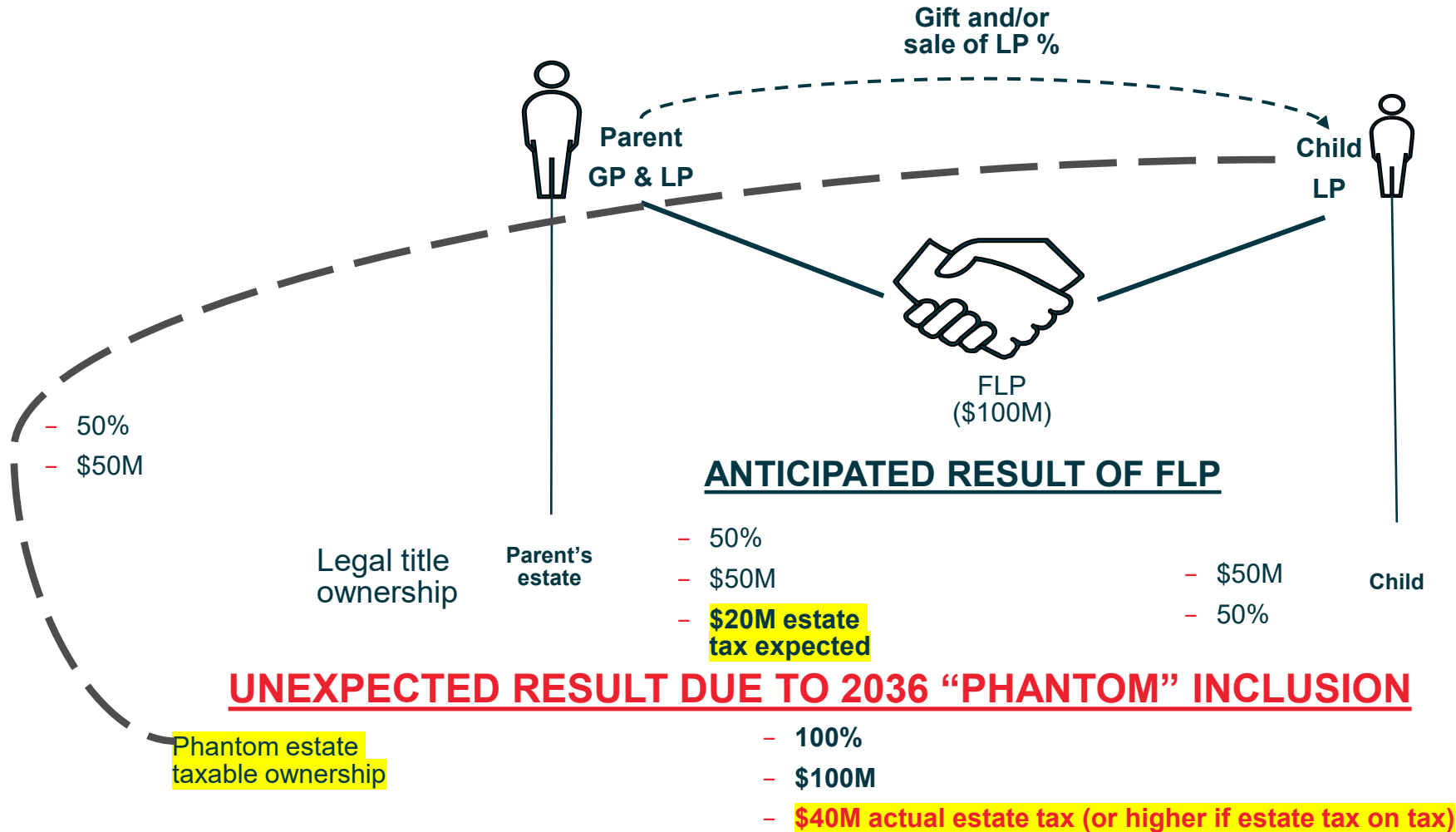
2036 Playing Field Analogy



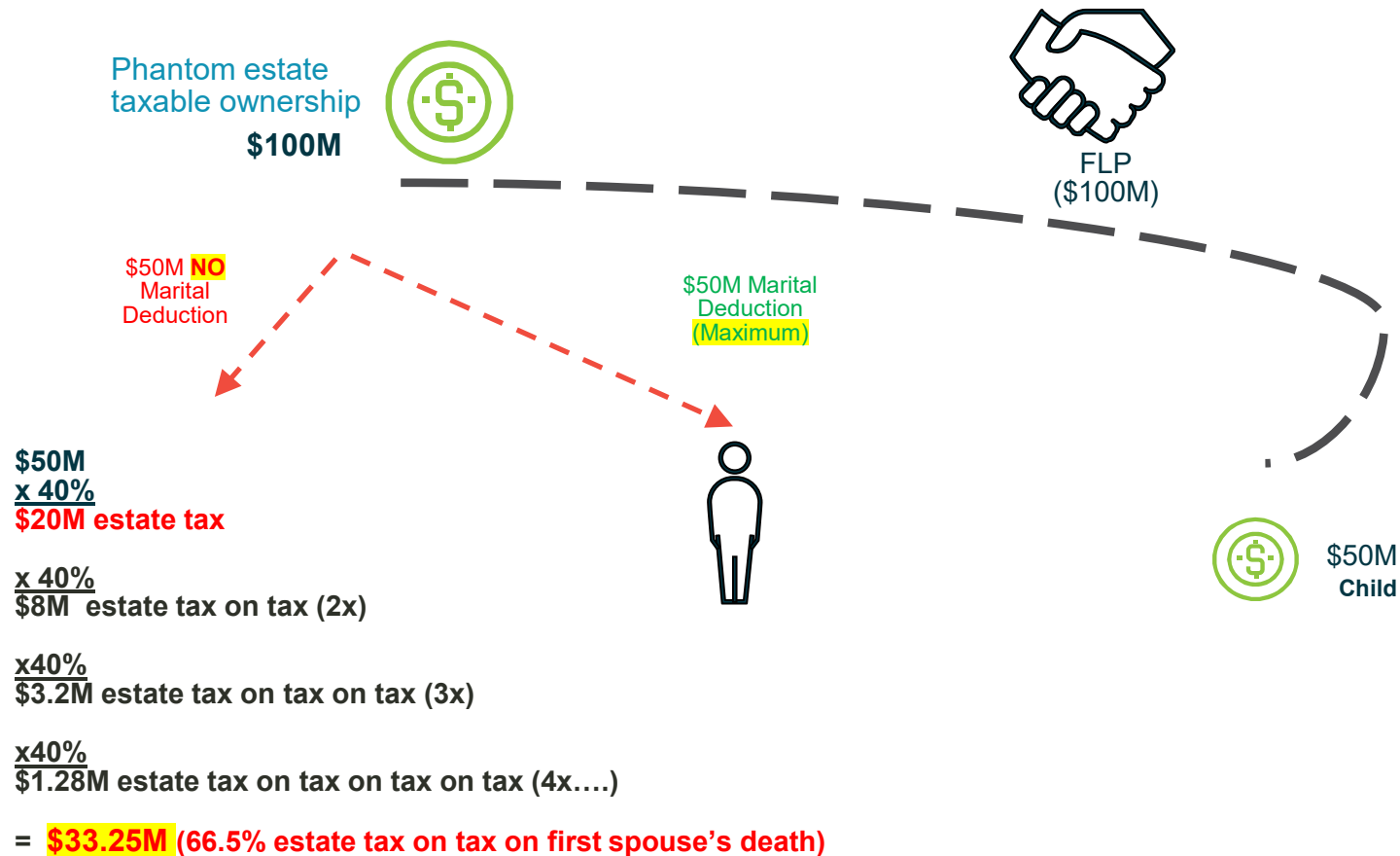
Three Critical Questions In Diagnostic Test

