American Bankers Association

ABA BRIEFING | PARTICIPANT'S GUIDE

Choose Your Weapon: The Advantages and Disadvantages of Corporations (C and S), LPs and LLCs

2015 Trust and Estate Planning Series

Thursday, October 1, 2015

Eastern Time	Central Time	Mountain Time	Pacific Time
1:00 p.m.–3:00 p.m.	12:00 p.m.–2:00 p.m.	11:00 a.m.–1:00 p.m.	10:00 a.m.–12:00 p.m.

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PROGRAM INFORMATION .... ENCLOSED

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PROGRAM OUTLINE

TIMES	SESSION AND SPEAKERS
12:45 – 1:00 p.m. ET	***Pre-Seminar Countdown***
1:00 – 1:03 p.m.	***Welcome and Introduction*** 1Source International
1:03 – 1:30 p.m.	***Basic Business Entity Options and Tax Attributes*** **Skip Fox,** *McGuireWoods LLP*
1:30 – 1:50 p.m.	***Operating as a C Corporation vs. a Flow-Through Entity*** ***Requirements for an S Corporation*** **Tom Abendroth,** *Schiff Hardin LLP*
1:50 – 2:00 p.m.	***Questions and Answers***
2:00 – 2:25 p.m.	***Special Attributes of LPs and LLCs*** **Skip Fox,** *McGuireWoods LLP*
2:25 – 2:50 p.m.	***Special Planning Considerations*** **Tom Abendroth,** *Schiff Hardin LLP*
2:50 – 3:00 p.m.	***Questions and Answers*** ***Wrap-up***

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Choose Your Weapon:
The Advantages and Disadvantages of Corporations (C and S), LPs and LLCs

2015 Trust and Estate Planning Briefing Series

American Bankers Association Briefing/Webinar
Thursday, October 1, 2015
1:00 – 3:00 p.m. ET

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Presenters

- **Thomas W. Abendroth,** Partner, Schiff Hardin LLP
- **Charles D. Fox IV,** Partner, McGuireWoods, LLP

Agenda

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- Basic Business Entity Options and Tax Attributes
- Operating as a C Corporation vs. a Flow-Through Entity
- Requirements for an S Corporation
- Special Attributes of LPs and LLCs
- Special Planning Considerations

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- The form of entity matters a great deal for tax and legal purposes.
- Impacts the tax burden and benefits to the owners, the legal protections available to owners against creditors, and the legal rights and obligations of owners to each other.
- The focus of these materials is on the impact form of entity makes on wealth transfer decisions.

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December 3	Recent Developments in Estate and Trust Administrations
Recordings Available	Hot Button Tax Issues for the IRS
	Ethical Challenges for Trust Professionals
	Show Me the Money: The Focus of States on Tax Revenues and its Impact on Estate Planning
	Fiduciary Litigation Roundtable
	Critical Concepts in Understanding Community Property vs. Common Law
	A Primer on Decanting
	Choose Your Weapon: The Advantages & Disadvantages of Corporations

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Apr 7, 2016	Life Insurance in a 21st Century Estate Plan
May 5, 2016	Fiduciary Litigation Roundtable
Jun 2, 2016	Charitable Tales from the Crypt
Sep 8, 2016	Issues with Art and Other Collectibles in the Administration of Trusts and Estates
Oct 6, 2016	Are You a Fiduciary?
Nov 3, 2016	Twenty Steps to Avoid Fiduciary Litigation
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Choose Your Weapon:

The Advantages and Disadvantages of

Corporations (C and S), LPs and LLCs

Thursday, October 1, 2015
1:00 p.m. to 3:00 p.m. E.T.

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CHOOSE YOUR WEAPON: THE ADVANTAGES AND DISADVANTAGES OF CORPORATION (C AND S), LPS AND LLCS

I. Introduction

A. For most consumers of products and services, the business entity form of the business is unimportant. If you hire the Webster Company, it does not matter to you if they are a corporation, a partnership, a limited liability company, or something else.

B. The form of entity matters a great deal for tax and legal purposes. The form of entity will impact the tax burden and benefits to the owners, the legal protections available to owners against creditors, the legal rights and obligations of owners to each other, and other aspects of operating the business. Form of entity also matters a great deal to lenders, and to potential purchasers of a business.

C. These materials will review the primary attributes of, and differences between, the major alternative structures for business entities.

1. The outline does not explore all the tax and business ramifications in detail. Many resources on this topic are available to a business owner or a person starting a business.

2. Rather the outline focuses on those particular attributes of the major business entity alternatives that impact wealth transfer, including taxation of distributions, creditor protection aspects, the use of trusts and the unique planning opportunities that exist with some entities.

II. Basic Business Entity Options

A. State Law Entities

1. In the United States, business entities are creatures of state law. Each state's statutory regime dictates what entities can be formed under the laws of the state and what the requirements are to create and operate the entity.

2. An entity formed in one state generally can operate in any other state, provided it satisfies any state registration and licensing requirements for engaging in activities in the state.

3. The primary business entity options are:

- Corporation
- Limited Partnership

- Limited Liability Company
- General Partnership
- Limited Liability Partnership
- Business Trust

4. The General Partnership is not a common way of conducting business, since all the participant owners retain liability for the debts and obligations of the partnership. The Limited Liability Partnership and Business Trust and less common forms of doing business, and will not be discussed in these materials.

    a. The Limited Liability Partnership is most frequently used by law and accounting, or other professional service firms. Some states limit the use of LLPs to such businesses.

    b. The Business Trust, or statutory trust, is a legal entity set up for business purposes. It historically is used by mutual funds and investment fund businesses, or as a special purpose entity. For tax purposes, it usually is treated as a corporation.

5. Two other forms of doing business frequently mentioned in the literature are joint ventures and sole proprietorships. Neither are entities.

    a. The term joint venture is used to refer to a contractual arrangement between two people, or, more commonly, business entities. The parties may create one of the aforementioned entities to carry on the joint venture's business.

    b. A sole proprietorship references an individual doing business without an entity. The person reports business income and deductions on Schedule C of his or her income tax return. From a tax and liability standpoint, it is not recommended that a person conduct business this way.

B. Corporation

1. The corporation is the most long-standing and well-defined entity. It is the most common form of doing business for large public businesses.

2. The ownership interests in a corporation are denominated in shares, and the owners are shareholders. There may be multiple classes of shares, with different attributes, such as voting rights, dividend rights or liquidation rights.

3. A corporation is formed by filing Articles of Incorporation (or a Certificate of Incorporation) with the state in which the entity is being incorporated. This document and by-laws provide the basic governance terms and define the rights of the parties.

4. State law typically requires designation of directors, who are fiduciarily responsible for the operation of the corporation, and designation of one or more officers.

5. State statutes

   - California – General Corporate Law. Cal Corp. Code §§ 100 et seq.

   - Illinois – Business Corporation Act. 805 ILCS 5/6.01 et seq.

   - New York – Bus. Corp. Law §§ 101 et seq.

   - Virginia – Stock Corporation Act. Va. Code §§ 13.1-601 et seq.

6. Most states also have a separate Not For Profit Corporation Act. See, e.g. Nonprofit Corporation Law, Cal. Corp. Code § 5000 et seq.; Illinois General Not For Profit Act. 805 ILCS 105/101.01 et seq.; N.Y. Not-for-Profit Corp. Law, §§ 101 et seq. Many states also have separate statutes for special purpose corporations, such as religious corporations or professional service corporations.

7. An S corporation is not a separate state law entity. It is a form of state law corporation defined by federal tax law.

C. Limited Partnership

1. A limited partnership ("LP") is a business entity owned two or more people or entities, referred to as partners. One partner must be a general partner, liable for the debts and obligations of the business. Limited partners are not subject to this obligation, provided that they do not participate too extensively in the management of the business.

2. The equity interests of the partners are represented by partnership interests. The partnership interests can be denominated in percentages, units, or even shares. There can be multiple classes of partnership interests. In fact, there is far more flexibility in structuring classes of equity in a partnership with different rights, priorities and obligations.

3. A limited partnership is formed by filing a formation document with the state. In many states, this is called a Certificate of Limited Partnership but

the name varies. A Limited Partnership Agreement governs the rights of the partners and operation of the entity.

4. By definition, the General Partner will control the day-to-day management of the partnership. State law typically gives the General Partner very broad authority to act.

   a. The limited partnership agreement may limit the General Partner's authority, including by requiring that certain extraordinary actions be subject to a vote of the partners and/or by giving the limited partners the right to remove the General Partner.

   b. The limits cannot be so constraining that the limited partners would be treated as having active management authority. As noted above, that could eliminate the liability protection of those partners.

5. State Statutes

   - California – Uniform Limited Partnership Act. Cal Corp Code § 15900 et seq.

   - Illinois – Uniform Limited Partnership Act. 805 ILCS 215/.01 et seq.

   - New York – Revised Limited Partnership Act §§ 121.101 et seq.

   - Virginia – Revised Uniform Limited Partnership Act. Va. Code § 50-73.1, et seq.

D. Limited Liability Company

1. The limited liability company ("LLC") developed as an alternative to the limited partnership. The LLC first became available in Wyoming in 1977. The LLC and LP are treated identically for federal tax law purposes. The primary distinguishing characteristic of a limited liability company versus a limited partnership is that all its owners are protected from the liabilities of the entity, regardless of the level of their participation. It provides all the favorable attributes of a limited partnership, without the need for a General Partner. In effect, all the LLC members are limited partners.

2. A limited liability company is formed by filing the operative formative document with the state – in many states called Articles of Organization. An Operating Agreement governs the rights of the partners and the operation of the entity.

3. A limited liability company can have a single member (in which it is disregarded for federal income tax purposes), or multiple members.

4. As with a partnership, the members' ownership interests can be denominated in percentages, units or shares. The LLC, like the LP, can have multiple classes of equity with a wide variety of rights.

5. An LLC can be member-managed or Manager-managed. The Manager role is similar to that of the General Partner, but with a couple of differences.

   a. The Operating Agreement can give the members much greater involvement in major decisions than the limited partners can have in a limited partnership. The Manager role in these cases may be more limited.

   b. The Manager need not have an ownership interest in the LLC.

6. State Statutes

   - California – Revised Uniform Limited Liability Company Act. Cal. Corp. Code §§ 17701.01, et seq.

   - Illinois – Limited Liability Company Act. 805 ILCS 1801/1-1, et seq.

   - New York – Limited Liability Company Law §§ 101, et seq.

   - Virginia – Limited Liability Company Act. Va. Code § 13.1-1000, et seq.

III. <u>Tax Attributes of Corporations, LPs and LLCs</u>

A. C Corporation

1. A C corporation is a separate taxable entity. It pays federal tax on its net income.

2. The highest marginal tax rate for corporations is 35%. It is 34% for corporations earning less than $10 million. The tax table for corporations is as follows:

Taxable Income over	Not over	Tax rate
$ 0	$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%

10,000,000	15,000,000	35%
15,000,000	18,333,333	38%
18,333,333	…..………	35%

3. Shareholders are taxed on distributions from the corporation. Except in certain limited situations, the distributions from a domestic corporation will be treated as qualified dividends, subject to a top rate of 20% (plus the 3.8% Medicare tax if applicable).

