NORTHERN TRUST

PUTTING IT ON & TAKING IT OFF:

Managing Tax Basis Today For Tomorrow

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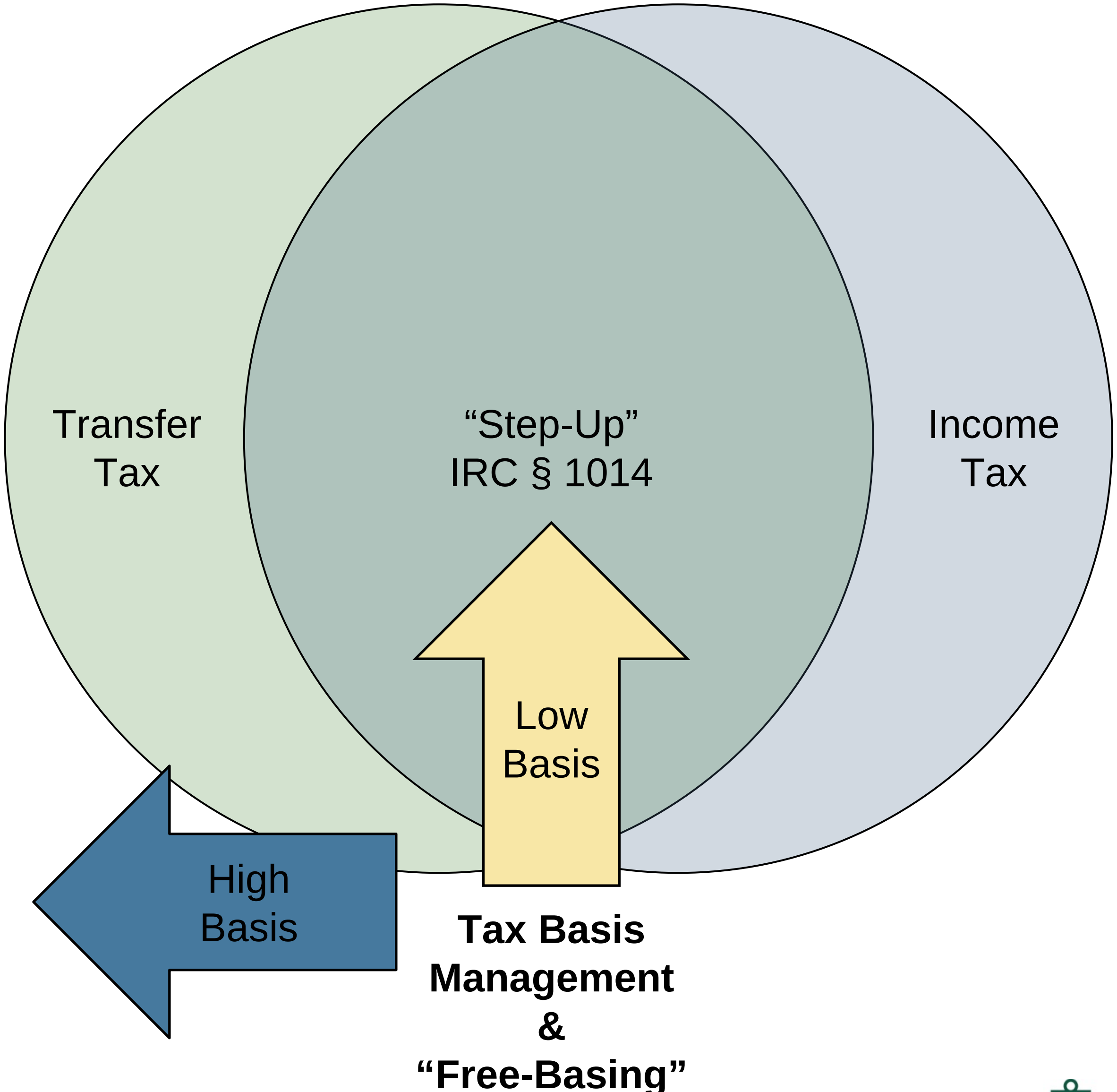
The Tax COVFEFE and Jibberish Act

The ATRA Transfer Tax Landscape: Venn Diagram

Assets to be Transferred Out of the Gross Estate

(Wealth Transfer)



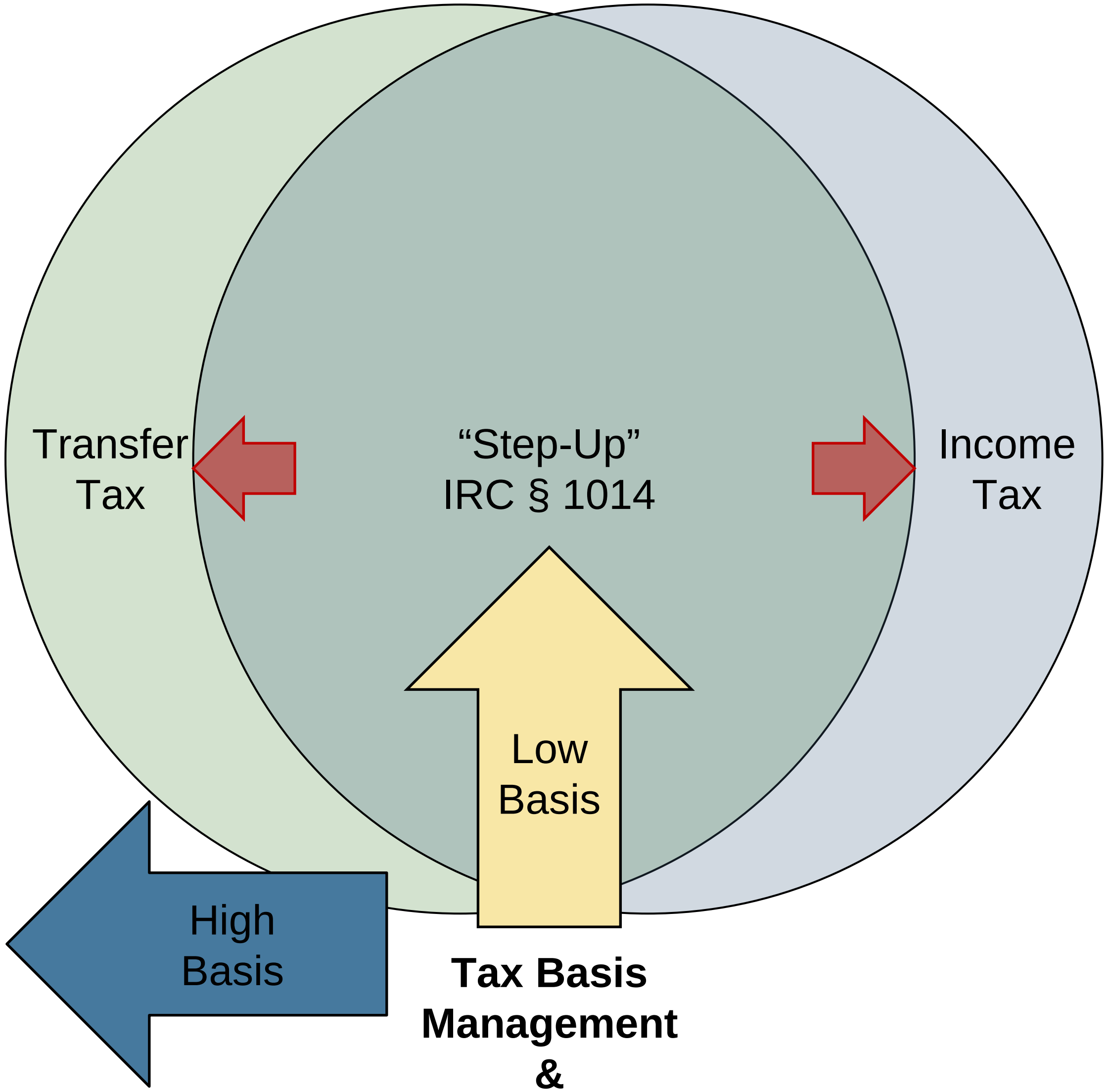
Assets Recognized During Lifetime

(Tax Avoidance & Deferral)

The Temporary TCJA Transfer Tax Landscape: Venn Diagram

Assets to be Transferred Out of the Gross Estate

(Wealth Transfer)

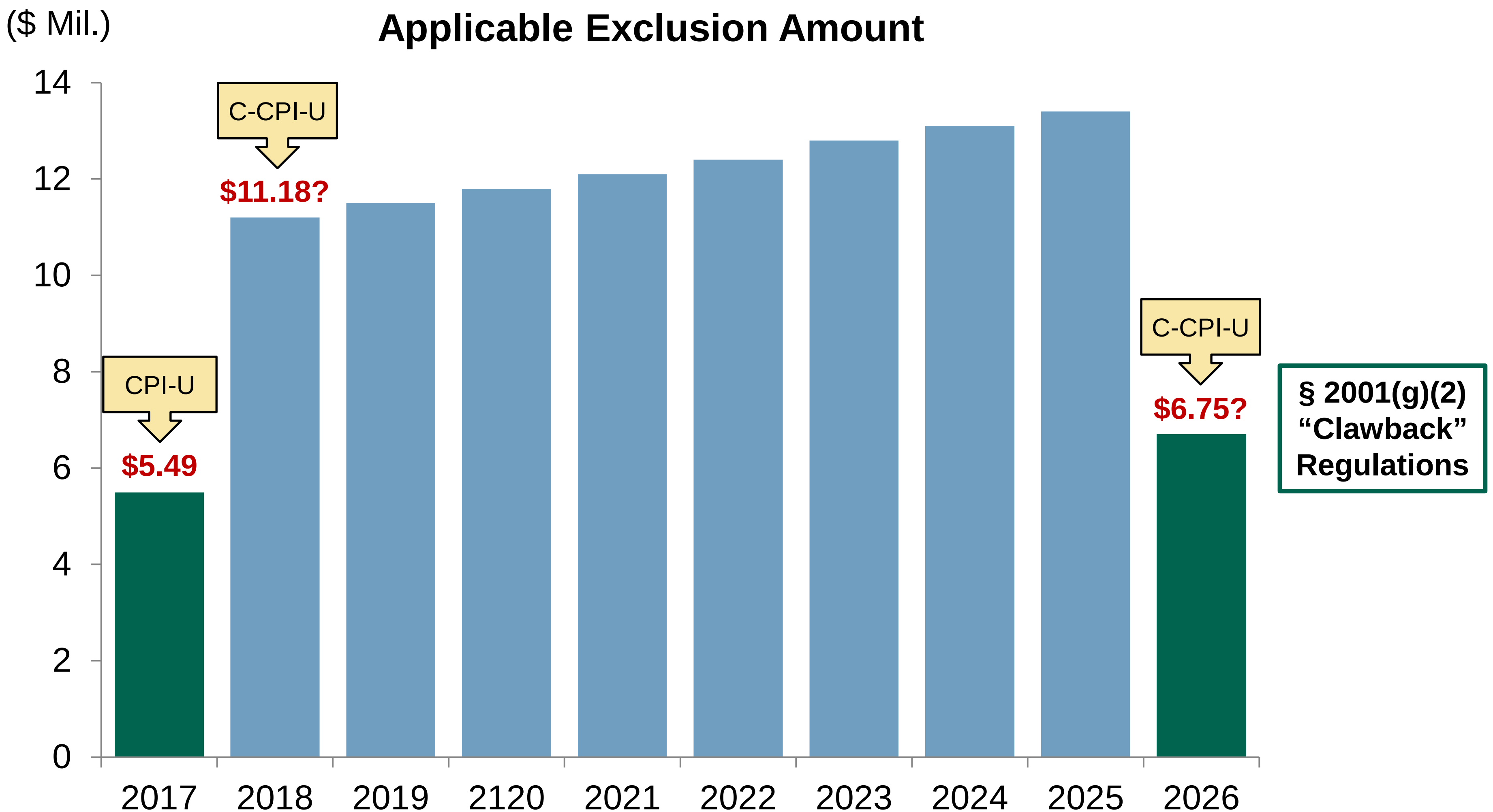


Tax Basis Management & "Free-Basing"

Assets Recognized During Lifetime

(Tax Avoidance & Deferral)

2012 All Over Again?



§ 199A: Qualified Business Income of "Pass-Thru" Entities

"Pass-Thru" Entities

<u>20% DEDUCTION</u>
"Qualified Business Income"—"Qualified Items"
"Qualified Trade or Business"—Not "Specified Service Trade or Business"

<u>QBI—SUM OF:</u>
(i) Deductible amount for each trade or business (DAFETB)
+
(ii) 20% qualified REIT and PTP income

<u>LIMITED BY THE SUM OF:</u>
Lesser of:
(i) Combined Qualified Business Income (QBI), or
(ii) 20% taxable income over net capital gain
+
Lesser of:
(i) Qualified cooperative dividends, or
(ii) Taxable income reduced by net capital gain

<u>DAFETB—LESSER OF:</u>
(i) 20% QBI w/r/t each trade or business
or
(ii) *Greater of*
(a) 50% W-2 wages, or
(b) 25% W-2 wages plus 2.5% unadjusted basis immediately after acquisition of "qualified property"

Does not apply to taxpayers below: $157,500/$315,000 ($207,500/$415,000)