- **Question 1** – What was non-tax reason for establishing FLP?
 - Did the transferor(s) have a legitimate/significant business or a non-tax purpose for forming the FLP and receive interests proportionate to fair market value of property? *Bona fide* sale exception to § 2036
- **Question 2** – Is FLP being operated in furtherance of and consistent with stated objectives and in accordance with formalities?
 - Did the transferor(s) retain express or implied possession, enjoyment or right to income from property despite the transfer to FLP? § 2036(a)(1)
- **Question 3** – Does senior family member have “Control” over the FLP?
 - Did the transferor retain rights, either alone or in conjunction with any person, to designate persons who shall possess or enjoy the transferred property or the income therefrom? § 2036(a)(2)

Beware of Phantom Estate Tax “Retained Strings” Infection



Estate Tax Circular Whirlpool Caused by Marital Deduction Mis-match from Phantom Estate Tax Inclusion



Chapter 14 – “Hogwarts” Mystical Rules



City of London – “Muggle World”
“Have I got a great idea for you!”
“What could possibly go wrong?”



Chapter 14 Sweeping & Navigating the Minefield

- Preferred Partnerships/LLC (2701 deemed gift on formation or on gift of common)
- Family Limited Partnerships (2703, 2704)
- Capital Contributions – recapitalizations and changes in capital structure (2701)
- Buy-Sell and Shareholder Agreements (2703)
- Multigenerational Split Dollar (2703)
- Carried Interest Transfer Planning (2701)
- Derivatives/Options (2703)
- Profits Interests (2701)
- GRATs/QPRTs/Sales of Remainder Interests (2702)
- Sales to Grantor Trusts (2701, 2702)
- Valuation Issues (2704) (2702 – GRAT CCA)
- Joint Purchases (2702)
- SPACs (2701)

