



## Carpe Diem! How to Seize the Opportunities in the Proposed IRS Regulations

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## The “Perfect Storm”

Proposed IRS regulations for Section 2704  
will eliminate valuation discounts and  
severely limit the ability to shift wealth.

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“There is no mulligan,” ...

... “If a family is considering doing some tax planning and they’re putting it off to next year, they can’t go back in time and take advantage of the discounts.”

*The New York Times | Treasury Wants to End Tax Deal for Some Family-Owned Businesses | August 19, 2016*

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An opportunity like this only occurs  
once every 5-10 years.

These proposed regulations will impact  
many clients and prospects, especially  
those with high net worth.

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## Other IRS Proposals Would Further Limit Estate Planning Opportunities

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The IRS maintains a  
“Green Book” listing transactions  
that it seeks statutory or  
regulatory relief from.

- Grantor Retained Annuity Trusts – eliminating short term rolling GRAT’s and imposing a 10 year minimum term
- Eliminating Beneficiary Defective Income Trusts
- Elimination of Dynasty Trusts
- Restricting other techniques perceived to be “abusive”.

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## The Political Climate Has Shifted

Income and wealth inequality is a national issue.

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The likely outcome of the presidential election is a democratic victory and their platform includes:

- Reduction of the estate tax exemption to \$3.5 million
- Increase of the estate and gift tax rate to 45%
- Reduction of the gift tax exemption to \$1 million
- Reduction of the generation skipping transfer tax exemption to \$3.5 million

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Interest rates are at historically low levels and likely to rise.

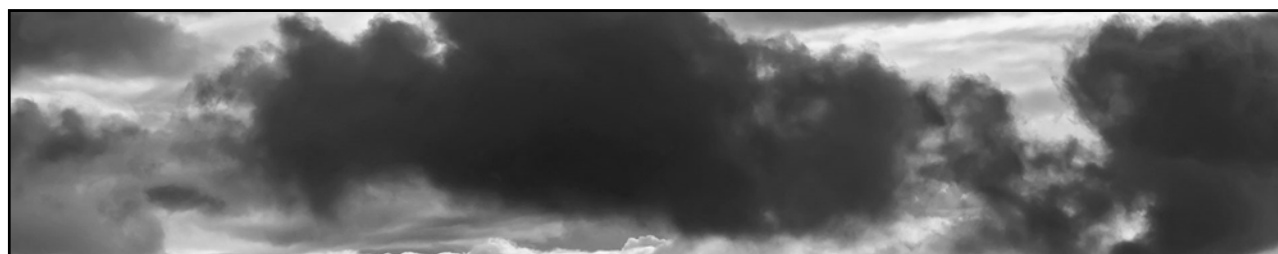
September 2016 Rates:

- Short-term federal rate is 0.61% (0-3 years)
- Federal mid-term rate is 1.22% (3-9 years)
- Federal long-term rate is 1.9% (9+ years)
- IRC Sec. 7520 rate is 1.4% (GRAT's & CLAT's)



## CAUTION: Capital Gains Tax Must be Considered

- Outright gifts result in carry-over basis
- Capital Gains Tax = 20% federally, with some states adding on
- IRC Sec. 1014 (e) provides step-up in basis for assets included in the Gross Estate
- When considering transfers of appreciated property, basis adjustments should be factored in
- Advanced trust planning can accommodate flexibility (more later)



The “Perfect Storm” sits on the horizon, but opportunities for Estate Tax Planning are available **NOW** for your clients, so...

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### Make hay while the sun shines...

- Valuation Discount Planning will remain available until 30 days after regulations have passed.
- Historically low interest rates fuel estate planning vehicles providing significant leverage.
- The current Federal Estate, Gift & GST exemption of \$5.45 million provides unprecedented opportunities for lifetime gifting.
- Dynasty Trusts in jurisdictions like Delaware, South Dakota and Nevada provide opportunities to control and perpetuate wealth for multiple generations, and to continue fine tuning the gift, estate and Capital Gains Tax.

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# Stan Miller

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## What is “Valuation” Really?

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My Definition:

How Difficult is it to Get to the Underlying Asset?

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## Basic Valuation Concepts

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- Fair Market Value is the price a willing buyer and will pay a willing seller, neither being under compulsion to buy/sell and both equally knowledgeable.
- Minority Discount: Fair Market Value is reduced by the inability to control an entity or enterprise.
- Lack of Marketability Discount: the recognition that a competitive market does not exist for partial ownership of an entity.