4. The double tax for distributed C corporation income results in an aggregate effective tax rate of 49.71%, for a corporation in the 34% bracket and a shareholder in the top bracket. In this situation, $1,000,000 of income would be taxed as follows:

Taxable income	1,000,000
Income tax (34%)	(340,000)
Net income for distribution	$660,000
Tax on dividend (23.8%)	(157,080)
Net funds for shareholders	$502,920

5. Double taxation also exists upon liquidation of a C corporation. The corporation is taxed on appreciated property held by the corporation, and there is capital gain tax at the shareholder level to the extent proceeds or assets received exceed the shareholders' basis in the stock.

   a. The tax consequences are substantially the same regardless of whether the corporation sells all of its assets and distributes the proceeds in liquidation, or distributes the assets in-kind as part of the liquidation.

   b. A shareholder's basis in his or her stock will equal the amount of cash and the basis of property transferred to the corporation, reduced by any liabilities of the shareholder assumed by the corporation.

B. S Corporation

1. The Subchapter S corporation is a creation of tax law. State corporate law generally does not distinguish between forms of for-profit corporations. The federal tax law allows owners to choose between C corporation status and S corporation status.

2. An S corporation generally calculates its income and permissible deductions in the same way as a C corporation. However, it does not pay federal income tax on that income. Instead, the income is passed through and taxed to the shareholders, similar (but not identical) to the pass-through of partnership income to its partners. The provisions governing qualifications as an S corporation, electing S corporation treatment, and

the tax treatment of the corporation and its shareholders, are found in Subchapter S of the Code, Sections 1361 to 1379.

3. To the extent the S corporation rules do not apply, an S corporation is treated in the same manner as a C corporation. Many of the rules governing C corporations, such as those related to reorganizations, apply to S corporations as well.

   a. The tax treatment upon liquidation of an S corporation will be different. Ignoring for the time-being those S corporations that have converted from C corporation status (discussed later), the tax consequences of liquidation all will be at the shareholder level.

   b. The shareholder will realize gain on any appreciated property distributed by the corporation or sold by it prior to liquidation. The shareholder also recognizes gain to the extent proceeds or assets received exceed the shareholder's basis.

   c. The major difference is that the basis of a shareholder of an S corporation is adjusted by taxable income allocated to the shareholder. Thus, the gain realized on assets inside the corporation is added to the basis of the shareholders. This prevents double taxation when the proceeds or assets are distributed.

   EXAMPLE: A and B form an S corporation by each contributing $100. Thus, A and B each have a beginning basis of $100 for their interests. If the S corporation later sells its assets to a third party for $1,000, $800 of gain is recognized. This increases the basis of A and B to $500 each. If the corporation then liquidates and distributes $400 to each of A and B, neither has additional gain.

4. The purpose of Subchapter S was to give taxpayers the option to use the familiar corporate form, with limited liability for all owners and the well-established body of state law, while using the flow-through tax treatment available up until then only to partnerships. In order to prevent taxpayers from using S corporation status to spread the corporate income too broadly among many taxpayers, Congress and the IRS created restrictive rules on the number and type of shareholders of S corporations.

5. Section 1361(b)(1) sets out the requirements that must be satisfied in order for a corporation to elect and maintain S corporation status.

   a. No more than 100 shareholders;

   b. No shareholders other than individuals, estates, certain trusts, and, as of January 1, 1998, certain tax-exempt organizations. The only tax-exempt organizations that qualify are charitable organizations

described in Section 501(c)(3) and qualified retirement plans described in Section 401(a);

c. No nonresident alien shareholders; and

d. No more than one class of stock (for these purposes, differences in voting rights among the shares of common stock are disregarded).

6. In addition, a few types of corporations are not eligible for S corporation status, including:

a. A financial institution that uses the reserve method of accounting;

b. An insurance company taxed under subchapter L of the Code;

c. A corporation claiming the Puerto Rico and possessions tax credit; or

d. A DISC (Domestic International Sales Corporation) or former DISC.

7. If the foregoing requirements are met, all shareholders must consent to making the S election before the election can be validly made (IRC § 1362(a)). Once the election has been made, it applies for all succeeding taxable years, so long as the corporation continues to meet the qualifying requirements. The election also can be voluntarily revoked in certain limited cases.

C. LPs and LLCs

1. Both LPs and LLCs are taxed under the federal partnership tax rules. As such, they are flow-through entities. The income and separately stated deductions of the entity are passed through to the owners.

2. LPs and LLCs are not subject to any restrictions on the number or identity of owners, as S corporations are.

3. Partially offsetting this flexibility is the complexity of the partnership tax rules. The partnership tax provisions are one of the more complex subchapters of the Internal Revenue Code.

a. There are many special rules for capital contributions, distributions and dissolution that can create unexpected income taxes if the partners and their tax advisors are not careful.

b. For example, entities taxed as a partnership are subject to disguised sale rules under Code Section 707(a)(2)(B). These rules can result

in a contributing partner or member recognizing gain when appreciated property is contributed.

4. The owner of an LP or LLC interest, like a shareholder in an S corporation, will have a basis in his or her interest that changes with allocations of taxable income or loss, and distributions.

   a. The initial basis of a member or partner equals the amount of cash and the basis of property transferred, less liabilities assumed.

   b. Unlike an S corporation, the basis of a partner or member includes his or her share of entity debt.

   c. Basis is increased by income allocations to the partner or member, and decreased by allocations of losses and by distributions.

5. Partnership tax also is unique in that it allows the LP or LLC to elect to have the basis step up of a deceased partner's interest applied to the assets inside the partnership. This is the Section 754 election. The benefit of the election only applies for purposes of determining gain allocable to the deceased partner's interest. It requires the entity to thereafter keep, in effect, two sets of books. And once the election is made by the entity, it must continue to be applied. So it could later cause a step-down in inside basis in a later estate. Nevertheless, it can be a distinct benefit in a family LP or LLC.

D. State Tax Law

1. Tax advisors also must be cognizant of the application of state tax law to entities.

2. States generally follow the federal tax law with respect to C corporations. But some do not have a corporate income tax.

   a. Ohio, Texas and Washington do not have a corporate income tax, but do impose a gross receipts tax on businesses.

   b. Nevada, South Dakota and Wyoming do not impose any form of corporate tax.

3. The spread between the state corporate tax rate and the state tax rate applicable to individuals who are owners of a flow-through entity (S corporation, LP or LLC) may tip the scale of overall tax burden in one direction or the other.

4. An S corporation, LP or LLC operating a multi-state business will need to apportion its income among the states, and will have multiple state income

tax filing requirements. This adds to the tax reporting complexity both for the entity and its owners.

5. Some states do not recognize S corporations and will tax the corporation under their C corporation rules.

6. Some states impose entity level taxes on flow-through entities. For example, Illinois imposes a 1.5% "replacement tax" on the income of partnerships and S corporations. Beginning in 2005, Illinois exempted investment partnerships from the replacement tax. An investment partnership is one in which 90% or more of the cost of its investments are in qualified investment securities, bank deposits, and similar investment assets, and 90% or more of its income is derived from such sources.

IV. Operating as a C Corporation vs. a Flow-Through Entity

A. Historical and Business Considerations

1. A family operating business that has been in existence for multiple generations likely started as, and still may be, a C corporation.

2. As noted earlier the corporation historically was the most accepted and best understood form of doing business. And, if corporate form was chosen for an entity, C corporation status was the only option until the late 1950's when the first S corporation tax legislation was enacted.

3. For an existing or newly formed business, non-tax consideration may dictate the form of the entity. The desire of the owner(s) for a certain organizational, management and capital structure; the anticipated need to raise capital in the future; foreign tax issues; and employment related issues, among many others, all may impact the choice.

4. The operations and cash needs of the business also may impact the tax-related considerations, as discussed below.

B. Impact of Tax Rates

1. The double taxation of the distributed income of a C corporation means that the federal income burden will be higher in a C corporation than a flow-through entity.

   EXAMPLE: Assume two identical entities, one a C corporation in a 34% marginal tax bracket, and one a flow-through entity, both with an owner in the highest individual tax bracket, who is subject to the 3.4% Medicare tax.

	C Corporation	Flow-Through
Ordinary net income from operations	$1,000,000	$1,000,000
After-tax distributable income	660,000	1,000,000
Income tax to owner on distribution	(157,080)	(434,000)
Net funds for owner	$502,920	$566,000

2. This gap has narrowed significantly with the increase in federal individual income tax rates in 2013. As noted earlier, state income tax will further impact the result.

3. The higher income tax burden, combined with the double tax impact on dissolution of the corporation or a sale of its assets, makes the C corporation a clear underdog in the tax analysis.

4. The result is different if the business has significant taxable income and high cash flow needs. If the business is not going to make distributions, the corporate tax rate compares favorably to the highest individual rates.

    a. A business that traditionally reinvests its profits may want to be a C corporation.

    b. Likewise, a corporation that must use a significant share of its profits to pay down debt may prefer to remain a C corporation.

C. Conversion to S Corporation Status

1. The shareholders of a C corporation can elect to convert to an S corporation, provided that the shareholder rules for S status can be satisfied, and the corporation has one class of stock.

2. Congress did not want taxpayers to be able to convert a corporation to S status and then immediately be able to liquidate and avoid double taxation.

    a. Section 1374(d)(7) requires the S corporation to pay corporate level tax on any built-in gain when realized for five years after the first day of the first tax year that the corporation converts to S status. The time period originally was ten years.

    b. Built-in gain is the excess of the fair market value of the corporation's assets over their adjusted basis at the time of the election.

    c. It is important for a corporation making the conversion to have accurate values for its assets, supported by appraisals, at the time of the conversion, to establish the amount of built-in gain.

3. Conversion also can be an issue if the corporation has significant amounts of passive income and accumulated earnings and profits form when it was a C corporation. Under Section 1375, the S corporation will be subject to a corporate level tax on excess passive income to the extent it exceeds 25 percent of its total gross receipts.

   a. A corporation can avoid this tax if it distributes all of its accumulated C corporation earnings and profits to its shareholders.

   b. This of course can be an expensive proposition. Another option is to have the corporation invest in an active business. Publicly traded MLPs can sometimes be used to avoid the tax on passive income.

V. Requirements for An S Corporation

A. Limit on Number of Shareholders.

1. Congress has increased the limit on the number of shareholders for S corporations several times. In 1996, it increased the limit from 35 to 75. Effective for tax years after December 31, 2004, it increased the number of permissible shareholders to 100. These changes have made S corporations accessible in far more situations.

2. With the last change, Congress also allowed members of a family to be treated as one shareholder (IRC § 1361(c)(1)). This treatment is obtained by making an election to treat the family group as one shareholder.

3. A husband and wife (and their estates) also are counted as a single shareholder.

4. A family is defined as a common ancestor, the lineal descendants of that common ancestor, and the spouses (or former spouses) of the common ancestor and his or her lineal descendants. The common ancestor is the person identified as of the effective date of the statutory change, or if later, the corporation's S election, who is not more than six generations above the family's youngest generation of shareholders (IRC § 1361(c)(1)(B)).

   a. The rule applies whether family members hold stock directly or are treated as a shareholder because they are a beneficiary of a trust that can hold S corporation stock.

   b. The common ancestor does not have to be alive when the election is made.

   c. Once the common ancestor is identified and the election made, future generations can become shareholders and be treated as

members of the family even if they are more than six generations lower.

d. A legally adopted child is treated as a child related by blood.

5. The family shareholder election does not waive any of the other requirements for electing S corporation status. For example, a nonresident alien will not qualify as a shareholder even if he or she is a member of a family for which the family shareholder election has been made.

