Leimberg Information Services, Inc.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2975

Date: 27-Jul-22

From: Steve Leimberg's Estate Planning Newsletter

Subject: Mary Vandenack's Notes from the 2022 NYU Advanced Trusts and Estates Conference

The **NYU Advanced Trusts & Estates Conference** was held in person in New York City and virtually July 14 and 15, 2022. **Mary E. Vandenack** attended the NYU Advanced Trusts & Estates Conference and agreed to share her notes. Members who wish to learn more about this topic should consider joining Mary in her exclusive **LISI** Webinar on August 11th @ 3:00 PM EST where she will review all the proceedings from the 2022 NYU Advanced Trusts and Estates Conference. Click this link to learn more: Mary Vandenack

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, is CEO, founding and managing member of **Vandenack Weaver Truhlsen** in Omaha, Nebraska, and Elite Trust and Estate Services, a Delaware entity. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, executive compensation, business and business succession planning, tax dispute resolution, and tax-exempt entities. Mary also has expertise in mental health law and professional licensing. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves on the Planning Committee, Nominations, and Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Vice Chair. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process automation. At conferences, Mary will also often teach a yoga or mindfulness class. Mary hosts a podcast called Legal Visionaries. https://www.vwattys.com/resources-vw-podcasts/

NOTES:

CHAIR:

Brad J. Richter, Partner, Fried, Frank, Harris, Jacobson, Shriver, New York, NY

<u>PLANNING ISSUES AND STATE TAX ISSUES WITH RESPECT TO DECANTING</u>

Presenter: Wendy Wolff Herbert, Esq., Fox Rothschild, LLP, Princeton, NJ

DECANTING DEMYSTIFIED: STATE LAW AND TAX CONSIDERATIONS

Families change over time resulting in situations where the terms of an irrevocable trust no longer meet the needs of the grantor of the trust or its beneficiaries. In some cases, judicial modification may be possible, but it is often accompanied by significant cost and loss of privacy. Nonjudicial modification by agreement is permitted in a majority of states, but beneficiaries whose consent may be required for modification may be unwilling or may lack capacity to provide such consent. Further, statutes allowing nonjudicial modification may not permit desired dispositive changes or a modification requiring beneficiary consent may result in adverse tax consequences. Decanting provides another option allowing the trustee alone to modify an otherwise irrevocable trust with minimal tax consequence and without having to obtain beneficiary consent or court approval.

What is Decanting?

Decanting is defined as a trustee's exercise of discretionary power to distribute the assets of one trust (referred to in this outline as the "initial trust") in favor of a second trust ("new trust") for one or more of the same beneficiaries. A trustee's power to decant arises from one of three sources—the trust's governing instrument, applicable common law or statutory authority. If decanting is a viable option, transfer tax consequences must be considered.

Why Decant?

Decanting may be used to advance tax goals such as protecting tax treatment of trust, convert a grantor trust to a non-grantor trust or vice versa, and extending trust for grandfathering generation skipping tax purposes.

Decanting might also be used to change beneficial interests including converting a support trust to a special needs trust following or in anticipation of a beneficiary becoming disabled; changing the duration of a trust to, e.g., extend asset-protection or accommodate beneficiary's changing situation and needs; adding or removing spendthrift provisions or other measures to reduce potential liability; giving the trustee greater control over distributions; increasing a beneficiary's right to distributions, e.g., converting a trust with discretionary distributions to one requiring that distributions be made for support, health, education or other reasons; providing a beneficiary with a 5%/$5,000 withdrawal power, or granting or removing a lifetime or testamentary power of appointment. Decanting also might be used to lengthen the termination date of a trust. The process could also be used to hasten the termination date although it is more typical to see a desire for lengthening.

Decanting might be used to change the trust situs for purposes of being in a more favorable jurisdiction for tax or other purposes. Decanting can be used to change trustee provisions, change the trustee, change successors or the way they are appointed and/or removed.

Decanting may also be used to change administrative provisions for purposes such as appointing a trust protector, expanding investment authority, and changing governing law. Decanting can be used to consolidate trusts for reasons such as meeting cash needs or to reduce administrative costs.

Different trusts may be created to permit investment strategies to vary among trusts or to create separate GST exempt and non-exempt trusts with different investment and distribution strategies. Decanting may also be used to address changes in applicable fiduciary or trust law as well as changes in circumstances subsequent to creation of the trust.

Phipps v. Palm Beach Trust Company, 142 Fla. 782. The Florida Supreme Court approved the removal of assets from one trust to another where the beneficiaries of the second trust were the same as the first. The goal of the decanting was to allow the primary beneficiary to have a testamentary power of appointment in favor of his spouse.

All states that have considered the issue of the power to decant have determined that the trustee has such power.

In *Weidenmayer v. Johnson*, 106 N.J. Super. 161 (App. Div. 1969) the trust at issue was a trust share created by John Seward Johnson for his son, John Seward Johnson, Jr. The trustees exercised their discretion to distribute Seward's interest to him and he contributed the distribution to another trust. As a result of the decanting, two children from a prior marriage were excluded as beneficiaries of the new trust. The children that were cut out as a result of the distribution to a second trust sued. The court held the trustees had not abused their discretion. The court noted that the two children who were cut out were not damaged because distribution or exercise of power of appointment could have prevented them from inheriting anyway. The court noted that the settlor's peace of mind was a reasonable basis for the exercise of the trustee's discretion.

