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Moving and holding business intesrests into and as an asset in an irrevocable trust, complexities and opportunities

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Introduction

Estate planners have long been fascinated with the dual concepts of 1) how to use the lifetime gift tax exclusion most efficiently; and 2) how business interests contributed or sold to a trust will be managed within that trust. In this era of an elevated exclusion, created by the 2017 Tax Cuts and Jobs Act,[1] larger wealth transfers have been enabled. This is true for both simple gifts into trusts and the "seeding," with liquid assets, of larger gifts into irrevocable grantor trusts that then acquire from the grantor other assets, usually worth far more than the seeded amount. The asset gifted or sold is often a business interest. Regardless of whether the business interest sold are units of a limited partnership ("LP") or limited liability company ("LLC") or shares of a Subchapter S Corporation ("S Corp") or of a C Corporation (a "C Corp"), valuation discounts are routinely claimed when a sale or gift is made. In this paper, the unique features of gifting or selling those business interests into trusts, planning opportunities involving qualified small business stock ("QSBS") – which arise only in the C Corp context, and the risks of a grantor's both transferring and retaining too much control will be explored.

I. Income taxation of irrevocable trusts – basic rules

Irrevocable trusts are established for any number of reasons, including creditor protection, income tax planning, and transfer tax planning. The creator of the trust, and the person (whether a natural person, another trust, or a business entity) that funds the trust is the "grantor." The "grantor" label has significance in the context of not only the trust's creation but also the treatment of trust income for income tax purposes. Because the Subtitle (A) of the Internal Revenue Code (the "Code") dealing with income tax differs from Subtitle B (Chapters 11-14, referred to as the transfer tax provisions) a person can move an asset out of his or her taxable estate without severing his or her duty to pay taxes on the income generated by those assets. Thus, a creator (sometimes referred to as a "settlor," "grantor," or "trustor") of a trust can usually decide whether to be the income tax owner of all or a portion of an irrevocable trust's assets (referred to as a "Grantor Trust"), or whether, instead, the trust will be considered the owner of all or a portion of the trust assets (referred to as a "Non-Grantor Trust") for income tax purposes.[2] That choice (intentional or accidental) by the settlor of the trust can lead to planning opportunities.

The Grantor Trust rules of §§ 671-679 were added to compel the grantor to be taxed on trust income when income tax rates for trusts were effectively lower than they were for individuals. That relationship has been reversed. For 2022, the top (seventh) 37% ordinary income tax bracket for individual, unmarried taxpayers start at $539,900; the top (third) bracket for long-term gains begins at $459,750 of gain. The net investment income ("NII") tax is imposed at a

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[1] An Act to provide for reconciliation pursuant to titles II and V of the current resolution of the budget for fiscal year 2018. P.L. 115-97 (December 22, 2017).

[2] Trust income is taxed under §§ 641-685. These statutes are contained in Subchapter J of Part A of Chapter 1 of the Code. Trusts described in §§ 671-679 are termed "grantor trusts" in which the trust is not the income taxpayer; rather, the persons or entities that create and fund the trust, or, with respect to § 678 a third party, is the taxpayer for all or a portion of income, gain, loss, deduction, and credit of the trust. The grantor trust rules compose Subpart E of Subchapter J. The other portion of the trust and estate income tax is composed of Subparts A, B, C, D, F.

non-inflation-adjusted $200,000 of adjusted gross income. Trusts, on the other hand, pay tax at the highest brackets at just $13,450 of ordinary income and NII, and $13,700 for long term gains.

If a trust is a Grantor Trust, the grantor must include on his, her, or its personal income tax return whatever portion (including, potentially, all) of the income, gain, loss, deduction or credit recognized by the trust over which he or she is the income tax owner. If the §§ 671-679 powers and rights are not reserved or possessed by the grantor, or a non adverse party,[3] then the trust pays the tax on its income and gains.

Complexity, and planning opportunities, increase substantially for separate taxpayers with what is referred to as the "portion rule" under § 671, under which the grantor can possess the income tax attributes of all income, gain, loss, deduction, and credit over "any portion of the trust."[4] We will discuss this issue more when we talk about S Corps in trust.

II. Retained control of business interests held in trust (§§ 2036 and 2038)

One of the key elements of business, regardless of entity type, is who controls it. Many times, taxpayers wish to transfer portions of the equity for valid family wealth accretion reasons. Often, a taxpayer wants to transfer a partial interest while retaining control of all major operational decisions. Many planners grew accustomed to transferring LP, LLC, or S Corp interests, with the grantor's continuing to hold a usually small but nevertheless controlling GP, managing member, or voting stock interest.

The Tax Court's 2017 decision in of *Powell v. Commissioner*[5] reignited concerns regarding the transfer tax implications of gifting interests in closely held businesses. These concerns were exacerbated after the Court in 2020 decided in favor of the IRS on all counts in *Moore v. Commissioner*[6]. What is clear from both the cases, and from the questions on the U.S. estate tax return (IRS Form 706),[7] is that all transfers, not just those into trusts, are subject to increased scrutiny and the holdings of those cases.

[3] *See* Code § 672(a). An adverse party is a person with a substantial beneficial interest in the trust, and the interest would be adversely affected by either the exercise or non exercise of the power that he holds over the trust.
[4] *See* Treas. Reg. § 1.671-3. There are six portions that a grantor may exercise powers over: ordinary income, income allocable to corpus, the entire trust, an undivided fraction of the trust, interest represented by a specific dollar amount, or specific trust property.
[5] *Estate of Nancy H. Powell v. Comm'r*, 148 T.C. 18 (May 18, 2017).
[6] *Estate of Harold V. Moore v. Comm'r,* T.C. Memo 2020-40 (April 7, 2020); *aff'd, Estate of Moore v. Comm'r*, No 20-73013, US App LEXIS 33111 (9th Cir. Nov. 08, 2021)
[7] *See* United States Estate (and Generation Skipping Transfer) Tax Return (rev. August 2018), Part 4 questions 11, 12, 13a, b, c, e.

First, let's review the relevant laws. § 2036 provides:

Transfers with retained life estate

(a) General Rule.- The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (*except in the case of a bona fide sale for adequate and full consideration in money or money's worth*), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death-

(1) the possession or enjoyment of or the right to income from the property, or

(2) *the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom*.[8]

Emphases added.

The statute's consideration of actions taken by the taxpayer, as well as the actions that are or could be taken by the taxpayer, along with unspecified and unlimited others, is further explained in the Treasury Regulations.

Treas. Reg. § 20.2036-1(b)(3) provides:

With respect to such power, it is immaterial (i) whether the power was exercisable alone or in conjunction with another person or persons, *whether or not having an adverse interest*; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to the contingency beyond the decedent's control when it did not occur before his death (e.g., the death of another person during the decedent's lifetime).[9]

Corporations – both S Corps and C Corps – are in the group of entities to which an increased risk of estate inclusion of partial interest transfers can apply under § 2036(b).

Code § 2036(b) Voting Rights –

(1) In General. - For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be the retention of the enjoyment of transferred property.

(2) Controlled Corporation. – For purposes of paragraph (1), a corporation shall be treated as controlled corporation if, at any time after the transfer of the

[8] Code § 2036(a).

[9] *See* Treas. Reg. § 20.2036-1(b)(3)

property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of § 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20 percent of the total combined voting power of all classes of stock.

(3) Coordination with § 2035.- For purposes of applying § 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.[10]

As will be discussed later, the potential impact of § 2036(b) can be seen in the use of Non-Grantor Trusts to multiply the Qualified Small Business Stock exclusion under § 1202. It can also be seen in other contexts when S Corp shares are transferred if the grantor were to retain the right to vote the gifted shares. If the grantor were to name a family member as the trustee of the trust, the "alone or in conjunction with" clause of the § 2036(b)(2) might be invoked to compel inclusion of gifted assets in the grantor's estate.

Further, under § 2036, the property of the decedent is pulled back into the estate, even if the interest in the property does not reach the level of comprehensive control. Thus, for example, if a decedent transfers property worth $100 during life, but retains a right to designate where the income from the property will go, and he or she holds that interest or ability at death, his or her estate will include the entire property (*i.e.*, $100 plus appreciation or minus declines in value as of the date of death).

In contrast, what is included in a decedent's estate under § 2038 is the value of the interest in property that the decedent had transferred during life, but over which the decedent held the power to *alter, amend, revoke, or terminate* the interest at death, or had transferred with three years of death. In the example above, if the decedent were to die with the power to revoke the existing income interest of a beneficiary, his estate would include not the entire property, but rather the value of the income interest he could revoke.

Code § 2038 – Revocable transfers

(a) In General. - The value of the gross estate shall include the value of all property-

(1) Transfers after Junes 22, 1936-To the extent of any interest therein of which the decedent has at any time made a transfer (*except in the case of a bona fide sale for adequate and full consideration in money or money's worth*), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change though the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.[11] (Emphasis added).

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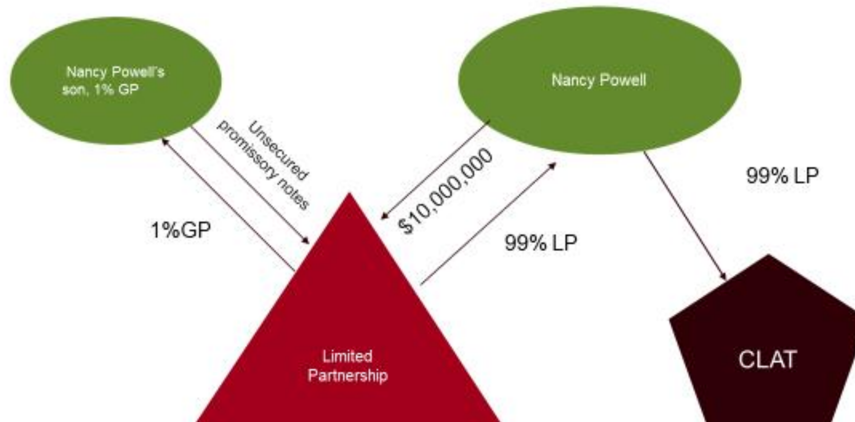
[10] Code § 2036(b).

[11] Code § 2038(a); *See Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) discussing the application of § 2038.

III. It all started /or restarted with *Powell*

Estate of Nancy H. Powell v. Comm'r, 148 T.C. 18 (May 18, 2017)



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A. The Problem - *Estate of Powell v. Comm'r*

In the 2017 landmark case of retained interests in limited partnership, *Estate of Powell v. Comm'r,* the Tax Court examined the planning and transfers that were undertaken: (1) by a "taker" (grantor's son) acting as attorney in fact under a power of attorney (POA) for the grantor; (2) nine days before the grantor passed away; (3) using a LP as a discounting vehicle. The consideration for the 99% LP interest was $10 million in marketable securities and cash from the grantor (with a son acting under the POA of the grantor). Her son was also the 1% general partner of the LP. Two days later, the son, as agent under the POA, attempted to contribute the decedent's 99% LP interest to a chartable lead annuity trust (CLAT) that named Mrs. Powell's sons as the remainder beneficiaries. This transfer to the CLAT apparently exceeded the authority granted under the POA, which was limited to making gifts to issue of the grantor (including, of course the GP) of amounts *not more than the annual exclusion*.

The IRS attacked both the $10 million contribution and the transfer of the 99% LP interest to the CLAT, though on separate grounds.