B. Trusts That Can Hold S Corporation Stock. Section 1361(c)(2) specifies six types of trusts that will qualify as S corporation shareholders:

1. A voting trust;

2. A trust, all of which is treated as owned by an individual who is a citizen or resident of the United States under the grantor trust rules of Sections 671-678 (a "grantor-type trust");

3. A trust for which a Qualified Subchapter S Trust ("QSST") election is made, which is then treated as a grantor-type trust as to the income beneficiary.

4. A trust that was a grantor-type trust (including a QSST for which a qualified election was made) immediately before the death of the deemed owner and that continues in existence after that person's death, but only for a period of two years;

5. An otherwise nonqualifying trust to which stock was transferred pursuant to a shareholder's will, but only for a period of two years beginning on the date of transfer; and

6. An Electing Small Business Trust ("ESBT"), defined under Section 1361(e), for which a qualifying election is made.

C. Deemed Owner of S Corporation Stock Held in Different Types of Trusts. Generally, when a qualifying trust owns shares of S corporation stock, the trust itself is not treated as the shareholder either for purposes of the 100 shareholder test or (except for an ESBT) for income tax purposes.

1. This avoids interfacing the income taxation rules for S corporations with those for trusts.

a. The rules of Subchapter J of Chapter 1 of the Code relating to taxable income, distributable net income, distributions, and other trust income tax concepts normally do not apply to S corporation income where the stock is held in trust.

b. Instead, all income, loss, deductions, and credits attributable to the trust's stock are treated as belonging to the deemed shareholder. This has important tax and fiduciary accounting ramifications, discussed later.

2. In the case of a voting trust, each beneficiary of the trust is treated as a shareholder of the corporation.

3. In the case of a grantor-type trust, the deemed owner (usually the grantor) of the trust is treated as the shareholder.

4. In the case of a QSST, the current income beneficiary of the trust is treated as the shareholder.

5. In the case of an ESBT, each current beneficiary of the trust is treated as the shareholder for purposes of meeting the 100 shareholder requirement, but the ESBT, and not any beneficiary of the ESBT, will be taxed on the ESBT's share of S corporation income.

6. In the case of a grantor-type trust after the death of the deemed owner, the estate of the deemed owner is treated as the shareholder for purposes of Section 1361 until the earlier of the disposition of the stock or the expiration of the two-year period during which the trust will be a qualifying shareholder. The trust is treated as the shareholder for federal income tax purposes.

7. In the case of a trust to which stock is transferred pursuant to a will, the estate of the testator again is treated as the shareholder until the earlier of the disposition of the stock or the expiration of the period during which the trust will be a qualifying shareholder. In these cases, the regulations indicate that the estate is considered the shareholder only for purposes of determining whether the corporation qualifies for the S election, and the trust itself is treated as the shareholder for income tax purposes (Treas. Reg. § 1.1361-1(h)(3)(ii)(A)).

D. Grantor-Type Trusts. For S corporation purposes, a qualifying grantor-type trust is a trust, all of which is treated under the grantor trust income tax rules as owned by an individual who is a citizen or resident of the United States (Treas. Reg. § 1.1361-1(h)(1)(i)).

1. Various grantor-type trusts may qualify as S corporation shareholders under this requirement, including:

a. A trust in which the grantor has a reversionary interest whose value exceeds 5 percent of the value of the trust as of the date of creation;

b. A trust in which the grantor has the power to control beneficial enjoyment;

c. A trust in which the grantor has certain borrowing or administrative powers;

d. A trust in which the grantor has a power of revocation; and

e. A trust in which the grantor or his spouse is entitled to receive distributions of income and corpus.

2. Various types of trusts used in estate planning qualify as grantor trusts and therefore are permissible S corporation Shareholders:

a. A Grantor Retained Annuity Trust (“GRAT”);

b. A Grantor Retained Income Trust (“GRIT”), which still can be created by a person with no descendants; or

c. An irrevocable grantor trust.

3. Certain trusts in which a person other than the grantor has a power to vest the income or corpus in himself also may constitute a qualifying grantor trust, provided that the entire corpus is treated as owned by the beneficiary (Treas. Reg. § 1.1361-1(k)(1), Example 2(iii)).

a. A beneficiary with a general inter vivos power to appoint all of the trust principal to himself or to withdraw it for himself is treated as the grantor for income tax purposes under § 678(a), and therefore a qualifying grantor-type trust for S corporation purposes.

b. The power must exist as to all of the principal, not just the S corporation stock.

c. A trust with a Crummey power of withdrawal in one beneficiary could qualify, if the power extends to all trust principal (see Letter Ruling 9140047 (July 2, 1991)). If the power might not extend over all contributions to the trust, it might still qualify as a QSST or ESBT.

4. If the trust ceases to be a grantor-type trust upon the deemed owner’s death, his estate is thereafter treated as the shareholder for purposes of Section 1361 if the trust continues in existence. As stated earlier, the trust will continue to qualify to hold the stock for at least two years after the deemed owner’s death.

E. Electing Small Business Trusts. An ESBT may have multiple beneficiaries and may accumulate income for future distribution. The ESBT, and not the

beneficiaries of the ESBT, will be taxed on the trust's share of the S corporation's income.

1. Definition of ESBT.

   a. All of the beneficiaries of the trust must be individuals, estates, or (after December 31, 1997) charitable organizations.

   b. The trust must not be a QSST or a trust exempt from taxation. (This requirement disqualifies charitable remainder trusts.)

   c. No beneficiary may have acquired an interest in the ESBT by purchase. Only interests that are the result of gift, inheritance, or other nonpurchase transactions are permitted.

   d. The trustee of the trust must elect ESBT treatment. IRS Notice 97-12 (1997-1 C.B. 385) and Treas. Reg. § 1.1361-1(m)(2) list the information that is required to be included in an ESBT election.

2. Qualified Beneficiaries

   a. For purposes of determining whether a trust can qualify as an ESBT, any beneficiary with a present, remainder or reversionary interest in the trust is considered.

   b. However, an object of a power of appointment is not considered a beneficiary of an ESBT until the holder of the power of appointment exercises the power in favor of that object (Treas. Reg. § 1.1361-1(m)(1)(ii)).

   c. A trust may have one or more successor trusts that are beneficiaries. For example, a trust may require that its property be added to another trust on termination. Or, property distributed to a minor may be added to a trust for the minor pursuant to a facility of payment clause. The existence of the trust as a beneficiary will not disqualify the original trust as an ESBT.

      (1) The regulations provide that a "distributee trust" (other than a charitable trust) will not itself be treated as a beneficiary of an ESBT.

      (2) Instead, the IRS will look through the distributee trust and treat any person who has a beneficial interest in it as a beneficiary of the ESBT (Treas. Reg. § 1.1361-1(m)(1)(ii)(B)).

      (3) Thus, a trust that provides for the discretionary distribution of principal and interest to A for life, then for the division

of the trust corpus into separate, existing trusts for A's children, will meet the requirements for an ESBT because A's children will be treated as beneficiaries, not the separate trusts for A's children.

d. Notice 97-49 states that a person whose contingent interest in the trust is so remote as to be negligible is not a beneficiary of an ESBT for purposes of Section 1361(e)(1)(A)(i).

3. Interest Acquired by Purchase

a. A person is treated as acquiring an interest by purchase in a trust if any portion of the basis in the acquired trust interest is determined under Section 1012 of the Code (Treas. Reg. § 1.1361-1(m)(1)(iii)).

b. An interest in a trust acquired in a part sale/part gift transaction would be treated as an interest acquired by purchase.

4. Potential Current Beneficiary

a. A "potential current beneficiary" of an ESBT is any person who is entitled to, or at the discretion of any person may receive, a current distribution from the principal or income of the trust (IRC § 1361(e)(2); Treas. Reg. § 1.1361(m)(4)).

b. The definition is important because each potential current beneficiary is treated as a shareholder of an S corporation for purposes of determining whether the S corporation meets the requirement of having no more than 100 shareholders.

c. The test regarding the 100 shareholder limit is distinct from the test whether the trust qualifies as an ESBT. A person may be considered a beneficiary for purposes of the ESBT rules but not a potential current beneficiary of the ESBT for purposes of the 100 shareholder limit.

d. The distinctions are particularly important with respect to powers of appointment. Although a person who may receive trust property pursuant to a <u>lifetime</u> power of appointment is not a beneficiary under the ESBT qualification rules until the power is exercised, such person is treated as a potential current beneficiary, even though the power has not been exercised.

(1) This rule applies only to a lifetime power. Persons who may receive property only pursuant to a <u>testamentary</u> power of appointment will not be treated as potential current beneficiaries until the power is exercised.

(2) A broad, lifetime, special power of appointment, pursuant to which property can be appointed among unlimited appointees (other than the holder of the power, his or her estate, and the creditors of either) will result in an unlimited number of potential current beneficiaries, each of which will be treated as S corporation shareholders. Since this will clearly cause the 100-shareholder limit to be exceeded, any ESBT holding S corporation stock and granting a lifetime broad special power of appointment will cause the immediate termination of the S election.

e. During any period that there is no potential current beneficiary of an ESBT, the trust shall be treated as the shareholder for purposes of the 100 shareholder test (Treas. Reg. § 1.1361-1(m)(4)(vii)).

f. If current distributions can be made to a distributee trust, and the trust does not qualify to be a shareholder of an S corporation, then the distributee trust will be considered to be a potential current beneficiary, and therefore a shareholder. In that case, the corporation's S election would terminate.

(1) For this purpose, a distributee trust is deemed to qualify to be a shareholder if it would be eligible to make a QSST or ESBT election if it held S corporation stock.

(2) If the distributee trust does qualify to be a shareholder of an S corporation, then the potential current beneficiaries of the distributing ESBT will include the potential current beneficiaries of the distributee trust.

(3) However, if the distributee trust is a former grantor trust prior to the owner's death, or is a trust receiving a distribution of S corporation stock from a decedent's estate, the estate of the decedent is treated as the only potential current beneficiary.

g. In no case will the same person be counted twice for purposes of determining the 100 shareholder limit. Thus, a person who is a current potential beneficiary of an ESBT and who also owns stock in the S corporation directly is counted as one shareholder.

F. <u>Qualified Subchapter S Trusts</u>.

1. To qualify as a QSST, a trust must meet four basic requirements (IRC § 1361(d)(3)).

a. The trust may have only one current income beneficiary, who must be a citizen or resident of the United States.

b. All of the trust income (not just that generated by S corporation stock) as defined in Treasury Regulation § 1.643(b)-1 (i.e., trust accounting income), must be distributed currently to that beneficiary.

c. Any corpus distributed during the current income beneficiary's life must be distributed to that beneficiary.

d. Each income interest in the trust must terminate upon whichever event occurs earlier, the death of the current income beneficiary or the termination of the trust.

2. Since only one income beneficiary is permitted, and the income beneficiary must receive any corpus distributions, a provision under which income or principal may be distributed among a class of beneficiaries is prohibited. Note, however, that the QSST may provide for successive income beneficiaries, after the death of the initial beneficiary (but each present interest segment of the trust must meet the same exclusive life interest rules in order to remain a QSST).

3. The requirement that all income must be distributed focuses on trust accounting income, not taxable income. Trust accounting income will be defined by local law.

   a. In this regard, the regulations indicate that the trust instrument need not mandate that all income be distributed currently so long as the trust in fact distributes all of its income annually (Treas. Reg. § 1.1361-1(k)(1) Example 4).

   b. The 65-day rule of Section 663(b) will apply to a QSST, so that the trustee may elect to treat any amount of income that is properly paid to a beneficiary within the first 65 days following the end of the taxable year as if properly paid on the last day of that taxable year (Treas. Reg. § 1.1361-1(j)(1)(i)).

