# 2016 Heckerling Highlights

## Washington, D.C. Estate Planning Council Webinar

**Mitch Drossman, Richard James, Steven Lavner, and Ramsay Slugg**

**March 3, 2016**

U.S. TRUST
Bank of America Private Wealth Management

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# Recent Developments
# Introduction

**2015**

- Busy year for estate planning, even though no real tax changes.
  - Low interest rate environment – favors GRATs and Sales to Grantor Trusts
  - Market volatility – take advantage of declines to transfer appreciation
- IRS attacks on estate planning strategies
  - Annual exclusion – *Mikel*
  - SCINs – *Davidson*
  - Sales to grantor trusts – *Woelbing*
  - Valuation discounts – waiting for 2704 regulations
- Emphasis on income tax planning
  - Narrowing gap between income tax and estate tax

**2016**

- Expect another busy year

# Recent Developments
# Consistency of Basis with Estate Tax Return

*Surface Transportation and Veteran's Health Care Choice Improvement Act of 2015* signed into law on July 31, 2015

- Includes new Code sections 1014(f) and 6035

- **Section 1014(f)**
  - The basis of property acquired from a decedent "**whose inclusion in the decedent's estate increased the liability for the tax** imposed by chapter 11 (reduced by credits allowable against such tax) on such estate" shall not exceed the final value determined for estate tax purposes, or, if the final value has not been determined, the value provided in a statement to recipients of a decedent's property.
    - Accordingly, 1014(f) does not apply to estates that are not taxable (after application of the various credits).
    - If there is no estate tax because of the marital or charitable deduction and therefore inclusion in the estate does not increase the liability for estate tax, then 1014(f) does not appear to apply, although there is no similar exception to the section 6035 reporting requirement.
- **Section 6035**
  - An executor who is **required to file an estate tax return** is required to report information on the value of property to "each person acquiring any interest in property included in the decedent's gross estate" and to the IRS. The statements must be furnished no later than 30 days after the estate tax return due date, including extensions, or 30 days after the return is filed, if earlier. If adjustments are subsequently made in the valuation, supplemental statements must be furnished within 30 days of the adjustment.
    - Unclear whether this applies to an estate under the filing threshold which elects portability, since it might then be considered as required to file a return.
    - In contrast to section 1014(f), section 6035 is not limited to property whose inclusion in the estate increases the tax.
    - Recipients might include all current and potential future trust beneficiaries.
      - It also may not be known 30 days after filing which beneficiaries receive which assets.

# Recent Developments
# Consistency of Basis with Estate Tax Return (cont.)

- The Treasury Department is given authority to provide details of implementation by regulation.
- These rules apply to property with respect to which an **estate tax return is filed after the date of enactment, July 31, 2015**.
  - This includes returns of decedents who died before July 31 for whom the return had not been filed by July 31.
- **Notice 2015-57** extends the due date for filing information reports to February 29, 2016, in order to allow the IRS to issue guidance.
- One speaker noted that the consistency of basis provision is unfair because the beneficiary may have had no input in the estate tax audit negotiations.
  - The executor may now have to consider the effect of audit negotiations on the basis of assets received by individual beneficiaries.
- It should be noted that the General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals (known as the **Green Book**), issued in February 2016, contains a proposal to expand the requirement of consistency in value.
  - Would expand the property subject to the consistency requirement under 1014(f) to also include (1) property qualifying for the estate tax marital deduction, provided a return is required to be filed, even though that property does not increase the estate's federal estate tax liability and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return.

# Recent Developments
# Annual Exclusion: *Mikel*

***Mikel v. Commissioner,*** **T.C. Memo 2015-64 (April 6, 2015)**

•Spouses in 2007 each gave $1,631,000 to a Crummey trust with **60 beneficiaries** having withdrawal rights. If those transfers qualified for the $12,000 gift tax annual exclusion for 60 beneficiaries, the resulting $720,000 of annual exclusion reduced the taxable gift by each spouse to $911,000 (which would be sheltered by the $1 million gift exemption.)

•The trust agreement provides that if any dispute arises regarding the proper interpretation of the agreement, the dispute shall be submitted to **arbitration** before a panel of three persons. The trust agreement also had an **in terrorem** provision stating that a beneficiary would cease to be a beneficiary if the beneficiary participates in a proceeding to oppose or challenge a trust distribution or files any action in a court of law.

•**IRS** takes position that the beneficiaries did not receive a present interest in property because the rights were not legally enforceable before a state court, and the arbitration provision would not meet that requirement. Furthermore, even though a beneficiary is not bound by the arbitration decision and can bring a state court action to contest the arbitration decision, the judicial enforcement remedy is illusory because of the in terrorem provision.

