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Highlights of the 2024 Heckerling Institute on Estate Planning

Kim Kamin, JD, AEP®
Partner and Chief Wealth Strategist at Gresham Partners LLC

Kevin Matz, Esq., CPA, LL.M.
Partner at ArentFox Schiff

Family Office Exchange

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Some 2024 Heckerling Highlights

1. Impact of increased federal transfer tax exemption amounts/higher interest rates
2. Looming sunset of TCJA bonus exemptions and proposed regulations on clawback
3. Rev Ruling 2023-2 (no step-up in basis at death for property in a grantor trust that isn't included in the grantor's gross estate)
4. CCA 202352018 (gift tax consequences of modifying a grantor trust to add a tax reimbursement clause)
5. Overview of Directed Trusts, Family Offices and Private Trust Companies
6. Corporate Transparency Act
7. Connelly case (buy-sell agreements and the Supreme Court's grant of certiorari)
8. Schlapfer case (substantial compliance standard under the gift tax adequate disclosure regulations)
9. Paulson case (successor trustee and beneficiary liability for unpaid estate taxes)
10. Hoensheid case (the assignment of income doctrine)
11. Social welfare philanthropy with IRC Section 501(c)(4) organizations
12. Latest on planning with retirement benefits under the SECURE Act and SECURE 2.0
13. The Magical Mystery Tour that is Chapter 14 of the IRC

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Increases in the federal exclusion amount and its effect on estate planning / the impact of higher interest rates

- The applicable exclusion amount for federal estate, gift and generation-skipping transfer (GST) taxes increased from $12,920,000 in 2023 to $13,610,000 in 2024 (an increase of $ 690,000)
  - Thus, a married couple can pass more than $27 MLN free of **federal** estate tax in 2024
- The gift tax annual exclusion has increased to $18,000 per donee in 2024
  - The gift tax annual exclusion for gifts to non-US citizen spouses has increased to $185,000 in 2024
- The consensus at Heckerling is that there is no realistic likelihood of a reduced applicable exclusion amount, or the enactment of any legislation that is adverse to estate planning (including to grantor trusts), until after 2024

Increases in the federal exclusion amount and its effect on estate planning / the impact of higher interest rates

- For 2024 and 2025, the focus for high net worth clients will be on maximizing use of the higher exclusion and GST exemption
- For the majority of clients full use of the exclusion is out of reach, but partial use of close to all of one exclusion may be possible, and SLATs can provide a safety net
- For any client close to death, consider termination of non-exempt trusts or swaps to push assets back into the estate and obtain a basis step-up
- Interest rates are higher than they've been in the recent past, which affects estate planning as well
  - GRATs, leveraged sales, and loans require better investment performance to succeed
  - QPRTs may be worth considering again for the first time in many years

The looming sunset of the 2017 increase in the applicable exclusion amount and proposed regulations on clawback

Proposed Regulations under IRC Section 2010 Concerning Clawback of the Basic Exclusion Amount

- As a reminder, the 2017 Tax Cuts and Jobs Act (TCJA) provides for sunset of the higher exclusion and it will revert back to $5 MLN plus inflation adjustments in 2026. Estimated amount in 2026 is $7 to $7.2 million.
- There is no expectation that Washington will alter the regulations that will prevent estate tax from applying to gifts that were tax-free only because of the higher exclusion. An estate will be able to calculate its estate tax credit using the **HIGHER** of the exclusion amount applicable as of the date of the gift or the exclusion amount applicable upon death.

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The looming sunset of the 2017 increase in the applicable exclusion amount and proposed regulations on clawback

- Also included in the 2019 regulations was clarification that the taxpayer would need to "use it or lose it" by making gifts exceeding the historical exemption amount in order to take advantage of the temporarily increased exclusion amount.
  - For example, if a taxpayer made a gift of $ 5MLN today when the exemption amount is $13,610,000, and the exemption amount is reduced to $ 7MLN in 2026, the taxpayer would only have $2 MLN of exclusion remaining.
  - However, if the taxpayer made a gift of $13,610,000 using all of the increased exclusion amount, then there would be no "clawback" of the exemption previously used if the taxpayer died after 2026 when the exemption amount is reduced to only $7MLN in this example.
- The question of how to treat gifts that are complete at the time of transfer, but still includible in the gross estate of the decedent upon death, has not been determined, and has loomed over taxpayers and estate planners since the promulgation of the "Special Rule."

The looming sunset of the 2017 increase in the applicable exclusion amount and proposed regulations on clawback

- The Proposed Regulations issued on April 26, 2022 make clear that transfers where the donor continues to have title, possession, or other retained rights in the transferred property under sections 2035, 2036, 2037, 2038 and 2042 of the Internal Revenue Code **do not qualify for the Special Rule** (subject to certain exceptions).
- For situations like these, the amount includible in the gross estate will only be given the benefit of the exemption amount available at the time of death.
  - The Proposed Regulations provide for exceptions to the Special Rule, and also exceptions to the exception in certain situations.

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The looming sunset of the 2017 increase in the applicable exclusion amount and proposed regulations on clawback

- The exceptions to the Special Rule (which exceptions operate to limit the available basic exclusion amount to the remaining basic exclusion amount that is in effect at death) are as follows:

(i) Gifts that are includible in the gross estate pursuant to sections 2035, 2036, 2037, 2038, or 2042 of the Code.

(ii) Unsatisfied enforceable promises.

(iii) Gifts subject to the special valuation rules of section 2701 (related to valuation of intra-family transfers of equity interests in an entity where the senior generation retains certain preferred interests) OR section 2702 (related to GRATs and QPRTs).

(iv) The relinquishment or elimination of an interest in any one of the aforementioned situations that occurs within eighteen (18) months of the date of the decedent's death.

- **If a transfer occurs under one of the above 4 categories, the Special Rule will NOT apply and the basic exclusion amount that is available at death will instead govern.**

The looming sunset of the 2017 increase in the applicable exclusion amount and proposed regulations on clawback

- It should be noted that the Biden Administration's Fiscal Year 2024 Greenbook proposals that were released in March 2023 do ***NOT*** make any mention of an accelerated reduction of the basic exclusion amount prior to January 1, 2026, so this rule does not yet potentially apply except in the case of persons dying after December 31, 2025.
- The word from Washington is that the Treasury is aiming to finalize these regulations promptly. Even if the sunset of the higher exclusion is cancelled, Congress and the Treasury want rules in place for any decrease in the exclusion that may happen in the future.

The looming sunset of the 2017 increase in the applicable exclusion amount and proposed regulations on clawback

- So, in sum, the "Special Rule" prevents the "clawback" for the use of the higher estate/gift tax exemption amount available on the date of the complete transfer when determining the amount of credit available as of the date of the taxpayer's death, even if the applicable estate/gift tax exemption is lower as of the date of the taxpayer's death.
  - This is good news for taxpayers, but the Proposed Regulations provide exceptions to the applicability of the Special Rule.
- As a result of the potential for clawback where the Special Rule does not apply, taxpayers need to take steps to protect against estate tax inclusion in particular in the case of transferred interests in family limited partnerships and family limited liability companies under Section 2036 of the Internal Revenue Code.

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Revenue Ruling 2023-2: no step-up in basis upon death for property in a grantor trust that is not included in the grantor's gross estate

- On March 29, 2023, the IRS released Rev. Rul. 2023-2, which addresses the "curious topic" of whether there is any step-up in basis upon death for property held in a grantor trust outside of the grantor's gross estate, which was a topic of keen interest to Representative Bill Pascrell (D-New Jersey), Chair of the House Ways and Means Committee's Oversight Committee.
- This Revenue Ruling surveys the list of circumstances contained in IRC Section 1014(b) that cause property to be "considered to have been acquired from or to have passed from the decedent" for purposes of the adjusted basis at death rule of Section 1014(a), and finds that a decedent's power over a trust that causes the decedent to be treated as the owner of the trust under the grantor trust rules but does not cause the value of the trust assets to be included in the decedent's gross estate is **NOT** on that list.
- Therefore, the basis of that trust's assets is **NOT** adjusted to fair market value at the decedent's death.

Revenue Ruling 2023-2: no step-up in basis upon death for property in a grantor trust that is not included in the grantor's gross estate

- The facts in this Revenue Ruling include the following caveats:
  (1) At the grantor's death, the trust's liabilities did not exceed the basis of its assets; and
  (2) Neither the trust nor the grantor "held a note on which the other was the obligor."
- On the same day the IRS released this revenue ruling, Representative Pascrell, in a press release, "praised fresh action by the U.S. Treasury Department and the Internal Revenue Service to curb abuse of arguably the worst loophole in the federal tax code, so-called stepped-up basis," and noted that "[t]his action follows prodding by Pascrell to issue this guidance."

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

- CCA 202352018 was released on December 29, 2023 and addresses the gift tax consequences of modifying a grantor trust to add a tax reimbursement clause.
- This CCA phrased the issue as follows:
  - What are the gift tax consequences to the beneficiaries when the trustee of an irrevocable trust [that is treated as a grantor trust as to its owner for federal income tax purposes] modifies the trust, ***with the beneficiaries' consent***, to add a tax reimbursement clause that provides the trustee the discretionary power to make distributions of income or principal from the trust in an amount sufficient to reimburse the grantor for income tax attributable to the inclusion of the trust's income in the grantor's taxable income?
- The CCA reaches the following conclusion:
  - The modification to add the tax reimbursement clause will constitute ***a taxable gift by the trust beneficiaries*** because the addition of a discretionary power to distribute income and principal to the grantor is a relinquishment of a portion of the beneficiaries' interest in the trust.