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## Where We Stand Now

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- For asset protection purposes and wealth transfer purposes, families have created limited partnerships and limited liability companies to own and hold assets including family-controlled businesses, real property, mineral interests and securities.

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## Where We Stand Now

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- Transfers of partial interests in these entities have been recognized by business appraisers to qualify for lack of marketability and minority interest discounts.

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## Where We Stand Now

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- Under the existing 2704 regulations as interpreted by multiple court holdings, the creation of family controlled entities, if properly created and maintained, will qualify for valuation discounts.

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## Important Concept:

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Discounts are NOT AUTOMATIC. The entity must be created for **significant and legitimate non-tax business reasons**.

*Estate of Purdue v. Commissioner* 145 T. C. Memo 2015 249  
December 28, 2015

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## List of Possible Strategies

1. Gifts of Fractional Interests in Real Property
2. Outright Gifts of LP, LLC or "S" or "C" Corp Interests
3. Sales to IGTs in Exchange for Notes, SCINs and Private Annuities
4. GRATs & CLATs

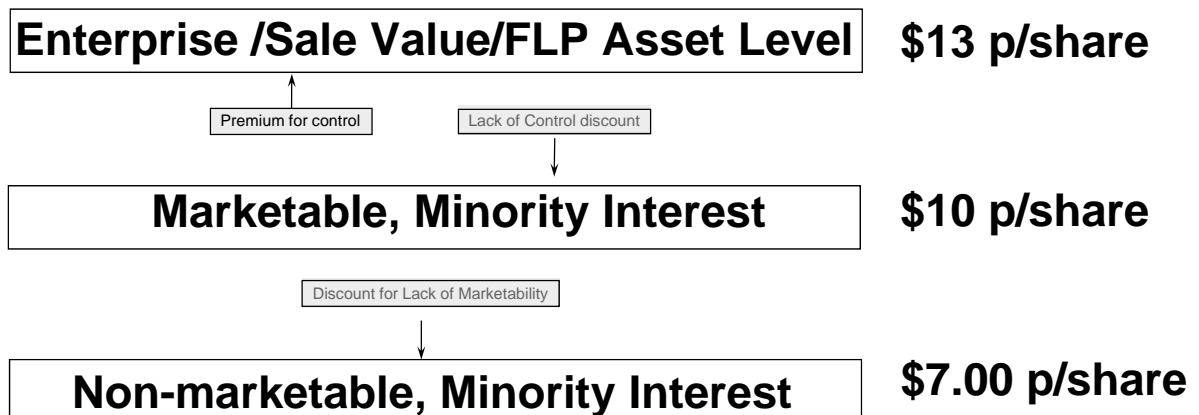
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# Chuck Coyne

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## Typical Valuation Adjustments - Control/Marketability



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## Other Discounts

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- Built-in Capital Gains – Liability or Discount
- Partial Interests (TIC) in Real Property
- S-corp./Pass-through Entity Premium
  - Typically applied to minority interests only
  - If assume control, then would go away
- Blockage/Restricted Stock Discounts
- Key Man Discount (family member vs non-family?)
- Inside Asset Discounts (PE funds, interests held in other companies inside IHC, etc.)

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## Other Discounts: Inside Investment Assets

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- Investment Holding Companies (IHCs)/FLPs/LLCs
  - Discounts on inside assets are impacted by types of assets held and not family relationships
- Mark these assets to FMV
  - Bonds, dividend paying preferreds – lower discounts
  - Equities – potentially full discounts
    - Public stock in less liquid companies –
      - Blockage discounts - larger blocks especially
    - Equity interests in non-family private companies
  - Hedge funds – function of time to redemption – discounts typically limited in size
  - Private equity LP investments – higher discounts

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## Context

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- 30 Years of History in 5 Minutes
- The 30 Years War the IRS Lost (Until Now)

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## Let's Remember Martha Watts

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- Martha Owned 15% of the Stock in a Pacific Northwest Timber Company
- Martha Did not own Enough Stock to Force a liquidation or a dividend
- In Fact, Martha Never Got Even One Dollar From the Company

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## Let's Remember Martha Watts

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- Martha Died
- IRS Says her Stock was worth \$20 (15% of Liquidation Value)
- But She Never Got Anything from the Company and Didn't Have the Right to Liquidate or force a Dividend
- 11<sup>th</sup> Circuit Says Stock worth \$2M—87% Discount- 823 F.2d 483 (1987)

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## The Light Bulb Comes On.....