4. The trust also must be drafted to preclude the possibility that it will not meet the qualification requirements. Thus, for example, the trust may not provide that corpus can be invaded or distributed upon termination in favor of someone other than the current income beneficiary, if the trust does not hold S corporation stock (Treas. Reg. § 1.1361-1(j)(1)(iii)). Separate shares in a single trust may qualify if they would be treated as separate shares under Section 663(c) (Treas. Reg. § 1.1361-1(j)(3)).

5. If the trust ceases to qualify because of the death of the income beneficiary and there is no successor, the estate of the deceased beneficiary is treated as the shareholder, and the two-year rule that applies to grantor-type trusts at the death of the deemed owner will apply (Treas. Reg. § 1.1361-1(j)(7)(ii)).

6. If there is a successor income beneficiary, that beneficiary is bound by the election of the predecessor unless he or she affirmatively refuses to consent (IRC § 1361(d)(2)(B)(ii)). However, this rule does not apply to the income beneficiary of a trust created at the death of the income beneficiary that receives a pour-over distribution of S corporation stock from the qualified trust. Such a trust is treated as a new, different trust that must separately elect. (Treas. Reg. § 1.1361-1(j)(9)(i)). The affirmative refusal to consent must be filed within 2 months and 15 days after the date on which the successor income beneficiary became the income beneficiary, and is effective as of the latter date.

7. A number of different types of trusts may meet the requirements for a valid QSST. These include:

   a. A general power of appointment or testamentary QTIP marital deduction trust;

   b. A unified credit shelter trust, so long as there is only one current income beneficiary, such as the surviving spouse, and income is distributed at least annually (however, the trust may not contain a provision permitting principal to be invaded for anyone other than the income beneficiary);

   c. A minor's annual exclusion trust meeting the requirements of Section 2503(c), so long as all of the trust income is distributed at least annually;

   d. A trust which provides that all income be distributed annually to a single beneficiary until the trust no longer holds S corporation stock, after which the income can be accumulated or, alternatively, the trust will be terminated (note, however, that the trust cannot be terminated in favor of a beneficiary other than the designated income beneficiary) (<u>see</u> Revenue Ruling 89-55, 1989-1 C.B. 268);

   e. A trust which provides that the income will be paid to three living beneficiaries in equal shares (each share would be treated as a separate trust; <u>see</u> Letter Ruling 8737038 (June 15, 1987)); and

   f. A variety of trusts in which the trustee can pay or accumulate income, so long as there is only one income beneficiary, and the trustee in fact pays out all of the income each year.

VI. <u>Special Attributes of LPs and LLCs</u>

A. There are a number of special attributes of LPs and LLCs that may come into play in the selection of entity. Two that are particularly relevant to wealth transfer planning are mentioned here.

B. Classes of Equity Interests

1. As noted, corporate law allows for multiple classes of interests. A C corporation potentially can have an unlimited number of classes of interests, with unique attributes, such as preferred stock, and stock with super-voting or special dividend rights.

2. If a flow-through entity is desired, however, the owners need to use an LP or LLC to create different classes of equity ownership. An S corporation can only have common stock, and the only allowed difference in attributes is with respect to voting rights.

3. Moreover, as mentioned, the law regarding LPs and LLCs is much more flexible, allowing owners to agree to create unique classes of interests not normally found in the corporate context.

   a. LPs and LLCs are the favored form of business for real estate investment deals, real estate and private equity investment funds, and hedge funds because of the unique classes of interests that can be created.

   b. It is the LP or LLC structure that allows for the creation of a carried interest – a special percentage right to profits.

   c. Many investment structures also create preferred interests that maintain that status only until capital is returned, waterfall provisions, springing profit participation interests and interests in which the right to profits shifts depending on the investment return that has been received.

4. These options available with LPs and LLCs are important in business and investment structures among third parties. They have more limited use in family investment vehicles because the special attributes invariably run afoul of Section 2701 of the Code.

   a. Section 2701 creates a special valuation rule for family transfers that, in simple terms, can cause a senior or preferred equity interest to be valued at zero for purposes of valuing transfers of junior equity interests, if the distribution rights for the senior equity interests are not cumulative and paid regularly.

   b. The Section 2701 rules were written to apply to the fairly straight-forward preferred and common stock interests most commonly used by corporations, or the partnership equivalent of those interests. It is extremely difficult to discern how the rules apply to the more complex equity interests found in LPs or LLCs used in today's business world. Thus uncertainty in itself prevents estate

planners from using these more unique forms of equity interests in family LPs and LLCs.

c. Section 2701 does not impact most venture capital or hedge fund structures because the principals are unrelated parties. It can, however, come into play when planning for a client who is a principal in one of these businesses and who wants to transfer some of their interests to a trust for descendants.

C. Creditor Protection

1. A corporation, LP or LLC can have contractual provisions that limit the transfer of its interests. Buy-sell agreements can be contained in the governing documents or entered into as separate contracts among the owners.

2. There is a difference in the impact of an involuntary transfer of stock in a corporation versus interests in an LP or LLC.

a. A transferee who acquires stock in an involuntary transfer (for example, incident to a divorce, or as a result of a creditor's foreclosure on the interest) becomes a shareholder with all the rights of any other shareholder.

b. The rights of a transferee who acquires an LP or LLC interest are more limited. This is an advantage of the LP or LLC form of entity that many wealthy families find attractive.

D. Rights of a Transferee of an LP or LLC Interest.

1. Under the typical limited partnership act, the interest of limited partner has the following attributes:

a. A partner's interest in an LP is personal property and is not an interest in specific assets of the LP;

b. An assignee will not become a partner of the LP without the unanimous consent of the other partners; and

c. An assignee who is not a partner is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LP.

2. LLC statutes generally contain the similar types of provisions.

3. These attributes provide protection against creditors of a member or partner who are seeking assets to satisfy a debt or judgment. The

protection derives from the limited rights granted to the assignee of a member or partner.

4. For a limited partnership, almost every state enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"), which was promulgated by the National Conference of Commissions on Uniform State Laws in 1976 and amended in 1985. RULPA restricted the rights of a creditor of a limited partner by limiting the remedy available to that creditor.

   a. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. An assignment does not dissolve the limited partnership or entitle the assignee to become or exercise any of the rights of a limited partner.

   b. Under RULPA, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides:

      > "On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest."

5. The creditor protection provisions of the Revised Uniform Limited Liability Company Act ("RULLCA") were patterned after RULPA, but with greater detail.[1] Section 503 of RULLCA provides as follows:

   > SECTION 503. CHARGING ORDER.
   >
   > (a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable

[1] The National Conference on Uniform Laws replaced RULPA with a new Uniform Limited Partnership Act in 2001. The new Act in turn incorporated much of the more detailed provisions of RULLCA, including the specific provisions about foreclosure on a transferee interest. The new ULPA has been adopted in whole or in part in 18 states and the District of Columbia. Illinois is one of those states.

interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders that the circumstances of the case may require to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to Section 502.

(d) At any time before foreclosure, the member or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure, a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(f) This [act] does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.

(g) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment out of the judgment debtor's transferable interest.

6. Most state LLC statutes contain charging order sections similar to that found in the RULPA or the RULLCA. The Illinois charging order statute is below:

> Illinois (805 ILCS 180/30-20):
>
> "(a) On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's share of profits and right to distributions with payment of the unsatisfied amount of the judgment with interest. To the extent charged, the judgment creditor has only the rights of an assignee. This Article shall not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company.
>
> (b) A charging order constitutes a lien on the judgment debtor's distributional interest. The court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time. A purchaser at the foreclosure sale has the rights of a transferee.
>
> (c) At any time before foreclosure, a distributional interest in a limited liability company that is charged may be redeemed:
>
> (1) by the judgment debtor;
>
> (2) with property other than the company's property, by one or more of the other members; or
>
> (3) with the company's property, but only if permitted by the operating agreement.
>
> (d) This Act does not affect a member's right under exemption laws with respect to the member's distributional interest in a limited liability company.
>
> (e) This Section provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.

7. Delaware also follows the general approach of the Uniform Act, but with a very important change. In Delaware, there is no right to foreclose on the interest under the statute. The charging order is the exclusive remedy. Several other states have followed this approach.

Delaware (Del. Code tit. 6, §18-703):

> "(a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment. To the extent so charged, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled in respect of such limited liability company interest.
>
> (b) A charging order constitutes a lien on the judgment debtor's limited liability company interest.
>
> (c) This chapter does not deprive a member or member's assignee of a right under exemption laws with respect to the judgment debtor's limited liability company interest.
>
> (d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest.
>
> (e) No creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.
>
> (f) The Court of Chancery shall have jurisdiction to hear and determine any matter relating to any such charging order."

8. The statutory limits on remedies for a creditor of an LP or LLC provide several clear advantages.

    a. The creditor is only an assignee of the partner's or member's interest and has no right to participate in the management of the entity or to vote.

    b. The effect of the charging order is that an interest-holder's creditor will only receive those entity distributions, which, absent the charging order, would have been distributed to the debtor owner.

        (1) Of course, if the debtor is a partner or member in a widely-held LP or LLC that makes regular distributions, the charging order may be an effective means for a creditor to collect upon a judgment.

(2) However, in a family or other closely held entity in which a relative of the debtor has control over distributions and in which distributions may be made infrequently and in very modest amounts, the creditor may find the charging order to be an unattractive remedy.

c. A charging order is a lien only on partnership distributions. Some commentators point out that it may be possible to enable the debtor partner or member, or other family members to pull cash or assets out of the entity through loans, salary, or guaranteed payments, without including the judgment creditor. See, e.g. Stein, "Practical Primer and Radical Approach to Asset Protection" 38 Estate Planning No. 6, at 25 (June 2011). Certain commentators go further and state that the agreement could permit distributions that are not proportionate to the ownership interests. Id. at 26.

d. The foreclosure remedy granted in LP and LLC statutes is unattractive because the purchaser obtains only the assignee interest, and therefore no greater rights than the creditor had. The creditor will not receive much for the interest. Id. at 25.

e. Delaware and several other states have eliminated the foreclosure remedy for LLCs and provided that the charging order is the sole and exclusive remedy available to a judgment creditor.

f. In a family entity, the family can build on the unsatisfactory nature of the charging order remedy by including provisions in the agreement that trigger purchase options in the other partners or owners when one owner's interest becomes subject to a charging order or that owner declares bankruptcy. Typically, the purchase options are at a deep discount from the net asset value of the LP or LLC interest. This allows the owners to take the creditor out of the picture entirely, while preserving the underlying entity assets to the maximum extent possible.

g. The tax treatment of a charging order also may discourage a creditor from going after an LP or LLC interest. Many tax practitioners believe that the income tax effect of a creditor obtaining a charging order is to cause the creditor to become liable for that entity interest's share of the income, even if no distributions actually are made by the entity. See Rev. Rul. 77 137, 1977 1 C.B. 178 (assignee of limited partner's entire interest is taxed on distributive share of partnership income even if not a substituted limited partner).

(1) Some commentators have questioned whether a creditor with a charging order can be equated with an assignee of an

entire partnership or LLC interest. Local law may determine how the holder of the charging order is to be treated for tax purposes.