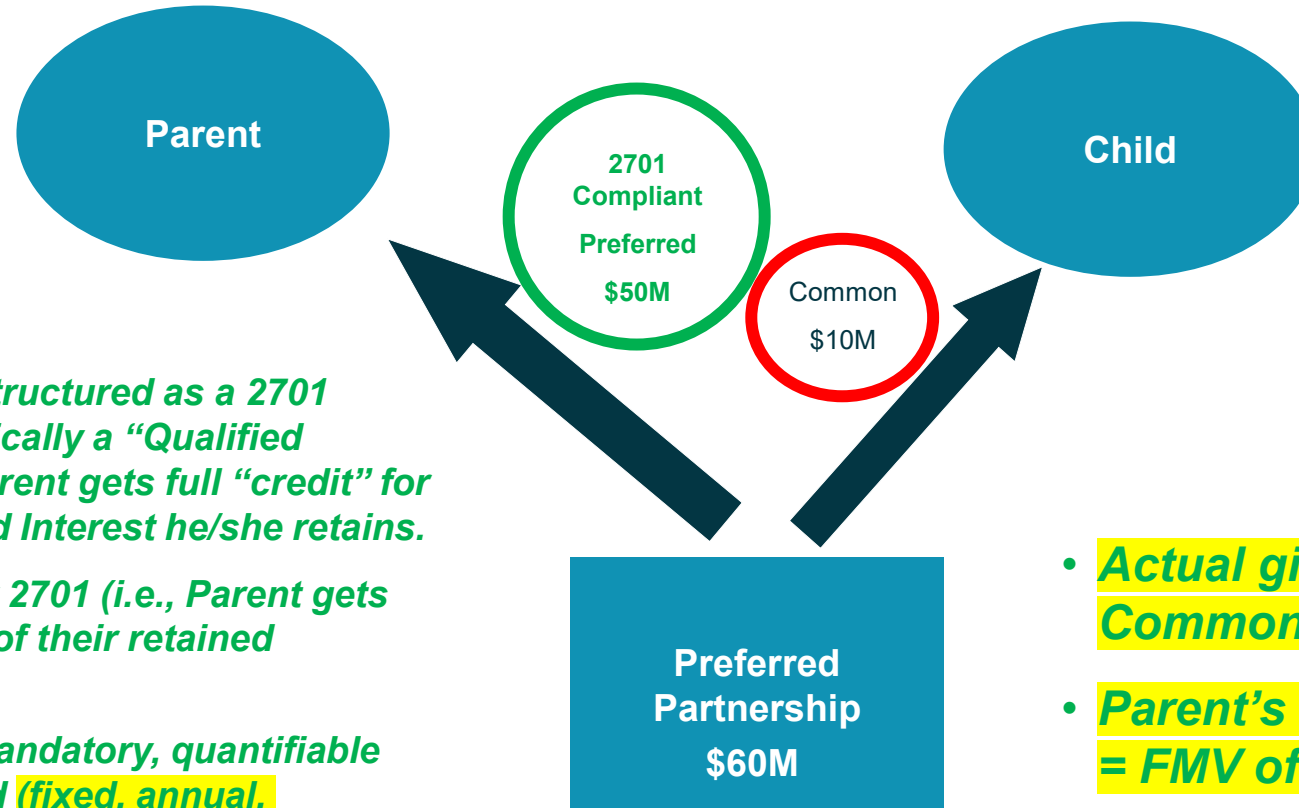


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Preferred Partnerships/LLCs



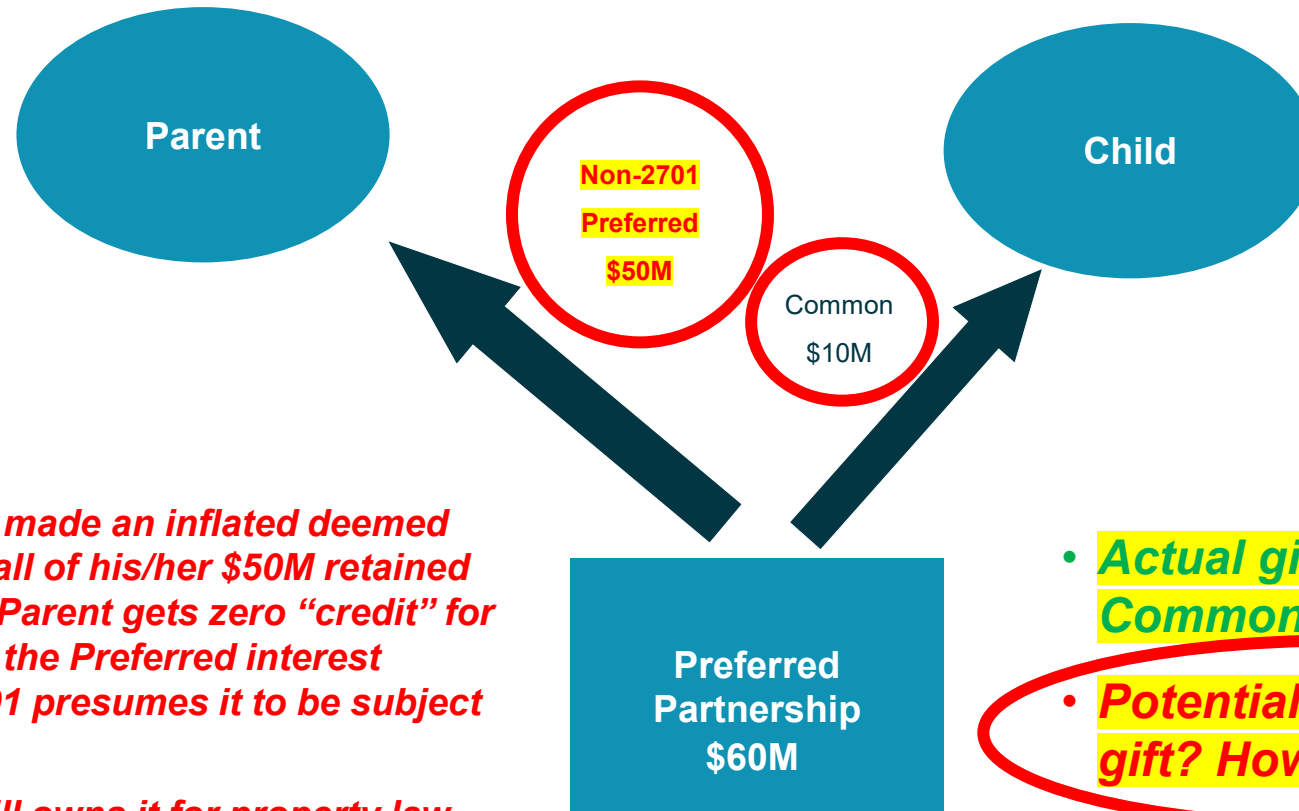
2701 Compliant - Preferred Partnership



- *If Parent's Preferred is structured as a 2701 compliant preferred (typically a "Qualified Payment Right") then Parent gets full "credit" for the value of the Preferred Interest he/she retains.*
- *So no deemed gift under 2701 (i.e., Parent gets full "credit" for the FMV of their retained Preferred Interest.*
- *A QPR is essentially a mandatory, quantifiable and cumulative preferred (fixed, annual, cumulative preferred)*

- **Actual gift = \$10M Common**
- **Parent's retained interest = FMV of QPR = \$50M**
- **Deemed gift = \$0**

“Bad” (pre-1990 styled) “Discretionary” Preferred Partnership – Violates 2701 = Deemed Inflated Gift



- Risk is that Parent has made an inflated deemed gift of some or maybe all of his/her \$50M retained preferred interest. i.e., Parent gets zero “credit” for certain components of the Preferred interest retained – because 2701 presumes it to be subject to manipulation.
- Even though Parent still owns it for property law purposes.

• Actual gift = \$10M
Common

• Potential 2701 Deemed gift? How much?



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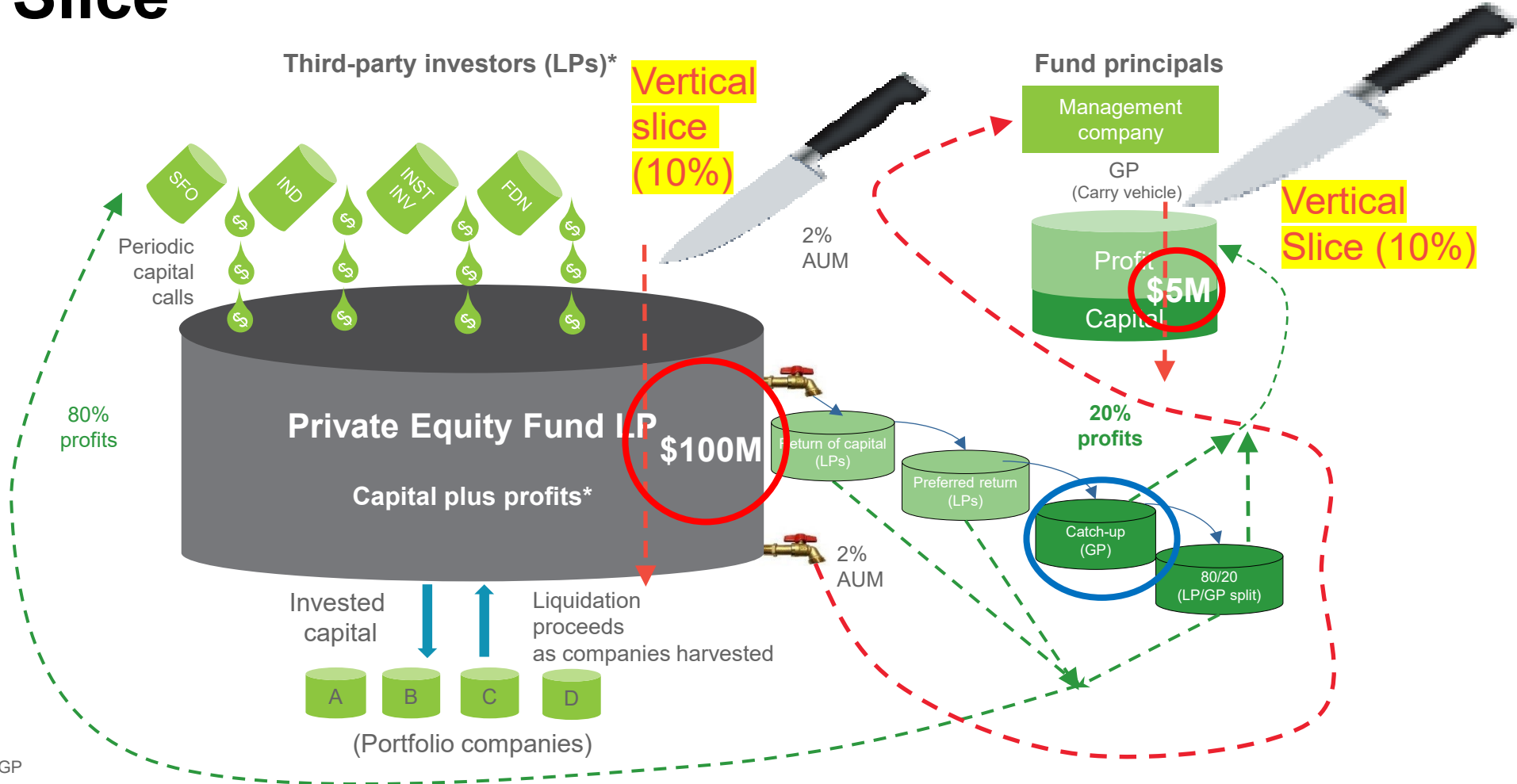
Carried Interest Estate Planning