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- Clever Planners Realize.....
- We Can Draft Family Business Structures to Purposely Incorporate Restrictions like Those in the Watts Case and Suppress the Value of the Business for Transfer Tax Purposes
- Harrison Case T.C. Memo. 1987-8

## The IRS Responds

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- Chapter 14 (including IRC Section 2704):  
“.....If you Draft Restriction More Restrictive than State Law Automatically Imposes, Those Restrictions will be Ignored for Valuation Purposes”

## The Light Bulb Comes On...Again

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- Clever Planners Realize.....
- We Don't Have to Draft Restrictive Provisions into Business Structures if we can get the State Legislatures to do it for Us.

## The State Legislatures Respond....

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- And the State Legislatures Did Respond
- Requirements added to LP & LLC Statutes:
  - Any Transferee is an Assignee (i.e.—no voting rights) unless 100% of current members agree
  - NV added other restrictions making it even harder to get to the money

## The IRS Responds Again....

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- The New Proposed Regulations are Fundamentally Designed to Say This:

“Regardless of Underlying State Law, Transfer of Interests in Business Entities to other Family Members will be Valued Using the Artificial Constructs We Have Imposed on You.”

## Our Objective Today

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- The object of this workshop is to provide enough information to understand the major provisions of the regulations and their critical impact on Estate Tax Planning for clients.
- For more detail please refer to a copy of “WealthCounsel’s Analysis of the New Proposed Regulations Under Code §2704” read the release and information from the Department of Treasury, 26 CFR Part 25 Internal Revenue, published August 4, 2016.

## Executive Summary

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- Applicable only to entities
- Equally applicable to entities operating businesses as well as those holding real estate or passive assets such as securities portfolios and debt
- Effective date: no sooner than December 31, 2016
- When final, regulations will apply to transfers made 30 days after finalization.
- A new “3 year rule” for limited bandwidth of transactions.

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## Targets of the 2704 Regulations

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- Death Bed transfers: While its not entirely clear how this is intended to work, the new proposed regulations suggest that at death, the discount component of any transfer within 3 years will brought back into the estate of transferor.
- The value of the transferred asset will be taxable within the estate, but the actual asset will not be available to pay the tax.
- The 3 year rule could apply to transfers made before the effective date. This will create a substantial risk of miscalculating the taxable estate.

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## Targets of the 2704 Regulations

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State laws that set default rules for control at greater than 50% will now be disregarded under the current version of the proposed regulation.

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## Targets of the 2704 Regulations

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- Any family owned entity or business
- Charitable Gifts resulting in discounts for minority and/or lack of marketability
- Gifts to third parties which have the effect of reducing control or produce discounts for minority or lack of marketability.

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## Summary Concepts

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- Entities: defined broadly to include any entity controlled by a family—LLCs, Corporations, etc.
- Control: defined as 50% or more of either capital or profit interest or the ability to liquidate the entity. Thus it is possible for two 50/50 unrelated persons/families will each be subject to new regulation
- Liquidation rights: defined more broadly
- Put Rights: transferees are inferred to have the right to receive fair market (liquidation) value in cash or 6-month note

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## Summary Concepts

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- Assignees: Transfers to an assignee will be treated as a part of new disregarded restrictions unless they have a new “put right” and transfers within three years of death will apply
- Phantom Equity: Transfers of minority interests in a family controlled entity resulting in a voting interest less than the percentage necessary to force liquidation will effectively throw the value of that interest back into the estate of the transferor as phantom equity that cannot be offset by a savings clause creating a charitable or marital deduction

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# Chuck Coyne

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## Where Final Regs May Impact Valuations - Unclear

- As currently proposed likely elimination of DLOC and DLOM in family transfers
- Passive vs active businesses
- Investment holding (marketable securities FLPs) or operating businesses (including real estate businesses)
- Newly formed (future) or existing
- What impact on charitable gifts and matrimonial tax values
  - Minority interest gifts to family foundations done without discounts?

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## Asset Based Options

- Use investments in third party controlled assets held in FLP/IHC rather than fully marketable assets
  - Inside asset discounts still apply
  - Less liquid the asset the larger the discount
- Transfer older S-corp or C-corp structure interests
  - Built in gains issues still exist
- Assets with long-lived contractual restrictions
  - life insurance – split dollar values – with long paybacks based on life expectancy of insureds (kids)
  - Time value of money for speculative investment returns
- Assets with significant risk (unrelated to family inputs) of payoff (speculative)
- Carried interests on asset performance

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Stan Miller

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# An IGT Gift/Sale Transaction

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Carl & Esther

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Married

Carl is 58

Esther is 55

Three Adult Children

Seven Grandchildren

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## Current Estate

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Estate of \$25M Principally Comprised of:

