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Session 1: Estate Planning Hot Topics: 2016

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In this presentation we will review several current estate planning/estate tax topics, including (i) an introduction to the Beneficiary Defective Inheritor's Trust, (ii) a review of the recently proposed regulations under §2704, expanding lapses and potentially limiting valuation discounts in family owned entities, and (iii) Rev. Proc. 2016-49 and the "null and void" QTIP election.

I. The Beneficiary Defective Inheritor's Trust (the "BDIT").

The BDIT is similar to the more common estate tax planning technique of an installment sale to an Intentionally Defective Grantor Trust (or "IDGT"), involving the transfer to a grantor trust of a non-marketable, minority interest in a closely held entity in exchange for a promissory note.

a. The IDGT typically involves:

i. Parent (the client) creates an irrevocable Trust for benefit of a Child.

ii. Parent sells property to the Trust in exchange for a promissory note. The property generates cash flow necessary to make scheduled payments on the promissory note.

iii. The Trust will include language causing the Trust to be treated as a grantor trust for income tax purposes but not for estate/gift tax purposes; such power often being a power to substitute trust assets.

iv. The trust property continues to be held in trust for the benefit of Child for life, and then for the benefit of Child's descendants for life, in a generation skipping format.

b. In contrast, the BDIT will involve:

i. A third party (i.e., Parent) creates an irrevocable Trust for the benefit of a Child (the client).

ii. Parent funds the Trust with minimal amount, $5,000, and gives Child a lapsing right of withdrawal (5/5 withdrawal power under IRC §2514(e)).

iii. Parent also gives Child a limited power of appointment over the Trust assets.

iv. Child sells property to the Trust in exchange for a promissory note. The property generates cash flow necessary to make scheduled payments on the promissory note.

v. The trust property continues to be held in trust for the benefit of Child for life, and then for the benefit of Child's descendants for life, in a generation skipping format.

c. BDIT Key Concepts:

i. BDIT must be created/funded by third party (i.e., Parent).

ii. BDIT beneficiary (Child) can not make gifts to the Trust.

iii. Trustee:
   1. Need independent trustee for purposes of making discretionary distributions.
   2. Beneficiary (Child) can be investment trustee.

iv. Grantor Trust Status – Lapse of 5/5 right of withdrawal:
   1. Causes Beneficiary to be treated as the owner of the trust for income tax purposes under §678(a)(2).
   2. But is not a transfer for estate/gift tax purposes. IRC §2514(e).

v. Beneficiary sells property to the Trust in exchange for a promissory note.
   1. Utilize defined value formula clause.
   2. No "seed money," but will need a third party to guarantee note (and receive a guarantee fee).
   3. If property sold is re-valued on audit:
      -- the excess value is treated as gift and allocated to a Non-GST Subtrust,

- -- but not a completed gift because Beneficiary retained limited power of appointment (power to control beneficial enjoyment), and
- -- the Non-GST Subtrust will be included in Beneficiary's estate for estate tax purposes. IRC §2036.

d. Benefits of the BDIT -- Beneficiary can transfer assets to a trust and:

   i. Retain managerial control (can be investment trustee).

   ii. Retain control over ultimate disposition of the trust property (through the limited power of appointment).

   iii. Continue to have discretionary access (through independent trustee).

   iv. Achieve creditor protection on trust assets (Beneficiary is not trust settlor/grantor).

   v. Exclude the trust assets from Beneficiary's estate for estate tax purposes. No application of IRC §2036 or §2038 as Beneficiary was not a grantor, and did not make gifts to the Trust.

   vi. Maintain the trust assets in generation skipping trust for benefit of future generations.

II. The §2704 proposed regulations.

a. IRC §2704, enacted in 1990, provides special rules for treatment of transferred interests where there are lapses of voting or liquidation rights (§2704 (a)) or restrictions on liquidation of the entity (§2704 (b)):

   i. §2704 (a) – deals with lapses, and provides that where (a) a voting or liquidation right lapses and (b) the family controls the partnership or corporation both before and after the lapse, then the lapse is deemed a taxable transfer.

The amount of the transfer is the excess of (i) the value of all interests held by the transferor (or decedent) immediately before the lapse (determined as if voting and liquidation rights inherent in the interest were non-lapsing) over (ii) the value of such interests after the lapse. §2704(a)(2).

ii. §25.2704-1(c)(1) provides a rule that a lapse of a liquidation right occurs at the time a presently exercisable liquidation right is restricted or eliminated.

However, §25.2704-1(c)(1) provides an exception – a transfer of an interest that results in the lapse of a liquidation right is generally not subject to this rule if the rights with respect to the transferred interest are not restricted or eliminated. That is, no lapse of a voting or liquidation right occurs if the interest given has all the rights in the donee's hands that it had in the donor's hands. See, for example, Treas. Reg. 25.§2704-1(f), Example 4:

-- If Parent has 84% of the vote and gives 42% away in equal shares to each of his children, the reduction from majority controlling shareholder to minority shareholder is not a lapse of a voting right or liquidation right contemplated by §2704 because the voting rights have not been eliminated.

iii. 2704(b) – deals with <u>restrictions on liquidation</u>, and provides that if there is:

- -- a transfer of an interest in a corporation or a partnership,
- -- to a member of the transferor's family, and
- -- the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity,

then, any "applicable restriction" is disregarded in valuing the transferred interest.

iv. §2704(b)(2) defines "applicable restriction" as any restriction that:

-- limits the ability of the corporation or partnership to liquidate,

-- and either:

-- the restriction lapses after the transfer, or

-- the transferor and members of the transferor's family, alone or collectively, have the right after the transfer to remove the restriction.

v. §2704(b)(3) provides that any restriction imposed or required to be imposed under Federal or State law is not an "applicable restriction".

