FSP WebEx

October 15, 2015

Recent Developments

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Threatened Changes to §2703 and §2704 Regulations Applicable to FLPs

When Congress enacted the "Special Valuation Rules" of §2701 - §2704 in 1996, it specifically designated certain estate planning arrangements for which "discounted values" would not be applicable. It also rejected that treatment for certain other arrangements.

The Obama administration has apparently decided that the scope of the statutory provisions enacted by Congress, and the application of these rules by the courts, has not been sufficiently effective in limiting the availability of valuation discounts. Even though the administration can't get the changes it would like to see enacted by Congress, it is now threatening to issue new regulations under §§ 2703-2704 which would extend "applicable restrictions" well beyond the current point.

Example

- Client has rental real estate in an FLP.
- Partnership Agreement includes provisions prohibiting a partner from transferring any interest in the partnership's underlying property, restrictions on transfer of partnership interest, etc.
- Client makes a gift or sale of a partnership interest to child or trust.

- IRS has routinely attempted to argue that the "property" transferred by the Client is the underlying partnership real estate, and that transfer is subject to limitations which should be ignored for valuation purposes under Section 2703 or 2704.

- Courts have held that the "property" transferred is the <u>partnership interest</u> (not the underlying real estate).

In one of the seminal FLP cases (Strangi v. Commissioner, 115 T.C. 478, 2000) Judge Cohen rejected the IRS argument saying, *"Treating the partnership assets, rather than decedent's interest in the partnership, as the 'property' to which section 2703(a) applies in this case would raise anew the difficulties that Congress sought to avoid by repealing section 2036(c) and replacing it with Chapter 14."*

- It is expected that, in any such new regulations, the administration will seek to override that result so that valuation will be determined without regard to the typical limitations in the partnership agreement.

- It is generally thought that transfers occurring before any such change in the regulations should be grandfathered.

Income Tax vs. Estate Tax

- With the new tax rates and the 3.8% Medicare surtax on net investment income, the federal income tax cost on a realized capital gain can reach 23.8%, plus the state income tax - in Georgia getting close to 30%. The estate tax rate (on transfers in excess of the unified credit exemption) is 40%.

When the client retains the asset for inclusion in his taxable estate at death, the income tax basis is "stepped up" to the estate tax value.

(IRC §1014)

When we give assets away, or sell assets to a grantor trust, to remove them from the taxable estate, the assets retain the donor's basis. The benefit of the basis step-up is lost.

- For estate tax purposes, only the increase in value after the gift is actually removed from the taxable estate. The value of the gift (the amount of the unified credit exemption used) is still reflected in the estate tax calculation as an "adjusted taxable gift."
- For income tax purposes, the unrealized gain at transfer plus that increase in value after transfer will eventually be subject to capital gain tax on sale.

Example – Annabelle has $1 million of Coke with a basis of $100,000. We assume the stock will appreciate to $1.5 million before her death.

* If she makes a gift of that stock to children, she uses $1 million of her unified credit exemption, and her taxable estate is reduced by $500,000 (the post-gift appreciation). The potential estate tax saving is $200,000. The children have a basis of $100,000. If the stock is sold for $1.5 million following her death, the income tax (state and federal) is about $389,000.

* If Annabelle keeps the Coke stock, it is included in her taxable estate at death at $1.5 million. The added estate tax (on the appreciation) is $200,000. However, the income tax basis in the stock at death becomes $1.5 million, so a sale generates a tax liability of zero (saving $389,000.)

Conclusion – a gift of low-basis assets can result in an increased overall tax liability unless the valuation leverage and appreciation are great enough to overcome loss of basis step-up.

RIGT plus ILIT

- RIGT – Client gives $5 million of low-basis assets to an irrevocable trust, and retains the right to receive all the trust income for life.

  Taxable gift of $5 million (no reduction for the retained income per §2702. Use unified credit and pay zero gift tax.

  Each year, if trust property appreciates, distribute appreciation from trust to children.

Trust distributions of appreciation are not taxable gifts, and remove that appreciation from the estate.

At client's death, trust property in included in gross estate because of retained income (§2036).

Basis on trust assets is stepped up (§1014).

Client's $5 million exemption is restored and used by estate. (§2001(b))

RIGT Result

- All future appreciation is removed from taxable estate with no gift tax.
- Entire unified credit exemption is restored at death and available for use in the estate.
- Full basis step-up on trust assets at death.