In *Ferri v. Powell-Ferri*, 476 Mass. 651 (2017), the Massachusetts Supreme Court approved trustee's distribution of trust property to a new trust for the same primary beneficiary. The father had created a trust for his son Paul's benefit. The Trustee had broad power to pay or segregate any portion of the trust for later payment. The son also had withdrawal rights over the trust assets. At the time of decanting, the son had power to withdraw 75% of the value of the trust property. After the son's wife filed for divorce, the trustees created a new trust for the son's benefit. The new trust was substantially similar to the initial trust but gave the son none of the withdrawal rights he had held under the original trust, including the son's then presently exercisable right to withdraw 75% of the trust assets. The trustees were the beneficiary's brother and his father's attorney. They initiated the decanting without advising the brother of the transfer of assets to the new trust. The Massachusetts court approved the decanting noting that the trustee had extremely broad discretion to make distributions and that the inclusion of a spendthrift clause evidenced the settlor's intent to protect trust property from son's creditors.

Hodges v. Johnson, 170 N.H. 470 (2017). New Hampshire has a decanting statute allowing a trustee to decant from one irrevocable trust to another. A trust had been created by Settlor. The settlor was married with five kids including step-children and the trust was created to benefit spouse and all five children. The beneficiaries were all in business together. Over the years, family rifts evolved related to the involvement of some family members in the family business. The Settlor requested the trustee to decant the trusts in a manner that would result in a change of the beneficiaries. The trustees did so and the result was to eliminate four of six beneficiaries and various contingent beneficiaries. The New Hampshire Supreme Court upheld a lower court ruling that the decanting was improper and void because the trustee violated his fiduciary duty. The Court stated that the trustee had failed to treat the beneficiaries equitably given the intent and purposes of the trust. There is a difference between a power to distribute and a power of appointment in this context. Even though state law may grant the power to decant, the Trustee is still a fiduciary.

It is very important to closely consider state law when decanting. State laws vary significantly.

Tax Issues Related to Decanting.

Decanting generally does not result in a recognition event for income tax purposes if the trustee has the power to distribute the assets; however, exceptions to this general rule will apply if the result is property that is substantially different or property with liabilities in excess of basis. A recognition event may also result if the decanting results in beneficiaries having substantially different interests.

Decanting is currently on the IRS no ruling list for specific issues related to income, gift or GST tax purposes.

Carrying out DNI from one trust to the other will likely result in income and related tax issues to the recipient trust. A shift of income from one trust to another could have a positive tax result.

Generally, there is no gift arising from decanting even when the decanting favors one beneficiary over another. There is a different result if the trustee is also a beneficiary. There can be a gift if there is a transfer of an interest from the trustee/beneficiary to another beneficiary.

Decanting may have tax issues where the trust from which assets are being distributed has an ascertainable distribution standard. When trustee is beneficiary, the best approach may be to use an independent trustee to effectuate decanting.

Presenter suggested keeping the trust name and identification number the same when decanting. This can be accomplished by treating the decanting as a reformation.

NAVIGATING THE SECTION 2701 MINEFIELD

Presenter: Scott M. Sambur, Partner, Seward & Kissel, NY, NY; Adam K, Sherman, Partner, McDermott, Will & Emery, Chicago, IL

Materials: N. Todd Angkatavanitch, Principal, Ernst & Young, Hartford, CT

What is a Preferred Freeze Partnership?

A preferred “freeze” partnership (referred to as a Freeze Partnership) is a type of entity that provides one partner, typically a Senior Family Member, with a fixed stream of cash flow in the form of a preferred interest, while providing another partner with future growth in the form of common interests in a transfer-tax-efficient manner. Preferred partnerships are often referred to as “Freeze Partnerships” because they effectively contain or “freeze” the future growth of the preferred interest to the fixed rate preferred return plus its right to receive back its preferred capital upon liquidation (known as the “liquidation preference”) before the common partners. The preferred interests do not participate in the growth of the partnership in excess of the preferred coupon and liquidation preference. The end result is that such growth benefits the common class of partnership interests, which is typically held by the younger generation or trusts for their benefit.

This is a different type of vehicle than the typical family limited partnership because the partnership is divided into at least two distinct classes. In the family structure, a Freeze Partnership might be used to consider the needs of different generations.

This freeze technique is used less than other freeze techniques such as a GRAT or sale to an IDGT. The reason for that may relate to the complexity of the approach; however, this is typically a more tax efficient approach when negative capital accounts are involved, which is common for real estate entrepreneurs. The negative capital account often results when a taxpayer owns several real estate properties in a holding company structure over a long period taking advantage of depreciation deductions and using non-recourse financing to make distributions. IRC Section 2701 adds to the complexity particularly in the context of controlled family partnerships.

An example of how this technique could be used:

- Taxpayer forms new entity.
- Taxpayer contributes the entirety of his interest in real estate holding company to new entity in exchange for a preferred interest (with liquidation and a fixed qualified payment preference).
- Taxpayer's children contribute cash in exchange for a 10% subordinated interest. This subordinated interest will be entitled to the growth and appreciation in excess of the preferred return.
- Operating agreement of entity provides for a fixed annual distribution to the owner of the preferred interest. The distribution must qualify as a qualified payment. Such distributions must be made prior to any distributions to the subordinated interest.

What is Section 2701?

Section 2701 addresses the value of transfers of interests in partnerships or entities when the transfers made are intra-family. Section 2701 can result in a deemed gift to occur in connection with a contribution to capital by a Senior Family Member to a Freeze Partnership or a transfer by gift of such an entity. By way of example, the transfer to which Section 2701 can potentially apply is when a parent who initially owns both common and preferred equity interests in a partnership transfers the common stock to his children (or trusts for their benefit) while retaining the preferred interest. Section 2701 has a broader reach and can apply in other situations such as when profits interests are issued.

Section 2701 applies and can cause a deemed gift to occur when a senior generation family member ("Applicable Family Member") holds an

("Applicable Retained Interest") after a "transfer" to a Junior Family Member ("Member of the Family") or trusts for their benefit. A "transfer" is defined to include a traditional gift transfer (e.g., I give my child 10 shares of common stock), capital contributions, redemptions, recapitalizations or other changes in the capital structure of an entity.