IRC Section 2701 and the “Vertical Slice”

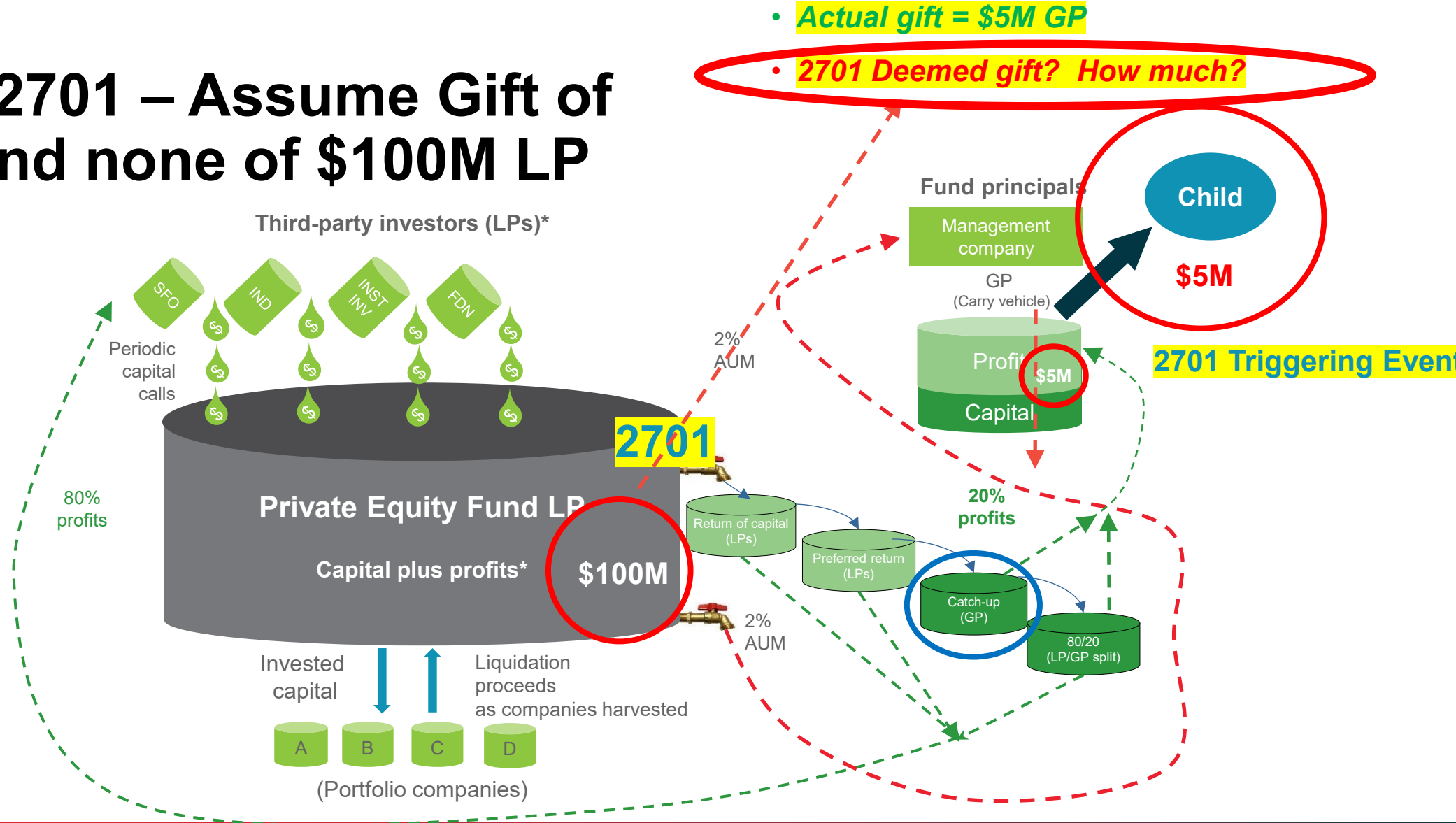


Vertical Slice

- **Actual gift = 10% of \$5M GP = \$500k**
- **Actual gift = 10% of \$100M LP = \$10M**
- **Total gift = \$10.5M**