(2) In family situations in states in which the law is not clear, the GP or manager could take the position that the charging order does burden the creditor with a share of the taxes, in order to encourage the creditor to accept a reduced amount in satisfaction of the debt.

9. Clearly, these attributes provide significant benefits in negotiating with the creditor of an LP or LLC member. Plaintiff's attorneys acknowledge that they do not like to expend time and energy going after illiquid and difficult to collect assets.

10. However, notwithstanding those meaningful benefits, the professional who emphasizes only the favorable attributes discussed above and touts the LP or LLC as a cure-all for asset protection does the client a disservice. In fact, too much reliance on the LP or LLC for asset protection could make it less effective not more.

    a. There are significant practical consequences to having a judgment creditor make a legal claim against an LP or LLC interest.

    b. The asset protection features of an LP or LLC do not work in all legal forums. Not surprisingly, courts sometimes do not follow the strict letter of the statutory law, in particular where the court decides it would create an inequitable result.

11. Practical Consequences of a Charging Order Against An LLC Interest

    EXAMPLE: Samuel, his wife, Wanda, created an investment LLC for the family 15 years ago. They contributed several rental properties owned by the family and significant marketable securities. When a trust created by Samuel's parents terminated several years ago, he convinced his children to contribute the assets they received outright, consisting of marketable securities and a family vacation home, to the LLC. As a result of these contributions and a gifting program by Samuel and Wanda, the children each own a 22% in the LLC outright. Samuel and Wanda own about 10% and the remaining 24% is held by various irrevocable trusts. The family administers the LLC with great care and follows the advice of their professional advisers. For example, they have a rental arrangement for the vacation home; no one in the family receives free use of it.

    Samuel's son, Baxter, started his own investment firm several years ago. Things went badly for Baxter, and he committed some major mistakes in trying to keep the firm solvent. The firm failed, he was indicted by the federal government for securities violations and numerous claims were

brought against him by individual investors. Assume that Baxter's judgment creditors now have judgments against him and several are seeking satisfaction in part from his LLC interests.

a. The creditors who obtain a charging order against Baxter's LLC member interest become assignees only and will receive only that member interest's share of those distributions, which the LLC decides to make.

(1) What if the LLC was planning on a significant distribution because of needs of certain other LLC members?

(2) What if the LLC routinely makes annual distributions of the income from the rental properties?

b. The income tax consequences of holding the assignee interest and being allocated a share of the LLC income each year are unattractive to a creditor. They are equally unattractive to the other LLC members, who may have become dependent on tax distributions from the LLC.

(1) Suppose that the LLC interest is the only asset held in one or more of the irrevocable trusts and that one or more of the trusts are separate taxpayers, not grantor trusts. The only source of cash for tax payments for those trusts is the LLC.

(2) Assume that Baxter's violation of the federal securities laws allowed the federal government to seize assets, and it has the charging order on Baxter's LLC interest. The government will not care about the income tax consequences of the charging order. It may not be compelled to negotiate a quick and favorable buy-out to liquidate its claim.

12. Purchase options that are triggered upon the involuntary transfer of Baxter's interest do provide a way for the family to terminate the interests of the assignees.

a. The discounts at which the LLC allows the family to purchase the interests may be significant. This clearly is a benefit. But the discounts will not be 100%, and in most instances they do not exceed 50%, because no family member at the time of formation wants to see their equity investment lost for too low a price.

b. The purchase option solution does not protect Baxter's assets and may not protect all the assets of the LLC. If the purchase options are exercised, Baxter will have lost his interest in the LLC, and, because it was purchased at a discount by the LLC or other family

members, his remaining judgment debt remains higher. The LLC may have to liquidate some investments to accomplish the buy-out.

c. Samuel and Wanda could take steps in their estate plan to try to restore what Baxter lost, but, as a practical matter, it seems unlikely that either Samuel and Wanda, or Baxter's siblings will feel much sympathy for Baxter. Most siblings will not be interested in having their future inheritances reduced to restore a sibling's lost wealth.

13. The other members could use loans from the LLC to deal with cash flow issues. But, the family must be conscious of the estate planning purposes of the LLC. The frequent use of loans may weaken arguments for valuation discounts for federal estate and gift tax purposes. For the same reason, the idea of amending the agreement to permit disproportionate distributions may be a non-starter.

VII. Special Planning Considerations

A. Investment Entities

1. Many wealthy families wish to form an investment entity to allow the family members to consolidate investments. It can enable the family to access investment managers with minimums that are too high for some individual family members, and allows even small contributors to benefit from these specialized managers and from greater investment diversification.

   a. A family investment entity also can negotiate lower investment management fees than individual family members could.

   b. Finally, the family investment entity is often the ideal vehicle for making gifts to family members.

2. In almost all cases an LP or LLC will be the preferred choice for a family investment entity.

3. A C corporation rarely makes sense because of the double taxation. In addition, C corporations are subject to certain special tax rules designed to discourage their use as passive investment vehicles.

   a. A C corporation that receives too much passive income will be treated as a **personal holding company** under Section 542 of the Code. A personal holding company is any corporation in which (1) at least 60% of adjusted ordinary income for a tax year is dividends, interest, and certain categories of royalties, rent or other passive income, and (2) 50% in value of the stock is owned,

directly or indirectly by not more than five individuals. For purposes of the second test, the constructive ownership rules in the Code apply, which cause most family-owned entities to be caught by the rules. A personal holding company will be subject to a second level of tax, at the 20% dividend rate, on its undistributed personal holding company income. This can make it very difficult for the investment entity to retain and reinvest earnings

b. In addition, a C corporation that retains too much of its earnings can be subject to the **accumulated earnings tax** under Section 531 of the Code. The tax applies if the corporation is formed or used "for the purpose of avoiding the income tax with respect to its shareholders" by not distributing a sufficient amount of its earnings and profits. If the IRS can establish that earnings are accumulated beyond the reasonable needs of its business, there is a presumption that the tax applies. Passive investing is not considered a business for this purpose.

4. Similarly, S corporations that formerly were C corporations are not ideal family investment vehicles, because of the passive income tax rules that were previously discussed. The estate planning professional may encounter the corporate form of investment entity where the family sold an operating business in the form of an asset sale, and retained the proceeds in the corporation. Unless the family is willing to invest a significant portion of the funds in an operating business or another investment, such as publicly traded MLPs, that produces active business receipts, it is difficult to maintain a family investment company in corporate form.

5. By contrast many of the attributes of the LP or LLC are ideal for a family investment vehicle.

a. The LP or LLC addresses the problems faced by many individuals who may be in a financial position that would permit them to gift property to children, but who are reluctant to do so because they are unwilling to give up management and control of the property, or do not want children to own the property directly.

b. The LP or LLC interests represent a right to a share in the entity income and capital, but grant no voice in management of the entity. This structure permits an individual to make gifts of LP or LLC interests to his or her spouse, children, and (eventually) more remote descendants, without transferring the underlying assets. As general partner of the partnership or manager of the LLC, the individual can continue to exercise control over the transferred interests. Thus, the individual can transfer interests in the entity to reduce the value of his or her estate, and retain authority to manage

the property. This combination is difficult to achieve in most circumstances. Normally, if a person gives away property, the person no longer can exercise control over it.

c. The LP or LLC agreement also can restrict the ability of any recipient of interests to make further transfers of those interests, by limiting the persons to whom any transfer could be made during life or at death, and the amount that the entity would be willing to pay a partner upon liquidation of his or her interest. These restrictions will help ensure that the interests are kept in the family and will help protect the underlying assets from potential creditors of a child, or from a spouse of a child in a failed marriage.

d. Many of the benefits that an LP or LLC provides also can be achieved by making gifts to an irrevocable trust for children or more remote descendants. In a number of respects, though, an LP or LLC provides flexibility not available in a trust.

(1) Unlike an irrevocable trust, the terms of the LP or LLC can be amended to address changing circumstances.

(2) An LP or LLC gives the managing partner or the manager greater latitude with respect to management decisions than a trustee of a trust may have. A managing partner's or manager's actions will be judged under the "business judgment rule" rather than the more restrictive "prudent man rule" applicable to a trustee.

(3) Although an individual who creates an irrevocable trust often can retain management control over trust assets by naming himself or herself as investment adviser, the individual generally cannot retain the trustee's discretionary authority to make distributions without causing Code Sections 2036 or 2038 to apply.

(4) The long-standing law with respect to business entities has been that the individual can retain this control as general partner of a limited partnership or manager of the LLC without Section 2036 or 2038 applying. See United States v. Byrum, 408 U.S. 125 (1972). The IRS has ruled that the general partner's powers do not cause transferred limited partnership interests to be included in his estate under Section 2036 or 2038 because the partner's authority is considered to be limited by his fiduciary obligations to other partners. Letter Rulings 9415007 (August 26, 1994); 9332006 (August 20, 1993); 9131006 (April 30, 1991).

6. From a tax standpoint, there are no special partnership tax rules that discourage passive investments or the accumulation of earnings.

   a. The entity of course usually will need to distribute enough cash to permit partners or members to pay their taxes, but it can accumulate and reinvest the remainder of its earnings.

   b. As noted earlier, the accumulation of taxable income in a flow-through entity increases the tax basis of the partners. This produces a significant tax benefit over time.

7. A family should seek competent tax advice when forming a family LP or LLC. As noted earlier, there are a number of complex partnership tax rules that can come into play in certain situations. The one that should receive particular attention with a family investment entity is the need to avoid being categorized at formation as an **investment company**.

   a. As a general rule, no gain or loss is recognized either by the partners or by the partnership upon formation. IRC § 721(a). Gain (or loss) is recognized, however, by the partners contributing property to an "investment company." IRC § 721(b). (An identical rule applies to transfers to corporations that are deemed to be investment companies pursuant to the tests set forth below. See IRC § 351(e)(1).) If a partnership is treated as an investment company, the partners will recognize gain (or loss) measured by the difference, if any, between the fair market value of the partnership interest received (generally, the fair market value of the property transferred) and the partner's tax basis in the transferred property.

   b. A contribution to a partnership will be treated as a transfer to an investment company if the following two requirements are met immediately after the transfer:

      (1) The transfer results in the direct or indirect "diversification" of the transferor's interests; and

      (2) The transfer is made to a partnership in which more than 80% of the value of the assets (excluding cash and nonconvertible debt obligations) are held for investment, and either are (i) readily marketable stocks or securities or (ii) interests in regulated investment companies or real estate investment trusts. Treas. Reg. § § 1.351-1(c)(1), (2).

   c. In the context of a family partnership, the critical test typically will be whether 80% of the value of the partnership assets consists of readily marketable stock or securities. For these purposes, stocks and securities are "readily marketable" if they are traded on a

securities exchange or traded or quoted regularly in the over-the-counter market. Treas. Reg. § 1.351-1(c)(3).

