

# Planning so the IRS doesn't peek under the hood



Southern Arizona Estate Planning Council

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This material is intended to help you understand the financial consequences of the concepts and strategies discussed here in very general terms. However, the strategies found herein often involve complex tax and legal issues. Only your own attorney and other tax advisors can help you consider whether the ideas illustrated here are appropriate for your individual circumstances.

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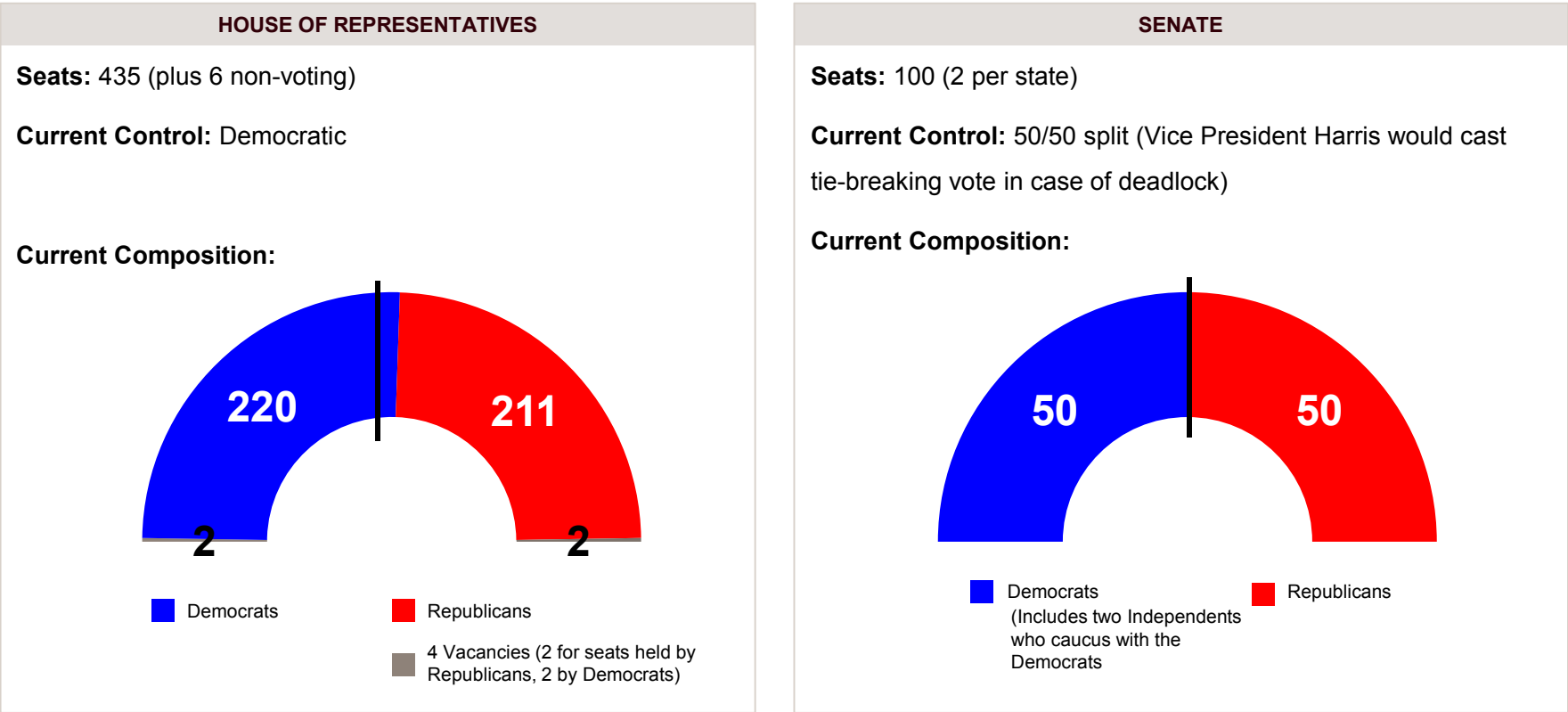
1. Mitigating the “strings” of Code §§ 2036, 2038
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## IRS priorities

- Drastic spending by Federal government in response to COVID-19 effects in 2020 and 2021
- IRS charged with collections across individual, corporate, and transfer tax
- Gift tax audits decreasing: 2018: 245,584; 2019: 239,618
- Gift tax collections increasing: 2018: \$715,499,767; 2019: \$1,516,044,000
- IRS wants more

# Enactment of tax law changes depends largely on who controls Congress and the White House

Democrats control the Executive Branch and, by the thinnest of margins, both houses of Congress



Source: Office of the House Clerk, United States Senate as of January 2021

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The views and strategies described herein may not be suitable for all investors, and more complete information is available which discusses risks, liquidity, and other matters of interest. This information is not intended as an offer or solicitation for the purchase or sale of any financial instrument. **Outlooks and past performance are no guarantee of future results.** It is not possible to invest directly in an index. Please refer to "Definition of Indices and Terms" at the end of this presentation for important information.

## Because of Senate rules, most legislation cannot be passed by a simple majority; passage requires a “filibuster-proof” number of votes (at least 60), unless “reconciliation” is available and used

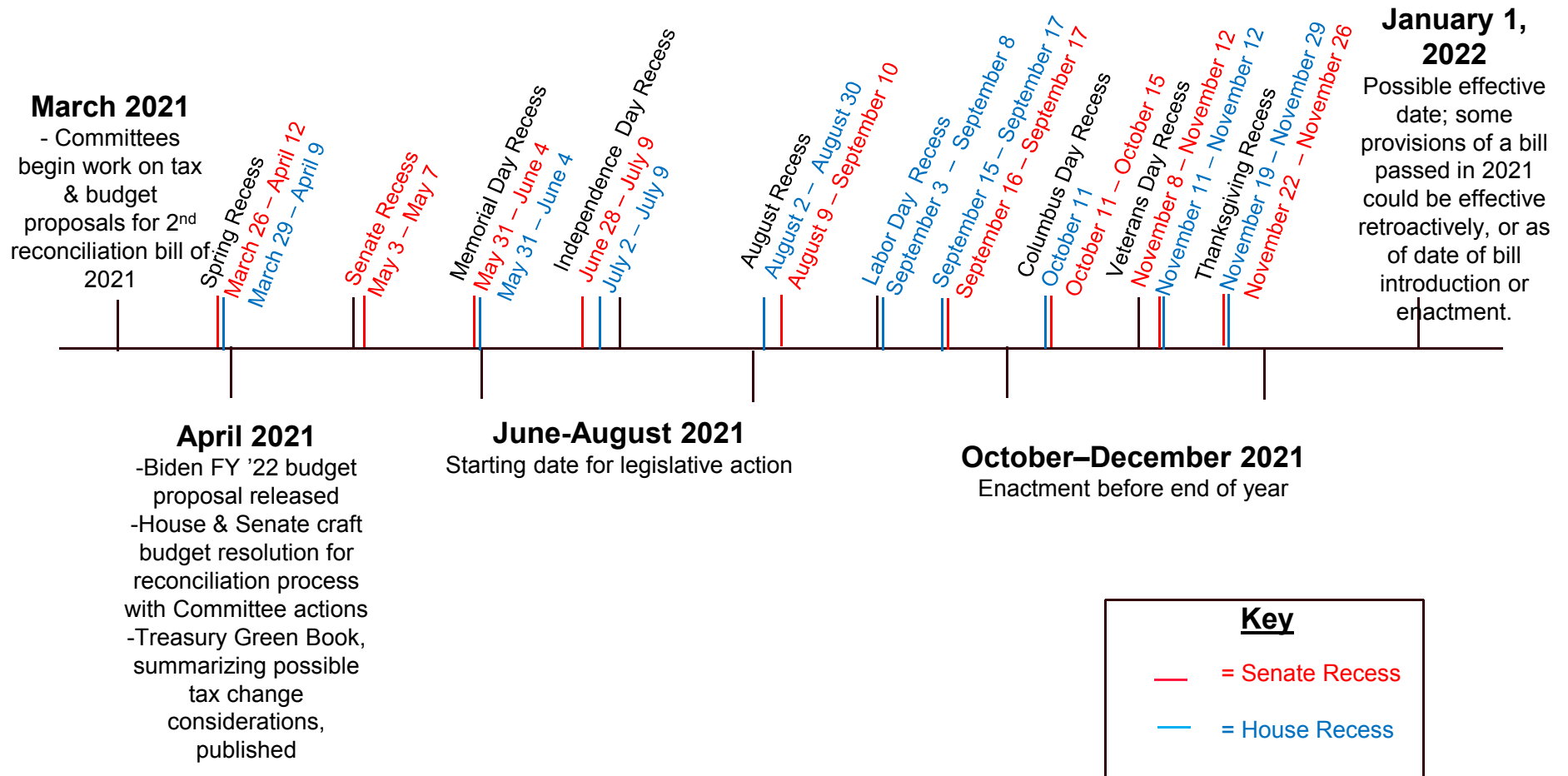
<b>FILIBUSTER</b>	<ul style="list-style-type: none"> <li>• “Filibuster” is a word used to describe procedures where one or more members attempt to block or delay Senate action on a bill by engaging in various obstructive actions (tactic not available under House rules) <ul style="list-style-type: none"> <li>• Threat of filibuster usually forces majorities in Congress to moderate bills</li> </ul> </li> <li>• “Cloture” is generally the only method by which the Senate can end a filibuster <ul style="list-style-type: none"> <li>• Under Senate rules, 60 votes are needed to invoke cloture</li> </ul> </li> <li>• However, the budget “reconciliation” process can avoid a filibuster of revenue, spending, and similar bills, effectively requiring only a simple majority in the Senate (as well as the House) to pass those bills</li> </ul>
<b>RECONCILIATION</b>	<ul style="list-style-type: none"> <li>• Legislation for which this process can be used is subject to certain requirements and limited by the so-called “Byrd rule,” which, among other things, generally disallows in the bill provisions that do not affect outlays or revenue <ul style="list-style-type: none"> <li>• The 2017 Tax Cuts and Jobs Act and 2021 American Rescue Plan are recent examples of laws passed via the reconciliation process</li> </ul> </li> <li>• Laws passed via reconciliation process are prohibited from making changes to Social Security and cannot increase the deficit in any year beyond the budget window (usually 10 years), unless offset by other changes in the same title</li> </ul>
<b>OUTLOOK</b>	<ul style="list-style-type: none"> <li>• Generally, “reconciliation” has been used only once per US fiscal year (y/e 9/30); having been used to pass the American Rescue Plan in March 2021, our intelligence is that reconciliation would not be used to pass tax legislation until 3Q21 at the earliest</li> <li>• Likelihood of enactment of tax legislation effective as of 1/1/21 is remote: for Constitutional, political, and administrative reasons, the majority of provisions for a bill not passed until 3Q21 would likely be effective as of 1/1/22, though several provisions can have various effective dates including date of introduction and date of enactment <ul style="list-style-type: none"> <li>• Deputy Assistant Treasury Secretary Mike Mazur in January described retroactive application of any tax law changes as “not the first choice”</li> </ul> </li> <li>• Any such legislation would likely have to be supported by all 50 Democratic Senators, meaning its provisions would have to satisfy the most moderate member of that caucus, and therefore likely would be modest in scope in terms of increasing rates and changing brackets</li> </ul>