•The **court** rejected the IRS position, holding that the transfers constituted present interests that qualified for the annual exclusion. The court stated "it is not obvious why the beneficiary must be able to go before a state court to enforce that right" and that the arbitration panel would suffice. As to the IRS argument that even if judicial enforcement is available, it it illusory because of the in terrorem clause, the court interpreted the in terrorem clause as not applying to a challenge to the withdrawal right.

•It should be noted that the **Green Book** contains a proposal to eliminate the present interest requirement for gifts that qualify for the annual exclusion. Instead, it would impose an annual limit of $50,000 per donor on the donor's transfers of property. The new $50,000 per-donor limit would not provide an exclusion in addition to the $14,000 annual per-donee exclusion, but rather would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion.

# Recent Developments
# SCINs: *Davidson* Settlement

In a self-cancelling installment note (SCIN), any future payments due on the death of the holder are automatically cancelled.

- **Valuation**. In order for the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. To calculate the premium, an advisor must determine what stream of payment is required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note. There is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. There have been few cases on SCINs.
- **Terminal illness test.** Pursuant to regulations under section 7520, the mortality component may not be used to determine the present value of an annuity, income interest, remainder interest or reversionary interest if an individual who is a measuring life is terminally ill at the time the gift is completed.
  - An individual who is known to have a terminal illness or other deteriorating condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year.
  - However, if the individual survives for 18 months or longer after the date the gift is completed, that individual shall be presumed to have not been terminally ill unless the contrary is established by clear and convincing evidence.
  - Until 8/5/2013, it was generally assumed that the terminally ill test also applied to SCINs because they are similar to private annuities in that the SCIN obligation is cancelled if the measuring life dies during the note term. Prior to this date, the IRS gave no official or unofficial indication that it would not apply the terminally ill test to SCINs.
- **CCA**. In Chief Counsel Advice (CCA) 201330033 (8/5/13 ), the IRS declared its position in *Estate of Davidson v. Commissioner,* which was filed in Tax Court. The major issues are the valuation of stock and whether SCINs provided consideration equal in value to the stock transferred in return for the notes. The case involves a series of gift and large sale transactions using SCINs. Soon after the transaction, the grantor was diagnosed with a serious illness and died, before receiving any payments on the notes. The IRS Notice of Deficiency alleged tax deficiencies of over $2.6 billion.

# Recent Developments
# SCINs: *Davidson* Settlement (cont.)

- **CCA** (cont.)
  - **Gift presumption and bona fide**. Citing *Estate of Costanza (6th Cir. 2003),* the CCA indicates the appellate court stated that a SCIN signed by family members is presumed to be a gift and not a bona fide transaction. The presumption may be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The court concluded the presumption had been rebutted because the decedent was not willing to make a gift of the properties, since he required a steady stream of income in order to retire. There was a real expectation of repayment and decedent intended to enforce the collection of the indebtedness.
    - The CCA distinguished its facts from *Costanza*. In the CCA, the decedent structured the note such that the payments during the term consisted of only interest with a large balloon payment on the last day of the term. "Thus, a steady stream of income was not contemplated. Moreover, the decedent had substantial assets and did not require the income from the notes to cover his daily living expenses. The arrangement in this case was nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock. In addition, the notes lack the indicia of genuine debt because there must be reasonable expectation that the debt will be repaid."
  - **Valuation.** The CCA addressed a related set of transactions, in which "the estate may argue that there was sufficient seed money that can be applied to reduce the debt and avoid any argument that the notes are not bona fide (i.e., the trust has sufficient assets such that it can repay the loan)…The decedent accounted for the self-cancellation mechanism by adjusting the principal to be repaid or the interest rate that applied to the principal."
    - The CCA states "we do not believe that the section 7520 tables apply to value the notes in this situation. By its terms, section 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in section 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account."

# Recent Developments
# SCINs: *Davidson* Settlement (cont.)

- **Settlement**
  - The CCA appeared to prohibit the use of the terminally ill test in deciding whether to disregard the standard mortality tables. While CCAs are issued to assist IRS personnel, they are not to be used or cited as precedent. However, a CCA represents the probable litigation position of the IRS. This leaves uncertainty as to how to value a SCIN.
  - It was hoped that a decision in the case would have clarified the valuation of a SCIN. Instead, the case was settled and a stipulated decision was entered on July 6, 2015. The total tax stipulated deficiency was about $152 million (as compared to the original deficiency of over $2.6 billion.)
  - Until there is some resolution of the IRS position that section 7520 does not apply in valuing SCINs, there will be uncertainty regarding these transactions. The CCA indicates that the IRS views SCINs negatively, particularly if the decedent has health issues or dies soon after the SCIN transaction.