1. § 2036(a)(2)

a) The IRS focused on the discount claimed on the transfer of $10 million as a contribution to the limited partnership for the grantor's 99% LP interest. Its argument was based on § 2036(a)(2), citing the grantor's ability to dissolve the limited partnership, *acting along with her son* (the GP). In her 99% LP

capacity, she (the decedent) could, with the GP, designate the persons who were to enjoy the property. Given her reserved right to act (even if just in conjunction with her son, the GP), the retained power fits within the plain language of § 2036(a)(2). In *Powell*, the *court expanded its then-established jurisprudence to include a* limited partner interest. In earlier § 2036 cases, the control exercised by the GP was determinative. The *Powell* court did not elaborate on the extent of the LP interest sufficient to cause inclusion. This remains an open question, though presumably it would not matter how much of an LP interest was retained if the power to dissolve the LP in conjunction with someone else were retained. Holding that the value of the decedent's contribution made to the partnership in exchange for her retained LP interest should be included as an asset in the grantor's estate constituted a substantial expansion of law and has altered what planners must consider in creating LPs.

b) The taxpayer did not allege any of the more common arguments to avoid inclusion of the LP interest in the gross estate under § 2036(a)(2). Those arguments include that: (1) a bona fide sale for full and adequate consideration was made; (2) the limited partnership was formed for a legitimate and significant non-tax reason; or (3) the fiduciary duty of the decedent, through her son as POA and GP, to the limited partnership or other partners, did not permit the termination of the limited partnership. Interestingly, the *Powell* court adopted the *Strangi*[12] court's reasoning on point (3) to negate the fiduciary duty argument previously advanced under the Supreme Court case of *United States v. Byrum.*[13]

c) *Strangi* provides some guidance, as the facts in that case parallel those of *Powell.* In *Strangi*, the court determined that there were retained interests in the assets transferred, as evidenced by Strangi's lack of retained liquidity for lifestyle, continued residence in the transferred house with deferred rent payments (2 years), and the actual payment of funeral and debts after Strangi's death from the transferred assets. The interest was determined to have been retained under § 2036(a)(1) for estate tax purposes, and the *Strangi* court did not reach a conclusion as to the applicability of § 2036(a)(2).

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[12] *See Estate of Strangi v. Comm'r*, T.C. Memo 2003-15, *aff'd*, 417 F. 3d 468 (5th Cir. 2005). In *Strangi,* the grantor's son funded a 99% LP interest, and a 47% interest in an S Corporation that was the 1% GP under a power of attorney. Despite the state law fiduciary duties of the partners to the partnership, the court found that the fiduciary duties in an intra family relationship were illusory.

[13] *See United States v. Byrum*, 408 U.S. 125 (1972). The taxpayer in *Byrum* transferred shares in 3 controlled corporations to an irrevocable trust. The taxpayer reserved the right to vote the stock and to veto the sale of the company shares in the trust. The IRS challenged under the IRC of 1954. The US Supreme Court found that the taxpayer's retention of the management resulted in control of dividends paid from the company to the trust. His status as majority shareholder in each company, and thus his ability to control the board member selection, led to recognition of fiduciary duties therein to "act reasonably in the best interest of the corporation and all of its stockholders, *citing Berkwitz v. Humphry*, 163 F. Supp 78 (ND Ohio 1958); *see also*, PLR 9710021; PLR 9415001 supporting non-inclusion under § 2036(a)(2) because the retained general partnership of the transferor was subject to a fiduciary duty.

2. § 2035

The *Powell* court considered an additional basis for inclusion of the $10 million under § 2035, which applies to transfers made within 3 years of the decedent's death. The Tax Court held that § 2035 also established inclusion of the decedent's contribution to the limited partnership.

3. § 2043(a)

The Tax Court further analyzed the extent to which the $10 million should be included under § 2043(a). That section limits the amount included in the gross estate when rights, powers or other trusts are made, created, exercised or relinquished for consideration, but under §§ 2035 to 2038 and 2041, are through *other than* a bona fide sale for full and adequate consideration. The limitation on the value included in the estate is "the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent."[14]

The *Powell* court's finding that there was no legitimate and significant non-tax reason for the creation of a limited partnership resulted in its determination that the transfer of the $10 million in exchange for 99% LP interest was not a bona fide sale. As a result, the reduction in the amount brought back into Mrs. Powell's estate was the $10 million contribution to the LP minus the discounts taken in calculating the value of the 99% LP interest. The taxpayer claimed 25% discount. The court did not include any appreciation from the date of the original transfer, 9 days before death in her estate.

4. § 2038(a)

The agent under her power of attorney (her son) sought to contribute Mrs. Powell's 99% limited partner interest to a CLAT. The CLAT transfer was invalidated under California law[15] and was thus void or revocable on the basis that the POA agent exceeded his authority as agent. The POA authorized gifts to or for the benefit of the principal and issue or others up to the annual gift exclusion amount under § 2503(b). That class of permissible beneficiaries did not include the CLAT itself, or the charitable lead interest of the CLAT. As a result, under California state law, the contribution was either void *ab initio* or revocable. Thus, the gift was incomplete[16] and no separate gift tax deficiency resulted, although the value of the 99% LP interest that had been contributed to the CLAT was then included in Mrs. Powell's taxable estate under § 2038.

5. Assessment

What does the *Powell* holding mean to the estate/tax planner? Clearly from the *Powell* case, the IRS continues to assert that the transfer to an LP in exchange for a limited partner interest can result in the transferor's having a retained right that would result in estate tax inclusion under §

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[14] 26 U.S.C. § 2043(a).

[15] Cal. Prob. Code § 4264(c); *see also Shields v. Shields,* 19 Ca. Rpt. 129, 130-131 (Cal Ct. App. 1962) (holding that general grants of authority to convey property do not provide the power to make gifts.)

[16] *See* Treas. Reg. § 25.2511-2(c) "A gift is incomplete in every instance in which the donor reserves the power to revest the beneficial title to the property in himself."

2036(a)(2). The casebooks are filled with stories of taxpayers who transfer assets into FLPs or irrevocable trusts but retain the prohibited strings to income under § 2036(a)(1). It is the "possession, enjoyment or right to income" and not the "alone or in conjunction with any person" provision that trips up many plans. But the structure of § 2036 (whether referring to § 2036(a)(1) or (a)(2)) creates a carve-out for transfers that are bona fide sales for full and adequate consideration in money or money's worth. Such a bona fide sale provides the planner with opportunities to avoid estate tax inclusion under § 2036.[17] (A similar carve-out also exists in §§ 2036(b) and 2038). In *Powell*, the transfer was structured as a simple purchase of the limited partner interest. As noted, the transfer in *Powell* was not within the carve-out of § 2036.

Partnership agreements should be carefully drafted with *Powell* in mind. The partnership agreement should limit the ability of the retained limited partner interest to participate in partnership's termination decision. *Powell* construes § 2036(a)(2) to include within its claws the decedent's exercise "the right either alone or *in conjunction with any person*, to designate the persons who shall possess or enjoy the property or income therefrom" (emphasis added). In *Powell*, the ability of the *limited partner* to act with the GP to terminate the partnership was sufficient for estate tax inclusion. The termination of the partnership was seen as an extension of the other proscribed retained power, the power of distribution. The "bad facts" element was that the dissolution of the partnership would result in the partnership's terminating distribution to the decedent. *That said, it is important to limit the influence of the taxpayer on the partnership operations, particularly as to distributions and partnership termination in all cases*.

IV. The planning world after *Powell*

The Tax Court followed *Powell* with an extension of the reach of § 2036(a)(2) and § 2038 in a split-dollar insurance case, *Cahill v. Comm'r*.[18] The IRS demonstrated its willingness to try to extend application of those Code sections the inquiry to trusts and insurance policies. The IRS was thus empowered to assert, or at least inquire during an examination, that the retained interest was fatal to the taxpayer's tax-efficient wealth transfer efforts.

The challenge for planners was further complicated with the Tax Court Memorandum decision in *Estate of Moo*re in 2020[19]. The case involved a hasty (and very expensive) planning effort that included a family limited partnership and five trusts.

The decedent was a landowner and farmer in Arizona; he created his land ownership through his efforts as a land leveler, where he was often paid in interest in land rather than cash. He leveraged his relationships with landowners in the area to acquire land in the Gila River, including the water rights in a long-dried riverbed. He slowly assembled more than one thousand acres of land, which eventually became more farms.

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[17] *See Estate of Black v. Comm'r*, 133 T.C. 340 (2009) (Court walked through the analysis for bona fide sale for adequate consideration and finding it, included the value of the LP interest retained, and not the value of the underlying assets.)

[18] *Estate of Cahill v. Comm'r,* T.C. Memo 2018-84 (June 18, 2018).

[19] *Estate of Harold V. Moore v. Comm'r, supra* note 6.

As Mr. Moore aged, he contemplated selling his land, and in 2004 began negotiations with a neighboring farm. Before a deal for the sale of the Moore farm was finalized, however, Mr. Moore suffered a heart attack, was hospitalized, placed in hospice care, and given less than six months to live. No doubt prompted by this near-death experience; Mr. Moore retained an estate planning lawyer to put his affairs in order.

His identified goals at the beginning of the planning effort included retaining control of his assets and eliminating estate tax. This was in 2004, when the estate tax rate was 49%, and the estate tax exemption was $1,500,000. Just 4 days after being discharged from the hospital, he created a living trust, a CLAT, a children's trust, a family management trust, an irrevocable trust, and the Howard V. Moore Family Limited Partnership.

In litigation, the IRS focused on the details of the funding of the FLP. The unusual contribution by the living trust in exchange for a 95% LP interest involved the property of both Howard Moore, and his son, Ronnie Moore. Ronnie contributed property in exchange for a 1% LP interest that he had previously received as a gift from Howard.[20] The FLP's purposes were identified as protection from liabilities of the partners, creditors, and bad marriages.[21] Further, the FLP was identified as a tool to bring the dysfunctional family together. There were substantial restrictions on a limited partner's ability to transfer units, and there was no negotiation among, or separate counsel retained by any of the limited partners.[22]

Howard Moore continued to live in the home that had been conveyed to the partnership when the farm had been sold, providing support for the IRS's § 2036(a)(1) argument that he had retained use and enjoyment of the property transferred. The IRS alleged that his relationship to his assets remained unchanged following contribution to the FLP. In fact, the Tax Court found that Mr. Moore "scooped into FLP assets to pay personal expenses."[23]He was thus found to have retained possession or enjoyment of assets consistent with § 2036(a)(1). Further that he had decided to sell the FLP's farm property before he contributed the property to the partnership. The resulting lack of any management responsibilities was contrary to the asserted purposes of the partnership, which were to protect against liabilities such as pesticides that was alleged in testimony.[24] The Tax Court found that the stated purposes of the partnership may have been important, but they were not the substantial and motivating non-tax business reasons required to sustain a finding that there had been a bona fide sale.[25]

The Tax Court found that the proffered reasons for establishing the FLP were not credible. The Court determined that Mr. Moore had no known liabilities, creditors, or marital problems to protect against. Further, the limited partners never met, aside from the initial organizational meeting. There was not an understanding by any of the partners of the requirements for capital accounts or maintaining separate partnership property.

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[20] *See id.* at 6.
[21] *See id at* 15.
[22] *See id* at 17.
[23] *Id* at 14.
[24] *See id*. at 6.
[25] *See Estate of Bigelow v. Comm'r*, 503 F.3d 955 (9th Cir. 2007).

The Tax Court examined whether there had been a bona fide sale and relied upon *Bongard*[26] in reciting that the concept of "full and adequate consideration" revolves around the issue of value, whereas that of "bona fide sale" is an issue of motive.[27]The Tax Court further observed that in the context of FLPs, a bona fide sale requires a legitimate and significant non tax reason for the creation of the partnership.[28]The Estate offered that the motivating factor was to bring the family together and to engage in joint management of the partnership property. However, Howard Moore sold the farm property just days after the partnership was formed. The limited partners who were members of his family delegated to him the investment management of the proceeds and never met to discuss management. Thus, the Tax Court concluded that the funding of the FLP was not accomplished in the context of a bona fide sale. As the Tax Court pointed out, after the sale of the farm, there was no business to manage**.**[29]The Tax Court, acknowledged that "the desire to consolidate marketable assets and manage them as a family asset for continuing investment purposes is also a genuine nontax motive under § 2036."[30]In *Purdue*, the decedent's children met at least annually to discuss the family's accounts and assets in great detail.[31] In contrast, the children in *Moore* participated in no supervision or interaction with the investments or the managers.

As an aside, during the time leading up to his demise, Moore made transfers to his children of $500,000 each. The recipient was required to execute a promissory note back to Howard Moore. There was no fixed payment schedule. No interest payments were made, none of the children had the resources to pay back the loans, the promissory notes were not secured, and Moore listed among his goals that his children should receive the $500,000. The Tax Court applied the factors in *Rosen*[32], and determined that the $500,000 payments were gifts, and not loans.