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

- In its recitation of facts, the CCA notes the following:
  - In Year 1, the grantor "A" establishes and funds an irrevocable inter vivos trust for the benefit of A's Child and Child's descendants
  - Under the governing instrument of the Trust, the trustee (who is not related or subordinate to the grantor within the meaning of Section 672(c) of the Code) may distribute income or principal to or for the benefit of Child in the trustee's absolute discretion. Upon Child's death, the Trust's remainder is to be distributed to Child's issue, *per stirpes*.
  - Under the governing instrument of the trust, A retains a power that causes A to be the deemed owner of the Trust under the grantor trust rules and, accordingly, all items of income, deductions and credits attributable to Trust are included in A's taxable income.

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

– *Recitation of facts continued*
  - Neither State law nor the governing instrument of Trust requires or provides authority to a trustee of Trust to distribute to A amounts sufficient to satisfy A's income tax liability attributable to the inclusion of Trust's income in A's taxable income.
  - In Year 2, when Child has no living grandchildren or more remote descendants, Trustee petitions the State Court to modify the terms of the Trust.
    - Pursuant to the applicable state statute, Child and Child's issue consent to the modification.
    - Later that year, the State Court grants the petition and issues an Order modifying the Trust to provide a trustee of the Trust the discretionary power to reimburse the grantor A for any income taxes A pays as a result of the inclusion of Trust's income in A's taxable income.

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

– *CCA's Analysis*

- In developing its analysis, the CCA observed the following:
  - Treas. Reg. Sec. 25.2511-1(c)(1) of the Gift Tax Regulations provides that the gift tax applies to gifts indirectly made. Further, any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to gift tax.
  - Treas. Reg. Sec. 25.2511-1(e) provides that if a donor transfers by gift less than their entire interest in property, the gift tax is applicable to the transferred interest. ***Further, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.***
  - Under Reg. Sec. 25.2511-2(a), the measure of the gift is the value of the interest passing from the donor with respect to which the donor has relinquished its rights without full and adequate consideration in money or money's worth.

CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

– *CCA's Analysis (cont'd)*

- Treas. Reg. Sec. 25.2511-2(b) provides that as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for their own benefit or for the benefit of another, the gift is complete.
  - If a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among the donor's descendants, no portion of the transfer is a completed gift.
  - On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or X's heirs, the entire transfer would be a completed gift.

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

– *CCA's Analysis (cont'd)*

- The CCA also referred to Rev. Rul. 2004-64 (which it distinguished) in the following manner:
  - In Rev. Rul. 2004-64, a grantor created an irrevocable inter vivos trust for the benefit of the grantor's descendants and retained sufficient powers with respect to the trust so that the grantor is treated as the owner of the trust under the grantor trust rules.
  - In relevant part, the ruling considers two situations in which the trustee reimburses the grantor for taxes paid by the grantor that are attributable to the inclusion of all or part of the trust's income in the grantor's income.
  - In *Situation 2* of Rev. Rul. 2004-64, the distribution reimbursing the grantor is mandated under the terms of the governing instrument.
  - In *Situation 3* of Rev. Rul. 2004-64, the governing instrument provides the trustee with the discretionary authority to make a reimbursing distribution.
  - In both of these situations, when the trustee of the trust reimburses the grantor for income tax paid by the grantor, Rev. Rul. 2004-64 concludes that the payment does not constitute a gift by the trust beneficiaries because the distribution was either mandated by the terms of the governing instrument or made pursuant to the exercise of the trustee's authority granted under the terms of the governing instrument.

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

– *CCA's Analysis (cont'd)*
  - The CCA concludes:
    - Under the governing instrument of Trust, Child and Child's issue each have an interest in the trust property.
    - As a result of the Year 2 modification of the Trust, grantor A acquires a beneficial interest in the trust property in that A becomes entitled to discretionary distributions of income or principal from the Trust in an amount sufficient to reimburse grantor A for any taxes A pays as a result of the inclusion of Trust's income in A's gross taxable income.
    - ***In substance, the modification constitutes a transfer by Child and Child's issue for the benefit of A.***
    - This is distinguishable from the situations in Rev. Rul. 2004-64 where the original governing instrument provides for a mandatory or discretionary right to reimbursement for the grantor's payment of income tax.
    - **Thus, as a result of the Year 2 modification, Child and Child's issue have made a gift of a portion of their respective interests in income and/or principal.**
    - ***The result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise the right to object.***

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CCA 202352018 – gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

– *CCA's Analysis (cont'd)*

- ***The CCA further concludes by noting that the gift from Child and Child's issue of a portion of their interests in trust should be valued in accordance with the general rule for valuing interests in property for gift tax purposes.***
- In a footnote, the CCA adds that ***"[a]though the determination of the values of the gifts requires complex calculations, Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate."***

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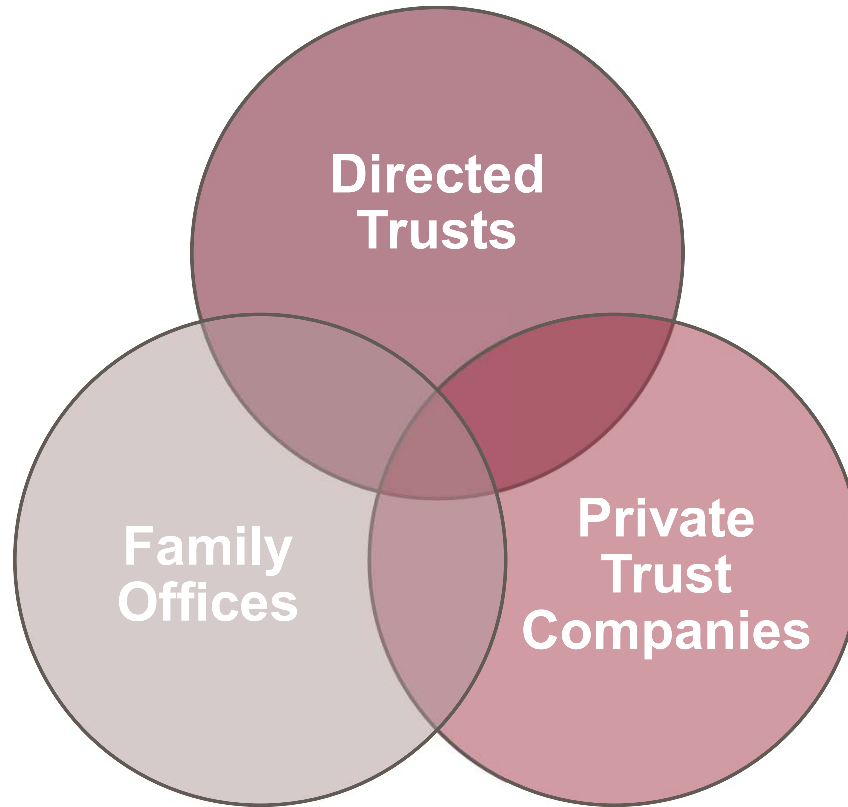

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Discussion Overview

- Directed Trusts
- Family Offices
- Private Trust Companies
- Using Directed Trusts, Family Offices and PTCs

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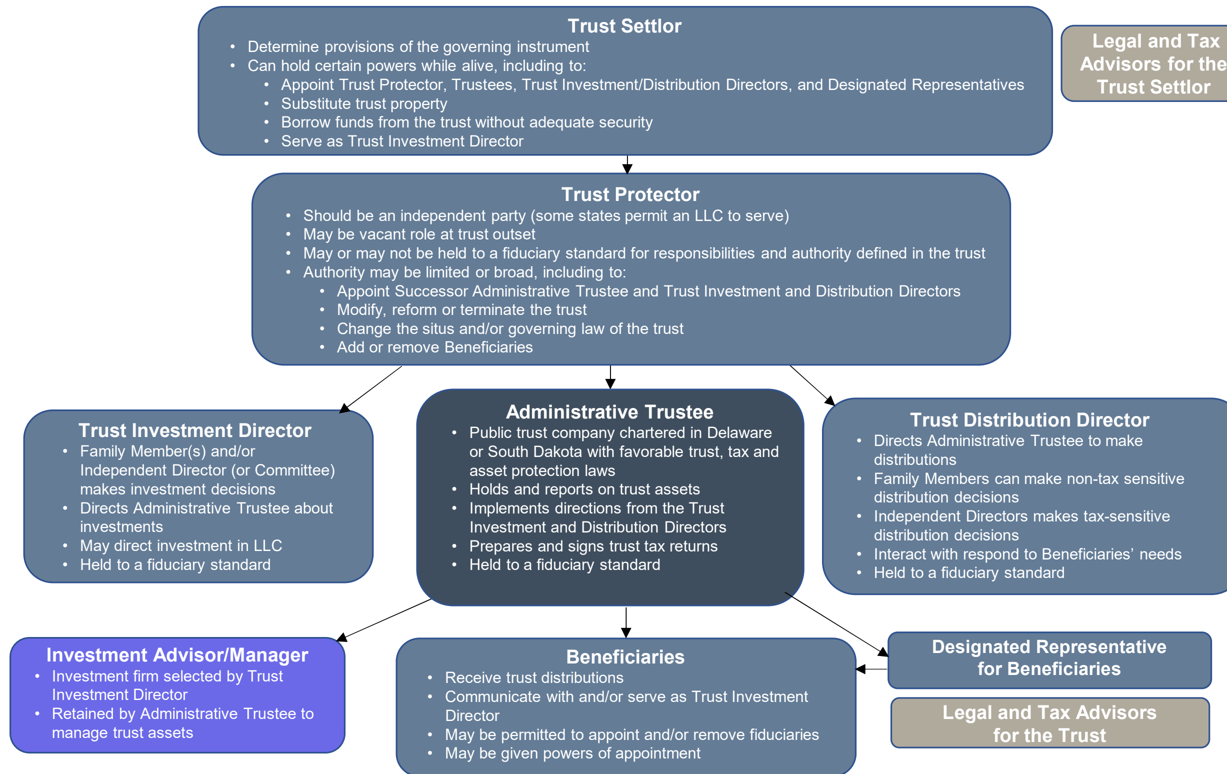
Roles in Directed Trust Structure