# Recent Developments
# Sales to Grantor Trusts: *Woelbing*

- ***Estate of Donald Woelbing v. Commissioner*** *and* ***Estate of Marion Woelbing v. Commissioner*** are two cases filed in Tax Court on December 26, 2013.
  - A sale of closely held stock was made to a grantor trust in exchange for a promissory note with interest at the applicable federal rate. The note had a defined value provision that adjusted the number of shares purchased if the IRS determined the value was different than the appraised value. There were personal guarantees to the trust for 10% of the purchase price of the stock. The estate claimed the trust had the financial ability to repay the note, even without considering the stock that was sold, and this was greater than 10% of the note.
  - Since the grantor and his wife died, the case involved both gift and estate tax issues. For gift tax purposes, the IRS claimed the note had a zero value under section 2702. The IRS also raised valuation issues with regard to the stock. For estate tax purposes, the IRS claimed the note was not includable in the estate, but rather the stock that was sold was includable under sections 2036 and 2038 at date of death value.
  - It is not yet known whether this is primarily just a valuation case. It remains to be seen whether the IRS will settle (as in *Karmazin v. Commissioner*) or drop (as in *Dallas v. Commissioner*) the claims under section 2702, 2036 and 2038. If the case proceeds as an attack whether the note is disregarded for gift tax purposes under section 2702 and whether the assets sold are includable under sections 2036 and 2038, it will provide guidance on the requirements for a valid sale to grantor trust transaction.
  - There were reports of a possible settlement in 2015, but that has not happened.

# Recent Developments
# Final Portability Regulations

Portability refers to the ability to transfer the unused estate tax exemption of a deceased spouse (called the Deceased Spousal Unused Exclusion, or DSUE). It applies in the case of a deceased spouse dying after December 31, 2010. Temporary and proposed regulations were issued on June 15, 2012. Final portability regulations were issued and are effective June 12, 2015. The final regulations make changes and clarifications in the following areas:

•**Availability of extension of time to elect portability** – clarifies that an extension of time under section 301.9100-3 is available for estates below the filing threshold and thus not otherwise required to file an estate tax return.

•**Election where DSUE amount is uncertain** – clarifies that a protective election is not required because the election is deemed made by filing a timely and complete return, and only the size of the DSUE amount would be changed.

•**Persons permitted to make the election** – clarifies that only the appointed executor or a deemed executor in possession of estate assets may make the election.

•**Requirement of a complete and properly prepared estate tax return** - clarifies that a complete and properly prepared estate tax return should be determined on a case by case basis by applying standards prescribed in current law.

•**Noncitizen spouses and QDOTs** – modifies the rule as to when the decedent's DSUE is no longer subject to adjustment and will become available for transfers by the surviving spouse.

•**Examination of returns to determine DSUE amount** - confirms that the IRS has broad authority to examine the correctness of any return, without regard to the period of limitations on assessment, to make determinations with respect to the DSUE amount.

•**Availability of DSUE amount by surviving spouse who become a citizen** – confirms that an NRA surviving spouse may not use the DSUE amount unless allowed under a treaty; and modifies the rule to allow an NRA surviving spouse who becomes a citizen to use the DSUE amount.

•**Effect of portability on Rev. Proc 2001-38** – indicates that guidance on this issue will be done by published ruling, rather than in the regulations.

# Recent Developments
# Green Book

Although the 2016 Green Book was discussed at Heckerling, the 2017 Green Book was issued shortly thereafter (in February 2016). The new Green Book includes the following transfer tax proposals by the President for fiscal year 2017.

- **Restore the estate, gift and GST tax parameters in effect in 2009**
  - 45% rate/$3.5 million exemption for estate and GST/$1 million gift exemption
- **Modify transfer tax rules for grantor retained annuity trusts (GRATs) and other grantor trusts**
  - Minimum GRAT term of 10 years /maximum term of grantor's life expectancy plus 10 years
  - Minimum GRAT remainder value of greater of 25% of trust or $500,000
  - Prohibit decrease in GRAT annuity and tax-free substitutions
  - For other grantor trusts, restrict ability of grantor to transact with trust
- **Limit duration of GST exempt trusts**
  - GST exemption allocated would terminate on 90th anniversary of creation of trust
- **Modify GST tax treatment of health and education exclusion trusts (HEETs)**
  - Exclusion only for tuition or medical payment by a donor directly, and not by a trust
- **Expand requirement of consistency in value for transfer and income tax purposes** (as discussed)
- **Simplify gift tax exclusion for annual gifts** (as discussed)
  - Eliminate present interest requirement
  - impose annual limit of $50,000