The IRS has been aggressive in challenging the validity of transfers where the grantor retained the right to designate the ultimate takers. In cases such as *Powell*, *Cahill*, and *Moore* where the IRS was successful, what were the key elements of vulnerability? In *Powell* and *Cahill*, the IRS focused on the "right, alone or in conjunction with any person" language of § 2036(a)(2). In *Moore*, the court focused on the retained use of income and decision making over the transferred property under § 2036(a)(1). Were they just bad fact cases? Do they uncover new avenues of approach for attack of other family entities by the IRS? Is there a lesson for planners in design, or timing, of these contemplated wealth transfer attempts?

[26] *See Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005).
[27] *See Moore v. Comm'r*, T.C. Memo 2020-40, at 30.
[28] *See Estate of Turner v. Comm'r*, 102 T.C.M. (CCH) 1277 (2008).
[29] *See Moore v. Comm'r*, T. C. Memo 2020-20, at 5. The Tax Court noted that with the farm sold, the only assets were liquid, and those were managed by an external manager. None of the other partners met that manager or reviewed the investments.
[30] *Id* at 12, citing *Estate of Purdue v. Comm'r*, T.C. Memo 2015-249
[31] See *Purdue v. Comm'r*, T.C. Memo 2015-249 at 3.
[32] *See Estate of Rosen v. Comm'r*, 91 T.C. M. (CCH) 1220 (2006). The factors used to identify bona fide debt are: 1) the name given to the instrument; 2) presence or absence of a fixed maturity date and schedule of payments; 3) presence or absence of a fixed interest rate and actual interest payments; 4) source of repayment; 5) adequacy or capitalization; 6) identity of interest between creditors and equity holders; 7) security for repayment; 8) transferees ability to obtain financing from outside creditors; 10) the extent to which transferred funds were used to acquire capital assets; 11) presence or absence of a sinking fund to provide repayment.

V. Planning with *Powell, Moore, (*and *Levine)* in mind

The proliferation of partnerships, LLCs, and S Corps has provided rich targets for audit and adjustments, and adverse court determinations. The events in the cases of *Powell* and *Moore*, which led to the decisions, occurred many years ago.[33] The planning tools used – FLPs, valuation discounts, gifts, and sales – continue to be mainstays of efforts by taxpayers to move assets out of their taxable estates. The reality of the vulnerability lies between sale and gift, and the retained interest in the gratuitous transfer.

What has been asserted as a defense in the cases of *Cahill* and *Moore*, and to a lesser extent in *Powell*, is the bona fide sale for full and adequate consideration exception. In those cases, the facts did not support a finding that there had been a bona fide sale for full and adequate consideration. If that can be established, the strings of §§ 2036, and 2038 do not apply to the transfer.

A. Bona fide sale for full and adequate consideration

Because the courts will look at transfers between family members with suspicion,[34] clients should, when possible, enter wealth transfer transactions early when negotiating leverage is real and can be demonstrated. Furthermore, proper documentation of the non-tax reasons for the transaction is very important. Being intentional and specific in the description of purpose in the partnership agreement or operating agreement can be a key evidentiary showing of non-tax purpose. Satisfying the bona fide sale test in newly formed LP and LLC structures is critical in avoiding the result in *Powell* and *Moore*. In *Moore*, the Court emphasized the absence of negotiations between partners in the sale of the LP interest.

Similarly, great care should be taken to observe the formalities required in both state law and federal tax law of partnerships and their capital accounts. Formalities of the LP operations must be observed in every partnership generally under the substantial economic effect test of § 704.[35] It is not clear from many §§ 2036 and 2038 cases whether the partnerships at issue are operated correctly. A review of the relevant cases demonstrates that partnerships with non-operating assets are subject to greater scrutiny. In *Black*[36], the assets contributed were passive investments, and the partnership did not observe partnership formalities. Whether or not the assets in the partnership are more complex than simply passive investments, organizational and operational formalities must be observed to defend against estate tax inclusion.

While the importance of proper maintenance of capital accounts is an issue not addressed in *Powell*, other cases have stressed the importance of this issue. The *Black* court resolved this issue

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[33] The transactions including Nancy Powell's hospitalization and death occurred in August <u>2008</u>. Decedent Richard Cahill died on <u>December 13, 2011</u>. Before his death, he had created the revocable trust, the MB trust in <u>2010</u>. Howard V. Moore created the 5 trusts and FLP on <u>December 10, 2004</u>.

[34] *See Kimbell v. United States*, 371 F.3d 257, 265 (5th Cir. 2004).

[35] *See* Treas. Reg. § 1.704-1(b)(2). The test of Substantial Economic Effect has two parts. First, the partnership must: 1) maintain capital accounts for each partner; 2) provide those liquidating distributions be made in accordance with the partner's capital account; and 3) the partnership agreement must call for deficit restoration obligations of each partner with a negative capital account. Second, if the partner is not expressly obligated to restore a deficit in his capital account, the partner restores the deficit.

[36] *See Black v. Comm'r*, supra *note* 17.

by applying a four-pronged test: a) the participants received interests proportionate to the value of the contributed property; b) the value of contributions was added to the participant's capital account; c) distributions reduced capital accounts; and d) there was a legitimate and significant nontax reason for the existence of the partnership.[37]

The standards to demonstrate a bona fide sale, including the requirement to establish significant, motivating nontax reasons for establishing the partnership, LLC, or trust, has been develop through three, the very instructive cases of *Kimbell* and *Bongard*[38]

1. *Kimbell v. United States*

In further development of the § 2036 exemption for transactions that constitute *a bona fide sale for adequate and full consideration in money or money's worth*, the 5th Circuit Court of Appeals in *Kimbell* examined a transfer by a 96-year-old grantor in the year of her death. In previous years, she had created the R.A. Kimbell Living Trust (the "Trust"), of which Mrs. Kimbell and her son were co-trustees. In January 1998, she, her son, and his wife formed the R.A. Kimbell Management Co., L.L.C. (the "LLC"). The Trust contributed $20,000 for a 50% interest. Her son and his wife each contributed $10,000 for 25% interests each. Her son was the sole manager of the LLC. Later the same year, the Trust and the LLC formed the R.A. Kimbell Property Co., Ltd., a Texas limited partnership (the "Partnership"). The Trust contributed $2.5 million in cash, oil and gas working interests and royalty interests, securities, notes, and other assets for a 99% pro-rata limited partner interest. The LLC contributed approximately $25,000 in cash for a 1% pro-rata GP interest. Her son managed Mrs. Kimbell's business interests before and after the creation of the LLC and the Partnership. The LLC, as GP, managed the Partnership and had exclusive authority to make distributions.

a. The partnership agreement

The Partnership Agreement provided that the GP owed no fiduciary duty to the Partnership nor to any Partner but owed a duty of loyalty and a duty of care to the Partnership itself. The Trust, as a limited partner, had no right to withdraw from the Partnership nor receive a return of contributions until the Partnership was terminated, which could occur only by unanimous consent of the partners. The Partnership Agreement provided that 70% in interest of the limited partners had the right to remove the GP. A majority in interest of the limited partners had the right to elect a new GP.

b. Asserted discounted valuation

At Mrs. Kimbell's death, the value of the Partnership assets was approximately $2.4 million. On the estate tax return, her estate claimed a 49% discount on the value of the Trust's interest in the Partnership and its interest in the LLC for lack of control and lack of marketability of the partnership interest. It reported the Trust's 99% limited partnership interest in the Partnership as

[37] S*ee id*.

[38] *See Kimbell v. United States*, *supra* note 34; *see also Bongard v. Comm'r*, supra note 26; *see also Estate of Black v. Comm'r*, *supra* note 17.

having a fair market value of approximately $1.2 million and its 50% interest in the LLC as having a fair market value of approximately $17,000.

c. The Fifth Circuit decision

The 5th Circuit Court of Appeals reversed the District Court, which had held that Mrs. Kimbell's gross estate included the value of the property that the trust had transferred to the LLC and the Partnership under § 2036(a)(1). The 5th Circuit explained its reasoning to exclude the property from her taxable estate. For the sale to be for adequate and full consideration, the exchange of assets for the partnership interests must be roughly equivalent so the transfer does not deplete the estate. In addition, when the transaction is between family members, it is subject to heightened scrutiny to ensure that the sale is not a sham transaction or disguised gift.

d. *Kimbell* and bona fide sale

The 5th Circuit established that the bona fide sale exception to § 2036 must satisfy both the bona fide sale element (a qualitative analysis), and the full and adequate consideration element, a quantitative analysis. In Mrs. Kimbell's case, she r*etained personal assets separately from the Partnership assets,* and the LP had *observed the required capital account and liquidation requirements under § 704*. Importantly, the 5th Circuit found that she had not retained the "strings" of control that would pull the assets back into her estate.

2**.** *Estate of Bongard v. Comm'r*

The following year, the Tax Court decided another case under the bona fide sale for full and adequate consideration exception to §§ 2036(a)(1) and 2038. Many believe that before *Powell*, *Bongard* was the most impactful case to this kind of estate planning. The lessons from this case emanate from the Tax Court's treatment of two transfers, each reviewed for estate tax inclusion. In *Bongard*, an ostensibly healthy taxpayer transferred his interest in an operating company that had been operating since 1980 first to WCB Holdings, LLC (the "LLC"). He then transferred his interest in the LLC to an FLP for a 99% limited partner interest. The taxpayer had previously established an irrevocable trust (the "ISA Trust") that also contributed its holding company shares to the FLP for a 1% GP interest. The taxpayer also gifted a 7.72% limited partner interest to his spouse. The taxpayer died 2 years later in an accident on a trip to Austria.

a. Taxpayer's argument

The decedent's estate argued for the tax-effectiveness of the transfer of his interest in the operating company, over which he retained the CEO role and was the sole board member.

First, the taxpayer had transferred his interests in Empak, a Minnesota corporation, to the LLC in exchange for Class A governance, Class A financial, Class B governance, and Class B financial shares, receiving in exchange an 89.39% interest in each subclass. The ISA trust contributed its shares in Empak to the LLC and a received 13.61% interest in the LLC. Class A governance and Class B governance shares were the only shares with voting rights.[39]The reasons proffered for

[39] See *Bongard*, 124 T.C. at 102.

the contribution included that the holding company would be more attractive to both equity and debit investors and consolidating the shares of Empack into a holding company would provide a greater opportunity for liquidity. The Operating Agreement for the LLC limited the taxpayer's powers in his capacity as chief manager, such that he could not exercise sole decision making over distributions. Further, most governance member interests could exercise all the chief administer duties and could replace the taxpayer in that role.[40](“Transfer #1”).

The same day that the taxpayer and ISA contributed their Emplak shares to the LLC (December 28, 1996), the taxpayer and the ISA Trust transferred their Class B governance shares and Class B financial LLC units to the Bongard Family Limited Partnership (“BFLP”). The taxpayer received a 99% LP interest, and the ISA Trust received a 1% GP interest. (“Transfer #2”)

The taxpayer also formed the Bongard Children's Trust on December 28, 1996, and funded it on March 15, 1997, with 77,262 of each of Class A governance and Class A financial units.

He created the Bongard Grandchildren's Trust on December 30, 1996, and funded that trust on March 15, 1997, with 77,262 of each of Class A governance and Class A financial units.

On December 30, 1996, he also formed a lifetime QTIP trust and funded it on March 15, 1997, with 71,319 of Class A governance and Class A financial units.[41]

WCB Holdings member	**Class A governance units/percent**	**Class A financial units/percent**	**Class B governance units/percent**	**Class B financial units/percent**
Decedent	287,620/48.39	287,620/48.39	0/0	0/0
ISA Trust	80,860/13.61	80,860/13.61	681,060/12.73	681,060/12.73
BFLP	0/0	0/0	4,667,844/87.27	4,667,844/87.27
CH Trust	77,262/13	77,262/13	0/0	0/0
GC Trust	77,262/13	77,262/13	0/0	0/0
QTIP Trust	71,319/12	71,319/12	0/0	0/0
Total	594,323/100	594,323/100	5,348,904/100	5,348,904/10042

In reviewing Transfer #2, the Tax Court noted that from its inception on December 28, 1996, until the taxpayer's death, the BFLP did not perform any duties, never acted to diversify its assets, nor made any distributions. The estate claimed that the LP was established for non-tax reasons; that the Trust, in negotiating for its 1% GP interest in exchange for its contribution of its operating company shares, showed independence; and that the formalities of partnership tax were maintained for the LP. The capital account of the taxpayer was credited and maintained as required under § 704.

