Planning in the ATRA-Math

(The Best Income and Estate Tax Planning Ideas Today)

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The End of Valuation Discounts?

- "Applicable restriction" under § 2704(b)(2)
  - Limit on ability of entity to liquidate
  - Does not include restriction imposed by State law or reasonable restriction from a "financing" with a third party

- Regulatory authority under § 2704(b)(4)
  - Other restrictions shall be disregarded
  - Effect of reducing the value of the transfer but does not ultimately reduce the value to the transferee (family member)

- Proposed regulations to be issued
  - Obama "greenbook"
    - Additional category of restrictions ("disregarded restrictions")
    - Lapse or be removed after the transfer by the family
    - Certain assumptions set out in the regulations
    - Limitations on holder's right to liquidate the interest and admitted as a full partner
    - Certain charitable interests and third party interests deemed held by the family
  - Speculation
    - Family attribution
    - Charitable attribution (nominal interest and disqualified person charities)
    - Third party attribution (subordinate parties)
    - Passive holding companies v. active businesses
  - Timing of issuance and effective date?
  - Validity?

Basis Consistency, Reporting & Penalties

- Basis Consistency: New § 1014(f)
  - Basis shall not *exceed* valued finally determined for estate tax purposes
  - Property "whose inclusion in the decedent's estate increased" the tax liability

"Zeroed-Out Estate Exception":
Does NOT apply to zeroed-out estates (due to marital/charitable deduction)

- Information Reporting Requirement: New § 6035
  - Report valuation information to recipients and IRS
  - If required to file an estate tax return
  - No later than 30 days of due date of return (or filed, if earlier)

Zeroed-Out Estate Exception
Does NOT apply

- Penalties: New § 6662(k)
  - Accuracy and underpayment penalties apply if report *higher* basis
  - § 6721 (failure to file correct information returns)
  - § 6722 (failure to file correct payee statements)
  - § 6724(a) (waiver if failure due to reasonable cause not willful neglect)

Underpayment Penalty
- 20% of the underpayment

Zeroed-Out Estate Exception
Applies BUT not for §§ 6721 and 6722

Failure to File Penalties
- $100 per/$1.5 mil. max (2015)
- $250 per/$3.0 mil. max (2016)

Intentional Disregard Penalties
- $200 (2015)/$500 (2015)
- 10% of aggregate amount of the items required to be reported correctly

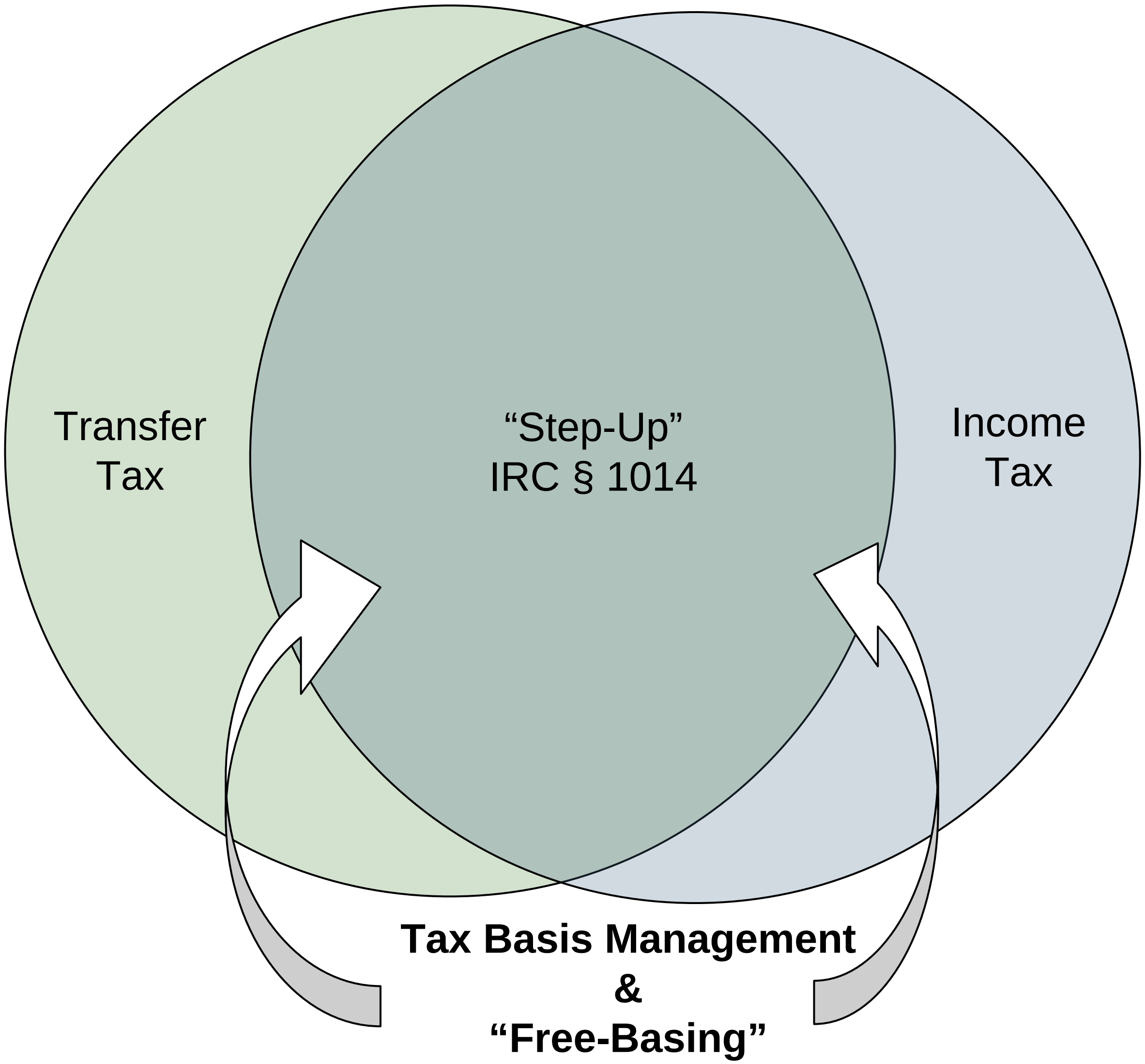
- IRS Notice 2016-19
  - March 31, 2016

- For,m 8971
  - Information Regarding Beneficiaries Acquiring Property from a Decedent

Venn Diagram: Transfer and Income Tax

Assets to be Transferred Out of the Gross Estate

(Wealth Transfer)

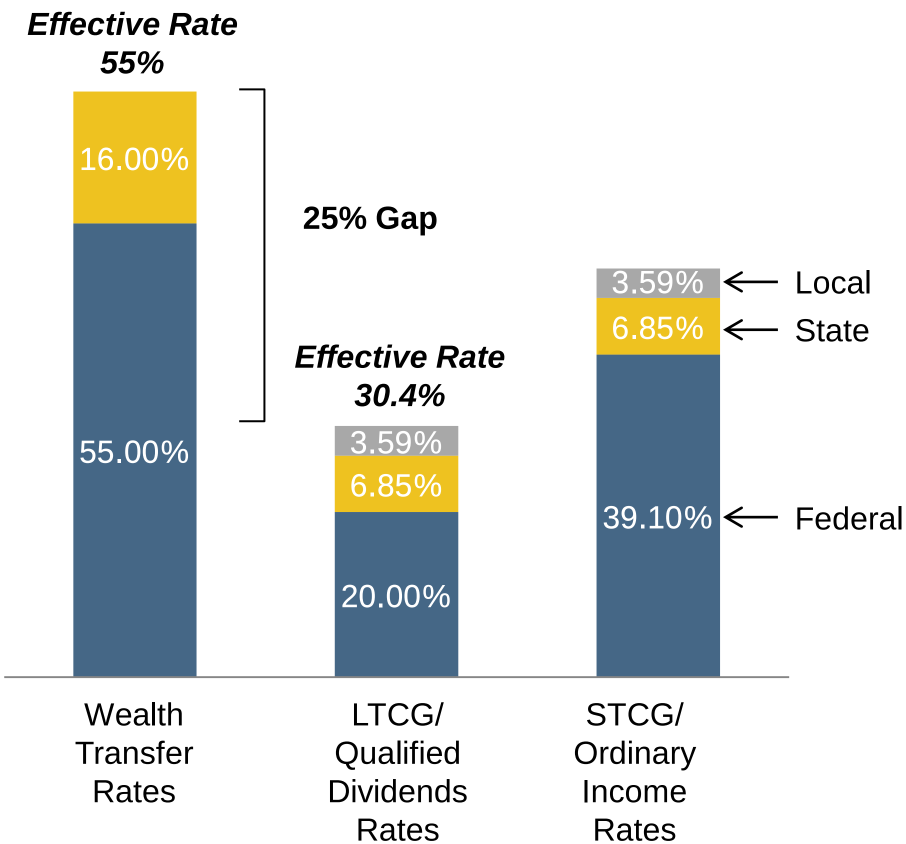


Assets Recognized During Lifetime

(Tax Avoidance & Deferral)

The Old Paradigm: When in Doubt, Transfer Out

2001: NYC RESIDENT



Federal Estate & Gift Tax Exclusion:	***$675,000***
GST Tax Exemption:	***$1,060,000***

ESTATE PLANNING RECOMMENDATIONS

- During life, use the estate and gift tax exclusion
- During life, transfer wealth as quickly as possible
- Avoid estate tax inclusion at every generation
- Step-up in basis at death is less important because of the relatively low capital gain tax rates
- Income tax consequences are secondary
- State of residence will not significantly affect the plan

Rates represent an estimate of the top marginal tax, federal and state income, capital gains and estate tax brackets, and assume the taxpayers are in AMT

The "Permanent" Fix to the Wealth Transfer Tax System

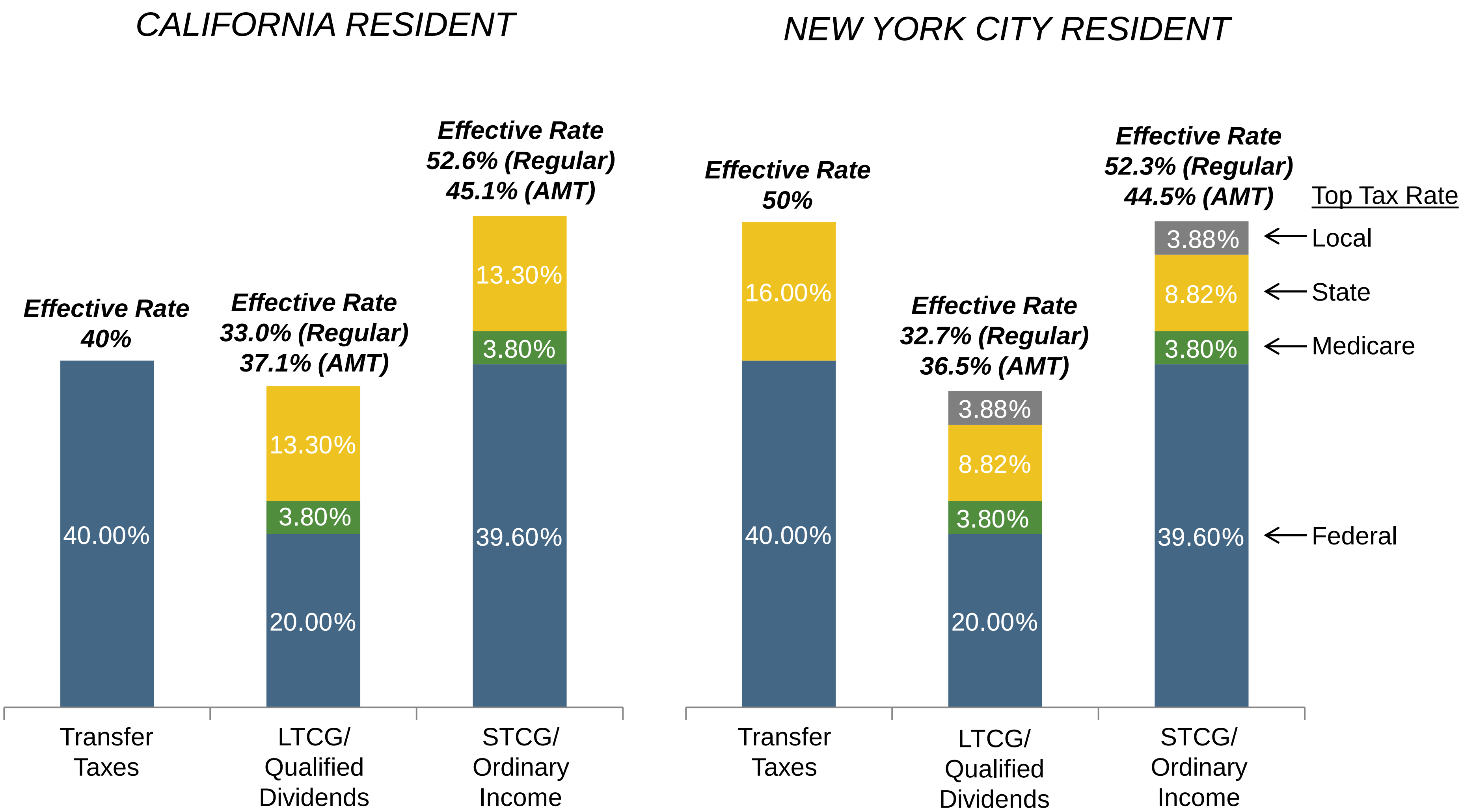
"American Taxpayer Relief Act of 2012*"

- Reunification of Gift, Estate and Generation-Skipping Transfer Tax
- **$5.45 million Applicable Exclusion Amount for 2016 (indexed)**
- **40% maximum rate**
- Portability of "Deceased Spousal Unused Exclusion Amount"
- No Sunset Provision

Don't forget about the income tax rates…

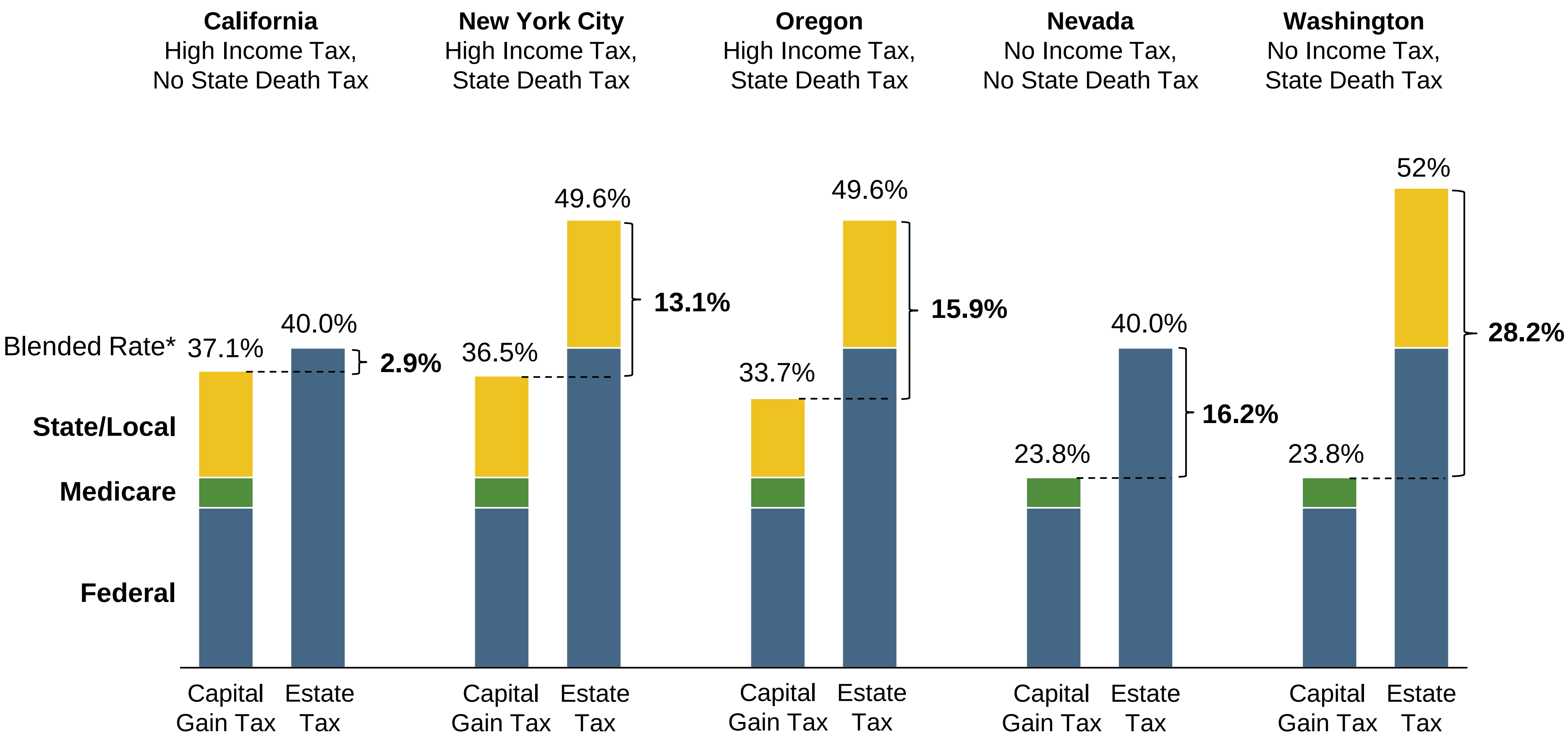
*P.L. 112-240, enacted January 2, 2013

Tale of Two City/States: The Gap Has Narrowed



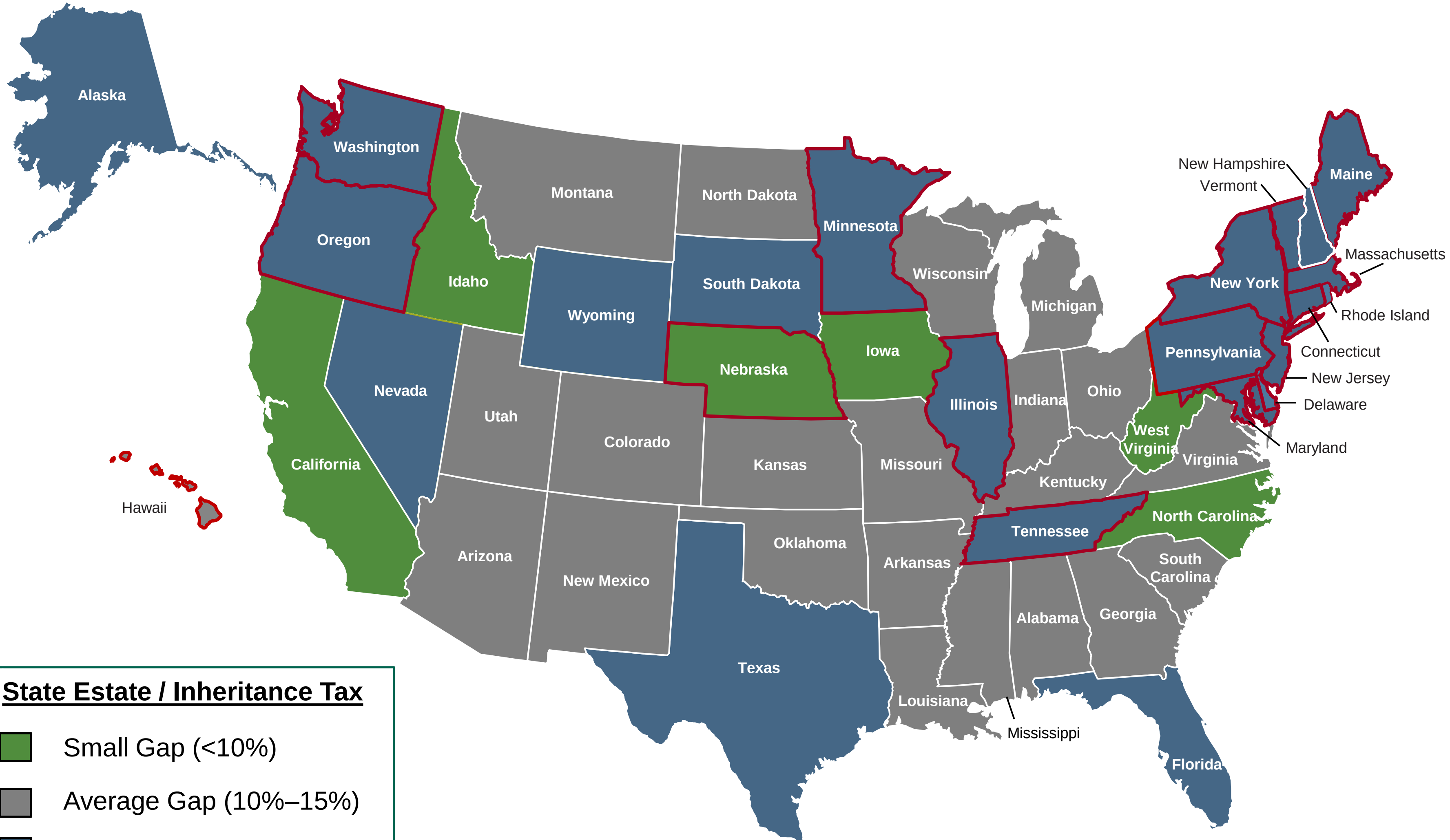
Rates represent an estimate of the top marginal tax, federal and state income, capital gains and estate tax brackets, and assume the taxpayers are in AMT

"Gap" Between Estate and Capital Gain Tax Rates by State



*Based on Health Care and Education Reconciliation Act of 2010 and the American Taxpayer Relief Act of 2012. Rates represent an estimate of the top marginal tax, federal and state income, capital gains and estate tax brackets. Blended rates assume the taxpayers in New York City and California are in AMT. Numbers may not sum due to rounding.

"Gap Map:" Estate and Capital Gain Tax Rate by State*



<u>State Estate / Inheritance Tax</u>

- Small Gap (<10%)
- Average Gap (10%–15%)
- Large Gap (>15%)

*As of January 1, 2014.

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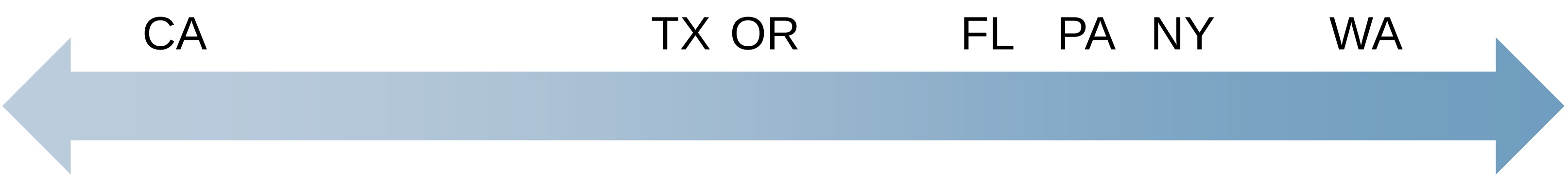
What Kind of State Are You In?