Sources: Tax Policy Center, Brookings, U.S. Senate

## Legislative process for enacting changes to tax law

- President Biden has not provided granular details for many of his tax proposals, but greater detail may be found as part of the Treasury "Green Book" (historically a document issued supporting a president's budget request to Congress) which is expected to be published alongside the administration's fiscal year 2022 budget submission to Congress. Some have indicated the budget may be released in late April or early May
  - No Green Book published since early 2017
- Regardless, U.S. tax policy originates in Congress (by the Constitution, in the House; by House rule, in the House Ways & Means Committee), not in the White House, though any changes in tax law would generally require the support of the Administration
  - Ways & Means chair Richard Neal and Senate Finance Committee chair Ron Wyden are key players in the process and appear generally supportive of the proposals Candidate Biden made during the presidential campaign (see pages 7-8)
- Details for those proposals are described in policy papers in the context of funding other priorities, e.g., financing Social Security and Medicare; providing broader medical insurance coverage; improving infrastructure; supporting higher education; expanding low income housing; implementing environmental priorities

# Timeline for potential tax policy actions



## Recent commentary from key administration officials and legislators

- January-March 2021 – Senate Finance Chair Wyden reintroduced his proposal for annual “mark to market” taxation of capital assets, and then tax, unrealized gains for taxpayers with incomes greater than \$1 million or “covered assets” greater than \$10 million
- February 2021 – Treasury Secretary Yellen indicates:
  - Wealth tax is not something President supports, in part because of the difficulties of implementation
  - Repeal of basis step-up rule is worth considering
  - Financial transactions tax warrants further study but could harm investors
  - President is focused on raising corporate tax rate to 28% to help pay for infrastructure improvements
  - Increase in capital gains tax worth considering
- February-March 2021 – IRS Commissioner Rettig says that the Service received \$11.92 billion of funding in 2021, \$408 million more than in the prior year, but needs more funding; bills with bipartisan support have been introduced that increase funding and require minimum audit levels for high-income individuals and corporations
- March 2021 – Senators Elizabeth Warren and Bernie Sanders reintroduce wealth tax bill that would tax wealth in excess of \$50 million at 2% annually and wealth in excess of \$1 billion at 3% annually – constitutionality of proposal remains uncertain
  - White House press secretary Psaki states President has not endorsed wealth tax, and that President would discuss making sure the wealthy “pay their fair share as part of the next package of legislation”
- March 7, 2021 – White House Communications Director Kate Bedingfield says President Biden remains opposed to ending the Senate’s filibuster rules



## Tax law changes proposed by Candidate Biden during the 2020 presidential campaign

PERSONAL TAXES		
\$BN raised over 10 yrs.		
Ordinary income	Generally set top ordinary income tax at 39.6% for taxpayers with income over \$400,000	\$520
Social Security	Apply a Social Security payroll tax of 12.4% to earnings above \$400,000	\$962
Income deductions	Reactivate Pease limitation for taxpayers with income above \$400,000	*
Itemized deductions	Limit tax benefit of itemized deductions to 28% of their value	*
Capital gains and dividends	Eliminate QDI benefit and tax long-term gains and qualified dividend at 39.6% on taxpayers with income in excess of \$1mm	\$448
Basis upon transfer	Repeal step-up in basis rule	*
Gift and estate exclusions	Reduce gift and estate tax exclusion amounts	\$210
Qualified business income	Phase out qualified business income deduction for taxpayers with income above \$400,000	\$219
Increased individual tax compliance	Increase IRS enforcement to audit more wealthy individuals to help close the tax gap and help pay for Caring Economy Plan	\$481
IRA Provisions	Replace with refundable tax credits; automatically enroll most workers without pensions in IRAs	-\$80
Miscellaneous	\$5k tax credit for informal caregivers; increased Child and Dependent Care Tax Credit; miscellaneous tax cuts; First Time Homebuyer Credit	-\$343

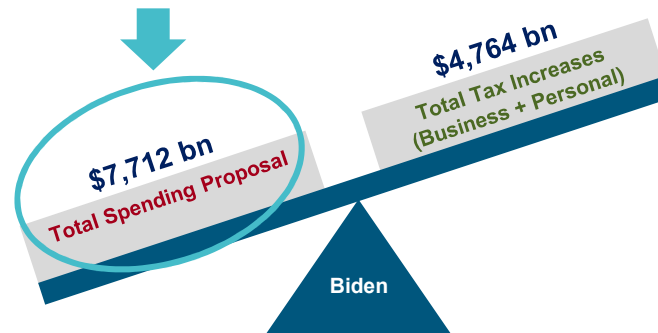
\*Included in other line items

Sources: J.P. Morgan Private Bank, Cornerstone Macro Research, J.P. Morgan Asset Management

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# Tax law changes proposed by Candidate Biden during the 2020 presidential campaign

BUSINESS TAXES		
\$BN raised in 10 yrs.		
Income	Increase the corporate income tax rate to 28%	\$1,300
Book income	Impose a corporate minimum tax on book income of \$100 million or higher (pay greater of corporate income tax or 15% minimum tax while still allowing for net operating losses and foreign tax credits)	\$166
Other income exclusions	Double the tax rate on GILTI	\$309
Business deductions	Eliminate tax preferences for pharmaceutical, fossil fuel, and real estate industries, including, for the latter industry, accelerated depreciation and tax	\$469
Bank tax (institutions w/ assets of \$50+ bn)	Institute a "financial risk fee" on banks, bank holding companies and non-bank financial institutions	\$103
<b>TOTAL PROJECTED TAX INCREASES (BUSINESS + PERSONAL)</b>		



\*Included in other line items

Sources: J.P. Morgan Private Bank, Cornerstone Macro Research, J.P. Morgan Asset Management

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**Question 1**

**1) Have you worked on the transfer of a partial interest in a partnership, LLC, S Corp since 2017?**

a) Yes

b) No

## Mitigating the “strings” of Code §§ 2036, 2038

## IRC § 2036

Sections 2036(a)(1) and (2) state:

“(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 case of a bona fide sale for an 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 the 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.”