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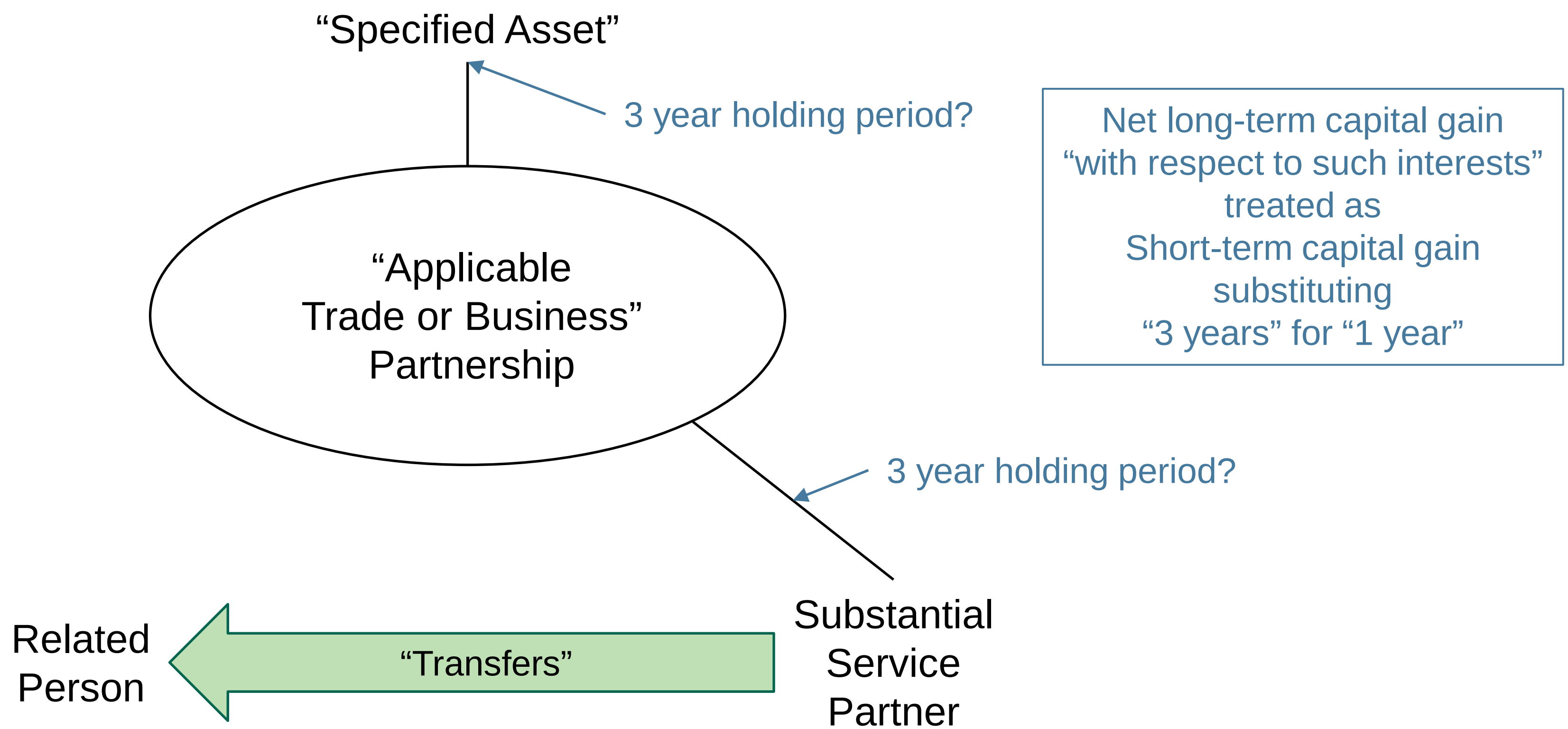
§ 1061: "Carried Interest" Provision

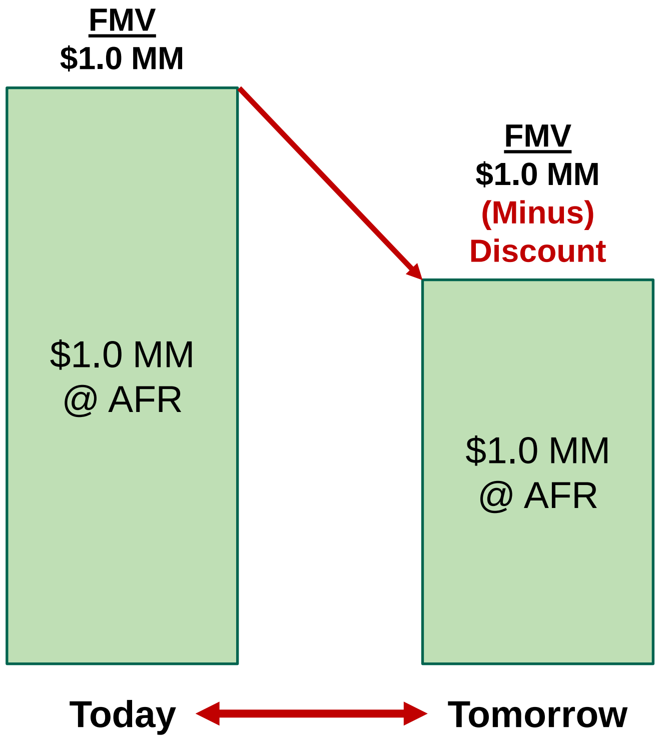


Include in gross income as short term capital gain
long-term capital gains "with respect to such interest"
for such year attributable to the "sale or exchange of any asset"
held for not more than 3 years as is "allocable to such interest"

Revenge of the § 2704 Prop. Regs.: Valuation of Notes

"In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." Prop. Treas. Reg. 25.2704-3(b)(iv).

- Loans and Installment Sales Today
  - Applicable federal rate (long-term, not short or mid-term);
  - 10% (or less) equity;
  - No prepayment penalty; and
  - Adequate security not required.
- Promissory Notes Will Need to Be:
  - Adequately secured;
  - Requires periodic payments on a non-deferred basis;
  - Issued at market interest rates; and
  - Has a fair market value equal to the liability.



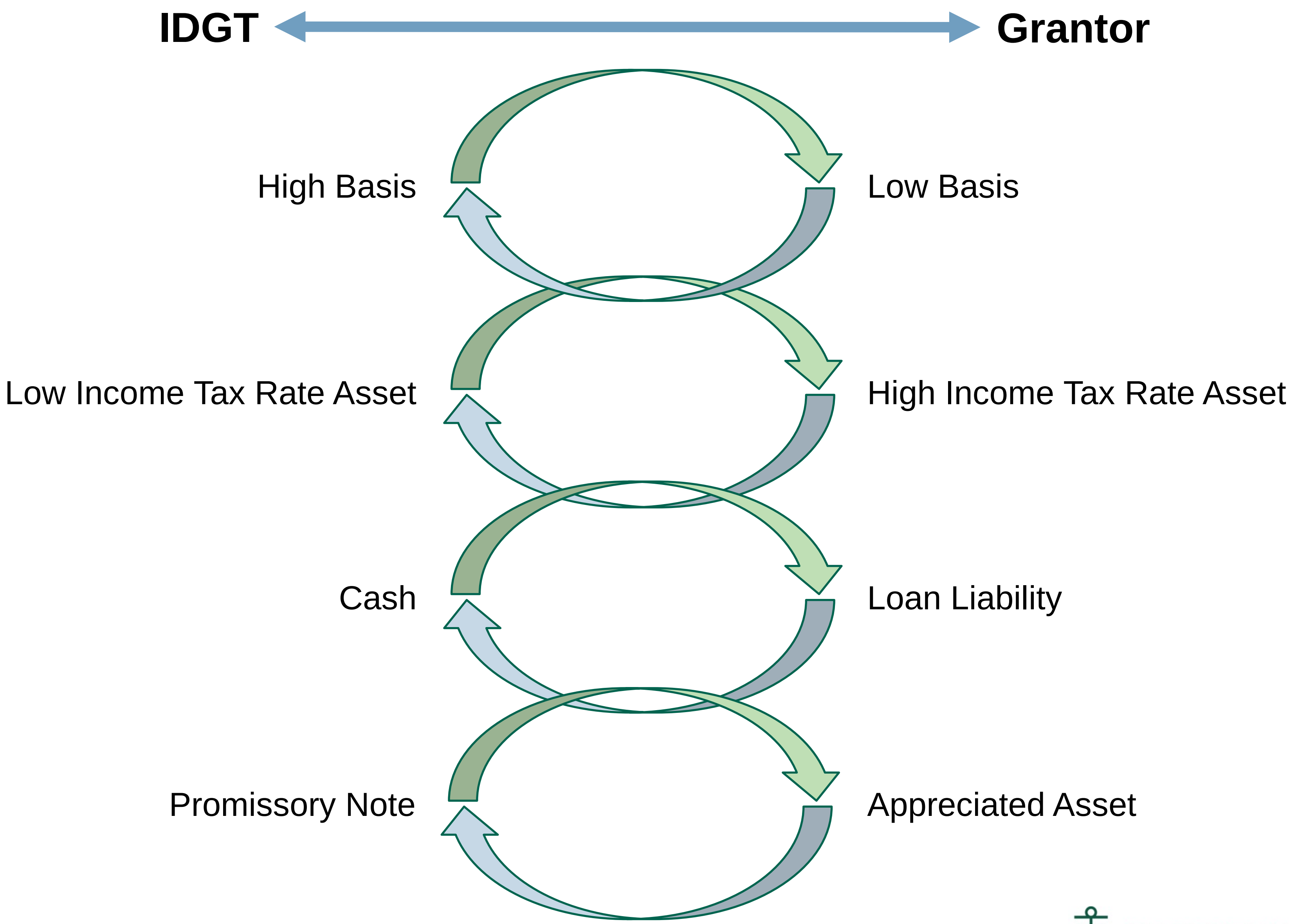
Some Assets Benefit from “Step-Up”—Some Do Not

“Step-Up” Important
[Higher Valuation]

Asset Type	Tax Characteristic
Creator-Owned Copyrights, Trademarks, Patents & Artwork	Ordinary Transforms to Long-Term
“Negative Basis” Commercial Real Property LPs	Recapture & >100% Long-Term
“Bonus Depreciation” Qualified Property under § 168(k)	§ 1245 Recapture
Oil & Gas Investments	§ 1245 Recapture
Artwork, Gold & Other “Collectibles”	28% Long-Term
Low Basis Stock	20% Long-Term
Roth IRA Assets	Tax Free & No Surcharge
Qualified Small Business Stock (QSBS)	§ 1202 Gain [50, 60, 75 or 100%] Exclusion
High Basis Stock	Minimal Gain
Fixed Income	Typically Minimal Gain
Cash	Basis = Face Value
Passive Foreign Investment Company (PFIC) Shares	No “Step-Up”
Stock at a Loss	Capital Loss Erased
Variable Annuities	Partially IRD
Traditional IRA & Qualified Plan Assets	100% IRD

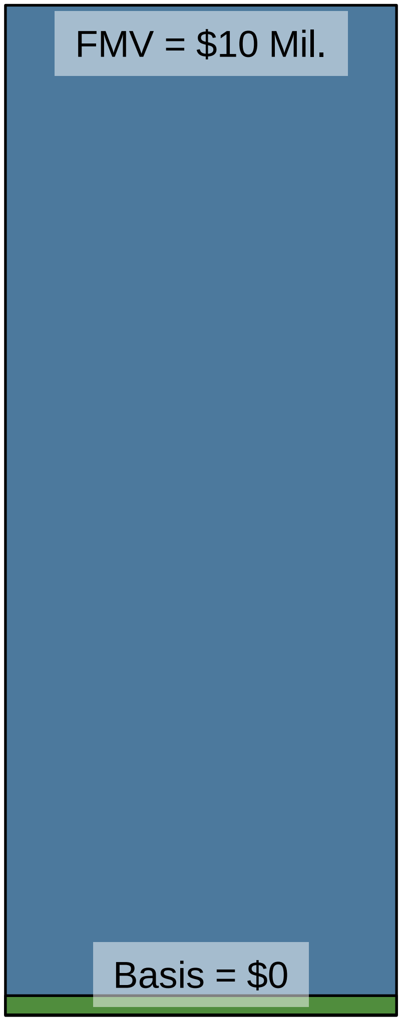
“Step-Up” not Important
[Lower Valuation]

Tax Basis Management Basics: Grantor Trust Swapping?



Using Debt to “Multiply” The “Step-Up” In Basis

Maximizing the "Step-Up" & Minimizing Estate Tax: Debt



Gross Estate
§ 2031 = $10 Mil.

Taxable Estate
§ 2051 = $10 Mil.

"Step-Up" in Basis
§ 1014(a) = $10 Mil.

Debt = $9 Mil.
(Cash)

Gross Estate
§ 2031 = $10 Mil.

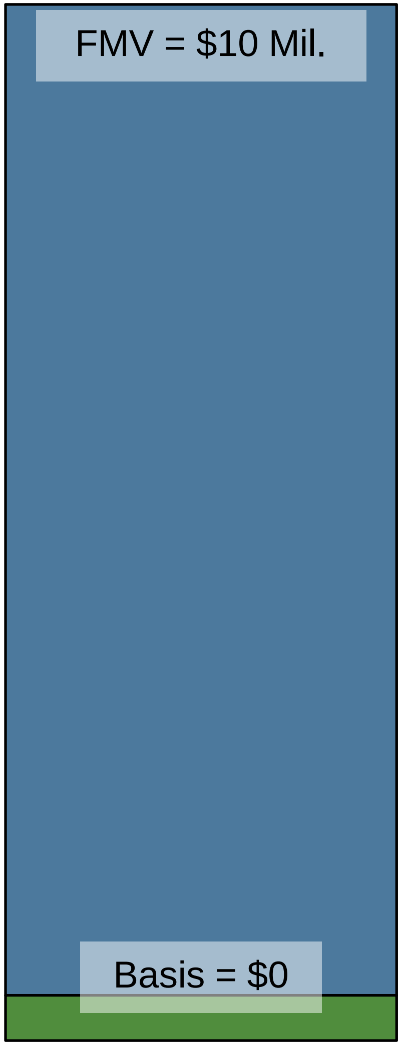
Indebtedness
§ 2053(a)(4) = ($9 Mil.)

Taxable Estate
§ 2051 = $1 Mil.

"Step-Up" in Basis
§ 1014(a) = $10 Mil.

"Zeroed-Out" Transfers
"Swap" for Appreciated Pty.
Private Split-Dollar Loan

Debt with QTIP Trusts?



Amount Includible
§ 2044(a) = $10 Mil.

Taxable Estate
§ 2051 = $10 Mil.

"Step-Up" in Basis
§ 1014(b)(10)→(b)(9)
= $10 Mil.