[40] *See Id*. at 103.
[41] *See id* at 107-108.
[42] *See id* at 110.

b. Tax Court expands standard for bona fide sale

In evaluating the arguments, the Tax Court considered the bona fide sale for full and adequate consideration exception under §§ 2036(a)(1) and 2038(a)(1). It reviewed the standards as to both the taxpayer's contribution to the LLC, and the transfer of the LLC interests to the BFLP. It found that the record must establish both the existence *and* the significance of the legitimate non-tax reason for the limited partnership. "A significant [non-tax] purpose must be an actual motivation, not a theoretical justification."[43]This purpose must be shown despite the partnership's requisite recognition of the contribution in the capital account of the grantor to establish bona fide sale. In the case of the LLC, the Tax Court determined that the consolation of interests, and the advantage for potentially raising liquidity by attracting investors, provided a motivating and substantial non-tax reason to form the LLC.

Further, the Tax Court found that despite the higher level of scrutiny that a transfer among related partners requires, that does not produce a bar to transactions between those parties.[44] The transfer of the Empak stock to the LLC in Transfer #1 satisfied the bona fide sale for full and adequate consideration exception to § 2036.[45]

c. Partnership did not perform

The Tax Court, however, found that in Transfer #2, the limited partnership did not exercise any of the understood management functions over the assets (the operating company shares) it received as contributions. Empak had been conducting and operating its electrical packaging operations for decades. Because there were no business operations engaged in for profit by the limited partnership, the estate tax savings sought were, according to the Tax Court, a significant motivation for the entity. Consequently, the Tax Court included the value of the holding company that had been contributed by the taxpayer to the limited partnership in his taxable estate.

d. How to consider *Bongard*

The Tax Court meticulously examined two transfers: (1) The contribution of the decedent to the LLC provides a model for planners, justifying the transfer in terms of a legitimate business opportunity by concentrating capital and developing investors. (2) In contrast, the Court found no significant nor compelling nontax business reasons for the contribution to the FLP. The Tax Court provided guidance for planners and a mixed result for the estate/taxpayer. The opinion therefore highlights the importance of properly documenting the significant non-tax reasons, particularly when dealing with operating entities.

B. Consider blocking § 2036 arguments with fiduciary duties

Another way for taxpayers to avoid results like those that bedeviled the taxpayers in *Powell, Cahill* and *Moore* may be to create an LP with an LLC acting as the general partner. The LLC interests would be owned solely by an irrevocable Non-Grantor Trust created by the grantor for the benefit of the grantor's descendants. The trustee should not be related or subordinate to the

[43] *Id.* at 118.
[44] *See id.* at 122-123.
[45] *See id.* at 125.

grantor, and should have sole power to liquidate the LP or make distributions decisions for the LP or LLC.[46] The LLC's operating agreement would provide that only the member of the LLC (i.e., the trustee of the Non-Grantor Trust) is empowered to vote and make decisions with respect to (i) the liquidation of the partnership, (ii) distributions by the partnership to its partners and (iii) amendment of the partnership agreement. The LLC could be manager-managed, with the grantor being the initial manager. The LLC operating agreement would expressly exclude the manager from voting on these liquidation, distribution, and amendment decisions, which would still give the manager of the LLC the power to control partnership business and investment decisions, including the ability to make loans to the partners and to others.

The U.S. Supreme Court in *United States. v. Byrum*[47] considered a decedent who had transferred stock, and the right to remove the trustee and appoint a corporate trustee. Along with the stock the decedent retained, the voting rights in the transferred shares gave him a majority vote. The IRS sought to include the transferred shares in the decedent's estate under an assertion that the decedent could vote the shares, control the distribution policy, and veto any sale of the transferred shares of the corporation, resulted in inclusion.

The Supreme Court determined that the legal constraints upon the decedent as to dividend policy in view of the rights of minority shareholders did not provide him de facto control of the shares.

The recognition of duties owed to minority shareholders has provided great protection in other corporate contexts for many years.

A lesson of *Byrum* is that the implied (or explicit) fiduciary duty limitations on the holder of the retained voting power help grantors considering how a § 2036(a)(2) analysis would apply for transactions they are contemplating or have already entered. The fiduciary standard may be protective of a § 2036(b) assertion by the IRS. Perhaps the grantor should not retain a 99% LP interest, as the decedent did in *Powell*.

The *Powell* majority opinion seemed to indicate that because there were no other limited partners to whom a fiduciary duty was owed, the *Byrum* fiduciary duty rule could not apply, and found that the fiduciary duty held by the son was illusory. In doing so, the majority adopted the *Strangi*[48]analysis.

However, recently adopted state laws on fiduciary duties create a basis for taxpayers to argue that, where a fact pattern like that in *Powell* exists, the result should nevertheless be different than the result in *Powell*. The Uniform Limited Liability Company Act of 2006, as recently adopted by Arizona, California, and Utah, contains provisions that require members, and not just managers of the LLC, to observe the duty of loyalty and the duty of care, and to discharge their duties and obligations consistently with good faith and fair dealing.

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[46] *See* Code § 672(c). A related or subordinate person to the grantor is a non-adverse party who is: 1) the grantor's spouse if living with the grantor; 2) any one of the grantor's father, mother, issue, brother, sister, an employee of the grantor, a corporation or its employee in which the grantor's stock holdings and the trust are significant from the voting control perspective, or a subordinate employee of a corporation in which the grantor is an executive.
[47] *United States v. Byrum*, supra note 13.
[48] *See Estate of Strangi v. Comm'r*, supra note 12.

These developments may have created an opportunity to perhaps organize an LLC to specifically create a fiduciary duty consistent with *Byrum* so that a grantor could retain voting rights over the LLC but still avoid inclusion of gifted LLC units in the grantor's estate for estate tax purposes. This will require sophisticated drafting of LLC Operating Agreements, as well as partnership agreements, and corporate bylaws.[49]

As noted above, the *Powell* and now *Moore* cases are the most recent examples of the IRS's attack on valuation discounts and transfers of assets to LPs and LLCs where the grantor retained the right to designate who would receive the benefit of those assets. The reasoning and holding in these cases, coupled with those in earlier cases such as *Strangi,* provide guidance in how to structure, and, perhaps more importantly, what to avoid, in establishing FLPs and LLCs for estate planning purposes.

In both *Powell* and *Moore,* as well as *Cahill*, the age and capacity of the grantor appeared to be a factor. In *Moore,* the grantor engaged in the planning after receiving a terminal diagnosis and having just been released from hospice care. In *Cahill*, the grantor was 90 and seemingly incapable of serving as his own trustee at the time the life insurance policies were issued. Similarly, in *Powell,* the grantor's advanced age and capacity resulted in a deathbed transfer by her agent – and son – just nine days before her death. The facts in *Strangi* were similar – and in all three cases, the lack of true independence of the grantor appeared to be a factor in the court's analysis.

For this reason, practitioners should encourage clients to 1) establish irrevocable grantor trusts and limited partnerships while the clients are younger and in good health: 2) make several, independent sales to the irrevocable grantor trust; and 3) document valuation discounts carefully.

C. Consider having the trust purchase the asset following cash gift

Despite the taxpayer-adverse ruling in *Moore*, another case gives planners a much clearer method to fund irrevocable trusts. The Tax Court in *Levine*[50]gave a detailed analysis of the § 2036(a)(2) trap, and how the taxpayer in that case avoided the "alone or in conjunction with" standard.

1. The situation

Marion Levine was an accomplished and aging business owner. She had two adult children. She owned several businesses and real estate. She had a friend and business associate named Larson. Larson was a U.S. Marine who obtained an accounting degree. After meeting Marion at her daughter's wedding, he became the controller at Penny's, one of Marion's businesses. He

[49] *See* PLR 9710021. The taxpayer created a business trust that was taxed as a partnership. It had three classes of interests, one of which "A" shares, were determined to be equivalent to a GP interest, with the "B" and "C" interests equivalent to LP interests. The IRS determined that the "A" interest holders possessed the same fiduciary duties as those in *Byrum*, and thus the transfer by the taxpayer of the "B" and "C" shares with retention of the "A" shares was not subject to Code § 2036.
[50] *Estate of Levine v. Comm'r,* 158 T.C. 2 (February 28, 2022).

worked for her for 50 years and became her friend. He elevated in rank with the companies, and he became President of two of them[51]

2. The fiduciaries

As Marion grew older, she decided that she needed help managing her business interests. Larson drafted powers of attorney naming himself, and her two children Robert and Nancy, as attorneys in fact. The operated under the power of attorney that imposed a majority rule among the three agents in fact.

Marion executed a revocable trust that named Larson, Robert and Nancy as the successor trustees, and Robert and Nancy's children as the beneficiaries. At about the time she executed the power of attorney, she resigned as trustee of her revocable trust and Larson, Robert and Nancy became trustees.

When she engaged in advanced estate planning, she transferred some of her wealth through a GRAT and a QPRT. She additionally formed a South Dakota Irrevocable Trust. It was a directed trust under which the three main functions of a trustee, administration, investment of the trust assets, and distribution to beneficiaries, were to be performed by different fiduciaries. In this case, the administration was performed by the South Dakota trust company. The investment direction was performed by an investment committee. The sole member of that committee was Larson.[52] As a fiduciary under South Dakota statutes, Larson's fiduciary duty was to "exercise his power to direct the Insurance Trust's investment prudently and he faced possible liability to its beneficiaries if he breached that duty."[53] In his role, only Larson, as the investment committee of the trust, could purchase or terminate the policies owned by the trust.[54]

3. The ILIT

After forming the Marion Levine 2008 Irrevocable Trust (the ILIT), the insureds under the policies were selected as Nancy and her husband Larry, because Robert has a preexisting medical condition. To fund the policies, Larson, Nancy, and Robert decided to take loans secured by various partnerships in the revocable trust, of which they were the trustees. They borrowed $6.5 million. The split dollar arrangement provided that the revocable trust would not own the policies; rather, the ILIT would. The revocable trust would pay the premiums. The ILIT would assign the insurance policies to the revocable trust, as collateral. The ILT agreed to pay the revocable trust the greater of (a) the total premium that was paid ($6.5 million), or (b) the cash surrender values of the polies on the date that they were terminated. The parties were careful to be sure that any incidents of ownership in the policies were neither reserved, nor conveyed, by the revocable trust or Levine.[55]

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[51] *See* I*d.* at 7.
[52] See Austin W. Bramwell and Jessica D Soojian, *The IRS' Alarming new Linked Attribution Theory-And what to do about it.,* (March 18, 2022); https://www.mondaq.com/unitedstates/wills-intestacy-estate-planning/1173682/the-irs39-alarming-new-linked-attribution-theory-and-what-to-do-about-it.
[53] *See Levine v. Comm'r* 158 T.C. at 13.
[54] *See id.* at 17.
[55] *See id.*

4. The holding

The Tax Court reviewed the split dollar rules. It also analyzed §§ 2036 and 2038. It held that the decedent did not retain the life insurance policies. She did not retain the receivable; it had been owned by the revocable trust. She had made a lifetime transfer of the $6.5 million. The Tax Court distinguished *Cahill* and *Morrisette II*,[56] in finding that the investment committee of the South Dakota trust (Larson) was the only person who could terminate the policies and unlock the cash surrender value, or the premiums paid. The IRS lost and nothing was clawed back into her estate.

This decision draws a roadmap for planners to follow. Even if the subject of the wealth transfer is not split dollar life insurance, what the planners did here was to gift assets (in this case loan proceeds (which may provide a § 2053 deduction on the estate tax return)) to the trust. The trust then purchased the assets. This is not the same approach as a selling to an irrevocable grantor trust. This purchase for value provides another way to get business interests into the trust.