26 U.S.C. § 2036(a)

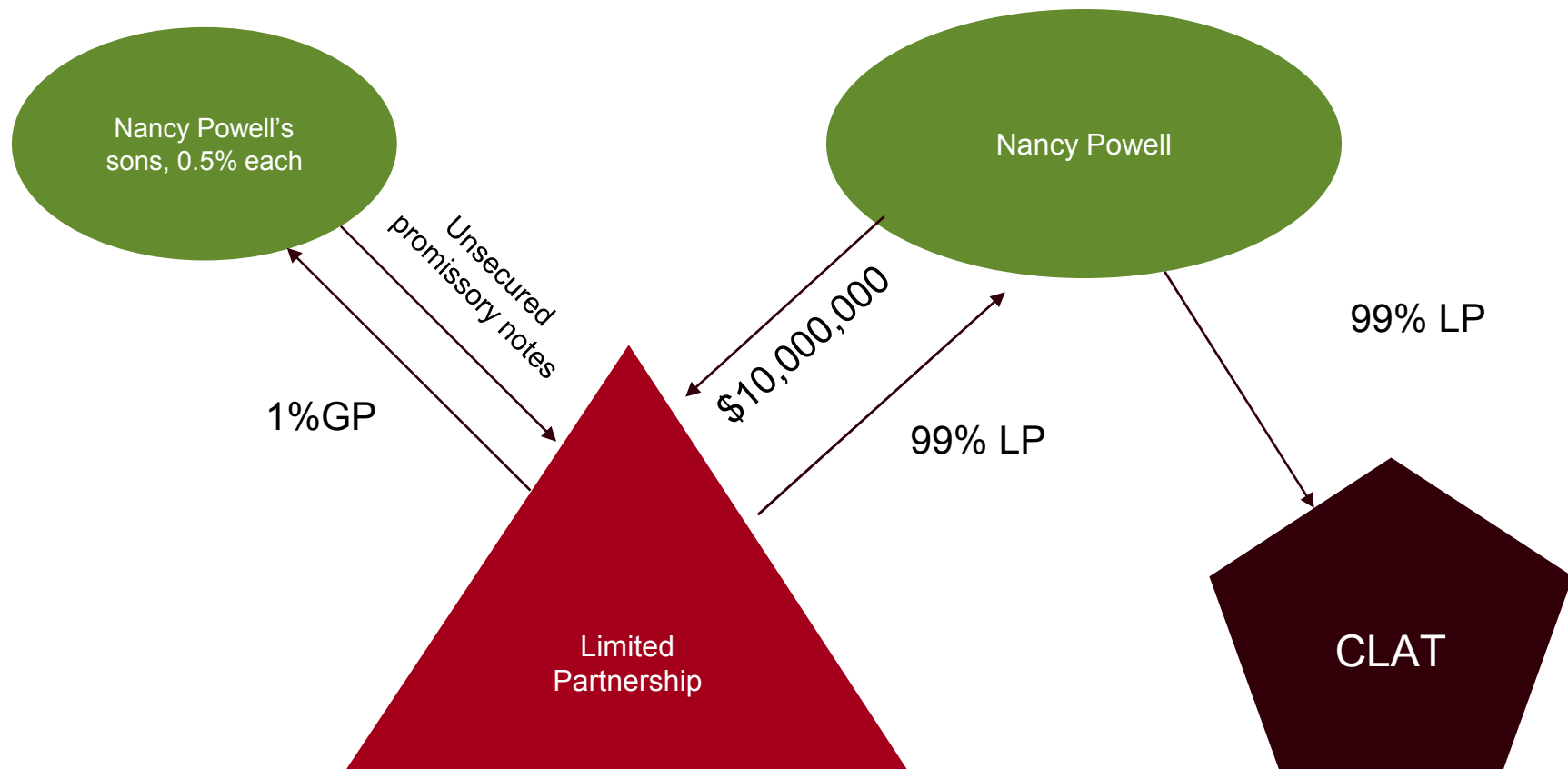
## IRC § 2038

(a) IN GENERAL.- The value of the gross estate shall include the value of all property-

(1) TRANSFERS AFTER JUNE 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 other 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.

26 U.S.C. § 2038(a).

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



## Planning with Powell 2.0

1. Bona fide sale exception (*Kimbell, Bongard, Murphy, Turner* (not), *Jorgensen* (not), *Moore* (not))
2. Significant non-tax reasons (*Bongard, Stone, Black, Shurtz, Purdue, Endrow* (not))
3. Fiduciary duty exception (*Byrum, Cohen*, PLR 9710021)
4. Drafting considerations
5. Voting interest (avoid giving clients any)
6. Age/Capacity/Documentation



## **Reboot of existing FLPs, LLCs and related estate plans**

1. Liquidate the entity
2. Gift to trust
3. Sell to trust for note or cash; be mindful of “bona fide sale” rules
4. Gift to spouse, if spouse does not currently own entity (possible issues)
5. Gift to lifetime QTIP trust for spouse (Better than #4 above)
6. Exchange marketable securities for assets that require more active management
7. Eliminate “offensive” powers
8. Review and revise voting rights, when possible
9. Consider fiduciary duties and LLCs (*Byrum*)

## Question 2

**1) Have you seen Code § 2036 or 2038 issued raised in an audit in the last 5 years?**

- a) Yes, at least one audit that I have worked on
- b) No, I work in audit defense and have not seen it in any case I have worked on
- c) No, but audit defense is not part of my practice

## The “four horsemen” of Chapter 14

## **Chapter 14 presents a quandary (Code §§ 2701-2704)**

- Issue arises when non-public security (LLC, LP, shares) is transferred to family members
  - Definition of “transfer” beyond gift, includes recapitalization, FLP, buy-sell, options, carried interests, GRATs, Sales, valuation, joint purchases
  - Often misunderstood, except by the IRS
  - If IRS can increase the value of the transferred property = more gift tax
  - Deemed gift §§ 2701, 2702, 2704(a)
  - Disregarded provisions §§ 2703, 2704(b)
- 
- 2701 - transfers of interests in trusts in closely held entities
  - 2702 -transfers in trust and joint purchases
  - 2703- disregarding certain rights or restrictions on acquiring or using property
  - 2704- rules regarding lapsing rights and restrictions

## Code § 2701

- Certain rights associated with Senior member equity (“applicable retained interests”)
- Subtraction method if transferor or “applicable family member” holds applicable retained interests after the transfer. Can cause heavy-handed “**zero value rule**”
- Transfer is a:
  - 1) capital contribution;
  - 2) redemption, or recapitalization if applicable retained interests are gained; or
  - 3) termination of a holding if the losing person is a “grantor” or if the interest would have been included in their estate if they held the interest before the termination

## Code § 2701

2 kinds of prohibited rights are Applicable Retained Interest

Distribution right (only if “Control”)

- Right to receive distributions as to an Equity Interest (except Same of Subordinate distribution rights as the transferred interest)

Extraordinary Payment Right

- Put, Call, right to compel liquidation, guaranteed payment or non lapsing conversion right
- The exercise or non exercise of which affects the value of the transferred interest
- No control requirement – no entity

Control

- Partnership – at least 50% of capital or profits interest; or a GP Interest
- Corporation- at least 50% of the total voting or total FMV of the equity

## Code § 2701

The Vertical Slice rule – the ultimate defense to a deemed gift under Code § 2701

- Built upon one of the exceptions to Section 2701 – the “proportionality” exception
- In an example, parent wants to transfer a portion of their GP carried interest to a trust for children. The parent must also transfer a proportional interest of LP interest (the carry + the LP interest)
- Beware of non proportional transfers, as well as the new final regulations under Code § 1061