Amount Includible
§ 2044 = $10 Mil.

Indebtedness
§ 2053(a)(4) = ($9 Mil.)

Taxable Estate
§ 2051 = $1 Mil.

Amount Includible
§ 2044 = 1 Mil.

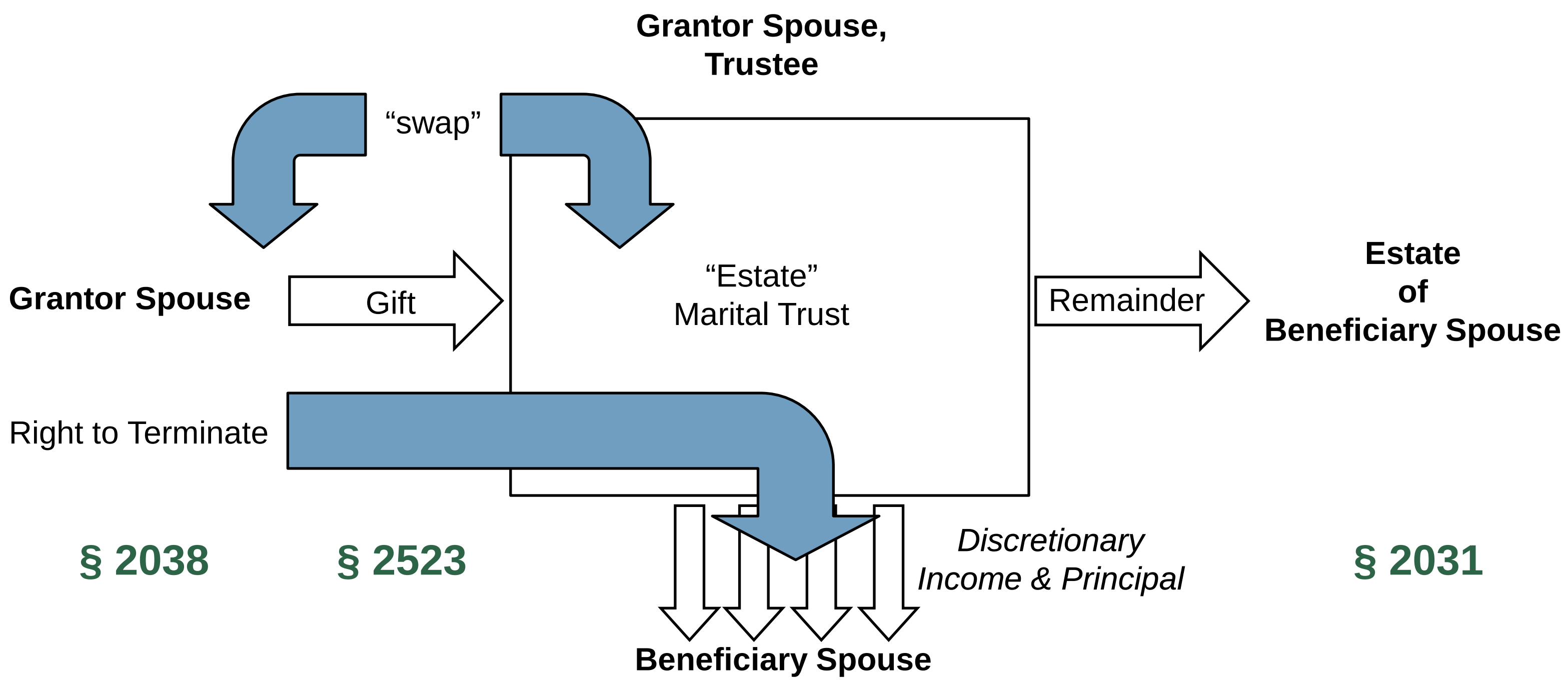
Taxable Estate
§ 2051 = $1 Mil.

"Step-Up" in Basis
§ 1014(b)(10) = $10 Mil. or $ 1 Mil. (?)

"Double Step-Up" In Basis

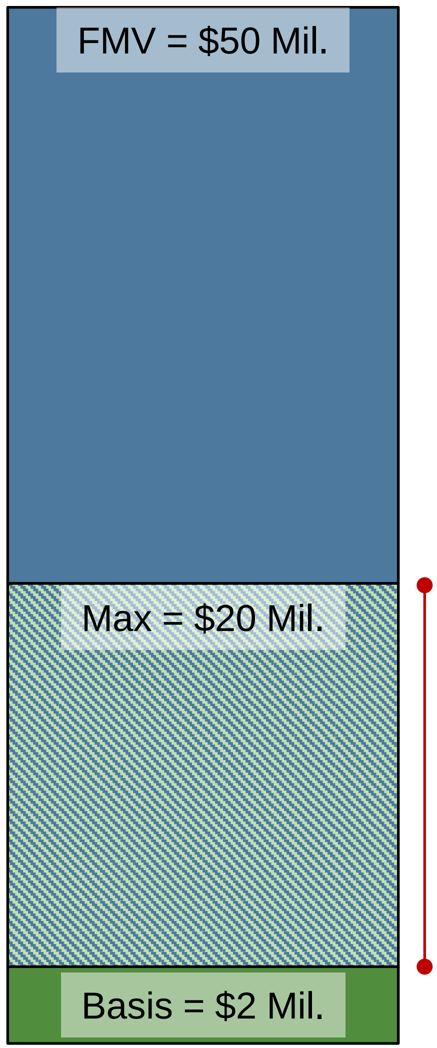
“Double Step-Up” in Basis

- Community Property
- Elective or Consensual Community Property Trusts (AK, TN & SD)
- Joint Exempt Step-Up Trust (JEST)
- Section 2038 Estate Marital Trust



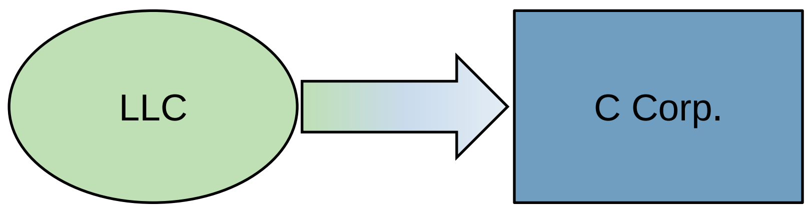
Tax Basis Management with Qualified Small Business Stock

Tenfold Benefit of Basis with QSBS

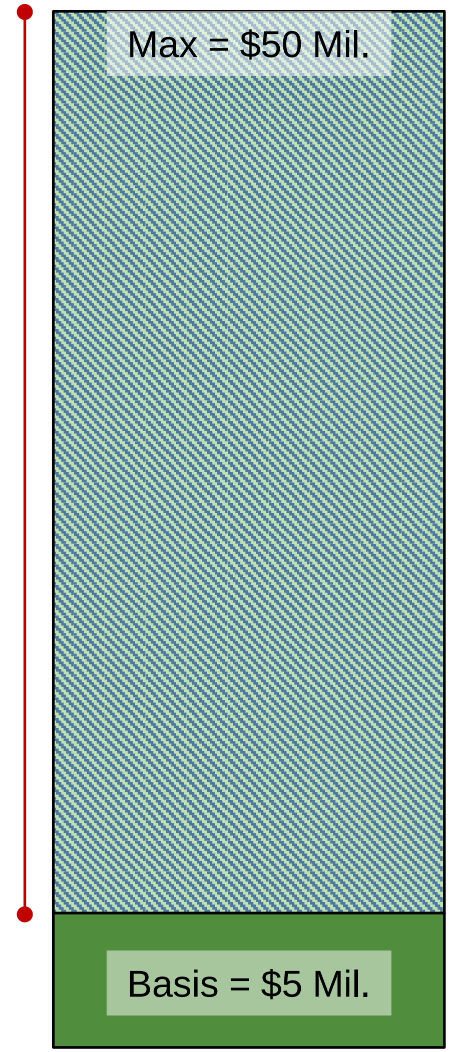


Maximum excluded eligible gain is ***greater*** of:
- $10 Mil. in aggregate for all prior taxable years; or
- 10 times adjusted basis (without regard to additions to basis after original issuance, *sort of…*).

$50 Mil. aggregate gross assets limitation:
- Cash, and
- Basis of property held by corporation (but contributed property is deemed to have basis equal to FMV)

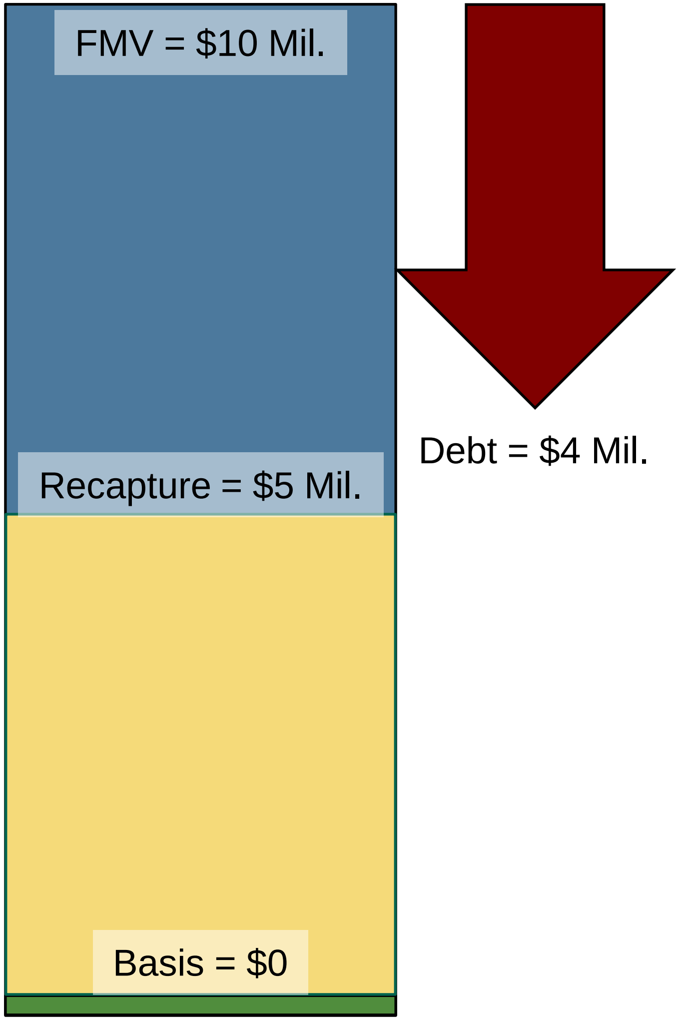


Tax Basis Management Prior to Conversion:
- Marking appreciated assets to FMV
- Contributions of appreciated assets
- Cash contribution
- Contribution of borrowed funds (not at LLC)
- Contribution of high basis property
- Selling assets for taxable gain



Using A Contract Derivative To "Transfer" But Still Own The Asset For The "Step-Up."

Sell The Appreciation Via Contract, Own The Asset



Depreciated Real Property

<u>9-YEAR CONTRACT</u>

Grantor "Sells"
Personal Obligation to Pay

Total Return =

FMV of Property
LESS Debt
PLUS Net Rental Income

<u>9-YEAR PROMISSORY NOTE</u>

$6 Mil.
LESS Discount
"Personal Obligation Risk"

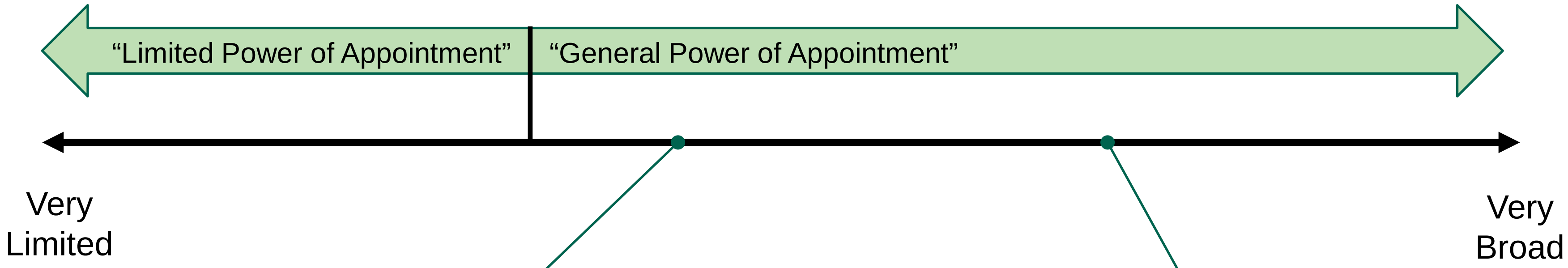
<u>BUSINESS REASONS</u>
Real Property Tax
Creditor Consent
Real Estate Transfer Tax
NIIT/Material Participation
Expenses of Transfer

IDGT

<u>ISSUES</u>
Valuation?
Settled Before Date of Death?
Estate Tax Deduction?
Ordinary Income/Deduction?
Satisfied with What Asset?

