Dear Reader,

Uncertainty clouded the picture when we released the first installment of Deloitte’s 2018 essential tax and wealth planning guide in November 2017. In particular, the prospect of US tax reform raised many questions: Would the new law pass Congress? If it did, what would it contain? How would it impact tax planning and what other important measures would be attached to it?

On December 22, 2017, we received the answers to these and other questions with the passing of the new tax law, officially known as An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the Act). It involves substantial changes in some areas, and offers greater certainty in others. The path forward is somewhat clearer, and the advice we provided in our last release—to look again at the important issues at hand—is more relevant than ever as a result. While we now have some clarity on the direction in which tax reform will take us, there are many new unanswered questions. That being said, we recognize that tax planning is no longer business as usual. We must challenge our traditional thinking when considering entity selection, assessing estate planning alternatives, and evaluating philanthropic alternatives to achieve our goals.

This second edition of the guide presents chapters on Family offices, Wealth transfer planning alternatives, and Postmortem planning considerations. These sections share the theme of preparedness—of taking a fresh look across a range of sophisticated planning topics and being ready for action when both expected and unexpected events happen:

- **Postmortem considerations** provides you with insights on how a well-thought-out estate plan can remove the friction that many families are left to deal with in the wake of someone’s passing. For those executors left with estate plans that, for many of life’s reasons, were left incomplete or not well constructed, postmortem planning becomes the imperative to shepherd the decedent’s assets to their orderly distribution.

This installment of the guide also contains a bonus feature on Choice of entity and addressing entity conversion considerations in light of the new tax law.

In the Tax policy update, we invite you to visit our Tax News and Views site to view the most up-to-date information on the Act. We encourage you to visit this site often to continue to learn about the new law as the story continues to unfold.

Each of these topics could create potential challenges and opportunities as 2018 unfolds. How effectively prepared will you be for whatever comes? Providing clear insights on complex topics, along with practical planning tools and new perspectives, this installment of the 2018 essential tax and wealth planning guide should be a valuable addition to your reading list in the coming weeks and months.

To find a member of the Deloitte Private Wealth practice who specializes in your area of interest, please contact us at PrivateWealth@deloitte.com.

Regards,

Julia Cloud
National Industry Leader
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Family offices have a unique opportunity, and a particular responsibility, to help the families they serve be aware of and prepared for inevitable challenges that arise on the global stage. Whether the result of political and legislative divisiveness, economic or social changes, scientific or technological developments, or a host of other factors closer to home, these challenges can impact family offices and the families they serve, both in the short term and in years to come. In Deloitte’s 2017 essential tax and wealth planning guide, we discussed one of these issues: Fraud in the family office. Now is a good time to take a fresh look at other important issues family offices could face in coming years and how to prepare for them.
Death, unsurprisingly, is a sensitive topic for most people. Yet it raises a significant question for family office executives: How prepared are they and the family office organizations they oversee to address the implications of the death of a principal?

It is an important question because family office executives are likely to be called upon to handle the aftermath. And they are uniquely positioned now to prepare the organization and the family they serve for the disruptions and transitions inherent in a principal’s death. By gaining a new perspective on the many issues arising from the death of a principal and being able to assemble the appropriate resources to address them, family office executives have a unique opportunity to support the family and family office during an inevitable time of transition.

The death of a principal doesn’t just disrupt the immediate family. Often there are ties to businesses, communities, philanthropic organizations, states, and countries other than where the principal is domiciled, and of course, to the family office organization. All of these ties can be disrupted with potentially profound implications postmortem, especially if there are liquidity implications that could arise following the death.

Some matters may be time sensitive, requiring financial or regulatory filings. Others may take months or years to resolve. Without a detailed preparedness plan, a postmortem resolution process can become chaotic when it should be orderly. It can be more costly and time-consuming than it otherwise might be. Most of all, it can extend and heighten the inherent disruption to the family, family businesses, and the family office during an already difficult period.
An emerging leading practice for family offices is a series of exercises that can put the family office, family advisers, and the family itself in an effective position to address issues arising from the death of a principal in a timely and effective manner (figure 1). These exercises identify gaps in knowledge, documentation, staffing, and other areas. They also lay out a plan that shows the critical path of steps to be taken after the death of the principal.

**Figure 1. Preparedness exercises**

- **90-day drill**
- Mapping estate administration period
- Family and entity goals and governance
- Financial preparedness
- Asset and liquidity education for heirs
- Risk mitigation

**Goals and governance planning** is vital for the family, the family office, and any related businesses. It includes developing succession plans to identify the right people for required roles and address structural items associated with family businesses, the family office, and other related entities. Key areas of emphasis are:
  - Rallying the family around a shared vision of the future
  - Defining the family office’s role in carrying out that vision
  - Helping the family develop and deploy a plan for carrying out the principal’s philanthropic goals, if any
  - Preparing plans to address the operation of the family business, family office, and other related entities postmortem

- Identifying who will be the successor in charge of the business and who will manage business operations day to day
- If the business is to be sold, aligning the family on a plan for the disposition process and preparing to address financial and tax-related issues
- Establishing and clearly communicating a plan for the family office postmortem, whether it will continue to serve the family, be divided into two or more family offices, or wrap up operations over time
- If there is an existing or planned family foundation, preparing it to accept (or dispose of) transferred funds and operate in the way the principal envisioned

In each instance, it is important that the family and existing entities have structures in place so they are prepared to operate effectively upon the death of the principal and to carry out the wishes of the principal and family.
Family office

Preparedness: The death of a principal

Financial preparedness is essential on many levels.

A cash flow and liquidity review can help determine, based on assets and income streams, whether family needs can be met immediately following the death of the principal and longer term. This involves understanding what cash flow and expenses are expected, what transfer tax liabilities there might be, and what liquidity events or income streams are expected to be available.

A business entity implications exercise projects what domestic and foreign business-related financial consequences of the principal’s death might be expected and develops action plans to address them.

Asset disposition is an analysis of how assets will be held, disposed of, or distributed postmortem. This includes valuing and planning for the disposition or distribution of large equity positions, real estate holdings, closely held businesses, and hard-to-value and illiquid assets.

Risk mitigation planning can encompass a range of risk and resilience capabilities, including assessments for fraud, cyber, and audit-readiness risks (see separate sections that follow). Beyond protecting and preserving the family’s wealth and reputation, these exercises can help family offices identify and develop risk-related considerations for value creation.

Assets and liquidity education for heirs can help the family office develop a plan to inform and educate heirs about the family’s holdings, the portion they might receive upon the death of a principal, and how to protect, sustain, and grow their assets.

In summary, few events in the life of a high net worth family can be as challenging and disruptive as the death of a principal. Through the types of preparedness planning described here, family office executives can help the principal, the family, and the family office organization be as prepared as possible, as far in advance as possible, and with a plan to mitigate those challenges and disruptions.
Tax exposures are a constant source of risk for family offices around the world. Family office executives who look anew for ways to identify and address these potential exposures may be able to help mitigate risk for the family.

One growing area of tax risk in which preparedness is especially important is tax examinations. Revenue authorities around the world are under increased pressure to generate revenues from limited resources, so they are aggressively expanding their scrutiny of the assets, transactions, and locations of high net worth families. They want to learn if they are receiving their portion of a wealthy family’s taxes, and they are using increasingly sophisticated methods to make that determination, including family members’ social media footprints.

In addition, once a high net worth family has been audited by revenue authorities, the risk of follow-up scrutiny increases. It is important that family office executives help the family identify, understand, and address tax risks before they become tax controversies. Periodic audit-readiness exercises can help the family office effectively prepare for a tax examination. These exercises can range from simple discussions with internal advisers to more detailed mock examinations.

A new look at an old challenge
Risk management is a top priority for family office executives today. Some risks are hard to detect, but others may be more obvious. The risk of a tax examination is one of the latter. It is important for family office executives to understand where potential pressure points are and how they can be addressed before they grow into problems for the family.

This is why audit-readiness exercises have become a standard practice for many family offices. For a family office that advises a family about potential risks and how to address them, being able to anticipate potential areas of tax controversy and take steps to mitigate the risks associated with them can be a significant value add.
Family office

Preparedness: Audit readiness

Three types of audit-readiness exercises can help position the family office, family advisers, and the family to understand and address the risk of tax examinations:

Identifying material issues that revenue authorities may focus on during a tax examination is the first audit-readiness exercise. Certain areas that can fall under scrutiny are:

- Income tax
- Lifestyle assets
- Residency issues
- Sales and use tax
- Value-added tax
- Common reporting standards
- Foreign Account Tax Compliance Act (FATCA)

Developing a system for handling information requests from revenue authorities is the second audit-readiness exercise for the family office to consider. Communications from revenue authorities can be an early warning sign that a tax examination may be imminent. These communications can anticipate which issues the revenue authority may raise and what documents might be requested. It is important that the family office be prepared to provide a concise response in a timely manner.

Developing an overall examination strategy is the third audit-readiness exercise. The strategy not only includes a proper presentation of positions, but also a system for providing the information that the tax examiner is likely to request. This point is critical because revenue authorities often dig deeply into the documentation behind tax returns and tax positions. Without proper documentation, tax examiners can reject the tax positions, assessing additional taxes, penalties, and interest. A mock tax examination can be a valuable part of the examination strategy and documentation process (see “Putting it to the test”).

Putting it to the test
A mock tax examination can help identify the strengths and weaknesses in the tax positions and supporting documentation for the family office and its clients, addressing uncertainty in advance of a tax examination by:

- Checking for documents often requested by tax examiners
- Conducting interviews of family office personnel as examiners might
- Explaining each issue, the law behind it, and the documentation required

Every tax examination is different, and examiners don’t necessarily look at every tax position on a return. If a taxpayer receives a “no change” decision on one tax examination, it doesn’t mean that the revenue authority won’t raise new or recurring issues in later years. This is why audit-readiness exercises, such as an examination strategy, documentation process, and mock examination, are so important: They can help family offices and the families they serve to understand the tax risks they face and prepare to address those risks if they receive a notice from a revenue authority.
Family office priorities can vary widely, but a common objective for all is protecting the family’s safety, privacy, reputation, and wealth. Better than any individual family member, adviser, or service provider, the family office is in a position to monitor and manage such risks for the family.

Many factors determine a family office’s approach to risk management, including the size of the office, its sophistication, and the experience of its personnel. Yet regardless of the family office’s makeup, a sound risk management framework with effective internal controls is essential.