### Pay attention to:

- Broad definition of transfer captured under Code § 2701
- Multiple classes of equity in family vehicle (LLC, S Corp, Partnership)
- Parent (senior generation) retains put, call, liquidation rights
- Profits interests
- Recapitalization transactions – capital contributions

## Code § 2702

- Transfers when grantor retained a qualified annuity or income interest for term of years
- Value of any retained interest valued as 0, making the transfer equal the complete FMV
- Many excluded transfer techniques, including incomplete gift, CLT, QPRT with qualified interests
- Qualified interests – primarily GRATs
  - Qualified annuity interest
  - Qualified Unitrust Interest
  - Qualified Remainder Interest



## Code § 2702

- Estate tax inclusion risk

Treasury regulation effective for decedents dying after November 7, 2011

- Portion of GRAT includable in the gross estate if the grantor does not survive the term is the amount needed to yield the annual payment using the date of death 7520 rate (See Treas. Reg. § 20.036-1(c)(2)(iv), Ex 2.)
- So includable amount = annual annuity/7520 rate (as of date of death)
- Example
- Grantor contributes \$1,000,000 to GRAT and is to receive \$120,000 over the 10 year term. Grantor dies when the GRAT is worth \$3,000,000, and the 7520 rate is 6%
- Section 2036 includable amount is:
$$\frac{\$120,000 \text{ Annuity}}{0.06 \text{ (7520 rate)}} = \$2,000,000$$
- Note inability to allocate GST exemption during term of the GRAT under ETIP rule

## Code § 2703

- Presumption that options, agreements and rights to acquire or use property at less than FMV
- Major exception for “bona fide business arraignment” non intended to transfer to family for less than “full and adequate consideration in money or money’s worth” in terms comparable to other arm’s length arrangements.
- Owners of less than 50% of the equity are exempt from rule
- Seen in buy-sell agreements, operating agreements, partnership agreements

## Code § 2704

- Historically significant with proposed regulations designed to “simplify” by expanding
- Designed to address lapse of voting rights and consider those gifts
- Voting rights on any issue is enough
- Adding non-family members as managers and “blockers” is a planning idea
- Further disregarding valuation discount if family member has “applicable restriction”

### Question 3

**3) Have you found the IRS to be knowledgeable of the requirements of Chapter 14 (Code §§ 2701-2704)?**

- a) Yes very knowledgeable
- b) Yes, but only when a supervisor is involved with the audit
- c) No, the issue has never been raised in the audits I have worked on
- d) No, but audit defense is not part of my practice

## **Valuation and discounts in today's environment**

## Valuation discounts

- “Eye candy” for IRS in selecting audit candidate 709s
- Valuation based on comparable sales, then discounts subtracted
- “Hypothetical willing buyer and willing seller each with knowledge of the relevant facts and neither under a compulsion to buy or sell.” Treas. Reg. § 25.2512-1
- Lack of marketability
- Minority interest
- Lack of control
- Blockage
- **COVID**

## Approaches to valuation

- Analytical and justified
- Aggressive and daring
- S Corp tax affecting under *Estate of Jones v. Comm'r*, T.C. Memo. 2019-101 (2019)

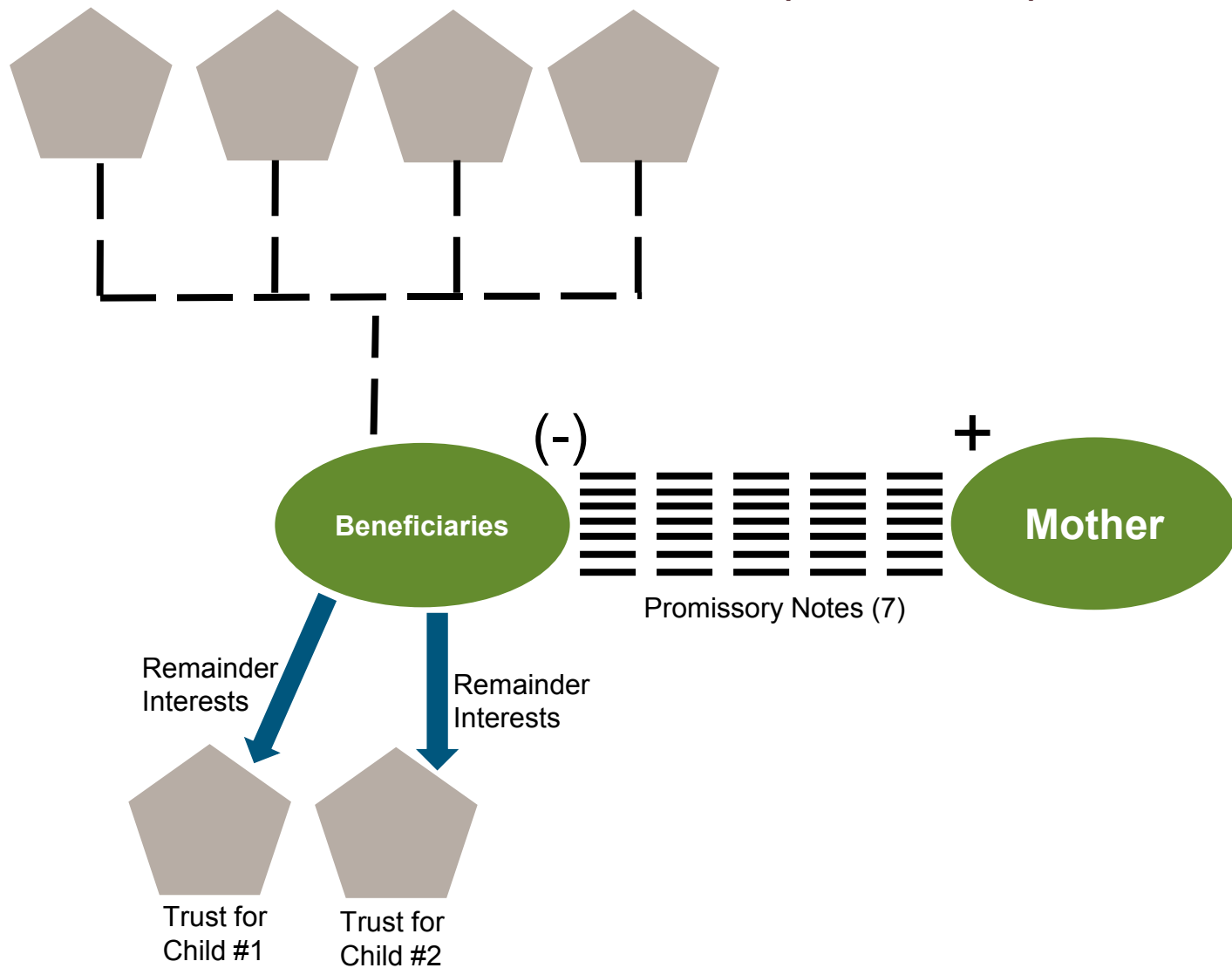
## Valuation adjustment clauses to the rescue

- Key, essential language “value as finally determined for federal gift (or estate tax)”
- Two types of defined value clauses – defined value transfer and defined value allocation
- Three cases stands supreme for the planner – *King v. United States*; *Wandry v. Comm’r*, *Petter v. Comm’r*
- Planners can learn from other cases, and pick up tips