▪ Residence.....	\$3.0M
▪ Cash/CDs.....	\$2.0M
▪ Investment Portfolio.....	\$10.0M
▪ Family Business (LLC).....	<u>\$10.0M</u>
TOTAL .....	\$25.0M

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## Current Situation

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Estate of \$25M = Estate Tax of \$5,640,000 at Second Death  
(if death of both occurs in 2016)\*

\*(assumes \$5,450,000 estate tax exemption for each)

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## Confirming Client Objectives

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Retain Control  
Maintain Personal Lifestyle  
Estate Tax Reduction  
Asset Protection  
Shift Future Appreciation

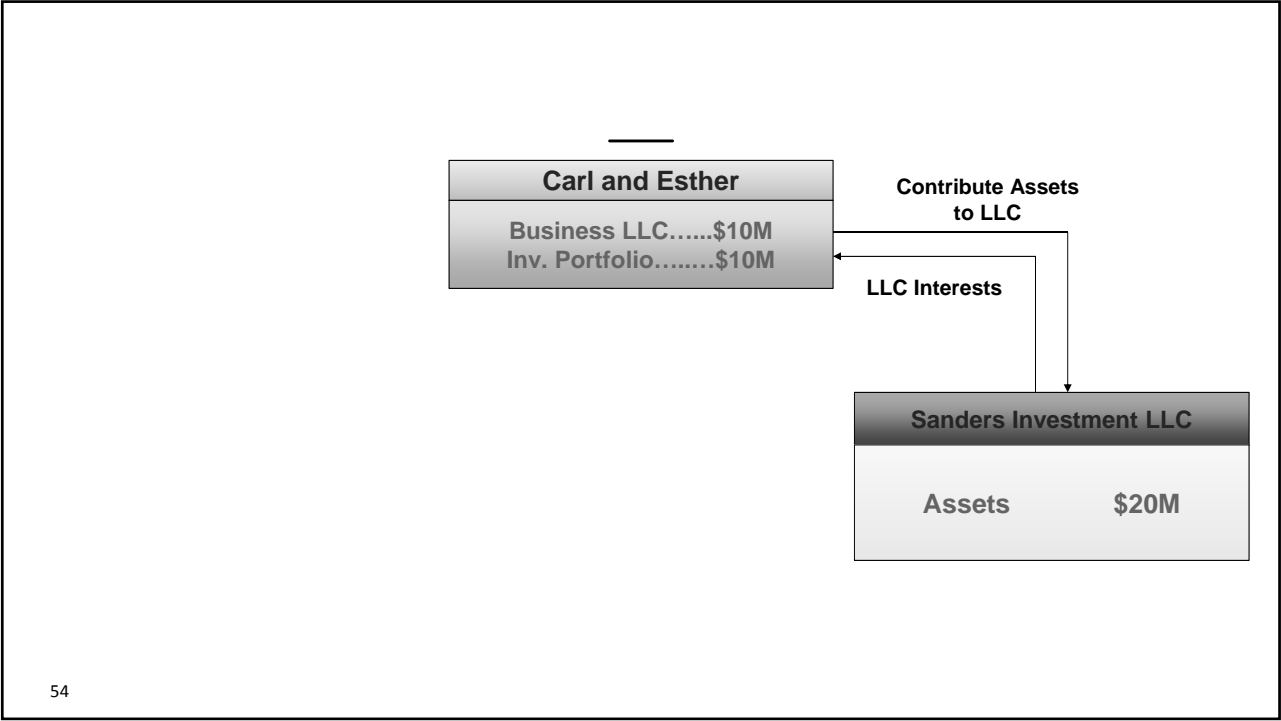
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## Our Recommendations