Powers of Appointment & “Upstream” Planning

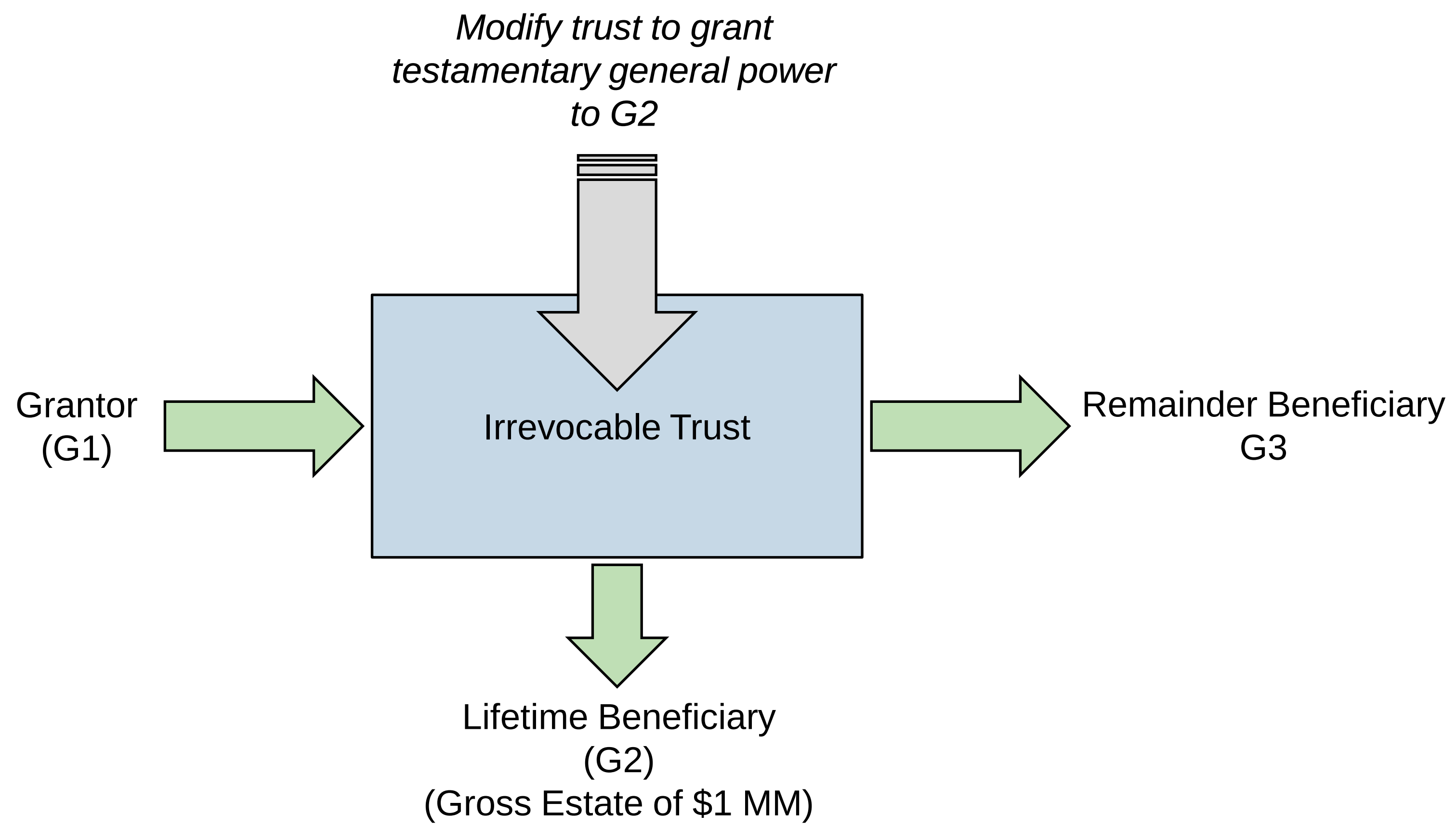
Powers of Appointment: How Restrictive?



- Testamentary power;
- Exercisable in favor of creditors of the estate of the powerholder;
- With the consent of a non-adverse party;
- To the extent of available exclusion amount; and
- Only over assets that benefit the most from a "step-up"

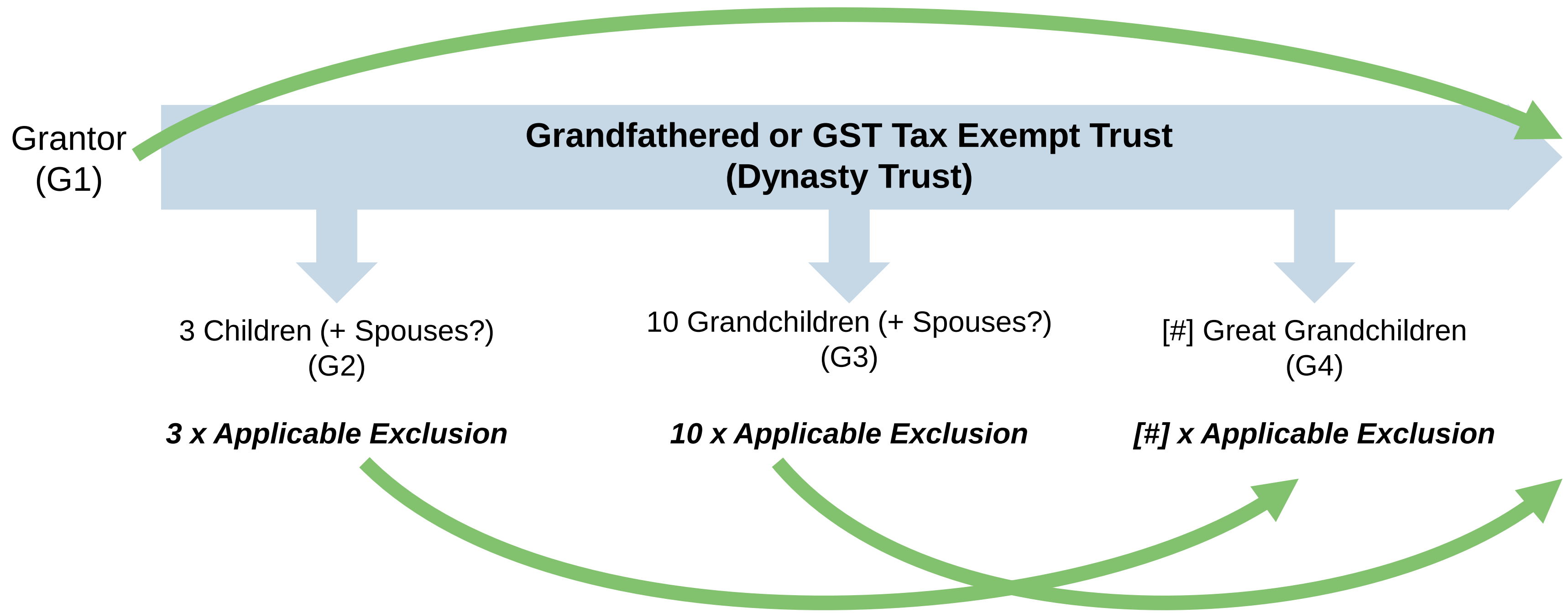
- Inter-vivos or testamentary
- Exercisable in favor of:
  - Powerholder,
  - Estate of powerholder, and
  - Creditors of the estate of the powerholder
- Over all assets.

Granting Powers of Appointment

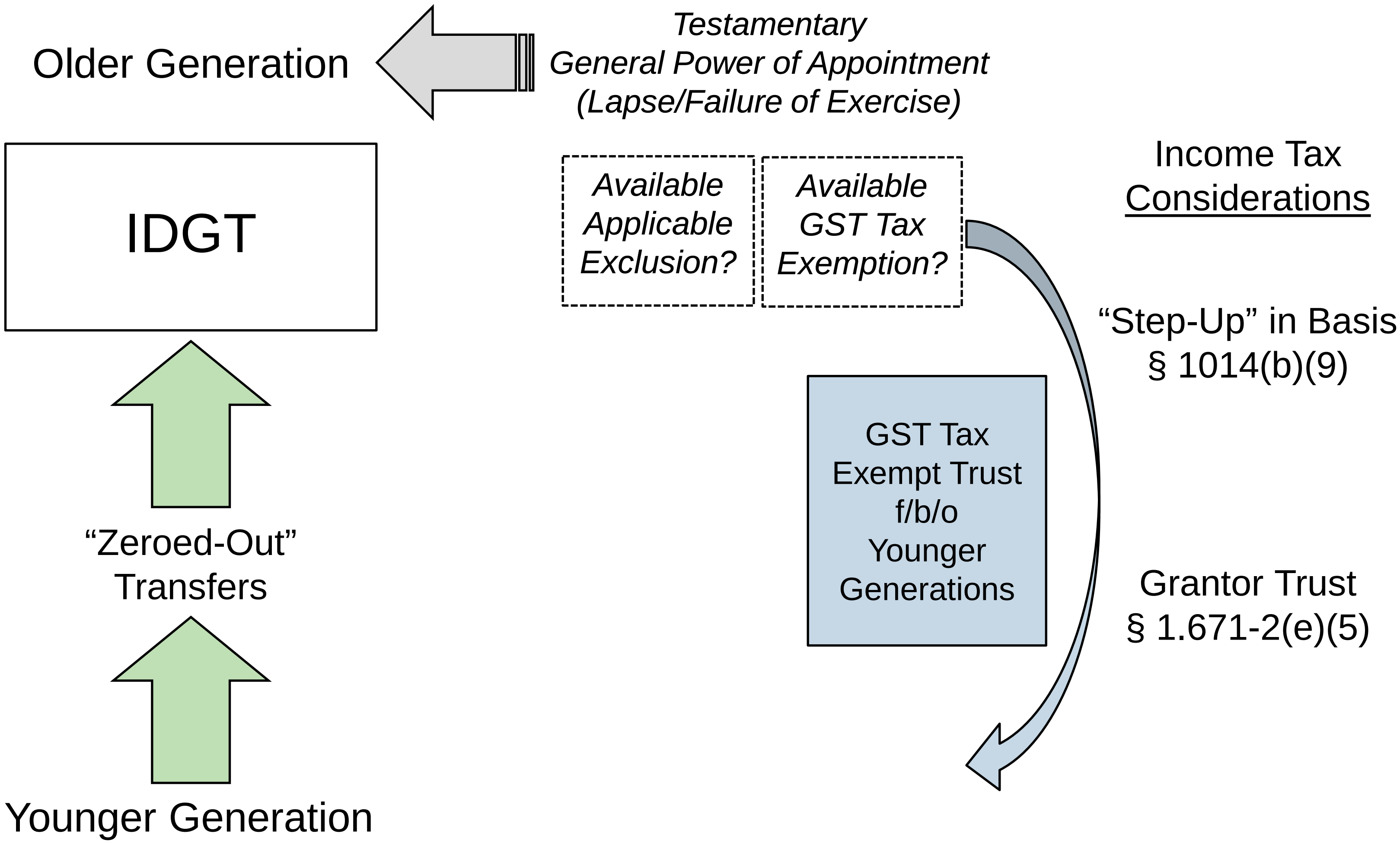


Powers and Multiplying the Applicable Exclusion

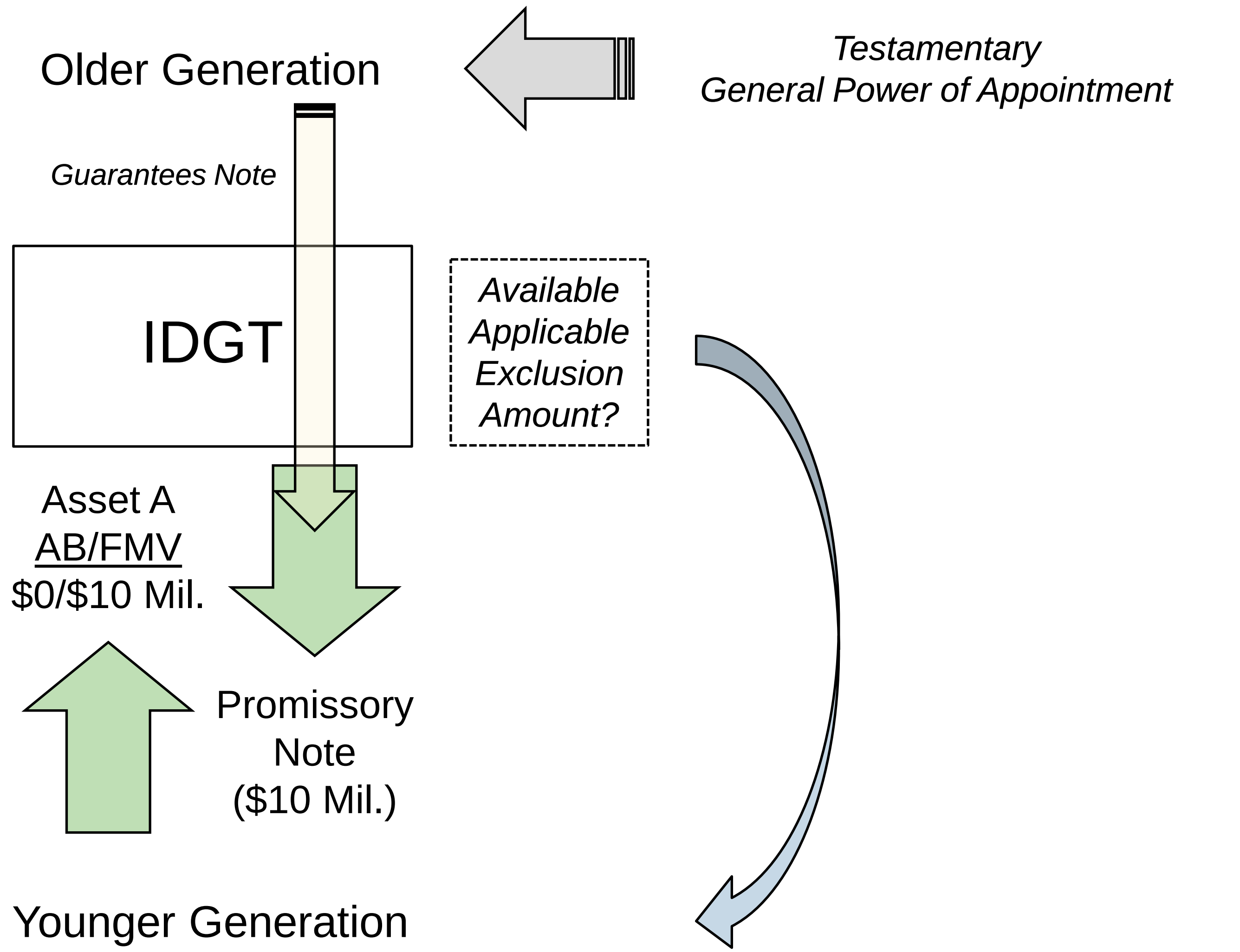
- Testamentary General Powers of Appointment
  - Formula clause: each beneficiary's unused Applicable Exclusion Amount (estate and GST tax), specific to asset that would most benefit from "step-up" in basis, and in default in further trust.
  - Independent trustee/protector giving testamentary general power of appointment to beneficiary.
  - Modification of existing trusts or decanting.