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Structural Options

- Multi-family Office (“MFO”)
- Virtual Family Office (“VFO”)
- Embedded Family Office (“Corner Office” model)
- Classic SFO Structure
- Profits Interest Model
- Private Trust Company (“PTC”)

Can be a combination of the above.

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What is the Corporate Transparency Act?

- The purpose of the Act is to:
  - Set a clear federal standard for incorporation practices;
  - Protect U.S. national security and commerce;
  - Enhance national security, intelligence, and law enforcement efforts to combat money laundering, terrorism financing, and other illicit activities; and
  - Bring the U.S. into compliance with international anti-money laundering and countering of terrorism financing standards.
- The Act does not create a public registry of business entities in the U.S.

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What Does the Corporate Transparency Act (CTA) Require?

- A **Reporting Company** must disclose information about the entity itself, the **Company Applicant**, and its **Beneficial Owners** to the Financial Crimes Enforcement Network (FinCEN) of the Department of Treasury.
- For each Beneficial Owner or Company Applicant, the disclosure must include
  - Full legal name and date of birth;
  - Each Beneficial Owner's current residential address, and each Company Applicant's current business address; and
  - An identification number (such as a driver's license or passport number) or **FinCEN Identifier** number (available upon request from FinCEN after providing name, address, and date of birth) and a digital copy of the identifying document.
- Effective January 1, 2024

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Reporting Companies

- The Act defines a Reporting Company as:
  - A corporation, LLC, or other similar entity that is
    1. Created by filing a document with a secretary of state or a similar office under the law of a State or Indian Tribe; or
    2. Formed under the law of a foreign country and registered to do business in the United States by the filing of a document with the secretary of state or a similar office under the laws of a State or Indian Tribe.
- LPs, LLPs and business trusts (statutory trusts) are "similar" entities
- Trusts are excluded from this definition
- General partnerships appear to be excluded

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Reporting Company Exemptions

- The Act **excludes twenty-three types of entities** from qualifying as a Reporting Company, including:
  - A "*Large Operating Company*"
    - With more than 20 full time employees in the United States
      - 30 hours a week or 130 hours per month
    - With gross receipts or sales as reported on a federal income tax return of over $5 million
      - Must be U.S. sourced income
    - With an operating presence at a physical office within the United States
  - 501(c) tax-exempt charitable organizations and foundations
  - 4947(a)(1) and (2) charitable and split interest trusts
  - Various regulated entities (*e.g.*, banks, investment advisers, insurance companies, registered public accounting firms, pooled investment vehicles, etc.)
  - Subsidiary of an exempt entity
  - Certain inactive entities formed on or before January 1, 2020

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Pooled Investment Vehicles

- An entity is a pooled investment vehicle exempt from CTA reporting if:
  - It is an investment company as defined in section 3(a) of the Investment Company Act of 1940 (*i.e.*, engaged primarily in investing or trading securities), or would be an investment company under that section but for the exclusions provided by section 3(c)(1) or (7) (applicable to certain closely held entities and those owned exclusively by qualified purchasers/those who received ownership interests by gift or bequest from qualified purchasers) and is identified by its legal name by its investment adviser in its Form ADV filed with the SEC; ***and***
  - The entity is operated or advised by a bank, credit union, registered broker-dealer, registered investment company or investment adviser, or venture capital fund adviser.

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Special Rules for Subsidiaries

- The exemption for subsidiaries of exempt entities applies to an entity whose ownership interests are **controlled *or* wholly owned**, directly or indirectly, by one or more exempt entities (money services businesses, pooled investment vehicles, entities assisting tax-exempt organizations, and inactive entities do not count as exempt entities for this purpose)
- Wholly owned subsidiaries of a Reporting Company may be able to use the Reporting Company's FinCEN identifier in lieu of separately reporting Beneficial Owner information
- If a Reporting Company is owned by one or more exempt entities, and an individual is a beneficial owner in the Reporting Company solely by virtue of the individual's ownership in the exempt entities, the Reporting Company may report the exempt entities' information in lieu of the ultimate beneficial owner's information

Are These Reporting Companies?

1. ArentFox Schiff - A law firm of over 600 attorneys.
2. The Law Offices of Perry Mason - 1 attorney and 2 staff
3. Real Estate LLC - Owns a single piece of rental property with two owners.
4. Property Management Co - A corporation with one owner, 21 employees and $8 million of income.
   - What if an employee quits?
5. Mason Family Investments - A general partnership co-owned by Perry Mason and his sister and governed by a 30-page operating agreement.

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Who is a Company Applicant?

- An individual who directly files a document creating a domestic reporting company.
- An individual who directly files the first document registering a foreign reporting company.
- The individual primarily responsible for directing such filing.
- There can be two Company Applicants, but no more.

Only applies to a reporting company formed or registered after January 1, 2024.

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Who is the Beneficial Owner?

Beneficial Owner	Not a Beneficial Owner
An individual who	• A minor child (as defined in the State **in which the entity is formed**) if the information of the parent or guardian of the minor child is reported in accordance with the Act, until the child reaches the age of majority.
• Directly or indirectly • Through any contract, arrangement, understanding, relationship, or otherwise—	• An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual.
(i) Exercises **substantial control** over the entity; **or**	• An individual acting **solely** as an employee of reporting company and whose control over or economic benefits from such entity is derived **solely** from the employment status of the person. This does not apply to senior officers (*e.g.*, CEO, CFO, COO, GC, President).
(ii) Owns or controls at least 25% of the ownership interests of the entity.	• An individual whose only interest in a reporting company is through a (future) right of inheritance.
	• A creditor of a reporting company, unless the creditor otherwise falls within the definition of a Beneficial Owner.

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Who Has "Substantial Control"?

- Senior officers
  - Includes a president, CFO, general counsel, CEO, COO, or anyone who performs a similar function
- Those with authority to appoint or remove any senior officer
- Those with authority to appoint or remove a majority of the board of directors (or equivalent)
- Those who can direct, determine, or have a "substantial influence" over important decisions made by the reporting company.

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What is an "important decision"?

- The sale, lease, mortgage, or transfer of any principal asset
- Reorganization, dissolution or merger
- Major expenditures, investments, and issuance of equity or debt
- Selection of business lines or geographic focus
- Setting compensation for senior officers
- Entering into significant contracts
- Amendment of governance documents

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Who is a 25% Owner?

- Ownership interest is defined broadly to include equity, profit sharing agreements, voting trusts, convertible debt, options, and other instruments.
- Ownership interests can be direct or indirect and can include a mere understanding or relationship.
- Trust assets are attributed to:
  - A trustee or other individual with authority to dispose of the asset.
  - A beneficiary who is the sole income and principal beneficiary.
  - A beneficiary who has the right to demand substantially all of the trust assets.
  - A grantor if the trust is revocable or they otherwise have the right to withdraw trust assets regardless of form.

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25% Owners, continued

- To determine whether an individual owns or controls at least 25% of a Reporting Company's interests:
  - Ownership interests are calculated at the present time, with all options and similar instruments deemed to be exercised;
  - For Reporting Companies that issue capital or profits interests, include the individual's capital *and* profits interests in the entity, as a percentage of the total outstanding capital *and* profits interests in the entity;
  - For corporations, check-the-box corporations, and other entities issuing stock, include the greater of (A) total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all voting classes of stock, or (B) total combined value of ownership interests as a percentage of all classes of interests; and
  - If the above cannot be computed with reasonable certainty, any individual who owns or controls at least 25% of any class or type of ownership interest is deemed a 25% owner.

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When is a Report Due?

- Initial Report
  - Existing Reporting Companies- by January 1, 2025
  - Reporting Company formed/registered on January 1, 2024 and after—30 calendar days (extended to 90 days for 2024 only)
- Updated Report
  - Within 30 calendar days after there is any change to any information previously submitted to FinCEN.
    - Change in who the Beneficial Owners are
    - Minor reaching age of majority
    - Information related to a Beneficial Owner (like a change in address or change in drivers license number)
    - An entity becomes exempt from reporting OR is no longer exempt
    - If a Beneficial Owner dies, a change occurs when the estate is "settled" – this term is not defined

Correcting a Report

- If a Reporting Company becomes aware "or has reason to know" that information contained in a report is inaccurate they have 30 calendar days from that date to file a corrected report.