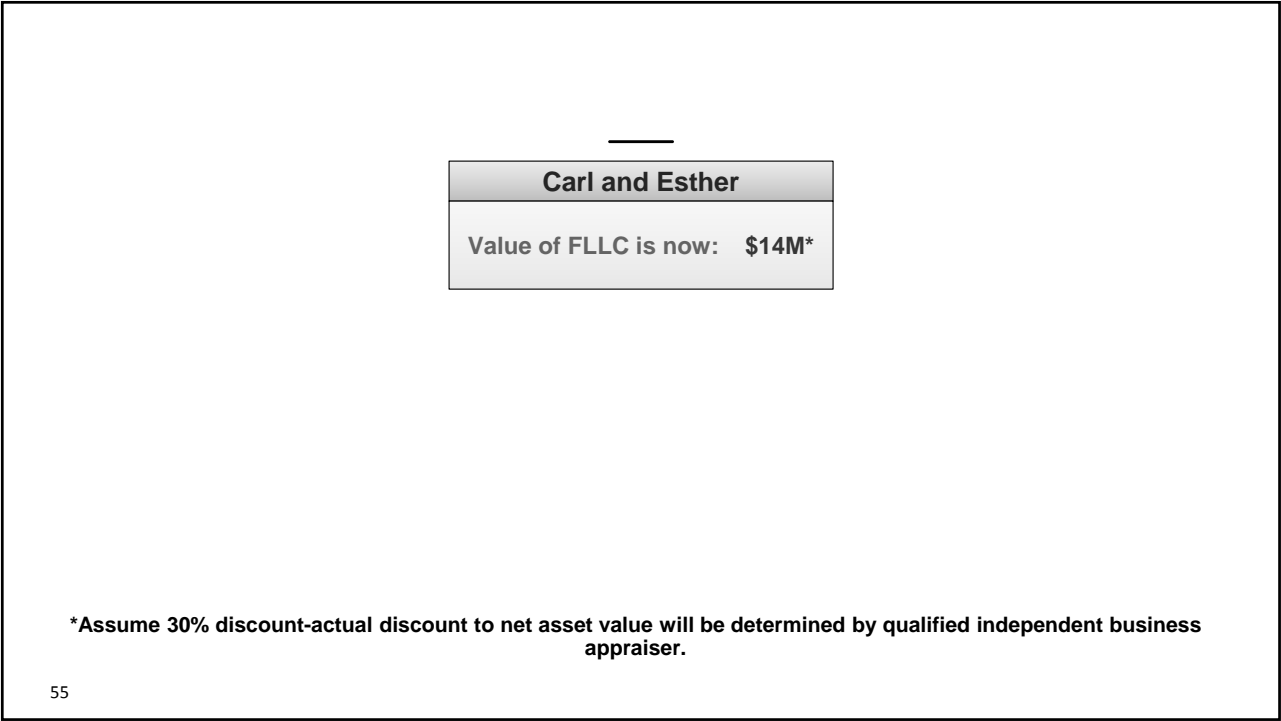
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1. Contribute selected assets to Family Investment LLC
  - Manager-Managed to Retain Control of underlying assets
  - Independent Appraisal will Document Discounts Applicable to Membership Interests

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## The LLC agreement in Wealth Docx

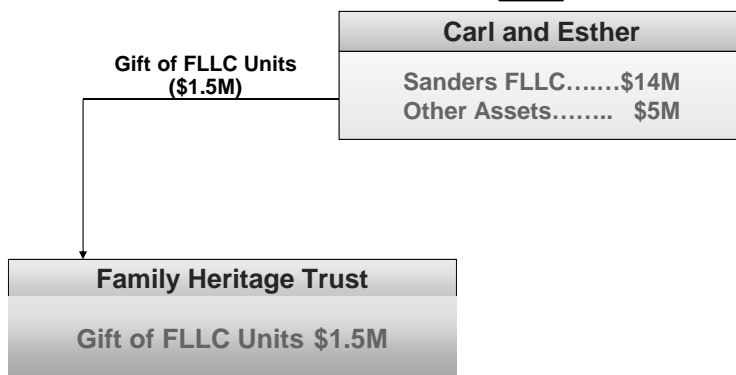


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## Our Recommendations

2. Use portion of lifetime gifting exemption and annual gifting exemption to make “seed” gift to Family Heritage Trust
  - Make a gift of LLC membership units to Family Heritage Trust
  - Allocate GST Exemption

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## Tax Implications of the Gift

1. Note that the gift used \$1.5M of the clients available lifetime Gift Tax Exemption [Generally, we don't provide for "Crummey Withdrawal Rights" on these gifts]
2. The gift also used \$1.5M of the clients Generation Skipping Transfer exemption

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Carl & Esther Still Have  
\$12.5M of FLLC Interests +  
\$5M of Other Assets

### Carl and Esther

Sanders FLLC.....\$12.5M  
Other Assets..... \$5M

### Family Heritage Trust

Gift of FLLC Units \$1.5M

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## The IDGT in Wealth Docx

- W WealthDocx 7 - Advanced Edition
  - Business Succession Planning System
  - Charitable Planning
  - Family Limited Partnership (FLP)
  - 1 Irrevocable Trust (IRT)**
    - Irrevocable Trust Agreement
    - Sample Answers - Inheritor's Trust
  - 2 Sample Answers - IDGT**
    - Sample Answers - HEET
  - Use IRT Scenarios
  - IRT Ancillary Documents