If Violate 2701 – Assume Gift of \$5M GP and none of \$100M LP

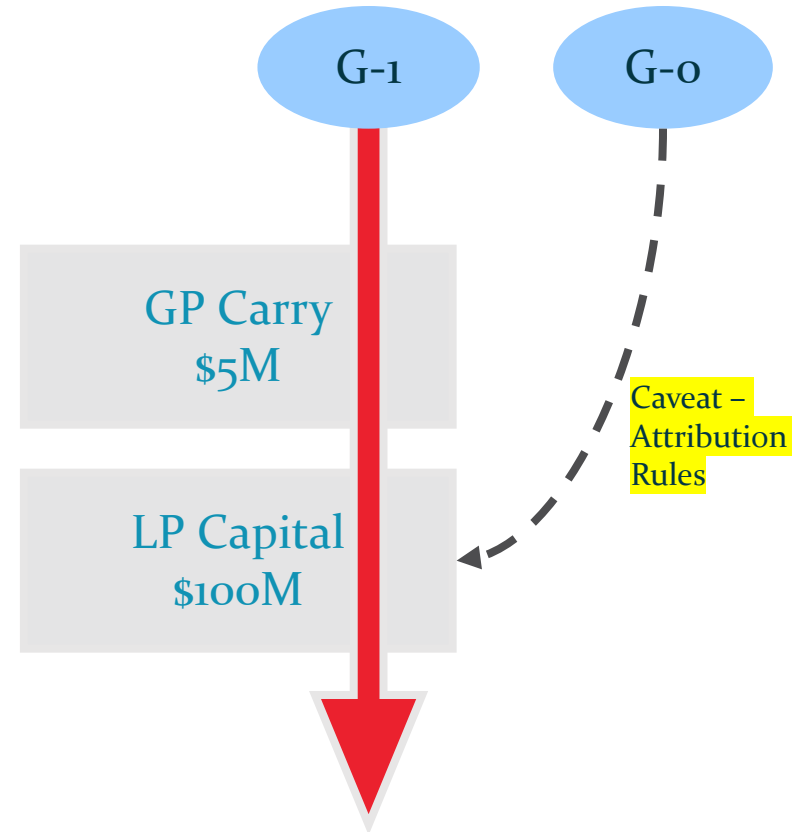


*including capital from GP

Limitations on Vertical Slice Planning

Example

- If Parent makes a Vertical Slice gift of 50% of his \$5M GP interest (= \$2.5M), he/she must also make a proportional gift of 50% of \$100M LP capital (= \$50M). Total gift of \$52.5M x 40% gift tax rate = \$21M gift tax liability.
- This can be too restrictive when a partner has significant LP capital invested in the Fund.
- So often limited to gifting a smaller percentage vertical slice than desired.
- Consider other “Non-Vertical” Approaches



IRS Attorney View on Value of Carried Interest

- On January 25, Clifford Warren of IRS Office of Associate Chief Counsel at USC Tax Institute clarified the IRS position on the view that carried interest is “worth zero” for gift tax purposes
- Rev. Proc. 93-27 treats issuance of a profits interest not as an income taxable event, clarified that the same does not apply for transfer tax purposes
- “On the day you get that carry ... if that’s a percentage interest in a major private equity firm, that thing is going to be worth tens of millions of dollars, potentially”
- Warren noted that if you were to gift tax carry and take a view that it is worth zero under the Rev. Proc., “That’s a fight we would love to take”

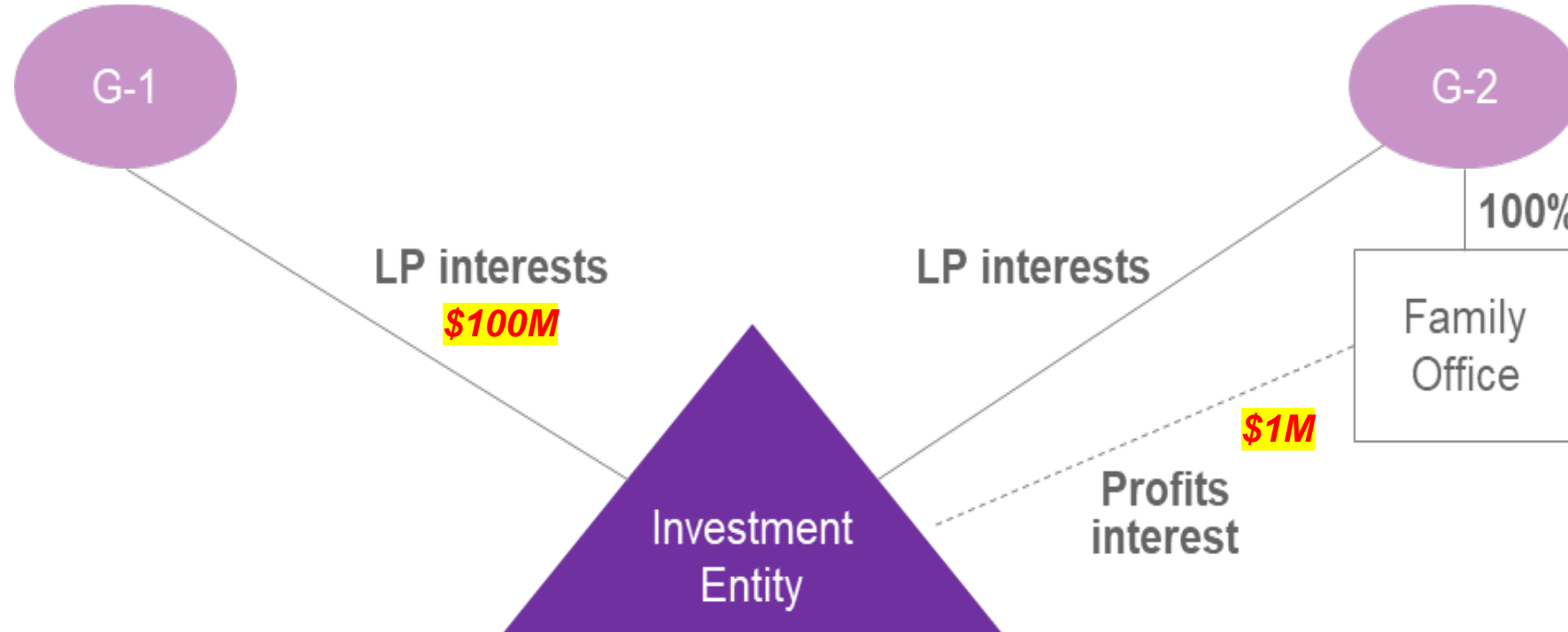


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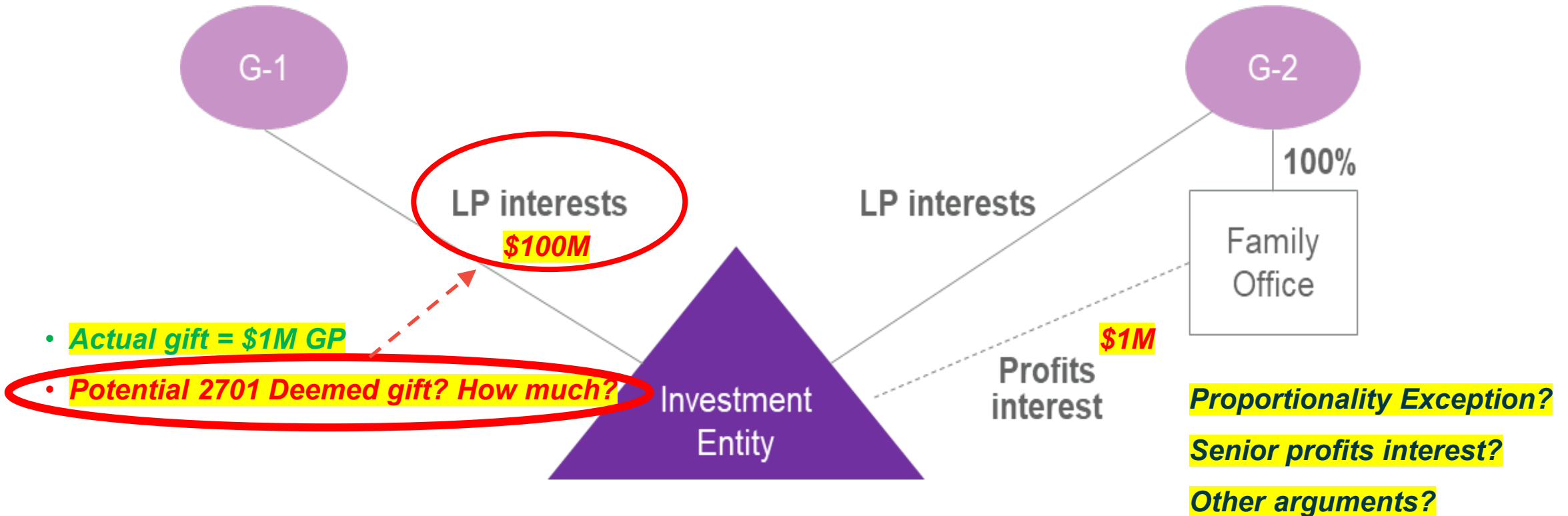
Unique Issues When Structuring Family Office Profits Interests Owned By Junior Family Members