D. For existing entities, there are other options

As a preliminary matter, dissolution or liquidation of an existing LP or LLC is perhaps the simplest, albeit the most dramatic, "reboot." By dissolving the partnership, the grantor likely loses all control of the assets. One of the benefits of planning with LPs and LLCs is that the grantor can make a completed gift yet delay the timing of when his or her intended beneficiaries have unlimited use of the underlying assets. Unless the limited partner/beneficiary is a trust, which would likely provide rules which further delay gratification, the beneficiary will have full use of his or her portion of the underlying assets held in the LP upon dissolution. This often defeats one of the primary purposes of the plan. On the other hand, the beneficiary/partners may be at a stage in their life where they may need or could put the distributed assets to good use. And finally, once the entity is dissolved, the grantor's estate will lose the opportunity to seek fractional or other discounts for any interest in the entity that he or she still owns.[57]

Another way to avoid the application of § 2036 and § 2038 is to have the grantor gift or sell all her interests in the partnership during her lifetime. The gift must, however, be made more than three years prior to death to not run afoul of §§ 2035 and 2038. Once the gift is made, of course, the donor no longer has access to the assets.

A sale to an irrevocable grantor trust ("IGT") in exchange for a note is a better and more practical solution than a gift. Of course, and as noted above, the sale must be "bona fide" for "full and adequate consideration." And, given the heightened scrutiny by the courts of intra-family transactions (which include, for these purposes, trusts for the benefit of other family members), consideration ought to be given to obtaining well-documented, well-supported valuation discounts.

[56] *See Estate of Cahill v. Comm'r,* supra note 18; *Estate of Clara M. Morrisette v. Comm'r*, T.C. Memo 2021-60 (May 13, 2021); known as *Morrisette* II.

[57] If the partnership were to be dissolved, caution should be exercised to confirm that the original non-tax reasons that warranted the creation of the entity no longer exist. It may be wise to consider including languages in the dissolution documents that first state the original non-tax reasons to create the entity and second, that those reasons no longer exist.

Valuation reports should of course be prepared by a qualified appraiser and should employ a valuation adjustment clause. The sale should be for cash, or a note.[58]

Because of *Powell's* extension of the *Strangi* holding to a situation in which the decedent only owned limited partnership interests, the grantor might consider gifting/selling his or her LP interests as well as any GP interest.

If only one spouse owns the FLP or LLC interest as his or her separate property, gifting the interest to the other spouse is an interesting option. A lifetime gift to a spouse should avoid gift tax because of the unlimited marital deduction under § 2523, if the recipient spouse is a U.S. citizen.[59]

A better alternative to an outright gift to a spouse is a lifetime gift to a qualified terminable interest property (QTIP) trust with an independent trustee and making the requisite election to qualify the gift for the marital deduction.[60]Great care must be taken in creating and administering the trust.[61]It would probably not be a best practice for the donor spouse to be a trustee. If the donor spouse is the trustee, or even if the donee spouse is the trustee, there is risk that the control exercised would result in the trust assets' being included in the estate of the donor spouse under §§ 2036(a)(2) and 2038. An independent trustee would therefore be preferable.

Finally, existing LP or LLC agreements could be revised to eliminate all the voting, liquidation, or amendment rights to stay within the parameters of the *Powell* holding. In doing so, however, as David Handler, David Herzig, and Naomita Yadav note,[62]care should be taken to be aware of the potential gift tax implications of giving away or relinquishing those rights, as the IRS could argue that a transfer for gift tax purposes has been made based on the value of the right relinquished.[63]

VI. Entitles owned by trusts

A. Limited Partnerships

LPs are used to achieve goals such as creditor protection and income tax efficiency and, when properly planned and structured, can provide a means to obtain valuation discounts on the transfer of LP units to other family members (or trusts for their benefit). Through preferred partnerships, taxpayers can create preferred and common partnership interests, while carefully adhering to the additional requirements of Chapter 14 of the Code, when those common interests are

[58] There is a risk in using promissory notes from the purchaser as reflecting fair market value of the GP interest sold. If the note is determined to be discounted based on 1) value of collateral; 2) environmental concerns with the collateral; 3) state law treatment of personal guarantees; 4) interest rate (market or applicable federal rate); 5) or time value of money, the argument could be made by the IRS of the lack of full and adequate consideration.

[59] Gifts to non-citizen spouses are subject to a modified annual exclusion for present interest gifts ($164,000 in 2022). *See* Rev. Proc. 2021-45.

[60] *See* Code § 2523(f)(4).

[61] See Code § 2523.

[62] *See* David A. Handler, David Herzig, Naomita Yadav, "Limiting the Family Limited Partnership" (2019).

[63] *See* Code § 2704 addressing lapsing of voting rights.

transferred.[64] LPs (and limited liability limited partnerships) provide substantial protection for the limited partners (and in some cases general partners) under most state laws. In addition to the many valid, non-tax reasons for these vehicles, their increased use was driven in part by the lower lifetime exclusions that existed in the late ‘80s and ‘90s ($600,000 from 1987-1997, $625,000 in 1998 and $650,000 in 1999). A properly structured partnership, planners have argued, provides a legitimate basis for valuation discounts on the transfers of limited partner units.

Of course, the governance of the LP is key to the effectiveness and the protection. Normally a general partner will exercise most day-to-day functions of buying, selling, and managing the assets held in the LP. This relegates the limited partners to higher level decision-making and, under most state laws, protection against creditors of the LP itself and its investors. For this paper, “inside creditors” are those with claims against the limited partners beyond the scope of their involvement in the partnership. Inside creditors’ claims attack the partnership interest as an asset of the individual. “Outside creditors” attack the partnership itself. Many partnerships rely on state law, which may allow a court to assess a charging order against a limited partner for activities undertaken outside of the partnership. Many partnership agreements are modified to protect the general partner, who has vulnerability for the partnership’s activity (outside creditors) and his or her personal activities (inside creditors).

One additional protective structure in the LP context is to make the general partner an entity, such as an LLC or an irrevocable trust. These structures can provide substantial protection for the general partner. Additionally, a “doomsday” provision in an operating agreement or partnership agreement can cause an automatic change to the general partner if an inside creditor gains traction in litigation. The partnership agreement or operating agreement can provide for this automatic swing away from the general partner who is subject to the inside creditor.

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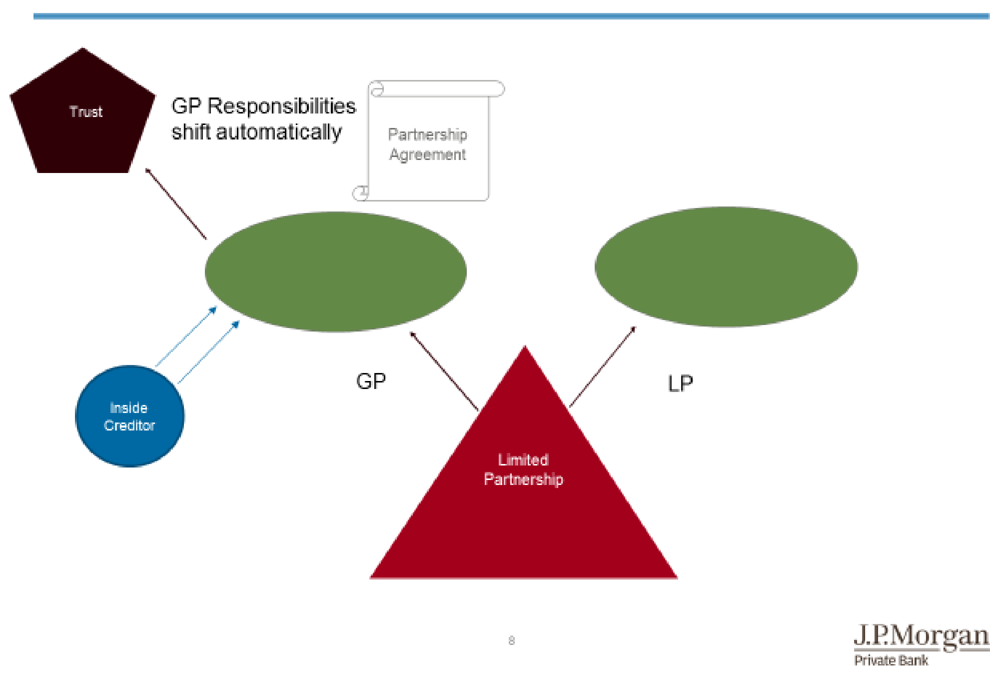
[64] *See* Code § 2701. *See also* N. Todd Angkatavanich, *Warming Up to Preferred Partnership Freezes: Multiple Planning Applications with this Versatile Vehicle,* 51st Annual Heckerling Institute (2017).

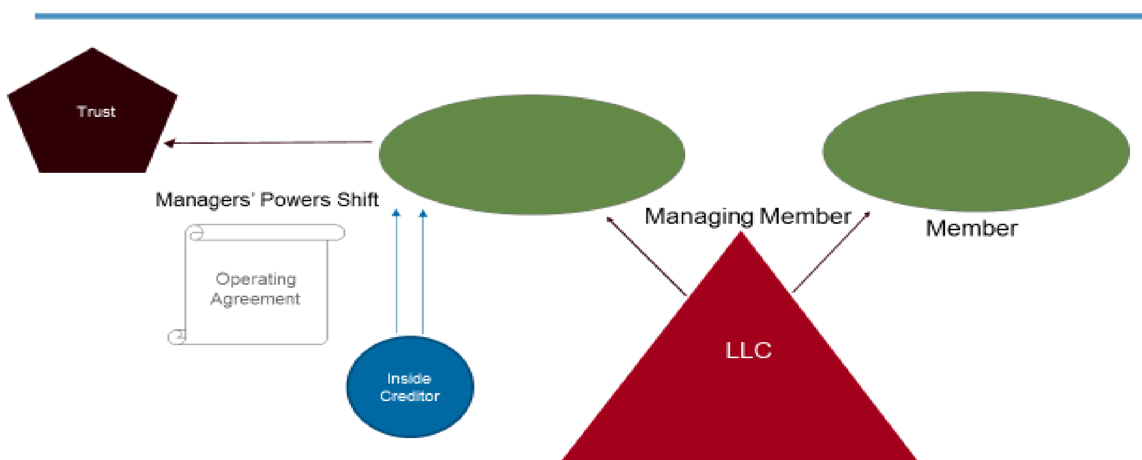


B. Limited Liability Companies

Likewise, an LLC with the option under the "check the box" rules to elect to be treated for tax purposes as, alternatively, a disregarded entity, a partnership, an S Corp or a C Corp, can be used in many contexts.[65] There are, as well, valid non-tax business reasons for creating LLCs, including, of course, creditor protection, retained control and continuity of management, consolidated management of a potentially diverse portfolio of different types of assets, and limited participation of family members uninterested or unqualified for the management of family wealth. Different classes of LLC interests, with different rights as to voting and distributions, as well as costs, can also be very helpful. These benefits exist in addition to the opportunity to use the limited rights of and non-voting members of LLCs to claim discounts on the transfer of any interest.

LLC operating agreements can provide similar creditor protections as described above as to limited partners.

[65] *See* Treas. Reg. § 301-7701-3.



C. S Corporations

S Corps[66] are often created for operating companies. They can present advantages in managing self-employment taxes for higher income earners.[67]Of course, both S Corps and partnerships, as well as LLCs, which can elect to be treated as disregarded entities or partnerships for tax purposes, can potentially offer the shareholder, or member, as the case may be, the advantage of the 20% deduction available on the qualified business income (QBI) of pass-through entities under § 199A.[68] § 179 expensing can also potentially be utilized. Further, and perhaps most importantly, while losses that a shareholder may deduct each year may be limited,[69] the disallowed losses are carried over to the next year as to that shareholder.

Challenges with S Corps include their eligibility requirements. Among them are a limit on the number of shareholders, the requirement of a single class of stock (voting and non-voting are permitted and considered as single class) and the necessity that all shareholders must be US

[66] *See* Code § 1361.
[67]S corporation shareholders who are employees can take a smaller, but still reasonable, salary, and take additional amounts out as potentially tax-free distributions, or distributions taxed as dividends under § 1368. Of course, this is subject to the shareholder's basis, as adjusted under § 1367, and the accumulated adjustment account, and whether the S corporation has earnings and profits in the year of distribution.
[68] *See* Code § 199A.
[69] *See* Code § 1366(d)(1).

citizens or permanent residents. Limitations as to the business operations also exist.[70]Further, there is no equivalent to a § 754 election for S Corps and their shareholders.