An "Applicable Family Member" is the senior family member and spouse. A "Member of the Family" is junior member and spouse. Attribution rules apply. There is a separate set of attribution rules for 2701 purposes.

An "Applicable Retained Interest" is an equity interest that confers upon its holder either an "extraordinary payment right," or in the case of a controlled entity, a "distribution right."

If Section 2701 applies, the value of an interest transferred to a Junior Family Member is determined by subtracting the interest retained by the Senior Family Member from the value of all family held interests. That amount will be deemed a gift to the Junior Family Member.

If the interest retained by the Senior Family Member is an "Applicable Retained Interest", its value for purposes of 2701 is determined using the zero value rule. That is, the value of the Applicable Retained Interest is zero and the entire value of the entity transferred will be deemed a gift.

Section 2701 Zero Value rules

The zero value rule applies if there is a transfer to a member of the family and after the transfer, an "applicable family member" retains an "applicable retained interest".

There are two types of rights that will result in a transfer being subject to the zero value rule. They are distribution rights and extraordinary payment rights.

A distribution right is a right to receive discretionary distributions with respect to an equity interest in a family-controlled entity. A distribution right does not include an extraordinary payment right or a right to receive distributions related to an interest in the same class or a class that is subordinate to transferred interest.

There is significant debate as to what is a distribution right. For example, is the right to take a withdrawal from a hedge fund a distribution right? There are a lot of gray areas in this analysis.

A distribution right that isn't a "qualified payment right" equals zero value. A qualified payment right must be cumulative payment, payable at least annually and at a fixed rate.

An extraordinary payment right includes a liquidation, put, call, conversion right, or a similar right which affects the value of the transferred interest. There is no control requirement because this is held individually rather than in an entity.

In the context of 2701, there is an assumption that the older family member will not exercise the extraordinary payment right. If a senior family member's equity interest contains a qualified payment right and an extraordinary payment right, the interest is valued assuming the extraordinary payment right is not exercised. That is, the zero value rule will apply in determining the value.

Control in the case of a limited partnership means holding any interest in the limited partnership as a general partner. Many commentators take position that if there are 20 members in an LLC that is a general partner, the members do not have control but it is not clear.

If a payment right is a "qualified payment right", with respect to an interest in a controlled entity, the right is a distribution right for purposes of 2701 and thus, and applicable retained interest; however the zero value rule does not apply. A qualified payment rights is valued under traditional valuation principles.

Exceptions to Applicable Retained Interests

There are certain rights that may be retained by the transferor that do not fall within the definition of extraordinary payment right nor distribution right.

- Liquidation Participation Rights. This is a right to participate in a liquidating distribution.
- Mandatory Payment Rights. This is a payment required to be made in a specific amount at a specified time.
- Right to Guaranteed Payment – This is a right to a guaranteed fixed amount payment. Sambur indicates he uses this approach quite often.
- Non-lapsing Conversion Right. This is a non-lapsing right to convert an equity interest into a specified number of shares.

Another way to avoid 2701 is to use a loan as long as the debt is bona fide. Additionally, leases, employment arrangements, and other interests that are not in the nature of equity are not applicable retained interests.

Some other exceptions to 2701 include:

- Marketable securities – market quotations are readily available.
- Same class exception – If you have two classes but they are substantially similar, they will still meet this exception.
- Vertical slice proportionality rule.

    - The basic idea is that there is an exception for proportionate interests, a proportional reduction of each and every class of equity ownership owned by the senior generational family member.
    - Be aware of the attribution rules when seeking to use a vertical slice.

Consider a family real estate business with multiple deals with promotes. If you give promote to a junior family member, 2701 could come into play.

Typical Hedge Fund Structure

Carried Interest typically is created with 2% of profits to general partner. There is typically principal and key employees in general partnership, which has the carry and there is a separate management company. The problem with the structure is the carry. In most cases, the limited partners have preferences over the general partnership interest. If the fund managers is deemed to control the fund, the limited partnership interests will be applicable retained interests. Generally, investors cannot withdraw.

Section 2701 solutions for hedge fund transfers include:

- Derivative transaction
    - There can be significant income tax issues if grantor dies before derivative is paid out.
    - Derivative can be a poor tool to use if fund does really well for a couple years but performs poorly thereafter.
- No-fee argument
    - You can take position that senior family member has a put right.
- Proportionality argument
- Vertical slice

Section 2701 solutions for PE/VC fund transfers:

- Vertical slice.
- Derivative transaction
- Mandatory payment and liquidation participation rights-based arguments.

Hot Carry Topics:

- Attribution rules and the control test. Consider interest “in” the general partner vs. interest “as” a general partner.
- Completed gift concerns (vested and unvested interests)
- Valuation of brand-new carry (2701 and traditional gift tax principles)
- Renewed Section 2036 concerns (post-Powell).

How do you value a carry in a brand new fund? If you use an option pricing method, there is likely a value.

Typical Family Office Structure

Family office is a typically C Corp and has a profits interest (with or without hurdle return) takes an interest in a fund. Family office employs those who provide services to the family. Family office is a family controlled entity.

Considerations include:

- Who owns the family office? Typically, this will be owned by senior family member.
- Distribution rights.
- Term of fund.

The purpose of these structures is to tax efficiently fund the family office. Profits interest comes out to fund the family office.

Can you give a family fund a “shelf life”?

Section 2701 Solutions for family office/fund structures:

- Reverse the Profits Interest
- Subtraction Method

Adequate Disclosure Rules:

Treas. Reg. Sec. 301.6501(c)-1(e) establishes a separate safe harbor for adequate disclosure for gifts subject to Chapter 14. These regs add requirements for focus on description of transferred and retained interest as well as relationship of all the parties/owners to the transferor. These regs also add use of regular adequate disclosure safe harbor and question of substantial compliance.