Concern That Section 2701 Could Apply to Issuance of Subordinate Profits Interest to Younger Generation



Concern That Section 2701 Could Apply to Issuance of Subordinate Profits Interest to Younger Generation



Planning to Steer Clear of the Section 2701 “Fire”



2701 Compliant Planning:

- Vertical Slice
- QPR Preferred Partnership
 - FO owned by Gen 1
 - Non-Vertical Planning
- Other compliant structures
 - Proportionality
 - Retained Subordinate

To keep the “fire” far far away from the (estate planning) structure



In Case of a Section 2701 “Fire” – Break Glass Here (to Try to “*Contain The Fire*”)

Conventional Wisdom –

2701 burns the structure to the ground



2701 Subtraction Method of Valuation–

More Nuanced “Damage Mitigation” Analysis



IRS Theories to Challenge Promissory Notes

- Not true debt from inception based upon post-loan ignoring formalities
- Below market interest deemed gift
- Subsequent gift due to changed circumstances
- Recharacterization of Note as disguised gift in trust deemed gift under Section 2702
- Recharacterization of Note as disguised preferred equity deemed gift under Section 2701
- Recharacterization of Note as Section 2036 retained string
- Note was insufficient consideration due to valuation challenge so partial gift

Section 2701 and *Karmazin* – Note Recharacterization Argument

- Taxpayer created a partnership and sold LP interests to IDGT in exchange for promissory note. LP interests sold to trust were financed 100% by promissory note.
- IRS argued that promissory note was disguised equity, not debt.
- If promissory note is really equity and not debt, amount of taxable gift is value transferred minus value of qualified payment rights under the subtraction method of Section 2701.
- Since the promissory note did not constitute a qualified payment right under Section 2701 the argument was that parent should get “credit” of zero under the subtraction method of valuation.

* *Karmazin v. Comm’r*, T.C. Docket No. 2127-03 (settled).

Section 2701 and *Karmazin* – Note Recharacterization Argument

- While *Karmazin* was settled, the Section 2701 argument remains a threat.
- If IRS can argue that promissory note received in connection with gift/sale transaction to grantor trust is not true debt, but rather, disguised equity, and if common interests represented by LP interests are transferred to younger family members (or their trusts), the risk is that the IRS would argue that Section 2701 could value the promissory note at zero and would cause a deemed gift with respect to parent's retained interest.

* *Karmazin v. Comm'r*, T.C. Docket No. 2127-03 (settled).

Section 2702 and *Karmazin* and *Woelbing* Cases – Note Recharacterization

- IRS argued — sale of the LP interest by the taxpayer in exchange for note constituted a “transfer in trust” under Section 2702.
- Under Section 2702, a retained interest has no value unless it is a “qualified interest.”
- IRS argument that the promissory note did not constitute a qualified interest under Section 2702.

Section 2702 and *Karmazin* and *Woelbing* Cases – Note Recharacterization

- IRS argued that the LP interest sold should be recharacterized as a gift to the IDGT, in exchange for a retained interest valued at zero under Section 2702, resulting in a taxable gift of all LP interests sold.
- *Estate of Marian Woelbing* and *Estate of Donald Woelbing* — ultimately settled before trial.

* *Estate of Marian Woelbing* and *Estate of Donald Woelbing*, Docket Nos. 30260-13 and 30261-13, respectively (settled).

Woelbing Section 2036 Argument

- The conventional wisdom is that estate tax exposure in the case of an IDGT transaction should be limited to the value of the promissory note owned by the parent at his or her death; only the promissory note should be included in the gross estate.
- However, it is possible that the IRS may raise an argument that the promissory note itself constituted a retained interest in the sold assets causing those assets to be included in the parent's estate under Section 2036. In *Estate of Donald Woelbing*, the IRS raised the argument that the sold stock was included in the grantor's gross estate under Section 2036(a)(1) under the theory that the promissory note was a retained income interest in the sold stock. It would seem that such an argument would be highly facts-and circumstances-based.

Woelbing Section 2036 Argument

Under the holding of the *Fidelity-Philadelphia Trust Co. v. Smith* case, practitioners should be careful to structure the transaction so that the payments due under the note do not match the projected income generated by the sold assets. *Fidelity-Philadelphia Trust Co. v. Smith*, 78 S.Ct. 730:

- In the context of debt obligations, three-part test to avoid Section 2036: (i) promise must be a personal obligation of the transferee, (ii) obligation must not be specifically chargeable to transferred property, and (iii) size of payments must not be determined by the income generated by the transferred property



