



FAMILY OFFICE TAX ROUNDTABLE

**McDermott
Will & Emery**

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CURRENT INCOME & TRANSFER TAX UPDATE

SPEAKERS



RICHARD DEES
Partner



GARY KARCH
Partner

FINAL TREASURY REGULATIONS UNDER SECTIONS 67 & 642

- Characterization of trust and estate expenses
 - Trust and estate miscellaneous itemized deductions (MIDs) are determined as an individual except the following deductions are non-MIDs per IRC §67(e):
 - “Costs that are paid or incurred in connection the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust”
 - Deductions for personal exemption or trust distributions
 - TR §1.67-4(a)(2) provides non-MIDs are not subject to disallowance under IRC §67(g) added in 2017
- TR §1.642(h)(2) preserves the deductibility to a beneficiary of non-MIDs passed out on termination
 - Deduction remains (1) allowable in arriving in AGI, (2) as a non-MID or (3) as a MID
 - These deductions are allowed only in the tax year of the beneficiary in which the terminations occurs
 - Because beneficiary steps into the shoes of the trust or estate, NOLs cannot be carried back

NEW DEVELOPMENTS IN VALUATION

- CCA 2018939002 held that a pending merger needed to be considered in valuing a gift of publicly-traded stock and could not rely on that day's trading price
- On the other hand, in *Carter v. US*, 124 AFTR 2d 2019-5467 held that a fraud that had occurred before death but after the filing of the return did not justify deviating from trading price
- *Kress v. US*, 123 AFTR 2d 2019-1224, applied IRC §2073 to a gift of S corporation stock to disregard transfer restrictions in By-Laws but only reduced the lack of marketability discount by 3%
- *Est. of Jones v. Comm.*, TC Memo 2019-101, upheld the “tax affecting” of earnings in valuing pass-through entities. The court said that prior tax court cases denied tax affecting “because the expert’s method of tax affecting was faulty, not because it should not be considered”
- *Nelson v. Comm.*, TC Memo 2020-81 (6/10/2020), rejected an intended formula gift when determining a higher gift tax value

FINAL TREASURY REGULATIONS §20.2010-1

- Current law “sunsets” the increase in the exemption from \$5 million to \$10 million (excluding inflation adjustments); therefore, new regulations were needed to explain whether a gift within the exemption prior to 2026 would effectively reduce the lower estate tax exemption at the donor’s death
 - The regulations provide a “*use it or lose it*” rule foregoing any “*clawback*” as the Blue Book provides
 - The carry over exemption from a deceased spouse (DSUE) must be used before the surviving spouse’s increased exemption
- The regulation introduction notes that the increased GST exemption may be allocated late to prior gifts in trust
- Will a reduction under a law change respect this no clawback approach?
- Threatens a possible “anti-abuse” rule “could except from the application of the special rule transfers where *“value” is included in the donor’s gross estate at death*”

BIDEN TRANSFER TAX PROPOSALS

2021	Estate tax exemption	Gift tax exemption	GST exemption	Annual exclusion	Tax Rate
Current law	\$11,700,000	\$11,700,000	\$11,700,000	\$15,000	40%
Biden proposal	\$3,500,000	\$1,000,000	\$3,500,000	\$13,000	45%

- Higher transfer tax exemptions and rates
- Biden proposal unlike current law precludes inflation adjustments
- Current law provides that assets includible in the gross estate will receive a basis step-up or step-down to date of death value
- Biden proposes to impose a Canadian–style capital gains tax at death by marking to market the value of estate assets, possibly at 39.6%. May accept carry-over basis at death

OTHER POSSIBLE BIDEN TRANSFER TAX CHANGES

- A regime change could also lead to any one or more of the following changes that were proposed during the Obama administration
 - The effective elimination of GRATs
 - Require the value of the (taxable) remainder be at least 25% of the value of property added to the trust; Requiring the annuity term be at least ten years and limiting how long they may last
 - The imposition of a time limit on GST Exempt Trust
 - Reset the inclusion ratio on GST exempt trusts after a period of time
 - The expansion of family attribution to minimize valuation discounts
 - The inclusion of grantor trusts in the grantor's estate and the treatment of distributions from grantor trusts as gifts
 - Least practical solution
 - More efficient to give grantor a tax reimbursement right, which could apply to existing trusts

POLL QUESTION

If Biden is elected, how likely is it that the family members you work with will be trying to make significant gifts by year end?