Some family offices are even beginning to look at risk management from a different perspective. They consider it an investment in the future of the family’s reputation and well-being and the preservation of the family’s assets, rather than an expense. An effective risk management framework can help prepare a family office to withstand market disruptions, cyberattacks, internal fraud, and other relevant threats.

Internal controls are important components of such a framework. The sooner a family office introduces and periodically reviews such controls, the better equipped it can be to manage risk and discourage inconsistency and unreliability in the management of the family’s affairs.

The value of audits and assessments

Family office priorities, personnel, and systems change over time, causing risks to evolve. As a result, an effective practice is to conduct periodic formal audits and assessments, tailored to the specific circumstances of the family office, to confirm that controls are focused appropriately.

Three types of audits and assessments are particularly effective:

- **Process assessments** focused on effective design and operation of key family office internal processes
- **Annual financial statement audits** for one or more entities, such as foundations, trusts, or the family office
- **Transactions testing** for effective internal control operation and documentation

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Family office

Cyber risk

In the digital era, family offices and the families they serve face many areas of potential cyber risk exposure, including personal identities and reputations; public and private schedules; business dealings; political connections; community and philanthropic relations; and interactions with regulators.

Just one lost laptop, a misplaced wallet or purse, a seemingly innocent social media post, or a carelessly opened email can be the trigger point. Suddenly, the very carefully guarded privacy, security, and even safety of the family, its businesses, and the family office may be in jeopardy.

This isn’t a hypothetical threat. It is very real, personal, and imminent—played out in the media all too often, and probably even more frequently behind the scenes. The urgent question is how can family office executives, often operating in a smaller enterprise environment with limited resources, gain new insights on and take meaningful action to address cyber risk before it becomes a problem?

Two fundamental cybersecurity questions:

1. What are the digital footprints of the family office and family members—individually, personally, and from a financial perspective?

2. What steps are being taken to manage those footprints?

The first step is to acknowledge, understand, and prioritize specific risks that might confront family members, the family office, and the entities it serves. Large companies and governments aren’t the only targets of cyber criminals. Any person or business—especially one with sizable assets, a smaller resource team, and a high public profile—is at risk.

Next, to address these risks it is important to design and implement appropriate cyber risk management solutions, such as identity and access management, data protection, software application security, transaction security, and core systems and device security.

Finally, it is vital that these cyber risk management solutions be monitored, maintained, and improved over time. This can include enhancing security operations, implementing risk monitoring across applications, conducting threat intelligence and analytics, and identifying and remediating vulnerability gaps.

A cyber risk management program should be:

- **Secure**
  Having risk-prioritized controls to defend against threats

- **Vigilant**
  Committing financial and talent resources to identify harmful behavior

- **Resilient**
  Recovering from and limiting the impact of cyber incidents
Family office

Family office transformation

Across the life cycle of wealth, high net worth families face many important decisions. These can include family or business-related events; formation of a family office, foundation, or trust; formalizing an existing family office to provide more services or expand the number of family members it serves; transitioning the family office from one generation to the next; and many others.

These decisions can involve many strategic, financial, and operational considerations. Careful analysis, planning, and communication are important to facilitate strong alignment both among family members and between the family members and family office that oversees their financial affairs.

An effective practice for addressing these types of events is to bring selected family principals and/or family office executives to an off-site, interactive Family Office Transformation Lab hosted by Deloitte and tailored specifically for the issues at hand. There they can focus, uninterrupted, on taking a new look at key issues, making meaningful headway on tough decisions, and addressing specific challenges associated with the family and the family office.

Driven by major events in the family’s life, Deloitte’s Family Office Transformation Labs can be specially designed to help the family and family office navigate issues associated with the family’s complex financial enterprise and personal objectives across the wealth life cycle (figure 2). Facilitators use tested methodologies to help family members, family office executives, and other key stakeholders align on important expectations and objectives. Opportunities for transformative change are identified and prioritized.

Family Office Transformation Labs can also help address specific issues surrounding the family office itself, whether it’s the design and implementation of a new family office organizational structure or the review of any area of an existing family office’s operations or performance (see “Family office transformation areas”).

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**Figure 2. Events impacting the life cycle of wealth**

<table>
<thead>
<tr>
<th>Wealth creation</th>
<th>Family events</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>• Marriage/divorce</td>
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<tr>
<td></td>
<td>• Birth/death</td>
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</tbody>
</table>

**Reassessment events**
- Discovery of fraud
- Subpar performance
- Family disharmony

**Business opportunities and investments**

**Monetization or liquidity events**

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**Family office transformation areas**
- Governance
- Family client relationship management
- Tax efficiencies
- Regulatory compliance
- Accounting and recordkeeping
- Internal controls
- Treasury and cash management
- Human resources
- Succession

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Personnel changes are a normal part of any business operation, including a family office. Such changes can be challenging for family office executives who are tasked with leading the organization and driving its success. They must be adept at juggling many different responsibilities and managing a range of challenges.

The importance of finding the right executive to fulfill these obligations cannot be overstated. The family will typically entrust that individual with significant personal information, and that person must be able to work with all family members served by the family office. It is important that the family invest the time necessary to identify the right executive and lay the groundwork for that executive’s success.

A Family Office Executive Transition Lab can facilitate that process by helping newly appointed executives make an effective transition into their new role (see “A welcome departure…” also on this page). An important output of a Family Office Executive Transition Lab can be a 180-day action plan, with specific milestones, to pursue the executive’s priorities. But what priorities should he or she pursue?

The Family Office Executive Transition Lab can help executives gain an understanding of the critical moments likely to arise in their new role. They can explore current capabilities of the family office and identify and classify issues likely to consume their time and energy, such as talent, systems, processes, relationships, controls, facilities, and communications. The readiness of the family office to execute those top priorities can be explored as well, along with ways to increase the executive’s confidence in outcomes. Importantly, the executive can also explore ways to accomplish priorities in alignment with the family’s wishes and expectations.

**A welcome departure from business as usual**

A Family Office Executive Transition Lab allows family office executives to step away from standard flat meetings, mind-numbing presentations, and stale status-quo thinking. Instead, they become immersed in an experience custom-designed to help them dig into complex issues and drive breakthrough results by:

- **Disrupting ordinary thinking**
  Instead of jumping right into solutions, step back and first build a rich understanding of challenges and their context.

- **Revealing new possibilities**
  Expand beyond the obvious and dive into unexpected, innovative, and creative solutions.

- **Inciting productive action**
  Bravely call out real barriers to progress, create ownership, and align the family office vision and 180-day plan on the precise actions required to get results.
Wealth transfer planning alternatives

In the prior release of our wealth planning guide, we discussed how important it is to periodically reevaluate your wealth transfer goals and revisit your wealth transfer plan for consistency with those goals. We also addressed how effective wealth transfer planning facilitates how to “slice up the pie” of your wealth between family and friends, charity, and the government (in the form of taxes). We provided you with a primer on the transfer tax system, covering the three related federal transfer taxes—the gift tax, the estate tax, and the generation-skipping transfer (GST) tax—as well as state transfer taxes. The prior release covered the basic concepts of wealth transfer planning. This release revisits those fundamental concepts, with appropriate illustrations, and discusses how they are frequently combined into many of the common planning alternatives available today. You may find it instructive to first review the foundational wealth transfer planning chapter from our first installment before exploring this wealth transfer planning alternatives chapter.
On December 22, 2017, an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the Act) was signed into law. Under this new legislation, the current tax regime with respect to the estate, gift, and GST taxes and the income tax basis adjustment to fair market value at death remain unchanged. The only exception is that the applicable exclusion amount (the amount that each citizen is entitled to transfer either during life or, if otherwise unused, at death without incurring a current tax) and the GST tax exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) is doubled to $10 million per person (indexed for inflation) from its existing $5 million per person (indexed for inflation) for transfers occurring after December 31, 2017. The exclusion and GST exemption continue to be indexed for inflation. As the Internal Revenue Service (IRS) recently announced, the inflation adjusted amount for 2018 is $11,180,000. However, beginning January 1, 2026, the exclusion amount and the GST exemption will return to the levels that would have prevailed under prior law.

For married couples expecting to have collective wealth in excess of approximately $12.5 million at the end of 2025, the Act provides a tax incentive to proactively plan now. Perhaps now is the time to take a fresh look at your tax and wealth planning objectives to refocus on what is most important—your family, business, and personal goals—in anticipation of impending change.

Our overriding intention for this release is to reiterate the concepts that form the “how” of wealth transfer as commonly considered by high net worth families to further inform the more personal considerations of “to whom” and “when” such transfers of wealth should occur: Importantly, every concept can be employed in multiple variations and combinations that are beyond the scope of this release. Not all of the concepts or examples provided in this release may be appropriate for everyone, and there may be other concepts not discussed in this release that may be more suitable for your particular goals and circumstances. For example, with the new larger exemption amounts, perhaps transfer planning is no longer as expedient; but, there is still income tax planning that should be considered—a topic for another release. Whether or not to employ one or more of the concepts is a function of the nature of the assets that comprise your wealth, your objectives regarding to whom, how, and when to convey those assets, and your overall risk tolerance. Merely reading this release is not a substitute for engaged and thoughtful planning with your tax advisers.
In this chapter we provide an overview of the following wealth transfer planning concepts:

1. Transfers through arbitrage—the use of preferred equity interests
2. Transfers of actuarial interests, arbitrage in a different form—the grantor retained annuity trust (GRAT)
3. Transfers through leverage—the sale to a grantor trust
4. Leveraged transfers of actuarial interests, combining two alternatives—the remainder purchase marital (RPM) trust

For each concept, we provide an example of one way it could be structured, along with comments about transfer tax issues, and in some cases, income tax concerns.

In addition, we reiterate two other concepts often used to supplement planning as circumstances permit:

- The net gift (and bargain sale) concept
- The use of formula valuation mitigation clauses

Note that for each concept, we present selected benefits and risks, which are by no means exhaustive. Readers should consult their advisers concerning the benefits and risks arising with respect to their own assets, goals, and circumstances.
A cautionary note: Establishing family investment entities, with or without multiple equity classes, has long been an object of intense IRS scrutiny. Using these vehicles requires scrupulous adherence to the entity’s governance provisions, and more importantly, based on recent case law, must be found to have been established and funded for a nontax purpose that is evident from the conduct of the parties. Typically, this requires a significant differentiation in asset management before and after the creation and funding of the entity. Failure to exhibit these qualities will result in the assets contributed to such an entity being included in the taxable estate of the contributor at their fair market value at death. The success of family investment entities can be a point of great risk without the support of a family office structure. Nevertheless, they do best illustrate the concept behind the alternative of moving wealth by arbitrage.