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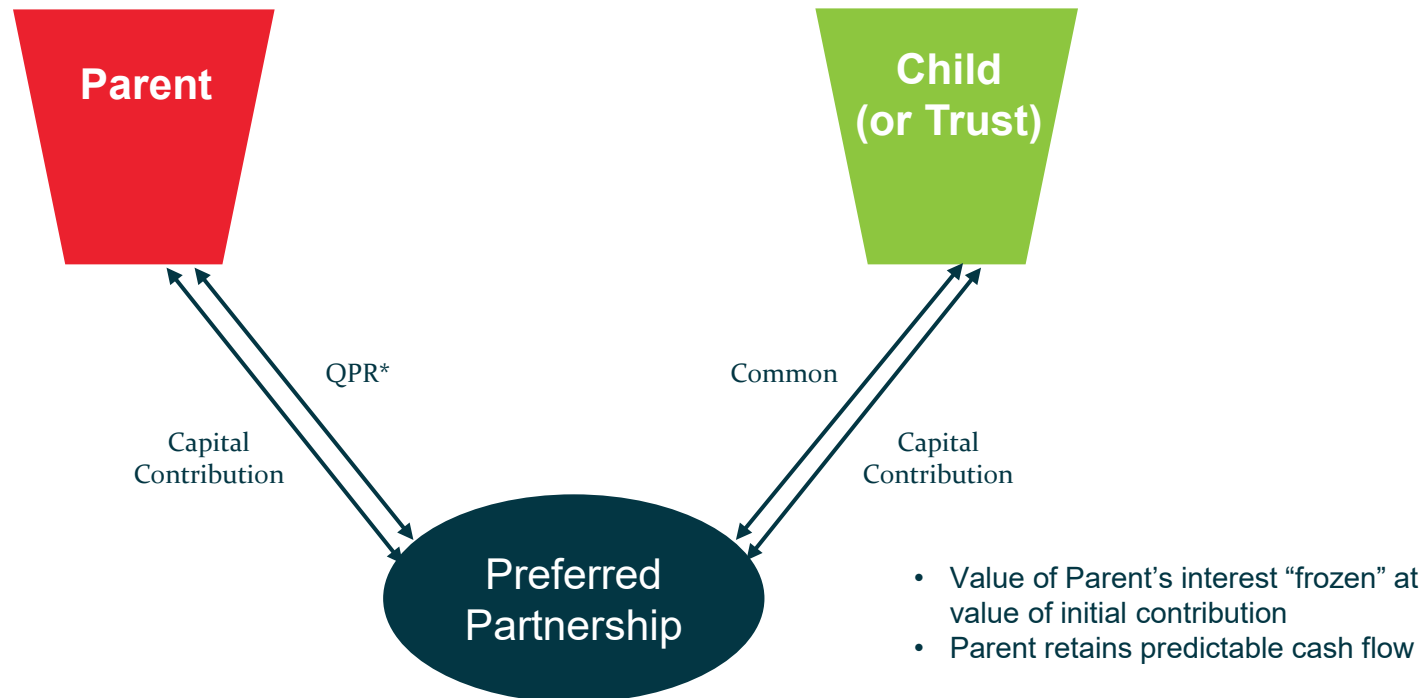
It's Not All Scary...

**“Adding Octane” to Family
Structures for Multigenerational
Wealth Preservation**



Pro-Active Planning with Section 2701 Compliant Entities

Basic Preferred Partnership

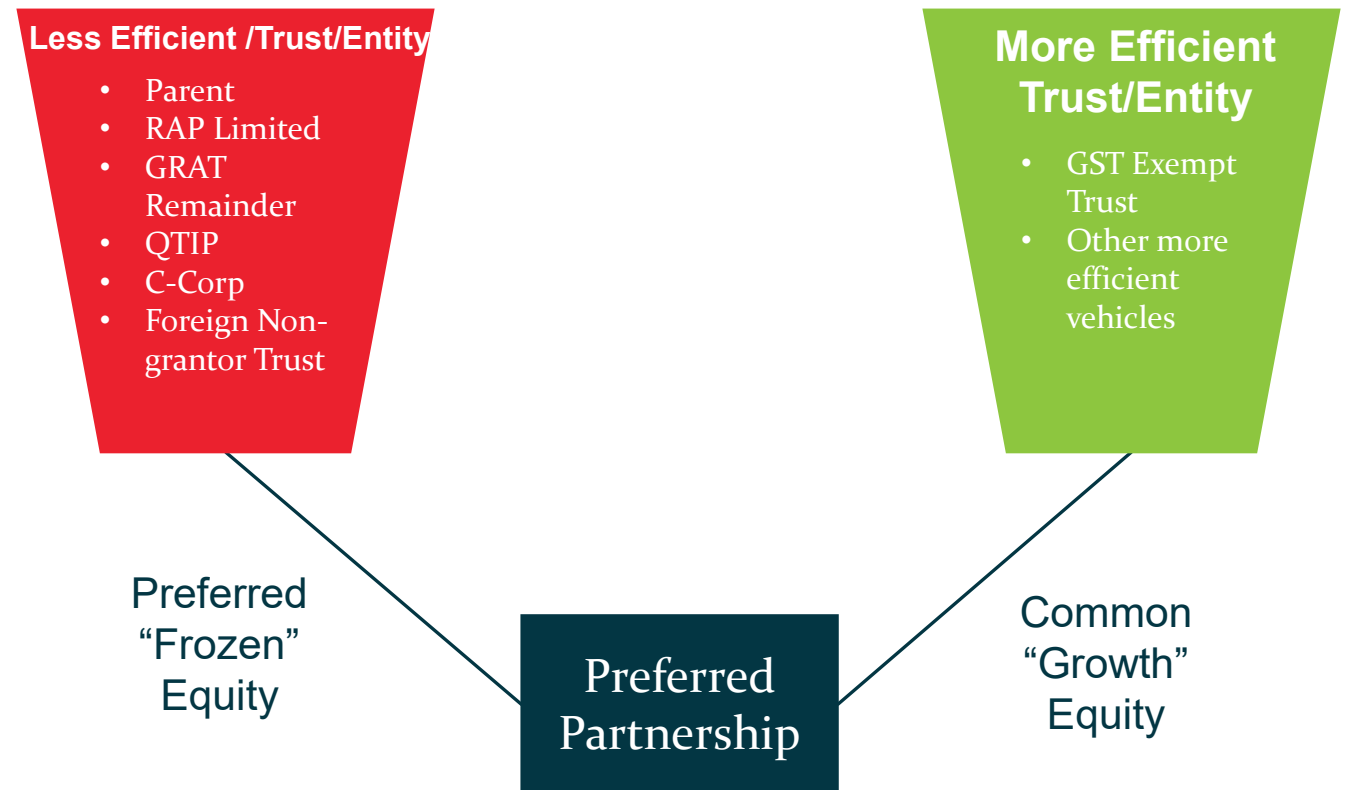


* Could also use mandatory payment right or guaranteed payment right

“Supercharging” with Preferred Freeze Partnerships

- Shifting growth from less efficient “red bucket” (ex. parent or GST non-exempt trust) to more efficient “green bucket” (ex. GST exempt)
- Provide cash-flow while shifting growth
- Elongating RAP limited structures
- Freezing GRAT Remainder, QTIP, C-Corp
- Creative funding out of other less efficient vehicles


Preferred Partnerships for Different Situations




Freezing GST Non-exempt Trusts (or RAP Limited Trusts)

- While GRATs are extremely powerful vehicles, they are only “two generation” inherently due to ETIP rule. Additional planning at the GRAT remainder level can “supercharge” overall family structure from a multigenerational standpoint
- IRS is a 40% silent partner of GST Non-Exempt Trust
- Proxy for other less efficient vehicles