MORE
PASSIVE
ESTATE PLANNING

PA
Inheritance Tax
4.5-12-15%

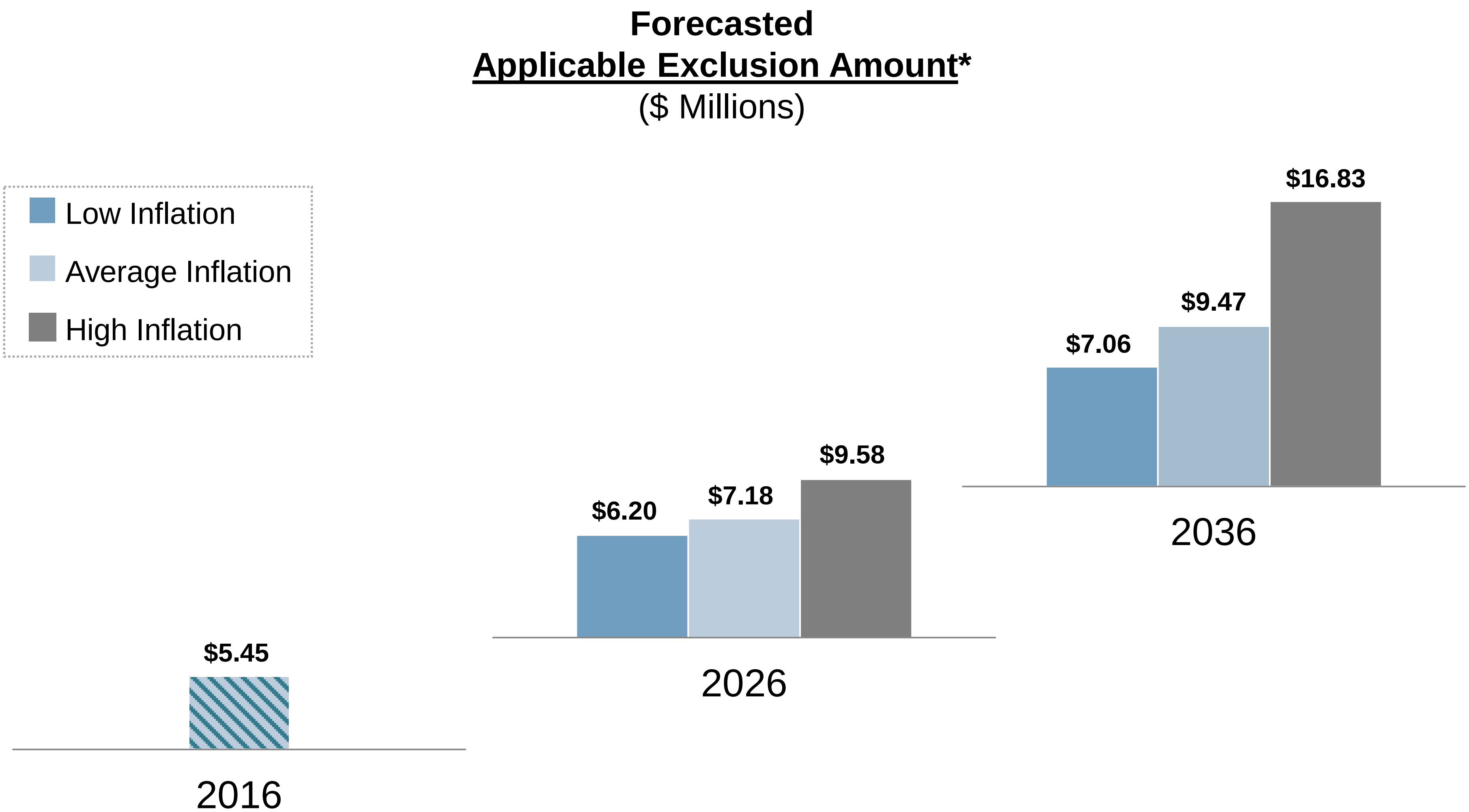
MORE
PROACTIVE
ESTATE PLANNING



Community Property State
High State Income Tax
State Gift Tax (Only CT and MN)
No State Estate or Inheritance Tax

Separate Property State
Low or No State Income Tax
No State Gift Tax
High State Estate or Inheritance Tax

Step Right Up and Eliminate Your Income Taxes…



*Based on the cost-of-living adjustment (rounded to the nearest $10,000) from 1985 to 2014 as published by the Bureau of Labor Statistics. Low is the lowest positive annual increase (1.30% in 1999- increase was 0% in 2010 and 2011); Average is the average annual increase (2.80%-median was 2.81%); High inflation is the highest annual increase (5.80% in 2009).

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The New Paradigm

- Estate Planning
  - Infinitely more complicated
- Applicable Exclusion Amount
  - Should be used as little possible
  - Taxpayers should consider keeping as much as possible for the “step-up” in basis
  - “Zeroed-out” transfers should be utilized instead
- Income Tax Considerations
  - Can be more important than the transfer tax consequences
  - Should be considered in tandem with potential transfer taxes
- Estate Tax Inclusion
  - Can save more in income taxes
  - Should be forced if the income tax savings are greater than the transfer tax cost
- State of Residence
  - Will give rise to very different types of estate planning

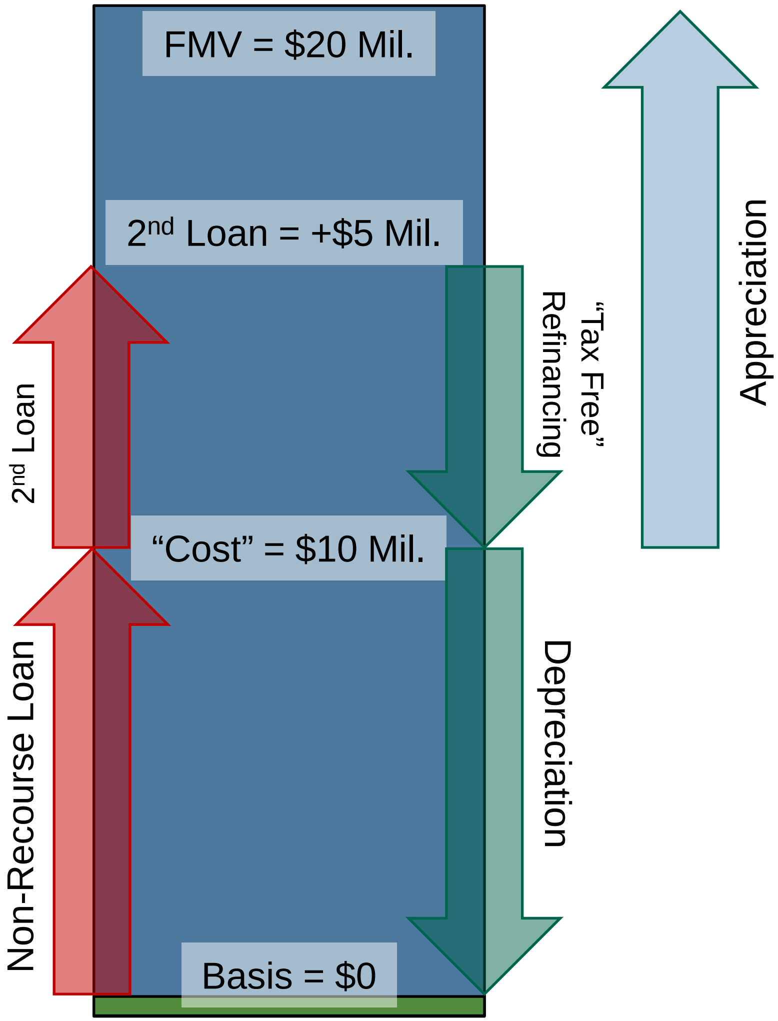
Some Assets Benefit from "Step-Up"—Some Assets Do Not

"Step-Up" Important

Asset Type	Tax Characteristic
Creator-Owned Copyrights, Trademarks, Patents & Artwork	Ordinary → Long-Term
"Negative Basis" Commercial Real Property LPs	Recapture & >100% Long-Term
Oil & Gas Investments (Sold)	§ 1245 Recapture
Artwork, Gold & Other "Collectibles"	28% Long-Term
Low Basis Stock	20% Long-Term
Roth IRA Assets	Tax Free & No Surcharge
Oil & Gas Investments (Not Sold)	Cost Depletion vs. Percentage Depletion
High Basis Stock	Minimal Gain
Qualified Small Business Stock (QSBS)	§ 1202 Gain [50, 60, 75 or 100%] Exclusion
Fixed Income	Typically Minimal Gain
Cash	Basis = Face Value
Passive Foreign Investment Company (PFIC) Shares	No "Step-Up"
Stock at a Loss	Capital Loss Erased
Variable Annuities	Partially IRD
Traditional IRA & Qualified Plan Assets	100% IRD

"Step-Up" Not Important

What is "Negative Basis"?



CASH FLOW ON SALE	
Sale Price	$20,000,000
Minus Basis	($0)
Minus Loan	($15,000,000)
Net Proceeds	$5,000,000

1. TAX LIABILITY ON SALE (§ 1250)		*Effective Rate*
Recapture @ 25%	$2,500,000	
Capital Gain @ 20%	$2,000,000	
State @ 13.3%	$2,660,000	
Total Tax Liability	**$7,160,000**	*35.8%*

2. TAX LIABILITY ON SALE (§ 1245)		
Recapture @ 39.6%	$3,960,000	
Capital Gain @ 20%	$2,000,000	
State @ 13.3%	$2,660,000	
Total Tax Liability	**$8,620,000**	*43.1%*

3. TAX LIABILITY ON SALE (§ 1411)		
Recapture @ 43.4%	$4,340,000	
Capital Gain @ 23.8%	$2,380,000	
State @ 13.3%	$2,660,000	
Total Tax Liability	**$9,380,000**	*46.9%*

Estate Planning Today Is a Multi-Variable Problem

- Time Horizon
- Spending
- Size of Estate
- Return and Income Tax Character of Assets
- Expected Income Tax Realization on Assets
- Investment and Non-Investment Income
- State of Residence of Grantor and Beneficiary
- Inflation

$$\dot{x}_i = \sum_{j=1}^{R} \rho_j(v) \left(\phi_i^j(X_i) + \psi_i^j(X_i) x_{i+1} \right)$$

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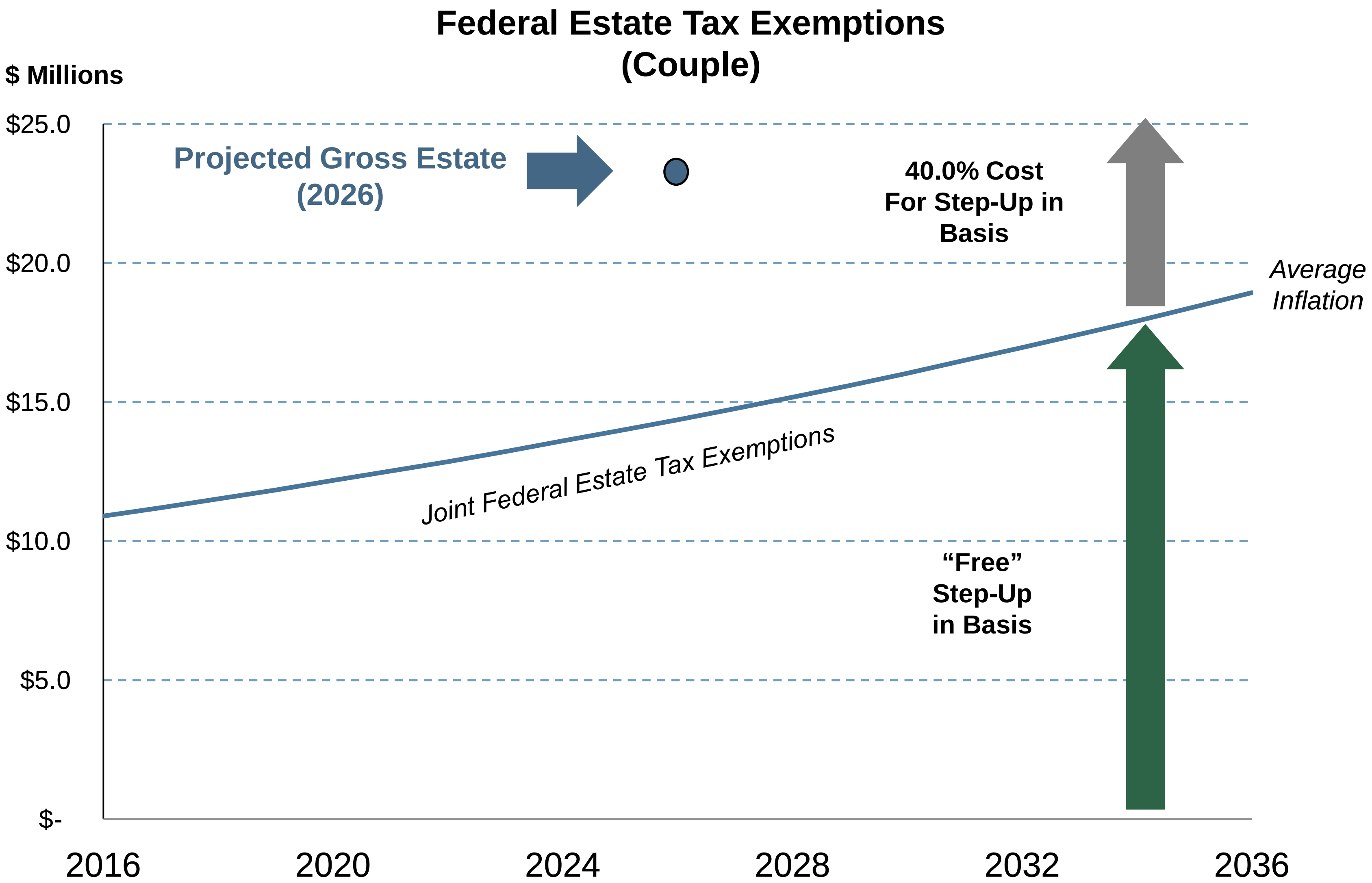
Income Tax Savings from "Step-Up" Vs. Transfer Tax Cost

Transfer Tax Cost $\gtrless$ Income Tax Savings

Estate Tax Cost vs. Income Tax Savings from "Step-Up"



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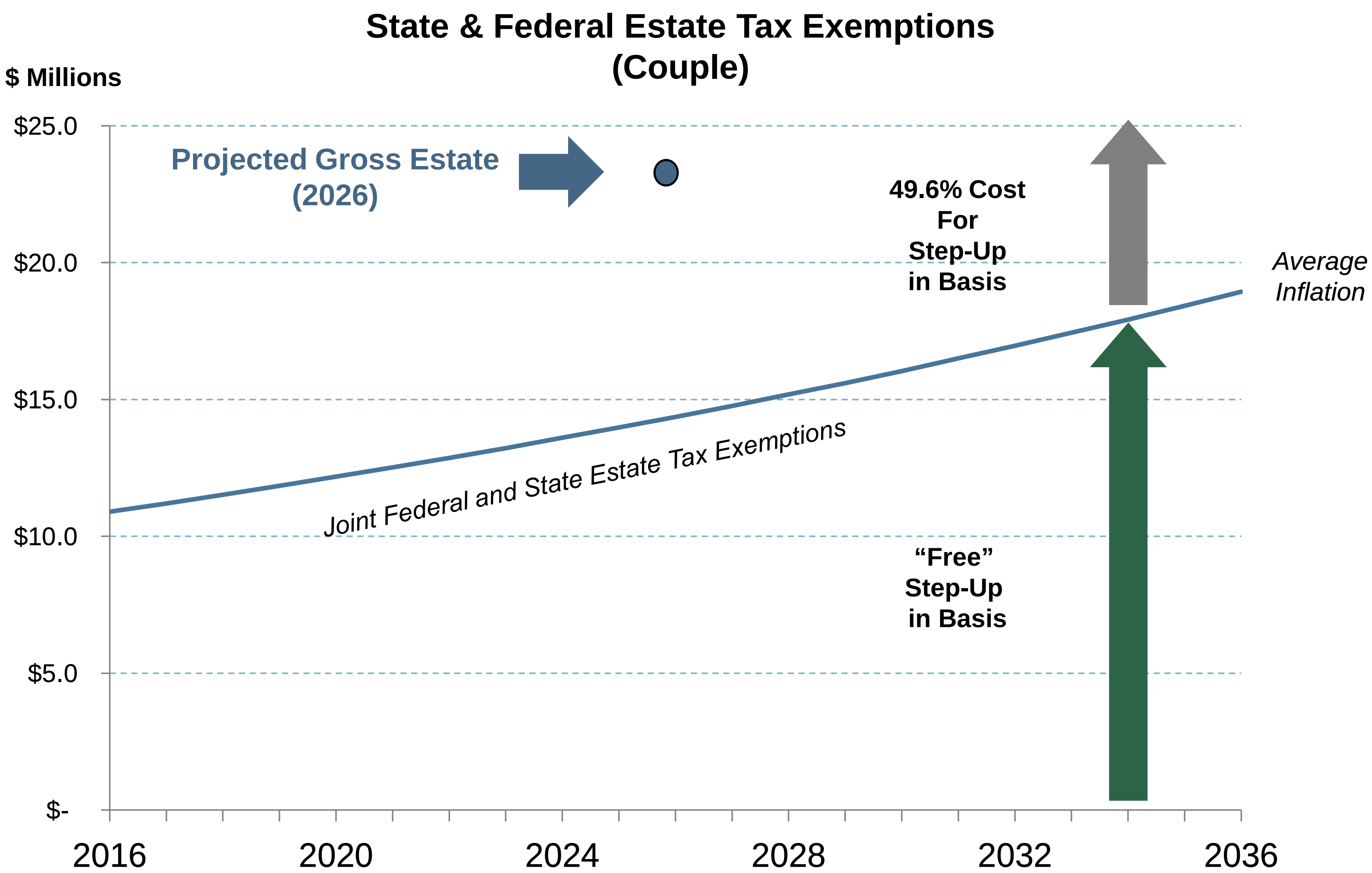
Estate Tax Cost vs. Income Tax Savings from "Step-Up"



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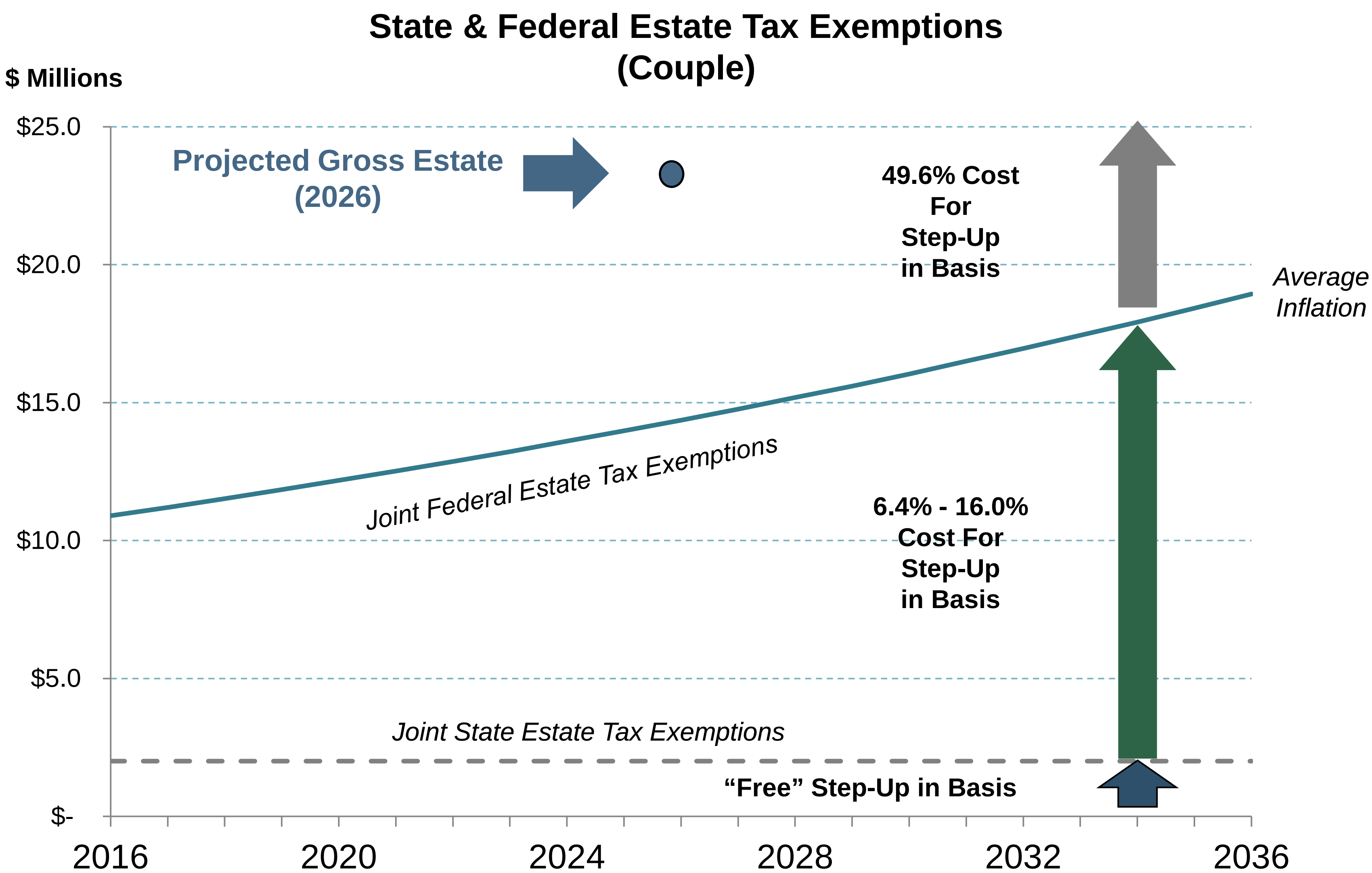
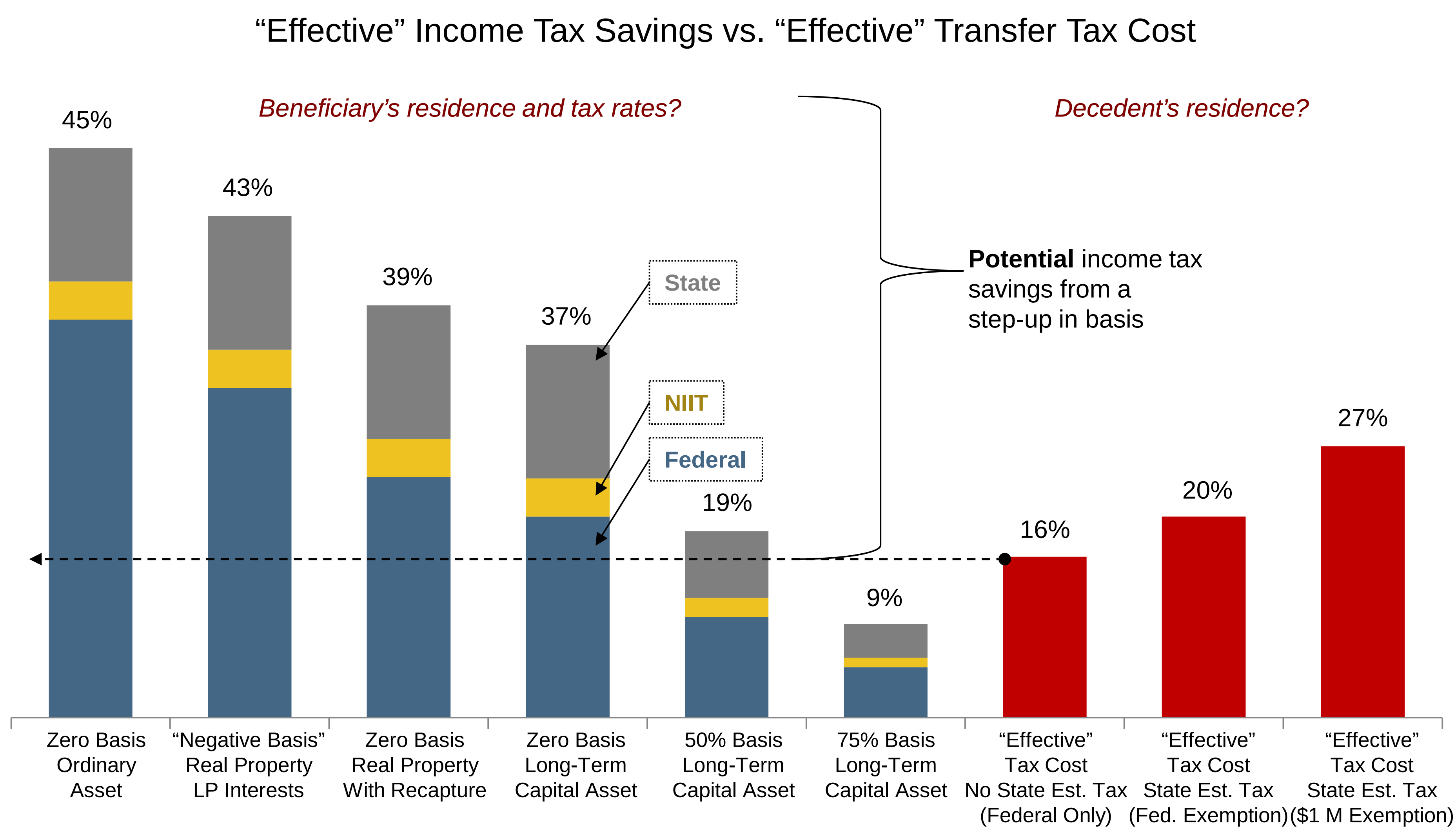


What Is the Nature of the Assets in the Estate?