Qualified Payment Election

Treas. Regs. Section 25.2701-2(c)(2) allows taxpayer to treat non 2701 compliant distribution rights as qualified payment rights (provided they are administered in that fashion).

ADVANCED PLANNING FOR REAL ESTATE

Norman Lencz, Esq. Partner, Venable, Baltimore, MD

Pass-Through Deduction from the TCJA:

- TCJA created a below the line deduction for qualified business income (“QBI”) from pass-through entities and sole proprietorships.
- Maximum deduction is 20% of QBI.
- This deduction sunsets in 2026.
- The deduction effectively reduces the tax rate on pass-through income.

- QBI is generally the ordinary income, gain, deduction and loss of a qualified trade or business.
  - Specified service businesses are excluded from being a qualified trade or business.
- Excluded items are taxpayer's wages (or reasonable compensation), guaranteed payments, and investment type income.
- Calculation:
  - Lesser of:
    - 20% of taxpayer's QBI; or
    - The greater of:
      - 50% of the W-2 wages with respect to the business or
      - 25% of the W-2 wages with respect to the business plus 2.5% of unadjusted basis of all qualified property
    - Plus 20% of REIT dividends and distributions from publicly traded partnerships.
- There are limitations based on amount of taxpayer income and type of business.

Real estate clients have raised the question of whether they should create C corp for ownership of real estate to tax advantage of the 21% tax rate. Presenter's math shows that flow through economics are still better than C corp even without QBI. The economics can be improved in a C corp by not taking anything out but that is typically unrealistic. There are limitations on ability to retain income in C corporations. There are a variety of rules that force owners to take distributions. For example, there is an accumulated earnings tax. Also, personal holding company rules may apply.

What are the considerations regarding choice of entity?

- Is pass through deduction available?
- What are the owner's plans for exit?
  - C corporation strategies are often less tax efficient. For example, if there is an asset sale, double tax will apply. If the sale is structured as a stock sale, the buyer may want to pay less than for the assets as the tax liability will be a consideration with respect to purchase price.
  - Tax free reorganizations may be useful for an owner who does not plan a full exit.
  - Section 1202 exclusion can be used by a real estate company only if it is an active business.
- Impact of state income tax

    - C corporation can deduct all state income taxes. The value of this depends on the state income tax rate.
- On a sale of a partnership interest, an owner may have depreciation recapture or ordinary income due to the sale of “hot assets”.
- Estate tax planning impacts entity choice. There may be a need for current distributions when using GRATs, IDGTs and Chapter 14 freezes.
- Charitable contribution deductions should be considered. This analysis should be done before a sale to determine whether an interest in entity should be contributed or proceeds.
- Partnerships can issue profits interests.
- REITs
    - There is only level of tax.
    - Shareholders are entitled to a 20% QBI for ordinary distributions with no W-2 limitations.
    - REIT compliance rules are onerous.

Is Rental Real Estate a Qualified Trade or Business?

- IRS issued Notice 2019-97.
    - A rental real estate business is a trade or business.
    - Taxpayer must maintain separate books and records for each rental real estate.
    - 250 or more hours of rental services must be performed each year with respect to the rental enterprise (beginning in 2023, this rule applies in 3 of 5 years)
- Triple net leases are not eligible for safe harbor.

Pass-Through Deduction Planning Opportunities

- Independent contractors are eligible whereas W-2 employee is not.
- Can a specified service business spin off? Must avoid 50% ownership overlap.
- Keep separate books and records for two lines of business.
- Multiply $170,500 per person through children and trusts.
- Switch from guaranteed payments to preferred returns.
- W-2 employees can increase W-2 limit.

Opportunity Zones

- Investor can defer realization of capital gains.
- Investor can permanently avoid some gain. (15% of gain on original investment and 100% of gain representing appreciation)
- There were so many dollars chasing these deals early on that the properties became inflated and the value of the savings wasn’t worthwhile.

- A 1031 can allow long term deferral whereas the gain in an OZ can only be deferred but 1031 requires full amount to be rolled over while QOZ only requires the gain to be involved.
- Partnership can elect to roll over gain into a QOF and partner indirectly gets rollover.
- QOZ Benefits
  - Defer gain on original investment through 2026.
  - 10% basis increase after five years on original investment gain.
  - 15% basis increase after 7 years.
  - Exclusion for gain realized on QOF investment if held for 10 years.
- QOZ as an estate planning vehicle:
  - QOZ interests can be gift to grantor trust.
  - Long term holding period is typically more consistent with estate planning goals.
  - QOZ can be transferred to a GRAT.
  - A grantor trust may be utilized and as recipient, the trust will step into the shoes of the transferor for income tax purposes.
  - OZ can be put in a GRAT.
- Interest Expense Limitation
  - Real estate entity can elect out of the interest deduction limit.
- Bonus Depreciation
  - 100% bonus depreciation for qualified property place in service 9/27/2017 to 1/12023. A phaseout begins in 2023 and sunset occurs in 2026.

<u>STATE INCOME TAXATION OF TRUSTS</u>

By: Richard H. Greenberg, Esq., CPA, Greenberg & Schulman, Woodbridge, New Jersey

Background

State taxation of trusts varies based on whether the trust is a resident trust or non-resident trust. A resident is typically subject to income tax on all income regardless of where the income was earned. Non-residents are taxed only on “source income.” Source income is generally income earned from business income earned in the State, real estate income earned in the State and the sale of real estate or other tangible assets within the State.

Example – A is a resident of New York. A earns $100,000 in interest income, $75,000 in rental income from a building located in New York and $30,000 from a business operating in Texas. A will be subject to State income tax to New York in connection with all of the income. If A were not a resident of New York, he or she would pay tax on only the New York rental income of $75,000.