ILIT

- Life insurance held in an ILIT can provide tax-free cash to cover the income taxes on the portion transferred from the trust during client's life.
- The arguments for this are the same as those used for years in demonstrating that life insurance provides a very efficient, less costly, vehicle for paying estate taxes.

General Rule

- Do not use any unified credit exemption unless it either
  - (1) buys a basis step-up and saves income taxes, or
  - (2) is likely to generate sufficient valuation leverage to safe enough estate tax to justify the loss of the basis step-up.

Life Insurance to Retire Business Debt

It is typical for a closely-held business to have a substantial borrowing relationship, in which the business owner is required to guarantee repayment of the debt. In many such arrangements, either the business owner or the lender, or both, want life insurance in place to satisfy that debt if the business owner dies.

Many people believe the life insurance pledged to satisfy such a debt can not be removed from the insured business owner's estate, because of the language of Regs. §2042-1(b)(1), providing that if life insurance proceeds are payable to the lender to satisfy a loan which would otherwise be an obligation of the insured's estate, then it is "payable to the estate" and included in the gross estate.

Inclusion in the gross estate under the language of that regulation is dependent on the insured's estate being relieved of an obligation. If the estate is not relieved of the debt, then the proceeds are not "payable to the estate" and can be excluded from the estate if the insured had no incidents of ownership.

- Alternate Structure –

  (1) the policy is owned by an irrevocable life insurance trust;

  (2) the policy is pledged to the lender as required; but

  (3) upon the insured's death the insurance proceeds fund the trust's <u>purchase of the debt, rather than the pay-off of the debt.</u>

- Result - Upon the death of the insured, the lender receives the policy proceeds and then executes a “transfer and assignment” of the loan to the trust, which then becomes the "lender".
- The debt has not been satisfied, the estate has not been relieved of an obligation, and nothing is includible in the estate of the insured.

Continued §419 Problems

Courts continue to support the IRS position on deductibility of contributions to §419 multi-employer welfare plans providing death benefits. In 1995 the IRS included these in the schedule of "listed transactions", and have subsequently imposed not only income tax deficiencies upon disallowance of deductions, and interest, but also the 30% accuracy penalty. (Prosser, et al v. Commissioner in 2015)

Captive Insurance Companies

Many successful businesses can save substantially on the after-tax cost of providing the many types of insurance for which they currently pay premiums if they shift that coverage to a "captive" insurance company. Even after the captive pays for "stop loss" coverage from a large commercial insurer, the owners may expect to generate substantial profits if the operating business can manage its risks effectively.

- In a "small captive" under §831(b) the insurance company can avoid any income tax on up to $1.2 million of annual premium income.
- The captive may be owned by one or more irrevocable trusts in the family, and provide a vehicle for removing the accumulated wealth to lower generations with no gift tax, estate tax, or GST tax.

- The main business purpose of a captive must be to provide P&C coverage to its insured parties, but once it has generated and retained substantial capital beyond that required for its reserves, its income tax status makes it attractive to use for the funding of life insurance on the lives of family members.

- In February 2015 the IRS published its concerns for the use of such captives, indicating that it will pay particular attention to the following:

  * poorly drafted insurance documents charging high premiums to cover ordinary risks, or esoteric, implausible risks which are extremely unlikely to occur.

  * total annual premiums which seem designed to optimize the use of the $1.2 million §831(b) exclusion.

  * missing or inadequate underwriting and actuarial substantiation for the insurance premiums being paid.

  * hefty fees paid to promoters to create and manage the captive.

  * lack of adequate "risk sharing and risk shifting" in the insurance pool.

STOLI Litigation

- Insurance companies continue to aggressively pursue policy owners and agents involved in issuance of policies without full disclosure of intent to sell policy to third party.
- Pruco filed suit in 2014 against Agent and General Agent, with reference to a policy issued in 2007.

- Rather than relying on the "incontestable period" in the policy, the court found that this policy was procured by fraud.
- The statute of limitations generally does not commence until Pruco actually discovered the fraud or "should have" discovered the fraud.

SCINs

A "Self-Canceling Installment Note" ("SCIN") is a form of payment in which the purchaser of property agrees to make payments under the note to the seller for the defined term of the note, or until the seller's death. If the seller dies during the term of the note, nothing further is payable and any remaining debt balance is "canceled."