Of course, the most interesting restriction for the estate planner is the types of trusts that can be a shareholder. Aside from the trusts or estates limited to only a 2-year holding period, the Code allows only a voting trust, a Grantor Trust, a qualified subchapter S shareholder trust ("QSST") [71]or an electing small business trust ("ESBT"),[72] as shareholders.

D. Opportunities with S Corps in Trust

A voting trust presents an interesting potential opportunity for retained control of gifted or transferred assets. Although very helpful for testamentary gifts or transfers, the use of a voting trust to vote S Corp stock that has been gifted risks running afoul of § 2036(b).[73]

A Grantor Trust is normally used for gifting, selling, and holding S Corp stock. A full range of powers can be used to hold the stock under the grantor trust rules. A challenge may arise, however, when the grantor dies or releases his, her, or its grantor trust-enabling-powers. When the grantor dies, the trustee (and perhaps the beneficiaries of the trust) must make an election (within two years of the conversion from grantor to non-grantor trust).[74] If the grantor releases a power and the trust thereafter becomes a Non-Grantor Trust that is not a qualifying trust, the corporation's S Corp status may be lost. In every case, a Grantor Trust should provide for an immediate conversion to a qualifying trust structure to avoid the disqualification of the S Corp. There are at least three options for the trustee, or beneficiary, to make.

1. Qualified S Corporation Shareholder Trusts (QSSTs)

A QSST [75]operates as a grantor-like trust as to the beneficiary of the trust.[76] The QSST has requirements that may not match the settlor's intent. A QSST election is made by the beneficiary, not the trustee. A QSST has only one income beneficiary, who must be a US citizen or permanent resident. That income beneficiary must receive or is required to receive all the trust income.[77] He or she is the only beneficiary who may receive principal distributions, and if he or she terminates the income interest during life, all the trust's assets must be distributed to him or

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[70] *See* Treas. Reg. 1.1361-1(d). An ineligible corporation for S Corp election is: 1) a financial institution that uses the reserve methos of accounting for debts (under Code § 585); 2) an insurance company; 3) a corporation to which a 936 election applies; or 4) a domestic international sales organization (DISC) or former DISC.

[71] *See* Code § 1361(d)(3).

[72] *See* Code § 1361(e).

[73] *See discussion infra*, note 91.

[74] *See* Code § 1346(c)(2)(A)(ii).

[75] *See* Code § 678(a)(1). The income beneficiary, by making the election to treat the trust as a QSST, and thus the election to receive (vest) all the income of the trust in his or herself, has grantor-like powers.

[76] *See* Treas. Reg. § 1.1361-1(j)(8).

[77] *See* Treas. Reg. § 1.1361-1(j)(1)(ii). Income for purposes of the income that must be distributed to the QSST beneficiary means all the income (including provisions of the governing instrument and local law) distributed to the trust from the S Corporation. Income for this purpose does not include the trust's pro rata share of all income, gain, loss, deduction, and credit that is passed through to the trust as an S Corp shareholder. Rather, it is the income that is distributed to the beneficiary. *See* Code § 1366.

her. And if he or she dies with the income interest, the QSST election ceases, and the trust fails to satisfy the requirements. A new beneficiary would then have a two-month, 16-day period following the cessation of the prior beneficiary's interest to make an election.[78]

An interesting aspect tax planning aspect arises with a QSST. The QSST is a grantor-like trust as to the beneficiary.[79]That means that the QSST income beneficiary will ostensibly report the income, deduction, and credit on his or her IRS Form 1040. Income of the trust includes just the income that is distributed from the S Corp to the trust.[80] It does not include the trust's pro rata share of the S Corp's income deduction and credits for the year.[81] Thus, the trust's pro rata share of income, gain, loss, deduction and credit from the S Corp, aside from income distributed to it, remains taxable to the trust.[82] This presents an opportunity to potentially structure another as the income tax owner of the QSST's pro rata share of the S Corp's non distributed income, gain, loss, deduction and credit. Care must be exercised by the planner to not violate the single income beneficiary rule of the QSST.[83]

Yet another interesting planning opportunity lies in the separate trust rule under § 643. The S Corp shares composing part of the corpus of an irrevocable, Non-Grantor Trust may not be all or even a large percentage of the trust's assets. Under the QSST rules, the portion of the trust over which the beneficiary makes the election is treated as a separate trust.[84] The separate trust rule offers possibilities that trust could have a portion that holds the S Corp shares, and is considered grantor-like as to the sole income beneficiary, and another portion considered a separate trust as to other beneficiaries and either be a Non-Grantor Trust, or a grantor-like trust as to one or more if its beneficiaries. Certainly, that would lead to an interesting GST exemption allocation, as well as a fiduciary income tax situation**.** The planner should thus consider how the trust will deal with the Non-Grantor Trust that, in most cases, will accompany every QSST. Creating a § 678 trust in the income beneficiary or other trust beneficiary could be helpful.

The GSTT allocation made by the trustee when a decedent held S Corp shares in a revocable trust should be influenced by the separate trust that is the QSST. Because all of the trust's income must be distributed to the income beneficiary of the QSST, there would be leakage of the

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[78] *See* Treas. Reg. § 1.1361-1(j)(6)(iii)((C).

[79] *See* Code § 678(a)(1). A person other than the grantor is treated as the owner of any portion of a trust as to which he or she, or it, has a power exercisable solely by he she or it to vest the corpus or the income in him, her, or itself. The QSST beneficiary, in making the QSST election, elects to vest all the trust's income in him or herself. The analysis becomes more complicated when considering the income-only portion of the trust, and how the beneficiary's ownership leaves the capital gain allocated to him or her as a matter for the trust to pay tax upon. Also, the fact that the non QSST portion of the trust may have another income tax owner under §§ 671-677.

[80] *See* Treas. Reg. § 1.1361-1(j)(1)(i).

[81] *See* Treas. Reg. 1.1361-1(j)(1)(i). Distributions made within 65 days of the close of a tax year can, if elected by the trustee under § 663, be considered to have been made in the previous year. *See also* Treas. Reg. 1.643(b)-1 providing that the definition of income must be consistent with state law. In the case of gain, whether short of long-term gain, inclusion of those recognized amounts would likely not be considered income by the trustee of the QSST.

[82] *See* Code § 643. Distributable net income (DNI) is income of the trust that can be or is required to be distributed to the beneficiary. In the QSST case, the only income that is required to be distributed to the income beneficiary is the income that is distributed from the S Corp to the QSST. *See* note 77, *supra*.

[83] *See* Treas. Reg. 1.1361-1(j)(1)(ii)(B). Any corpus distributed during the life of the current income beneficiary must be distributed to that income beneficiary.

[84] *See* Treas. Reg. § 1.1361-1(j)(3).

GST exempt share. This may inform against allocating testamentary GST to the QSST on the decedent's IRS Form 706. However, if the income beneficiary is a non-skip person and the next income beneficiary is then a skip person, there may be a GST transfer when the income of the trust is paid to that skip person. This will be the result if there is no GST exemption applied to the QSST, and the income beneficiary becomes a skip person. There is long term planning that must be undertaken if the S Corp shares in the trust are to be held. But the flexibility that is offered in that sense could possibly be combined with one or more of the next two options.

The fiduciary income tax issue is the disconnect between what is considered "income under the QSST rules, and the § 678(a)(1) grantor-like status of the QSST income beneficiary. If the income distributed to the trust does not include the recognized gain, or deductions and credits attributable to transactions within the S Corp, what happens to that recognized gain? Under the Treasury Regulations, each shareholder is required to take into account its pro rata share of income, loss, deduction, and credit. These amounts include gains and losses as an addition, pro rata allocation to the S Corp shareholder.[85] The QSST, however, does not realize income beyond the income that is distributed to it by the S Corp.[86] So the trustee of the QSST will certainly have to allocate the income of the S Corp under § 1361, and allocate gain, loss, deduction under § 1366 as a Non-Grantor Trust. The Non-Grantor Trust will also realize the income, gain, loss, deduction, and credit of all other property other than the S Corp. This tax situation may be adjusted using an additional § 678(a)(1) structure.

2. Electing Small Business Trusts (ESBTs)

The election to be treated as an ESBT structure is made by the trustee, not the beneficiary. It may be more accommodative of the settlor's intent. An S Corp interest that has been acquired by sale is not eligible for an ESBT election. However, an S Corp share that has been sold to an irrevocable Grantor Trust is not disqualified.[87]Not all trusts can elect ESBT treatment and QSSTs. Tax-exempt trusts and any charitable remainder trusts are ineligible.[88]

An ESBT, unlike a QSST, can have multiple current beneficiaries. Also unlike the QSST, the ESBT itself is the taxpayer. Further, the income tax related to an ESBT is treated separately from all other assets in the trust. Both the S Corp portion and the non-S Corp trust assets can be treated as a Grantor or Non-Grantor Trusts.[89] Importantly, distributions can be made pursuant to any standard, including purely discretionary, to the current income beneficiaries of the ESBT.[90]

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[85] *See* Treas. Reg. § 1.1366-1(b)(2).
[86] *See supra* note 80.
[87] *See* Treas. Reg. § 1.1361-1(m)(iii). A disqualifying sale occurs when any portion of the S Corp share basis is determined under § 1012. The basis is not determined under § 1012 in a sale to an irrevocable grantor trust because the income taxpayer on both sides of the transaction is the same.
[88] *See id.* at (iv).
[89] *See* 1.641(c)-1. The grantor trust portion of the trust (whether treated as a grantor or grantor-like trust under §§ 671-677 or 678) provide that all income, gain, loss, deduction, and credit below to the grantor. The income of the ESBT portion is assessed at the highest marginal ordinary rate, and the highest rate for net capital gain. *See also* Treas. Reg. 1.641(c)-1(e).
[90] *See* Treas. Reg. 1.641(c)-1(l)(5), ex. 5. The income tax scenario can be complex and can include both a non-grantor allocation of items of income and gain, as well as a grantor-like portion and distributions.

Because the separate trust rule allows a portion approach to ESBT, the planner can structure the trust in a manner to ensure both income tax efficiency, and continued qualification of as an S Corp shareholder. The grantor-like approach under § 678(a)(1) is particularly interesting as an S Corp solution that can be considered either for the separate trust, or otherwise in combination with QSST or ESBT.

3. § 678 trusts

The flexibility offered by holding the S Corp shares in an irrevocable trust that qualifies as a grantor trust makes this a beneficial option for the planner. There are many income tax advantages to qualifying as a § 678(a)(1) trust.

- The § 678(a)(1) trust will be treated as a grantor trust as to the beneficiary whether the beneficiary withdraws income
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- A § 678(a)(1) trust can simplify income taxes, as it removes the trust from the fiduciary income tax regime. Potential advantages:

  – Beneficiary may be in a lower tax bracket than the trust, reducing tax burden

  – The Trust may be able to avoid overlapping state fiduciary income taxes, as it is a grantor trust

  – Beneficiaries may be able to take advantage of income tax rules that apply to individuals v. complex trusts

    • For example: They can take charitable deductions based on individual (§ 170) rather than trust (§ 642) rules, as well as § 179 expense deductions without limitations, and § 469 deduction for real estate losses will be allowed. They can also pass out capital losses (or an asset held at a loss) to the trust beneficiary

- The beneficiary can transact with the trust, such as by selling assets to the trust for a promissory note, without income tax recognition

An inter vivos § 678(a)(1) trust must ensure that the settlor will not be treated as the owner under §§ 671-677.[91]

A § 678(a)(1) trust can be created by endowing one or more beneficiaries with the power to withdraw income or principal. The concept of "vesting" the income or corpus has not been explained in regulation or ruling. The power is most often expressed as a withdrawal right. The power can be created and withdrawn through provisions governing the powers of a Trust Protector, or an independent trustee. There is another dynamic, and that is whether the trust will be owned by the beneficiary with the power completely, or just the income portion. This nuance is created because of the feature of "income" understood as fiduciary accounting income ("FAI").