The key issue in trust state income taxation relates to what properly constitutes a resident trust as opposed to a non-resident trust. Re Some States utilize the residency of the trustee (e.g., California) as the basis for residency of a trust. Other states utilize where the trust is administered (e.g., Maryland). Some States utilize the residency of the beneficiary (e.g., North Carolina). Some States utilize a combination of factors.

The residence of a grantor trust for state income tax purposes will be based on the residence of the grantor. The exception is Pennsylvania, which doesn't recognize grantor trusts.

A traditional approach by states was to treat a trust as a resident if the grantor was a resident of the state at the time it became irrevocable. Some states had laws providing that the trust would be a resident if the grantor had been a resident at any time. In general, courts held that this was insufficient nexus to treat a trust as a resident trust.

In New York, the rule was modified to include additional criteria. The additional criteria included:

- New York resident trustee.
- There are assets in New York.
- Grantor resides in New York at time trust becomes irrevocable and trust has New York source income.

New Jersey adopted a similar rule but by publishing the criteria in a tax newsletter.

These various criteria still pose issues in determining residency.

Trustee Residency

One approach was to combine residence of trustee with residence of grantor. What happens if the trustee moves or trustee is replaced with a trustee that is not a resident?

In *Linn vs. Illinois Department of Revenue* 2013 Ill. App (4th) 121055, a trust created by an Illinois resident with Illinois trustees and governed by Illinois law replaced the Illinois trustee with a trustee who was not a resident of Illinois. Everything was moved to Texas. The taxpayer argued that once all contacts are removed, the State cannot prospectively tax the trust as a resident trust. The Department of Revenue argued that the trust had already availed itself of the Courts of Illinois and its laws and thereby created a nexus which could not be undone with a change of residency of the trustee.

The Court held that what had happened historically with the trust in the Illinois Courts and under Illinois law had no bearing on the tax year in question during which no such contact existed. Accordingly, a taxpayer may argue that the nexus test need be examined each year and the trust is not irrevocably bound to taxation as a resident trust merely because the test was initially met.

Trustee Residency and Trust Protector

Many trusts now provide not only for a trustee but add a “trust protector”, which is typically an individual or entity provided with the authority to perform certain acts which enhance flexibility with respect to the terms of a trust.

For example, a trust initially created to save estate taxes and avoid inclusion of the assets in the estate of a beneficiary might produce a more tax efficient result if there were inclusion of those assets in the estate of the beneficiary if a basis adjustment in accordance with Section 1014 were more valuable notwithstanding estate tax inclusion. In a time when the estate tax exemption is in constant flux, having a choice as the result to be achieved is an important tool. A common technique to provide such an opportunity is the appointment of a trust protector who has they power, usually in a non-fiduciary capacity, to grant to the beneficiary a general power of appointment over the appreciated assets of the trust. If it appears that the inclusion of the appreciated assets in the estate of the beneficiary produces a more efficient tax result, the trust protector can grant to the beneficiary the general power of appointment. Upon the death of the beneficiary, the appreciated assets will be included in the estate of the beneficiary, increasing the basis of those assets and achieving the desired result. If the estate tax exclusion will be the better result, the trust protector will not grant the general power of appointment to the beneficiary.

The residency of a trust protector could become a basis by which the trust could be taxed as a resident trust. As the use of trust protectors and other third parties with various powers becomes more common, States may seek to use those roles to assert residency of a trust.

Multi-State Corporate Trustees and Residency –The Big Kahuna

Another issue is residency of a corporate trustee operating in multiple states. In *Bank of America vs. Commissioner of Revenue* 474 Mass. 702

(July, 2016), the question of residency turned on whether or not Bank of America was a resident of Massachusetts, notwithstanding that its domicile is North Carolina.

A resident of Massachusetts is statutorily defined as a person that is either domiciled in the State or if not a domiciliary, is in the State for 183 days and has a place of abode within the State. In the case, Bank of argued that the statute applied only to individuals on the basis that banks do not have “places of abode”.

The Court noted that Bank of America had over 200 “places of abode” in the form of them branch offices. The Court concluded that Bank of America was a resident of Massachusetts.

The Court found that in order to treat the trust as a resident trust, fairness dictated that administration of the trust also had to occur within the State, notwithstanding the reading of the Statute. Although not directly stated in the holding, it appears the additional requirement of administration within the State is applicable to corporate trustees treated as residents. In Bank of America, the Bank performed most of its administrative functions for the trusts at issue in Massachusetts.

The holding in Bank of America could have significant effects. Practitioners should monitor evolving case law in this area.

Assets Located in the State

Another modification to Traditional Methodology was with respect to whether a trust can be treated as a resident trust is whether the trust owns assets within the State. This might appear to be a simple analysis, at least when considering real property or tangible property which is held or located in the State; however, intangibles may have a different analysis. Cash and marketable securities, whether or not held or maintained in a State are not considered assets of that State; they are intangibles with no specific location for tax purposes.

What if the trust included shares of stock in a New York C Corporation which operated its business in New York? In *Residuary Trust Under the Will of Fred E. Kassner v. Division of Taxation*, Dept. of Treasury, 2015 WL 2458024 (N.J. Super. Ct. App. Div. 2015), the New Jersey Tax Court held that the ownership of stock in a New Jersey corporation, which operated their businesses in New Jersey did not constitute ownership of a New Jersey asset. The corporations may have owned New Jersey based assets, but the trust owned the stock, an intangible asset similar to any publicly traded stock.

If a C Corporation distributed dividends, the rule doesn't change. Dividends from intangible stock is not State source income.

State Source Income

What if the corporation is an S corporation? Any business or real estate profits paid to the trust from the corporation would be considered State source income and render the trust a resident trust pursuant to the third "nexus prong". Presumably, the same result would occur with respect to a limited liability company or a partnership.