At the outset, the family contributes property to a family-controlled limited partnership or limited liability company (LLC). The senior generation typically receives the general partner (GP) units or managing member LLC units (typically, 1 percent of the capital and income). The limited partner (LP) units (or nonmanaging member LLC units) are divided into two classes: preferred and residual. Who comes to own the preferred and residual units depends on the alternative employed.

Preferred units typically have liquidation participation rights, but generally not a liquidation preference, and a set annual cumulative payout rate that is a stated percentage of the liquidation value. For example, a preferred unit may have a liquidation value of $100 and a preferred payment rate of 8 percent, meaning that each year the preferred unit is expected to pay $8 to its holder. To avoid adverse gift tax consequences, the annual payment, if not made, will accumulate for later payment before the residual owners are paid. The residual units receive what is left of any annual distribution. Upon liquidation, any cumulative deferred payment is made to the preferred unit holders; thereafter, the preferred units participate proportionately in the liquidation proceeds, but not in excess of their liquidation value.

The preferred payment rate is determined by an independent appraiser. The preferred rate is fundamentally based upon an analysis of market corollaries, considering the relative risk profile and credit quality of the interest. The object of the analysis is to reflect a rate of return that preserves the liquidation value of the preferred units. Given prevailing interest rates over the past decade, that preferred rate has ranged between 6 and 10 percent and is trending higher.
Wealth transfer planning alternatives

Transfers through arbitrage: The use of preferred equity interests

The forward arbitrage structure

To arbitrage forward, the senior generation family members obtain the preferred units generally in exchange for capital contributions, and the junior generation obtains the residual units either by capital contribution or by gift from the senior generation. This configuration provides a preferential cash flow stream to the senior generation while shifting future appreciation and/or income generation in excess of the preferred rate to the junior generation. The value of any gift of residual units is generally determined by taking into account discounts for lack of marketability and lack of control (which are frequently a matter of contention with the IRS) and also the value of the preferred equity class.

Proper structuring of a forward arbitrage is essential to gain the intended benefits. Internal Revenue Code (IRC) section 2701 mandates the necessary provisions with respect to family-controlled entities having multiple equity classes. If these requirements are not met, significant valuation complications are imposed and a significant gift tax can result. The requirements are beyond the scope of this release; please consult with your tax adviser for additional details.

While there are no constraints on the types of assets or business activities that can be undertaken by the partnership or LLC, once again, what is important is that appreciation or income production outpace the preferred payout rate. Preferably, cash flow will permit the payment of the preferred return on a relatively current basis rather than only at liquidation. Current law requires that any cumulative but unpaid preferred return, including compound interest in certain circumstances, be treated as a separate asset if unpaid at the date of a gift of the preferred interests or upon the holder’s death.

Wealth transfer planning alternatives

Transfers through arbitrage: The use of preferred equity interests

Forward arbitrage partnership (FAP) illustration

1. Contribute cash or other property to FAP in exchange for GP interest and preferred LP units and, if circumstances require, residual LP units.
2. Senior family member transfers any acquired residual LP units to junior generation.

2017 tax reform provides opportunity

Concepts for consideration

Transfers through arbitrage: The use of preferred equity interests

Transfers of actuarial interests: The GRAT

Transfers through leverage: The sale to a grantor trust

Leveraged transfers of actuarial interests: The RPM trust

Supplemental planning concepts

Considerations for your path forward
Wealth transfer planning alternatives

Transfers through arbitrage: The use of preferred equity interests

Forward arbitrage structure select benefits and risks

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash flow to senior generation</strong> – Provides the preferred unit holders with annual cash flow.</td>
<td><strong>Proper structuring</strong> – Complying with section 2701 requirements is necessary to avoid adverse gift tax consequences.</td>
</tr>
<tr>
<td><strong>Appreciation to junior generation</strong> – Allows appreciation/income generation above the preferred rate to the residual unit holders.</td>
<td><strong>Asset performance</strong> – If the partnership asset performance is less than the preferred rate, any gifted residual units may prove to be valueless and, if junior family members contributed to the residual units, a reverse wealth transfer may result.</td>
</tr>
<tr>
<td><strong>Control</strong> – Although not generally advisable, senior generation can control through ownership of general partnership units.</td>
<td><strong>Complexity</strong> – Structure requires an outside appraisal, annual partnership tax returns reflecting complicated partnership income allocation issues, and a more complicated gift tax return. Involves strict adherence to the governance provisions of the LP or LLC agreement.</td>
</tr>
<tr>
<td><strong>Valuation discounts</strong> – Valuation discounts may be available to reduce the gift tax value of transfers of residual units by gift, if any.</td>
<td><strong>Costs and administration</strong> – Includes more significant setup and administration, which may increase transaction costs.</td>
</tr>
<tr>
<td><strong>Flexibility</strong> – While a four-year grace period is allowed to make preferred payments, providing for greater flexibility with cash flow fluctuations, the cumulative unpaid amount, plus compound interest if the four-year grace period is exceeded, is treated as a separate asset that has both gift and estate tax implications.</td>
<td><strong>Risk profile</strong> – IRS may challenge the value of the preferred equity interests or the valuation discounts applied to transfers of the residual units. Either argument, if it prevails, may result in additional gifts and additional transfer tax. Additionally, whether the transfer was ultimately effective will turn on whether estate inclusion of contributed assets can be avoided.</td>
</tr>
</tbody>
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Wealth transfer planning alternatives

Transfers through arbitrage: The use of preferred equity interests

The reverse arbitrage structure

In a reverse arbitrage, the senior generation retains the residual interest, and the junior generation—through capital contributions or by transfers from the senior generation—receives the preferred LP or nonmanaging member units. The alternative, when structured in this manner, is not subject to the statutory constraints of the forward arbitrage structure. Thus, the preferred units are frequently structured to convey an above-market return (for example, by imposing an above-market hurdle rate that is generally noncumulative). This, too, should be set by an appraiser since fair market value becomes less sensitive to higher hurdle rates depending on the assets contributed to the entity. In all other respects, they resemble the preferred units in the forward arbitrage structure.

The structure anticipates that the high preferred rate will consume most (if not all) of the partnership’s appreciation and income generation, resulting in the residual interest retained by the senior generation actually experiencing little growth and perhaps a diminution in value between the date of transfer and the senior generation unit holder’s death. More importantly, this structure transfers cash flow to junior family members (or their trusts), which may make additional planning easier to undertake (such as sales to grantor trusts). The value of any gift of preferred units is generally determined by taking into account discounts for lack of marketability (which are generally modest given the hurdle rate) and lack of control (which is an issue if the preferred return is not cumulative). As stated earlier, discounts are frequently a matter of contention with the IRS. Structured in this manner, the relative gift value of preferred units is generally relatively high.

Again, while there are no constraints on the types of assets or business activities that can be undertaken by the partnership or LLC, what is important is that the preferred interest holders receive their anticipated above-market yield. This puts an emphasis on annual cash flow since the preferred yield is not generally cumulative—thus, cash flow planning is crucial.

Reverse arbitrage partnership (RAP) illustration

1. Contribute cash or other assets to RAP in exchange for preferred LP units
2. Senior family member gifts any acquired preferred LP units to junior generation
3. Trust(s)
4. Junior family members

1. Contribute cash or other property to RAP in exchange for GP interest and residual LP units and, if circumstances require, preferred LP units

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Reverse arbitrage structure select benefits and considerations

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 2701 rules don’t apply – A reverse arbitrage structure is not subject to the section 2701 considerations.</td>
<td>Cash flow to senior generation – This alternative provides NO cash flow to the senior generation.</td>
</tr>
<tr>
<td>Cash flow to junior generation – Provides the preferred rate cash flow to the preferred unit holders.</td>
<td>Asset performance – If the partnership asset performance is greater than the preferred payments, the wealth of the senior owners will increase.</td>
</tr>
<tr>
<td>Control – Although not generally recommended, senior generation can still control through ownership of general partnership units.</td>
<td>Complexity – Structure requires an outside appraisal, annual partnership tax returns reflecting complicated partnership income allocation issues, and a more complicated gift tax return. Involves strict adherence to the governance provisions of the LP or LLC agreement.</td>
</tr>
<tr>
<td>Valuation discounts – Valuation discounts may be available to reduce the transfer tax value of residual units held by the senior generation at death.</td>
<td>Costs and administration – Includes more significant setup and administration, which may increase transaction costs.</td>
</tr>
<tr>
<td>Flexibility – There are no required annual payments; however a failure to make annual payments can affect the efficacy of the alternative since the preferred payments are not cumulative.</td>
<td>Risk profile – IRS may challenge the value of the preferred equity interest resulting in additional gifts, including potential gifts from junior family members to senior family members. Additionally, whether the transfer was ultimately effective will turn on whether estate inclusion of contributed assets can be avoided.</td>
</tr>
</tbody>
</table>
A GRAT is an irrevocable trust to which the grantor contributes property and retains a fixed annuity, payable in cash or in kind, from the trust for a term of years. The remainder interest (the property that remains in the GRAT after the final annuity payment is made) is distributed to the specified beneficiary, typically the grantor’s children or trusts for their benefit. As will be evident below, GRATs can be funded with extraordinary amounts, yet result in very small taxable gifts. They are not a substitute for, but rather augment, the judicious use of a taxpayer’s applicable exclusion amount.

In its most common iteration, the “zeroed-out” GRAT or Walton GRAT, the calculated present value of the retained annuity payments flowing to the grantor generally equals, within a few dollars, the value of the property he or she contributed. The gift subject to tax is the current value of the remainder interest in the GRAT transferred to the beneficiary—the value of the assets contributed to the GRAT less the present value of the retained annuity. If the value of the retained annuity is essentially equal to the value of the property contributed, a minimal gift results. The present value of the annuity payments is calculated using a prescribed discount rate updated monthly by the IRS. That rate is 3 percent for March 2018 (its historical high was 11.6 percent in May 1989).

As a cautionary note, when a trust is established fundamentally for the benefit of its grantor, the trust’s assets will be included in the grantor’s gross estate should he or she die as a beneficiary of the trust. Thus, should the grantor die while the annuity is still being paid, the desired estate tax savings will not materialize. Most GRATs include short annuity periods to mitigate this mortality risk.