[91] *See* Anita Sarafa, "BDITs and BDOTs: The Basics, Concerns to Evaluate, and Best Practices", 46th Annual Notre Dame Tax & Estate Planning Institute (2020).

FAI is the trust income determined by the trustee to be distributable to the beneficiaries.[92]If the formula for rights of withdrawal is structured as "income" that would generally be understood to mean FAI. The planner who wishes to use the withdrawal right to achieve § 678(a)(1) should define the withdrawal to extend over all the trust's "taxable income," which would then include recognized gain as well as ordinary income.

Planners should be aware that in achieving the intended effect of making the beneficiary of the trust the income tax owner of the trust, an estate tax inclusion may be created. The right of withdrawal existing at the death of the beneficiary will be a general power of appointment held by him or her over the income.[93]Allowing a lapse on withdrawal right of taxable income of the greater of $5000 or 5% of corpus ("5x5 power"), with a hanging power to the extent of income in excess of 5% of corpus can relieve the estate and GSTT exposure. Note that any amounts of income over the 5x5 power should be hanging. Any of the income that was subject to the beneficiary's withdrawal power in the year of death will be included in his or her estate.[94]

Because the § 678(a)(1) trust is a grantor-like trust, it can be a qualified S Corp shareholder. In view of the limited flexibility of QSSTs or ESBTs, creating this type of trust should be a consideration whenever a trust may be an S Corp shareholder. Importantly, the opportunity to treat portions of the trust differently give a new dimension to trust design. For example, the beneficiary of a QSST is the owner of all the income distributed by the S Corp to the trustee. He or she could also be the income tax owner of the Non-Grantor Trust by having a withdrawal right over corpus including gain attributable to corpus. Similarly, in the ESBT context, the ESBT portion of the trust could be structured to provide a withdrawal right over taxable income to one or more of its beneficiaries. Further, the Non-Grantor Trust containing all the other assets of the trust other than the S Corp could be designed to provide a withdrawal right over all taxable income and thus create a § 678(a)(1) grantor-like trust. Then estate tax effect of the trust design must be considered as well, and the potential income tax and other advantages.

VII. Unique opportunities for C Corp shares in Trust - QSBS

C Corp labor under the weight of a double taxation regime. Many startup companies steer clear of C Corps despite their greater flexibility in several different contexts, including creditor protection features and the relatively low 21% tax rate on corporate income.[95]

Because the limitations of S Corp shareholders do not apply to C Corps, any irrevocable trust can hold C Corp shares. Thus, gifting or selling C Corp shares to a Grantor Trust is a viable wealth transfer technique. Likewise, gifting C Corp shares to a Non-Grantor Trust can be done in such a way as to take advantage of benefits provided under § 1202.[96]

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[92] *See* Code § 643(b).
[93] *See* Code §§ 2041, 2514.
[94] *See* Treas. Reg. § 20.2041-1(b)(3). The example in this regulation construes unwithdrawn income and effect of the power holder's estate under § 2041(a)(2).
[95] *See* Tax Cut and Jobs Act (Dec 22, 2017).
[96] Code § 1202 contains the requirements and terms of the income tax exclusion of gain on sale of qualified small business stock.

§ 1202 provides planning opportunities to capitalize on the potential to exclude the greater of up to $10,000,000 of realized gain or the amount of gain equal to 10 times the basis the shareholder had in his or her shares. A further explanation of this potentially large tax benefit is warranted.

A. What is the exclusion available?

1. A taxpayer (whether an individual, or any other taxpayer, other than a corporation), receives its stock through original issuance, holds or tacks its holding of the qualified small business stock for five years, and realizes eligible gain on the sale or exchange of the stock from one or more dispositions in a taxable year, is eligible to exclude the greater of:

   a) $10,000,000 reduced by the aggregate amount of gain considered in *previous years* issued by the corporation; or

   b) 10 times the aggregate adjusted basis of the qualified small business stock issued by the corporation and disposed of by the taxpayer *during the taxable year.*[97]

[97] Code § 1202(b).

B. What is qualified small business stock?

1. Specified qualified trades or businesses

The requirements to fit within the exclusion of § 1202 include a categorical avoidance of each of the following enumerated buckets of industries. These other than qualified trades or businesses including health; law; engineering; architecture; accounting; actuarial sciences; performing arts; consulting; athletics; financial services; brokerage services; other trades or businesses where the assets of the company are the reputation and skill of 1 or more of the employees; a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit (REMIC), a cooperative.

2. Specified business qualities

In addition to the ineligible business categories, the statue explains other aspects of a qualified small business. A qualified small business is a domestic corporation in active business on or after August 10, 1993, that has not more than $50,000,000 in aggregate gross assets at the time the taxpayer gains their shares. Each of these terms has its own nuances.

The active business requirement includes the use of the corporation's assets in large part in the active conduct of a qualified line of business (other than an excluded industry). The standard is 80% of the company's assets must be used and that level of commitment to the qualifying business must be maintained for substantially all the period of qualification of the qualified small business.

3. Real Estate and QSBS

But there is a 10% rule. Not more than 10% of the assets can be real estate that is not being used in the conduct of the trade or business. So, what about real estate that is being used in the trade or business? Often, real estate is an integral part of operations. Clearly, brokerage and passive, investment and rental operations cannot be considered active trade or business. But what about a multiple location manufacturing operation where the real property is both used and valuable. That would apparently escape the 10% rule and thus the real estate contributes to the 80% standard for use of assets in the conduct of the trade or business.

C. Taxpayer qualities and how they received the QSBS

The taxpayer must receive shares while the qualified small business is qualified, and through an original issuance from the corporation. The shares can be received as an exchange for a contribution to the corporation, or through compensation delivered to the corporation, except for compensation for underwriting the corporation's stock.

D. Planning opportunities for QSBS

1. Irrevocable grantor trusts – gifting

A most compelling opportunity is to gift assets into a trust. The transfer can use the lifetime exclusion against gift taxes up to the value of the gift. The lifetime exclusion is $12,060,000 per person in 2022. Further, the donor can allocate GSTT exemption to the gift.

In the context of QSBS shares, the gift of shares allows the grantor's acquisition of shares through original issuance, time of possession and income tax basis of the QSBS shares to transfer to the trust.

The significance of gifting QSBS shares to a "partial" Grantor Trust presents a greater opportunity. If the trust can be designed to create a power in the grantor over just a portion of the trust corpus, then the other portion could be considered a separate taxpayer (a Non-Grantor Trust). In that case the grantor would continue to be the owner over all the income, gain, loss, deduction, and credit over just *a portion* of the trust, but *not all the trust corpus*.

2. Irrevocable Grantor Trusts – selling

Grantor trust status of the trust, where the grantor is the income tax owner of the trust, permits "selling" assets to the grantor trust with no gain recognition. This technique is seen by many planners as a powerful technique, so long as the trust assets grow. Any growth of the "sold" assets remains in the trust after the promissory note is repaid. A manner of "growth" that can be achieved in a trust, particularly when the QSBS is gifted to the trust, is the valuation of that QSBS when it is gifted to the trust.

The opportunity to use the "portion rule" against this grantor trust could be more challenging, in that most of the assets are being sold to the trust, not gifted. The term in § 1202(h)(2)(A) allowing the donee to "tack" the original issuance, the holding period and the basis is "gift." Despite the income tax non-effect, and the fact that appreciation ends up in the trust, a sale is not a gift, and taxpayers should expect this provision to be construed narrowly by the IRS and by the courts.

For example, John establishes an irrevocable grantor trust for the benefit of his children Jake and Sara. He then gifts $3,000,000 of QSBS stock. He then sells other stock with a fair market value (assuming discounts) of $10,000,000 ("real" value of $13,000,000 at a 23% discount). He takes a promissory note for nine years as an interest-only note at 3.14% (September 2022 mid-term AFR). He receives $314,000 in interest each year, with no income tax realization on the note payments. He pays income tax on $2,500,000 in income generated on the $16,000,000 trust corpus. The corpus grows to $40,000,000 over the 9-year term. He is paid back the $10,000,000 face amount on the promissory note. He has netted an eventual estate tax savings of $12,000,000 + $4,725,000 income tax he paid on the trust corpus - $2,826,000 received as nontaxable interest payments from the trust to the note holder. Total removed from the grantor's taxable estate is $13,899,000 while using just $3,000,000 of his lifetime exclusion.

3. “Stacking” ‘

A more straightforward way to add to the number of taxpayers through gifting as permitted in § 1202(h)(2)(A) is “stacking” the QSBS exclusion. The gift can be made outright to individuals, likely family members, or into trusts for their benefit. The trust in the stacking scenario must be a Non-Grantor Trust. As separate taxpayers, the filing of an IRS Form 1041 and payment of income taxes must be managed by the trustee. Because the transfer to the trust must be a gift under Chapter 12 of the Code, the allocation among trusts is generally limited to the exemptions and exclusions available to the grantor. Greater opportunities may exist in community property states where the ownership of the QSBS, unless governed by a premarital agreement or a property settlement agreement, can be seen as owned by both spouses. In that case, the gift into a Non-Grantor Trust can be even more substantial.

Another aspect of transfers into trust involves the exercise of voting rights. If the QSBS shares must be voted by the original holder under the shareholder agreement or grant agreement or other document, a complexity arises regarding the trustee. If the grantor has a controlling interest at the time of the gift or the three years before the grantor’s death, then special mitigation will be required. Under § 2036(b), the retained ability to vote the gifted shares of a controlled corporation will be enough to include the assets in the trust in the estate of the grantor when he or she passes.[98] To add a further issue, is appears that a Non Grantor Trust is not possible if the grantor retains the right to vote the shares of any company where the holdings of the grantor and that trust are significant from a voting perspective.[99]Planners who consider this rule understand the complexity of the trustee role and conflict between possible corporate requirements and the retained voting interest that could cause inclusion in the estate. A careful examination of the corporate documents and the obvious requirements of the trustee role are required. Often a voting trust or other entity exercising the right to vote the shares, with the settlor of the Non- Grantor Trust not involved, can be structured. This offers the corporate counsel and the estate planner the opportunity to collaborate and communicate. Using such a voting trust must also consider the grantor trust rule to achieve the Non-Grantor Trust.

If the controlled corporation situation does not apply, the planning can be more straightforward. For example, John creates three Non-Grantor Trusts for the benefit of his 2 children and other descendants. Important planning considerations must be observed to ensure that the separate trusts are respected by the IRS. § 643(f) explains that multiple trusts with the same grantor or grantors for the benefit of the same beneficiary or beneficiaries may be treated as a single trust by the IRS. With that rule in mind, it may make sense that trust A’s beneficiary could be Jack and his descendants, trust B’s beneficiaries could be Sara and her descendants, and perhaps trust C’s beneficiaries could be the taxpayer’s grandchildren (if then existing). John would then, using valuation and discounting principles, gift in QSBS shares into the trusts. Each trust would be its own taxpayer, and thus holder of the QSBS. Thus, John has “stacked’ the exclusion available to him by adding taxpayers to the QSBS equation each with its own advantage under § 1202(b).

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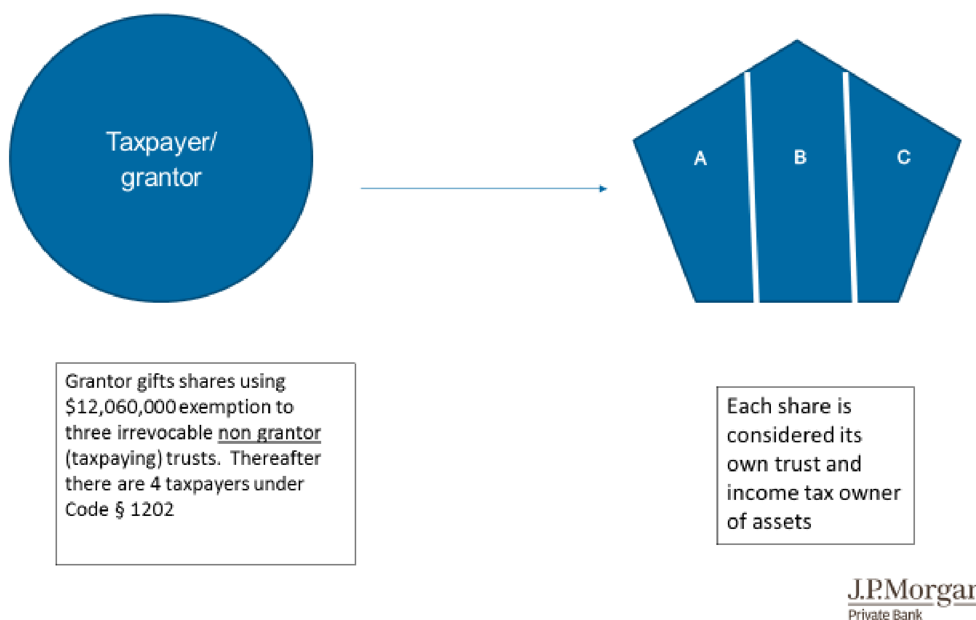
[98] *See* Code § 2036(b). Control for purposes of a controlled corporation, means 20% of the total combined voting power of all classes of stock. There is an attribution rule as well, with Code § 318 as the governing attribution standard. *See also supra* note 10.