Penalties

- An individual who willfully provides false or fraudulent information, or willfully fails to report complete or updated Beneficial Ownership information faces a civil penalty of $500/day while the violation continues or is not remedied, and a criminal fine of up to $10,000, and/or 2 years imprisonment
  - There is a 90-day safe-harbor if an individual voluntarily submits a report containing correct information

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Focusing on Trusts

- For a given trust, its beneficial owners could include any one or more of the trustee, grantor, and beneficiaries.
- As a reminder, indirect ownership through a trust can be attributed to (1) a trustee with the authority to dispose of trust assets, (2) a beneficiary who is the sole permissible recipient of income and principal from the trust or has the right to demand a distribution of or withdraw substantially all of the trust's assets, and (3) a grantor or settlor with the power to revoke the trust or otherwise withdraw its assets.
  - This presumably may also include a grantor or settlor who has retained the power to substitute assets of equivalent value as a grantor trust trigger

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Focusing on Trusts

- Applying the governing principles for beneficial owners, it would appear that a beneficial owner may also include:
  1. Those with authority to appoint or remove a trustee who can exercise power over a reporting company
  2. Those with authority to direct a trustee who can exercise power over a reporting company
  3. Those with authority to remove and replace any of the individuals who are described in items (1) or (2) above.

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The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

- In *Connelly v. United States*, No. 21-3683 (8th Cir. 2023), the United States Court of Appeals for the Eighth Circuit, on the taxpayer's appeal from an order granting summary judgment in favor of the IRS by the United States District Court for the Eastern District of Missouri, considered:
  - ***(i)*** whether a buy-sell agreement was able to fix the value of the decedent's corporate shares for estate tax purposes (***it was not***), and
  - ***(ii)*** whether life insurance proceeds payable to the corporation to help fund a corporate redemption of shares needed to be considered in determining the fair market value of the corporate shares for federal estate tax purposes.
    - ***It was so considered in determining the fair market value of the corporate shares without any offset to take into account the redemption obligation to the decedent's estate under a buy-sell agreement***.

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The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Facts

- Brothers Michael and Thomas Connelly were the only shareholders in Crown C Supply, Inc. ("Crown"), a closely-held family business that sold roofing and siding materials.
- Michael owned approximately 77% of the company's shares, while Thomas owned approximately 23% of the company's shares.
- The brothers entered into a stock purchase agreement that gave the surviving brother the right to buy the decedent's shares.
- If the surviving brother declined, then Crown (the company) was required to buy back the shares of the first brother to die, and the company bought $3.5 million in life insurance on the life of each brother to ensure it had enough cash to make good on the agreement.

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The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Facts (cont'd)

- The stock purchase agreement provided two mechanisms for determining the price for which Crown would redeem the shares.
  - The principal mechanism required the brothers to execute a new Certificate of Agreed Value at the end of every tax year, which set the price per share by "mutual agreement."
  - If they failed to do so, the brothers were supposed to obtain two or more appraisals of fair market value.
- The brothers never executed a Certificate of Agreed Value or obtained appraisals as required by the stock purchase agreement.

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The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Facts (cont'd)

- Michael died in October 2013, and the company repurchased his shares which constituted an approximately 77% ownership interest in the company for $3MLN.
- The rest of the life insurance proceeds ($500,000) went to fund company operations. Michael's estate paid estate taxes on his shares in the company.
- The IRS assessed additional estate taxes of over $1 MLN.
- Thomas, as executor of his brother's estate, paid the deficiency and filed a suit in federal district court for the Eastern District of Missouri seeking a refund.
- At the core of the dispute was the question of the proper valuation of the company on the date of Michael's death.
- Aside from the life insurance, the company was worth approximately $3.3 MLN on the date of Michael's death.
  - On that date, the company had an obligation to repurchase Michael's shares from his estate.
  - Also on that date the company became entitled to receive $3.5 MLN in life insurance proceeds.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri

- **The first question presented** in this case (initially before the United States District Court for the Eastern District of Missouri on motion for summary judgment) was whether the buy-sell agreement was effective to fix the price of the shares for estate tax purposes under Section 2703 of the Internal Revenue Code. **The district court held that it was not.**
- In order for a buy-sell agreement to fix value for estate tax purposes under Section 2703, a series of requirements must be satisfied.
- First, under the statutory requirements of Section 2703:
  - **(i)** there must be a bona fide business arrangement;
  - **(ii)** the agreement must not be a device to transfer property to family for less than full and adequate consideration; and
  - **(iii)** the agreement must be comparable to similar agreements negotiated at arm's length between unrelated parties.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri (cont'd)

- In addition, there are the following additional requirements under the section 2703 regulations and the caselaw:
  - (a) there must be a fixed and determinable offering price;
  - (b) the agreement must be binding both during life and after death; and
  - (c) there must be a bona fide business reason and it must not be a testamentary disposition for less than full and adequate consideration.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri (cont'd)

- With respect to the statutory requirements of section 2703, the district court concluded **(i)** that although the buy-sell agreement was a bona fide business arrangement, **(ii)** it was a device to transfer property to family for less than full-and-adequate consideration, in part because the parties ignored the appraisal requirement under the agreement and basicly picked a $3 MLN redemption price for the shares – which is a different price than what the parties stipulated to in the court proceedings.
- In addition, **(iii)** the taxpayer could not show that the agreement was comparable to similar agreements entered into between unrelated parties at arm's length.
- Accordingly, the $3 MLN redemption price per the buy sell agreement was not binding to fix the value of the shares for federal estate tax purposes.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri (cont'd)

- Further, the district court also noted **(a)** that the agreement was not fixed and determinable in determining value as the parties did not treat it as such; and **(b)** that the parties' own conduct demonstrated that the stock purchase agreement was not binding after Michael's death.
- Accordingly, the district court concluded that the stock purchase agreement did NOT fix the company's value for estate tax purposes.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri (cont'd)

- The district court next considered **the second question** of whether life insurance proceeds owned by and payable to the company should be considered in valuing the company.
- The ***estate*** relied upon the decision of the United States Court of Appeals for the Eleventh Circuit in *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005), which had reversed the Tax Court below in holding that the fair market value of a closely-held corporation did ***not*** include life insurance proceeds, on the grounds that the stock purchase agreement created a contractual liability for the company which offset to that extent the life insurance proceeds.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri (cont'd)

- The district court in *Connelly* rejected the Eleventh Circuit's approach in *Blount* finding that the Eleventh's Circuit approach in *Blount* was "demonstrably erroneous" and that there "are cogent reasons for rejecting it."
- The court in *Connelly* focused on what a hypothetical willing buyer would pay for a company subject to a redemption obligation and concluded that it would not factor the company's redemption obligation into its assessment of the value of the company because, with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation.
- As a result, the buyer's redemption obligation would then be owed solely to itself. ***(NOTE -- Importantly, this however, is factually incorrect, as the payment obligation was owed instead to Michael's estate.)***
- The court continued that the company could choose to cancel this obligation if it did not wish to change the company's capital structure, or alternatively receive the equivalent of a distribution from the company leaving the buyer in the same economic position as if the redemption obligation had been cancelled.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

U.S. District Court for the Eastern District of Missouri

- The district court in *Connelly* therefore construed the redemption obligation as not constituting a corporate liability for estate tax purposes.
- It therefore held that the life insurance proceeds used to redeem the decedent's shares in the company must be included in determining the fair market value of the company (and therefore in determining the fair market value of the decedent's shares of stock in the company) without any offset relating to the company's redemption obligation for its shares.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Eighth Circuit Court of Appeals

- The estate appealed the district court's grant of summary judgment in favor of the IRS, and the United States Court of Appeals for the Eighth Circuit affirmed the district court.
- On the issue of the applicability of section 2703, the Eighth Circuit focused on the fact that the stock purchase agreement fixed no price nor prescribed a formula for arriving at one.
  - It merely laid out two mechanisms by which the brothers might agree on a price.
  - One was the Certificate of Agreed Value, which the Eighth Circuit regarded as nothing more than "an agreement to agree."
  - The other was an appraisal process for determining the fair market value of Crown – as to this, the Eighth Circuit noted that there is nothing in the stock purchase agreement, aside from minor limitations on valuation factors, that fixes or prescribes a formula or measure for determining the price that the appraisers will reach.
- Instead, the agreement required only that the appointed appraisers independently determine and submit their appraisals of the fair market value of the company, and the brothers were supposed to average the results or consult a third appraiser as a tiebreaker.
  - **None of this was ever done.**
  - **Thus, the buy-sell agreement was not binding to fix the value of the shares for federal estate tax purposes under section 2703 because the agreement was not fixed and determinable in determining value due to the parties' failure to treat it as such.**
  - (None of the other grounds raised by the district court in its Section 2703 analysis were mentioned by the Eighth Circuit.)