Rates represent an estimate of the top marginal tax, federal and state income, capital gains and estate tax brackets in relation to the fair market value of the assets. Rates assume a taxpayer in California is in AMT. In the "negative basis" scenario, assumes 20% of gain is Section 1250 recapture and 10% of additional gain due to reduction in non-recourse debt. In the zero basis real property scenario, assumes 20% of the gain is Section 1250 recapture.

Portability: Game Changer? Useless?

Deceased Spouse's Unused Exemption Amount (DSUEA)
- "Ported" to surviving spouse
- Avoids traditional by-pass/credit shelter/AB trust planning
- May be used to shelter surviving spouse's gifts and testamentary transfers

<u>ADVANTAGES</u>

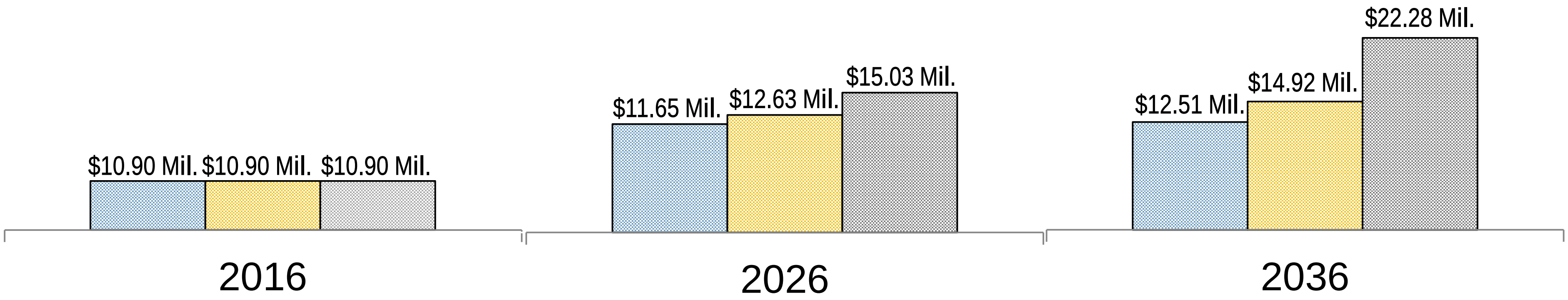
- "Free" double "step-up" in basis
- Simplicity
- All income tax reported by surviving spouse
- Surviving spouse can gift DSUEA to grantor trust

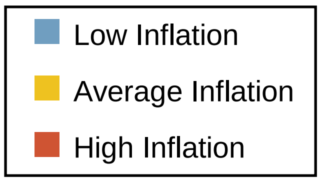
<u>DISADVANTAGES</u>

- "No cost-of-living increase on DSUEA
- No GST Tax exemption portability
- No state estate/inheritance tax portability
- Appreciation above DSUEA subject to estate tax
- Estate tax return required even if no tax payable
- Spouse may not retain benefit of subsequent DSUEA gift
- No creditor protection for benefit of spouse

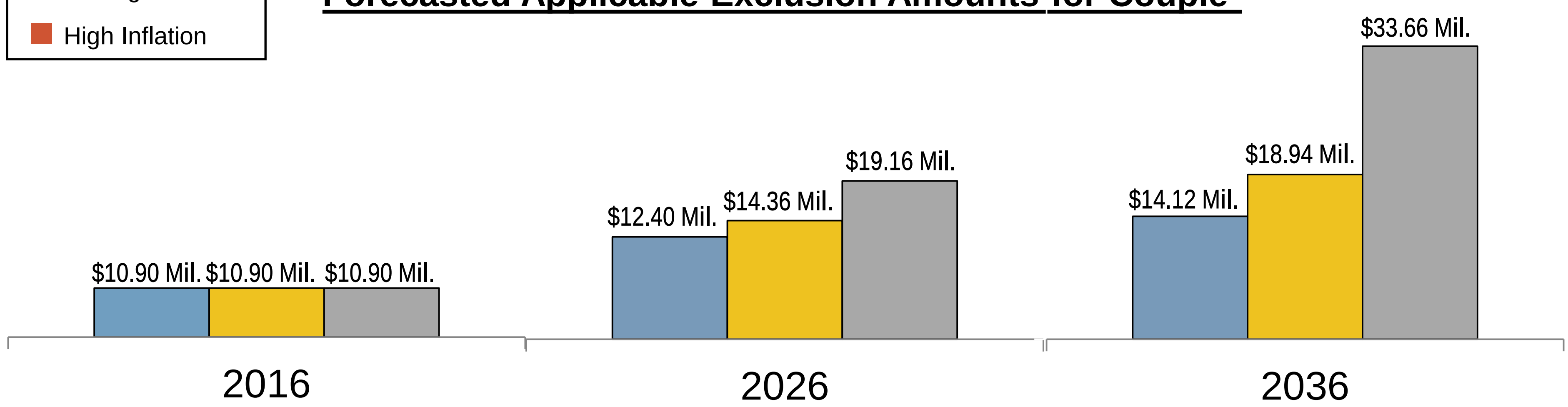
DSUEA Will Lose Estate Tax Benefit Over Time

Forecasted Applicable Exclusion for Surviving Spouse + Portability in 2016*





Forecasted Applicable Exclusion Amounts for Couple*



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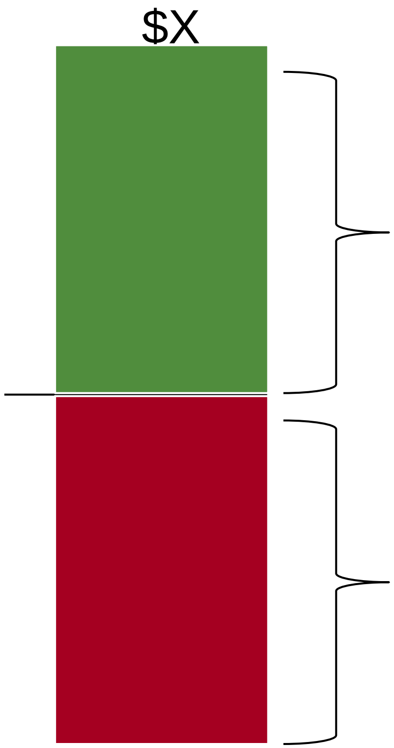
Tax Trade-Off Between By-Pass Trust vs. Portability-Based Plan

Tax Trade-Off of Traditional By-Pass Trust Plan = Estate Tax Savings – Income Tax Costs



Estate Tax Savings =
Taxable Appreciation x
Estate Tax Rate

Income Tax Costs =
No Subsequent "Step-Up"
+ Non-Grantor Trust Tax Drag

- If Estate Tax Benefit > Income Tax Costs, By-Pass Trust Plan Wins
- If Estate Tax Benefit < Income Tax Costs, Portability-Based Plan Wins

Source: AllianceBernstein

When Portability Might Make Sense

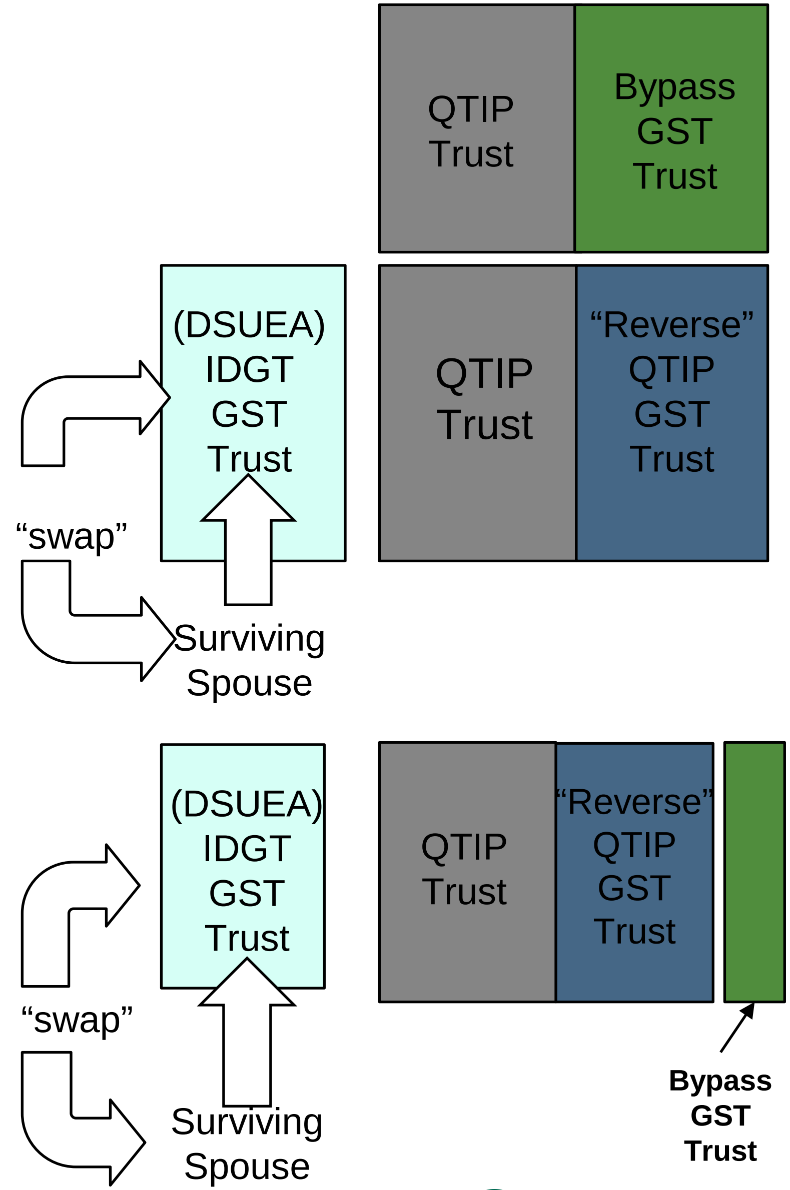
- Combined assets of:
  - $3.0 Mil. to $7.0 Mil.

- Assets are primarily:
  - Traditional IRA & qualified plan assets (Rollover & RMD)
  - Primary residence (§ 121 Exclusion & Homestead)

- Assets that are depreciable or depletable:
  - Commercial real property
  - Oil & gas and other mineral interests
  - Timber interests

When Portability Might Make Sense

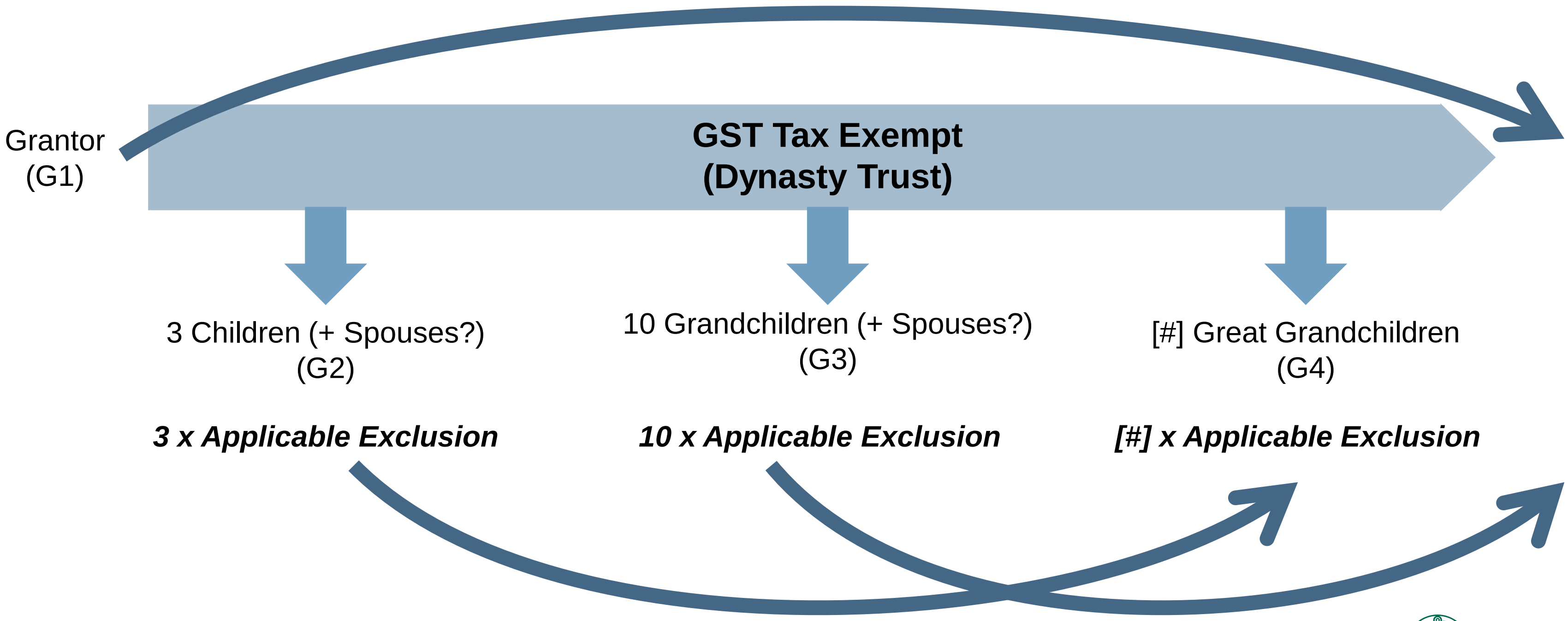
- Surviving spouse and estate are willing to:
  - Establish 100% QTIP
  - “Reverse” QTIP election
  - Fund an “intentionally defective grantor trust” (IDGT) with DSUEA gift
  - Apply surviving spouse’s GST exemption to the transfer
  - Give up beneficial interest in gifted assets
- State Estate/Inheritance Tax: No State QTIP, No State Gift Tax
  - Bypass trust funded with state exemption amount
  - Elect portability on the remainder above state exemption
  - Gift of DSUEA to IDGT
- Surviving spouse
  - Has significantly appreciated assets (separate property)
  - Will proactively transfer stepped-up assets in “zeroed-out” techniques



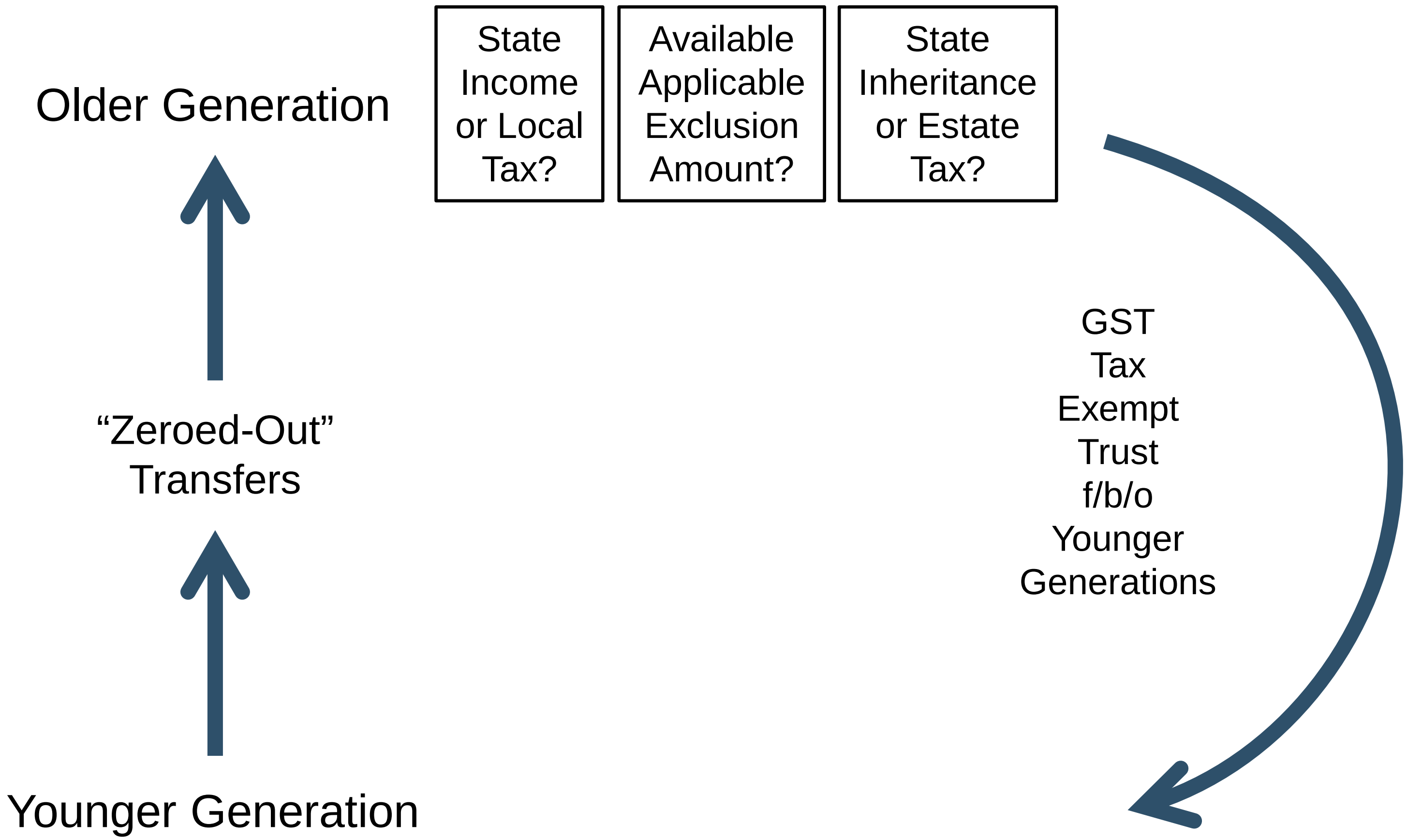
Forcing Estate Inclusion and Multiplying the Applicable Exclusion

- In-Kind Trust Distributions

- Testamentary General Powers of Appointment
  - Formula clause: specific to beneficiary's unused Applicable Exclusion Amount (estate and GST tax), specific to asset that would most benefit from "step-up" in basis, and unexercised in further trust.
  - Independent trustee/protector giving testamentary general power of appointment to beneficiary.
  - Modification of existing trusts or decanting.



"Reverse" Estate Planning?



“Reverse” Estate Planning: UpSPAT? Accidentally Perfect?

Older Generation

Testamentary
General Power of Appointment
(Lapse/Failure of Exercise)

IDGT/APGT

Available Applicable Exclusion Amount?

State Inheritance or Estate Tax?

Income Tax Considerations

“Step-Up” in Basis
§ 1014(b)(9)

GST Tax Exempt Trust f/b/o Younger Generations

Grantor Trust
§ 1.671-2(e)(5)

“Zeroed-Out” Transfers

Younger Generation

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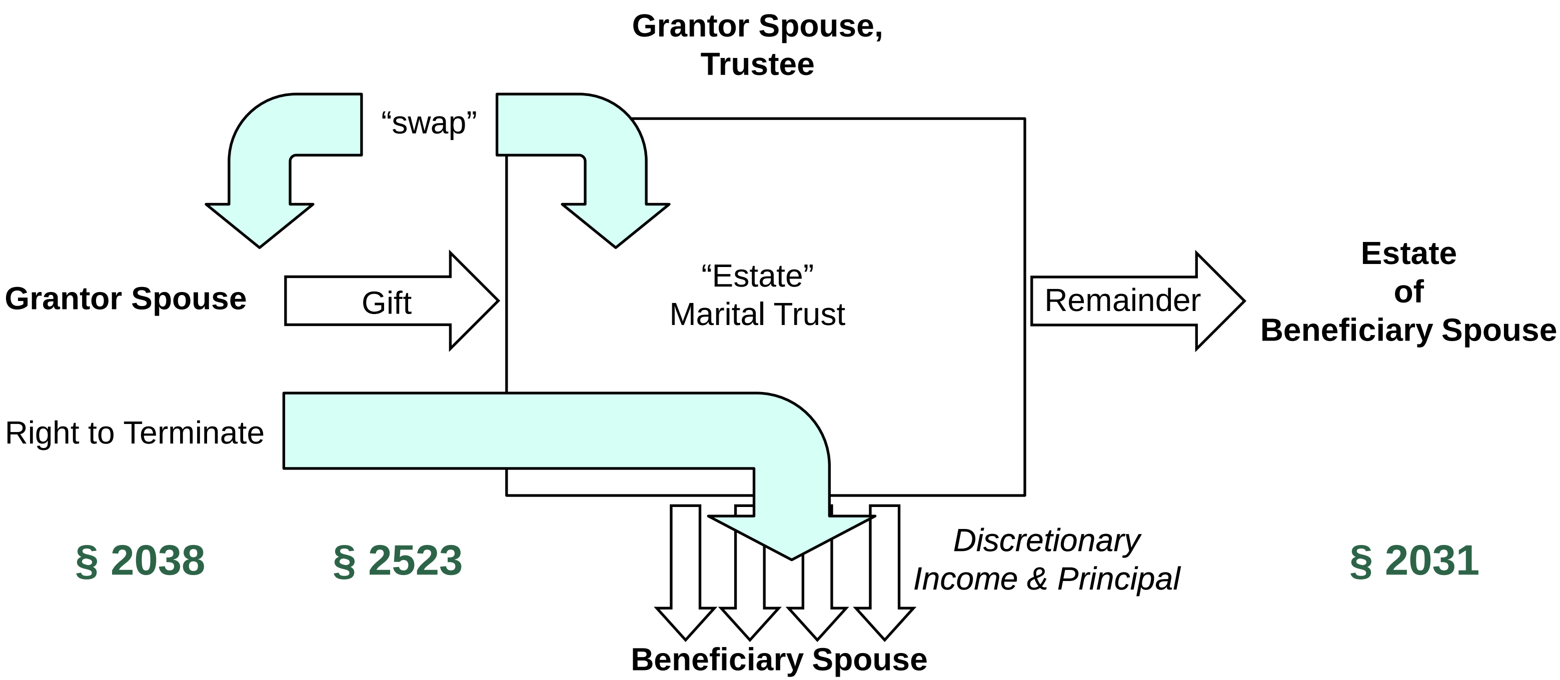
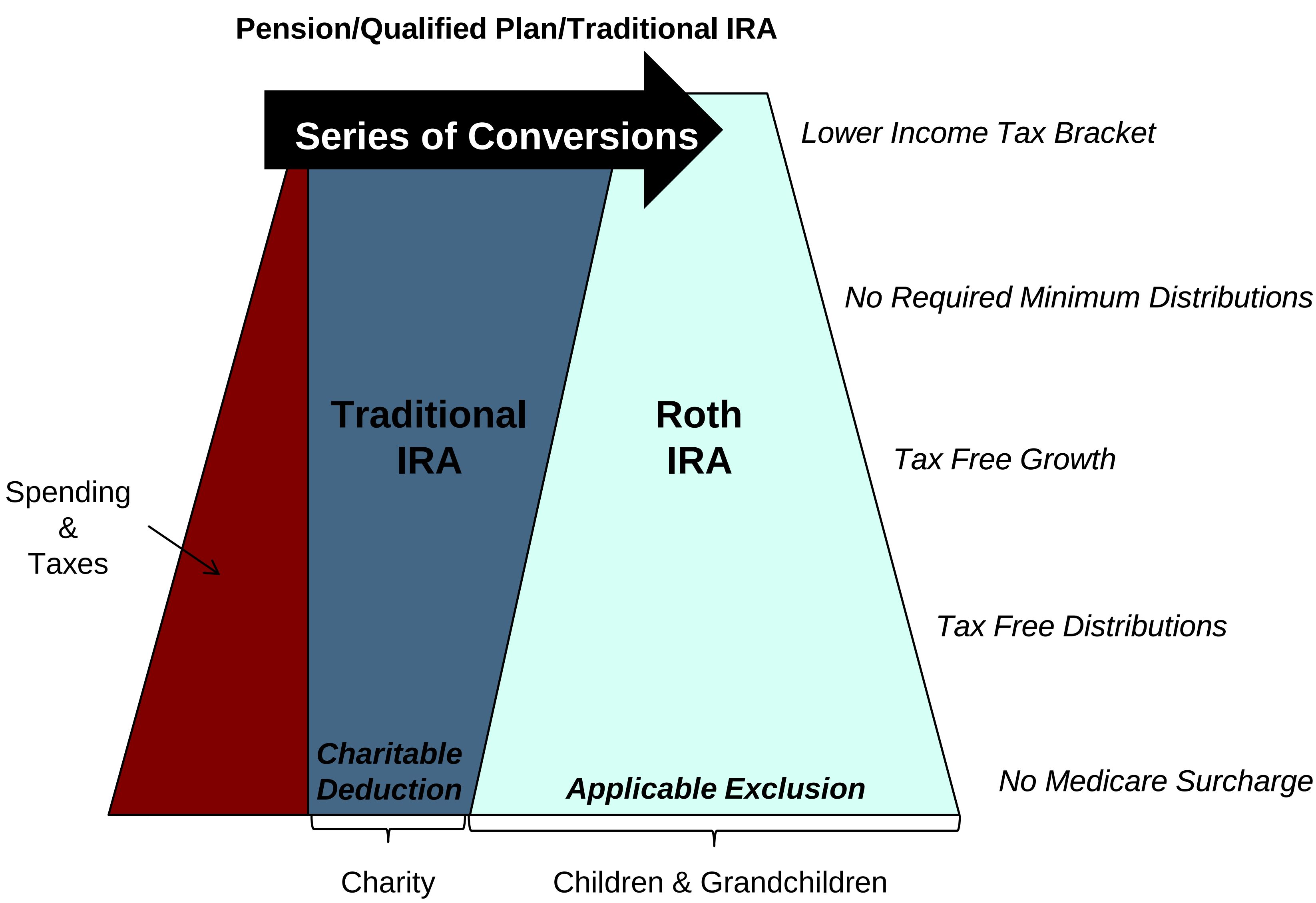
Double "Step-Up" in Basis