- As a condition to approving the value of the promissory note with such a cancelation feature, the courts have held that the debtor must actually pay for the "mortality risk" of the seller dying in the trust term, either by an increased rate of interest or an increase in the principal amount of the debt.

- In the Davidson case, the decedent had sold stock in his company to his children and to grantor trusts benefiting his grandchildren in exchange for SCINs.
- Mr. Davidson died 6 months after the sale.
- IRS asserted a $2.6 billion tax deficiency.

- The real underlying issue was whether the SCIN was bona fide indebtedness reasonably expected to be paid, and how the "mortality premium" was determined.

- Estate and IRS settled for $388 million, including taxes, interest, and penalties. (Probably still a significant victory for the taxpayer).

- **Suggestion –** By some life insurance when the SCIN is implemented.

  I have recommended that my client buy some life insurance at the time we create the SCIN transaction. Even if rated, the issuance of the life insurance gives us a basis for computing the value of the mortality premium to be included in the SCIN, and provides a strong argument to combat the IRS if the client dies prematurely.

"BDIT"
Beneficiary Defective Inheritance Trust

- Lots of recent promotional noise about these.
- Typically, trust is created by Parent for Child (and Child's descendants). Parent funds trust with nominal corpus (e.g.: $5,000), and a Crummey withdrawal power.
- Parent retains no power which would make it a grantor trust as to Parent.

- Child is typically the sole Trustee.
- §678 provides that a person other than the donor (such as Child) will be treated as the owner of the trust for income tax purposes where that person "(1) has the power, exercisable solely by himself, to vest the corpus or income in himself (such as the power to withdraw gifts to the trust), or (2) having 'released or modified' such power, the person has other powers or control over the trust which would, if held by a grantor, cause the grantor to be the deemed owner of the trust under the grantor trust rules. "

- The objective of the BDIT is that Child will be treated as the income tax "owner" of the trust so that Child can use the trust for lifetime estate planning transactions.
- The Crummey power is clearly a power to "vest the corpus or income in himself".
- After the Crummey withdrawal period, it is argued that Child has "released" the power but has other powers covered under the grantor trust rules.

- Those ‘other powers’ include

  * beneficial right to receive trust income;

  * right to withdraw corpus limited by an ascertainable standard; and/or

  * right to appoint trust corpus to others.

NOTE – Do NOT give Child a typical grantor trust “swap power” because it will make the trust a grantor trust as to Parent. §675(4)

- if §678 applies as suggested for a BDIT, then

  (1) Child can sell appreciating assets to the trust without recognizing gain to remove those assets from his estate,

  (2) Child can enrich the trust by paying all income taxes arising from trust transactions, without any gift tax, and

  (3) Child can retain some economic interest in the assets sold to the trust, and have a power to change the trust beneficiaries or terms applicable to other beneficiaries, without the trust property being taxed as part of Child's estate for estate tax purposes.

- Also, a BDIT trust can be a good vehicle for purchasing and owning life insurance on Child's life, outside his taxable estate, if we are careful not to give Child any indirect incidents of ownership in the policy. There would need to be another trustee other than Son, and Son prohibited from exercising any incidents of ownership.

- There could be some very attractive results from a split-dollar loan arrangement between the trust and Child's employer, with the policy cash accumulation being ultimately available to supplement Child's retirement.

- BDIT Trust could own a C corporation in which the “cheap” 15% income tax bracket is used to fund life insurance premiums.

- **Problems –**

  §678 specifically refers to a power which has been "released or otherwise modified." When talking about general powers of appointment (such as the Crummey power) the tax law makes a clear distinction between powers which have been "exercised", or have been "released", or have "lapsed".

For gift tax purposes, the "exercise" or "release" of a general power of appointment is treated as a taxable gift from the power holder to the taker of the property. However, the "lapse" of such a power is taxable only to the extent the property is greater than 5% or $5,000.

QUERY - Is a "lapsed" power the same as a power which has been "released or otherwise modified" under §678?

There is no reliable law on which one may depend with any certainty as to the tax treatment of the BDIT. The IRS has included the issues of installment sales to a BDIT on its "no-ruling" list, signifying both their discomfort and likelihood that they are thinking about this.

However, there do not appear to be any estate tax issues which are not manageable, so the "risk" is generally limited to income tax questions.

If Child as Trustee regularly files fiduciary income tax returns (Form 1041) adequately disclosing any such transactions with the trust, it would seem that the statute of limitations would run and the risk would be small.

The End

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