Treas. Reg. §25.2704-2(b) further provides that a limitation on the ability to liquidate an entity that is more restrictive than the limitations that would apply under State law is an applicable restriction.

Default State law became the standard for measuring whether a particular restriction was imposed or required to be imposed by State law. Many states then amended their partnership laws to provide the default rule that unanimous consent is required to dissolve/liquidate.

vi. Legislative history states that §2704(b) does not affect minority discounts or other discounts available under present law.

vii. §2704(b)(4) provides that: "The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interests in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

b. §2704 Proposed Regulations.

i. Prop. Reg. §25.2704-1(c) – treats a transfer of control as a lapse if the transfer occurs within three years of transferor's death:

The proposed regulations narrow the exception in §25.2704-1(c)(1) -- The lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's' death is treated as a lapse occurring on the transferor's date of death, includible in the gross estate pursuant to §2704(a). A transfer of an interest occurring more than three years before the transferor's death that results in the lapse of a voting or liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated.

Modifies Treas. Reg. 25.§2704-1(f), Example 4 by adding the italicized language:

If Parent has 84% of the vote and gives 42% away in equal shares to each of his children, the reduction from majority controlling shareholder to minority shareholder (and thus giving up the right to liquidate) is not a lapse of a voting right or liquidation right contemplated by §2704 because the voting rights have not been eliminated, *and the transfer occurs more than three years before Parent's death. However, had the transfers occurred within three years of Parent's death, the transfers would have been treated as the lapse of Parent's liquidation right occurring at Parent's death*.

ii. Prop. Reg. §25.2704-2(b)(4)(ii) – provides than an applicable restriction does not include a restriction imposed or required to be imposed by federal or state law (as per IRC §2704-2(b)(3)), but only if the restrictions imposed under federal or state law are mandatory (as opposed to no more restrictive than would apply under the State's default rules.)

iii. Prop. Reg. §25.2704-3 – creates a new class of restrictions (in addition to applicable restrictions) that would be disregarded in valuing the transferred interest, called "disregarded restrictions."

This is the provision in the proposed regulations that, at least initially, was thought to be Treasury's attempt to eliminate minority and marketability discounts if a family controlled the entity immediately after the transfer, by bringing back family attribution.

The term "disregarded restriction" means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in items (b)(i) – (iv) below, <u>if the restriction in whole or in part either lapses after the transfer or can be removed by the transferor or any member of the transferor's family, either alone or collectively</u>.

Restrictions that limit the transferee's ability to:

(b)(i) – sell the interest;
(b)(ii) – sell for less than minimum value (net fmv of the interest);
(b)(iii) – get payment for more than 6 months (the "6 month put"); or
(b)(iv) – get cash/property for interest (and certain notes).

c. Effective Date: Not before 30 days after the proposed regulations become final.

III. Rev. Proc. 2016-49 and the "Null and Void" QTIP Election.

a. Issue – Whether a QTIP election is effective if the QTIP election is not needed to reduce or eliminate estate taxes?

   i. IRS has issued private letter rulings and technical advice memorandum that contain as "dicta" a reference that a QTIP election can only be made if the effect of the election is to reduce estate tax.
   ii. Similar to §2032 Alternate Valuation Date election – the value of the gross estate may be determined if the executor so elects, on the date that is 6 months after the decedent's death.
   iii. Difference – Statutory:
      1. IRC §2032(c), provides that no election may be made under this section unless the election will decrease (i) the gross estate and (ii) the estate tax imposed on the estate.

2. IRC §2056(b)(7), authorizing the QTIP election, does not contain a requirement that the election must decreased the estate tax.

iv. Result – some confusion on ability to make QTIP election where not needed to reduce estate tax.

b. Background -- Use of the QTIP election to preserve the step-up in basis at the surviving spouse's death.

i. With the basic exclusion amount now equal to $5,450,000, subject to a cost of living adjustment, and with portability, most clients won't have an estate tax. As a result, estate planning now focuses on methods to cause property to be included in a decedent's estate in order to allow a basis adjustment.

ii. IRC §1014 provides that property acquired from a decedent receives a step-up (or step-down) in basis equal to the fair market value of the property on the decedent's date of death.

iii. IRC §1014(b)(10) provides that "property acquired from a decedent" includes property included in the gross estate of the decedent under IRC §2044 relating to property for which a marital deduction was previously allowed.

c. The Disclaimer Trust.

i. At first death, all trust property is allocated to a Marital Trust for benefit of surviving spouse.

1. Revocable – no QTIP election needed.
2. Irrevocable – QTIP election needed to cause inclusion in surviving spouse's estate.

ii. Elect portability to ensure no estate tax at surviving spouse's death.

iii. If irrevocable, Marital Trust is drafted in a manner that qualifies for the QTIP election.

iv. Causing the Marital Trust to be included in the surviving spouse's estate for estate tax purposes.

v. Giving the Marital Trust beneficiaries a 100% step-up in basis in the Marital Trust assets.

vi. Issue – whether a QTIP election is effective if not needed to reduce estate taxes?

d. Rev. Proc. 2016-49, IRB 2016-42, modifies/supersedes procedures to disregard as null and void for transfer tax purposes a QTIP election where the QTIP election wasn't necessary to reduce the estate tax liability to zero, where the following are satisfied:

i. The estate's federal estate tax liability was $0 regardless of the QTIP election, thus making the QTIP election unnecessary to reduce the federal estate tax liability; and

ii. The executor neither made nor was considered to have made the portability election.

Therefore, Rev. Proc. 2016-49 does not treat as void QTIP elections made to treat property as QTIP property where the executor made a portability election, even if the decedent's DSUE amount was zero.