1. Unlikely as most of our family members have already used their transfer tax exemptions.
2. Unlikely as most of our family members see no need to make further gifts to their descendants.
3. Unlikely as most of our family members expect that they will have time next year to make gifts under current law.
4. Likely as most of our family members have taken a wait and see approach before making large gifts.

WAYS TO COUNTER THE DONOR'S CONCERN ABOUT LACK OF ACCESS TO GIFTED PROPERTY

- There are a number of ways that might be used to preserve a donor's access to gifted property. They include:
 - Gifts of promises to make gifts
 - Creation of an intentionally defective preferred interest in an entity
 - Gifts to trusts of which donor's spouse is a beneficiary
 - Gifts to Domestic Asset Protection Trusts (Trusts of which the donor is a beneficiary if established in a state that does not permit the donor's creditors to reach the assets)

GIFTS OF PROMISES TO MAKE GIFTS

- An enforceable promise to make a gift not based on adequate and full consideration in money or money's worth is treated as a taxable gift. *Comm'r v. Copley's Estate*, 194 F. 2d 861 (2d Cir. 1952)
- If not paid before death, no estate tax deduction will be permitted - Rev. Rul. 84-25 will remove the promised amount from the promisor's adjusted taxable gifts
- The enforceability of a promise to make a gift is determined under applicable local law
 - All states with the exception of Pennsylvania require some consideration, perhaps a promise by one of the trust beneficiaries to read at least one good book each month for a year

GIFTS OF PROMISES TO MAKE GIFTS

- Under Pennsylvania law, a written promise is enforceable if the writing states that the signer intends to be legally bound. 33 P.S. § 6. It is not clear what connection with PA would be required but a promise to a PA trustee of a PA trust would seem to be sufficient
- Consider relying on PA law
 - Bryn Mawr Trust Company of PA has agreed to serve as trustee for trusts created by our clients, the principal of which consists of a promise to make a gift for \$1,500 per year

CREATING AN INTENTIONALLY DEFECTIVE PREFERRED INTEREST

- An intentionally defective preferred interest is a senior interest in an entity such as a limited liability company that intentionally fails to comply with the requirements established by § 2701 of the Internal Revenue Code. Because it does not comply, the interest is deemed to have a zero (0) value for gift tax purposes
- If the holder of the preferred interest transfers junior interests in the entity to family members or trusts for their benefit or if an individual acquires a preferred interest at the same time as his or her family members or trusts for their benefit acquire the junior interest, the preferred interest holder will be treated as having made a taxable gift equal to the value of his or her retained, preferred interest

EXAMPLE OF INTENTIONALLY DEFECTIVE PREFERRED INTEREST TECHNIQUE

- D creates an irrevocable trust for her children and transfers property worth \$1.1 million to the trustees
- D and the trustees form a limited liability company (L) with two classes of membership interests, A and B
- The holders of the A interests are entitled to a 1% noncumulative return on their investment plus 1% of any additional profits. They have the right to withdraw their investment at any time
- The holders of the B interests are entitled to all additional profits
- D contributes \$9.9 million of appreciated assets to L; the trustees contribute \$1.1 million

EXPECTED RESULTS

- D should be treated as having made a taxable gift of \$9.9 million at the time of the contribution
- D's gift, if the contribution occurs in 2020, will be protected by D's remaining exclusion amount up to \$11.58 million
- D's contribution, to the extent it exceeds her exclusion amount will be subject to gift tax at the 40% rate. If she survives for three (3) years after the contribution, her effective tax rate on the deemed gift will be only 28.57%
- The \$9.9 million contributed by D will be available to her during her life if needed
- If D retains the preferred interest until death, her interest will receive a basis equal to its value on the date of death, presumably about \$9.9 million