Upstream Planning: "Accidentally Perfect" Grantor Trust

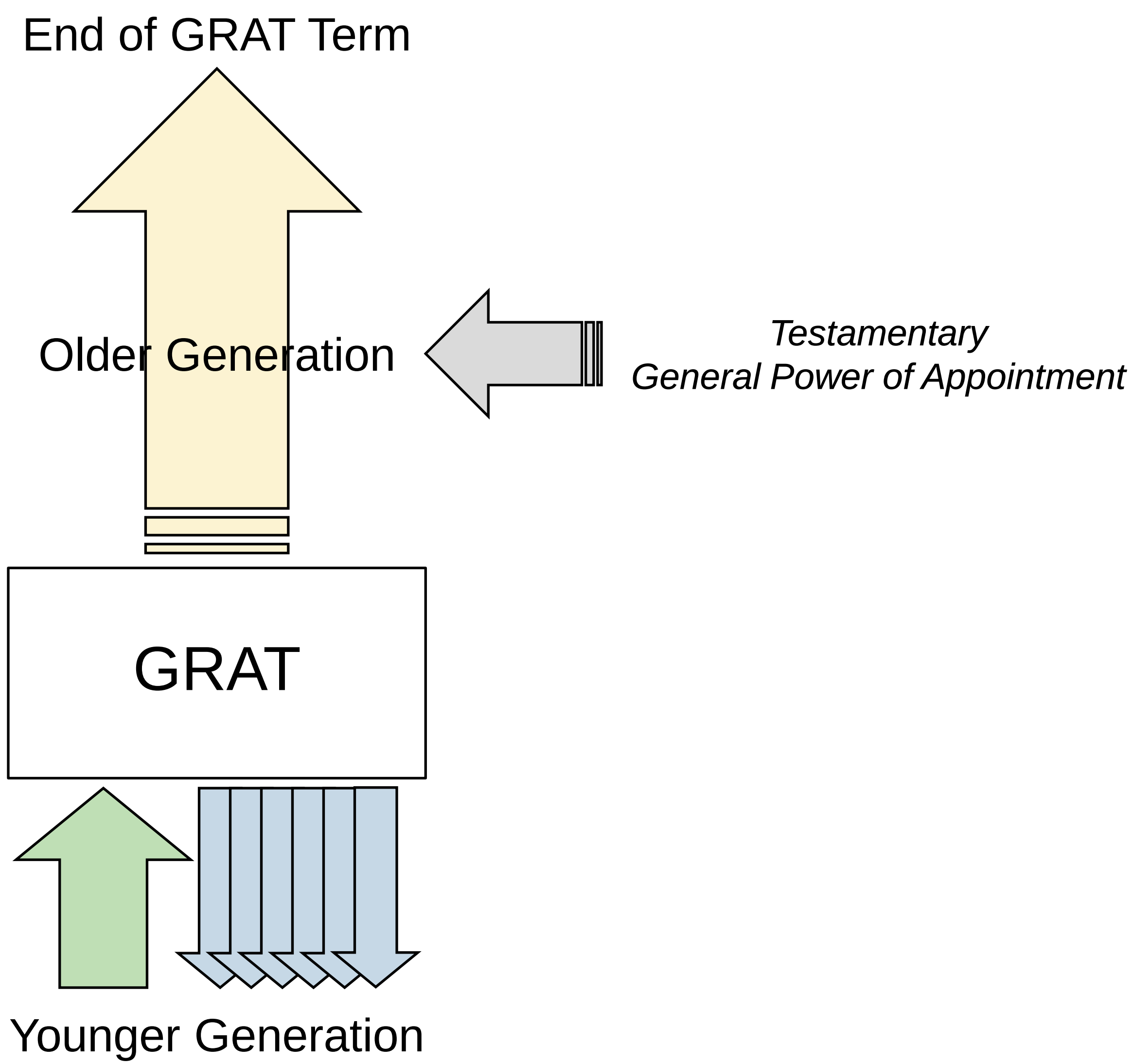


Upstream Planning: UPSPAT?



What about *Crummey* gifts to the IDGT?

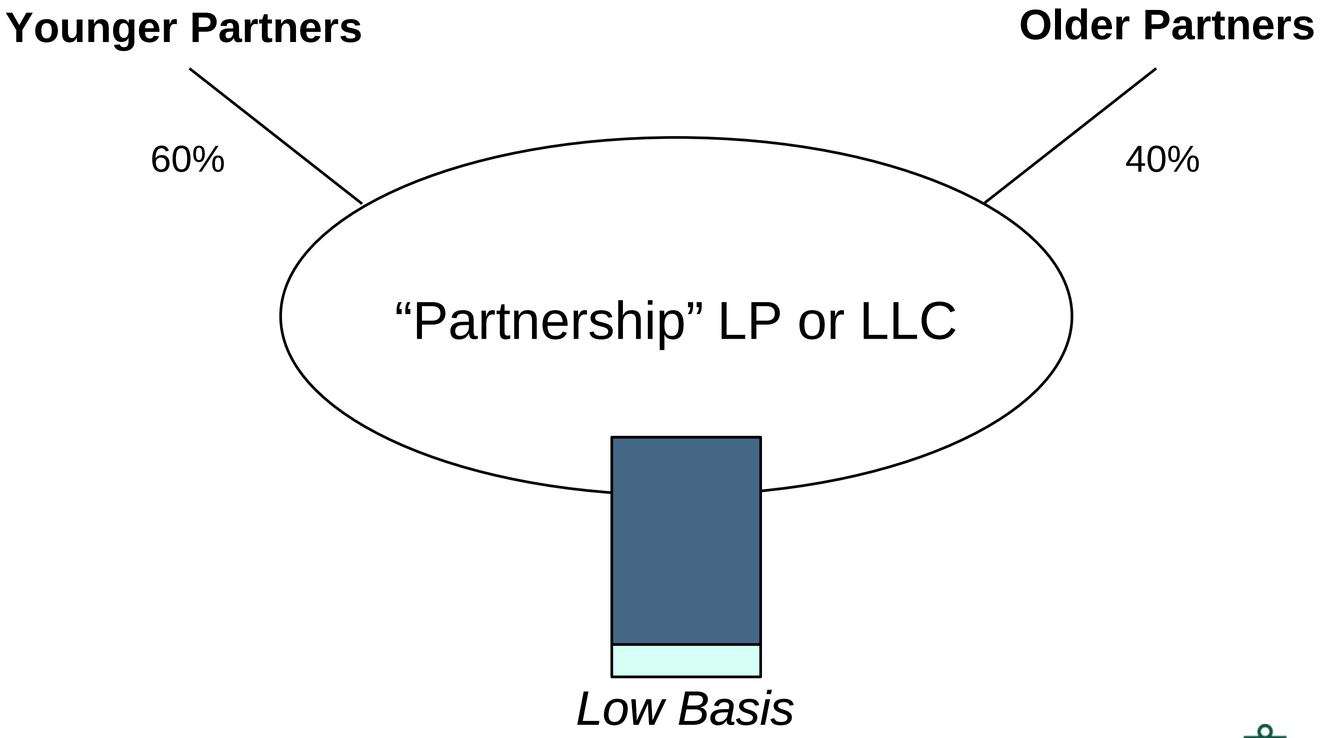
Upstream GRAT Remainders?



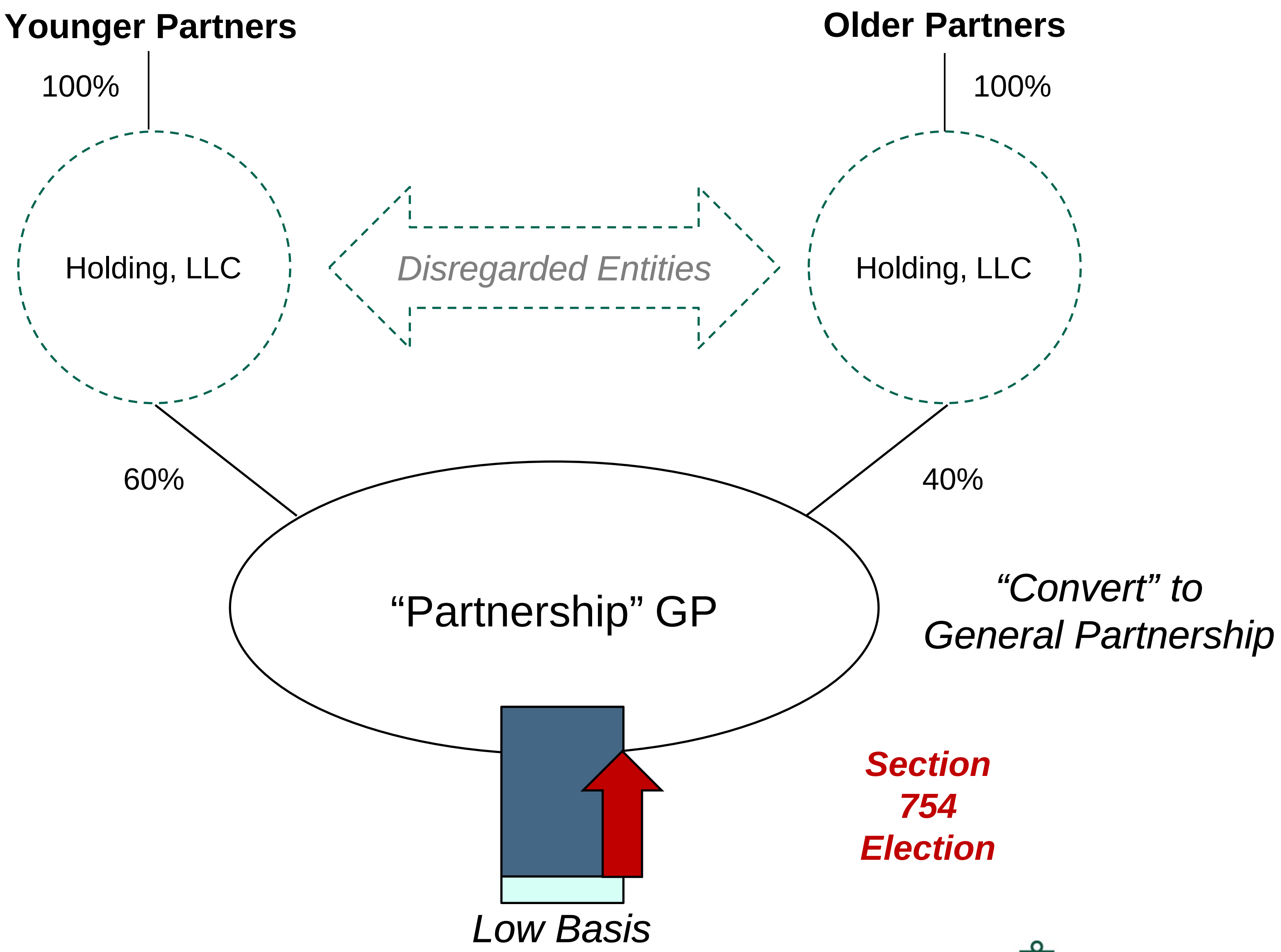
Partnerships:
The Most Flexible
Tax Basis Management
Tool For Planners

Eliminating Valuation Discounts On Pre-Existing FLP Interests Included in the Gross Estate