- Community Property
- Elective or Consensual Community Property Trusts (AK and TN)
- Joint Exempt Step-Up Trust (JEST)
- Section 2038 Estate Marital Trust



Roth IRA Conversions Are More Important to Consider



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Splitting Income: Simple, Complex, Non-Grantor, and Grantor

"Running the Brackets" Savings

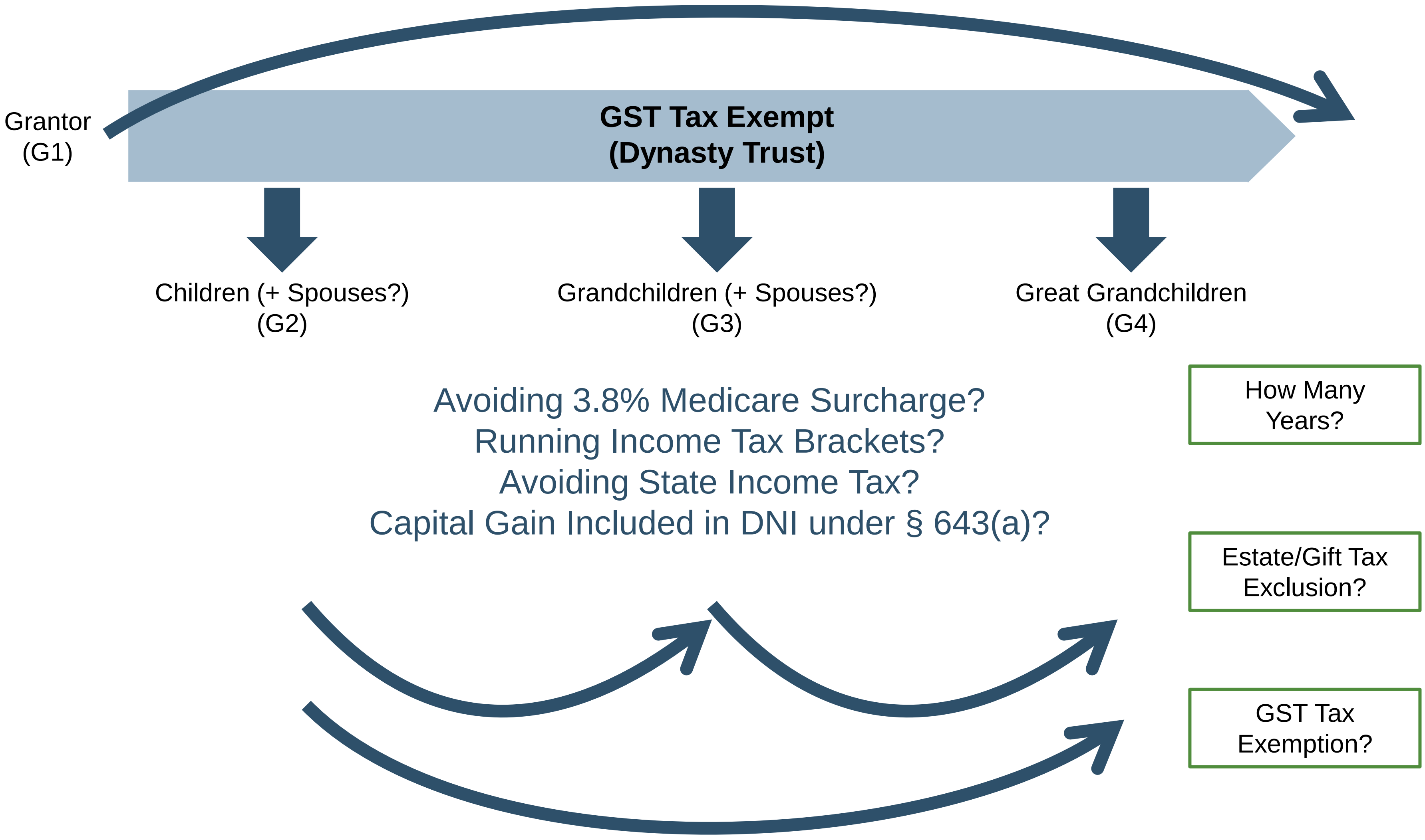
STCG/Ordinary Rate	Single ($43,830 in savings)	Joint ($54,333 in savings)
10%	$0-$9,275	$0-$18,550
15%	$9,276-$37,650	$18,551-$75,300
25%	$37,651-$91,150	$75,301-$151,900
28% / 31.8%	$91,151-$190,150	$151,901-$231,450
33% / 36.8%	$191,151-$412,350	$231,451-$413,350
35% / 38.8%	$413,351-$415,050	$412,351-$466,950
39.6% / 43.4%	$415,051 and above	$466,951 and above

LTCG/QD Rate	Single ($30,235 in savings)	Joint ($36,612 in savings)
0%	$0-37,650	$0-$75,300
15%	$37,651-*$200,000 MAGI*	$75,301-*$250,000 MAGI*
18.8%	*$200,001 MAGI*-$415,050	*$250,001 MAGI*-$466,950
23.8%	$415,051 and above	$466,951 and above

Non-Grantor Trusts
Highest
Tax Bracket
@ $12,400
Taxable Income

Splitting income, not necessarily cash flow: S corporation, LLC and LP shares

Distributing from Dynasty Trusts?



Charitable Remainder Trusts: Back in the High Life

TAXABLE SALE

zero basis

<u>Effective Federal Rate</u>
$5 Mil. Gain: 23.1%
$10 Mil. Gain: 23.4%

Taxpayer → CRUT (Tax-Exempt) → Charity

Tax Deduction

Taxpayer

<u>Tier: *Character of Income*</u>
1(a): *Ordinary*
1(b): *Qualified Dividend*
2(a): *Short-Term Gain*
2(b): *Long-Term Gain*
3: *Tax-Exempt*
4: *Basis*

LTCG/QD Rate	Joint
0%	$0-$74,900
15%	$74,900–**$250,000 MAGI**
18.8%	**$250,000 MAGI**–$464,850
23.8%	$464,850+

Effective Federal Rate

13.5%

15.9% = $36,488 tax savings/year

The Ideal Tool: Entity Taxed as a "Partnership"

Advantages: Flexibility

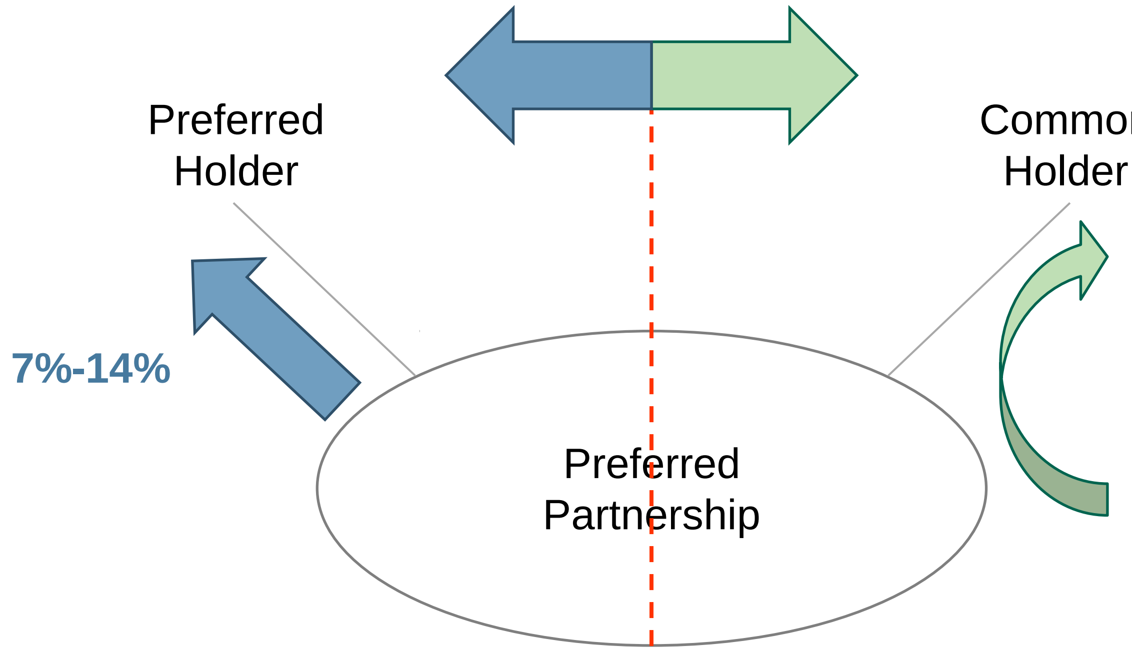
- Non-Tax Reasons (e.g., control, centralization, management, etc.)
- Potential Valuation Discounts
- Proactive Tax Basis Management
- Multiple Classes of Interests

Disadvantages: Complexity

- Subchapter K
- Chapter 14

"Partnership"

Preferred & Common: Retain or Transfer?



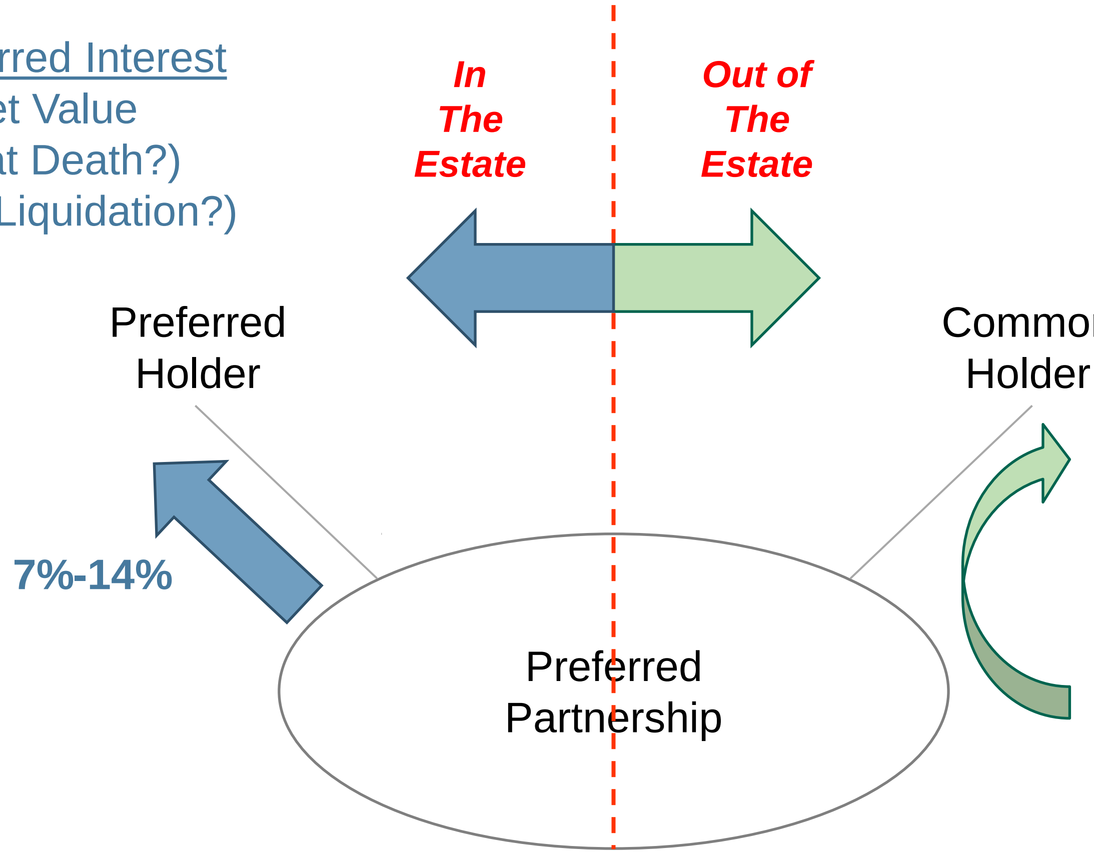
- o Fixed Liquidation Value
- o Fixed Rate Annual Distribution
- o Tax Items Preferentially Allocated
- o If Retain, § 2701 Applies
- o If Transfer, Normal Gift Tax Rules

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

Retain Preferred/Transfer Common: Qualified or Non-Qualified

Estate Tax

<u>Qualified Preferred Interest</u>
Fair Market Value
(Liquidated at Death?)
(Cost-of-Living Liquidation?)



<u>Non-Qualified Preferred Interest</u>
Fair Market Value (Liquidated?)
less
Reg. § 25.2701-5(a)(3) Adjustment

Gift Tax

<u>Common Interest</u>
Family Interests
less
Qualified Interest
less
Discounts

<u>Common Interest</u>
Family Interests
less
Zero

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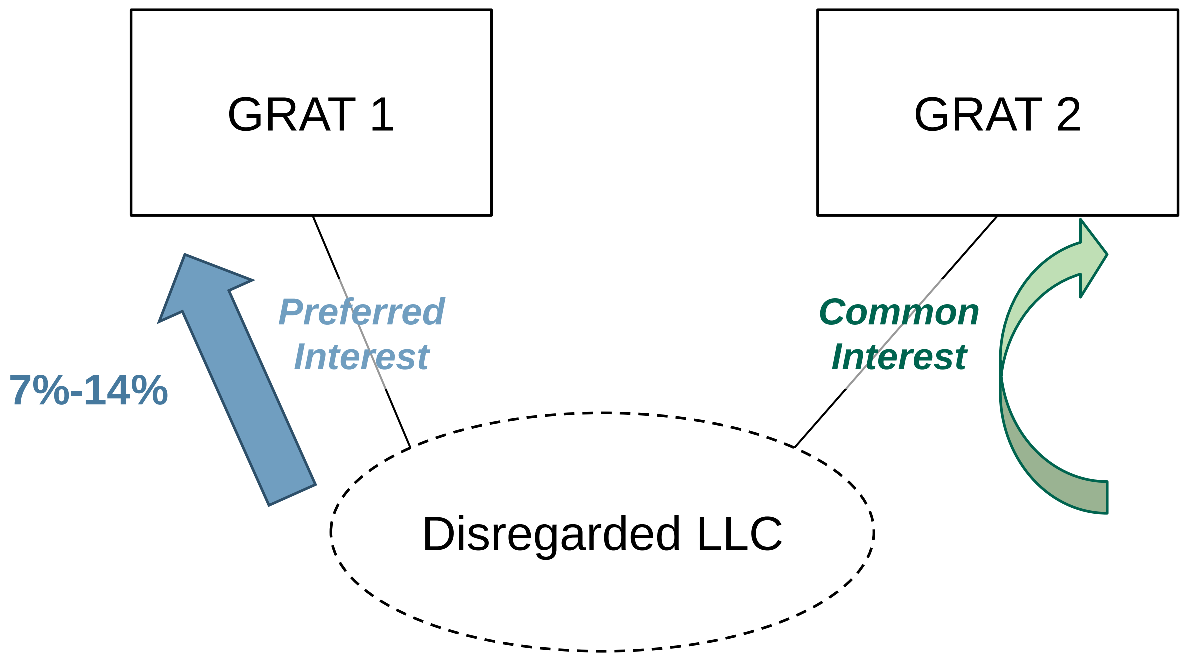
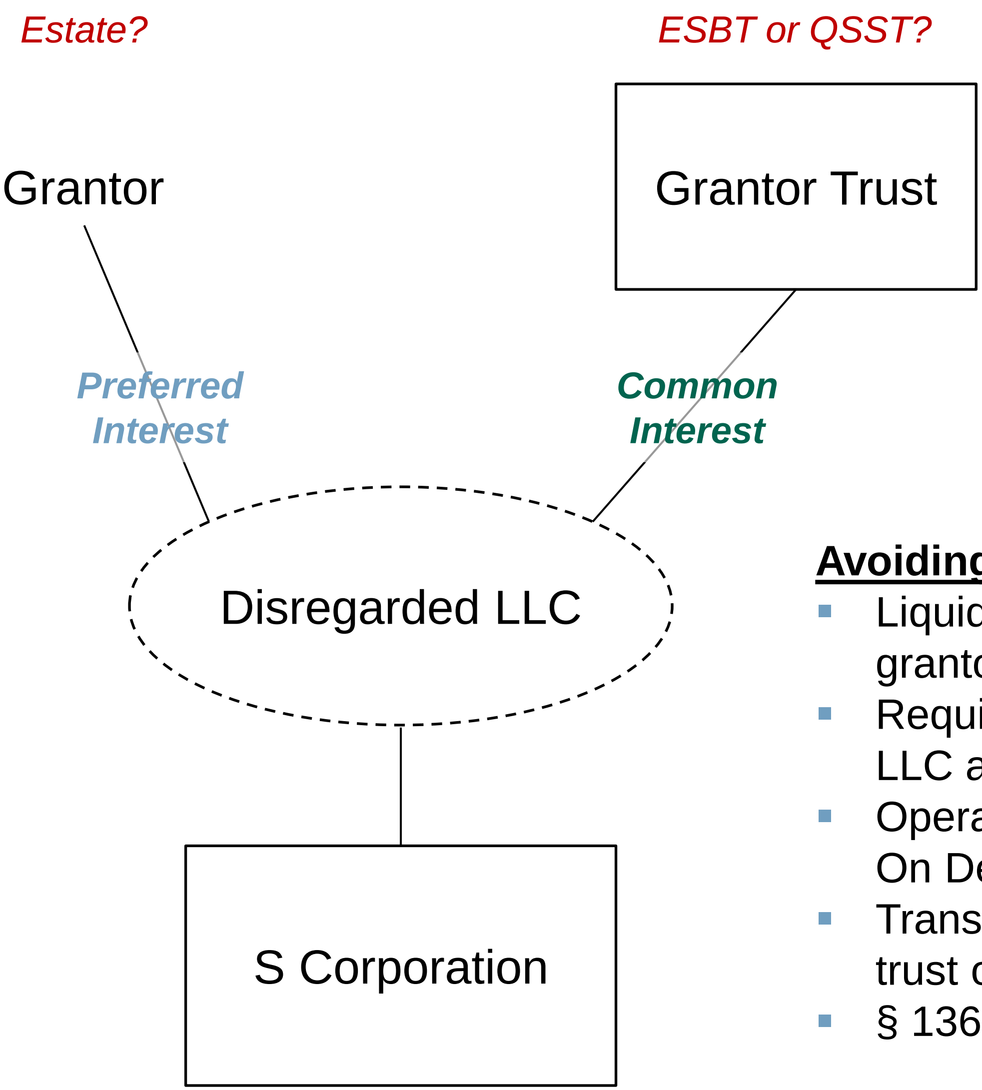
Disregarded Entities: GRATs



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 (PLR 200841007)

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Run the Basis

(Capture Maximum Tax Savings)

Tax Basis Management: Grantor Trust Swapping? Discount?