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Eighth Circuit Court of Appeals

- On the issue of the fair market value of the decedent Michael Connelly's shares in Crown, the Eighth Circuit (similar to the district court) phrased the issue as whether the life insurance proceeds received by Crown and intended for redemption should be taken into account when determining the corporation's value at the time of Michael Connelly's death.
- The Eighth Circuit emphasized that in valuing a closely held corporation, the regulations under Code Section 2031 require that consideration shall also be given to non-operating assets including proceeds of life insurance policies payable to or for the benefit of the company.
  - In this regard, the Eighth Circuit stated that although not directly applicable, section 2042 helps to illuminate what it means to take into account life insurance proceeds for Section 2031 purposes, including in valuing a corporation's stock that is affected by the receipt of life insurance proceeds for purposes of the willing buyer / willing seller test.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Eighth Circuit Court of Appeals

- The Eighth Circuit then tackled head on the Eleventh Circuit's decision in *Blount*.
- The Eighth Circuit in *Connelly* observed that the Eleventh Circuit in *Blount* had concluded that the life insurance proceeds had been accounted for by the redemption obligation, and that the 11th Circuit in *Blount* views the life insurance proceeds as an asset directly offset by the liability to redeem shares, yielding zero effect whatsoever on the company's value.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Eighth Circuit Court of Appeals

- According to the Eighth Circuit, the *Blount* court's premise that an offsetting liability should be recognized due to the corporation's obligation to redeem shares is ***flawed***, because an obligation to redeem shares is not a liability in the ordinary business sense, but instead simply a reduction to corporate surplus.
- According to the 8th Circuit in *Connelly*:
  - "Consider the willing buyer at the time of Michael's death. To own Crown outright, the buyer must obtain all of its shares. At that point, he could then extinguish the stock-purchase agreement or redeem the shares ***from himself***. This is just like moving money from one pocket to another. There is no liability to be considered – the buyer controls the life insurance proceeds. ***(NOTE -- This, however, is factually incorrect as Crown [now owned by surviving brother Thomas Connelly] is redeeming shares from brother Michael's estate and paying $3 million to brother Michael's estate which no longer has any ownership interest in Crown.)***

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Eighth Circuit Court of Appeals

- The court continued:
  - A buyer of Crown would therefore pay up to $6.86 million, having "taken into account" the life insurance proceeds, and extinguish or redeem as desired.
  - On the flip side, a hypothetical willing seller of Crown holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of the ***seller's own shares***." ***(NOTE -- This, however, is factually incorrect, as it was instead the Estate's shares.)***
  - On this basis, the Eighth Circuit affirmed the district court's grant of summary judgment in favor of the IRS.

ArentFox Schiff

The *Connelly* Case (Buy-Sell Agreements and the Supreme Court's Grant of *Certiorari*)

Observations

- Some observations here:

A. The critical distinction in the analysis between *Blount* and *Connelly* lies in the recognition (or non-recognition) of an offsetting liability to implement the redemption obligation under the buy-sell agreement.

   - The 11th Circuit in *Blount* recognized an offsetting liability for such redemption obligation, while the 8th Circuit in *Connelly* did not.

B. But is this a complete analysis, however, or is there something else that may be missing?

   - It would seem that the correct analysis in a "conceptual sense" would be to allow the offset for such liability in determining the value of the corporate stock ***but then recognize for estate tax purposes a corresponding asset to the estate in the form of a receivable equal to the amount of the redemption payment obligation***.
   - The *Connelly* court's denial of an offsetting liability for this corporate obligation to pay out cash to the estate in connection with the redemption transaction seems to be functioning as somewhat of a ***proxy*** for this approach.

C. *The Supreme Court has granted certiorari to hear this case*

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The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

- *Schlapfer v. Commissioner*, T.C. Memo. 2023-65 (U.S. Tax Court May 22, 2023), is the ***first reported case*** to contain a detailed discussion of the adequate disclosure requirements under the gift tax adequate disclosure regulations that are set forth in Treas. Reg. Sec. 301.6501(c)-1(f).
  - The IRS generally has three years from the filing of a gift tax return to assess additional gift tax.
  - If no gift tax return is filed, or if the gift is not "*adequately disclosed*" on or with the gift tax return, then the IRS may assess additional gift tax at any time.
  - However, the adequate disclosure of a completed gift on a gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer even if the transfer is ultimately determined to be an "incomplete gift" for gift tax purposes.
- Very significantly, the Tax Court in *Schlapfer* applied a lenient "substantial compliance" standard for determining whether there has been adequate disclosure (in contrast to a strict compliance standard).

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The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

Facts

- Ronald Schlapfer was the policyholder of a universal variable life insurance policy issued in 2006. The policy was funded with cash and the corporate stock of European Marketing Group, Inc. (EMG), an entity solely owned by Schlapfer. Mr. Schlapfer assigned ownership of the policy to his mother, aunt and uncle.
- Mr. Schlapfer had significant foreign connections and income having been born abroad before later becoming a U.S. citizen.
- In 2013, Mr. Schlapfer submitted a disclosure packet to the IRS Offshore Voluntary Disclosure Program (OVDP). In this disclosure packet, he included a gift tax return for 2006 that informed the IRS that he had made gifts of EMG stock (as opposed to the universal variable life insurance policy that was funded with EMG stock), and that he made such gifts to his mother (but not to his aunt and uncle).

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The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

Facts (cont'd)

- The disclosure packet included the following four documents to which Mr. Schlapfer later pointed in support of his claim of adequate disclosure concerning this transfer:
  - (1) the 2006 gift tax return;
  - (2) a protective filing statement attached to the gift tax return;
  - (3) Schedule F of Form 5471 to his 2006 federal income tax return reporting EMG; and
  - (4) the "Offshore Entity Statement" concerning EMG.
- The IRS concluded following an audit that the gift was incomplete for federal gift tax purposes until 2007, and that because Ms. Schlapfer failed to file a gift tax return for 2007, he did not adequately disclose the gift to commence the running of the gift tax statute of limitations.

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The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

The Tax Court's Analysis

- In developing its analysis, the Tax Court started out by noting that the IRS generally has three years from the filing of a gift tax return to assess additional tax.
  - If no return is filed, or if the gift is not adequately disclosed on or with the gift tax return, then the IRS may assess additional tax at any time.
  - In contrast, the adequate disclosure of a gift on a gift tax return will commence the running of the statute of limitations on the transfer ***even if the transfer is ultimately determined to be an incomplete gift for federal gift tax purposes*** (which was the case here).

ArentFox Schiff

The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

The Tax Court's Analysis (cont'd)

- The Tax Court on cross-motions for summary judgment ultimately determined that Mr. Schlapfer sufficiently disclosed the gift on his 2006 gift tax return to commence the running of the gift tax statute of limitations because the documents he attached to, and referenced in, his gift tax return were sufficient to satisfy adequate disclosure under a ***substantial compliance standard*** (as opposed to a strict compliance standard).

- In this regard, the Tax Court noted that when deciding whether an item has been adequately disclosed, it may consider not only a return, but also documents attached to the return and information in documents referenced in the return.

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The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

The Tax Court's Analysis (cont'd)

- Because a substantial compliance standard applies – as opposed to a strict compliance standard – the following technical shortcomings under Treas. Reg. Section 301.6501(c)-1(f)(2) did ***not*** preclude a finding of adequate disclosure:
  - the fact that the submission referred to ownership of stock (as opposed to ownership of a universal variable life insurance policy that owned the stock),
  - the fact that the asserted recipients of the gift failed to include Mr. Schlapfer's aunt and uncle, and
  - the fact that no statement was provided describing how Mr. Schlapfer determined the fair market value of the gift.

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The *Schlapfer* Case (Substantial Compliance Standard under the Gift Tax Adequate Disclosure Regulations)

The Tax Court's Analysis (cont'd)

- ***Rather, according to the Tax Court, a disclosure is adequate if it is sufficiently detailed to alert the Commissioner and his agents as to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one.***
  - According to the Court, that was done here.
- Therefore, because the Tax Court found the gift tax adequate disclosure requirements to have been met here, the IRS's period of limitations to assess gift tax commenced when the gift tax return was filed in 2013.
- Because the IRS issued its notice of deficiency more than three years after the gift tax return's filing (taking into account an extension that the taxpayer agreed to), the IRS was barred from assessing gift tax.

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The *Paulson* Case (Successor Trustee and Beneficiary Liability for Unpaid Estate Taxes)

- Allen Paulson died in 2000 with a $187.7M estate. After audit, the total estate tax due was $11.1M. The estate made a 6166 election.
- Between 2003 and 2006 the estate and living trust made distributions of $68.3M to the widow and other beneficiaries. There were various disputes among family members and multiple changes in the trustee role with multiple family members serving at different times.
- By 2015, there was still over $10M of unpaid estate tax liability. The IRS filed suit to collect from the trustees and trust beneficiaries who received distributions.

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The *Paulson* Case (Successor Trustee and Beneficiary Liability for Unpaid Estate Taxes)

- Code Section 6324(a)(2) (transferee liability) provides that if “the estate tax . . . is not paid when due [list of categories of the transferee] *who receives, or has on the date of the decedent’s death,* property included in the gross estate under sections 2034 to 2042 . . . shall be personally liable for such estate tax.” (emphasis added)
- The court held that the statute did not require that the transferee receive or have the property at the date of death. Therefore, the defendants who became successor trustees nine and eleven years after the date of death are liable. Beneficiaries who received distributions from the trust also were liable.
- Prior cases did not agree with the *Paulson* court interpretation.