Eliminating Valuation Discounts on Pre-Existing FLPs

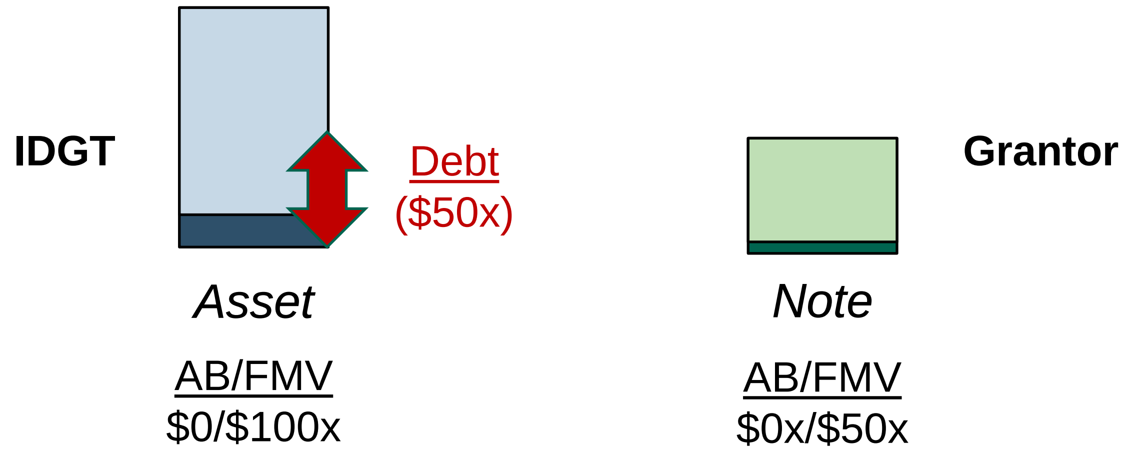


Eliminating Valuation Discounts on Pre-Existing FLPs



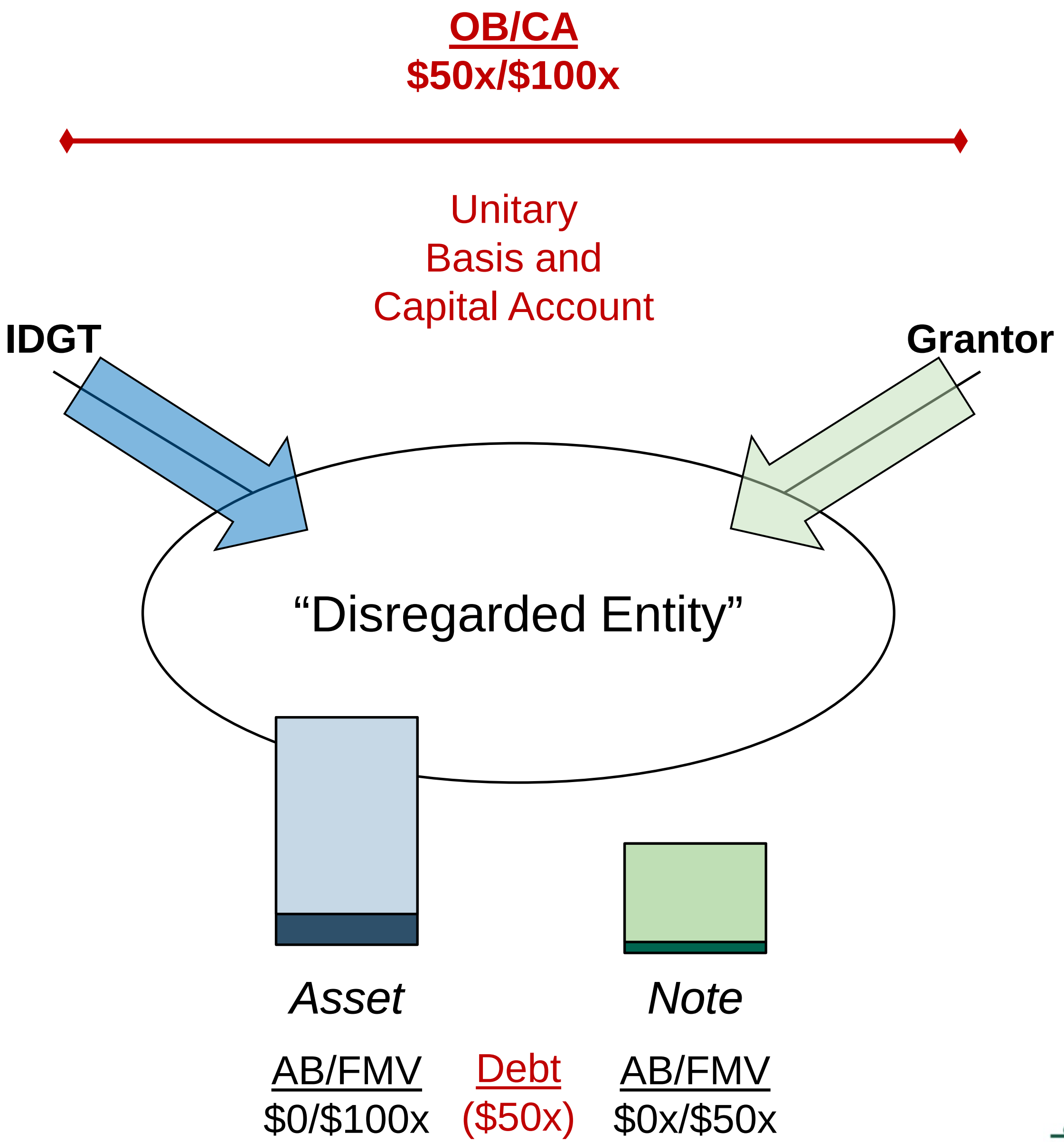
Eliminating Outstanding Installment Notes, Avoiding Gain At Death, And Getting A "Step-Up" On The IDGT Property

Installment Sale to IDGT and Outstanding Note



Potential $50x Taxable Gain
Upon Conversion of
Grantor Trust to Non-Grantor Trust

Contribution to Disregarded Entity



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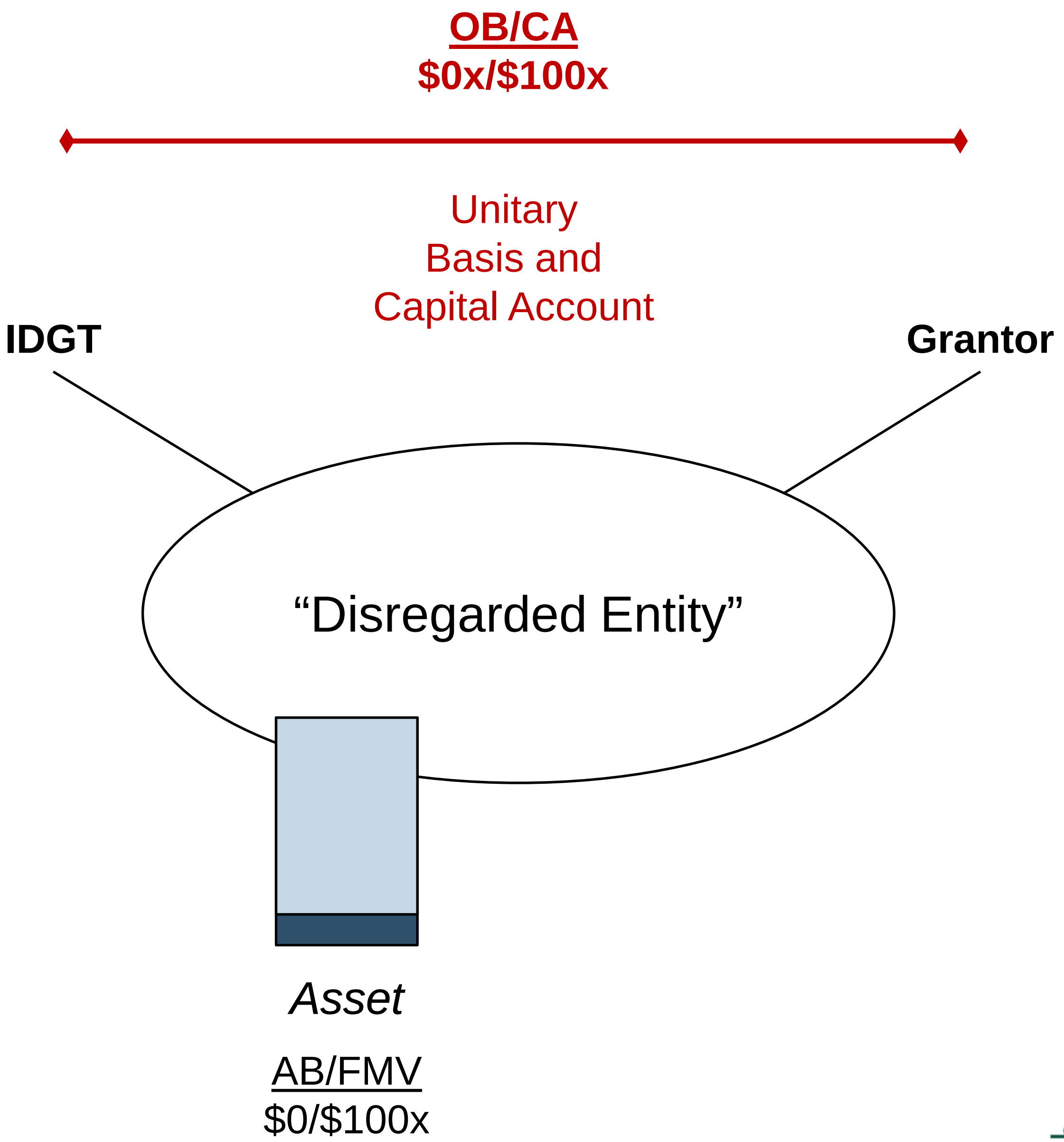
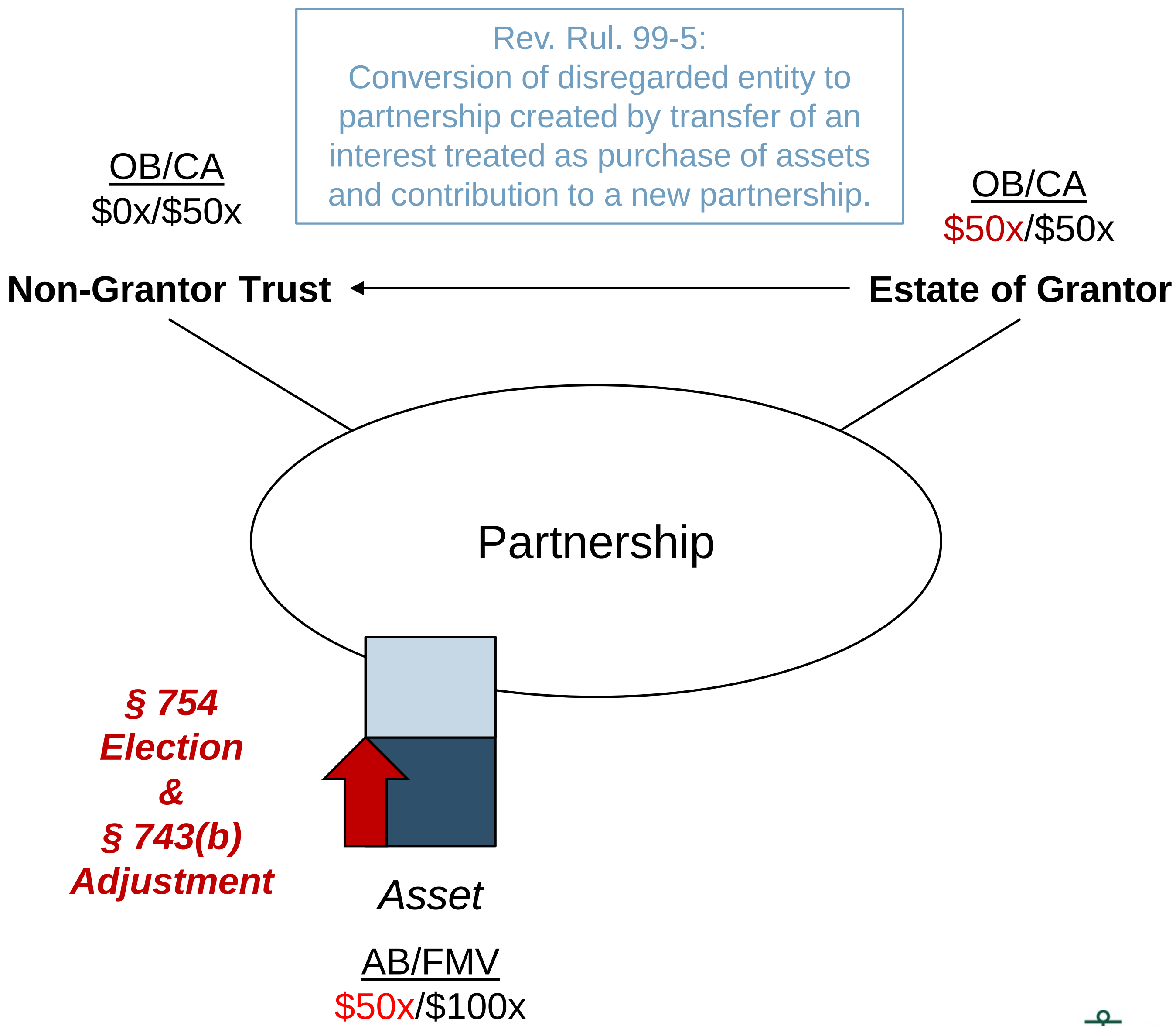
Debt Merges and Disappears

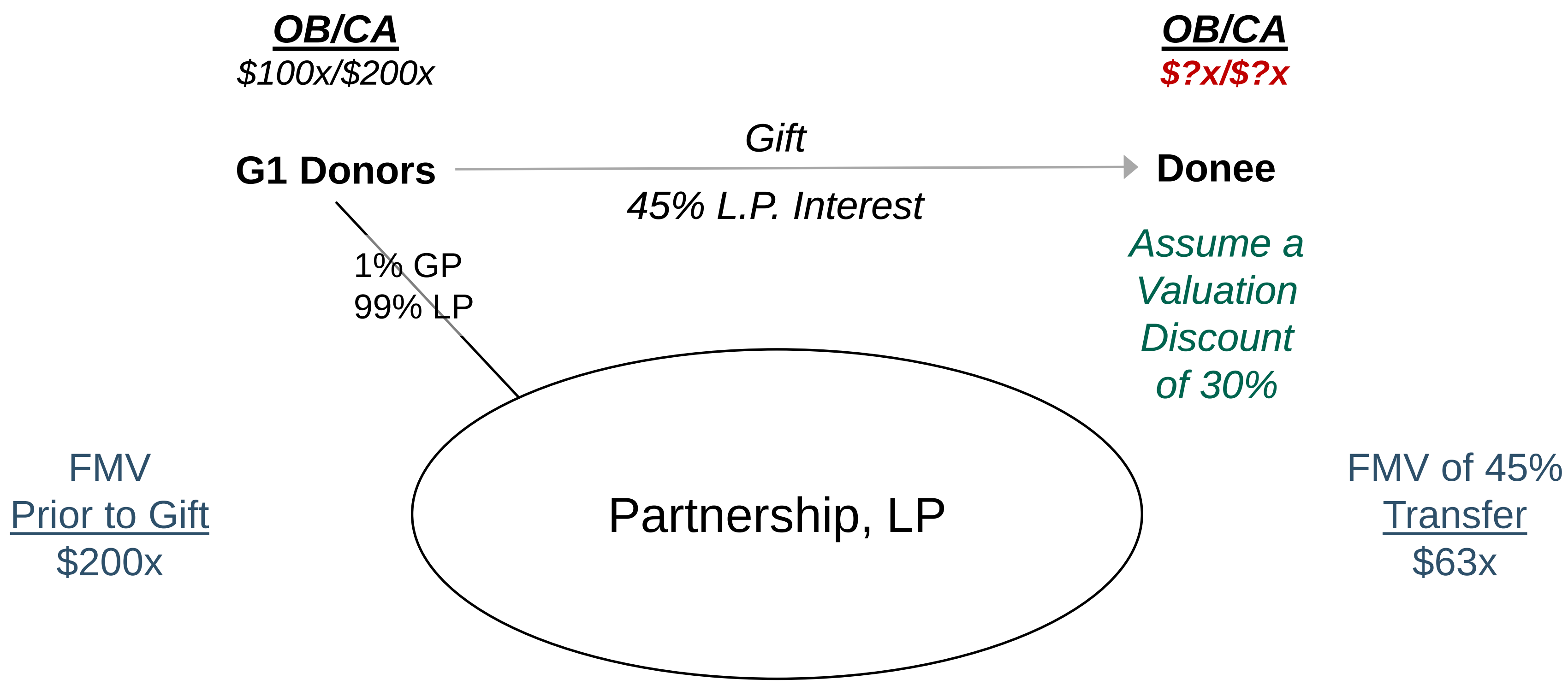


Conversion to Non-Grantor Trust & Partnership at Death



Calculating Outside Basis And Capital Account When A Partnership Interest Is Transferred

Transferring Basis and Capital Account



Calculating Capital Account & Basis of Transferred Interest

CAPITAL ACCOUNT OF TRANSFERRED INTEREST

Upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner." Treas. Reg. § 1.704-1(b)(2)(iv)(l). *See* Treas. Reg. § 1.704-1(b)(5), Ex. 13.