As described above, a Walton GRAT is successful only if the grantor survives the annuity term, and most importantly, if the trust property appreciates and/or generates income at a rate higher than the discount rate noted above. If the trust property fails to outperform the discount rate, the required annuity payments will erode or “cannibalize” the trust. Thus, the GRAT’s advantage is in the rate arbitrage between actual yield and the mandated discount rate. However, since the gift tax value of the remainder interest is typically structured to be a modest number, a failed GRAT imposes no significant hardship. Thus, while GRATs are very attractive in the current lower interest rate environment, they still must be funded with assets capable of significant appreciation or income production during the annuity period. For example, in the past this has sometimes been realized with closely held stock in a company anticipating a public offering, or an asset that provides substantial cash flow. Because of the annual payment requirement, if the yearly annuity is to be paid in kind with difficult-to-value assets, such assets will also need to be annually appraised in order to determine that the annuity requirement is met in good faith. Examinations of GRAT transactions by the IRS indicate that the due diligence in determining the amount of any annuity payment in kind will be strictly scrutinized.
Wealth transfer planning alternatives

Transfers of actuarial interests, arbitrage in a different form: The GRAT

For income tax purposes, the GRAT is a grantor trust (discussed in the foundational wealth planning chapter from our first release). Therefore, the grantor continues to report any income attributes of the GRAT on his or her individual income tax return. Since a GRAT itself does not attract income taxes, the GRAT assets grow income tax-free, thus enhancing the probability of a yield in excess of the discount rate.

**Grantor Retained Annuity Trust (GRAT) illustration**

1. Grantor contributes property to GRAT
2. GRAT makes annual annuity payments to grantor
3. At end of annuity term, any remainder passes to remainder beneficiaries

**GRAT example**

In January 2018, Jack contributes $10 million of appreciated, marketable securities to a GRAT, which was established for the benefit of his daughter, Alyssa. The term of the GRAT is five years and the required discount rate is 2.6 percent. Jack retains an annuity of roughly 14.6 percent of the initial value of the property contributed, which increases by 20 percent each year (the maximum escalation allowed by statute). The present value of the annuity payments is $9,999,999, which results in a gift of $1.

Over the term of the GRAT, the marketable securities appreciate at an annual rate of 6 percent. Accordingly, at the end of the annuity term, which Jack survives, $1,356,438 is left for distribution to Alyssa.

**The result:** Jack transferred over $1.35 million to Alyssa utilizing only $1 of his gift exemption.
Wealth transfer planning alternatives

Transfers of actuarial interests, arbitrage in a different form: The GRAT

GRAT select benefits and risks

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Control</strong> – In most cases, the donor can be trustee of the GRAT, but generally not beyond the annuity period.</td>
<td><strong>Mortality risk</strong> – Grantor must outlive the GRAT term for the GRAT to be successful.</td>
</tr>
<tr>
<td><strong>Tax-free growth</strong> – Property in trust appreciates tax-free (because the grantor reports the trust’s income on his/her tax return).</td>
<td><strong>Inflexible</strong> – Timing and amount of annuity payments are inflexible, and by statute, the trust cannot be terminated early (commuted).</td>
</tr>
<tr>
<td><strong>Minimal cost to failure</strong> – If trust property does not perform better than the discount rate, trust assets are returned to the grantor with little or no gift tax exemption utilized.</td>
<td><strong>Market risk</strong> – Because the GRAT remainder interest is so small, volatility, particularly in the early years, may preclude a GRAT’s success.</td>
</tr>
<tr>
<td><strong>Limited valuation protection</strong> – Expressing the annuity as a percentage of initial fair market value allows for automatic adjustment of the determination of the required annuity amounts if valuation is later contested. However, there is no valuation protection with respect to any annuity payment made in kind.</td>
<td><strong>Limited GST planning</strong> – GRATs are most effective for single generation transfers (for example, transfers to children) because GST exemption cannot be allocated to a GRAT until the end of the annuity period.</td>
</tr>
<tr>
<td><strong>Risk profile</strong> – GRATs and their governance are statutory (IRC section 2702).</td>
<td><strong>Carryover basis</strong> – Property received by the remainder beneficiary maintains carryover tax basis.</td>
</tr>
</tbody>
</table>

The qualified personal residence trust (QPRT) – an alternative transfer of a future interest

Family members interested in transferring their principal residence or vacation home may want to consider a QPRT. A QPRT performs much like a GRAT except that the annuity payment is replaced by the rent-free use of the residence for the specified term of years. At the end of the term, the ownership of the home typically passes to children. Although one can continue to live in the home after the children take ownership, paying fair market rent will be required to avoid adverse estate tax consequences. QPRTs are more favorable in a higher interest rate environment because higher rates increase the value of the retained use of the residence, thus reducing the taxable gift.
Wealth transfer planning alternatives

Transfers through leverage:
The sale to a grantor trust

There are a number of retained interests and powers that give rise to grantor trust status. The grantor trust used in this alternative must, however, employ one of a select subset of retained powers, which enable it to also avoid later estate tax of the trust’s assets. Stated differently, the trust must be regarded as a separate and distinct entity for transfer tax purposes, but be disregarded for income tax purposes. Because the grantor pays all income taxes on the tax attributes of the trust, the trust’s assets grow free of income tax, thus better facilitating the sale transaction discussed below. The income tax paid by the grantor on behalf of the trust further reduces the grantor’s taxable estate.

In many cases, the trust is drafted as a dynasty trust, which as the name implies, typically benefits children, grandchildren, and future generations. In certain states, a dynasty trust can have a perpetual term. Unlike a GRAT, the dispositive terms of a dynasty trust can be very flexible with respect to who benefits from the trust, and to what extent. Such a trust is transfer-tax effective, however, only if it is exempt from the GST tax. To accomplish this, the grantor’s GST exemption must be allocated to each gift transfer made to the trust.

Once the grantor trust is established with sufficient capital (which will utilize some or all of the grantor’s remaining gift exclusion, and generally, GST exemption), the independent trustee enters into a purchase agreement with the grantor, most typically conveying a promissory note as consideration. As a general rule of thumb, the trust should have capital of at least 10 percent of the total purchase price fundamentally to forestall the negative gift and estate tax repercussions of a default on the note. Because the trust is disregarded for income tax purposes, the sale of assets by the grantor to the trust (the “purchasing trust”) is also disregarded for income tax purposes. Thus, income taxable gain or loss and interest income and expense with respect to the note are avoided; but, the grantor’s basis in the assets will also carry over to the purchasing trust.

The interest rate on the note must be at least equal to the applicable federal rate (AFR) prescribed monthly by the IRS. For example, a note with a three- to nine-year term would utilize the midterm AFR, which is currently 2.57 percent for transactions occurring in March 2018.
Wealth transfer planning alternatives

Transfers through leverage: The sale to a grantor trust

The tax consequences described above, however, assume that the grantor survives to see the note fully paid. Since grantor trust status ends when a grantor dies, the death of the grantor prior to the payment of the note introduces a number of income tax complications, some of which have uncertain answers, including whether or not any built-in gain with respect to the purchased assets is subject to recognition.

Unlike a GRAT, a sale transaction is not subject to: (1) mortality risk (other than the complications arising if the note is not paid prior to the death of the grantor), (2) highly structured payments (other than the annual payment of interest), and (3) the related volatility risk. However, a sale always carries a valuation risk—that the purchase price is determined to be less than fair market value. If such an outcome prevails, the spread between the sales price and the fair market value of the purchased property, absent mitigation (discussed later), is considered a taxable gift, which will absorb the grantor’s exclusion amount (and GST exemption, if applicable) or even give rise to a gift tax payable.
Wealth transfer planning alternatives

Transfers through leverage: The sale to a grantor trust

Sale to grantor trust example

Ralph is the owner of a successful company, an S corporation, and wishes to transition ownership of his business to a dynasty trust to benefit his immediate family and future generations. Ralph forms and funds a specific form of grantor trust with $10 million of cash, utilizing some of his gift and GST tax exemptions. Ralph names his long-time advisor, Barbara, as trustee.

At a later date, Barbara, as trustee, agrees to purchase $100 million of company stock from Ralph. The purchase is financed through a promissory note with a nine-year term, with equal annual payments of interest and principal. The interest rate on the note is 2.57 percent, utilizing the midterm AFR for the month of the sale. The sale is disregarded for income tax purposes.

Over the nine-year term of the note, company sales and net income soar. The company makes tax distributions to its shareholders. Barbara, as trustee, utilizes this cash and, where prudent, the seed money, to make the required annual payments on the note and even some prepayments. The grantor used these funds to pay his income tax liability related to the income of the S corporation. After the note obligation is paid in full, the remaining assets of the trust will include all of the purchased company interest.

The result: Ralph leveraged $10 million of his gift and GST tax exemption to transfer $100 million of the S corporation through a transaction disregarded for income tax. Furthermore, because the note payments were utilized to pay income taxes related to the grantor trust’s assets, Ralph’s estate was actually reduced by $110 million (the $10 million seed plus the $100 million face value of the note), excluding the post-sale appreciation on the company interest.
## Wealth transfer planning alternatives

### Transfers through leverage: The sale to a grantor trust

Sale to grantor trust select benefits and risks

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Disregarded sale</strong> – The sale (and interest on the note) is disregarded for income tax purposes, at least until the death of the grantor.</td>
<td><strong>Control</strong> – The grantor cannot be the trustee nor retain control over the property in trust.</td>
</tr>
<tr>
<td><strong>GST planning</strong> – Suitable for multigenerational wealth transfers (for example, transfers to both children, grandchildren and great-grandchildren).</td>
<td><strong>Cash flow</strong> – The grantor must be willing and able to pay the trust’s income taxes throughout its term even if insufficient cash is received through the note payments.</td>
</tr>
<tr>
<td><strong>Tax-free growth</strong> – Property in trust grows income tax-free because the trust is structured as a grantor trust.</td>
<td><strong>Risk profile</strong> – A bargain sale valuation risk (subject to mitigation) is always present.</td>
</tr>
<tr>
<td><strong>Flexibility</strong> – Compared to a GRAT, there is more flexibility in making principal payments (if a balloon note is utilized).</td>
<td><strong>Carryover basis</strong> – Property in trust receives carryover tax basis.</td>
</tr>
<tr>
<td><strong>Lower mortality risk</strong> – Unlike the GRAT, the grantor does not need to outlive the note term to realize wealth transfer benefits; however, the collection of the note becomes more complex if it remains outstanding at death and the bona fides of the transaction may be open to greater scrutiny.</td>
<td><strong>Market and downside risk</strong> – If trust property doesn’t perform and the note cannot be paid, the grantor has likely wasted some gift (and GST) exemption and the property is returned to the grantor.</td>
</tr>
</tbody>
</table>
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

Combining two alternatives
The remainder purchase marital (RPM) trust requires a married couple and, conceptually, combines the mechanics of a GRAT and the leverage of a sale transaction. At the outset, the grantor contributes property to a grantor trust (structured in the same manner as the trust discussed above). In its most common iteration, the trust conveys an annuity for the lesser of a term of years or life to the grantor’s spouse. This element of the structure behaves very much like a GRAT. Simultaneously, a family member or a trust purchases the remainder interest from the grantor. The purchasing trust is often structured as a dynasty trust.