# 2016 Heckerling Highlights
# Financial Topics:

- Financial Topics (Four Sessions)
  1. Modern Uses of Partnership
  2. Naked Derivatives & Other Exotic Wealth Transfers
  3. Alternative Investments – breakout session
  4. Wealth Transfer Planning with Interests in Private Investment Funds – breakout session

# 2016 Heckerling Highlights
# Financial Topics

## Modern Uses of Partnerships

- Income tax planning is equally or even more important than estate planning
  - Keep 0% basis assets and give away 100% basis assets.  What about mixed basis assets?
- Partnerships are flexible and offer many advantages – but reading between the line: they are also far more complicated than other entities and the application of the below rules can be very narrow.
  - Partnerships may permit active tax basis management
  - Must avoid "mixing bowl" rules – 7 years
  - Must avoid "disguised sale" rules – 2 years
- **Basis Strip**
  - Isolate certain assets (low and high basis asset) in a p-ship (accomplished via p-ship division)
  - Distribute high basis asset from p-ship to senior family member in full or partial redemption. Becomes a "0" or low basis asset in hands of distributee
- **Basis-Shift**
  - Use p-ship to transfer basis of asset to create near 0%/100% so you can better identify which assets to retain and which to remove from estate.

# 2016 Heckerling Highlights
# Financial Topics

## Modern Uses of Partnerships (cont.)

- **Income Shift**
  - Create preferred p-ship and give away preferred interest to lower bracket / lower state taxpayer. Preferred interest will likely shift most of p-ship income away from non-preferred (common) interests.
  - Can also shift income to a non-grantor trust located in a low/no tax jurisdiction.

# 2016 Heckerling Highlights
# Financial Topics

- **Naked Derivatives & Other Exotic Wealth Transfers**
- What is a derivative?
  - Private contract with economic return based on underlying assets (whether or not the family owns that asset), with or without leverage.
  - Derivative can be customized, capped (and would require an appraiser to determine value)
- Why use a derivative for estate planning?
  - Cure to low growth assets; non-transferrable assets; non-cash-flow assets
- Should be for consideration, with a grantor trust; terminate at earlier of death or term certain.

- **Example:** Grantor and irrevocable grantor trust enter into derivative contract. Trust pays Grantor $1 million for return on X to be settled at earlier of 5 years or Grantor's death.
  - Risk to Trust; could result in reserve wealth transfer.
- **Example:** Grantor and Spouse enter into derivative contract for consideration (same terms as above). Spouse then transfers contact to a GRAT. No exemption used or possibility of reverse estate planning. For unmarried Grantor: Grantor can purchase option from an incomplete gift trust.

# 2016 Heckerling Highlights
# Financial Topics

- **Naked Derivatives & Other Exotic Wealth Transfers**

| # of Options | Option Price | Share Price | # of Shares |
|---|---|---|---|
| 100,000 | 7.8396 | 50 | 15,679 |
| -42,518 | 8.667 | 55 | -6,700 |
| -55,276 | **8** | 58 | -7,624 |

| **Options GRAT** | | 20.00% | | |
|---|---|---|---|---|
| | **Beginning of Year Value** | **GRAT Annuity** | **End of Year Value** | **# of Options** |
| | | | | 100,000 |
| 10% | $783,960 | ($368,506) | $498,194 | -42,518 |
| 5% | $498,194 | ($442,207) | $17,646 | -55,276 |
| | | | | 2,206 |

| **Share GRAT** | | 20.00% | | |
|---|---|---|---|---|
| | **Beginning of Year Value** | **GRAT Annuity** | **End of Year Value** | **# of Shares** |
| | | | | 15,679 |
| 10% | $783,950 | ($368,501) | $493,844 | -6,700 |
| 5% | $493,844 | ($442,202) | $78,579 | -7,624 |
| | | | | 1,355 |

For illustrative purposes only. This hypothetical illustration does not reflect the performance of any specific investment.
Actual rates of return cannot be predicted and will fluctuate.

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# 2016 Heckerling Highlights
# Financial Topics

• **Naked Derivatives & Other Exotic Wealth Transfers**

- <u>C-PAS: Contingent Private Annuity Strategy</u>
  - Transaction between Grantor and Grantor Trust
  - Grantor pays Trust $$ in exchange for Trust's promise to pay Grantor an annuity if the grantor's spouse dies during the year and the Grantor is living at year end.
  - Annuity would be paid for shorter of (i) Grantor's life or (ii) term of years.
    - Amount paid to trust would be value of annuity multiplied by actuarial probability of spouse dying during the year survived by the grantor.
      - Trust must have sufficient assets or purchase insurance policy.
    - Each year parties can enter into same agreement.