Does the mere existence of some state source income subject the entire trust to being resident of a state? For example, assume a trust with no nexus other than State source income owns $100,000,000 of marketable securities which produce $7,000,000 of income and owns a 1% interest in an S Corporation whose fiduciary accounting and taxable income from in-state sources for the year is $10. In analogous tax arenas, proportionate fairness is a key element to the validity of a State statute to impose a tax. For example, Treichler vs. Wisconsin 338 U.S. 251 (1949) and Quill Corp. vs. North Dakota 504 U.S. 298 (1992), both raise the issue of a proportionately fair tax.

13 THINGS YOU MAY NOT KNOW ABOUT PREPARING A FEDERAL ESTATE TAX RETURN

Presenter: George Karibjanian, Franklin Karibjanian & Law, PLLC, Boca Raton, FL

5 Points to 706 Preparation

- Determine what assets will be included in the gross estate, value, and whether alternate valuation will be elected.
- Compute the tentative taxable estate: Gross Estate less Deductions. Deductions include:
  - Expenses, debts, claims, taxes, losses
  - Marital deduction
  - Charitable deduction
  - Deduction for state death taxes
- Compute a tentative tax under the unified rate schedule on the sum of:
  - The tentative taxable estate and

    - The total amount of the decedent's post-1976 gifts not includable in the gross estate ("adjusted taxable gifts")
- Subtract from the tentative tax the total amount of gift taxes paid or payable on gifts made be decedent after 1976.
- Subtract the following credits:
    - Applicable credit
    - Foreign death tax credit
    - Credit for federal estate taxes on prior transfer
    - Credit for gift tax on pre-1977 gifts
- The result is estate tax payable.
- Credits are not refundable.

706 Overview

- Part 1 – Decedent and Executor
- Part 2 – Tax Computation
- Part 3 – Elections by Executor
- Part 4 – General Information – This is a very important part to consider.
- Part 5 – Recapitulation
- Part 6 – Portability (portability of deceased spousal unused exclusion)

Decedent and Executor Information

- Explain any name discrepancies if decedent was known by more than one name.
- Use decedent's identification number on 706.
- If decedent was domiciled in a foreign country, then a certified copy of any inventory filed in a foreign jurisdiction as well as any return filed in a foreign jurisdiction must be attached.

Calculating the Estate Tax

- Report funeral and administration expenses on Schedule J.
- Claims against the estate should be reported on Schedule K.
- Indebtedness on property included in gross estate is reported on Schedule K.
- Casualty and theft losses incurred during administration are reported on Schedule L.
- Transfers to surviving spouse are reported on Schedule M.
- Charitable bequests are reported on Schedule O.
- State death taxes paid are reported in Part 2, Line 3b.

Portability Only Return

- A return being filed only for portability purposes may be eligible for simplified reporting.

Adjusted Taxable Gifts

- Adjusted taxable gifts are total “taxable gifts” made by decedent after 1976, other than gifts included in gross estate. Reminder: Read the Statute. See 2001 of Code. Adjusted gifts are not “reported gifts” but gifts made. **Preparer should make a reasonable effort to determine the existence of such gifts.**
- **Always prepare Worksheet TG.**
  - Part 1 is gifts made before 1977 on line 1 and gifts made after 1976 on Line 2.
  - Taxable gifts should be entered in Column B.
  - Include gifts after 1976 that are included in gross estate.
  - If decedent and spouse did any gift splitting, gift tax paid by spouse should be reported in Column F.
- Reduction for Gifts Included in Gross Estate – This is how AEA comes back for GRATs and QPRTs included in gross estate because decedent died during term.
- The concept of “tentative tax” captures tax at marginal rate. The concept was more meaningful when the graduated tax rates applied to the calculation.
- There is a reduction for gift taxes paid on post 1976 adjusted taxable gifts. The tentative tax is reduced by the gift tax that would have been payable on taxable gifts made after 1976 using the rate schedule in effect for the year of death. Decedent’s gift taxes must be recomputed (using rates in effect at time of death) for each year after 1976 that decedent made a gift. Reminder that this is not the same as gifts reported on 709s.
- Pre-1976 gifts can factor into the equation. The effect of including these gifts in the amount of prior year gifts is to cause the credit for the current year to be calculated in the highest possible marginal tax bracket.

Alternate Valuation of Joint Property and IRAs

- Alternate valuation occurs upon the first to occur of 6 months from date of death or the sale or disposition of an asset.
- IRS has not ruled on how the alternate valuation date election applies to IRAs. If estate is beneficiary, alternate value will apply to distributions from the estate. If third person is beneficiary, IRA does not leave gross estate until transfer to named beneficiary occurs.
- Once the election is made, it is irrevocable.
- For jointly owned assets with right of survivorship and retirement accounts, disposition refers to disposition ***by recipient***. See Treas. Reg. 20-2032-1(c)(3) and Prop. Reg. 20-2032-1(c).
  - Executor
  - Trustee
  - Heir or devisee to whom title passes by operation of law

    - A surviving joint tenant or tenant by the entirety

Special Use Valuation

- IRS 2032A allows executor to elect to value farms and certain business realty based on present use (e.g. farmland in the path of development but being used as a farm).

Audit Finder

- Ownership – If decedent owned an interest in a partnership or unincorporated association, or LLC, the yes box on 11a should be checked.
- Discounts – If 11a was yes, 11b requires disclosure of any discounts taken. Rumor is that checking 11b is an audit finder.
- Transfer or Sale Disclosure - This was added in 2006. Line 13e requires an affirmative response if decedent sold or transferred an interest to a trust. If the year was closed for statute of limitations purposes, this question is meaningless; however, if there was a transaction that has not been reported on a 709, this question allows IRS to review transaction.