The structure of the RPM trust transaction is intended to avoid a taxable gift by having (1) the spouse’s annuity interest qualify for the gift tax marital deduction, and (2) the grantor receiving full and adequate consideration from the purchaser of the remainder interest. The grantor retains no interest in the trust (thus eliminating the mortality risk inherent in a GRAT), but does take back an asset (the consideration for the purchase of the remainder interest). The amount of that consideration is determined by subtracting the value of the annuity interest from the net value of the assets contributed to the trust, to arrive at the value of the remainder interest. Where the RPM trust transaction differs from that of a Walton GRAT is that here, the remainder value should not be insubstantial (for example, several percent of the value of property contributed to the trust), thus encouraging robust oversight by the remainder beneficiary.

Whether an annuity interest is for a term of years, or the lesser of life or a term of years is a function of the spouse’s health. A term of years, or the lesser of life or a term of years, is used in order to provide certainty as to when the trust’s income or annuity payments will end. Subjecting a sum certain annuity for a term to the spouse’s life expectancy reduces its value (thus increasing the value of the remainder interest), but terminates upon the death of the spouse. If a term-of-years interest is used, the spouse’s estate will continue to collect any outstanding payments until the term expires.

While the actuarial factors above may affect the ultimate performance of the RPM transaction, its effectiveness is anchored in whether and the extent to which trust appreciation and/or income generation outpaces the imposed discount rate—since it is the discount rate that is used to compute the value of the annuity interest. If it fails to do so, like a GRAT, the trust will erode or “cannibalize” from the annuity payments to the spouse (although this risk does not arise with an income interest). Any trust assets left after the termination of the spouse’s interest pass to the purchaser of the remainder interest.
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

There are two significant risks associated with the RPM trust transaction. The first is proper valuation of the property contributed. A successful valuation contest by the IRS may lead to a determination that the remainder interest was not transferred for full and adequate consideration. If the IRS prevails on this point, the potential exists that the gift tax marital deduction will be lost and a corresponding taxable gift will result equal to the value of the trust property less the consideration received for the remainder interest. Therefore, it is important to consider contributing readily marketable property and/or considering the use of formula valuation clauses (discussed later) to consummate the sale transaction. The second risk is that the transaction cannot easily accommodate a future divorce of the spouses.

RPM trust example
Jack (grantor) contributes $20,000,000 of appreciated, marketable securities to an RPM trust when the prevailing discount rate was 2.6 percent. The trust was established for the benefit of his wife, Jill (spouse), age 62. After modeling the expected performance of the property and considering Jill’s health, Jill was conveyed a 7.25 percent annuity interest ($1,450,000 annually) for the lesser of 20 years or life (an actuarial value of $18,482,860). Jack retained the remainder interest, which he simultaneously sold for $1,517,140 cash to a long-standing dynasty trust, which at the date of the sale, was a grantor trust to Jack.

Assume that Jill passes away at the end of year 12, at which time the RPM trust terminates in favor of the dynasty trust. Over the term of the RPM trust, Jill collected a total of $17,400,000 ($1,450,000 per year for 12 years), which she sprinkled among her children and grandchildren in annual exclusion gifts or gave away to charities, leaving just enough to utilize her unused applicable exclusion amount for estate tax purposes. Having undertaken the planning, at the end of the 12th year, Jack’s estate is $37,191,146 less than it would have been had Jake done nothing (even after taking into account the $1,517,140 of sales proceeds).

Note that Jill received less than the actuarial value of her interest, $18,482,860, because she predeceased her actuarial life expectancy by several years. This actuarial difference benefits the dynasty trust, which also benefits from the appreciation in excess of the 2.6 percent discount rate (the discount rate used to determine the purchase price). The dynasty trust, growing at the discount rate, would be expected to have a value of $3,052,784 at the end of its 12th year.
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

RPM trust illustrations

At inception

1a Grantor contributes property to RPM trust...

1b ...simultaneously the dynasty trust purchases the RPM trust remainder interest from the grantor for cash or a note...

RPM trust

Dynasty trust

Family members

Grantor

Spouse

Over its term

2 Dynasty trust makes required payments of principal and interest on the note (if any) to the grantor

2 RPM trust makes annuity or income payments to spouse under the terms of the document

Dynasty trust

Family members

Grantor

Spouse

At end of the annuity or income interest term, any remaining assets pass to dynasty trust

RPM trust

Dynasty trust

Family members

Grantor

Spouse
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

RPM trust structure selected benefits and risks

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disregarded sale – The sale (and interest on the note), if the purchaser is a grantor trust, can be disregarded for income tax purposes.</td>
<td>Valuation – Proper valuation of the property contributed is paramount if adverse gift tax consequences are to be avoided.</td>
</tr>
<tr>
<td>GST planning – Suitable for multigenerational wealth transfers (for example, transfers to both children, grandchildren and great-grandchildren).</td>
<td>Control – The grantor cannot be the trustee nor retain control over the property in trust.</td>
</tr>
<tr>
<td>Tax-free growth – Property in trust appreciates tax-free (because the trust is a grantor trust).</td>
<td>Cash flow – Grantor must be willing and able to pay the trust’s income taxes throughout its term, notwithstanding that the only consideration received is the purchase price of the remainder interest (and, perhaps, the distributions received by the spouse).</td>
</tr>
<tr>
<td>Low downside risk – The alternative is structured not to give rise to a gift. However, it is subject to high valuation risk.</td>
<td>Carryover basis – Property in trust receives carryover tax basis.</td>
</tr>
<tr>
<td>Mortality risk – The grantor and spouse do not need to outlive the transaction term—however, for a life income interest, outliving one’s life expectancy will undermine the planning. Unless a term-of-years annuity interest is conveyed to the spouse, the only assets includible in the spouse’s estate will be the trust distributions actually collected. The grantor will have the proceeds of the remainder interest sale in his or her estate.</td>
<td>Market risk – If trust property does not perform better than the prescribed discount rate, depending on the structure, all trust assets could be conveyed to the spouse. Similarly, the purchaser of the remainder interest could receive nothing, but the grantor would still retain the purchase price.</td>
</tr>
<tr>
<td>Risk profile – Less common planning transaction, has a higher than average valuation risk. Presupposes a solid marriage.</td>
<td></td>
</tr>
</tbody>
</table>

Wealth transfer planning alternatives

Supplemental planning concepts

The net gift (and bargain sale) concept
A net gift is a gift conditioned on the donee reimbursing the donor for (at a minimum) the related gift tax. It is called a net gift because the amount subject to tax is the net of (1) the value of the property transferred, less (2) the amount that the donee will reimburse the donor. With the new 2018 applicable exclusion amount of $11,180,000 per taxpayer—a net gift is helpful only with respect to very large transfers. However, because of its attributes, it can prove extraordinarily useful in the right circumstances.

The consideration in a net gift transaction need not be paid at any set point in time. If the donor is in a position to pay the tax with available liquid assets, the donee can agree to pay the bargain sales price through an installment note if circumstances require.

Because the net gift results in a bargain sale, the donor must consider whether there will be any income tax consequences arising from the transaction. If the donee is other than a grantor trust, taxable gain will result if the consideration received exceeds the donor’s tax basis. In addition, as is the case with all taxable gifts, the donor’s death within three years of the net gift will result in the gift tax being added back to the gross estate as a phantom asset, notwithstanding that the tax was reimbursed by the donee.

A net gift can be useful for significant transfers where there is an unwillingness on the donor’s part to bear the tax burden. It can also be used in situations where the asset being transferred is illiquid and the donee is better positioned to pay the related gift tax (as in the example below).

When considering the renunciation of a marital trust by a surviving spouse, because of how the regulations approach the various steps of the transaction, a net gift will always result if the resulting gifts exceed the surviving spouse’s unused applicable exclusion amount.

Net gift example:
For ease of illustration we will assume a donor who has fully used her applicable exclusion amount agrees to transfer a highly illiquid asset to an existing irrevocable trust (for the benefit of her children) with a value of $14 million on condition that the trust reimburses her for the resulting gift tax. By virtue of this agreement, the trust would expend $4 million and the trust’s equity will have grown by the net amount of $10 million. The reimbursement of the gift tax of $4 million is treated as consideration for the transfer and thus, a bargain sale results—a sale of property having a value of $14 million for $4 million, resulting in a taxable net gift of $10 million.
Wealth transfer planning alternatives

Supplemental planning concepts

The use of formula valuation mitigation clauses

Valuation risk is inherent in any transfer of a hard-to-value asset—for example, an equity interest in a closely held business. Attempts to mitigate valuation risk have been relatively unsuccessful until recently. It now appears that formula valuation mitigation clauses can, if appropriately employed, provide that protection; although the IRS, despite its recent setbacks, continues to pursue the matter. There are three broad categories of valuation mitigation clauses:

A formula transfer clause operates by setting the value of the property transferred at a fixed amount. Thus, any upward adjustment in the value of the property gifted or sold is translated to a corresponding reduction in the quantum of property transferred and requires the parties to “true up” the economic consequences to correspond to those that would have existed had the finally determined quantum of property been known from the beginning.

A formula allocation clause fixes the quantum of property transferred, but also fixes the value of the property transferred to the primary donee. Thus, any adjustment in the value of the transferred property results in the primary donee transferring property having a value equal to the upward adjustment to a secondary donee. In order to avoid a deficiency in the gift tax arising from the increased value, the secondary donee is typically the donor’s spouse or a charity since such transfers can be made to qualify for the gift tax marital or charitable deductions. Thus, the taxable gift remains a sum certain.

A formula adjustment clause arises solely in a sale transaction and adjusts the purchase price to the value of the property transferred as ultimately determined, with corresponding provisions with respect to the interest due on the adjusted purchase price.