[99] *See* Code § 675(4)(A).

Further, if § 643(f) is the separate trust rule, then § 663(c) is the separate share rule. The planner working with a single trust document, and a single grantor for the Non-Grantor Trust must be design the trust to meet two requirements. First, the trust must ensure that capital gains are included in distributable net income.[100] This grant of power to the trustee of the Non-Grantor Trust can allow the allocation of the proceeds from the sale of the QSBS to income. With that proper allocation, the separate share rule should permit the creation of separate shares, each to hold QSBS, and each to be an independent taxpayer for purposes of § 1202(b).[101] Note that structuring a trust in this manner should consider the trust's income tax reporting and identification of the separate shares. For example, the separate shares are not required to file separate income tax returns, obtain separate tax ID numbers, or make separate income tax payments.[102]The Trustee must nonetheless clearly identify and allocate QSB shares to and among the separate shares of the trust to capture the exclusion multiplication effect of § 1202.

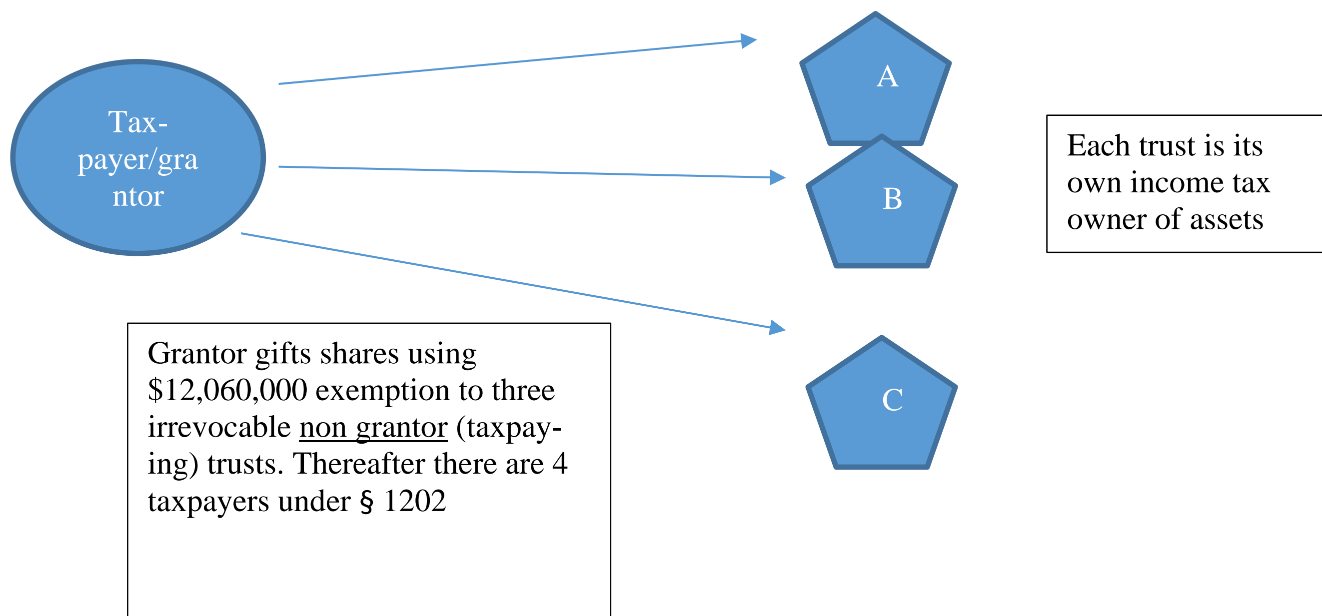


[100] *See* Code § 643(a)(3). Distributable Net Income specifically excludes gains from the sale of capital assets to the extent they are: 1) allocated to corpus; and 2) are not paid, credited, or required to be distributed to any beneficiary during the tax year; or 3) paid or permanently set aside to be used for the purposes in § 642(c). *See also* Treas. Reg. § 1.643(b)-1, providing that state law will determine which elements of income will be allocated to income or corpus. An allocation of gains from a sale or exchange of assets will be respected will generally be accepted if the allocation is made pursuant the governing instrument and the applicable local law, or pursuant to a reasonable and impartial exercise of permissible discretion by a fiduciary by applicable law or the governing instrument.

[101] *See* Code § 663(c). "For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust with more than one beneficiary, substantially separate and independent shares of the different beneficiaries in the trust shall be treated as separate trusts."

[102] *See* Treas. Reg. § 1.663(c)-1(b).

Timing is important, in that the appreciation on the gifted amounts will escape John's estate. John is shifting both the benefit of the QSBS exclusion, but also the other income tax attributes, to the Non-Grantor Trust. For example, suppose that John has transferred QSBS in the amount of $3,000,000 (valuation discount applied). The company is sold or exchanged and the shares in the trust are worth $40,000,000. Of the $40,000,000, $30,000,000 is excluded under § 1202. But $10,000,000 is subject to long term capital gain that has been shifted through the gift to trust A. If the timing of the sale is such that the sale or exchange were imminent, the IRS could allege the assignment of income common law doctrine.[103] This would negate the opportunity to transfer a GSTT exempt and income tax efficient asset into the trusts for the beneficiaries.



4. "Racking"

Another possible opportunity exists within the language of the § 1202 statute. In § 1202(b)(1), there is established a "per issuer limitation." The limit on the exclusion offered in § 1202(a) is the ***greater of:***

a) $10,000,000 – aggregate eligible gain considered by the taxpayer for <u>*prior taxable years*</u> attributable to sales or exchanges of stock in the corporation; or

b) 10x the aggregate adjusted basis of QSBS issued by the corporation and disposed of by the taxpayer <u>*during the taxable year*</u>.

So, let's understand this limitation by looking at a taxpayer who disposes by sale or exchange $6,000,000 of $0 basis stock in year 1, $3,000,0000 in $0 basis stock in year 2: and $5,000,000 of $1,000,000 basis stock in year 3.

[103] The most familiar common law doctrines the IRS can use to unwind wealth transfer strategies are: 1): assignment of income: 2) business purpose; 3) form over substance; 4) sham transaction; and 5) step transaction.

In year 1, the taxpayer's gain is $6,000,000. Applying the greater of formula in § 1202(b)(1); 10x $0 is $0, so the greater-of formula reveals a $6,000,000 exclusion.

In year 2, the taxpayer's gain is $3,000,000. Again, applying the greater of formula; $10x $0 is $0, so the greater of the current gain and prior gain considered is $6,000,000 + $3,000,000 = $9,000,000 of exclusion used.

In year 3, the taxpayer's gain of $1,000,000 basis stock is $5,000,0000. Applying the greater-of formula, $10,000,000 - $9,000,000 is $1,000,000. Under the second calculation 10 x $1,000,000 = $10,000,000. Thus, the taxpayer would be entitled to a total of $19,000,000 exclusion under the statutory formula.

This reality springs forth a planning opportunity involving two operations. First, the taxpayer needs to understand and manage the tax lots of the sales or exchanges occurring. Second, the taxpayer needs to gather as much basis for their shares as possible to be prepared for that "10x adjusted basis" event.

In the first operation, applicable to any QSBS opportunity, corporate records detailing company adjusted gross asset value, method of acquisition of shares, and the basis of the shares that are held by the taxpayer.

To be eligible for QSBS exclusion of gain, the shareholder must receive its shares through original issuance. This means through an exchange of property or cash as a contribution to the corporation, or through compensation for to the corporation. In the case of a contribution of property to the company, the taxpayer takes a basis in their shares equal to the basis of the property contributed (an exchanged basis).

So, for example, if the taxpayer contributes real property with a basis of $1,200 and a fair market value of $1,000,000, the shareholder will likely get shares worth $1,000,000, and an exchanged basis of $1,200. Building basis in the C Corp shares would be challenging. Additional basis can be built by contributing high basis assets in exchange for shares. If securities, for example, can be exchanged in a non-recognition transaction, basis will be built.

5. "Rolling"

One of the challenges for the taxpayer is to achieve the five-year holding period required under § 1202(a)(1). One of the options if the taxpayer's C Corporation is sold or exchanged before the 5-year holding period is attained is to roll the proceeds of the sale or exchange to a new C Corporation that is a QSB.

Under § 1045, if the taxpayer has held the QSBS stock for at least six months and contributes the proceeds from the stock that is sold or exchanged to a new QSB *within 60 days*, no gain is recognized on the first sale or exchange.

A substantial limitation applies for purposes of the five-year holding period. Further, the holding period can tack to the taxpayers' holding of the second QSB to achieve the exclusion under § 1202(a). As explained in § 1202(c)(2), a corporation must meet the active business requirement

for substantially all the taxpayer's holding period. The § 1045 rollover will credit just six months of the taxpayer's holding period in the initial QSB for this purpose. For example, if the taxpayer holds the QSBS for four years at the time the C Corporation sells all its shares to a third party, the taxpayer, *within 60 days* must roll the proceeds it received to a new C Corporation. For purposes of the five-year eligibility of the QSB, only six months has accrued for the new C Corp, regardless of the duration of time of its operations as to the taxpayer.[104]

To the extent that ordinary income, rather than capital gain, is realized on the initial sale or exchange, that ordinary income cannot be rolled into a new QSB and will be recognized by the taxpayer in the year received.

The rolling opportunity can work well with the stacking strategy explained above. The duration of the required holding period is a challenge in some situations and this opportunity under § 1045 offers a planning solution.

VIII. Conclusion

Planners can capture great benefit for clients though transfer and trust planning with business interests. Creditor protection considerations can be incorporated into plans. The unique features of LP, LLC, and S Corps can enable continued value to be transferred to the grantor's beneficiaries. C Corps can also be used in wealth transfer particularly when the shares qualify as QSBS. There are many considerations around both income tax and transfer tax that must be understood to be successful. The increased focus of IRS enforcement efforts mean that planners must consider and mitigate partial interest transfers and associated risks. As the old expression goes, bad facts make bad law, and the IRS' success in *Powell, Cahill* and *Moore* are based, in some measure, on bad (from the taxpayers' perspective) facts. Nevertheless, the IRS' success in those cases, and others, has exposed vulnerabilities that the taxpayers could not overcome. Of particular concern is the IRS' focus on the "right, either alone or in conjunction with any person" language of § 2036(a)(2), as well as § 2036(b) applicable to controlled corporations, and its extension of that retained power to limited partners in *Powell*. The concern raised in the intergenerational spilt dollar context in *Cahill* presents to an expansion of the IRS' application of § 2036(a)(2) beyond limited partnerships. *Moore* brings into the current day the facts of retained income and aggressive planning under § 2036(a)(1). It seems that *Powell* interpretation of "alone or in conjunction with any person" language of § 2036(a)(2) and § 2036(b) heightens the risk to structures already in place, and that planners are working on now. The recent case of *Levine* can potentially change the argument to focus on valuation only, and not retained interests. Using valuation adjustment clauses in every case can help. QSSTs, ESBTs and 678 trusts for S Corp holdings can be used to great advantage by the planner at the front end of any planning effort involving S Corps. C Corps qualifying for QSBS treatment offer an innovative and impactful planning opportunity with trusts.

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[104] *See* Code § 1045(b)(4)(B).

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