Real Estate Contracts

- Schedule A. An executed sales contract to purchase real property is considered an interest in real property on Schedule A.
- An executed contract to sell real property where title was not transferred before death is not reported on Schedule A, as this is reported on Schedule C. This is a matter of following the directions for the 706.

Mortgages

- Schedule A. If debt is non-recourse, only the net equity is reported on Schedule A. If debt is recourse, value is reported on Schedule K and unpaid portion of mortgage is reported on Schedule A.

Promissory Notes

- Treas. Reg. 20.2031-4. You can discount promissory notes. FMV is presumed to be the amount of unpaid principal plus accrued interest but appraiser may be able to establish that the note is wholly or partially worthless.
- Rev. Rul. 67-276 – sets forth evidentiary factors for valuing at less than FMV.

- Always consider alternate value of a promissory note. It is possible to have a significant reduction in value after date of death. For example, there could have been a change in interest rates or a bankruptcy of maker of note.
- A note that is barred by statute of limitations may not necessarily be worthless as debtor may waive the defense. If defense is valid and would be raised by debtor, the note is worthless. If note is secured, value should be limited to value of collateral.

Deathbed Checks

- Rules for gift checks at deathbed are different for non-charitable and charitable gifts.
- Checks for annual exclusion gifts that have not been cashed come back into the estate.
- A charitable gift is considered complete when check is written.
- Does executor have an obligation to recover funds from recipients who cashed check after date of death? Answer is not clear. Executor has to account for these in some manner. Are these gifts by residuary beneficiaries?
- Consider doing a funding analysis for every estate so that such issues are always considered.

Joint Spousal Interests

- 2040(b) came into code in 1977. For pre-1977 interests, contribution test can be used. After 1976, spousal owned joint property shall be considered to be half and half.
- Joint Refund – The share that belongs to decedent goes to estate. Treas. Reg. 20-2053-6(f). This is calculated by a fraction that considers the decedent's tax liability as if decedent had filed separately compared to total tax of both spouses.

Funeral Expenses

- State law controls what is deductible for funeral expenses.
- These expenses are deductible to the extent actually paid out of property subject to claims.
- Deductible expenses include the cost of a plot for an entire family including a reasonable amount for future care.
- Cost of funeral reception is likely not deductible.
- Many expenses that are not directly attributable to the burial have been successfully deducted. By way of example, the printing of

acknowledgment cards have been treated as an expense without disallowance.

- In come cases where it is not entirely clear, consider taking the expenses.

Schedule L

- Certain expenses not subject to claims are deductible. These are typically expenses related to administration of non-probate assets that are not included in decedent's estate. These would typically be assets that pass contractually.

Schedule M

- Estate administration expenses are one of two types: estate transmission expenses or estate management expenses. Estate transmission expenses will reduce the marital or charitable deduction of charged to marital or charitable property. Estate management expenses generally not reduce the deduction of deducted on estate's income tax return.
- Expense clause should say "Follow the Hubert case".
- Marital deduction has to match what is used to fund the marital deduction.
- In making the decision, the considerations include the step up of assets in the marital trust versus assets passing to the credit shelter trust that will increase in value estate tax free. Create a funding analysis and consider these factors.

ESTATE PLANNING FOR ENCUMBERED REAL ESTATE USING PREFERRED PARTNERSHIPS

Presenter: Professor Jerry Hesch

What Can the Preferred Freeze Partnership Provide that Gifts, GRATS and Installment Sales to Grantor Trusts Cannot Provide?

- A Freeze Partnership provides one partner a preferred interest with a fixed cash flow. The other partner receives an interest that will receive the future growth. Such a partnership can, over time, transfer a significant amount of value to the junior owners in a tax efficient manner.

- Financial Leverage is important. Gifts, GRATs, Installment Sales and Preferred Partnerships all shift a portion of a partnership's annual income to trusts . This is the financial leverage.
- All of these strategies shift appreciation in the value of partnership assets to irrevocable trusts not exposed to the transfer taxes (the "freeze").
- The burn is the most important technique. This means that the grantor pays the income taxes on all partnership income including what goes to the holder of the common interests (the "burn"). All of these strategies can use grantor trusts.
- **Only the preferred partnership, by retention of the preferred interest, can use the tax-free step-up in basis at death.**
- Only the preferred partnership can provide decedent with a guaranteed payment for life.
- Only the preferred partnership interest can qualify for § 6166 because it is included in the gross estate (15-year payout of estate tax).

What is a Freeze Partnership?

- A freeze partnership has two classes of interests.
    - One class is a preferred interest which has a priority return and a liquidation preference.
    - The second class, common interest, will benefit from all income after the preferred return and all appreciation. There is no liquidation preference.
- The preferred partner's capital interest must be fully redeemed prior to and redemption of the common partner's interest.

Key Objectives:

- Obtain an income tax free step up in basis at death when including encumbered real estate in the gross estate.
- Avoid the "leaky freeze" by minimizing the hurdle rate paid on the retained preferred interest.
- Seek to lock in valuation discounts with respect to the common interest.
- Freeze the discounted value of the common interest. Shift income allocated to common interest to a trust that is not exposed to estate tax. The typical strategy used to achieve this is by a sale of the common interest to a trust in exchange for a promissory note.
- The "Burn". Structure so that the grantor pays all income taxes on partnership income.

Example of a Preferred Partnership

- Senior creates a partnership and contributes business valued at $20 million. Senior receives a preferred interest with a $10m capital account and common interest with a $10m capital account. Priority allocation to preferred interest is 6% of capital account. Appreciation in value of assets is allocated to the common interest. Partnership income in excess of the $600,000 is allocated to the common interest. Senior sells common interest to irrevocable grantor trust in exchange for a promissory note. (This could be effectuated by a gift.)
- Only income in excess of priority income can be allocated to common partner. Prior to any redemption of common, all distributions must be made to preferred partner. Any income shortfalls must be accumulated in arrears. Partnership is not required to redeem preferred partner's capital contribution. Risk of loss is first born by common partner.