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The following example compares and contrasts the first two categories of formula clauses to illustrate possible results in a gifting situation:

Facts: Taxpayer intends to transfer a sum certain of $1 million of ABC Partnership units to DEF Trust. An independent appraisal values the units at $2,000/unit as of the date of transfer. Based upon this appraisal, taxpayer transfers 500 ABC Partnership units to DEF Trust. The IRS subsequently audits the gift tax return and a $2,500/unit value is sustained. Assuming the formula valuation mitigation clause is respected, following are the results under each approach:

<table>
<thead>
<tr>
<th>Formula transfer clause approach</th>
<th>Formula allocation clause approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;I hereby assign and transfer as a gift to DEF Trust a sufficient number of my units as a partner of ABC Partnership so that the fair market value of such units for federal gift tax purposes shall be $1,000,000.&quot;</td>
<td>&quot;I hereby assign and transfer as a gift 500 units of ABC Partnership. I transfer to DEF Trust a fractional share of that 500 units, the numerator of which is $1,000,000 and the denominator of which is the value of such property as finally determined for federal gift tax purposes, and I allocate the remaining units, if any, to GHI Charity.&quot;</td>
</tr>
</tbody>
</table>

Result: Taxpayer has transferred a sum certain of $1,000,000 of units to DEF Trust. Upon revaluation, taxpayer was determined to have transferred 400 units (400 units $2,500/unit = $1,000,000) to DEF Trust. Thus, of the 500 units to which DEF had originally taken title, 100 units were held in constructive trust (including any distributions related to those 100 units) for the grantor. No incremental gift tax is assessed as taxpayer’s transfer was defined as the number of units that would equal the sum certain of $1,000,000.

Result: Initially, taxpayer had transferred 500 units to DEF Trust. Upon revaluation, taxpayer was determined to have transferred 400 units to DEF Trust and 100 units to GHI Charity. Thus, taxpayer transferred the sum certain of $1,000,000 to DEF Trust (400 units at $2,500/unit) and $250,000 (100 units at $2,500/unit) to GHI Charity. The transfer of 100 units to GHI Charity qualifies for the gift tax charitable deduction, thus leaving the taxable gift at the original $1,000,000 and resulting in no incremental gift tax.

In addition to having an effective formula clause, there must also be a “mechanism outside of the IRS audit (that) exists to ensure accurate valuation reporting.” In other words, not only must there be a qualified appraisal at the outset, but mechanisms must be in place to properly and expeditiously adjust the transaction as necessary if an adjustment in the value of the property prevails.

This includes, among others, proper titling of the property, trueing up equity distributions over the duration of the valuation controversy, adjusting promissory notes and interest obligations, updating records, and amending tax returns (unless a grantor trust is involved in the transaction) to reallocate income and loss, if necessary.

It is important to note that because the IRS continues to contest the effectiveness of formula valuation mitigation clauses, how they are drafted in documents should not deviate from those forms that have been accepted by the courts. You should consult your attorney (in conjunction with your tax adviser) about specific language to be utilized.
Wealth transfer planning alternatives

Considerations for your path forward

We hope that this chapter has provided you with a helpful overview of certain wealth transfer planning alternatives that wealthy families are employing today, depending on their goals and circumstances. Having read this release, you may have noted that these alternatives have a common theme—transferring wealth in a tax-efficient manner. However, each alternative has unique characteristics, benefits, and risks that may have greater or lesser importance to you given your goals and circumstances. Consider your planning objectives, your balance sheet, your risk tolerance, and your family dynamics in order to explore appropriate wealth transfer planning alternatives. And remember, don’t walk this path alone—your wealth advisers should assist you through the planning process. Enjoy the journey.
Postmortem considerations

In an ideal world, every wealthy individual has prepared for an orderly estate distribution, in favor of his or her family, charity, or a combination of both. Often such plans include proactively transferring wealth during his or her lifetime and leaving a thoughtful, well-constructed testamentary plan (updated as wealth and family considerations dictate) that takes taxes into consideration. But in the real world, many estate plans remain a work in progress for reasons ranging from evolving business complexity to family conflict, ill health, and indecision. Consequently, matters unconsidered by the testamentary plan make postmortem planning inevitable.
Postmortem considerations

US tax concerns during the administrative process for an estate

Developing a thoughtful, well-constructed estate plan during life leaves fewer actions and decisions to be taken by executors, trustees, and postmortem advisers, thus conserving both time and resources. The converse is also true, an estate plan that is vague, incomplete, or nonexistent is generally tax inefficient and leaves major decisions regarding asset management, estate liquidity, and the timing and nature of distributions to the estate’s fiduciaries, advisers, and the courts, which consumes both time and resources.

For the families and beneficiaries of high net worth individuals, settling an estate can be consuming and stressful, beginning with the process of gathering information to create a net asset inventory (complete with necessary valuations of assets) and ending—often many years later—with the final distribution of assets. The period in between, the postmortem administrative period, often gives rise to complex tax, financial, and family considerations.

While estate administration has its own legal and tax cadence, there is typically pressure to accelerate outcomes, even during the initial period of emotional loss.

Effective postmortem administration requires flexibility when responding to an estate’s unique mix of assets, liabilities, and family considerations.

Every high net worth estate is unique. The type and level of activities required for settling the estate will depend on a host of factors, including the nature of the assets and liabilities, family considerations, and the extent and efficacy of the decedent’s estate plan. For example, the approach for an individual who dies intestate (without a will or other testamentary declaration) will be very different from the approach for someone who dies with a thoughtful, well-constructed estate plan and a family office actively involved in its administration.

Effective postmortem administration requires flexibility when responding to an estate’s unique mix of assets, liabilities, and family considerations. It requires one to be versatile enough to think outside of the box as circumstances arise while winding up the decedent’s affairs.

While managing tax liabilities is often a specific goal during postmortem administration, equally important are the steps taken to accumulate and efficiently manage estate assets. This includes dealing with the issues every large enterprise encounters, proactively approaching administrative costs, closing the estate in a timely manner, and anticipating the impact of the estate’s settlement on an asset management structure. While this is a much more complex topic than we can cover in a few pages—with implications as unique as the individuals involved—there are important considerations during this stage of family wealth management that require attention.

Steps from death to distribution

1. Executor retains tax adviser for the estate
2. Obtain asset, liability, and cash flow information
3. Calculate federal, state, and foreign estate taxes
4. Plan for liquidity to pay estate tax
5. Report information to relevant taxing authorities

Disagree → Tax controversy process → Pay additional tax, if determined → Distribute assets pursuant to will and trusts, considering the income tax effects of those distributions

Agree → Taxing authorities agree or disagree with reported positions

US tax concerns during the administrative process for an estate

Tax implications for settling the estate

Special considerations for periods of market volatility and loss

Alternatives for paying estate tax liabilities

High net worth individuals
Postmortem considerations

US tax concerns during the administrative process for an estate

At a minimum, the executor or personal administrator will be responsible for filing federal and state income and estate tax returns. For income taxes, a chronological view is instructive, with the first major hurdle being the coordination of the decedent’s unfiled individual Form 1040 (and related state income tax returns) with the filing of the estate’s initial Form 1041 (and related state income tax returns). Hopefuly, the final Form 1040 for the year of death will be the only unfiled individual income tax return. Because the final Form 1040 reports income properly reported only through the date of death, with all postmortem income being reported on the first Form 1041, income in the year of death must be allocated. While conceptually simple, making the allocation and reporting that allocation properly can be tedious, particularly in situations where the decedent owned interests in pass-through entities, including trusts, partnerships, limited liability companies (LLCs), and/or S corporations.

Additional complexities arise because the income tax basis of assets passing from a decedent is reset at fair market value as finally determined for estate tax purposes. Again, while conceptually simple, accounting for and tracking the new basis can be onerous, particularly if estate tax values are adjusted later during the estate tax examination process—especially for depreciable or depletable assets and those that are jointly owned with others (e.g., community property and joint tenancy). Complexity is increased exponentially if offshore investments exist. Consideration should be given to consolidating the preparation of the final Form 1040, the estate tax return Form 706, and the initial Form 1041 with one tax adviser.

Having the same tax adviser prepare the tax returns of entities substantially owned by or controlled by the estate or the family also may be advisable in order to manage the potential for errors. For example, if the decedent owned partnership interests, then a section 754 election must be considered. This election, made by the partnership, allows the partnership to reflect internally the change in the income tax basis of the partnership interest to fair market value at the date of death by allocating the change among the partnership’s assets. The benefit (or potential detriment) to the estate and its successors is that coordinating the inside basis of assets with the basis of the partnership interest hastens basis recovery. However, it also reduces or prevents anomalies that can arise when the partnership is liquidated or the partnership interest is sold.

The universe of tax filings

Form 706
Form 709
Form 1040
Form 1065
Form 1120S
645 election
State forms
Estate

US tax concerns during the administrative process for an estate

Tax implications for settling the estate

Special considerations for periods of market volatility and loss

Alternatives for paying estate tax liabilities

High net worth individuals
Postmortem considerations

US tax concerns during the administrative process for an estate

There are tax elections that must be made for the estate on its initial Form 1041. For example, the estate must elect a tax year and has the option of electing a fiscal year. Typically, a 12-month tax year is desirable, but it could be a different one, including a calendar year, if considerations dictate otherwise. A similarly fundamental election must be considered when the decedent had established revocable trusts. These trusts can be combined with the estate in a consolidated Form 1041 during most of the postmortem administrative period. Because of specific tax benefits provided only to estates, such a consolidation is recommended almost universally. However, as is the case with many tax elections, utilizing the benefits that they permit often introduces an element of complexity. Thus, the logistical implications of the election must be understood before the election is made.

The estate will continue to file federal and state income tax returns for each year of the postmortem administrative period. The estate will continue to file federal and state income tax returns for each year of the postmortem administrative period. Eventually, the estate will terminate as assets are distributed to beneficiaries, or commonly, in favor of continuing trusts. Continuing trusts will be new taxpayers but, unlike estates, they must utilize a calendar year. Situations where any pecuniary bequest (distributions of a sum certain), whether in trust or otherwise, is funded with assets other than cash will result in gain or loss and should be planned carefully. Additional complications arise when a fiscal year-end estate terminates to a calendar year-end trust (or trusts) if income bunching and other problems are to be avoided.
Postmortem considerations

US tax concerns during the administrative process for an estate

In addition, the executor or personal administrator must prepare and file the estate tax return (Form 706), the decedent’s as-yet-unfiled gift tax returns (Form 709), and any applicable state tax forms related to the items reported on the federal forms. Estate tax returns for high net worth estates can be highly complex due to:

- Complicated issues regarding assets that may have been inherited recently from others
- Prior asset transfers that circumstances may require be included in the taxable estate
- The inclusion and taxation of assets owned jointly (for example, community property and joint tenancy)
- The determination of asset values generally through appraisals
- Technical issues regarding qualification for various estate tax deductions and credits

States may impose additional filing requirements. For example, if a decedent owns real estate in multiple states, these states may require their own estate tax returns and ancillary probate procedures. Similarly, if the decedent owned foreign property, the estate may be responsible for foreign estate and income tax returns.