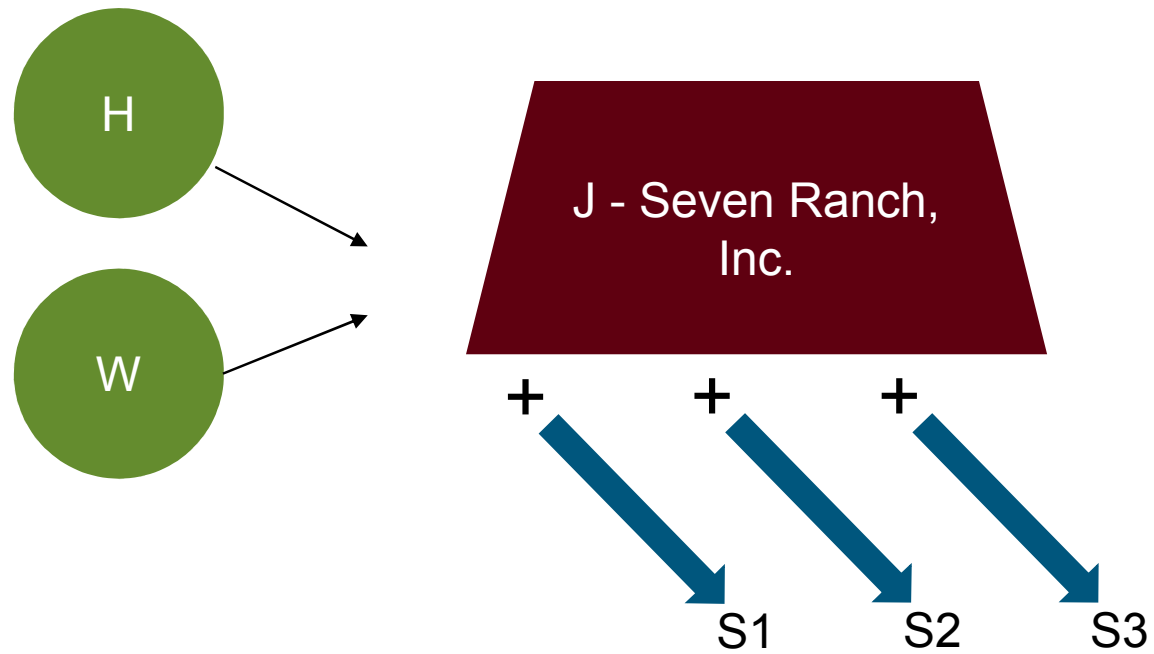


## Defined value transfer clauses

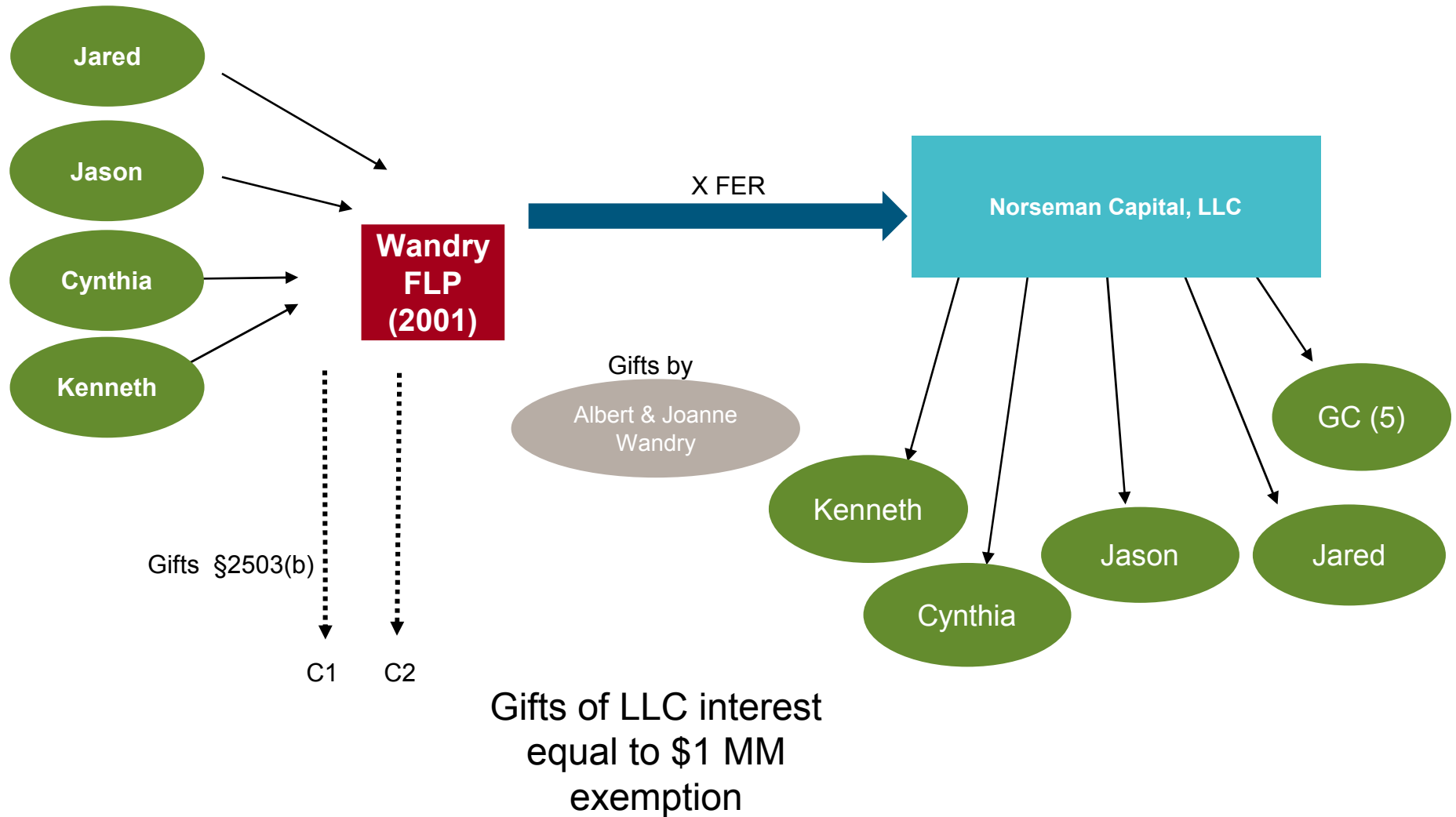
***Comm'r v. Procter*, 142 F.2d 824 (4<sup>th</sup> Cir. 1944)**