EXPECTED RESULTS

- Because D was treated as having made a gift of assets she actually retained, the regulations under §2701 will permit her estate to reduce the amount subject to estate tax at her death by the amount of her contribution to L that was treated as a gift because of the application of §2701. The reduction amount should be \$9.9 million
- Under current regulations, D's estate will be able to use the full amount of the exclusion used to protect the 2020 contribution to L for estate tax purposes regardless of the level of exclusion in effect at her death

GIFTS TO TRUSTS OF WHICH DONOR'S SPOUSE IS A BENEFICIARY (SLATS)

- Simple idea
 - If marriage remains stable, funds that can be distributed to spouse can be made available to donor in time of need
- *With potential complications*
 - If marriage is dissolved, will spouse remain a beneficiary?
 - If so, donor will remain liable for tax on trust income
- Terminate spouse's interest at death or separation?
 - Define spouse as the person to whom grantor is married while the grantor lives
- **Beware** reciprocal trusts!

DOMESTIC ASSET PROTECTION TRUSTS (DAPTS)

- If the donor is a discretionary beneficiary of a trust the donor has created, the funds in that trust could be available to him or her in case of future need. The DAPT would be designed to be a completed gift
- If the donor's creditors can reach trust assets to satisfy the donor's obligations, however, the IRS takes the position that the donor has retained enjoyment of or control over trust assets within the meaning of §§ 2036 and 2038
- Only 19 states, Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia West Virginia, and Wyoming permit self-settled spendthrift trusts
- It's unclear whether the creditors of a donor who does not live in a DAPT state but who funds a trust with a trustee in a DAPT trust that complies with that state's requirements for a DAPT trust will be able to reach the trust's assets

INCOME TAX UPDATE – SECTION 385 REGULATIONS

- 2016 Proposed Regulations
 - Intercompany loans automatically treated as stock
 - If instrument not documented
 - If ability to repay not documented
 - Not applicable to partnerships
- November 2019 Final Regulations
 - Withdrew the documentation regulations

INCOME TAX UPDATE – CARES ACT

- Fixed the “Retail Glitch”
 - Leasehold improvements unintentionally ineligible for bonus and subject to 39 year amortization
 - CARES Act retroactively makes eligible for bonus and otherwise depreciable over 15 years
 - Procedure to change prior reporting
- Relaxed 163(j) interest deduction limits

INCOME TAX UPDATE – CARES ACT

- Relaxed 461(h) – Excess business losses
 - Delayed application to 2021
 - Provided disallowed loss becomes NOL that is not retested under 461(h) in subsequent years – so one-year deferral
- Allows 5-year carryback of NOLs incurred in 2018, 2019 and 2020
- Suspended charitable deduction limit for cash contributions
 - TCJA increased from 50% to 60% through 2026
 - CARES Act increases from 60% to 100% for 2020 only
 - Does not apply to donor advised funds

INCOME TAX UPDATE – DISASTER LOSSES

- Presidential Proclamation 9994 (March 13, 2020)
 - Entire US is a COVID disaster area
- IRC section 165(i)
 - Disaster losses can be claimed in year prior to disaster
- Possibility worth investigating:
 - 2020 capital loss due to COVID creates income benefit securing refund of 2019 tax paid
 - Do not need to have an NOL in 2020 or 2019

INCOME TAX UPDATE – PPP LOANS

- CARES Act section 1106(i)
 - Forgiveness is excluded from taxable income
- IRS Notice 2020-32
 - Related expenses are attributable to tax-exempt income and therefore not deductible
- Potential for administrative or legislative reversal of IRS position, but nothing yet
- Some suggest waiting until 2021 to apply for PPP loan forgiveness

INCOME TAX UPDATE – EXPENSE MATCHING

- 469(e)(1)
 - Interest, dividends, and gains on assets generating interest and dividends (portfolio income) are not taken into account in determining passive income
 - Expenses *clearly and directly allocable* to such gross income are not taken into account
 - Application to family office 162 expenses incurred to generate K-1 portfolio income