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The *Paulson* Case (Successor Trustee and Beneficiary Liability for Unpaid Estate Taxes)

- The court's result could be viewed as one driven by the equities – the conclusion that somebody has to pay.
- There was a strong dissent from the majority opinion of the court, arguing that the ruling is contrary to the long-standing interpretation of the statute.
- This is the first case to apply personal liability to trustees or trust beneficiaries who are appointed or receive distributions only after the decedent's death. The taxpayers have filed a petition for certiorari with the U.S. Supreme Court.
- The major takeaway is that successor trustees should be cautious about accepting the position if estate tax remains to be paid.

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The Hoensheid Case (Assignment of Income Doctrine)

- *Hoensheid v. Commissioner*, T.C. Memo 2023-34. Denial of charitable deduction for gift to charity immediately followed by sale.

- Facts
- Three brothers, each owned 1/3 stock of CTSC;
- Fall 2014 decide to explore, settle on $80M target price
- April 2, 2015 receive bid for $92MLN.
- Mr. Hoensheid emailed his attorney that he and his wife wanted "to put 3.5MM in [DAF], but I would rather wait as long as possible to pull the trigger" in case a sale did not go through.

Hoensheid Key Dates

April 23 – Nonbinding letter of intent signed to sell for $107MLN.

June 1 – Donor signed Letter of Understanding with DAF describing planned donation but without specifying number of shares to be donated. Donor emailed his attorney stating, "I do not want to transfer the stock until we are 99% sure we are closing."

June 11 – Shareholders approved sale and Purchaser consented to DAF donation (number of shares to DAF left blank).

June 12 – Stock certificate prepared to transfer shares to DAF. Donor didn't deliver to his attorney until about July 10.

July 1-6 – Purchaser's counsel revised Stock Purchase Agreement; Purchaser organized new corporation to purchase shares.

July 6 – Donor emailed attorney that "We are not totally sure of the shares being transferred" to the DAF.

July 9 – Company revised Purchase Agreement mentioning 1,380 shares to DAF.

July 10 – Employee bonuses paid, Articles of Incorporation amended as requested by purchaser, minority stock purchase agreement to be signed by Fidelity for DAF shares circulated.

July 13 – Fidelity refused to sign stock purchase agreement pending receipt of stock certificate. Shares transferred later that day.

July 15 – Final stock purchase agreement signed, purporting that shares transferred to DAF on July 10. Fidelity representative signed to sell shares to purchaser.

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Issues Analyzed

1. Whether and when Donors contributed shares to DAF;
2. Whether Donors had unreported capital gain income;
3. Whether Donors were entitled to charitable contribution deduction; and
4. Whether Donors were liable for an accuracy-related penalty under Section 6662(a).

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Issue 1. If/when did Donors Contribute to DAF?

- Valid gift under state law requires:
  - Donor intent;
  - Delivery; and
  - Acceptance.
- Present intent did not occur until July 9, when Donor settled on 1,380 shares.
- Delivery apparently occurred by email of pdf of stock certificate to Fidelity on July 13, which provided "the strongest documentary evidence of the shares leaving [Donor's] dominion and control."
- Acceptance occurred July 13.

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Issue 2. Did Donors Have Unreported Capital Gain?

- Under *Humacid* two-part test, no assignment of income if:
  - Donor gives property away absolutely; (Yes, on July 13)
  - Before property gives rise to income by way of sale.
- Did Donor give away "early enough" to satisfy second prong?
  - Did Donor have already fixed or vested right to unpaid income before the charitable gift?
    - DAF not legally obligated to sell the shares, but
    - Actions of the parties suggested sale was a "virtual certainty," and
    - Unresolved contingencies weren't "substantial enough to have posed even a small risk" to the transaction.

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Issue 3. Were Donors Entitled to Charitable Deduction?

- Two Requirements under IRC 170(f)(8)(A) and (11)(D):
  - Contemporaneous written acknowledgement of donation by charitable organization; and
  - Qualified appraisal.
- Contemporaneous written acknowledgement satisfied.
- Qualified appraisal requirement not satisfied. Appraisal deficient in multiple respects.

Issue 4. Were Donors Liable for 6662(a) Penalty?

- Under IRC 6662(a), 20% penalty for underpayment attributable to negligence or substantial underpayment of income tax (meaning greater of 10% of tax to be reported or $5,000).
- Notice of deficiency assessed penalty, but IRS conceded that it related to the charitable deduction and tried to assert a new penalty based on anticipatory assignment of income.
- Because of timing, IRS bore the burden of proof that no defenses to the penalty applied. Taxpayers won on this prong!

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Social welfare philanthropy with IRC Section 501(c)(4) organizations

501(c)(4) Social welfare organizations – Brad Bedingfield

- Generally not subject to Private Foundation Rules
- Relative additional flexibility with 501(c)(4)'s
  - No 5% spend
  - No charitable class restrictions
  - Allow some political/lobbying activities
- Need to consider deductibility issues with 501(c)(4)
  - Gift Tax does not apply under IRC 2501(a)(6)
  - No Income Tax Charitable Deduction
  - No Estate Tax Charitable Deduction
- Not subject to federal income tax related to exempt purposes.

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Evolution of Gift Tax Nonapplicability for (c)(4) Gifts

- Pre-2015, unclear if transfers to a 501(c)(4) were subject to gift tax (no clear exception to Rev. Rul. 82-216).
- IRS acknowledged lack of clarity in 2011.
- In 2013, IRS was accused of targeting political groups ('Tea Party" scrutiny).
- Path Act in 2015 enacted IRC 2501(a)(6), which provides that the gift tax "does not apply" to the transfer of money to a (c)(4), (5), or (6) organization. Nonapplication rather than deduction.

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What Organizations are exempt under 501(c)(4)?

501(c)(4)(a) Civic Organizations

- Operated "exclusively" for the promotion of social welfare. Treas. Reg. 1.501(c)(4)-1(a)(2)(i): must be "primarily engaged in promoting in some way the common good and general welfare of the people of the community."
- *Erie Endowment*: must be "a community movement designed to accomplish community ends"
- *IRS Exempt Organizations – Technical Instruction Program:* IRC 501(c)(4) remains in some degree a catch-all for presumptively beneficial non-profit organizations that resist classification under" other provisions.
- Outward focused, community events
- 501(c)(4)(b) Local Associations of Employees. Local associations of employees allowed if limited to persons in a particular municipality and net earnings devoted exclusively to charitable, educational, or recreational purposes.

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Social Welfare Activities and Restrictions

1. Social activities (for community, not just member, benefit);
2. Business activities ok (e.g., mixed income housing), but not to merely serve the financial interests of an affiliated corporation;
3. Some private benefit permissible, such as community beautification projects (e.g., homeowners organizations, if they clearly establish that services to the members benefit the community as a whole and not merely the members);
4. No charitable class requirement, so long as benefitting the public (e.g., public safety organizations);
5. Economic development organizations may be ok; and
6. Some impermissible activities may be acceptable if organization is primarily engaged in promoting the common good. Long considered a "49% test", but this is recently challenged by the IRS.
7. Prohibition on Private Inurement (no part of net earnings may inure to the benefit of any private shareholder or individual).

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Social welfare philanthropy with IRC Section 501(c)(4) organizations

- Taxes applicable to 501(c)(4) organizations
  a. UBIT
  b. Excess benefit sanction rules – if transaction with an insider, that can be done so long as it is fair (soft version of 4958)
  c. 4960 tax on excess compensation to employees
  d. 527(f) tax on expenditures for certain political activities where net investment income is expended for such purpose (this gets reported on the 501(c)(4) organization's Form 990)
     i. Consider setting up a 527 to house these activities
- Charitable Deductions: No worry about distribution deductions for trusts under 642(c)
- Potential Disadvantages
  a. No income tax deduction on contributions to it
  b. Potential reputational concerns

Some Prominent 501(c)(4)s…for example

- Rotary Clubs
- Lions Clubs
- NRA
- AARP
- Miss America Organization
- Volunteer fire departments

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Patagonia Case

- Yvon Chouinard gave the voting stock of Patagonia to a trust, and the bulk of the economic value to the Holdfast Collective, which is a 501(c)(4);
- Holdfast receives Patagonia dividends income tax free;
- Devotes dividends to social welfare causes, with a focus on the environment.

Recognition of Exemption

- Not required to apply for exempt status, but best practice is to get an affirmative determination.
  - May voluntarily file Form 1024-A to request determination
  - Important to show how you intend to make the world a better place.
- Gift tax exemption under 2501(a)(6) only applies if IRS agrees with designation
- Must file Form 8976, Notice of Intent to Operate Under Section 501(c)(4), within 60 days of formation, regardless of 1024-A filing.

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Estate Tax Concerns under IRC 2036

- The gift tax nonapplicability rule was set up for political reasons. There is no analog for estate tax purposes.
- No estate tax charitable deduction available.
- Need to avoid inclusion under *Rifkind*/2036(a)(2).
- Plan around by either:
  - Avoiding any powers that would trigger IRC 2036 inclusion, or
  - If included, provide for a contingent gift over to charity.