EXAMPLE: H, W and their four children formed HW Family Partnership by contributing stock in FabCorp. valued at $5 million and marketable securities worth $5 million. FabCorp. is not traded on an exchange or quoted over-the-market. The Partnership would not be deemed to be an investment company within the meaning of Code § 721(b) since readily tradeable stocks and securities constitute only 50% of the partnership's assets.

d. The regulations provide that "[a] transfer ordinarily results in the diversification of the transferor's interest if two or more persons transfer nonidentical assets..." in the exchange. Treas. Reg. § 1.351-1(c)(5). Thus, if A transfers 100 shares of AT&T to a partnership and B transfers 100 shares of General Electric, there is diversification. However, if A and B each transfer 50 shares of AT&T and 50 shares of General Electric, diversification has not occurred. Diversification does not occur if the nonidentical assets transferred constitute only an "insignificant amount" of the total assets transferred. The regulations indicate that contributions that in the aggregate represent no more than 1% of the total partnership capital will be considered an insignificant amount. Treas. Reg. § 1.351-1(c)(6), Examples (1) and (2).

e. The IRS takes the position that an impermissible diversification can occur if one partner contributes marketable securities and the other partner(s) contribute more than an insignificant amount of cash. Rev. Rul. 87-9, 1987-1 C.B. 134.

f. The investment company rules created significant challenges in structuring family partnerships that would be holding marketable securities. One approach is to have the client contribute the securities (or perhaps the client and his or her spouse contribute identical securities) and have the other partners (such as children) each contribute a nominal amount of cash or securities. After the partnership is formed, the parents could make gifts of partnership interests to the children to increase their interests in the partnership. This is counter to other goals, however. A LP or LLC is less subject to challenge if multiple individuals contribute more than de minimis amounts.

g. The Treasury Department has made the process easier by enacting a provision under the Section 351 regulations pursuant to which a partnership will not be treated as an investment company if each of the transferors to the partnership transfer an already diversified portfolio of stocks and securities. Treas. Reg. § 1.351-1(c)(6)(i).

A portfolio is considered to be diversified if no more than 25% of the portfolio is invested in one issue of stock, and no more than 50% of the portfolio is invested in five or fewer issues of stock. For purposes of calculating the total value of the portfolio, cash is not counted. Government securities are counted in determining the total value of the portfolio, unless they were acquired to meet the 25 and 50-percent tests.

EXAMPLE 1: Jane Jones has a $100,000 securities portfolio with $20,000 of stock A, $5,000 each of stocks B, C, D, E, F, and G, and $50,000 of numerous government securities (held for a substantial period of time). Sam Smith also has a $100,000 securities portfolio with $10,000 each of stocks H, I, J, and K and $5,000 of twelve other stocks. Neither Jane nor Sam has more than 25% of the portfolio in any one stock (Jane comes closest with 20% in stock A), or more than 50% of the portfolio in 5 or fewer stocks (Jane has 50% in 7 stocks and Sam has 50% in 6 stocks). Jane and Sam will not recognize gain or loss if they contribute their portfolios to a partnership.

EXAMPLE 2: Same facts as above except that Jane has $20,000 of government securities and $30,000 of cash, instead of $50,000 of government securities. The cash is not counted in determining whether the portfolio is diversified. Stock A constitutes 28.6% of her portfolio ($20,000/$70,000), so her portfolio is not diversified. If Jane and Sam form a partnership, they will recognize capital gain.

B. Valuation Discounts

1. Valuation discounts are available for all of the major entity options. A transfer of stock or an interest in an LP or LLC can be subject to discounts for lack of marketability and lack of control. The type of entity itself will not have as significant an impact on the amount of the discount as will the nature of the assets and the manner in which the rights and restrictions of the owners are defined.

2. Transfers of interests in any of the entities are subject to IRS rules regarding valuation, in particular the Chapter 14 rules (Section 2701 – Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships; Section 2703 – Certain Rights and Restrictions Disregarded; and Section 2704 – Treatment of Certain Lapsing Rights and Restrictions.

   a. Section 2704(b) provides that a restriction "which effectively limits the ability of the corporation or partnership to liquidate" is ignored for valuation purposes if the transferor and members of the

transferor's family control the entity. However, an applicable restriction does not include "any restriction imposed, or required to be imposed, by any Federal or State law." In its regulations, the IRS interpreted this exception to mean that an applicable restriction is a restriction on "the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under state law generally applicable to the entity in the absence of the restriction."

b. When this provision was enacted, many states amended their LLC and LP statutes to provide that liquidation requires unanimous consent of the partners or members, and that a partner or member may not withdraw unless the right is granted in the governing entity agreement. The IRS tried several times to apply Section 2704(b) to negate valuation discounts, but failed. See Kerr v. Commissioner, 292 F.3d 490 (5th Cir. 2002) (affirming 113 T.C. 449 (1999)); Estate of Jones v. Commissioner, 116 T. C. 121 (2001).

c. The IRS has been working on a new regulation project under Section 2704. It is expected that the new regulations will be much broader in attempting to limit valuation discounts, in particular in investment entities that are not operating businesses.

3. In one respect, C corporations are subject to special valuation rules. It is clear under the case law that the valuation of a C corporation can take into account the tax impact of the built-in capital gains in its assets, and apply a discount for that.

a. For many years, the courts refused to permit a discount for built-in capital gains in assets owned by the corporation. The position of the courts was that no reduction should be made unless the evidence established that a liquidation or sale of the corporation or its assets was likely to occur. The position of the court changed in 1998 with Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir. 1998) (reversing 74 T.C.M. (CCH) 1046 (1997), and Estate of Davis v. Comm'r, 110 T.C. 552 (1998). The courts in those cases noted that a willing buyer would take potential capital gains into account in some manner, even if liquidation was unlikely or steps might be able to be taken to avoid the gains.

b. In Davis, the court did not take into account the full amount of the tax on unrealized gain. Rather, it allowed a discount for a portion of that tax. This has been followed in some subsequent court decisions. Unless liquidation is imminent, these courts in the effect use a present-value of the future possible tax. See Estate of

Litchfield v. Comm'r, T.C. Memo 2009-21; Estate of Jameson v. Comm'r, 77 T.C.M. (CCH) 1383 (1999).

c. In Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002), the court used a more objective approach for taking potential capital gains tax into account. The case involved the valuation of stock in Dunn Equipment, Inc., a company that was in the business of renting out heavy equipment and providing related services. The IRS had asserted an estate tax deficiency based on an alleged under-valuation of the stock. It based its claim on an asset-based valuation of the company. The estate had relied primarily on an earnings-based valuation method. On appeal the Fifth Circuit reviewed both the Tax Court's determination of weights given to the two valuation methods and how the Tax Court factored in potential tax liability for capital gain. The court first determined that the built-in gains tax liability is not relevant at all in an earnings-based valuation calculation. However, it stated that it must be taken as a dollar-for-dollar reduction in an asset-based valuation. Thus, in the asset-based method, the built-in gains tax liability resulted in a reduction equal to 34% of the unrealized appreciation on corporate assets. The court found liquidation of Dunn Equipment unlikely, and therefore assigned 85% weight to the earnings-based value and 15% weight to the asset-based value.

d. Several subsequent cases have followed the approach of the court in Dunn and adopted a dollar-for-dollar discount. See, e.g. Estate of Jelke v. Comm'r, 507 F.3d 1317 (11th Cir. 2007).

e. The most recent case on the question is Estate of Richmond v. Comm'r, T.C. Memo 2014-26. The court agreed that the built-in capital gains attributable to the company's stock holdings (estimated to be approximately $18 million) needed to be taken into account, but held that the estate was not entitled to a dollar for dollar discount for the tax liability. Instead, the tax liability should be discounted to its present value based on a reasonable holding period.

C. Charitable Planning

1. A taxpayer always should obtain competent tax advice when considering a charitable gift of a non-publicly traded entity to charitable entity, in particular a private foundation or split-interest trust. In charitable planning, the scales tip in favor of the C corporation, because the pass-through characteristics of an S corporation, LP or LLC that often are helpful to individuals mean that a charitable entity would receive items of income that it cannot or does not want to receive.

2. Private foundations are subject to numerous restrictive excise taxes and regulations. In general, these laws and regulations ensure that the foundation is used to further charitable purposes rather than to benefit the individual who established the foundation or his family (see IRC §§ 4940-4946 and the regulations thereunder). Two in particular that arise with business interests are:

   a. The Code Section 4941 self-dealing rules, under which a tax is imposed on acts of self-dealing between a foundation and disqualified persons; and

   b. The Code Section 4943 tax on excess business holdings; through these provisions the Code places percentage limitations on the business holdings that a private foundation may have in a business enterprise.

3. Charitable split-interest trusts are subject to most of the special operational restrictions applicable to private foundations. However, a charitable remainder trust is not subject to Code Section 4943 (excess business holdings) or Code Section 4944 (jeopardizing investments) if no charity has a current (as opposed to a remainder) interest in the trust (IRC Section 4947(b)). Thus, unlike a private foundation, a charitable remainder trust can be funded with stock in a closely-held company or other unusual investments.

4. Even if the excess business holding rules can be avoided, there is a danger that the investment could violate the self-dealing rules. Any sort of loan from or partial liquidating distribution to a private charitable entity would be self-dealing (IRC § 4941(d)). Although the IRS has issued some favorable private rulings, there is a concern that a charitable entity's investment in a family controlled partnership or LLC (particularly as a general partner or member-manager) is per se self-dealing (see Letter Rulings 9448047 (Dec. 2, 1994); 9114025 (April 5, 1991)).

5. In addition, any charity, public or private, must pay tax on unrelated business taxable income ("UBIT"). See Code Section 512. This may not be a problem if the charity holds the investment for only a short period of time. However, a charity that receives a significant amount of UBIT over multiple years could lose its exemption.

   a. C corporation dividends are not UBIT.

   b. Income from a flow-through entity retains the character it had in the entity. If it is either business income or debt-financed income, it will constitute UBIT.

   c. The UBIT rules make it difficult for any charity to hold an interest in a LLC or LP that invests in a venture capital or private real

estate fund or a hedge fund. Commercial funds will form a separate blocker entity (often taxed as a C corporation) to allow charities and endowments to invest. But this may not be practical or cost-effective in a family investment situation.

6. The liberalization of the rules governing permissible shareholders in an S corporation did not open the door for charitable remainder trusts to hold S corporation stock. Certain tax-exempt entities became permissible S corporation shareholders for tax years beginning on or after January 1, 1998, but a charitable remainder trust was not among them (see IRC § 1361(e)(1)(A)).

7. A charitable remainder trust can hold interests in an LLC or partnership. However, as was demonstrated in Leila G. Newhall Unitrust v. Comm'r, 104 T.C. 236 (1995), aff'd, 105 F.3d 482 (9th Cir. 1997), the grantor and/or trustee must be certain that the LLC or LP holds only passive investment assets, and no assets that generate unrelated business taxable income. In Newhall Unitrust, the trust was treated as a taxable entity because it received UBIT. Under current law, in effect beginning in 2007, the trust would be subject to a 100% excise tax on its UBIT.

D. Use of Entities in Common Estate Planning Techniques

1. The general estate planning principle that the transfer tax technique needs to be matched with the client's assets is especially true when it comes to closely held entities.

2. Stock in a C corporation or interests in an LP or LLC can be transferred to a family investment partnership or limited liability company.

   a. This can be done to try to achieve greater valuation discounts when making gifts.

   b. It also is frequently done when the client has an investment in a third-party entity, and wishes to make gifts of it over time without the administrative hassle of dealing with the third-party transfer process. By transferring the interest to a family LP or LLC, the client needs to report only one transfer to the third-party entity, and thereafter can make gifts of the family entity interests without complying with the third party's administrative requirements.

3. S corporation stock cannot be held by an LP or LLC.

4. Likewise, S corporations are the one of the four common entity forms that cannot be used in an entity freeze transaction.

   a. A C corporation, an LP and an LLC all can be restructured to create fixed value, preferred cash flow interests. These are

typically retained by the senior generation, and the common equity interests are transferred to or for the benefit of lower generations.

b. As previously noted, freeze transactions must comply with Section 2701 of the Code. Even with these requirements, they can be valuable tools for transferring long-term appreciation.