**Irrevocable Trust Options**

Type of Irrevocable Trust  
☐ Individual  
☐ Joint

Which of the following best describes the primary purpose for this irrevocable trust:  
☐ ZSI(c) Minor's Trust  
☐ Asset Protection  
☐ Third-Party DAPT (aka Steve Oshins' "Hybrid Domestic Asset Protection Trust")  
☐ BERT Family Bank Trust (aka Intermittent Intentionally Defective By-Pass Trust / BERT - The Wonder Trust)  
☐ Gifting  
☐ Health and Education Exclusion Trust (HEET)  
☒ Intentionally Defective Grantor Trust

The primary objective of an **Intentionally Defective Grantor Trust (IDGT)** is to create a trust that is effective for estate tax purposes but defective for income tax purposes.

This is accomplished by including certain provisions that will result in the Grantor being considered the owner of the trust for income tax purposes pursuant to Section 671 of the Internal Revenue Code. These provisions will not cause the trust assets to be included in the Grantor's estate at the time of his or her death.

An IDGT should be considered a sophisticated tax planning tool involving complex and changing gift tax, estate tax, generation skipping transfer tax and income tax issues. No practitioner should attempt to draft and implement an intentionally defective grantor trust without a sound understanding of the tax issues surrounding this device.

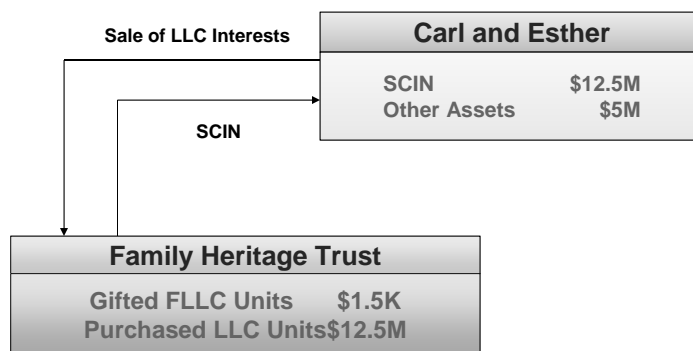
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## Our Recommendations

### 2. Shift Current Value + Future Appreciation of FLLC (not previously gifted):

- Sell FLLC Units to Family Heritage Trust in Exchange for Self Cancelling Installment Note (SCIN) [Note: Non-Taxable Transaction]
- Utilize “self-settled jurisdiction” as Trust situs; Carl and Esther can be beneficiaries

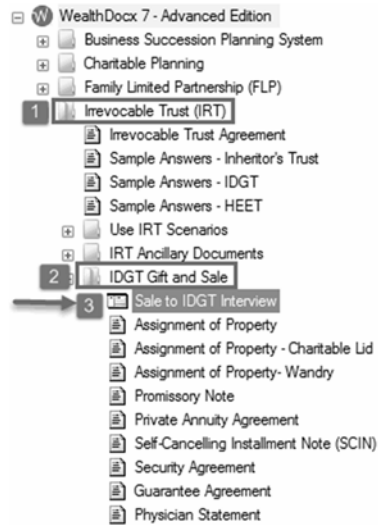
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\* Assume 30% discount-actual discount to net asset value will be determined by qualified independent business appraiser

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## Documenting the Sale Using Wealth Docx



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## SCIN in Wealth Docx



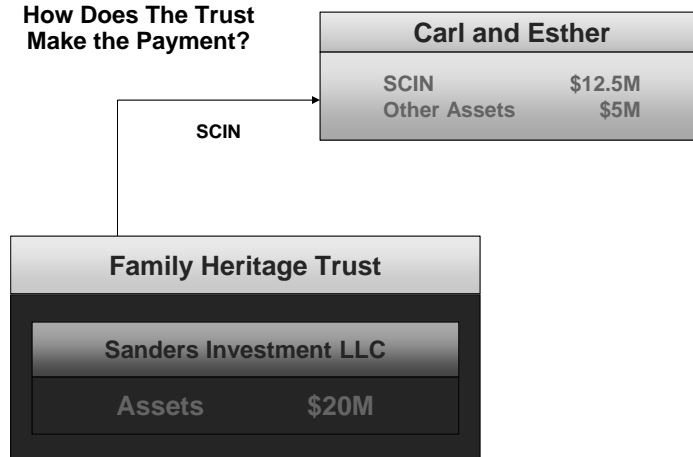
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## SCIN Terms

Principal Amount: \$12,500,000  
Terms: 20 Year Self-Amortizing  
Long Term AFR: 1.90% (Aug 2016)  
Mortality Risk Premium (JT): 0.2635%  
Total Interest Rate: 1.6635%  
Annual Payment: \$739,860

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How Does The Trust  
Make the Payment?