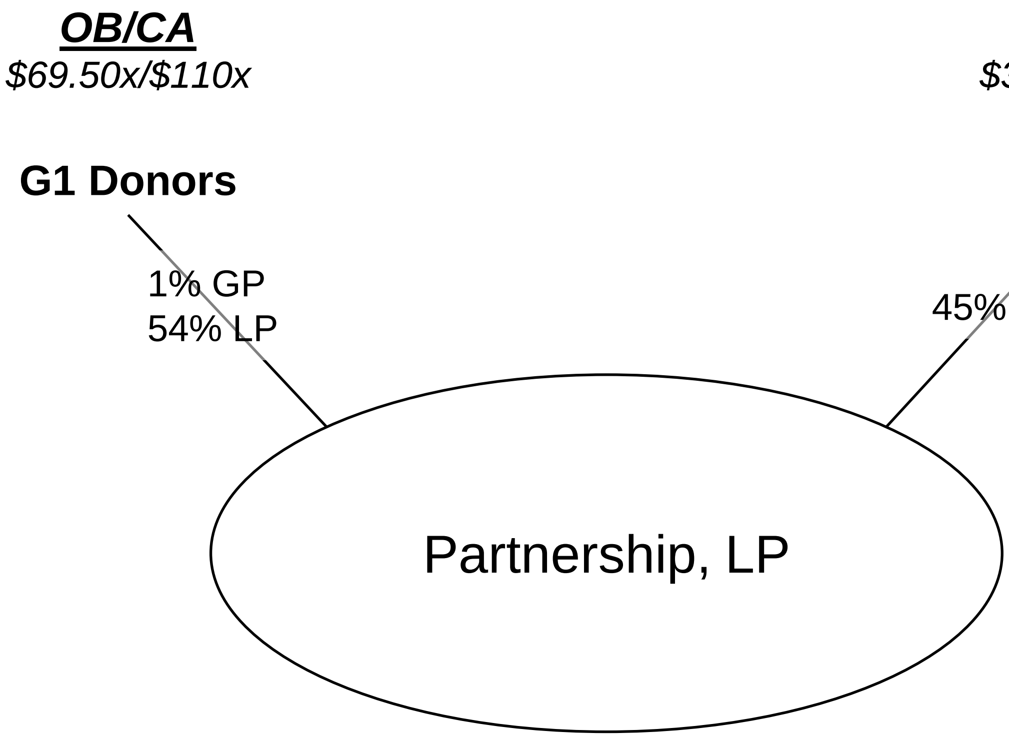
$$\frac{\text{Transferor's}}{\text{Capital Account}} \; \$200x \quad \times \quad \frac{\text{Percentage}}{\text{Transferred}} \; 45\% \quad = \quad \frac{\text{Transferee's}}{\text{Capital Account}} \; \$90x$$

ADJUSTED BASIS OF TRANSFERRED INTEREST

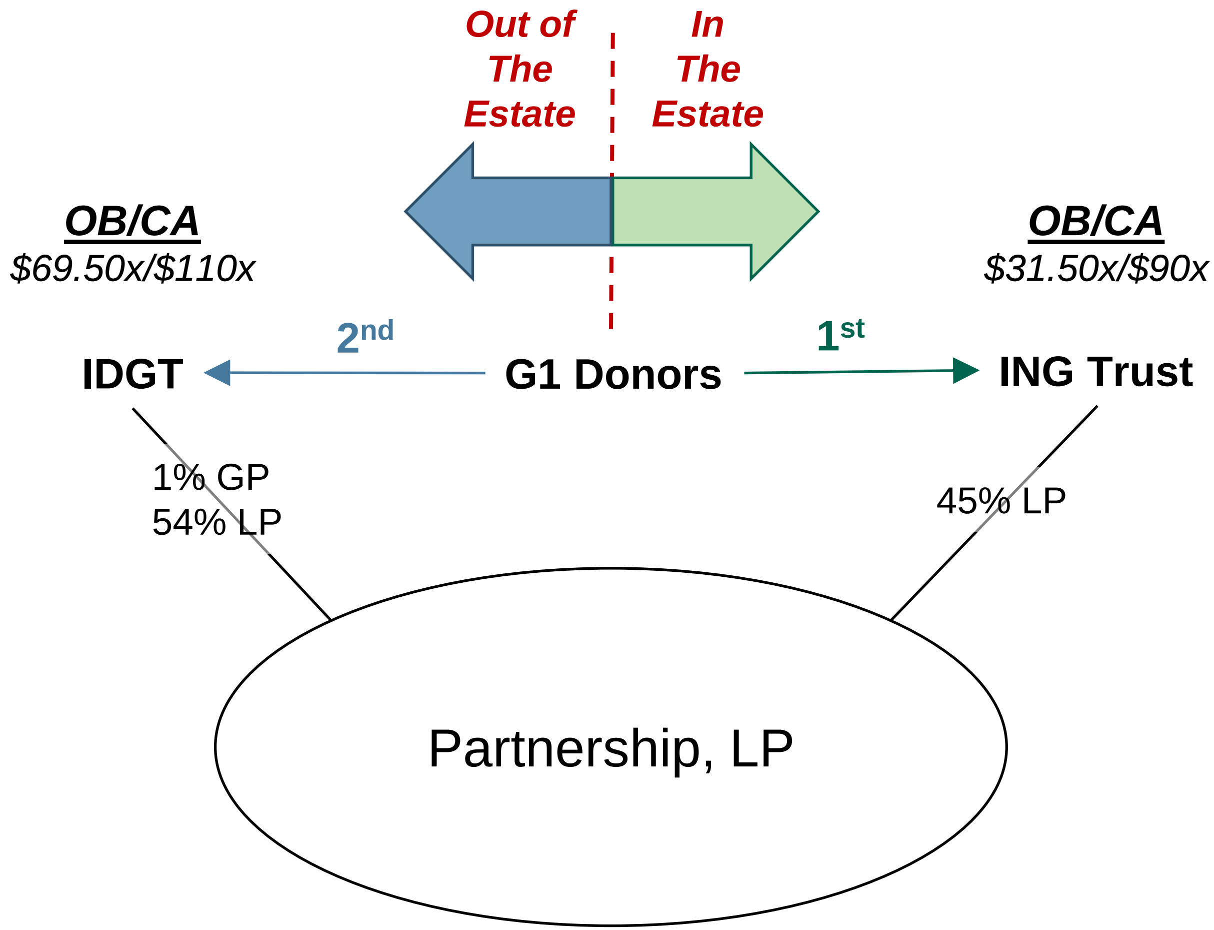
"[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest." Rev. Rul. 84-53, 1984-1 C.B. 159.

$$\begin{array}{c}\text{Transferor's}\\ \underline{\text{Adjusted Basis}}\\ \$100x\end{array} \quad \times \quad \frac{\begin{array}{c}\text{Fair Market Value (Discounted)}\\ \underline{\text{Transferred Portion}}\\ \$63x\end{array}}{\begin{array}{c}\text{Fair Market Value}\\ \underline{\text{Transferor's Entire Portion}}\\ \$200x\end{array}} \quad = \quad \begin{array}{c}\text{Transferee's}\\ \underline{\text{Adjusted Basis}}\\ \$31.50x\end{array}$$

Less Basis is Transferred

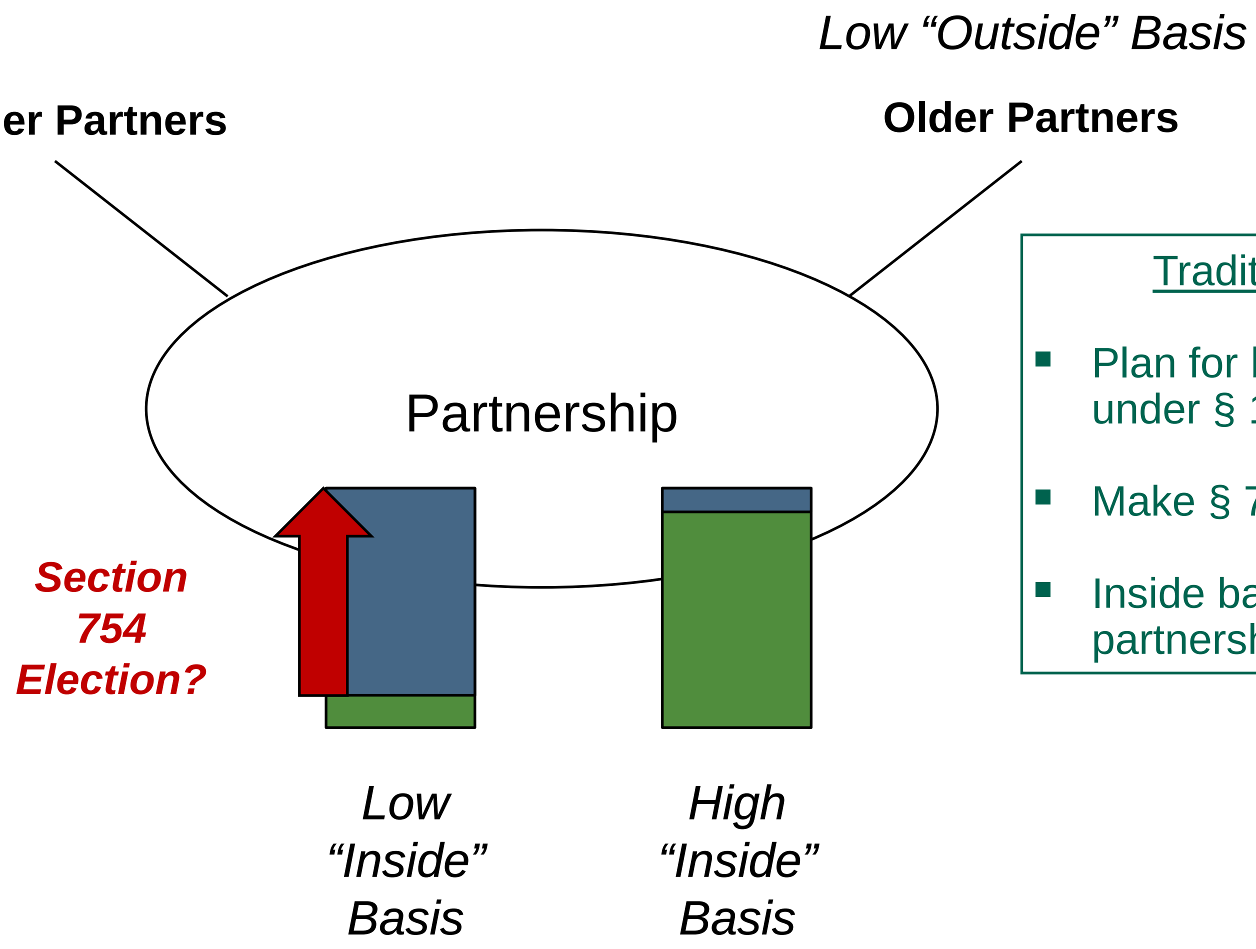


Incomplete Gift to Non-Grantor Trusts First?



Limitations on the Inside Basis Adjustment On the Death of a Partner

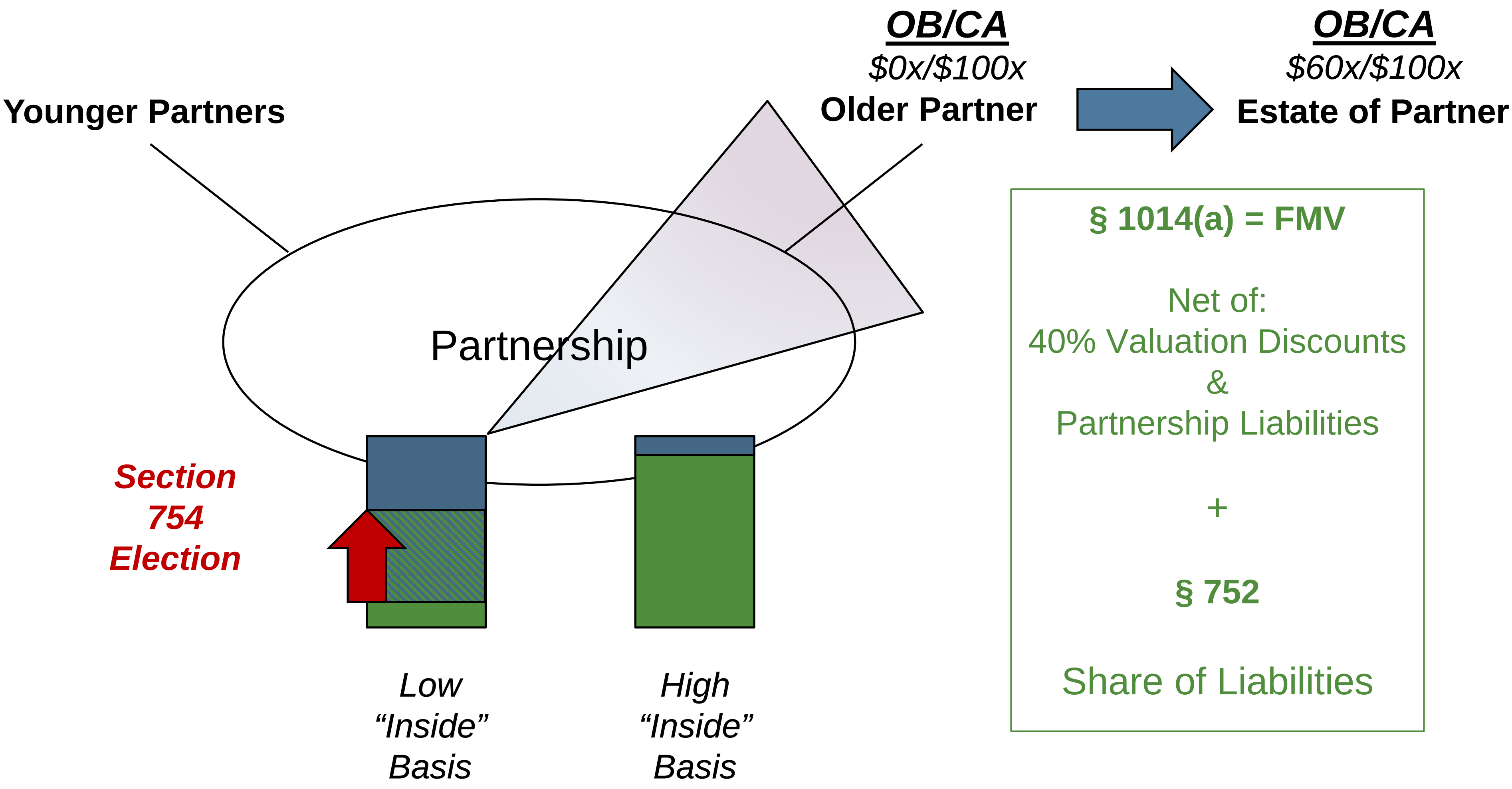
Importance of Partnerships in Tax Basis Management