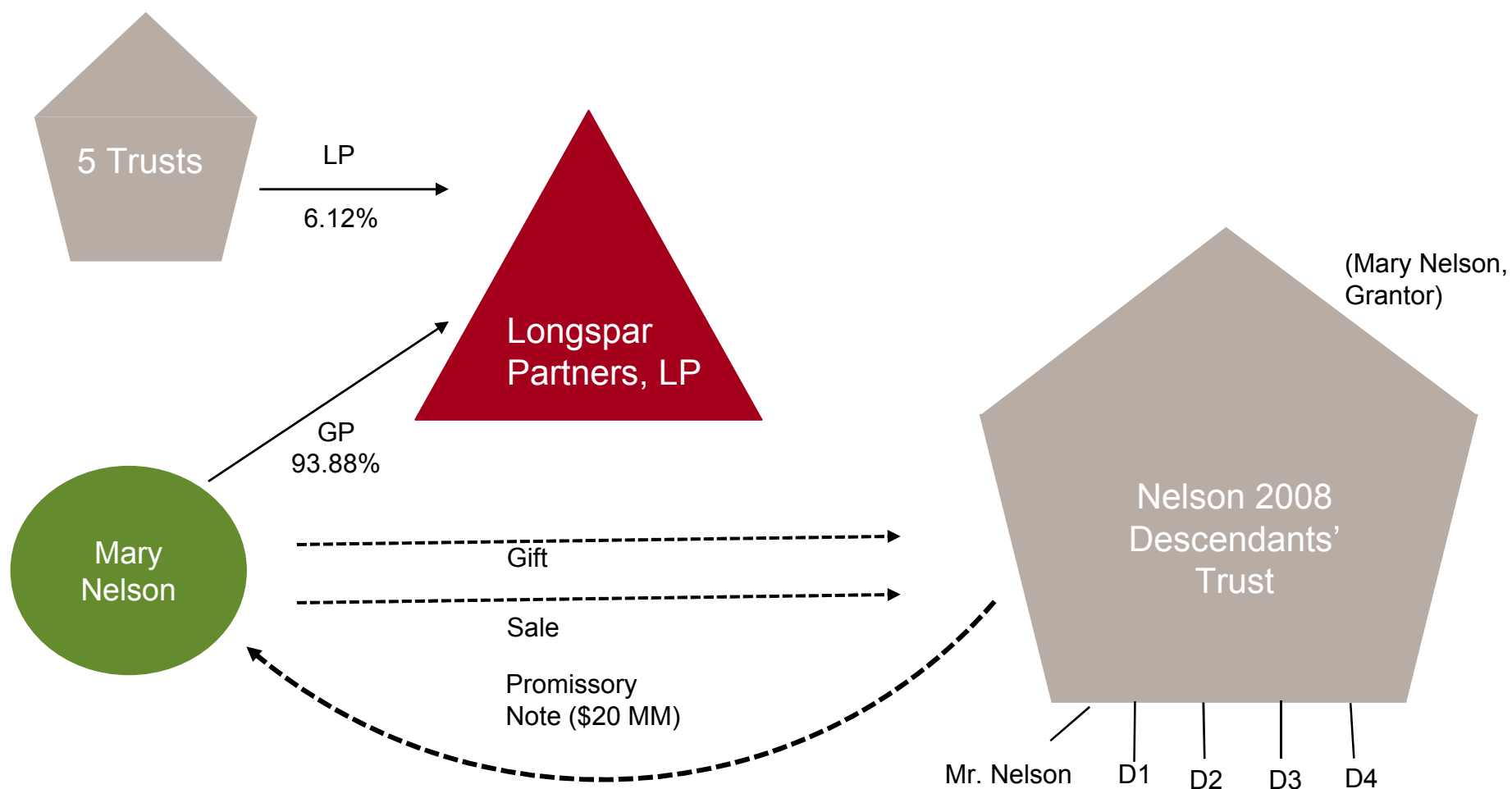
***Ward v. Comm'r*, 87 T.C. 78 (1989)**



***Wandry v. Comm'r*, 103 T.C.M. (CCH) 1472 (March 26, 2012)**

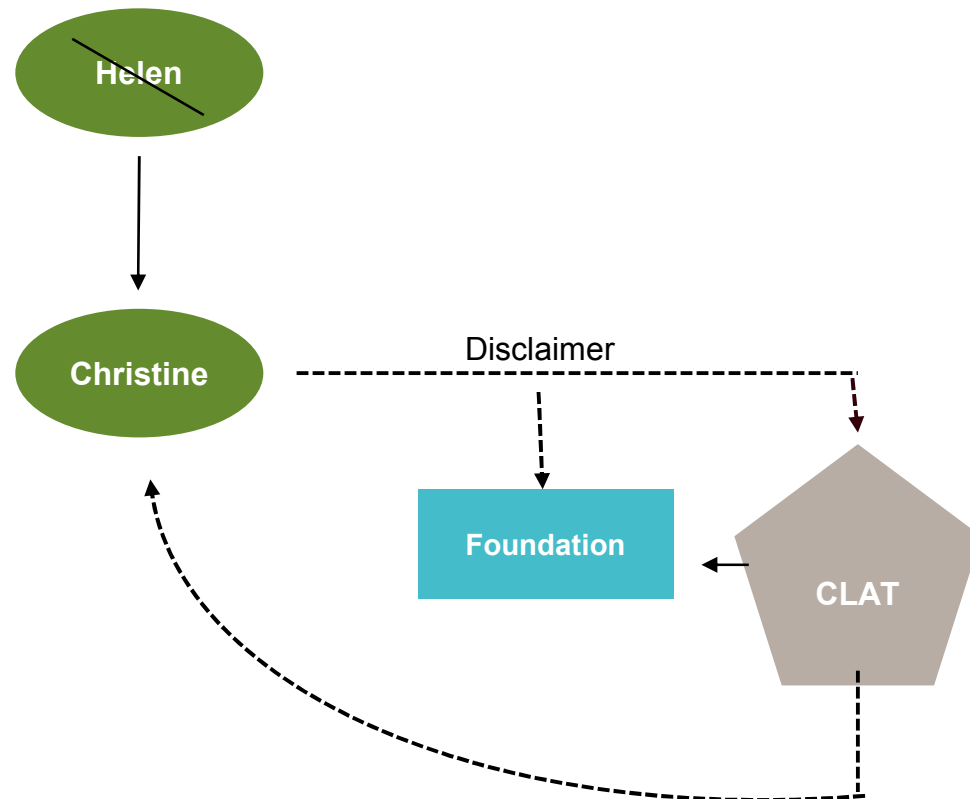


***Nelson v. Comm'r, T.C. Memo 2020-81 (June 10, 2020)***

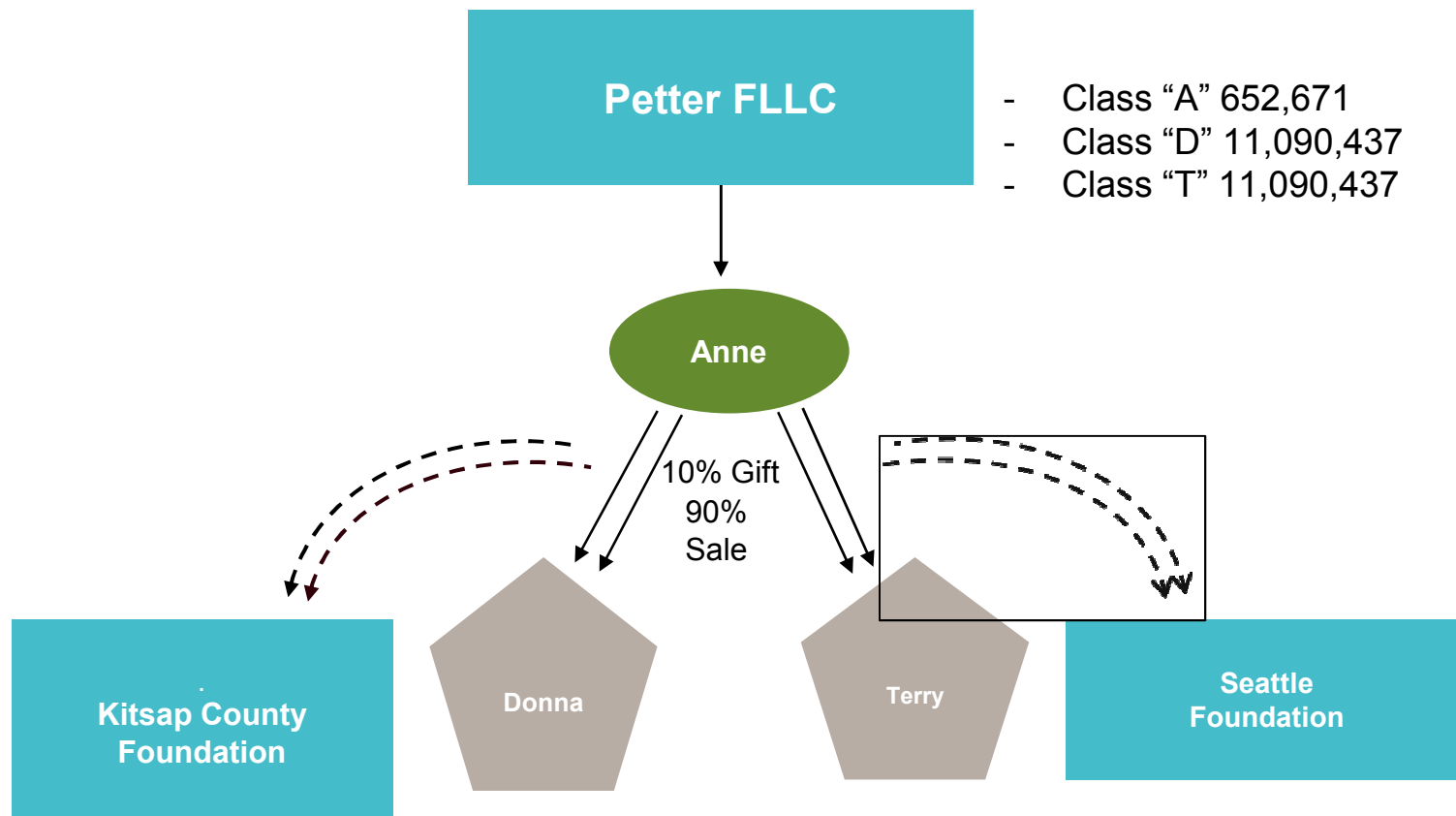


## Defined value allocation clauses

***Estate of Christiansen v. Comm'r, 130 T.C. 1 (January 24, 2008)***

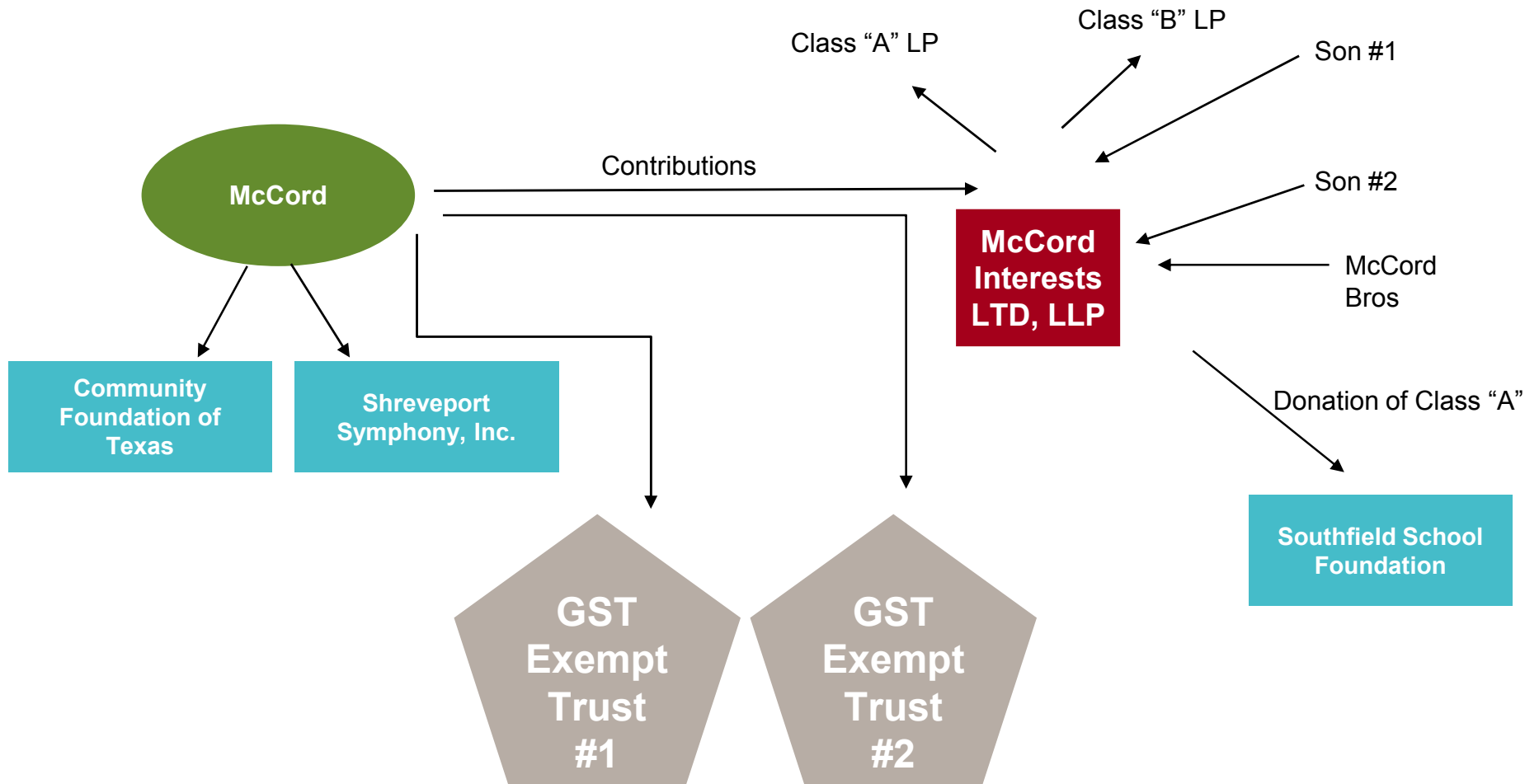


***Estate of Petter v. Comm’r 98 T.C.M. (CCH) 534 (December 7, 2009)***

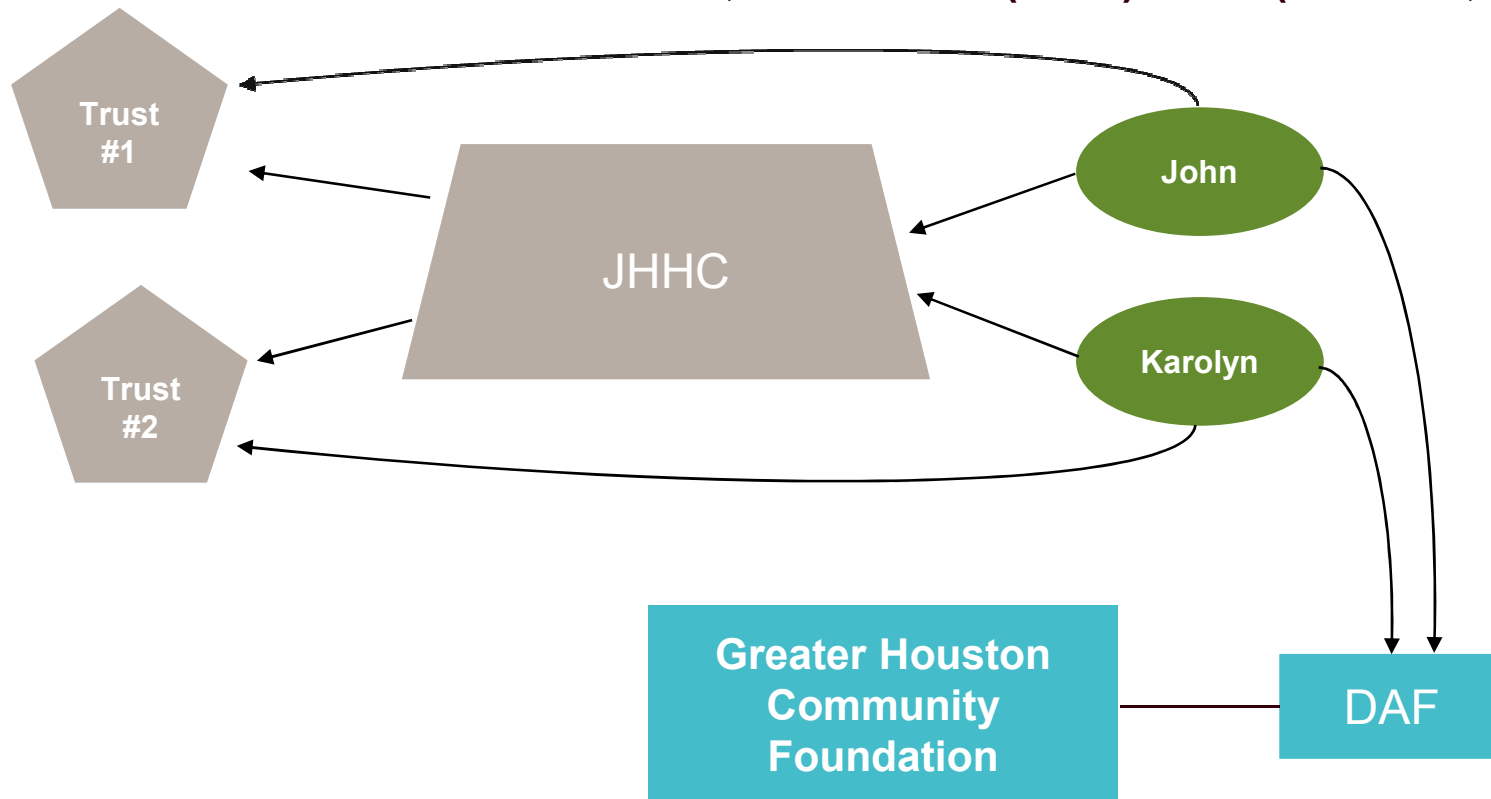




## Succession of *McCord v. Comm'r*, 461 F.3d 614 (5<sup>th</sup> Cir. 2006)

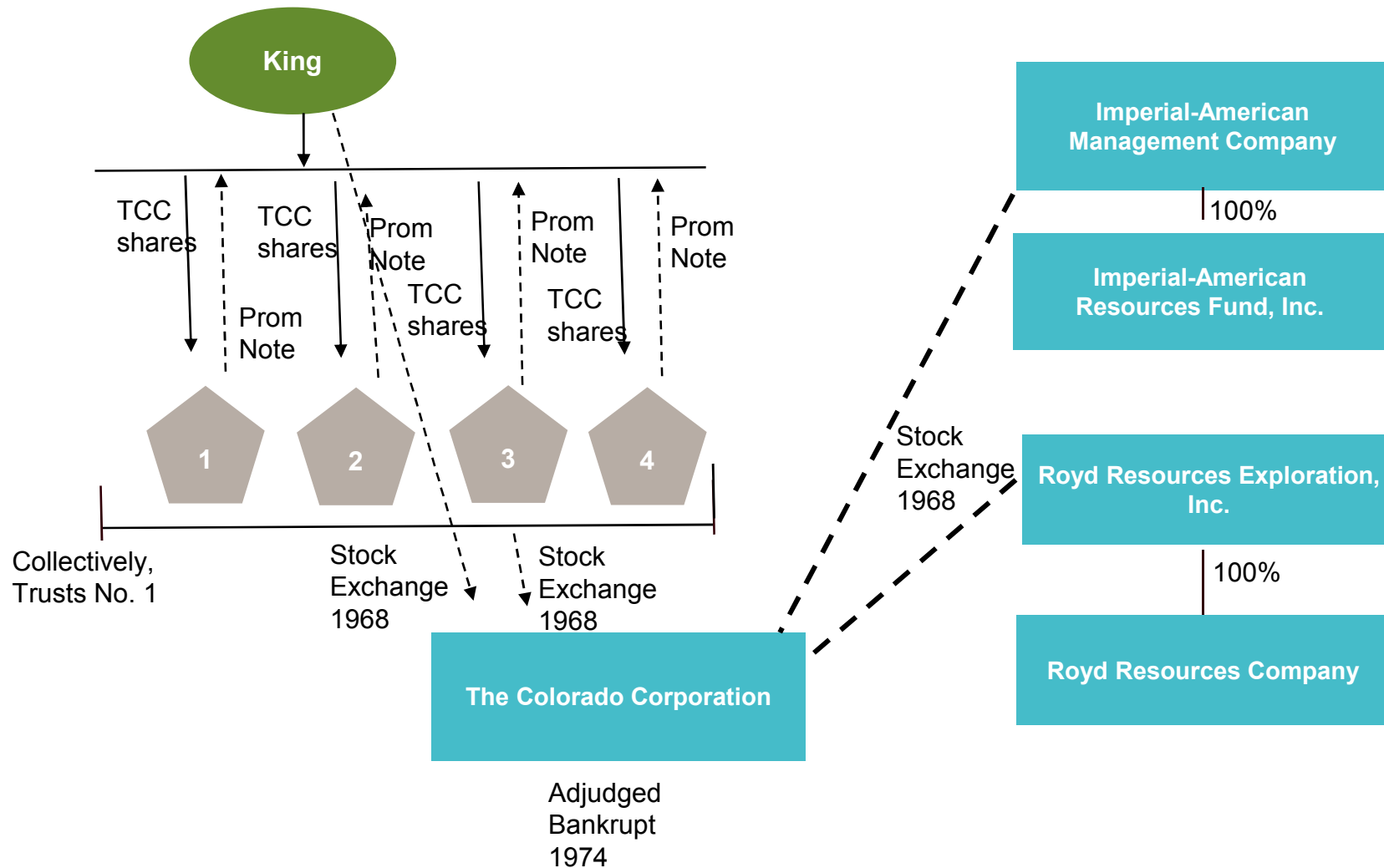


***Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642 (June 15, 2011)***



## Price adjustment clauses

## ***King v. United States, 545 F.2d 700 (10<sup>th</sup> Cir. 1976)***



## Question 4

**4) Have you drafted a defined value or price adjustment clause in the past 5 years?**

- a) Yes, I use formula clauses regularly in my planning
- b) No, I do not use formula clauses in my planning
- c) No, but partial interest transfers is not part of my practice

## The power of the grantor trust

## **Grantor trusts, the good, the bad and the opportunity**

- Irrevocable grantor trusts viewed as a top planning tool since the 1986 Tax Act
- Among the retained powers leading to grantor trust status, the power to reacquire trust assets by substituting for assets of equivalent value (§675(4)); the right of the grantor or non-adverse party to add a charitable beneficiary (§674); and borrowing from the trust for less than adequate security or interest (§ 675(3)) (essentially allowing the grantor to “toggle on” grantor trust status) are the most used in practice
- One of the flexibility points offered to the grantor is to “toggle off” the grantor trust power. This may be contemplated ahead of a significant income recognition event
- Some critics of the grantor trust maintain that subjecting the grantor to continued reporting and payment of tax on all items of income, gain, loss, deduction and credit without access to the trust corpus is a drawback