The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- On October 7, 2022, the Internal Revenue Service issued Notice 2022-53, which provides much needed transition relief in the form of an IRS waiver of the 50% excise tax that could otherwise be imposed upon certain beneficiaries of qualified retirement plans (“Qualified Plans”) or individual retirement accounts (“IRAs”) who fail to take required minimum distributions (“RMDs”) during 2021 or 2022.
- In Notice 2023-54, the IRS provided further transition relief.

The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- ***To set the stage here*** -- in December 2019, Congress passed the Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act").
- The SECURE Act introduced a new "***10-year rule***" that applies to distributions to certain beneficiaries who are considered "designated beneficiaries" of Qualified Plan participants and IRA owners who have died (collectively "participants").
- As a term of art under the SECURE Act, "designated beneficiaries" are to be contrasted with "eligible designated beneficiaries" – who continue to get the benefit of a life expectancy payout under the SECURE Act.

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The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

– The classes of persons who may be considered "eligible designated beneficiaries" under the SECURE Act are very limited, however, and are confined to the following:

(i) the participant's surviving spouse;

(ii) the participant's child who is under the age of 21 (note that the 10-year rule would spring into play once the child attains age 21);

(iii) a disabled individual;

(iv) a chronically ill individual; and

(v) an individual who is not more than 10 years younger than the participant.

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The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- The SECURE Act's language led most practitioners to believe that designated beneficiaries of participants who have died would not be obligated to take any annual RMDs from Qualified Plans and IRAs until at least 10 years after the participant's death.
  - This belief stemmed from the fact that the language of the SECURE Act that introduced the 10-year rule referenced the methodology for making distributions that are subject to the "5-year rule" that applies in the case of participants who have died prior to their "required beginning date" (which is generally age 72, subject to certain exceptions) without having named a designated beneficiary.
  - Under the 5-year rule, no annual RMDs are required to be made prior to the end of the 5 year period.

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The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- It therefore came as quite a jolt to the estate planning community when the IRS, in proposed regulations issued in February 2022, took the position that designated beneficiaries of participants who died subsequent to the "required beginning date" need to take annual RMDs each year under the 10-year rule.
- The IRS's position precipitated the submission of numerous comment letters to the U.S. Department of Treasury by various groups and interested parties throughout the country.
  - These comment letters challenged the correctness of the IRS's interpretation of the SECURE Act in this respect, and in several instances requested *transition relief* to prevent the imposition of a 50% excise tax on designated beneficiaries that are subject to the 10-year rule who fail to take their RMDs due to the IRS's surprising construction of the 10-year rule in its proposed regulations.

The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- Fortunately, the IRS has issued **Notice 2022-53**, in which it has yielded to the estate planning community's request for transition relief while it continues to review how to address this issue (and others) in final regulations.
- The IRS has done this by waiving the 50% excise tax that would otherwise be imposed under Section 4974(a) of the Internal Revenue Code on beneficiaries for any shortfall in the amount of the RMD during 2021 or 2022 in either of the following two circumstances:
  1. Where the RMD is to be made to a designated beneficiary of a participant if: (1) the participant died in 2020 or 2021 and on or after the participant's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments (due, for example, to such person also being an "eligible designated beneficiary"); or
  2. Where the RMD is to be made to a beneficiary of an eligible designated beneficiary if (1) the eligible designated beneficiary died in 2020 or 2021, and (2) that eligible designated beneficiary was taking lifetime or life expectancy payments pursuant to certain relevant provisions of the Internal Revenue Code.

The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- In ***Notice 2023-54***, the IRS pushed back the proposed effective date even further, stating that "Final regulations regarding RMDs under Section 401(a)(9) and related provisions will apply for calendar years beginning no earlier than 2024."
  - Notice 2023-54 also provides that the IRS will not assert the Section 4974 penalty for RMDs not made in 2023 where the ten-year payout rule applies.

The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- Notice 2023-54 also provided guidance related to the change in the required beginning date of RMDs made under the SECURE 2.0 Act of 2022.
  - The SECURE 2.0 Act increased the required beginning date age to 73 for those who turn 72 after 2022 and to 75 for those who turn 74 after 2032.
  - Apparently mindful that it may take time for automated payments to be updated to conform to these changes in the required beginning date, this Notice provides relief by announcing that any distribution made in the first 7 months of 2023 to a participant born in 1951 (or to that participant's spouse) that would have been a RMD under pre-SECURE 2.0 Act law still qualified as eligible for a rollover.
  - The Notice further extended the 60-day rollover deadline in all cases to September 30, 2023.

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The latest on planning with retirement benefits under the SECURE Act and the SECURE 2.0 Act

- As is the nature of transition relief, Notice 2022-53 and Notice 2023-54 are not the final chapter in the story here, as the U.S. Department of Treasury and the IRS continue to review the comments submitted on both this and various other aspects of the proposed regulations under the SECURE Act.
- In addition, this transition relief only applies where the 10-year rule comes into play in the case of a person who dies after his or her required beginning date – very importantly, it does **not** provide an automatic waiver from excise taxes for failure to take a RMD in any other circumstances, such as in the case of an eligible designated beneficiary who is still living (as to whom no such ambiguity was presented concerning the need to take annual RMDs each year).
- But these Notices provide much needed transition relief for the years 2021, 2022 and 2023 as the rules in this area of the tax law continue to unfold.

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The *Magical Mystery Tour* that is Chapter 14 of the Internal Revenue Code

Overview of Chapter 14 of the Internal Revenue Code

- Chapter 14 of the Internal Revenue Code (IRC §§ 2701-2704) was enacted to combat so-called "estate freezes" -- manipulative valuation techniques used in connection with transfers of partial interests in property where the transferor retained an interest in that property.
- Prior to the enactment of Chapter 14, when a transferor transferred a residual interest in property and retained the income interest in the property, the transferred interest was valued for gift tax purposes by taking the value of the entire property and subtracting the present value of the retained interest.
  - Through the use of various techniques, the transferor would overvalue the transferor's retained interest which would produce an undervaluation of the transferred interest.

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Overview of Chapter 14 of the Internal Revenue Code

- Chapter 14 provides valuation rules to combat specific instances of valuation abuses.
- Under Chapter 14, the valuation of a transferred interest (residual interest) is generally determined by the ***subtraction method*** of valuation.
  - First, the value of the retained interest is determined; then, this value is subtracted from the value of the entity (corporation, partnership or trust).
  - In many cases, the value of the retained interest under the special valuation rules is zero, resulting in a taxable gift of the entire property.

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Overview of Chapter 14 of the Internal Revenue Code

– CORPORATION OR PARTNERSHIP EXAMPLE:

- FACTS: A is the sole shareholder of a corporation with a value of $10 MLN and recapitalizes it to have both preferred and common stock. A transfers the common stock to his children, retaining the preferred stock. The preferred stock does not require the payment of annual dividends, including on a cumulative basis.
- RESULT: Because the preferred stock does not provide for "qualified payments," unless certain other exceptions apply, the preferred stock that A retains will be ascribed a **zero value for Federal gift tax purposes** and therefore A will be deemed to have made a $10 MLN gift.

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Overview of Chapter 14 of the Internal Revenue Code

- Chapter 14 contains four sections:
  - **Section 2701 provides rules for determining the value for gift tax purposes of certain interests in corporations and partnerships that are transferred to members of the transferor's family.**
  - Section 2702 addresses the valuation of retained interests held through trusts or arrangements that are in the nature of trusts.
  - Section 2703 disregards certain options, restrictions and agreements (including certain buy-sell agreements) for valuing certain interests in business and other property.
  - Section 2704 treats the lapse of certain voting and liquidation rights as transfers and disregards certain restrictions on liquidation.

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Overview of Chapter 14 of the Internal Revenue Code

- It is important to consider when Chapter 14 will *not apply*. Chapter 14 does ***not*** apply to the following entities or transactions:
  - **Publicly-traded securities**;
  - Employment contracts;
  - Leases;
  - Debt, except as it may affect the value of a transferred residual interest (e.g., common stock);
  - **Transfers of interests in partnerships or corporations that are not controlled by the transferor or the transferor's family**, unless it involves certain liquidation, put, call or conversion rights;
  - Direct transfers of interests in corporations or partnerships if the transferor retains only stock or partnership interests of the **same class** as those transferred;
  - Direct transfers of interests in corporations or partnerships if the transferor retains only stock or partnership interests that differ from the transferred interest with respect to nonlapsing voting rights (in a corporation) or as to management and liability (in a partnership);
  - Irrevocable life insurance trusts; and
  - Private annuities, installment sales and self-canceling installment notes.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- Section 2701 applies special valuation rules to determine the value for gift tax purposes of certain interests in corporations and partnerships that are transferred to members of the transferor's family.
- Under Section 2701, a **"subtraction method"** is employed to value the transferred junior equity interest (e.g., common stock in a corporation), which is arrived at by subtracting the value of all family-held senior equity interests (e.g., preferred stock in a corporation) from the value of all family-held interests in the entity as determined immediately before the transfer.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- Significantly, for purposes of this computation, an "applicable retained interest" (which may consist of either an "extraordinary payment right" or a distribution right in a controlled entity other than a "qualified payment right") is generally valued at ***zero*** for gift tax purposes.
- Section 2701 also requires the value of the common equity to be at least 10% of the total value of all entity interests, plus total debt owed by the entity to family members (i.e., the "**10% minimum value rule**").
- **The upshot of this is that it could produce an unpleasant "gift tax surprise" whereby the full value of the family-held interests in an entity may be subject to gift tax without any offset to reflect the value of retained senior equity interests. This gift tax surprise could also occur upon an arm's length sale to a family member for full and adequate consideration.**