5. GRATs and sales of assets to a grantor trust work especially well with flow-through entities. This includes S corporations, since a grantor trust can be an S corporation shareholder. See, e.g., Ltr. Rul 9415012 (January 13, 1994). Because the S corporation, LP or LLC is a flow-through entity for income tax purposes, the trustee of a GRAT or grantor trust that holds interests in the entity can satisfy annuity or note payments with pre-tax dollars from the entity.

6. For example, for a GRAT, the cash flow usually distributed to shareholders for tax obligations could in part or in whole satisfy the annuity payments.

EXAMPLE: Carlos owns a 10% interest in an S Corporation that has an entity value of $27,500,000. After discounts, his interest is worth $2,000,000. He anticipates it will appreciate rapidly. Carlos transfers his $2,000,000 of S Corporation stock to a GRAT and retains an annuity of $200,000 per year for 12 years. The value of Carlos' retained annuity interest is $2,000,000, so Carlos makes no taxable gift when he creates the GRAT. The S Corporation currently distributes cash of about $200,000 per year to Carlos (about 7.2% of the initial undiscounted value) to provide funds for income taxes and some additional discretionary shareholder funds. The GRAT can pay Carlos the annuity out of the cash distribution that the GRAT receives each year, and Carlos uses a portion of the annuity distribution to pay his income taxes related to the S Corporation income. The GRAT is able to retain all of the stock. If the value of the stock increases by about 5% per year, the GRAT will have $3,600,000 in it after 12 years.

7. If voting stock in a family corporation (one in which the grantor and related parties own 20 percent or more of the voting stock) is transferred to the GRAT, the grantor should not retain the right to vote that stock beyond the date that is three years before the end of the annuity term. The right to vote the stock will cause the stock to be included in the grantor's estate under Section 2036(b), and the relinquishment of that right within three years of death will cause inclusion under Section 2035(d). If the grantor retains the right to vote the stock until the end of the annuity term, he must survive an additional three years to ensure that the property will be excluded from his estate. This problem can be avoided by using non-voting stock.

E. Partnership or LLC Holding Closely Held Stock

1. If an LP or LLC is to be funded with closely held stock, it is important to consider the impact of Section 2036(b), which provides that the direct or indirect retention of the right to vote the stock of a controlled corporation is a retained interest that will cause the stock to be included in the transferor's estate.

   a. A controlled corporation is one in which the decedent owns at least 20% of the voting power, taking into account the family attribution rules of Section 318.

   b. If an individual who will act as general partner transfers his closely held stock to a partnership and then gives limited partnership interests to family members, the individual's retained right to vote the stock as general partner may cause the transferred limited partnership interests or some portion thereof attributable to the value of the stock to be included in his estate. The same problem could arise in an LLC where the individual retains control as manager.

2. The IRS has not ruled directly on the application of Section 2036(b) to partnerships or LLCs that hold voting stock of a closely held corporation. The technical requirements of the statute are such that the provision should not apply to a properly structured entity. Section 2036 does not apply to a transfer that is for full and adequate consideration. For Section 2036(b) to apply, (1) there must be a lifetime transfer of stock, (2) the transfer must be for inadequate consideration, and (3) the decedent must directly or indirectly have retained voting rights in the stock. See General Counsel Memorandum 39140. If the general partner transfers voting stock to the partnership in exchange for partnership interests of equal value, the second requirement is not satisfied. Subsequent transfers of limited partnership interests to children or other beneficiaries are not transfers of the stock.

   a. Notwithstanding this technical interpretation of the statute, the IRS could assert that the substance of a gift of limited partnership interests in a partnership holding closely held stock is a gratuitous transfer with a retained right to vote. It has done this in at least one private ruling. See TAM 199938005.

   b. Moreover, the initial transfer of stock to the partnership will not fall under the full and adequate consideration exception if the IRS can establish that the stock had a value even $1 greater than the partnership interests received.

3. For these reasons, if the client wishes to use a LP or LLC to hold stock in a family company, he should consider creating a class of nonvoting stock and transferring the nonvoting stock to the entity.

F. Life Insurance in an Entity

1. The Treasury Regulations provide that corporate ownership of an insurance policy on the life of a controlling shareholder does not cause the incidents of ownership to be attributed to that shareholder if the proceeds are payable to the corporation. Treas. Reg. § 20.2042-1(c)(6).

   a. Although the regulations do not specifically address the application of this rule to partnerships, the Tax Court and the IRS have applied it to partnerships on a number of occasions. See Knipp Estate v. Comm'r, 25 T.C. 153 (1955), acq. in result, 1959-1 C.B. 4, aff'd on another issue, 244 F.2d 436 (4th Cir. 1957); Watson, Transferee v. Comm'r, T.C. Memo 1977-268; Letter Ruling 200111038 (March 16, 2001).

   b. The IRS also appears to have recognized the application of the regulation to partnerships. In Revenue Ruling 83-147, 1983-2 C.B. 158, the IRS ruled that proceeds of a partnership-owned insurance policy would be included in the controlling partner's estate when the proceeds are not paid to the partnership, but it specified that this result was mandated because the partnership did not receive the proceeds, and it reiterated its acquiescence in the result in Knipp Estate.

2. An entity may want to own a policy for a variety of reasons, including redemption of the owner's interest at death. A flow-through entity is a more advantageous form to hold life insurance. The proceeds are subject to AMT in a corporation.

3. In appropriate circumstances, a partnership or LLC can be used as an alternative to an irrevocable insurance trust. This might be appropriate where the client does not want the hassle of dealing with Crummey powers or is not comfortable with the irrevocability of a trust.

   EXAMPLE: Parent transfers a piece of investment real estate with a net value of $80,000 and $20,000 of cash to a newly formed limited partnership. He takes back a $1,000 general partnership interest and $99,000 of limited partnership interests. He immediately gifts the limited partnership interests to his four children, discounting their value by 20% to $79,200. The gifts qualify for the annual exclusion. The partnership purchases a $2,000,000 insurance policy on Parent's life. The premium is $20,000 in the first year and $25,000 per year thereafter.

The next year, Parent makes a $25,000 capital contribution to the partnership and receives an additional $250 general partnership interest and $24,750 in limited partnership interests. He gifts the limited partnership interests to his children, using his annual exclusion. In making the gifts, he discounts the value of the limited partnership interests by 20%, to a value of $19,800. The partnership uses the cash to pay the next year's premium.

Each year, Parent could make an additional capital contribution to the partnership and transfer the limited partnership interests received in exchange for the contribution to his children. At Parent's death, he will have only a 1% interest in the partnership. If the Partnership then holds $2,000,000 of insurance proceeds plus real estate worth $200,000, Parent's interest in the partnership will be worth only $22,000 (1% of $2,200,000).

4. The partnership also gives the Parent the option of keeping the units he receives for his annual contributions. This gives the Parent some flexibility in deciding later how much wealth to shift to the children.

5. The interests owned by Parent should be the only amount included in Parent's estate. Thus, even though Parent, as managing partner, had substantial control over the partnership assets (including the insurance policy), the bulk of the policy proceeds would be excluded from his estate.

6. It is uncertain whether an individual could create a partnership or LLC for the sole purpose of owning life insurance. To be classified as a partnership for tax purposes, the entity must have some business purpose. The formation of a partnership to pool investments is considered a valid business purpose, but it could be argued that a single life insurance policy is not an investment sufficient to justify the need for a partnership. It is best to have other investment assets in the entity.

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ABA BRIEFING SERIES

2015 Investment Series – Focusing on the Client

January – October 2015 ▪ 2:00–3:30 p.m. ET*

The **American Bankers Association** announces a series of four briefings/webcasts on the dynamics surrounding the investment arena. These ninety-minute briefings are designed to provide you with practical applications that you can put to use immediately. Expert advisory skills are crucial to attracting and retaining loyal clients. These educational opportunities will help set you and your team apart. Show your clients you understand them, not just their product needs.

October 20, 2015
Behavioral Finance: Are Fear and Greed Driving Investors' Decisions?
2.0 CRSP, 2.0 CTFA (INV), 1.5 CPEs for CPAs (Finance)

Investment theory is based upon the rational world of applied mathematics maximizing the return/risk trade-off in the capital markets. Do investors really want to maximize their Sharpe Ratio? Do they even know what that is? Is annualized standard deviation how investors define risk? This briefing will discuss the realities of behavioral finance, and how we can incorporate it into prudent investment strategies. We will work through specific case studies that will help client facing professionals with their conversations regarding investments.

Is Your Portfolio Truly Global?
2.0 CISP, 2.0 CRSP, 2.0 CSOP, 2.0 CTFA (INV)
Aired: Jan 22, 2015—*Recording Now Available*

Globalization is a common topic in investment discussions, but what does it really mean? Most portfolios have some global exposure, but is it effective and appropriate? This Briefing discusses the realities of globalization, impacts to the economy and capital markets, and how to incorporate it into investment strategies. We will present specific ideas around global allocations and how to discuss the topic with clients.

Economics, Government Policies, and Investment Strategy
2.0 CCTS, 2.0 CISP, 2.0 CRSP, 2.0 CSOP, 2.0 CTFA (INV)
Aired: Apr 21, 2015—*Recording Now Available*

Today's economy faces a variety of anticipated actions from the Federal Reserve, a Republican Congress, and a Democratic President that cause mixed currents. This Briefing will discuss important economic indicators and how they are being influenced by policies from Washington. We will analyze how these policies can influence the capital markets, and what your clients should consider to protect their investments and profit from these policy influences.

Are Rising Interest Rates Good or Bad for the Economy, Savers, and Investors?
2.0 CCTS, 2.0 CISP, 2.0 CRSP, 2.0 CSOP, 2.0 CTFA (INV)
Aired: Jul 9, 2015—*Recording Now Available*

Is the party fueled by cheap debt over? For the past 30 years, we have been in a declining interest rate environment. This has benefited bond holders as falling rates pushes up bond prices. This has also benefited borrowers as debt servicing costs have dropped. But now, the Federal Reserve is letting interest rates rise to normal levels after several rounds of Quantitative Easing. What does this mean for borrowers, savers, and investors? We will discuss specific strategies designed for a rising interest rate environment.

Speaker:
Ronald Florance, CFA, Industry Consultant, Scottsdale, AZ

Who Should Attend?

- Portfolio Managers
- Wealth Managers
- Investment Managers
- Private Bank Relationship Managers
- Trust Officers
- Trust Managers
- Financial Planners
- Registered Financial Advisors

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ABA Professional Development

ABA Briefing/Webcast

2015 Trust and Estate Planning Briefing/Webcast Series

The American Bankers Association announces the **2015 Trust and Estate Planning Briefing/Webcast Series**. Our featured speakers, **Charles D. Fox IV**, partner, McGuireWoods LLP and **Thomas W. Abendroth**, partner, Schiff Hardin LLP are nationally-recognized trust and estate attorneys and tenured teachers from the **ABA Trust Schools**. They will provide you and your staff with critical information on estate planning and trust administration topics. This series provides you with an excellent business development opportunity; invite outside counsel to attend these informative programs at your location. ***New this year—programs will be streamed over the Internet.***

Reserve 1:00 – 3:00 p.m. ET on these dates

In order to provide listeners with timely information, the presenters reserve the right to alter the content or emphasis of the programs.