State estate and inheritance tax rates and exemptions in 2017

<table>
<thead>
<tr>
<th>State</th>
<th>Estate tax</th>
<th>Inheritance tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>$2M; 7.2%–12%</td>
<td></td>
</tr>
<tr>
<td>Delaware*</td>
<td>$5.49M; 3.8%–16%</td>
<td></td>
</tr>
<tr>
<td>Hawaii</td>
<td>$5.49M; 10%–15.7%</td>
<td></td>
</tr>
<tr>
<td>Iowa</td>
<td>$4M; 0.8%–16%</td>
<td>0%–15%</td>
</tr>
<tr>
<td>Illinois</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td></td>
<td>0%–16%</td>
</tr>
<tr>
<td>Maine</td>
<td>$5.49M; 8%–12%</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>$3M; 16%</td>
<td></td>
</tr>
<tr>
<td>Massachusetts</td>
<td>$1M; 0.8%–16%</td>
<td></td>
</tr>
<tr>
<td>Minnesota</td>
<td>$2.1M; 10%–16%</td>
<td></td>
</tr>
<tr>
<td>Nebraska</td>
<td></td>
<td>1%–18%</td>
</tr>
<tr>
<td>New Jersey*</td>
<td>$2M; 0.8%–16%</td>
<td>0%–16%</td>
</tr>
<tr>
<td>New York</td>
<td>$5.25M; 3.06%–16%</td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td>$1M; 10%–16%</td>
<td></td>
</tr>
<tr>
<td>Pennsylvania</td>
<td></td>
<td>0%–15%</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>$1.515M; 0.8%–16%</td>
<td></td>
</tr>
<tr>
<td>Vermont</td>
<td>$2.75M; 16%</td>
<td></td>
</tr>
<tr>
<td>Washington</td>
<td>$2.129M; 10%–20%</td>
<td></td>
</tr>
<tr>
<td>District of Columbia</td>
<td>$2M; 8%–16%</td>
<td></td>
</tr>
</tbody>
</table>

Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the decedant; different rates and exemptions apply depending on the relationship.
Postmortem considerations

Tax implications for settling the estate

It is clear from Internal Revenue Service (IRS) statistics that estate tax audits are effective in generating revenue because estate taxes are based fundamentally on asset values. Valuation is a less precise measurement process than those generally employed to measure income, and consequently, it is frequently the basis for controversy. Thus, estate tax returns—particularly returns showing taxes due—historically have been subject to a nearly 100 percent audit coverage rate. For high net worth estates, there is almost no question that estate tax returns will be subject to audit.

The executor has a fiduciary obligation to take tax positions within established norms. Particular care should be exercised in asset valuation where the burden of proof is clearly on the estate. Failure to do so could subject the estate to penalties—up to 40 percent of the deficiency assessment. Executors and personal administrators are well advised to seek competent advisers, especially valuation specialists, when preparing the estate tax return.

Although valuation controversies with the IRS are common, having a tax controversy turn into tax litigation remains uncommon. Statistically, well over 95 percent of controversies raised by an examiner are either resolved at the exam level or, more frequently, through the IRS internal appeals process.

What type of team will the family need to assist during the administrative period?

When dealing with the estate of a high net worth individual, the executor or personal representative and the family will need access to four specific types of advisors throughout the postmortem administrative process.

These include:

• Accountants to handle the estate and income taxes and, potentially, certain fiduciary accounting activities.

• Attorneys to handle the probate and disposition of assets

• Appraisers or valuation specialists to support the calculation of estate tax. In addition, because many high net worth individuals fractionize asset ownership or otherwise cause assets to be disproportionately shared, valuation support may be helpful in assisting in the equitable division of the state—particularly when there is a span of many years between death and distribution.

• Investment advisors to provide continued investment counsel. Depending on the mix of assets in the estate and the likely length of the postmortem administrative period, investment advisors can help the family maintain a prudent investment plan throughout the postmortem process. In a period of market volatility, professional investment advice will be particularly important.

For the high net worth estate, involving appraisers and professionals experienced in estate tax controversy, including appeals (either because of prior employment with the IRS or specialization in such proceedings) early in the exam process will generally save time, headaches, audit support costs, and, hopefully, tax dollars as valuation positions are sustained and controversies are settled efficiently.

Statistically, well over 95 percent of controversies raised by an examiner are either resolved at the exam level or, more frequently, through the IRS internal appeals process.
Postmortem considerations

Special considerations for periods of market volatility and loss

Tax law allows the estate to take a second snapshot of asset value six months after the date of death and, if certain conditions are met, elect to use this alternate valuation in filing returns. To use the alternate valuation date, two conditions must be present:

• The value of the estate’s assets must have declined since the date of death.
• Use of the alternative valuation must result in a reduction in aggregate estate and GST taxes.

In other words, the estate must have a tax liability. If the entire estate goes to a surviving spouse or to charity, the executor cannot elect to use alternative valuation.

The valuation approach becomes particularly important during periods of value volatility, such as that experienced in late 2008 and much of 2009. In periods of market decline, it is possible that the downward trend may extend beyond the alternative valuation date. Although skilled appraisers will work this into their summaries, it is difficult in practice since appraisals are typically based on information and events that occurred well before the alternative valuation date. In an audit, which typically takes place several years later, the IRS has the benefit of hindsight and will take issue with valuations that it believes are too aggressive.

Periods of declining value also have important income tax implications, particularly as the estate is distributing assets to successors. Estates are taxpayers in their own right; to the extent that an estate makes distributions, those distributions carry out tax attributes to the distributees and will reduce the estate’s taxable income. But the law is clear that tax attributes carried out during administration are limited to income and some credits. If the estate is generating losses—either net operating losses or capital losses, as is common in turbulent economic environments—those losses must be accumulated at the estate or trust level and carried forward until the estate terminates, at which point they are distributable to certain beneficiaries. Excess deductible administrative costs in any year cannot be carried forward to offset future income and simply lapse, except in the final year of the estate when the excess expenses for that year are also distributable to certain beneficiaries.

Tax law allows the estate to take a second snapshot of asset value six months after the date of death and, if certain conditions are met, elect to use this alternate valuation in filing returns.
Postmortem considerations

Alternatives for paying estate tax liabilities

For many high net worth estates, one of the specific considerations in the final phase of postmortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds or sell assets to generate cash to pay taxes.

Historically, the government has allowed estates with closely held businesses to pay off the tax liability arising from those businesses over a period of up to 15 years at favorable interest rates. However, the government recently has begun requiring the estate to bond for the outstanding liability or subject certain estate assets to special liens, thus making this avenue more expensive for business owners.

Another option, particularly for high net worth families, is to borrow from a related party at market rates, with the interest payments indirectly benefitting family members. Because greater care must be exercised when borrowing directly from a beneficiary, it is more common to borrow from a life insurance trust, from a closely held business, or against real estate. The interest paid to third parties can, if properly structured and documented, be considered a cost of administration that is deductible in determining the estate tax liability, thus decreasing the effective interest rate actually paid. Furthermore, if properly structured, the estate liability can be determined and the estate terminated before the borrowing is paid in full. This often results in an estate terminating earlier than would an estate that utilizes the government’s 15-year tax deferral. In many cases, families use a combination of sources—government, banks, and related parties—to meet tax obligations.

The other alternative, selling assets, also can require careful planning. Sales arising from buy/sell or other owners’ agreements can be particularly troubling since the terms of many such agreements, while legally binding, are not necessarily binding for estate tax purposes. Sales proceeds generated through corporate and partnership redemptions are subject to special income tax rules. Some sales transactions can give rise to ordinary income treatment, where other options might have permitted capital gain treatment.

Similarly, sales transactions that give rise to losses may complicate the future administration of the estate because losses generally are suspended until the termination of the estate. Finally, if there are to be excess sales proceeds not needed to pay taxes, liabilities, or the expenses of administration, it may be prudent to retain accounting and investment advisory specialists.

For many high net worth estates, one of the specific considerations in the final phase of postmortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds or sell assets to generate cash to pay the taxes.

**How to pay the estate tax liability**

- **Sell?**
- **Borrow?**
- **Government deferral?**

**Estate tax liability**

**Estate executor**

**Estate assets**

US tax concerns during the administrative process for an estate

Tax implications for settling the estate

Special considerations for periods of market volatility and loss

Alternatives for paying estate tax liabilities

High net worth individuals
Prudence dictates that individuals should have an estate plan that accomplishes their current nontax objectives. Estate taxes should not drive the estate plan. Rather, adjustments to the plan provisions may be dictated by tax considerations that either facilitate or prevent the accomplishment of the plan's objectives.

Discussions about changes to the estate tax code have been circulating since its inception in 1916. Future legislation is by its nature speculative. However, the compromises which led to the estate tax as it now exists are more likely to preserve the tax than to contribute to its repeal.

How well the plan is accomplishing its desired ends need not be a matter of speculation, it can be determined by proactive monitoring and periodic adjustments.

Where possible, creating documents with a degree of administrative flexibility may help in periods of uncertainty, but are essential if the estate plan calls for continued asset management through trusts. Remember, the endgame is meeting wealth transfer goals in a manner that does not create or exacerbate family tensions.
Tax policy update

In late December 2017, Congress approved and President Trump signed into law massive tax reform legislation officially known as *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018* (the Act). The tax reform package lowers tax rates on corporations, pass-through entities, individuals, and estates and moves the United States toward a participation exemption-style system for taxing foreign-source income of domestic multinational corporations. Some of the cost of that tax relief is offset by provisions that scale back or eliminate many longstanding deductions, credits, and incentives for businesses and individuals.
Historic tax reform becomes a reality

Some of the highlights of the Act that are likely to impact individuals and their estates and business holdings include:

**Highlights of provisions for individuals**
The Act generally follows the structure of the Senate-approved tax reform bill—and 2017 law—by maintaining seven individual income tax brackets. The top individual income tax rate is 37 percent (lower than in either the House or Senate bills) but includes a significant “marriage penalty.” It also nearly doubles the standard deduction, repeals the current Pease limitation on itemized deductions, and expands the refundability of the child tax credit. It retains the deduction for unreimbursed medical expenses (and even offers a boost for 2017 and 2018) and leaves intact the capital gains exclusion on the sale of a primary residence in effect prior to its enactment. On the revenue side, the measure repeals personal exemptions, retains the individual AMT (albeit with higher exemption amounts), pare’s back the deduction for home mortgage interest (with existing mortgages grandfathered), and places substantial new limits on the ability of taxpayers to deduct state and local taxes. As in the Senate-passed bill, almost all of the Act’s individual tax changes (including all of those just mentioned) expire after 2025.