"Step-Up" Important		Higher Valuation
	Creator-Owned Copyrights, Trademarks, Patents & Artwork	
	"Negative Basis" Commercial Real Property LPs	
	Oil & Gas Investments (Sold)	
	Artwork, Gold & Other "Collectibles"	
	Low Basis Stock	
	Roth IRA Assets	
	Oil & Gas Investments (Not Sold)	
	High Basis Stock	
	Qualified Small Business Stock (QSBS)	
	Fixed Income	
	Cash	
	Passive Foreign Investment Company (PFIC) Shares	
	Stock at a Loss	
	Variable Annuities	
"Step-Up" Not Important	**Traditional IRA & Qualified Plan Assets**	Lower Valuation

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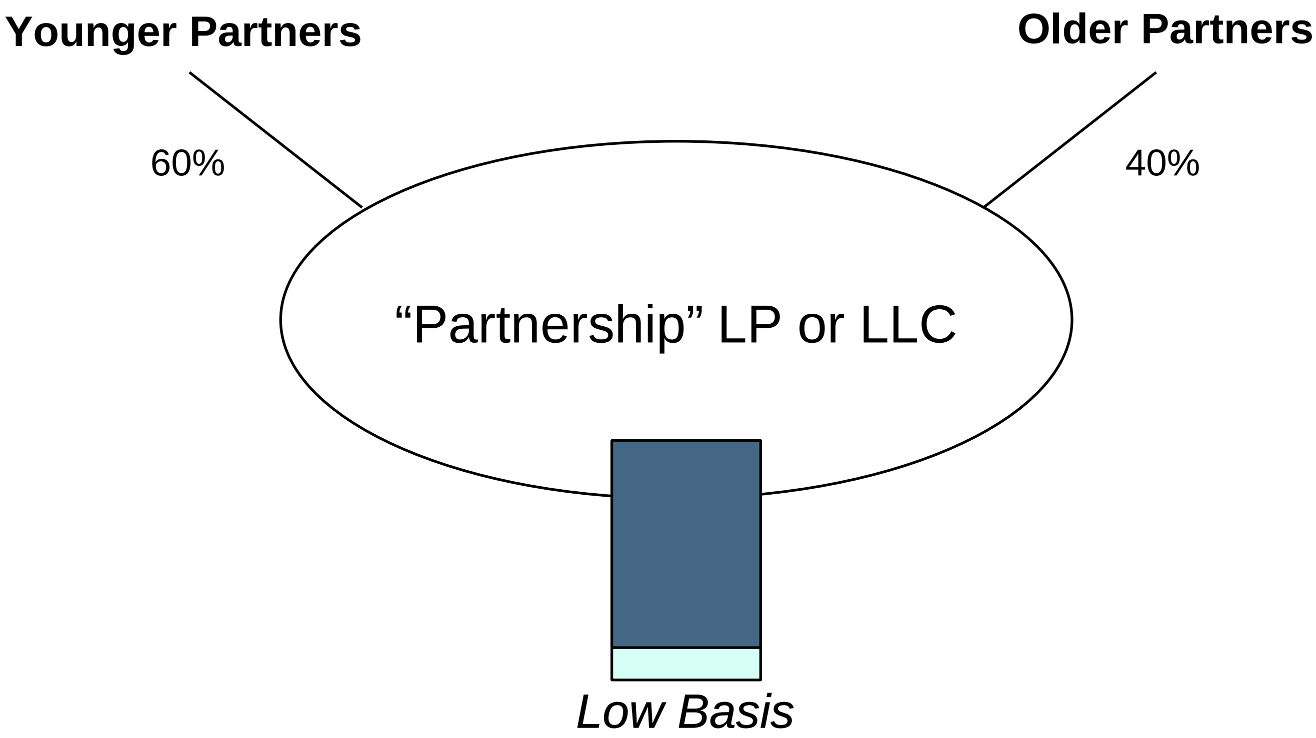
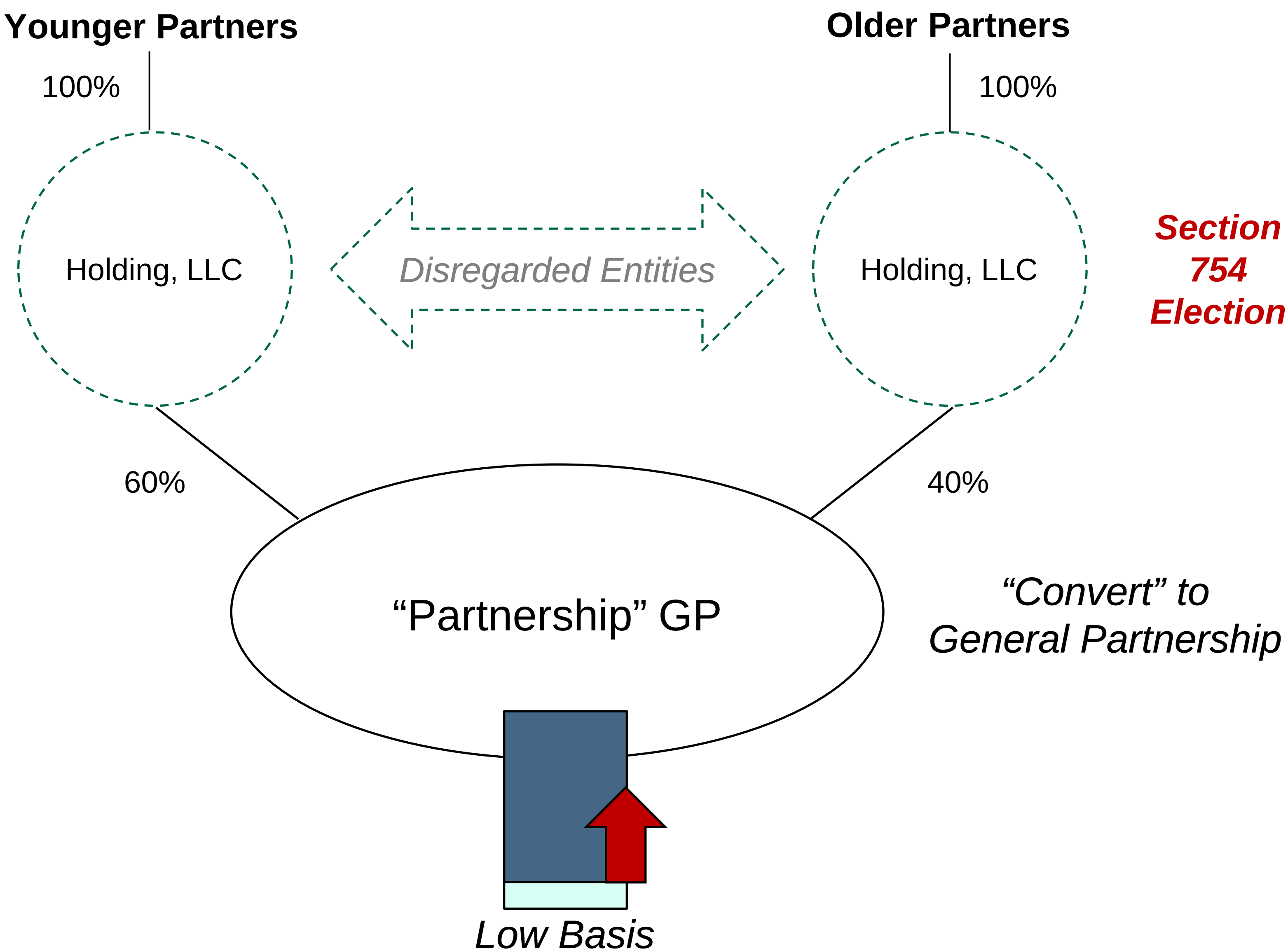
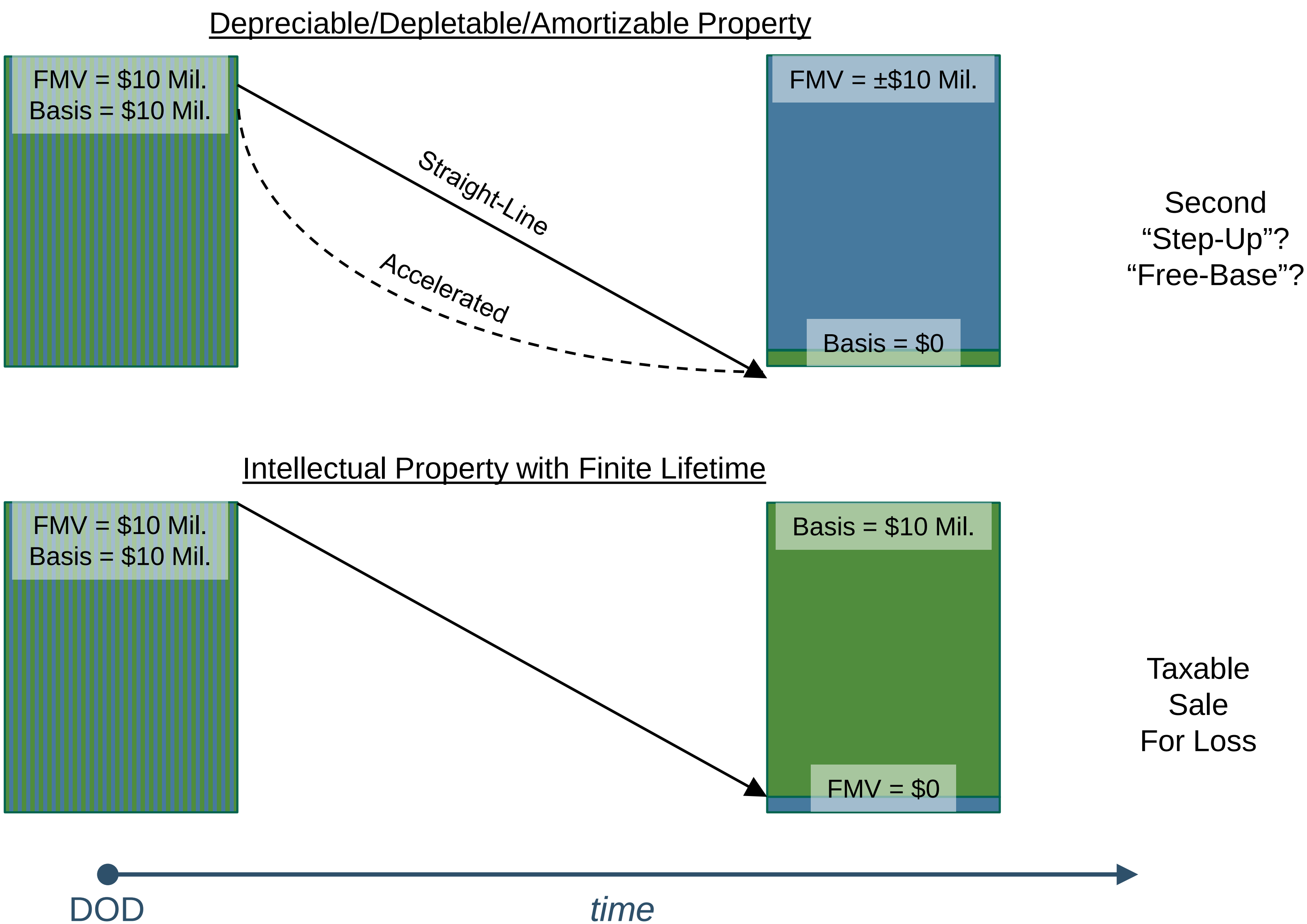
Eliminating Valuation Discounts on Pre-Existing FLPs



Eliminating Valuation Discounts on Pre-Existing FLPs



Understanding How Basis & Value Might Change



How Do You "Transfer" An Asset But Still Own It For The "Step-Up" In Basis?

CONTRACT DERIVATIVE

Sell The Appreciation Via Contract, Own The Asset

FMV = $10 Mil.

Recapture = $5 Mil.

Basis = $0

Debt = $4 Mil.

9-YEAR CONTRACT

Grantor “Sells”/
Personal Obligation to Pay

Total Return =

FMV of Property
LESS Debt
PLUS Net Rental Income

9-YEAR PROMISSORY NOTE

$6 Mil.
LESS Discount
“Personal Obligation Risk”

BUSINESS REASONS
Real Property Tax
Creditor Consent
Real Estate Transfer Tax
NIIT/Material Participation
Expenses of Transfer

IDGT

ISSUES
Valuation?
Settled Before Date of Death?
Estate Tax Deduction?
Ordinary Income/Deduction?
Satisfied with What Asset?

How Do You Get More Than $1 Of "Step-Up" In Basis For $1 Of Estate Tax Inclusion?

DEBT

Maximizing the “Step-Up” & Minimizing Estate Tax: Debt

FMV = $10 Mil.

Basis = $0

Gross Estate
§ 2031 = $10 Mil.

Taxable Estate
§ 2051 = $10 Mil.

“Step-Up” in Basis
§ 1014(a) = $10 Mil.

Debt = $9 Mil.
(Cash)

Gross Estate
§ 2031 = $10 Mil.

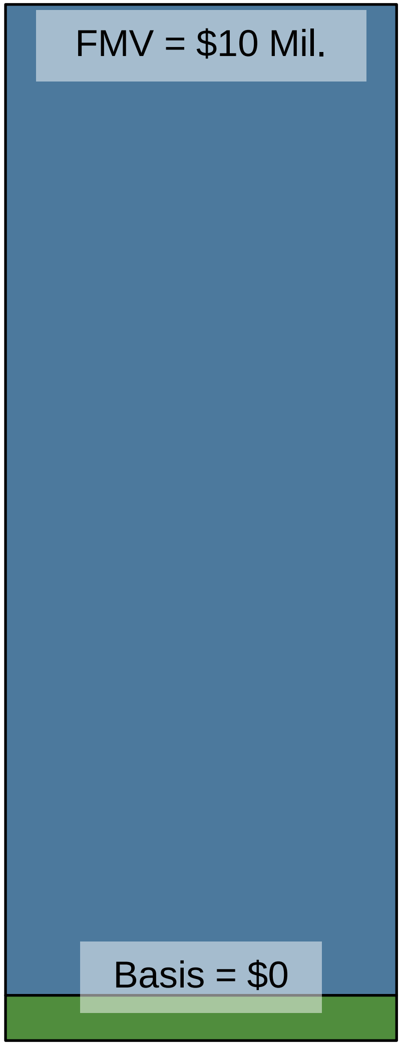
Indebtedness
§ 2053(a)(4) = ($9 Mil.)

Taxable Estate
§ 2051 = $1 Mil.

“Step-Up” in Basis
§ 1014(a) = $10 Mil.

“Zeroed-Out” Transfers
“Swap” for Appreciated Pty.

Debt with QTIP Trusts?



Amount Includible
§ 2044(a) = $10 Mil.

Taxable Estate
§ 2051 = $10 Mil.

"Step-Up" in Basis
§ 1014(b)(10)→(b)(9)
= $10 Mil.

Amount Includible
§ 2044 = $10 Mil.

Indebtedness
§ 2053(a)(4) = ($9 Mil.)

Taxable Estate
§ 2051 = $1 Mil.

Amount Includible
§ 2044 = 1 Mil.

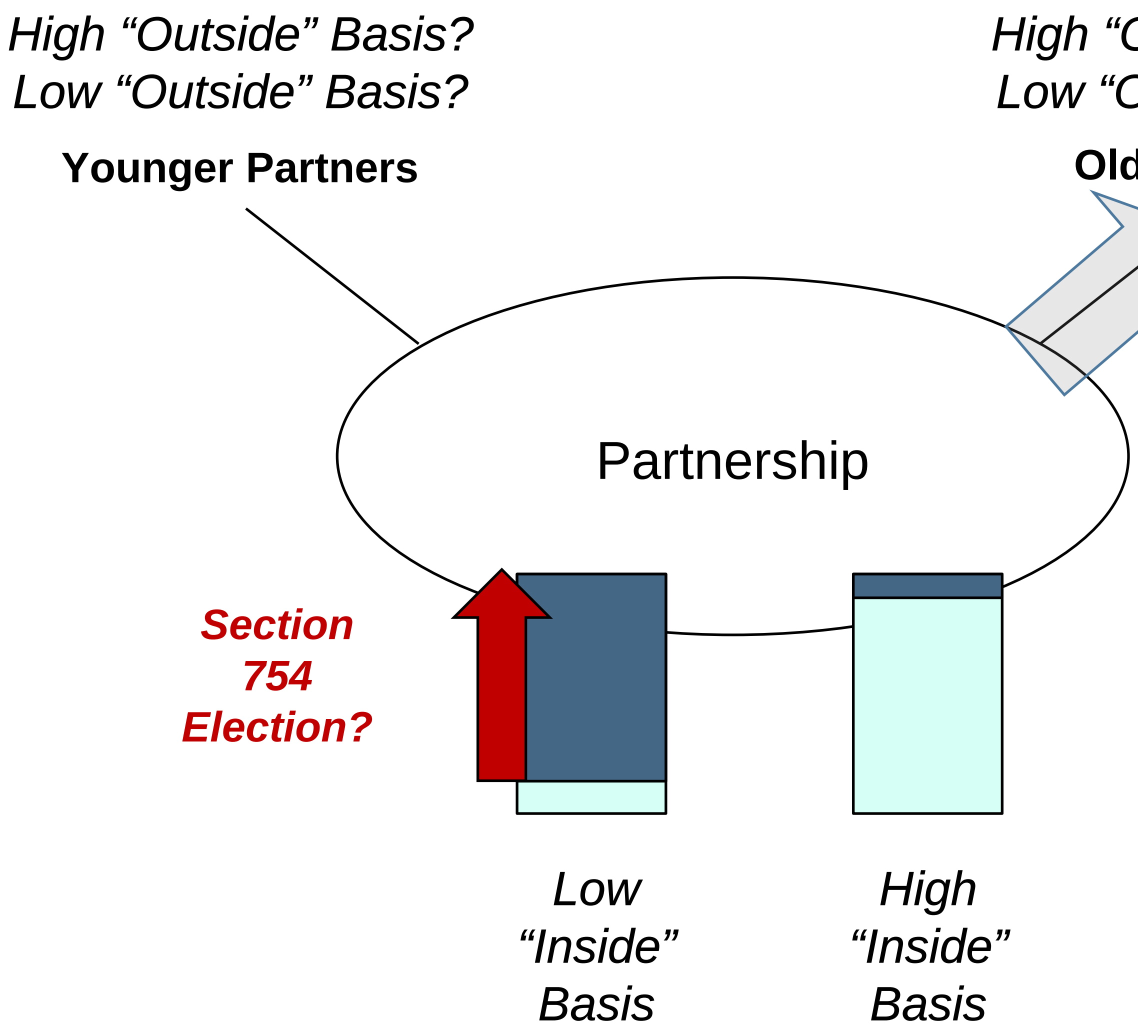
Taxable Estate
§ 2051 = $1 Mil.

"Step-Up" in Basis
§ 1014(b)(10) = $10 Mil. or $ 1 Mil. (?)

How do you change the tax basis of a non-depreciable asset without death or a taxable event?

PARTNERSHIPS

Importance of Partnerships in Tax Basis Management



Need to Know from Subchapter K:

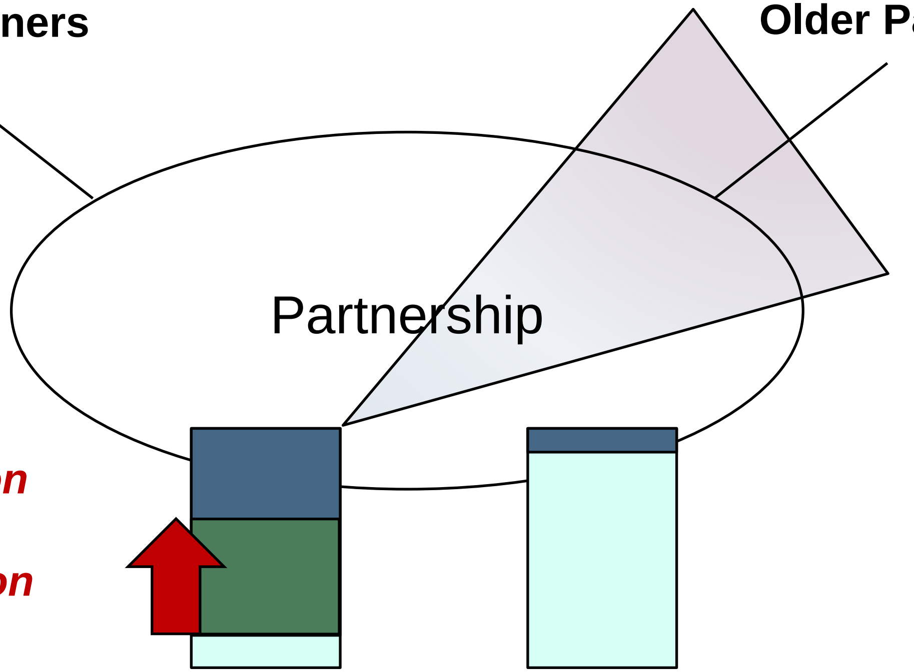
- Unitary basis rules
- Distributions of partnership property
  - "Mixing bowl" transactions
  - "Disguised sale" rules
- Partnership debt rules and outside basis
- Section 754 and inside basis adjustments
- Partnership divisions
- Anti-abuse rules

Limits of 754 Election and Basis Adjustment at Death (§ 743)

Younger Partners

OB/CA
$0x/$100x
Older Partner

OB/CA
$60x/$100x
Estate of Partner



Section 754 Election

Low "Inside" Basis

High "Inside" Basis

§ 1014(a) = FMV

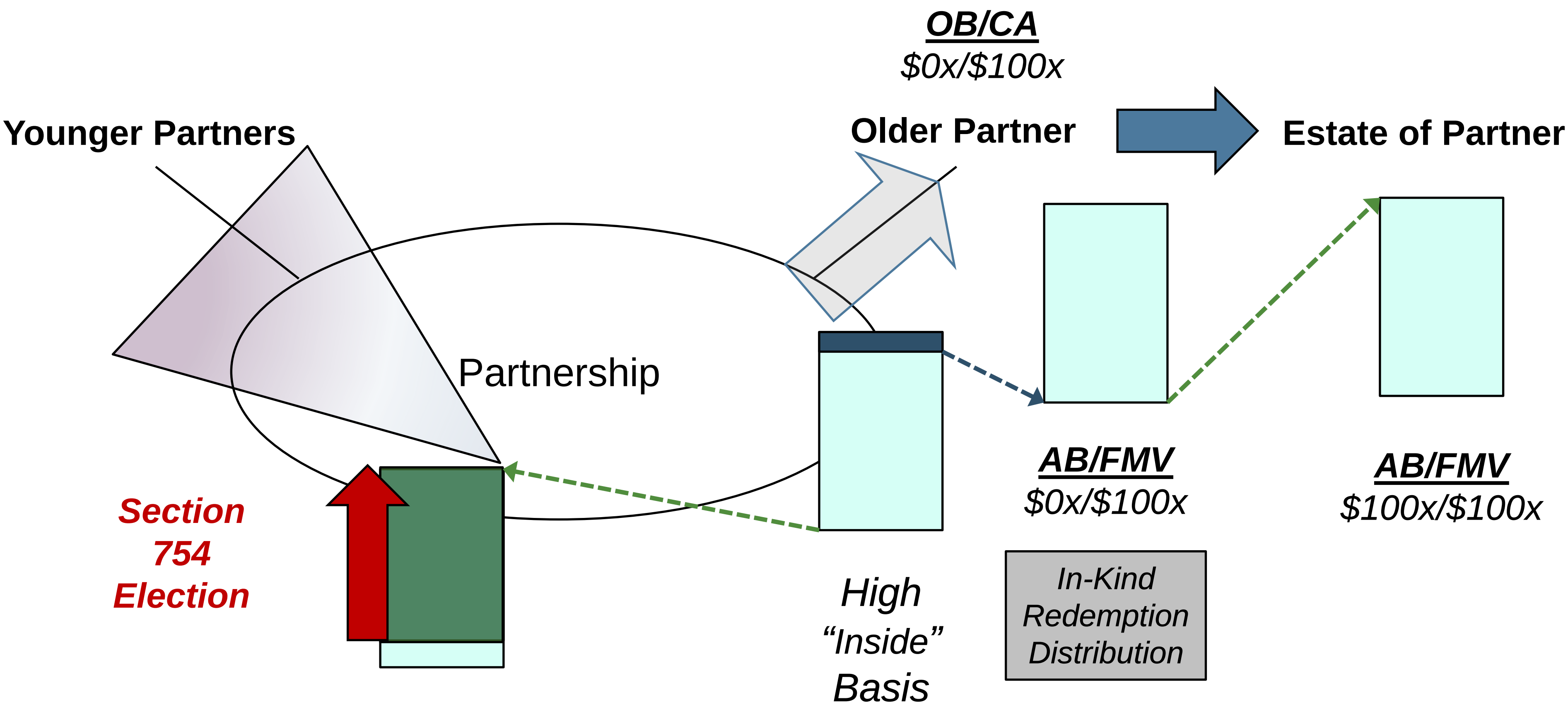
Net of:
40% Valuation Discounts
&
Partnership Liabilities