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- Even if it is ultimately determined not to apply, Section 2701 is always of concern in estate planning for carried interests because the **carried interest** represents a "**junior**" class of equity, as it entitles the holder to a portion of **residual** investment gains.
- In contrast, the following classes of equity that are typically held, directly or indirectly, by the fund manager would be considered "**senior**" to the carried interest because they are preferred as to distributions or allocations:
  1. The fund manager's interest in any co-investment or subscription capital
  2. The fund manager's interest in any partnership allocation in lieu of management fees
  3. The fund manager's interest attributable to the general partner's catch-up allocations on any hurdle return before the carried interest becomes entitled to distributions (other than "tax distributions")

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- The special valuation rules only apply if one of the following rights (referred to as an "**applicable retained interest**") is retained by the transferor or "applicable family members" immediately after the transaction:
  - A liquidation, put, call or conversion right (which are referred to as "extraordinary payment rights" in the regulations); and
  - A distribution right, but only if the transferor and applicable members of the transferor's family *control* the corporation or partnership (referred to as a "controlled entity" in the regulations).
- An "**applicable family member**" is the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor. Applicable family members are in the same generation as or above the generation of the transferor.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- Importantly, a "**controlled entity**" is a corporation or partnership controlled immediately before the transfer by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse.
  - In the case of a corporation, control means holding at least 50% of the total voting power or total fair market value of the equity interests in the corporation.
  - In the case of a partnership (including a limited partnership), control means holding at least 50% of either the capital interests or the profits interests in the partnership.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- **In addition, per IRC section 2701(b)(2)(B)(ii), "in the case of a limited partnership, [control also means] the holding of any interest *as* a general partner."**
- This is to be distinguished from merely holding an interest ***in*** a general partner.
- This critical distinction is illustrated by **Private Letter Ruling 9639054**, in which the IRS determined that a controlled entity did not exist for purposes of Section 2701 where a corporation, that served as the sole general partner of a limited partnership, was 37% owned by family members upon applying the attribution rules under the Section 2701 regulations.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

– The "**as** a general partner" language of Section 2701(b)(2)(B)(ii) is also quoted on page 12 of the preamble to the proposed regulations under Sections 2704 and 2701 that were issued by Treasury in 2016 (and have since been withdrawn by Treasury), in this context, in connection with clarifying the determination of control of an LLC or other entity or arrangement that is not a corporation, partnership or limited partnership including through "the ability to cause the full or partial liquidation of the entity or arrangement."

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- **Attribution rules** can cause an individual to be treated as holding an equity interest where the interest is held indirectly through a corporation, partnership, estate, trust or other entity.
- If an individual holds an equity interest in more than one capacity, the interest is treated as held in the manner that attributes the largest total ownership of the equity interest to the individual.
- An additional set of attribution rules applies for **grantor trusts**, which effectively override all other attribution rules relating to **applicable retained interests** to treat the deemed owner for income tax purposes (generally the grantor/transferor) as the holder of the applicable retained interest.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- As mentioned above, Section 2701 can also be triggered if the transferor or applicable family members retain an "**extraordinary payment right**."
- An extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the value of the transferred interest.
  - A call right includes any warrant, option, or other right to acquire one or more equity interests.
  - These rights confer upon the transferor discretion over whether to receive the payments or otherwise benefit from these rights.

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Section 2701 – Transfers of Certain Interests in Corporations or Partnerships

- In contrast, certain rights are **not** considered extraordinary payment rights and therefore will **not** be valued at zero under Section 2701.
  - Specifically, mandatory payment rights, liquidation participation rights (unless the transferor, members of the transferor's family, or applicable family members have the *ability to compel liquidation*), rights to guaranteed payments of a fixed amount under IRC § 707(c), and non-lapsing conversion rights are valued under normal valuation rules because they are not considered extraordinary payments.
  - These rights effectively give the transferor no discretion over whether to receive the payments or otherwise benefit from these rights, and therefore the policy reason for applying Section 2701 to these rights (*i.e.*, to prevent a disguised gift) does not exist.

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Section 2701 cont'd -- Safe Harbors to Protect Against the Application of Section 2701

- There are safe harbors set forth in the Section 2701 regulations that may be employed to protect against the risk of a Section 2701 gift tax surprise.
- Chief among these safe harbor techniques is the so-called "**vertical slice**" exception.
  - Under this exception, Section 2701 will not apply where there is a transfer of equity interests to the extent the transfer proportionately reduces each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.
  - For example, Section 2701 would not apply if the fund manager of a private equity fund owns 50% of each class of equity in the general partner and other affiliated entities, and transfers a portion of each class of equity thereby reducing each interest held by the fund manager and any applicable family members in the aggregate by 10%.

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Section 2701 cont'd -- Safe Harbors to Protect Against the Application of Section 2701

- Finally, the application of Section 2701 is by no means a death knell as far as estate planning is concerned.
  - First, certain of the cumulative preferred interests that are retained by the transferor or applicable family members may constitute "**qualified payments**" -- which ***are* given value for purposes of Section 2701**, although a **10% "minimum value rule"** would then apply for determining the value of the transferred junior equity interests.
  - Under the 10% minimum value rule, a junior equity interest in a corporation or partnership shall in no event be valued at an amount less than the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of (i) the total value of all of the equity interests in such entity, plus (ii) the total amount of indebtedness of such entity to the transferor (or an applicable family member).

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Section 2701 cont'd -- Safe Harbors to Protect Against the Application of Section 2701

- In addition, even if a preferred interest does not meet the definition of a qualified payment because it is not cumulative, the fund manager may elect to treat it for federal gift tax purposes *as though it were a qualified payment*.
- Further, particularly in the early stages of a fund, the value of the applicable retained interests (to which Section 2701 would potentially ascribe a zero value) may be sufficiently low so that the amount of the deemed transfer attributable to these interests would be manageable (*i.e.*, within lifetime gift tax exemption limits).

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Revenue Ruling 98-21 and Risk of Incomplete Gifts on Transfers of Unvested Interests in the General Partner

- In contrast to the carried interests that are held **by** the fund's general partner, a fund manager's interest **in** the general partner will often be subject to a vesting schedule.
- Commentators have noted the risk that the IRS may argue that a transfer of a fund manager's **unvested** interest in the fund's general partner to a trust established for descendants does **not** constitute a completed gift for federal gift tax purposes.
- **The concern here is that the gift may not become complete for federal gift tax purposes until the interest transferred becomes fully vested.** At that point the gift tax value of the interest transferred may have significantly increased, thereby exposing the fund manager to substantial gift tax exposure.

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Revenue Ruling 98-21 and Risk of Incomplete Gifts on Transfers of Unvested Interests in the General Partner

- The basis for this concern is **Revenue Ruling 98-21**, which addressed the gratuitous transfer of **nonstatutory stock options**.
- In that Ruling, the IRS concluded that the transfer to a family member, for no consideration, of a nonstatutory stock option is not a completed gift for federal gift tax purposes until **the later of** **(i)** the transfer or **(ii)** the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.

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Revenue Ruling 98-21 and Risk of Incomplete Gifts on Transfers of Unvested Interests in the General Partner

- There are significant reasons why the IRS's analysis in the context of unvested compensatory stock options should not apply to gifts or other transfers of unvested partnership or membership interests in the fund's general partner.
- Importantly, there can be little doubt that a fund manager who holds an interest in the entity that is the fund's general partner holds a substantial property interest.
  - Even prior to vesting, he or she will be entitled to allocations and distributions from the fund's general partner, and may be able to exercise certain voting and management rights under the entity's governing instruments.

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Revenue Ruling 98-21 and Risk of Incomplete Gifts on Transfers of Unvested Interests in the General Partner

- Nevertheless, until the IRS confirms by ruling that the reasoning of Rev. Rul. 98-21 does not apply to a transfer of unvested equity interests in the fund's general partner, it may be appropriate depending upon the circumstances to prioritize the interests to be transferred for estate planning purposes so that the fully vested interests are transferred first, followed by a transfer of the unvested interests that will be first in line to vest.
- By structuring the transaction in this manner, the risk (if any) posed by an IRS extension of Rev. Rul. 98-21 can be minimized.

Questions?

Kevin Matz
Partner
ArentFox Schiff
212.745.9576
kevin.matz@afslaw.com

Kim Kamin
Partner & Chief Wealth Strategist
Gresham Partners LLC
312.960.0200
kkamin@greshampartners.com

Upcoming Events

FOX Rising Gen Leadership Program
April 12-13, 2024
Denver, CO

FOX Premier Technology and Risk Management Days
April 17-18, 2024
Virtual

FOX Family Advisor Training Program
In-person
May 15-16, 2024, Chicago, IL
Virtual modules
April 24, May 8, and June 26

FOX Global Investment Forum
May 7-8, 2024
Miami, FL
and Virtual

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