The Alphabet Soup of Planning and Trust Acronyms and Service Marks – November 5, 2015

2.5 CTFA (FID), 2.5 CISP credits, 2.0 CPEs for CPAs (Taxes); 2.0 CFP credits

Well-known and less well-known acronyms in the trust field and the advantages and disadvantages will be examined. Among the types of trusts to be discussed are:

- The Supercharged Credit Shelter Trust
- ILITS
- SLATs
- GRATS or its cousin, the GRUT
- GRITs
- QPRTs
- IDGTs
- BING
- DINGs
- Charitable techniques such as CRTs and CLTs

Recent Developments in Estate and Trust Administration – December 3, 2015

2.5 CTFA (TAX), 2.5 CISP credits, 2.0 CPEs for CPAs (Taxes); 2.0 CFP credits

A review of recent legislation, regulatory developments, cases, and public and private rulings in the estate, gift, generation-skipping tax, fiduciary income tax, and charitable giving areas will be provided. Some of the subjects to be discussed include:

- Marital Deduction Planning
- Portability
- Valuation Issues
- Availability of Discounts
- Gifts
- Charitable Planning
- Post Mortem Planning
- The Generation-Skipping Tax
- Asset Protection
- Insurance
- Fiduciary Income Tax

Hot Button Tax Issues for the IRS – Aired: Feb 5, 2015

2.5 CTFA (TAX), 2.5 CISP, 2.5 CRSP credits

Recording Now Available

This session will examine those areas on which the IRS is currently focusing in both audits and litigation. Among the topics to be discussed are:

- Adequate Disclosure on Estate and Gift Tax Returns
- Challenges to the Charitable Façade Easement
- Reciprocal Trusts
- Material Participation for Trusts to Avoid the 3.8% Net Investment Income Tax
- Graegin Loans
- Defined Value Clauses
- Valuation of Self-Canceling Installment Notes
- Limits on Valuation Discounts

Ethical Challenges for Trust Professionals – Aired: Mar 5, 2015

2.5 CTFA (Ethics), 2.5 CISP, 2.5 CRSP, 2.5 CSOP credits

Recording Now Available

Different ethical rules and situations will be addressed during this briefing.

- The duty of loyalty
- The duty of impartiality
- The duty to invest prudently
- The fiduciary exception and communications with lawyers for the trust or estate
- Handling conflicts of interest

Show Me the Money: The Focus of States on Tax Revenues and Its Impact on Estate Planning – Aired: Apr 2, 2015

2.5 CTFA (TAX), 2.5 CISP, 2.5 CRSP credits,)

Recording Now Available

This program will look at state tax systems for taxing the income of trusts and estates, and the impact they have on estate planning. Some of the topics to be discussed are:

- Constitutional challenges to a state's ability to tax trusts
- Examples of techniques to minimize exposure to state income taxation
- The possible exposure to taxation by multiple states
- The basic rules for the state income taxation of
- non-grantor trusts and estates as compared to the federal rules

- The different points of nexus used by states to justify taxation irrevocable non-grantor trusts
- State efforts to limit the ability of resident individuals and trust to move for tax purposes

Fiduciary Litigation Roundtable – Aired: May 7, 2015

2.5 CTFA (FID), 2.5 CISP, 2.5 CRSP credits

Recording Now Available

A panel of attorneys will discuss current trends in fiduciary litigation and how to minimize a trustee's exposure. Topics will include:

- Current fiduciary litigation cases
- Diversification and Other Investment Disputes
- Keeping Beneficiaries Informed
- Decanting
- Closely-Held Assets in Trust

Critical Concepts in Understanding Community Property vs. Common Law – Aired: Jun 4, 2015

2.5 CTFA (FP) credits

Recording Now Available

This session will be a primer on what trust professionals need to know about community property vs. common law states. Topics to be covered include:

- The basics of community property and distinctions from common law property rights
- What is quasi-community property
- How to plan for clients who move from a community property state to a common law state
- How to opt out or into community property
- The income, estate, and gift tax consequences of community property
- Community Property Trusts, LLPs and LLCs

A Primer on Decanting – Aired: Sept 3, 2015

2.5 CTFA (FID) credits

Recording Now Available

Twenty-two states now permit a trustee to decant an existing trust to a new trust if certain requirements are met. Topics to be discussed include:

- What is decanting
- The theory behind decanting
- Different state law approaches to decanting
- Changes permitted in decanting
- Planning opportunities involving decanting
- The estate, gift, and generation-skipping tax consequences of decanting

Choose Your Weapon: The Advantages and Disadvantages of Corporations (C and S), LPs and LLCs – Aired: October 1, 2015

2.5 CTFA (FP) credits

Recording Now Available

This briefing will examine the tax and non-tax advantages of different types of entities. Topics to be discussed include:

- The structure of corporations, partnerships, limited liability companies, and sole proprietorships
- Factors in deciding which type of entity to use
- The tax consequences of C and S Corporations
- Structural and operational differences between limited partnerships and LLCs
- The choice in the tax treatment of LLCs

Who Should Attend?

- Trust Officers
- Estate Planners
- Trust Counsel
- Trust Dept. Managers
- Wealth Managers
- Private Bankers
- Trust Tax Professionals
- Financial Planners
- CTFAs, CPAs, CFPs

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American Bankers Association

ABA BRIEFING SERIES

2016 Trust and Estate Planning Briefing Series

February – December 2016 ▪ 1:00–3:00 p.m. ET

The **2016 Trust and Estate Planning Series** featured presenters are, **Thomas W. Abendroth**, partner, Schiff Hardin LLP and **Charles "Skip" D. Fox IV**, partner, McGuireWoods LLP. These nationally-recognized trust and estate attorneys and tenured teachers from the **ABA Trust Schools** will provide you and your staff with critical information on estate planning and trust administration topics. This series is an excellent business development opportunity; invite outside counsel to attend these informative programs at your location.

The New Paradigm in Trusts and Estates Valuation

Thursday, February 4, 2016
2.5 CISP, 2.5 CRSP, 2.5 CTFA (TAX)

The estate planning community is waiting with nervous anticipation for expected new IRS regulations that are likely to impact the use of valuation discounts in estate and gift transfers, in particular for family owned investment entities. This briefing will discuss the new regulations and implications on estate planning. Topics to be discussed are:

- Legal and Economic Basis for Valuation Discounts
- Past IRS Attempts to Regulate Discounts
- Section 2704 Rules and Application to Family LPs and LLCs
- New Valuation Regulations
- Planning Under the New Regulations

Uniform Fiduciary Access to Digital Assets Act (UFADAA) and Digital Assets

Thursday, March 3, 2016
2.5 CTFA (FID)

The laws on the disposition of tangible and financial assets are well-defined and well-understood. By contrast, there is little uniformity or even agreement about the rights of persons to dispose of digital assets, and grant control over them to others. Presenters will review the current uniform law proposals, and planning options under current law.

- Uncertain Current Federal and State Legislative Environment
- Different Approaches of Tech Industries and Estate, Trust, and Financial Planning Professionals
- Uniform Fiduciary Access to Digital Assets Act
- Personal Expectations Afterlife and Choices Act
- Provisions in Wills, Trusts, and Powers of Attorney to Deal with Digital Assets

Life Insurance in a 21st Century Estate Plan

Thursday, April 7, 2016
2.5 CRSP, 2.5 CTFA (Fin. Plan.)

Life insurance products have become increasingly sophisticated and personalized. At the same time, the role of life insurance in estate planning has changed. This briefing will explain the role of life insurance in current estate plans.

- Reasons for having Life Insurance
- Types of Life Insurance and Specially Designed Insurance Products
- Who Can Be Insured
- Private Placement Life Insurance
- Estate Tax Planning with Life Insurance
  - Irrevocable Life Insurance Trusts
  - Qualifying the Payment of Premiums for the Annual Exclusion
- Premium Financing
  - Split Dollar Insurance
  - Third-Party Loan Arrangements

Fiduciary Litigation Roundtable

Thursday, May 5, 2016
2.5 CISP, 2.5 CRSP, 2.5 CTFA (FID)

A panel of attorneys will describe current trends in fiduciary litigation and will explain how to minimize a trustee's exposure. Topics will include:

- Current fiduciary litigation cases
- Diversification and Other Investment Disputes
- Keeping Beneficiaries Informed
- Decanting
- Closely-Held Assets in Trusts

Charitable Tales from the Crypt

Thursday, June 2, 2016
2.5 CISP, 2.5 CTFA (TAX)

This briefing will describe frequent misuse of the charitable deduction. It will also explain the most recent errors made in charitable planning.

- Qualifying for the Estate Tax Charitable Deduction
- Qualifying for the Income Tax Charitable Deduction
- Avoiding the Imposition of Capital Gains on a Charitable Foundation
- Problems with Private Foundations
- Challenges with Charitable Remainder Trusts

Issues with Art and Other Collectibles in the Administration of Trusts and Estates

Thursday, September 8, 2016
2.5 CTFA (INV)

Artwork and other tangible collectibles are unique assets that present many challenges to fiduciaries. Our presenters will explore best practices in dealing with these unique assets and protecting their value in the trust and estate administration context.

- Confusing Legal Environment of Local, State, Federal and International Rules
- Verifying Authenticity and Good Title
- Limitations on Sales of Art such as Endangered Species Restrictions and Cultural Heritage Limitations
- Rights of Artists
- Ways to Sell Art
- Securing Art
- Special Considerations with Collectibles such as Guns

Are You a Fiduciary?

Thursday, October 6, 2016
2.5 CISP, 2.5 CRSP, 2.5 CSOP, 2.5 CTFA (FID)

The role of the fiduciary is far more complicated than it was 25 years ago. In the trusts and estates context, the fiduciary role is often now bifurcated in any number of ways. In the non-trust asset management context, fiduciary obligations have been greatly expanded. This session will discuss some of the major issues surrounding the fiduciary role in wealth management.

- Fiduciary Role in Trusts
  - Co-Trustees
  - Delegation of Authority
  - Directed Trusts
- Non-Trustee Fiduciary Roles in Trusts
  - Trustee Appointers and Removers
  - Trust Protectors
  - Distribution Committees
- Fiduciary Roles under ERISA and New DOL Proposed Rules
- Fiduciary Roles for Investment Advisers Outside of ERISA

Twenty Steps to Avoid Fiduciary Litigation

Thursday, November 3, 2016
2.5 CISP, 2.5 CRSP, 2.5 CSOP, 2.5 CTFA (ETH)

The best defense against claims of a breach of fiduciary duty is to have procedures that prevent them in the first place. This briefing will explore best practices for minimizing claims.

- Duty of Loyalty
- Steps to Take in Opening Relationships
- Steps to Take when Taking Over Another Trust Department
- Communications with Beneficiaries
- Fees
- Accountings
- Seeking Court Approval

Recent Developments in Estate and Trust Administration

Thursday, December 1, 2016
2.5 CISP, 2.5 CTFA (TAX)

This program will review recent legislation, regulatory developments, cases, and public and private rulings in the estate, gift, generation-skipping tax, fiduciary income tax, and charitable giving areas. Some of the subjects to be discussed include:

- Marital Deduction Planning
- Portability
- Possible changes in the Estate Tax Laws
- Valuation Issues
- Gifts
- The Availability of Discounts
- Charitable Planning
- Post Mortem Planning
- The Generation-Skipping Tax
- Asset Protection
- Insurance
- Fiduciary Income Tax

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These programs are being reviewed for Certified Financial Planners (CFP) continuing education credits and CPE credits for CPAs.

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