INCOME TAX UPDATE – EXPENSE MATCHING

- 461(I) – Excess Business Loss (Delayed until 2021)
 - Excess of:
 - Aggregate deductions attributable to trade or business, over
 - Aggregate gross income or gain *attributable to such business*
 - Application to family office 162 expenses incurred to generate K-1 interest, dividend and capital gain income

INCOME TAX UPDATE – EXPENSE MATCHING

- 1411 – 3.8% tax on net investment income
 - Excess of:
 - Interest, dividends and capital gains, over
 - Deductions which are *properly allocable to* such gross income or net gain
 - Application to family office 162 expenses incurred to generate K-1 interest, dividend and capital gain income

INCOME TAX UPDATE – SALT CAP

- Charitable Deduction Workaround shut down
 - TD 9907 (August 11, 2020)
- Entity Level Tax Workaround neither challenged nor approved
 - In place in CT, LA, MD, NJ, RI, WI
- Repeal not part of the Biden tax plan, but possible if Democrats gain control

INCOME TAX UPDATE – TELEWORK

- Working from home in a different state
 - Wage withholding
 - Business nexus and apportionment factors
- 19 instances of state-by-state relief where telework due to COVID
 - Including AL, CA, DC, GA, IL, IN, IA, MA, ME, MN, MS, ND, NE, NJ, ND, OR, PA, RI, SC
 - Some applicable only to business nexus; other applicable to remote workers employment tax
 - Duration varies
 - Tie to COVID varies – mandatory shutdown vs discretionary work from home
 - Bloomberg State Tax publishes a COVID-19 Telework Snapshot
- Federal legislation under discussion

INCOME TAX UPDATE – BIDEN TAX PLAN

- Apply 12.4% social security tax to income over \$400,000
- Increase top rate from 37% to 39.6%
- Apply ordinary rates to capital gains if income over \$1 million
- Tax appreciation at death or repeal step-up in basis
- Increase corporate tax rate from 21% to 28%
- Repeal 20% 199A deduction for income over \$400,000
- Reduce benefit of itemized deductions (Restore Pease Amendment)

INCOME TAX UPDATE – BIDEN TAX PLAN

Highest Marginal Rates				
	Current	Current	Biden	Biden
	Wages	SE	Wages	SE
Income tax	37.00%	37.00%	39.60%	39.60%
SE tax	1.45%	3.80%	1.45%	3.80%
Social Security tax	0.00%	0.00%	6.20%	12.40%
Total	38.45%	40.80%	47.25%	55.80%
New York state	8.82%	8.82%	8.82%	8.82%
New York city	3.88%	3.88%	3.88%	3.88%
Total with New York	51.15%	53.50%	59.95%	68.50%
California	13.30%	13.30%	13.30%	13.30%
Total with California	51.75%	54.10%	60.55%	69.10%
Federal deduction of state tax at 28%				
New York			56.39%	64.94%
California			56.83%	65.38%

INCOME TAX UPDATE – BIDEN TAX PLAN

- Planning to obtain 2020 rates in certain circumstances
 - 2020 sale – structure as installment sale – ability to elect out when filing return
 - 2021 sale – transfer asset to LLC and sell LLC interests – 75 days to check the box on LLC
 - Others

INCOME TAX UPDATE – EMPLOYMENT TAX EXCEPTIONS

- Application of 12.4% tax to income over \$400,000 increases the value of established exceptions to employment tax
- Active state law limited partner – avoids employment tax under 1402(a)(13); avoids net investment income tax so long as limited partner is active in the business
 - IRS does not accept, but limited partners have prevailed in court
 - LLC members and LLLP partners have not prevailed in court

INCOME TAX UPDATE – EMPLOYMENT TAX EXCEPTIONS, *CONTINUED*

- Active S Corporation shareholder
 - Avoids employment tax because 1402 does not include S corporation flow-through income as income from self-employment
 - Avoids net investment income tax so long as shareholder is active in the business
 - Consensus that this exception is a historical accident without policy justification; has been a target of proposed legislation for decades
- Famously used by presidential candidates John Edwards and Newt Gingrich (sometimes known as the Edwards/Gingrich exception)
- More recently became public that exception has been used by Joe Biden and Donald Trump

THANK YOU

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