**Highlights of provisions for estates**
The Act retains the estate tax at its current rate, but doubles the exemption amounts. The expanded estate tax exemption amounts sunset after 2025. The pre-enactment tax regime with respect to the estate, gift, generation-skipping transfer (GST) taxes, and the income tax basis adjustment to fair market value at death remain unchanged under the Act except that the applicable exclusion amount (the amount that each citizen is entitled to transfer either during life or, if otherwise unused, at death without incurring a current tax) and the GST tax exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) is doubled to $11.18 million from its existing $5.6 million for transfers occurring after December 31, 2017. The exclusion and GST exemption continue to be indexed for inflation. However, beginning January 1, 2026, the exclusion amount and the GST exemption will return to the levels that would have prevailed under pre-enactment law.

**Highlights of provisions for pass-throughs**
The Act allows a deduction of up to 20 percent of pass-through income, subject to certain additional computations and limitations. However, for those owners of specified service businesses with income under $157,500 (twice that for married filing jointly) and the definition of “specified service” no longer includes architecture or engineering, the additional limitations do not apply. The deduction is available to trusts, including electing small business trusts (ESBTs), as well as individuals, and owners are allowed to calculate their maximum deduction based on either 50 percent of their share of W-2 wages paid or a combination of 25 percent of their share of W-2 wages paid plus 2.5 percent of the unadjusted basis of all qualified property. Carried interest income retains its treatment as a capital gain, although it will be subject to a longer holding period (three years as opposed to one year in prior law) in order to qualify for lower long-term capital gains rates.

**Dig deep into the new tax reform law**
Learn more about the provisions in the new tax reform law (H.R. 1) and their far-reaching implications for businesses and individuals in Deloitte’s report *Reshaping the code: Understanding the new tax reform law.*
Tax reform resources

Move forward with confidence

Your tax reform journey will reveal challenges and opportunities at every stage. Deloitte is here to help you move forward with confidence. From assessing your starting point through the enactment of reform and beyond, we can help you create value at every turn.

Stay connected to US tax reform insights through our perspectives. Deloitte’s US tax reform services help you understand the provisions in the new law, analyze their impact on your company, prioritize your tax planning efforts, and monitor legislative changes and clarifications so you can adapt your strategic tax plan.

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Choice of entity and addressing entity conversion considerations

The new tax law created substantial changes in corporate, pass-through, and individual tax provisions. In light of these changes, many companies and their owners are now asking whether it makes sense to change their structure from a pass-through to a C corporate entity.
Choice of entity and addressing entity conversion considerations

Key provisions of the 2017 tax Act

There are numerous factors to consider with a conversion, and it is important to understand all the facts and circumstances of your business, as well as the individual shareholder/partner situations, before moving forward.

Some of these considerations are listed within this chapter, but we have found that modeling is important to quantify the potential tax implications of a conversion. Moreover, there are a number of qualitative considerations that also should be addressed as part of the analysis.

Federal income tax rate changes

<table>
<thead>
<tr>
<th>Prior law</th>
<th>New law</th>
</tr>
</thead>
<tbody>
<tr>
<td>C corporation shareholder</td>
<td>C corporation shareholder</td>
</tr>
<tr>
<td>50.47%</td>
<td>39.80%</td>
</tr>
<tr>
<td>Partner/S corporation shareholder</td>
<td>43.40%</td>
</tr>
<tr>
<td>(with no pass-through deduction)</td>
<td></td>
</tr>
<tr>
<td>40.80%</td>
<td>33.40%</td>
</tr>
</tbody>
</table>

- For corporate scenarios, assumes that all after-tax earnings are distributed
- For simplicity, the employment tax rate is assumed to be 3.8% and payroll tax deductions are ignored
- Does not factor in compensation paid
- Does not factor in active vs. passive ownership (assumes either 3.8% employment tax or 3.8% net investment income (NII) tax applies to all income)
- Does not include state tax implications

1 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the Act).
Choice of entity and addressing entity conversion considerations

Key provisions to consider

Some of the key provisions that go into the modeling of entity conversion include understanding:

- Key pass-through provisions, such as qualification for and ability to claim the section 199A deduction (pass-through deduction)
- Key individual provisions, such as the owner’s effective tax rate structure and the changes to the overall individual tax system, which sunset December 31, 2025
- How those provisions compare to key corporate provisions, including the permanent corporate rate reduction to 21%
- Other key provisions, such as the new international provisions of the Act

These items must be analyzed in conjunction with other considerations, including:

- Amount of annual distributions, now and in the future, which can impact the benefit of a conversion
- Character and timing of income recognized, such as the benefit of keeping long-term capital gain (LTCG) character
- State tax liability generated from the business activity
- Exit strategy alternatives and timing considerations for shareholders and/or partners
Choice of entity and addressing entity conversion considerations

Key provisions to consider

Key pass-through provisions
- Section 199A deduction 20% qualified business income (QBI), real estate investment trust dividends, PTP income (pass-through deduction)
- Carried interest
- Repeal of section 708(b)(1)(B) related to technical terminations
- Effectively connected income on the sale of a partnership interest

Key individual provisions
- Maximum individual rate of 37%
- Limitation on excess business losses
- Increased alternative minimum tax (AMT) exemption
- Personal exemption phaseout repealed
- Limitation on itemized deductions repealed
- Deduction of up to $10K ($5K MFS) for the aggregate of nonbusiness: (1) state and local property taxes, and (2) state and local income taxes or sales tax

Key corporate provisions
- 21% corporate rate
- Section 162(m) executive compensation
- Corporate AMT repealed
- Change in indirect foreign tax credits

Other key provisions
- New international provisions
  - Global Intangible Low-Taxed Income (GILTI), Base Erosion and Anti-Abuse Tax (BEAT), Foreign-Derived Intangible Income (FDII)
- Section 199 repealed
- 100% bonus depreciation
- Interest limitation on 30% adjustable tax income (ATI)
- State tax implications for entity choice

Sample considerations for analyzing a conversion from pass-through to C corporation
- Annual distributions—now and into the future
- Qualification for section 199A deduction
  - US-sourced vs. non-US-sourced income
  - QBI
- Character of income recognized
  - LTCG and qualified dividends
  - Section 212 portfolio deductions
  - Owners of the company
- Growth of the business assets vs. growth of cash distributed
- Section 351 considerations
- International considerations
  - Structure
  - Foreign tax credit planning
  - Certain gain recognition provisions such as overall foreign loss recapture and section 367
  - Impact on dual consolidated loss rules
- Potential future changes in tax law
- Carryforward attributes of partners
- Accumulated adjustments account distribution planning for terminated S corporations
- Estate planning
- Implications of section 7519 payments for fiscal year filers
- State tax implications
  - State sourcing and income tax rates
  - Investment partnership rules
  - Compliance costs
  - State tax footprint of the entity
  - State tax footprint of the owners
- Exit strategy considerations
  - Sale of partnership interest
  - Stock vs. asset deal of corporation
  - Holding period upon exit
  - Purchase price considerations
Choice of entity and addressing entity conversion considerations

Modeling your path forward

Modeling is important to quantify the potential tax implications of a conversion. Although the Act resulted in a lower overall corporate rate, converting to C corporation status may not always be the right answer. You will need to consider specific facts and circumstances of the entity and individual shareholders/partners, as well as both federal and state tax implications of each entity form.

Entity conversion modeling process

<table>
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<tr>
<th>Step 1</th>
<th>Analyze Strategic considerations</th>
<th>Federal</th>
<th>State</th>
<th>Other</th>
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<tr>
<td></td>
<td>Qualification of section 199A deduction</td>
<td>• Qualification of section 199A deduction</td>
<td>• State tax footprint for entity</td>
<td>• Distributions—current and future</td>
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<tr>
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<td>Business interest expense limitation</td>
<td>• Business interest expense limitation</td>
<td>• Residency of owners</td>
<td>• Exit strategy/timing</td>
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<td>Character of income</td>
<td>• Character of income</td>
<td>• Individual state tax considerations</td>
<td>• Form of exit and impact on sales price</td>
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<td>Portfolio deductions</td>
<td>• Portfolio deductions</td>
<td>• Number of state tax filings/administration</td>
<td>• Growth of assets in the business</td>
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<tr>
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<td>Fiscal vs. calendar year</td>
<td>• Fiscal vs. calendar year</td>
<td>• Change in apportionment methodology</td>
<td>• Projected growth of business</td>
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<td>Active vs. passive</td>
<td>• Active vs. passive</td>
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<td>• International considerations</td>
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<td></td>
<td>Excess business losses</td>
<td>• Excess business losses</td>
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<td>• Estate planning</td>
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<table>
<thead>
<tr>
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<th>Model Understanding the impact of converting</th>
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<td>Annual after-tax cash flow</td>
<td>• Annual after-tax cash flow</td>
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<td>• Individual credits for taxes paid to other states</td>
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<td>• Individual state taxes paid to resident state</td>
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<table>
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<tr>
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<th>Execute Putting your plan into action</th>
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<td>Conversion to a C corporation—Prepare and execute the steps to effectuate a conversion considering the federal, state, and international requirements</td>
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<td>Retain existing structure—Address strategic planning opportunities identified within steps 1 and 2 of the modeling process</td>
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Choice of entity and addressing entity conversion considerations

Services for the path forward

We invite you to look again at the important issues at hand and consider Deloitte’s additional tax reform services as you move forward on the path ahead.

Additional tax reform services
- Tax accounting and provision assistance, ASC 740
- E&P and tax basis analyses; separate state analysis may be required
- Technology and systems updates
- Strategic compensation and benefits reviews
- Global mobility cost analysis and program design planning
- Value chain alignment
- Tax compliance services
- Private wealth planning assistance

Key provisions of the 2017 tax Act
# Resources

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