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## Trust Payment Options

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1. Income generated by Sanders Investment FLLC is distributed to Family Heritage Trust
2. Borrow Funds
3. Pay with LLC Interests (in-kind payment)

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## SCIN Analysis

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The FLLC Would Need to produce a 3.7% Return on Investment to Fully Fund the \$739,860 Annual SCIN payment

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## SCIN Analysis

Without the Benefit of the 30% Discount, the SCIN Payment (after a \$1.5M gift) Would be \$1,094,993, and Would Require a 5.47% Return on FLLC Assets.

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How is the Trust Income  
Taxed for Income Tax  
Purposes?



Answer:  
To Carl & Esther

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## What Happens at the First Death?

SCIN Payments Continue

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## What Happens at the Second Death?

- SCIN Payments Terminate
- Family Heritage Trust Owns All Assets

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## Estate Tax Comparison

- Estate Tax Before Planning: \$5,640,000
- Estate Tax After Planning:  
\$0\*

\*Assumes SCIN Payments were spent to fund lifestyle, family gifting and to fund income tax payments on Trust Income.

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## Multi-Generational Features

- Entire Value of Trust Continues to Benefit Generations of Family Members Until the end of the Rule Against Perpetuities Period.
- So, All Growth in Value Escapes Estate Tax—Potentially Forever.

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## Consider.....

Consider Using a Defined Value Formula Clause to Protect the Transaction from an IRS Revaluation:

- Marital Deduction
- GRAT
- Charitable Deflection (McCord, Christiansen, Petter)
- Wandry—T.C. Memo. 2012-88
- Value Adjustment Clause (King--545 F.2d 700, 703 (10th Cir. 1976))

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## Also Consider.....

- Consider Naming a Trust Protector AND Granting the TP the Power to Grant General Powers of Appointment to Beneficiaries.
- An Innovative Planning Device in WealthDocx that Allows you to Integrate Basis Step-Up Planning with Estate Tax Planning and Optimize for the Best Result.

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## Achieving Client Objectives

Retain Control	☑
Maintain/Improve Personal Lifestyle	☑
Estate Tax Reduction	☑
Asset Protection	☑
Shift Future Appreciation	☑
Maximize Basis Step-Up	☑

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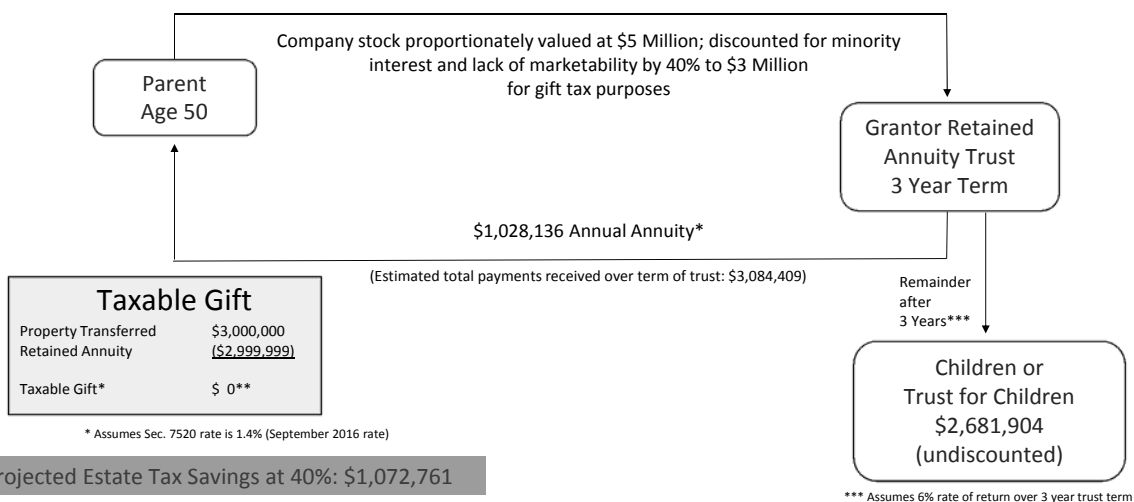
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# GRATs & CLATs

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## Grantor Retained Annuity Trust (GRAT)