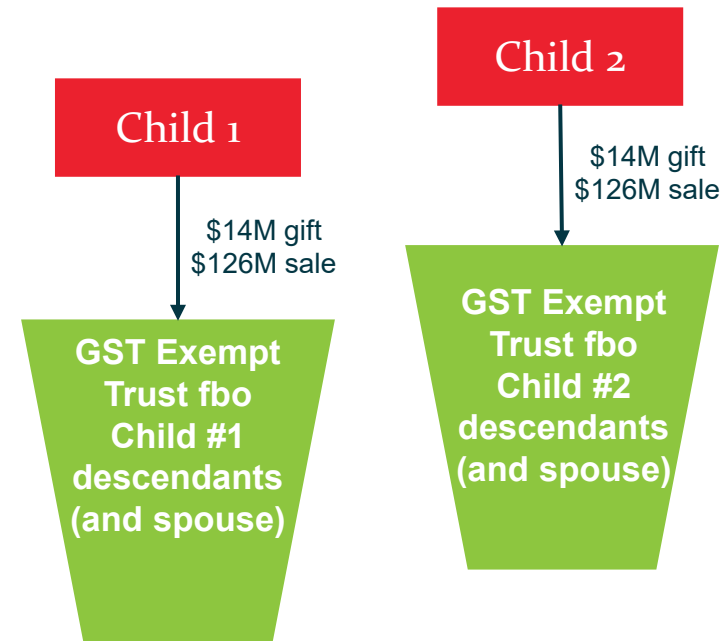
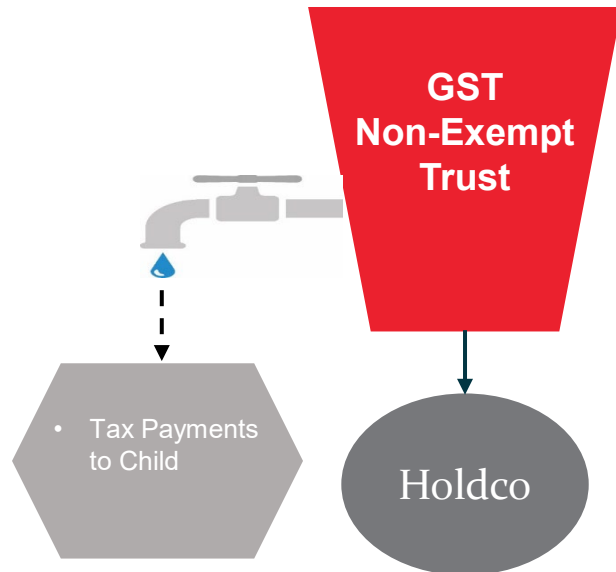
GST event today

 <p>GST Non-Exempt (GRAT Remainder) \$1B fbo G-2</p>	
Value today	\$1B
40% GST tax at triggering event	\$400M

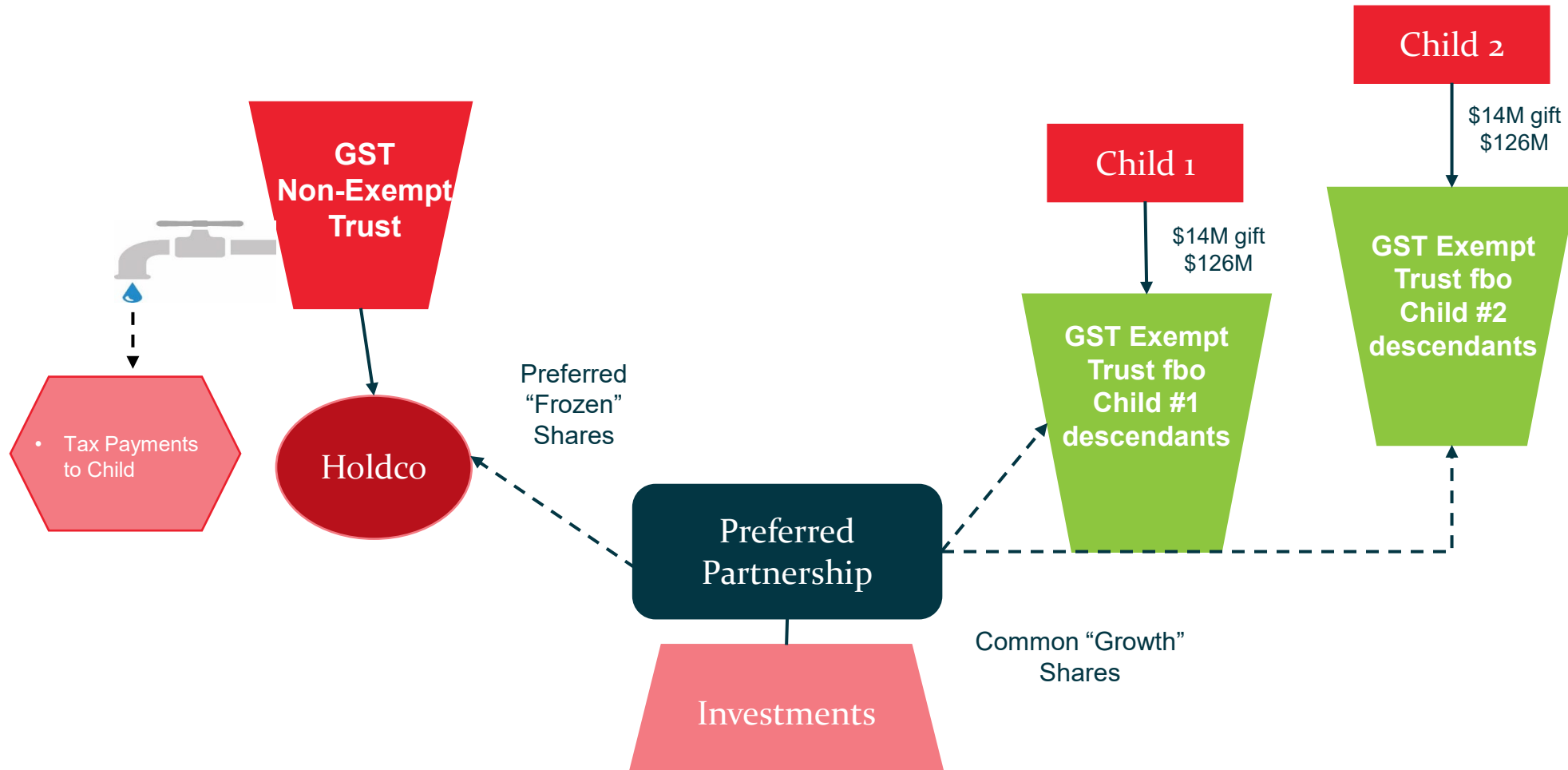
GST event in 50 years

 <p>GST Non-Exempt (GRAT Remainder) \$10B fbo G-2</p>	
Value in 50 years	\$10B
40% GST tax at triggering event	\$4B

“Down-Gen” Exemption Planning



Supercharged Multigenerational Preferred Application



Supercharged Application – with Gen-2 GRAT Funding Program