+

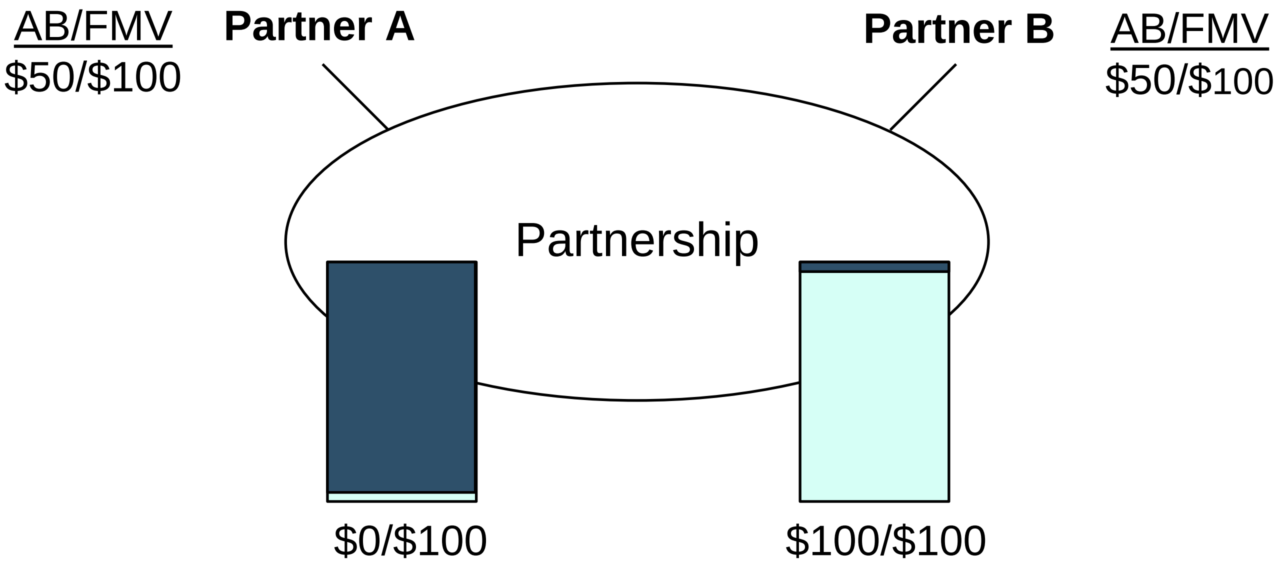
§ 752

Share of Liabilities

Maximizing "Step-Up" and Moving Tax Basis (§ 734)

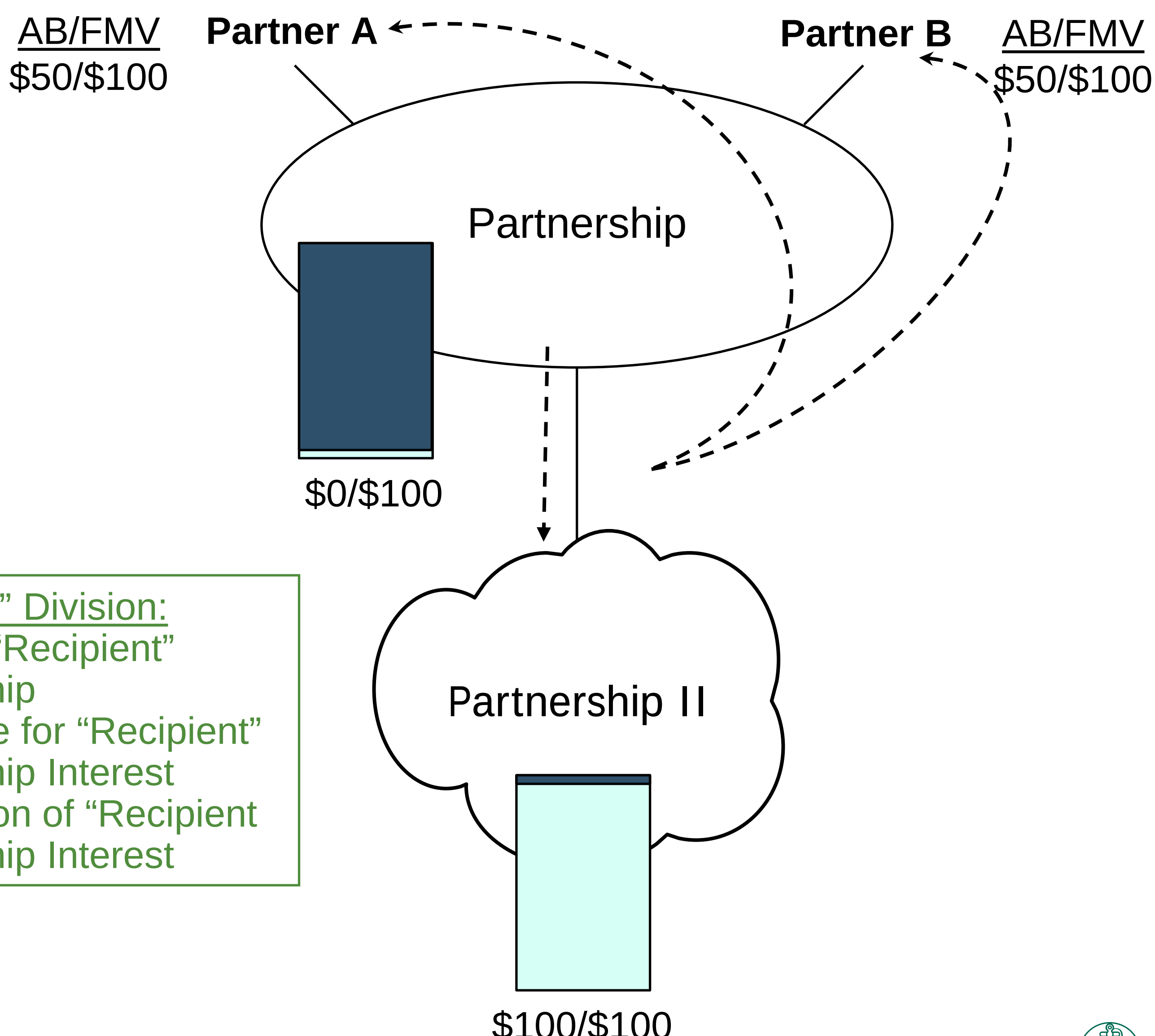


Unitary Basis Works Against Efficient Tax Basis Management



Northern Trust

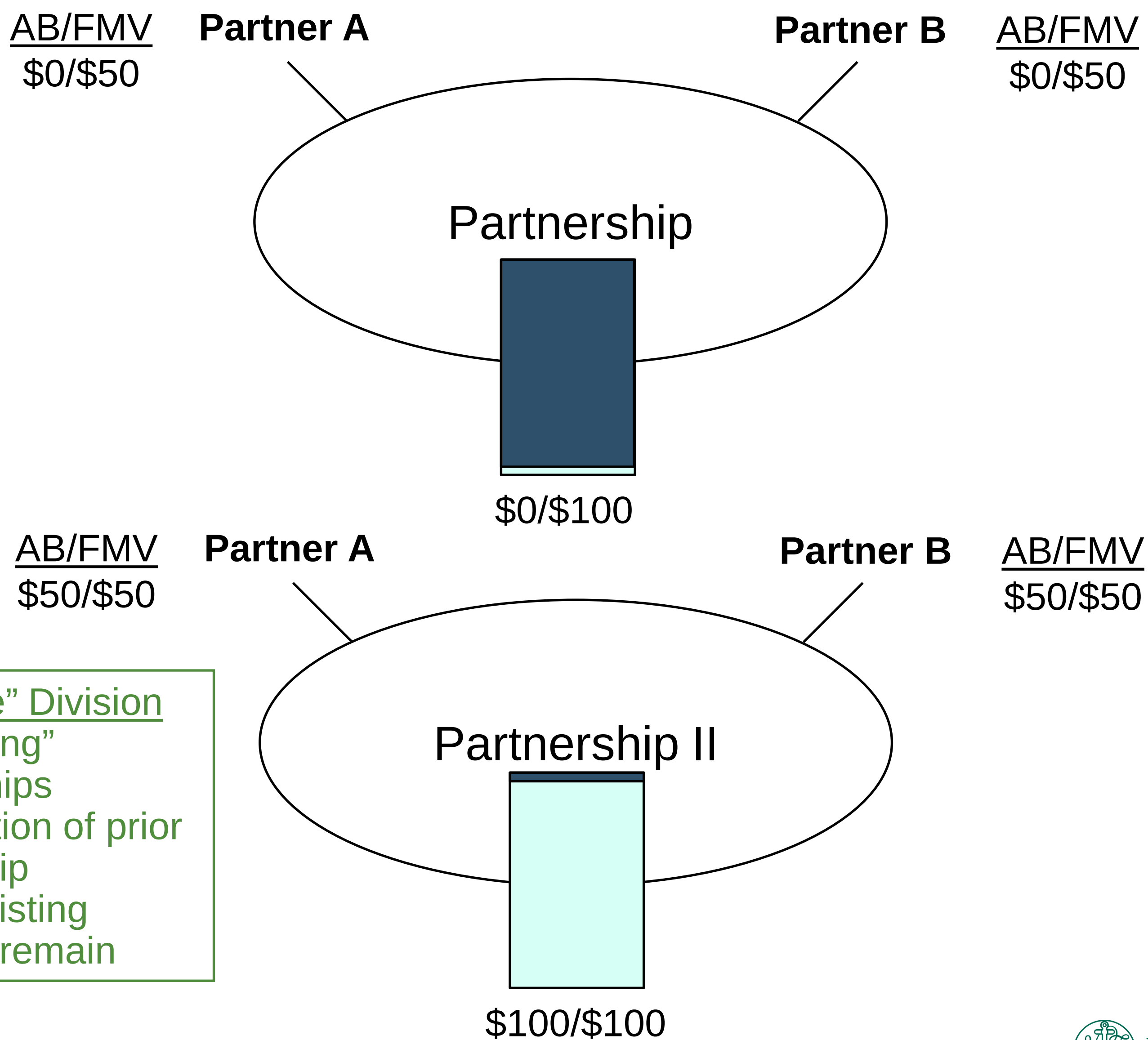
Partnership Division Can Solve Unitary Basis Problem



"Assets-Over" Division:

1. Asset to "Recipient" Partnership
2. Exchange for "Recipient" Partnership Interest
3. Distribution of "Recipient" Partnership Interest

Partnership Division Can Create High & Low Outside Basis



"Vertical Slice" Division

1. 2 "Resulting" Partnerships
2. Continuation of prior partnership
3. All pre-existing elections remain

FLP Evolution: Ancient Alien Theory

No § 754 Election

“Mother Ship”
All Asset
Partnership

Bourbon: “Age for at Least 7 Years”

No § 754 Election

“Mother Ship”
All Asset
Partnership

Isolated
“Aliens”

§ 754 Election

Ancient Alien Theory: 3 Lines of Evolution?

"Mother Ship"
All Asset (Ex. Assets)
Partnership

"Mother Ship"
Section 751 "Hot" Assets
Partnership

"Mother Ship"
Marketable Securities
Partnership

Bourbon: "Age for at Least 7 Years"

No § 754 Election

"Mother Ship"
All Asset (Ex. Assets)
Partnership

"Mother Ship"
Section 751 "Hot" Assets
Partnership

"Mother Ship"
Marketable Securities
Partnership

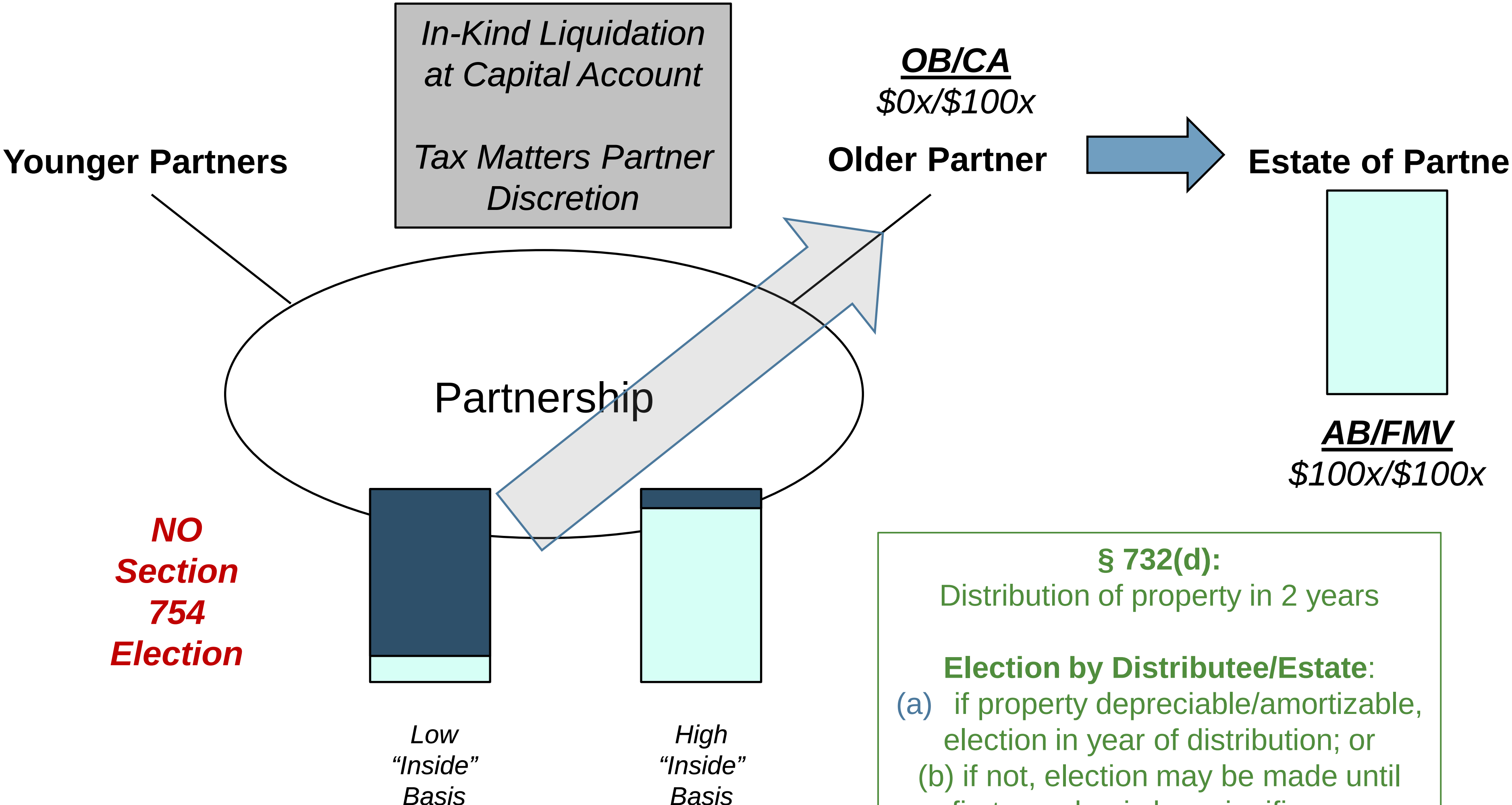
§ 754 Election

Isolated
"Aliens"

Isolated
"Hot" Assets

Isolated
Securities

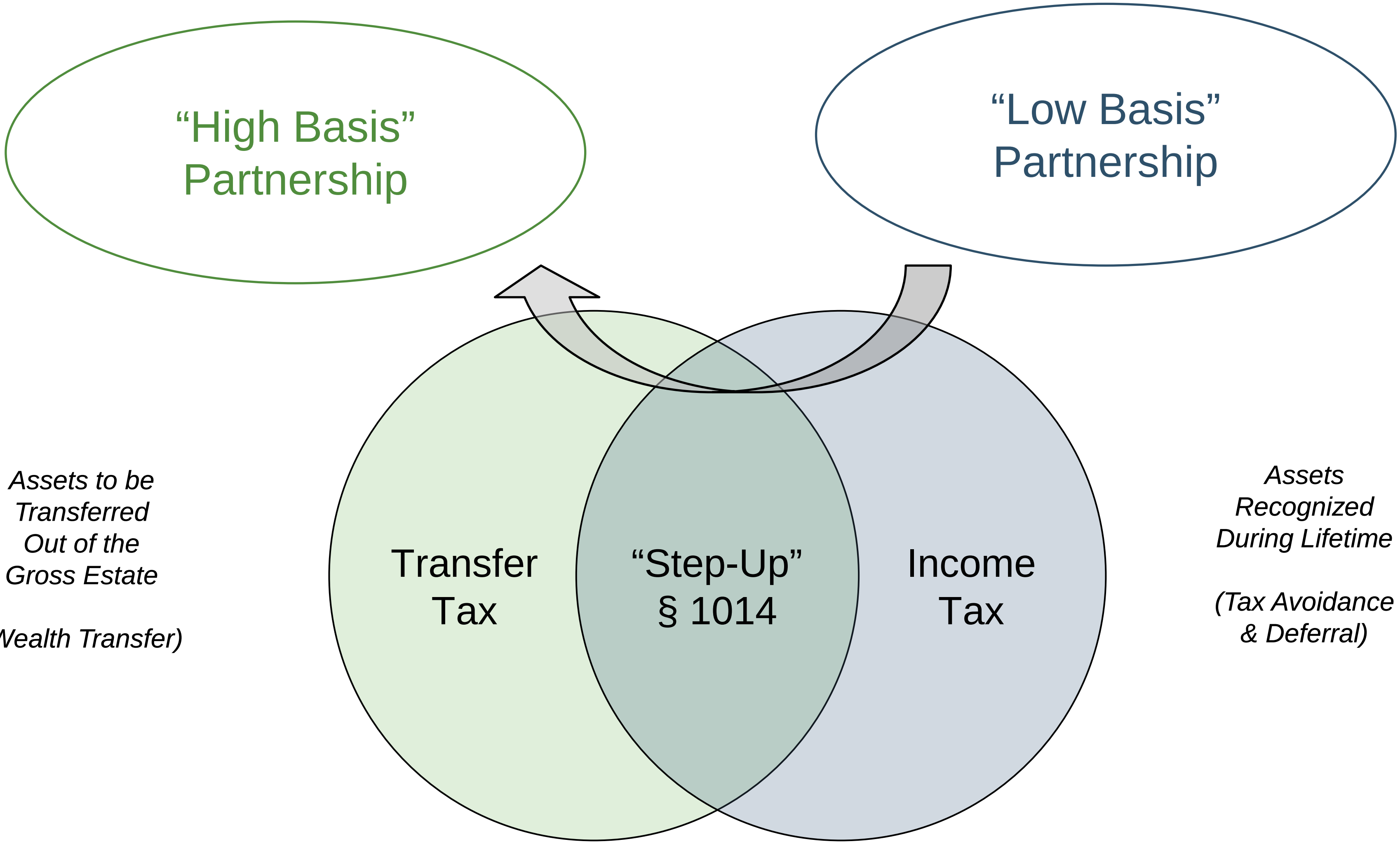
Section 732(d) Election: Solution to Section 743 Limitations



§ 732(d):
Distribution of property in 2 years

Election by Distributee/Estate:
(a) if property depreciable/amortizable, election in year of distribution; or
(b) if not, election may be made until first year basis has significance

Second Theory of FLP Evolution: Creationism



Assets to be Transferred Out of the Gross Estate

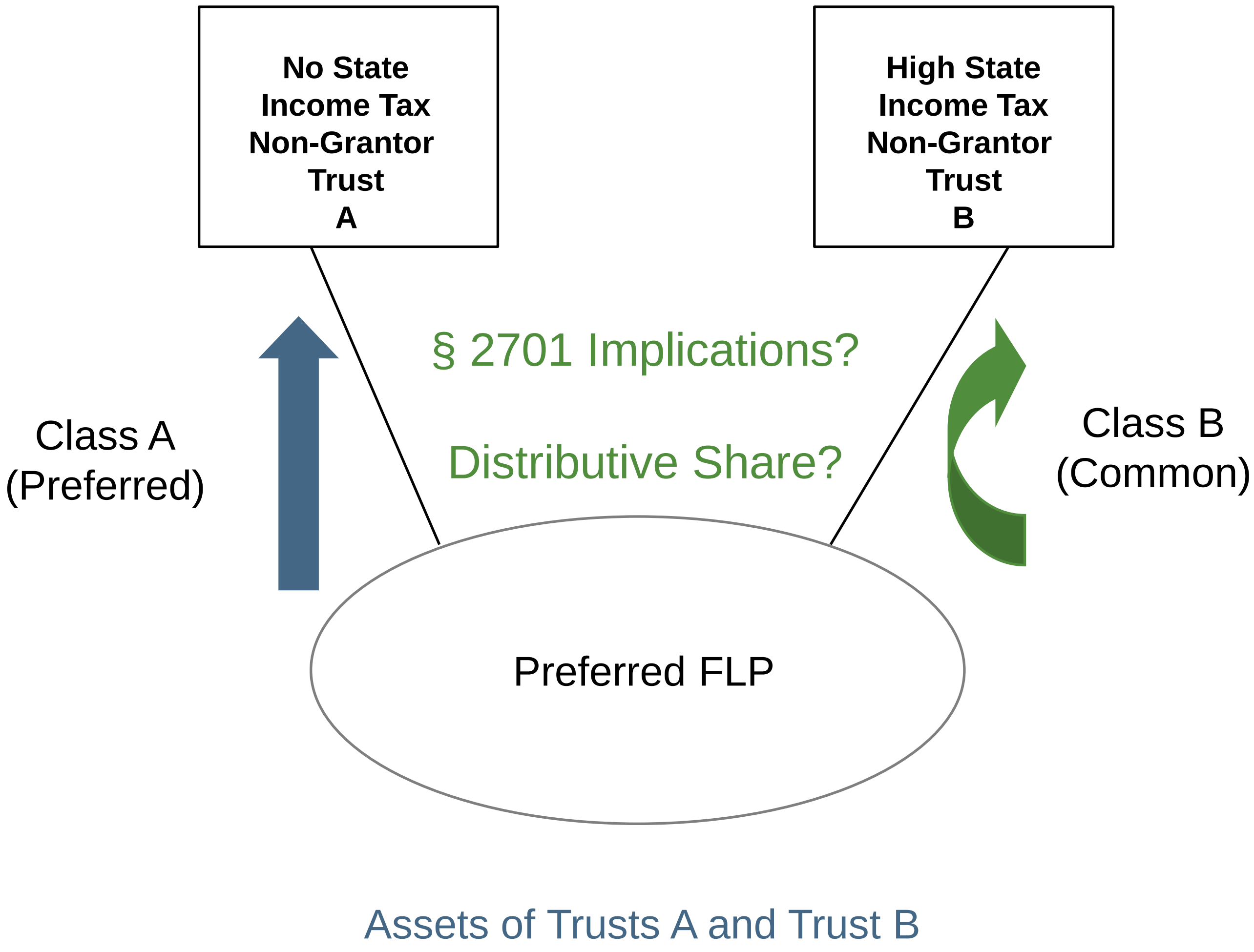
(Wealth Transfer)

Assets Recognized During Lifetime

(Tax Avoidance & Deferral)

Northern Trust

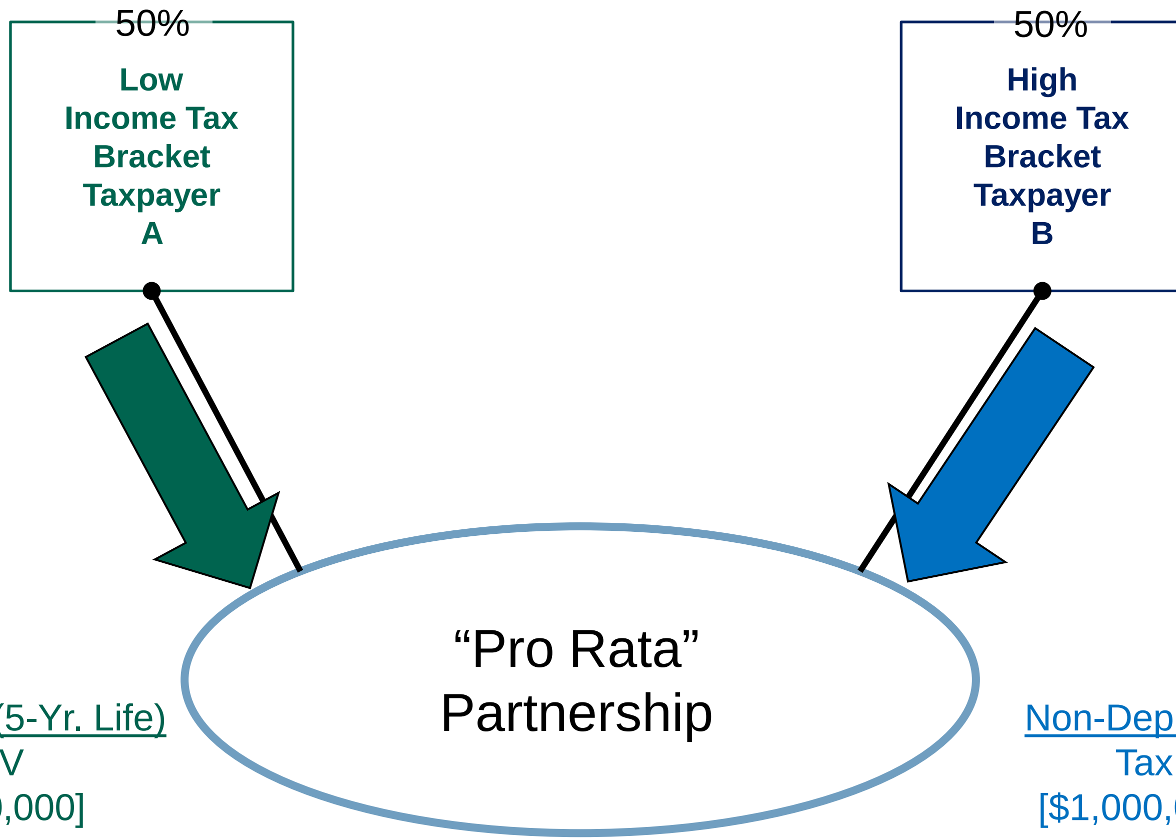
Trust to Trust Preferred



How do you allocate taxable income to other family members in a pro-rata FLP without making a taxable gift?