- However, others maintain that the continued payment of income tax offers a great opportunity for non-gift tax wealth transfer, by further reducing the grantor’s estate

Question 5

**5) What is the longest promissory note you have worked with in the context of a sale or loan to a grantor trust?**

- a) 9 years
- b) 20 years
- c) longer than 20 years
- d) Transfers using promissory notes is not part of my practice



## Grantor trust vs deep valuation discounts

Total Wealth Transferred (in \$MM)							
		Valuation Discount					
		0%	10%	20%	30%	40%	50%
Note 3	3	1.73	1.85	2.01	2.22	2.49	2.87
	9	6.23	6.86	7.66	8.68	10.04	11.56
	15	11.29	12.56	13.82	15.09	16.36	17.63
	20	17.84	19.26	20.69	22.11	23.53	24.96
	30	38.34	40.25	42.16	44.07	45.98	47.89
	40	65.83	68.42	71.02	73.61	76.21	78.81
Cumulative Income Tax Paid by Grantor (in \$MM)							
		Valuation Discount					
		0%	10%	20%	30%	40%	50%
Note 3	3	0.33	0.33	0.33	0.33	0.33	0.33
	9	1.73	1.74	1.74	1.74	1.75	1.75
	15	4.05	4.07	4.1	4.12	4.15	4.17
	20	7.04	7.1	7.16	7.21	7.27	7.33
	30	17.63	17.82	18.02	18.22	18.41	18.61
	40	35.91	36.4	36.9	37.39	37.88	38.37
Cumulative Income Tax Paid by Grantor (as a % of Wealth Transferred)							
		Valuation Discount					
		0%	10%	20%	30%	40%	50%
Note 3	3	19%	18%	16%	15%	13%	11%
	9	28%	25%	23%	20%	17%	15%
	15	36%	32%	30%	27%	25%	24%
	20	39%	37%	35%	33%	31%	29%
	30	46%	44%	43%	41%	40%	39%
	40	55%	53%	52%	51%	50%	49%

## Question 6

**6) This presentation will be helpful to me in my practice**

- a) very helpful
- b) somewhat helpful
- c) nothing new that is not already in my practice
- d) my practice is not related to the topics discussed

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# Appendix

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Chris Siegle is an Executive Director and Senior Wealth Advisor in the Scottsdale, Arizona, office of J.P. Morgan Private Bank. With his strong legal and tax background, he and his team provide successful individuals, families and organizations with creative strategies for investing, tax and estate planning, and family succession issues. His focus on family circumstances and grantor intent adds depth to every conversation.