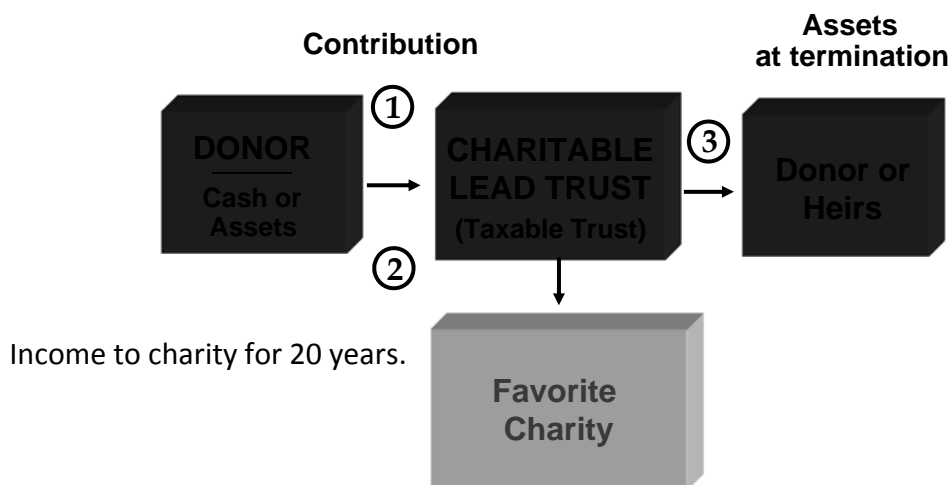
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## CAUTION: Capital Gains Tax Must be Considered

- Outright gifts result in carry-over basis
- Capital Gains Tax = 20% federally, with some states adding on
- IRC Sec. 1014 (e) provides step-up in basis for assets included in the Gross Estate
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## Charitable Lead Trust (CLT)



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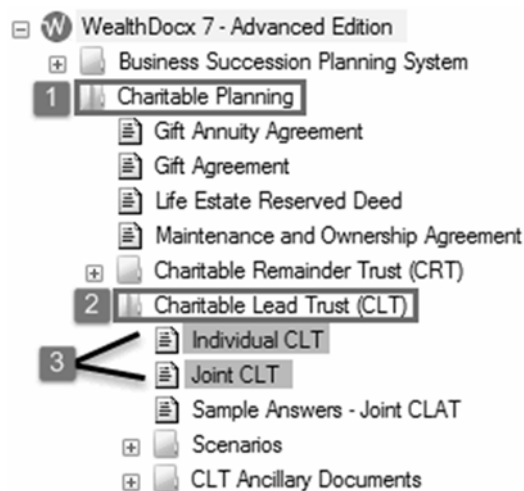
## Inter Vivos vs. Testamentary CLTs

(Used by Onasis, Buffet, Zuckerberg)

- **Inter Vivos = during life (*Buffet, Zuckerberg*)**
  - Permits “grantor style” CLAT – income tax deduction
  - Grantor/spouse can be remainder beneficiary
  - Can take advantage of known (low) interest rate (1.4%)
- **Testamentary = at death (*Onasis*)**
  - Can “zero out” estate tax with formula – regardless of unified credit (AEA)
  - Adjustments on audit result in more \$ going to charity
  - Valuation discounts currently apply, but will be discontinued by the new regulations
  - Can use escalating payout: 20%, Shark Fin!

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## Inter Vivos CLTs in Wealth Docx



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## CLT Example | Consuela & Jorge

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- \$10,000,000 contributed to Charitable Lead Annuity Trust, invested at 6%
- Hurdle rate = 1.4%
- Income to charity - 20 years - total = \$11,536,000
- Remainder to Family – after 20 years = \$10,853,425
- Gift Tax = \$0
- Estate Tax = \$0
- If structured as a Grantor CLAT income tax deduction = \$10,000,000

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## CLT Example | Consuela & Jorge

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- \$10,000,000 contributed to Charitable Lead Annuity Trust, invested at 6%
- Discounted value = \$7 million
- Hurdle rate = 1.4%
- Income to charity - 20 years - total = \$8,075,200
- Remainder to Family – after 20 years = \$16,602,906
- Gift Tax = \$0
- Estate Tax = \$0
- If structured as a Grantor CLAT income tax deduction = \$7,000,000

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# Patrick Carlson

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## Outreach Strategies

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Who Can Benefit from this Information Now?

1. Existing Clients
2. Advisors

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## Resources

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1. Letter & Email Templates
2. Short Explanation Paper
3. Longer White Paper
4. PPT

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