PARTNERSHIP ELECTIONS

Contributions of Depreciable Property



Depreciable Property (5-Yr. Life)
Tax Basis/FMV
[$400,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

Non-Depreciable Property
Tax Basis/FMV
[$1,000,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

Section 704(c): Attempts to Avoid Shifts of Income

	Book Depreciation		
	Total Basis	Per Year	Partner B
	$1,000,000	$200,000	$100,000
5 Years	**$1,000,000**	**$1,000,000**	**$500,000**

	Tax Depreciation		
	Total Basis	Per Year	Partner B
	$400,000	$80,000	$40,000
5 Years	$400,000	$400,000	$200,000

Each Year
B Has

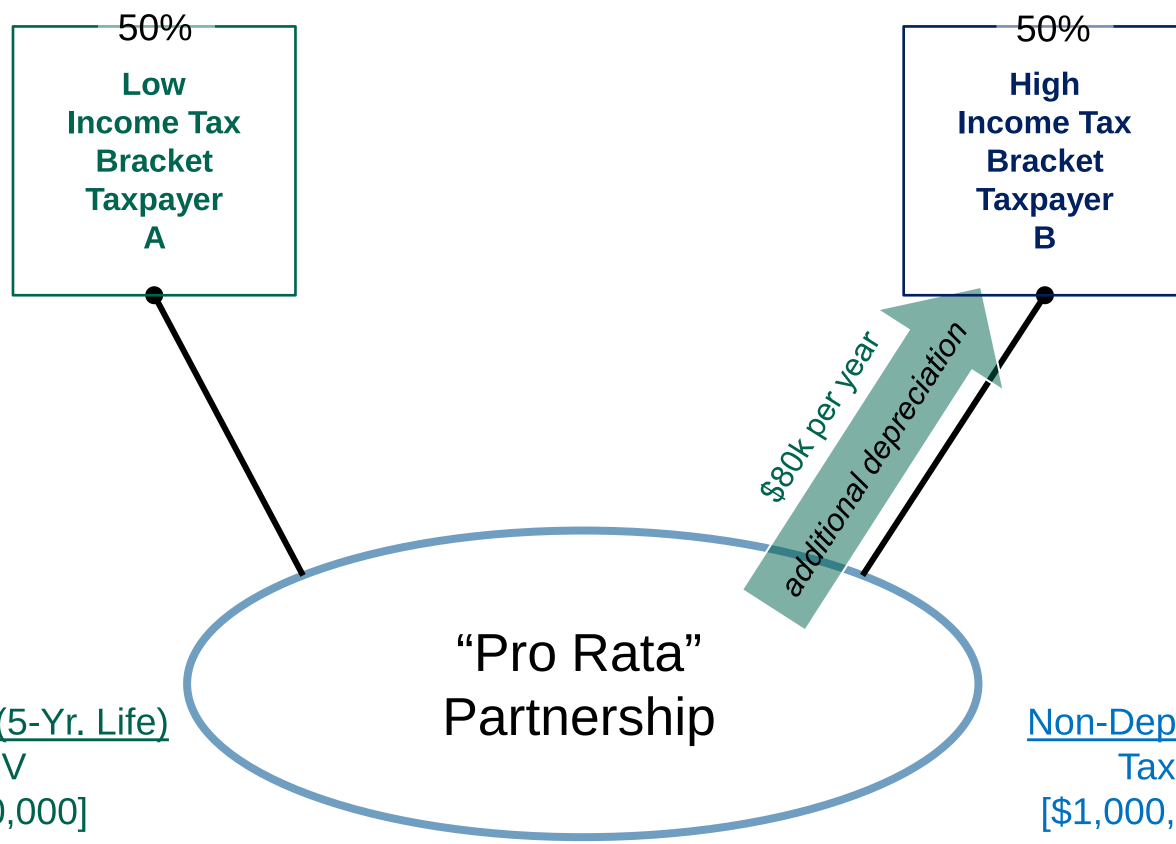
$60,000

LESS
Depreciation

MORE
Taxable
Income

§ 704(c) assumes A is, in effect, disproportionately shifting taxable income to B because A has already enjoyed more of the depreciation prior to the contribution.

“Traditional Method” of Allocation



<u>Depreciable Property (5-Yr. Life)</u>
Tax Basis/FMV
[$400,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

<u>Non-Depreciable Property</u>
Tax Basis/FMV
[$1,000,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

“Ceiling Rule” Limits the Traditional Method

	Book Depreciation		
	Total Basis	Per Year	Partner B
	$1,000,000	$200,000	$100,000
5 Years	**$1,000,000**	**$1,000,000**	**$500,000**

	Tax Depreciation		
	Total Basis	Per Year	Partner B
	$400,000	$80,000	$80,000
5 Years	$400,000	$400,000	$400,000

In 5 Years
B Is
Allocated

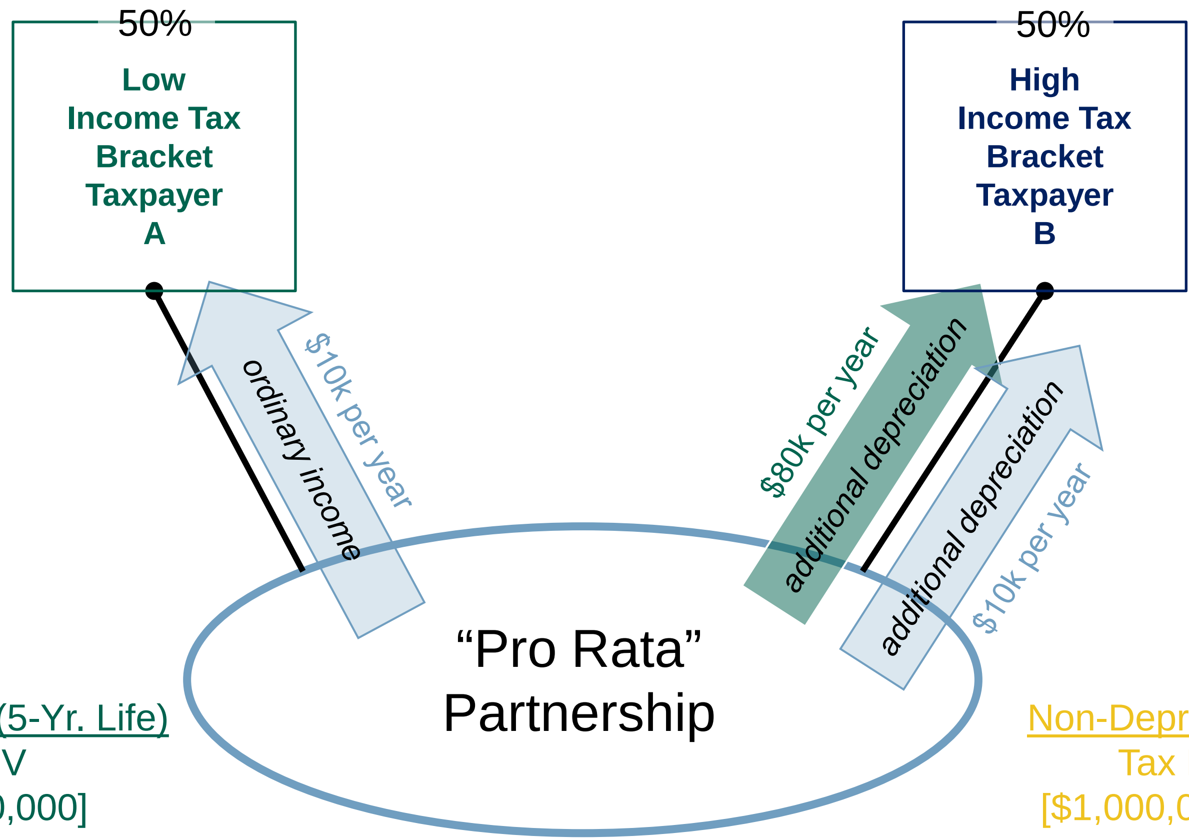
$100,000

LESS
Depreciation

MORE
Taxable
Income

“The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, or deduction with respect to that property for the taxable year (the ceiling rule).” Treas. Reg. § 1.704-3(a)(1).

“Reasonable” Curative Allocations



Depreciable Property (5-Yr. Life)
Tax Basis/FMV
[$400,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

Other Partnership Property
Depreciable Property
Ordinary Income Property

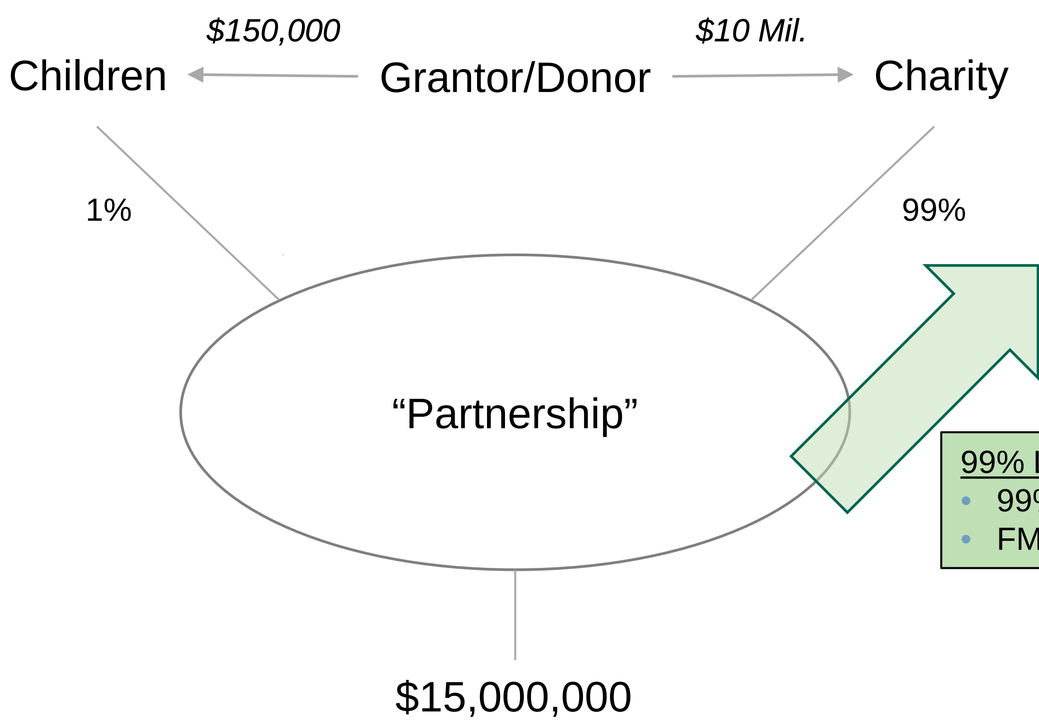
Non-Depreciable Property
Tax Basis/FMV
[$1,000,000/$1,000,000]

Book Basis/FMV
[$1,000,000/$1,000,000]

How Can Charity Play a Role in the New Estate Planning Paradigm?

CHARITABLE FLIPS

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.)

IRS Scrutiny and Planning Considerations

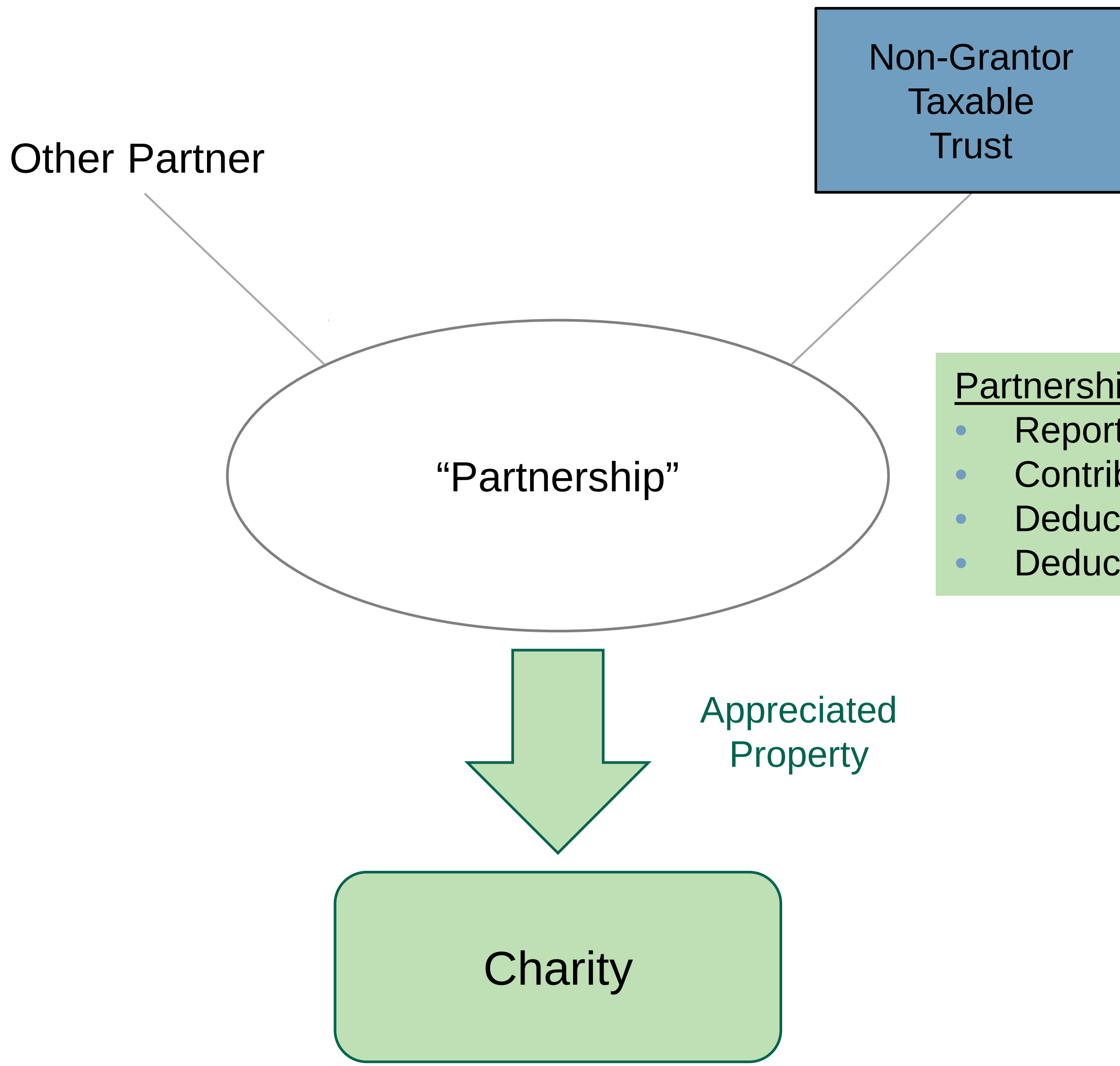
2001 EO CPE: G (Control and Power : Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions)

- "[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

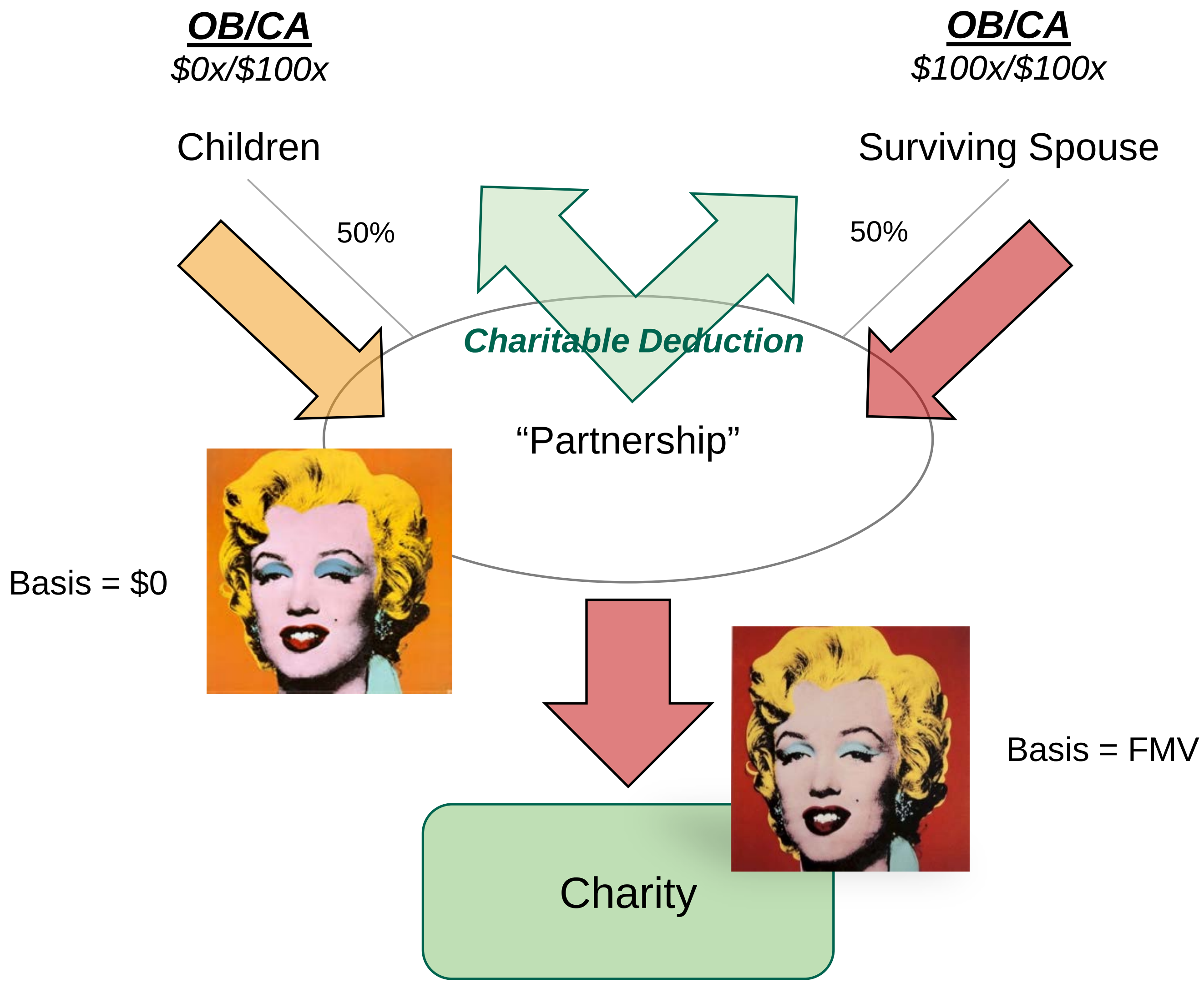
Charitable Contributions Through a Partnership



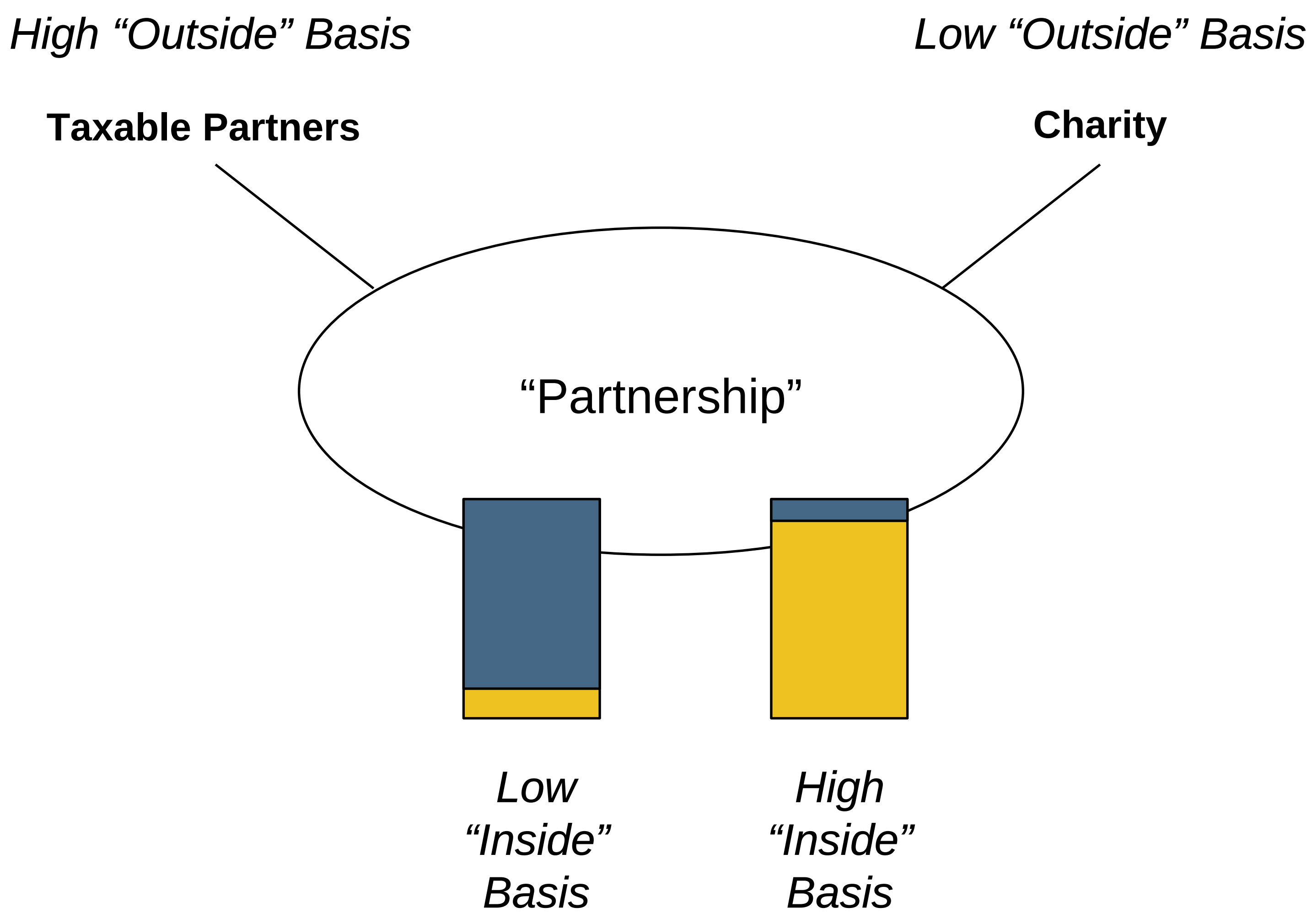
<u>§ 642(c) Deduction</u>:
- Governing instrument
- Limited to income
- Not principal