# 2016 Heckerling Highlights
# Financial Topics

- **Alternative Investments**

- Difference between Hedge Funds and Private Equity.
  - No focus on investment strategies
  - Focused on structure of fund; term; management; side agreements; withdrawals
- Focused on various ways PE management fee is determined.  Offered insight that could helpful when negotiating agreement / fee with fund.
- Practical  nuts and bolts approach to this topic with no/limited estate planning application.

# 2016 Heckerling Highlights
# Financial Topics

- **Planning with Interest in Private Investment Funds**
- Overview of typical fund structure (private equity and hedge fund)
- Overview of Chapter 14 rules and definitions (e.g., 2701)
  - Violate 2701: deemed transfer of all interests in fund (retained interest valued at "0")
  - Solution to 2701 problems: vertical slice.
    - To ensure vertical slice, use a "vertical slice holding company"
    - Cashless contributions and mgmt. fee offsets could create a problem for management company ownership interests (include in vertical slice).
  - Other solutions:
    - Parallel trust structure
    - Derivative technique (problem: taxable event at death because no grantor trust)
    - Trust for parents / siblings with LPOA to appoint to others.
    - Disclaimers Trust
- Favored planning technique: sale to grantor trust
  - GRATs are problematic for PE ownership because of additional capital contributions.
- No discussion of AI, QP or Key Employee rules

# 2016 Heckerling Highlights
# Trust Administration and Trust Taxation

- Fundamentals
  - Covered rules relating to trusts permitted as shareholders of S Corps
- Recent Developments
  - Recent cases have reinforced the perception that the rich abuse Crummey powers
  - States passing new laws and becoming more aggressive about enforcing trust income taxes
  - Other topics discussed related to:
    - Sales to defective grantor trusts
    - IRC § 67(e) on the 2% floor on miscellaneous itemized deductions
    - Trust protectors and directed trusts
    - Decanting
- Advising the Wealthy
  - Discussed history of development of trusts and future trends

# 2016 Heckerling Highlights
# Trust Administration and Trust Taxation

- Navigating trusts through the NIIT
  - Short-term income tax planning vs. long-term wealth transfer planning
  - 3.8% is not small when you think about collecting it over many years
  - What constraints do distribution standards (HEMS, discretionary, mandatory, etc.) impose?
  - Possible classification of capital gains as DNI
  - Passive loss / material participation issues
  - Strategies
    - Distribution to avoid/minimize NIIT vs. Maximizing wealth accumulation inside the trust
    - Separate trusts vs. pot/sprinkle trusts
  - Other considerations
    - Assets held by the trust (e.g. family business vs. portfolio of securities
    - State income taxes
    - Choice of trustee

# 2016 Heckerling Highlights
# Trust Administration and Trust Taxation

- Special needs trusts
  - $1^{st}$ party vs. $3^{rd}$ party funded
  - Tax differences (grantor vs. non-grantor, etc.)
  - Choice of trustee
  - Use of trust protectors
- Trust design (special session)
  - Grantor vs. non-grantor and other income tax issues
  - Domestic vs. foreign
  - Divided trusteeships
  - Trustee succession
  - Addressing NIIT
  - State domicile of trust
- Lifetime QTIPs
  - Divorce

# 2016 Heckerling Highlights
# Trust Administration and Trust Taxation

- A New World Order (FATCA, FBAR and the rest of the alphabet)

- Trustee selection minefield
  - Impact on state income taxation
  - Powers

- Deeper scrutiny of trustee selection
  - When trustee is also a beneficiary

- Retirement plans
  - Designated beneficiary issues
  - Pecuniary funding issues

# 2016 Heckerling Highlights
## Charitable Topics

- Charitable Topics
- Three Sessions
  - Non-Profit Board Service
  - Non-Profit Board Service breakout session
  - Fundamentals Program on Charitable Remainder and Charitable Lead Trusts
- Non-Profit Board Service
  - Thorough discussion of the roles and responsibilities or board members, key areas of liability, ethics and best practices
  - Good checklists of items to consider before and after joining BOD, plus BOD self-assessment
- Charitable Remainder and Charitable Lead Trust Basics
  - Comprehensive discussion of the basics of tax rules, drafting guidelines and planning suggestions
  - Selected highlights

# Q & A