Chris's advice on family dynamics, wealth preservation and individualized legal structures is sought throughout the West. He speaks and writes frequently on tax planning, charitable giving, investments and advanced estate planning strategies. He has presented to the Arizona State Bar Tax Section, the USC Tax Institute, the Notre Dame Tax and Estate Planning Institute, the Maricopa County Bar Association, the Collier County Bar Association (FL), Valley Estate Planners, and he has appeared at numerous seminars and panels for professional groups.

Chris joined J.P. Morgan in 2010 after practicing law in Arizona for more than 13 years, during which he specialized in trusts and estates, employee benefits and corporate transactions. A member of the State Bar of Arizona and the Maricopa County Bar Association, he offers his expertise to his clients and to their other tax and legal advisors as well.

Chris earned his J.D., with Honors, from the University of Tulsa College of Law, his M.S.S. from the United States Army War College, and his LL.M. (tax) from Villanova University School of Law. He received his A.B. from the University of Illinois at Urbana-Champaign. During his study at Tulsa University Law School, he was an articles editor for the *Tulsa Law Journal*. He is an adjunct Professor of Law at the Villanova University School of Law. Chris is an Accredited Estate Planner®.

Active in his community and imbued with a strong sense of responsibility and leadership, Chris is a Captain (retired) in the U.S. Navy having served from 1990-2020. He is a member of the Professional Advisory Boards of the Arizona Community Foundation and the Catholic Community Foundation in Phoenix. He also devotes time to the Central Arizona Estate Planning Council and other professional organizations.

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