<u>Partnership Charitable Contributions</u>
- Reported by partners (§ 702(a)(4))
- Contribution reduces outside basis
- Deduction not limited by outside basis
- Deduction based on FMV not basis

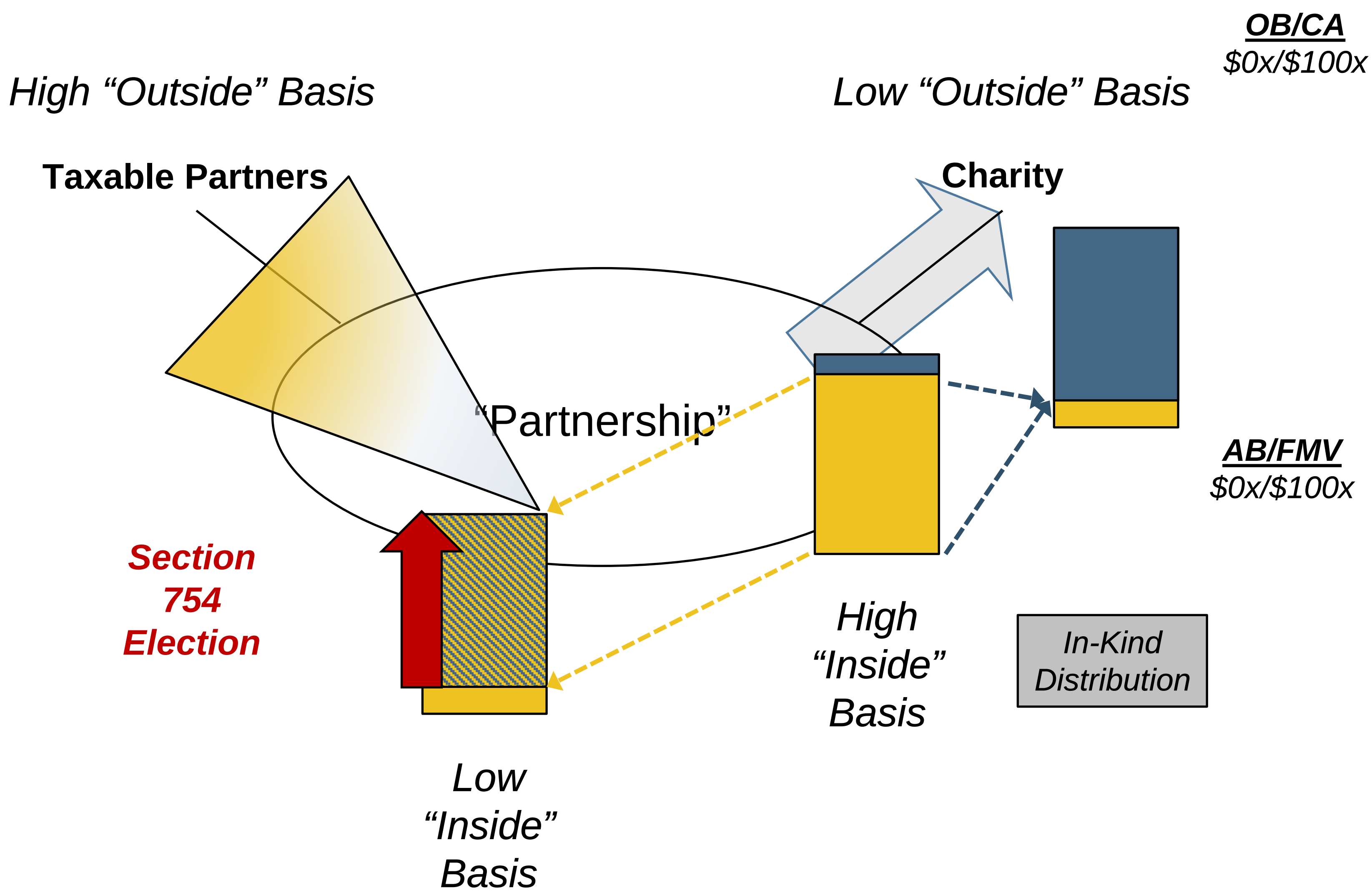
Getting Deductions Even with No Basis & No Related Use?



Charity and Tax Basis Management

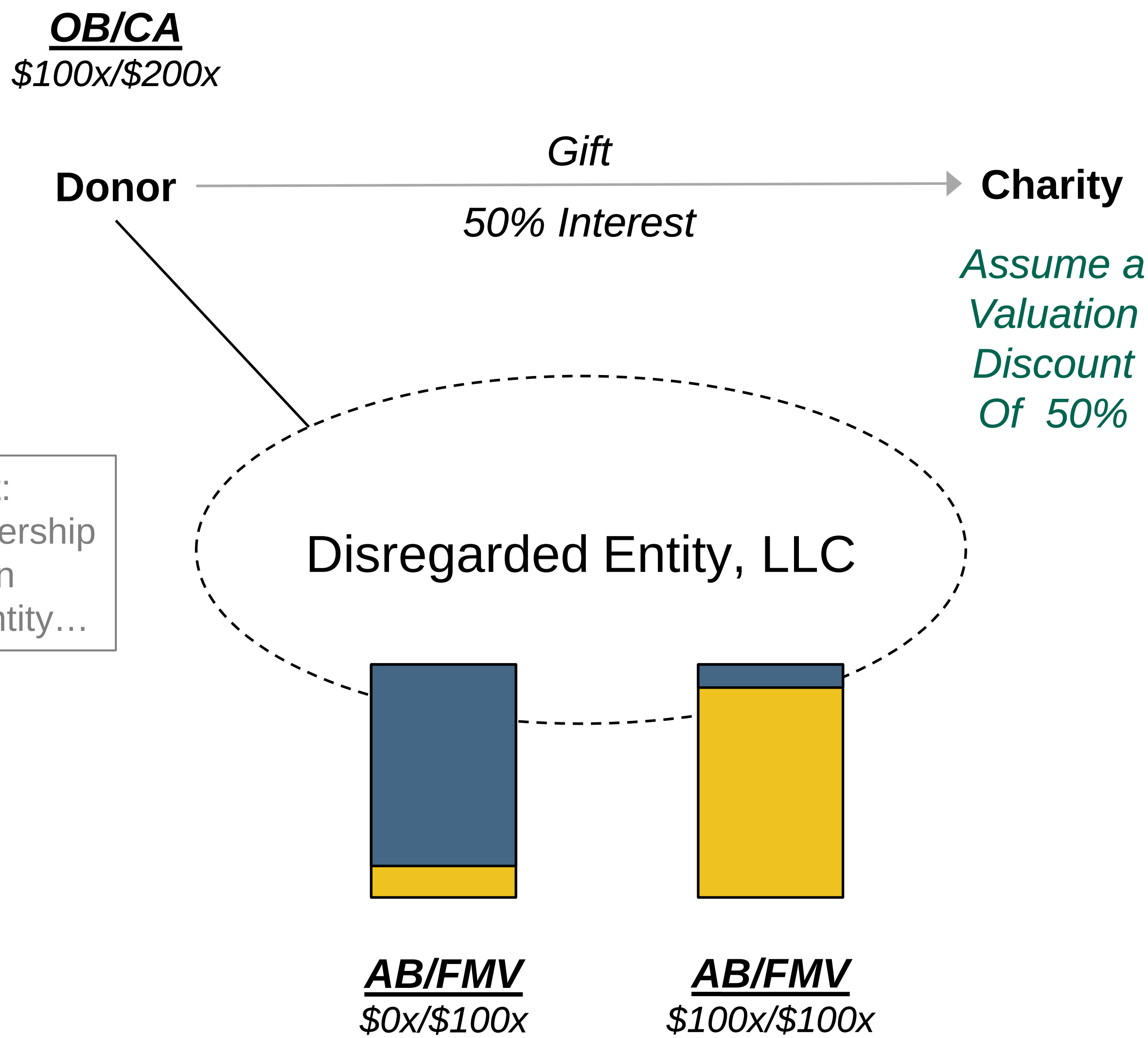


Basis “Strip” and “Shift” with Charity



Northern Trust

Gift to Charity to Assist with Tax Basis Management



Comment:
Could be partnership rather than disregarded entity…

Calculating Capital Account & Basis of Transferred Interest

CAPITAL ACCOUNT OF TRANSFERRED INTEREST

Upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner." Treas. Reg. § 1.704-1(b)(2)(iv)(l). *See* Treas. Reg. § 1.704-1(b)(5), Ex. 13.

Transferor's Capital Account		Percentage Transferred		Transferee's Capital Account
$200	x	50%	=	$100

ADJUSTED BASIS OF TRANSFERRED INTEREST

"[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest." Rev. Rul. 84-53, 1984-1 C.B. 159.

Transferor's Adjusted Basis
$100

x

Fair Market Value (Discounted) Transferred Portion
$50
———
Fair Market Value Transferor's Entire Portion
$200

=

Transferee's Adjusted Basis
$25

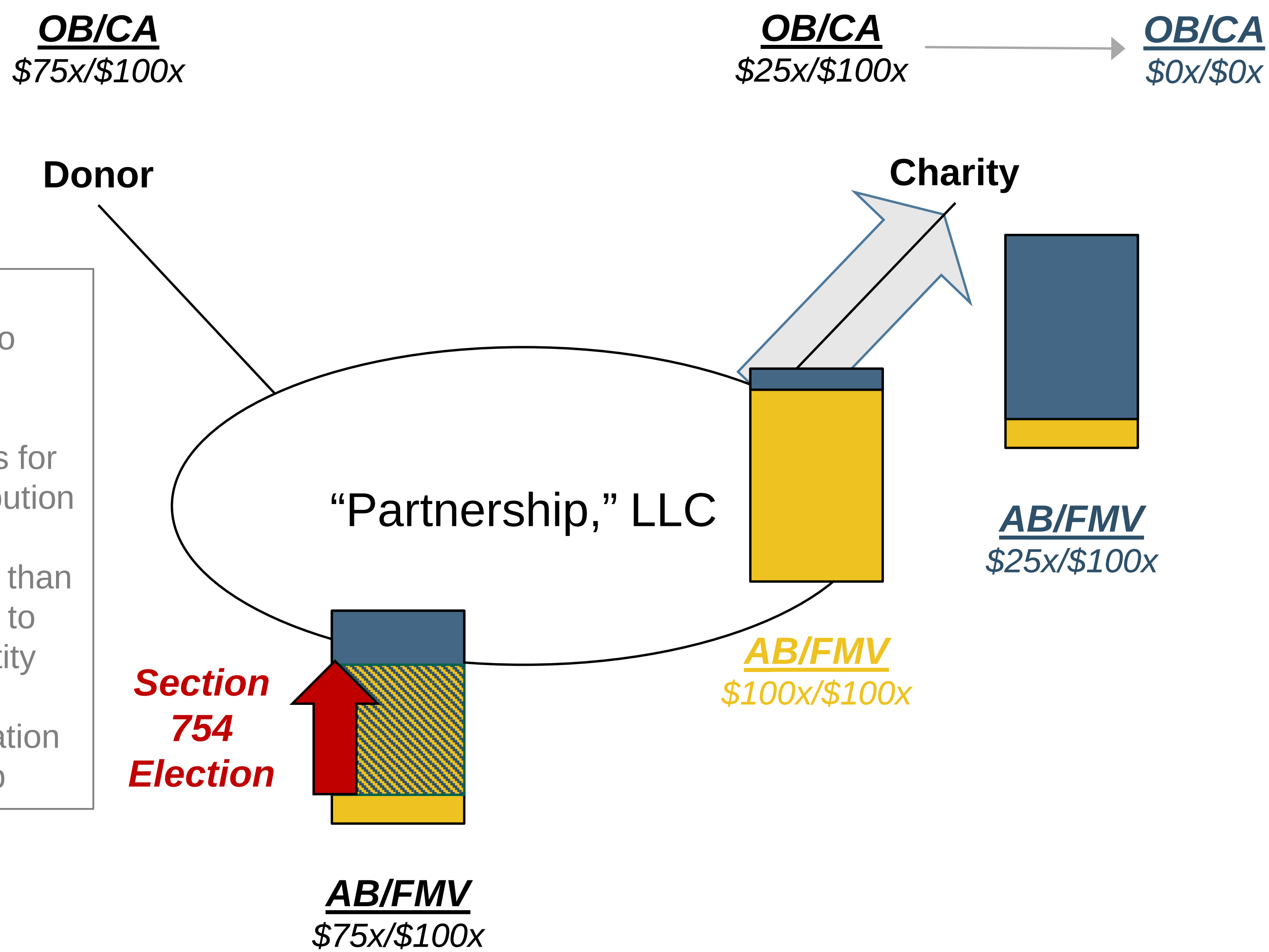
Basis “Strip” and “Shift” Example

Comment:
Gift converts to partnership

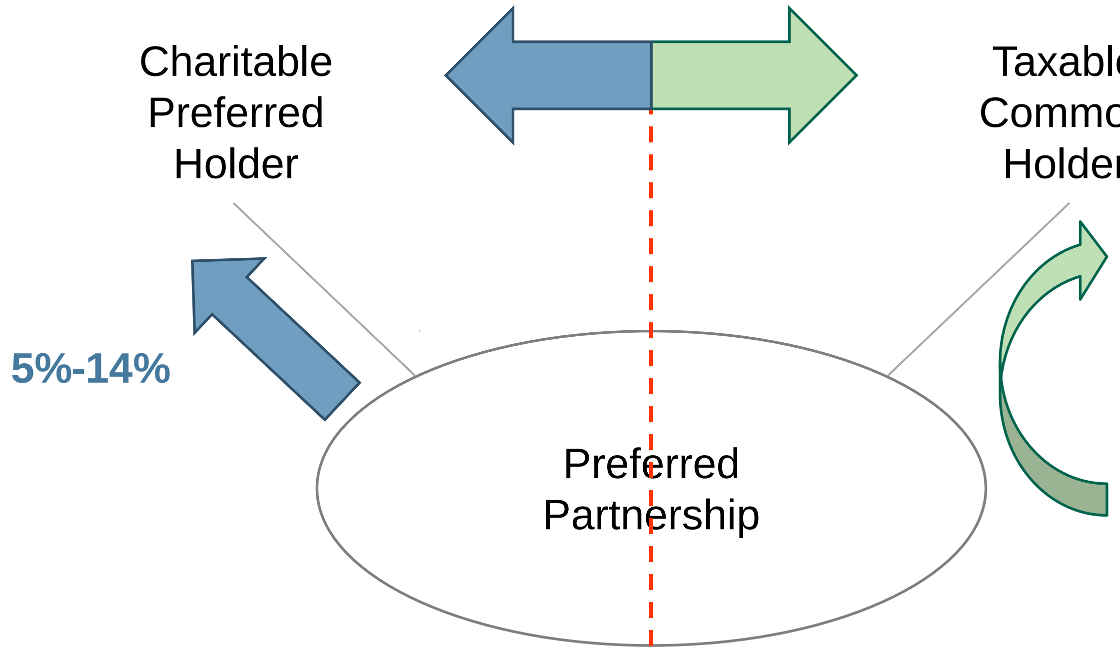
Must wait 7 years for subsequent distribution

If no other partner than donor, converts to disregarded entity

Technical termination of partnership



Preferred & Common Shares



- Fixed Liquidation Value
- Fixed Rate Annual Distribution
- Tax Items Preferentially Allocated
- If Transfer, Normal Gift Tax Rules

- All Value in Excess of Preferred
- No Fixed Annual Distribution
- Residual Tax Items or Deductions
- If Retain, Normal Gift Tax Rules

The Most Annoying Tax?

"The Knights who say NI
demand a sacrifice!...
NI! NI! NI! NI!...
We shall say NI again to you
if you do not appease us"

Knights Who Say NIIT Demand a Sacrifice: Can You Spell NII?

- Category 1: income not derived in ordinary course of business
  - Interest, dividends, rents, royalties, and annuities
  - Includes such income from working capital of a trade or business
  - Includes such income from a pass-through entity, as allocated to the taxpayer
  - Does not include “self-charged” income (interest/rents) to an active business
- Category 2: other gross income derived from a trade or business that is a:
  - Passive activity, or
  - Trading in a financial instrument or commodity
- Category 3: net gains from the disposition of property
  - Other than property held in an active trade or business or trading business
  - Includes sales of interests in pass-through entities

Pass-Through Entities: Disparate Treatment & Complexity

Dispositions of Entity Interests Taxed at Owner Level

Active Family Members

Passive Family Members

Passive or Active in Trade or Business Determined at Owner Level

Partnership
or
S Corporation

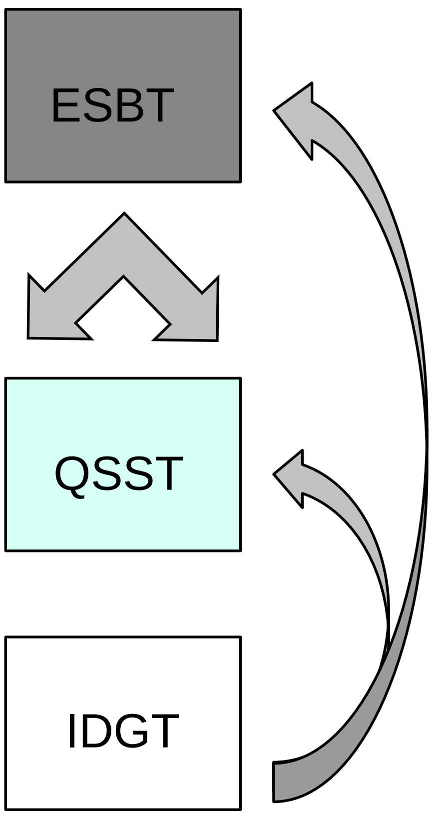
Hypothetical Sale of Assets at FMV at Entity Level

Trade or Business
with
passive income & assets
(including from working capital)

Trade or Business (§ 162) or Trading Activity in Financial Instruments Determined at Entity Level

S Corporation Trusts: ESBTs, QSSTs & Grantor Trusts

- Electing Small Business Trusts (ESBTs):
  - NIIT and dispositions of S corp. stock determined at trust level
  - Treated as two separate trusts for income tax purposes
  - Treated as a single trust for NIIT purposes
- Qualified Subchapter S Trusts (QSSTs)
  - NIIT determined at beneficiary level
  - Dispositions of S Corp. stock determined at trust level (e.g., trustee material participation)
- Grantor Trusts
  - Grantor is the deemed owner for NIIT purposes
  - Turning off grantor trust status to QSST or ESBT



IRS Notice 2007-73 Problem?

Application to Trusts (and Estates): UNII & NII

- Taxable trusts are taxed on Undistributed Net Investment Income (UNII)

- UNII is NII reduced by:
  - NII distributed to beneficiaries (deductions under §§ 651 & 661)
  - NII included in charitable contribution (deductions under § 642(c)).

- NII deducted by the trust becomes NII of the beneficiaries

- Allocating deductions
  - Follow categorization of income method contained in §§ 651 through 663
  - Allocable deductions include (to the extent allocable to NII):
    - fiduciary commissions
    - legal and accounting fees
    - other administrative expenses

- Deductions must be allocated among NII and income excluded from NII

Material Participation of Non-Grantor Trusts

- Consequences of Passive or Non-Passive status
  - Distributed non-passive income retains character as non-NII (exempt)
  - Regular Tax: suspended PALs allowed if activity generates non-passive income in current or future years
  - NIIT: suspended PALs are NOT allowed if activity generates non-passive income current or future years.
  - Activity becomes a “former passive activity” under § 469(f)

- Case Law & Rulings:
  - S. Rept. No. 99-313 (1986), 1986-3 C.B. (Vol. 3) 1, 735
  - Mattie K. Carter Trust v. U.S., 256 F. Supp.2d 536 (N.D. Tex. 2003)
  - TAM 200733023
  - PLR 201029014
  - TAM 201317010
  - Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014)

Material Participation

- 500 hours in the current year
- If owner is NOT a limited partner
  - Constitutes substantially all of the participation of all individuals
  - 100 hours and no one participates more
  - Activity in all Significant Participation Activities (SPAs) aggregates to 500 hours
  - Activity is regular, continuous, and substantial (facts and circumstances)
- Material participation in any 5 of last 10 years
- Personal service activity (PSA) with 3 years of material participation

- Member in LLC not necessarily considered a limited partner

- SPA: trade or business activity in which individual participates for 100 hours

- PSA: trade or business activity in which individual participates for 100 hours

Rental Income and NIIT

- Generally, rental income (even if constitutes a trade or business and taxpayer materially participates) is passive
  - Exception: Real Estate Professional Safe Harbor

- 2 prong test:
  - Derived in the ordinary course of a trade or business
  - Activity must be regular, continuous and substantial to be a trade or business

- Key factors
  - Property type (commercial vs. residential, equipment vs. real property, etc.)
  - Owner involvement
  - Short vs. long-term leases
  - Lease type (e.g., triple net)
  - Number of properties rented

Real Estate Professional Safe Harbor

- Qualify as a real estate professional under § 469(c)(7):
  - Contractor, real estate agent, landlord, property manager, etc.
- Materially participate under either of the following tests:
  - 500 hours in current year
  - 500 hours per year in 5 of last 10 years
- Activity is presumed to be a trade or business (income)
  - In addition, the real property is deemed to be used in a trade or business (dispositions)
- Other option is based on facts and circumstances

CRTs with Real Property: Category & Class Tier Rules

How will material participation be determined with a CRT?
Trustee, Grantor, Recipient, or Combination?

CRT Distributions

Category	Class	Excluded/NII	Rate	Note
Ordinary Income	Taxable Interest	NII	43.4%	
	Net Rental Income	NII	43.4%	Passive
	Taxable Interest	Excluded	39.6%	Pre-2013
	Net Rental Income	Excluded	43.4%	Active
	Qualified Dividends	NII	23.8%	
	Qualified Dividends	Excluded	20.0%	Pre-2013
Capital Gain	Short-Term	NII	43.4%	
	Short-Term	Excluded	39.6%	Pre-2013
	Unrecaptured § 1250 Gain	NII	28.8%	Passive
	Unrecaptured § 1250 Gain	Excluded	25.0%	Active
	Long-Term	NII	23.8%	
	Long-Term	Excluded	20.0%	Pre-2013
Other Income	Tax-Exempt Interest	Excluded	0.0%	Exempt
Corpus	Basis	n/a	n/a	

Disclosures

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