Using the Preferred Partnership for Encumbered Real Estate

- Senior purchased a commercial office building in 1984 for $20 million. $16 million was depreciated over 18 years. Senior took out substantial funds out of building income. This was achieved by refinancing and taking loans.
- Current Status:
  - Value $54m
  - Adj. Basis $4m
  - Mortgage $44m
  - Equity $10m
- Phantom Gain $40m is generated by liabilities in excess of basis. This is "negative capital account."
- Total potential income tax gain is $50m.
- Income taxes can exceed the $10m netted from the sale.
- The advantage of this real estate being included in decedent's gross estate is elimination of the $50m in gain. If this encumbered real estate is subject to estate tax, $10m is subject to estate tax for an estate tax cost of $4m. If real estate sold immediately after death, income taxes saved can be $14.4m.
- If building continues to be held, basis step up can be allocated to building and depreciated against ordinary income. This save $18m income taxes over time.
- Of course, the downside is that to the extent the real estate is held until death, all appreciation will be included in the estate and subject to estate tax at the current estate tax rate.

- Alternative 1:
  - Reorganize partnership into preferred and common. Senior disposes of common interest by gift or sale to an irrevocable grantor trust that is not exposed to estate tax.
  - Required Allocation is 90/10 (with 10 to common). Note that at least 10% of partnership capital must be allocated to the common interest. IRC 2701.
  - Structure:
    - Preferred – Tax Basis $3.6m; Gross Value $48.6m; Liability 39.6m; Phantom Gain $36m; Capital account $9m
    - Common - Tax Basis $400k; Gross Value $ 5.4m; Liability $4.4m; Phantom Gain $ 4m ; Capital account $1m
  - Senior dies with only the frozen preferred partnership interest included in Senior's gross estate. Estate tax value for the preferred interest is $9m. Because preferred is still allocated 39.6 of liabilities, estate's income tax basis is 48.6m. Common interest will still have $4m of phantom gain.
  - The issue with this alternative is that 10% of the liabilities did not receive a step up in basis.
- Alternative 2
  - Senior contributes 10m of other assets for a common interest and the 10m is later converted to a preferred interest or child or trust can make the capital contribution for the common interest. If a market based approach can result in a preferred priority return in the 5 to 6% range, the "leaky freeze" has been minimized.
    - A preferred 9% priority return was used when 10% of partnership capital was allocated to the common interest.

What is a Preferred Priority Return?

- A priority return is a priority allocation of partnership income.
- If a preferred priority return is 9%, partnership income must be allocated to the preferred interest based on 9% of the preferred capital account.
- Using more common coverage reduces the preferred risk. That is, if more of the capital is allocated to common, the risks of under performing the preferred return are less.
- Rev. Rul. 83-120 requires market based approach for priority return. Such a return will result in a rate greater than the 7520 rate used for GRATs and installment sales.

Estate Tax Advantage of Transferring the Common Interest to A Grantor Trust

- Example: Senior contributes $10m of assets to a partnership and receives a preferred interest of 6m and common interest of 4m. Preferred interest provides 6% return.
- Grantor pays income taxes on the trust income. This is the “burn”.
- Senior sells the common interest to a grantor trust for $3m (using a 25% valuation discount) taking back the grantor trust’s promissory note at the long-term AFR (assume 2%), paying $60,000 interest annually with all note principal due in 20 years.
- Assume that the partnership’s income gradually increases each year.
- Assume Senior’s income tax rate is 40%.
- If the income increases gradually each year, over time, Senior receives the same preferred allocation and note interest while the income to the grantor trust, on which Senior pays the tax, increases.

Factors to Consider After Formation of Preferred Partnership

- Real estate partnerships are likely to continue to refinance.
- The increase in partnership liabilities can increase the phantom gain in the preferred interest.

Partnership Disguised Sale Regulations

IRC 707 includes a presumption that a disguised sale occurs when a member contributes appreciated property to a partnership and cash or other property is distributed to such contributing member within two years. There are various safe harbor approaches to avoiding a disguised sale. One approach would be to structure the preferred right to restrict the amount of the payment for the first two years with a true-up payment in Year 3. An alternate would be to have full coupon payments begin in Year 3. An additional safe harbor is one that does not result in distributions in excess of partnership’s cash flow from operations. It is possible to create a structure for payments that does not satisfy a safe harbor but is a reasonable preferred payment.

Section 2036(a)(1) and the Common Interest

Compliance with Section 2701 should meet bona fide sale exception.

Section 2036(a)(2)

Section 2036(a)(2) results in estate tax inclusion if decedent has "the right, either alone or in conjunction with any other person to designate the persons who shall possess or enjoy the property or the income therefrom. The safe approach is to structure the preferred interest to have no vote on any partnership matters.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary Vandenack

CITE AS:

LISI Estate Planning Newsletter #2975 (July 27, 2022) at http://www.leimbergservices.com. Copyright 2022 Leimberg Information Services, Inc. (LISI). All rights reserved. Reproduction in Any Form or Forwarding to Any Person Prohibited Without Express Permission. This newsletter is designed to provide accurate and authoritative information regarding the subject matter covered. It is provided with the understanding that **LISI** is not engaged in rendering legal, accounting, or other professional advice or services. If such advice is required, the services of a competent professional should be sought. Statements of fact or opinion are the responsibility of the authors and do not represent an opinion on the part of the officers or staff of **LISI**.

Click here to comment on this newsletter.

HELP US HELP OTHERS! TELL A FRIEND ABOUT OUR NEWSLETTERS. JUST CLICK HERE.

Click Here for Steve Leimberg and Bob LeClair's **NumberCruncher** and **Quickview** Software, Books, and Other Resources