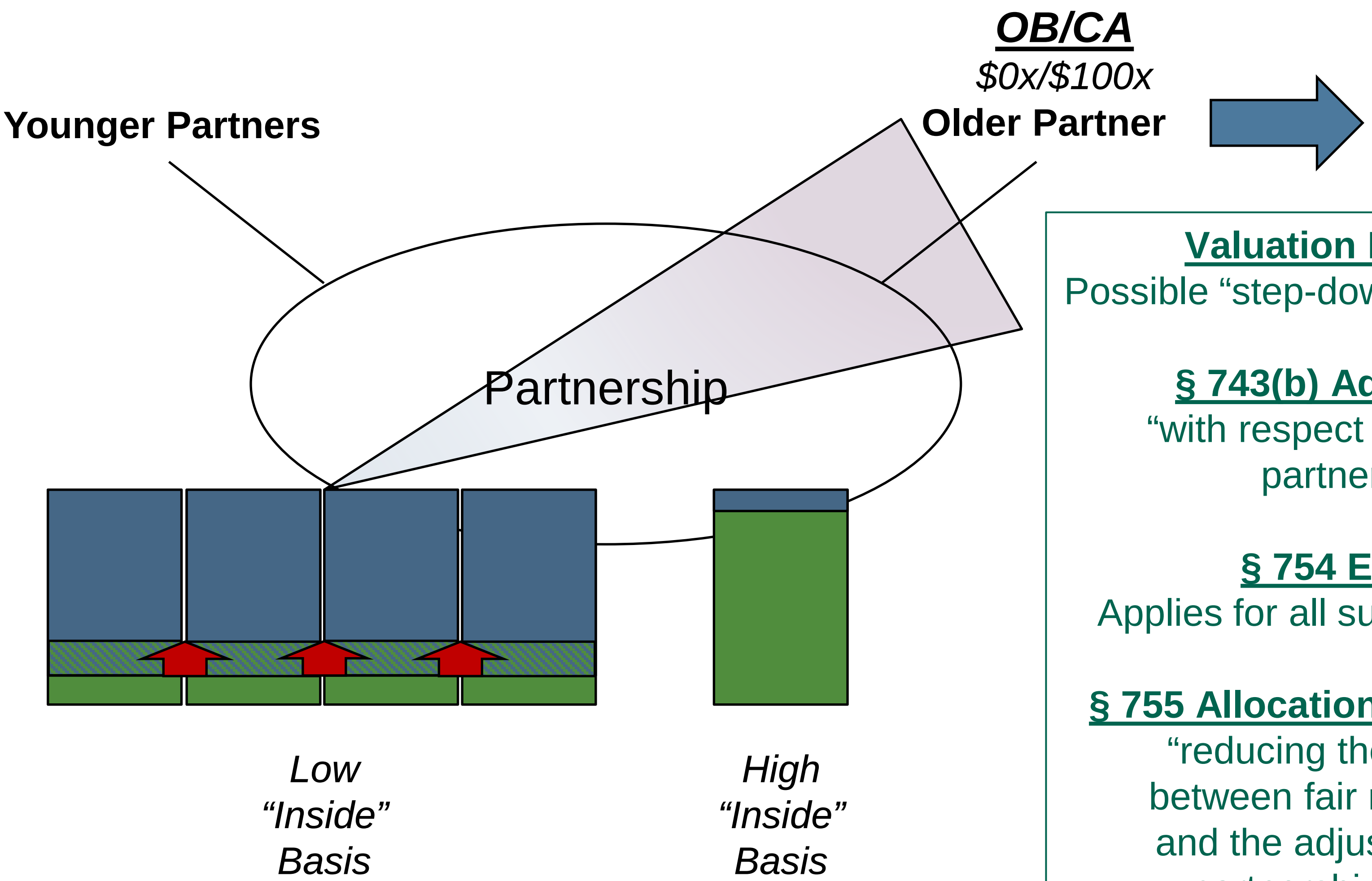
Traditional Advice:

- Plan for basis adjustment under § 1014.
- Make § 754 election.
- Inside basis adjustment to partnership property.

Limits of 754 Election and Basis Adjustment at Death (§ 743)



Other Limits of Inside Basis Adjustment under § 743



Valuation Discounts
Possible “step-down” in inside basis

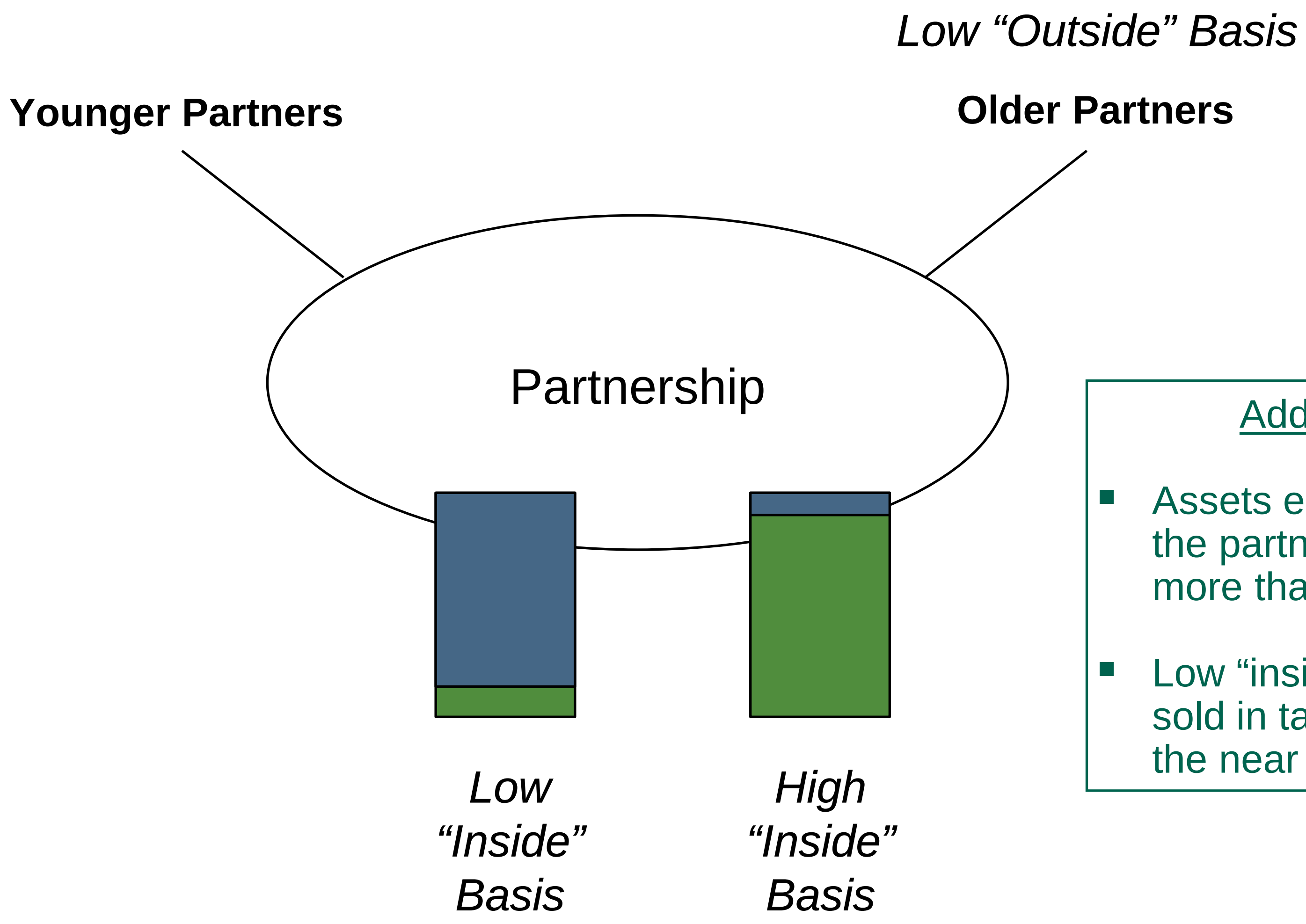
§ 743(b) Adjustments
“with respect to transferee partner only”

§ 754 Election
Applies for all subsequent years

§ 755 Allocation of Adjustment
“reducing the difference between fair market value and the adjusted basis of partnership property”

The Basics of Basis
Stripping, Shifting, and Swapping

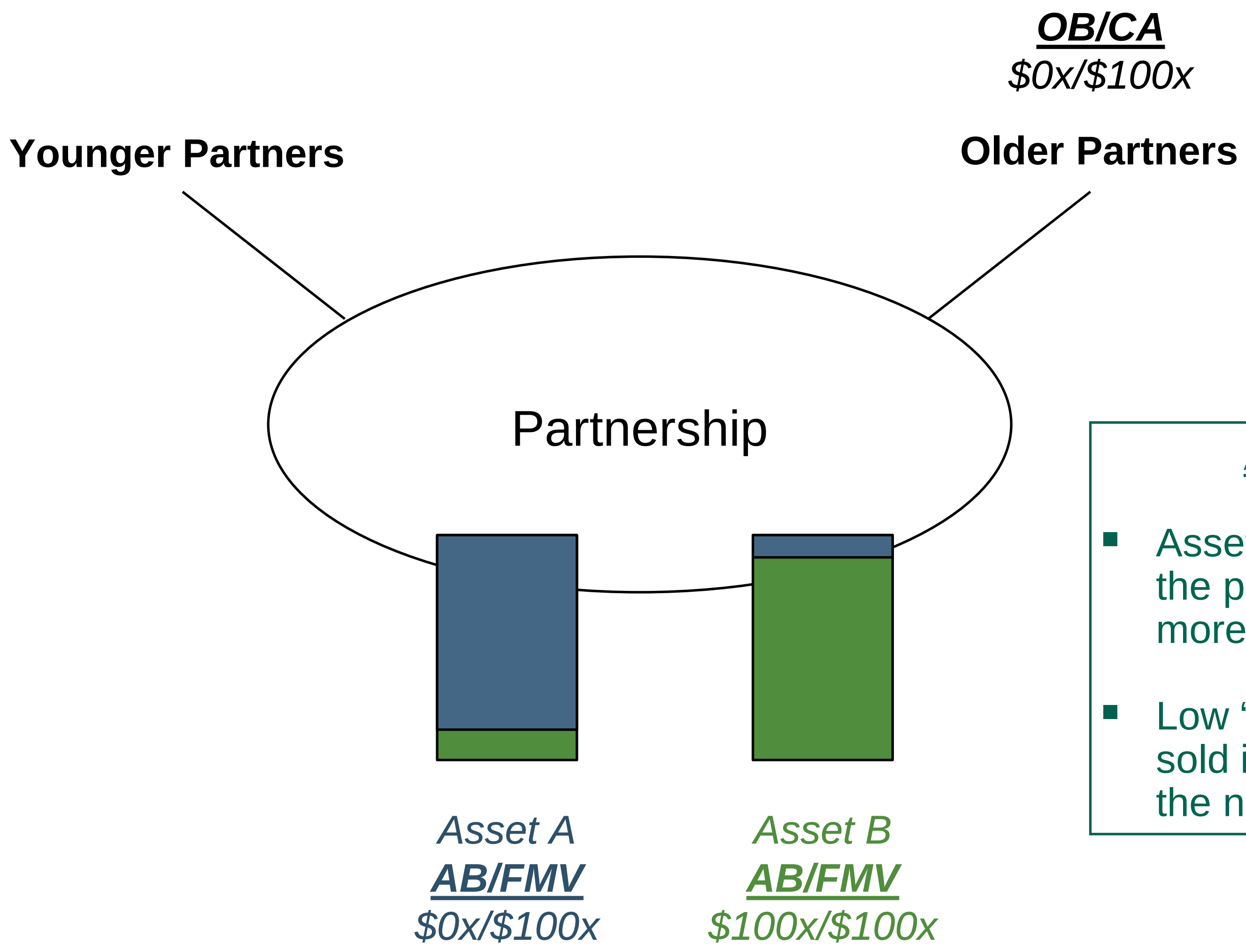
Importance of Partnerships in Tax Basis Management



Additional Facts:

- Assets either purchased by the partnership or contributed more than 7 years ago.
- Low "inside" basis asset to be sold in taxable exchange in the near future.

Importance of Partnerships in Tax Basis Management



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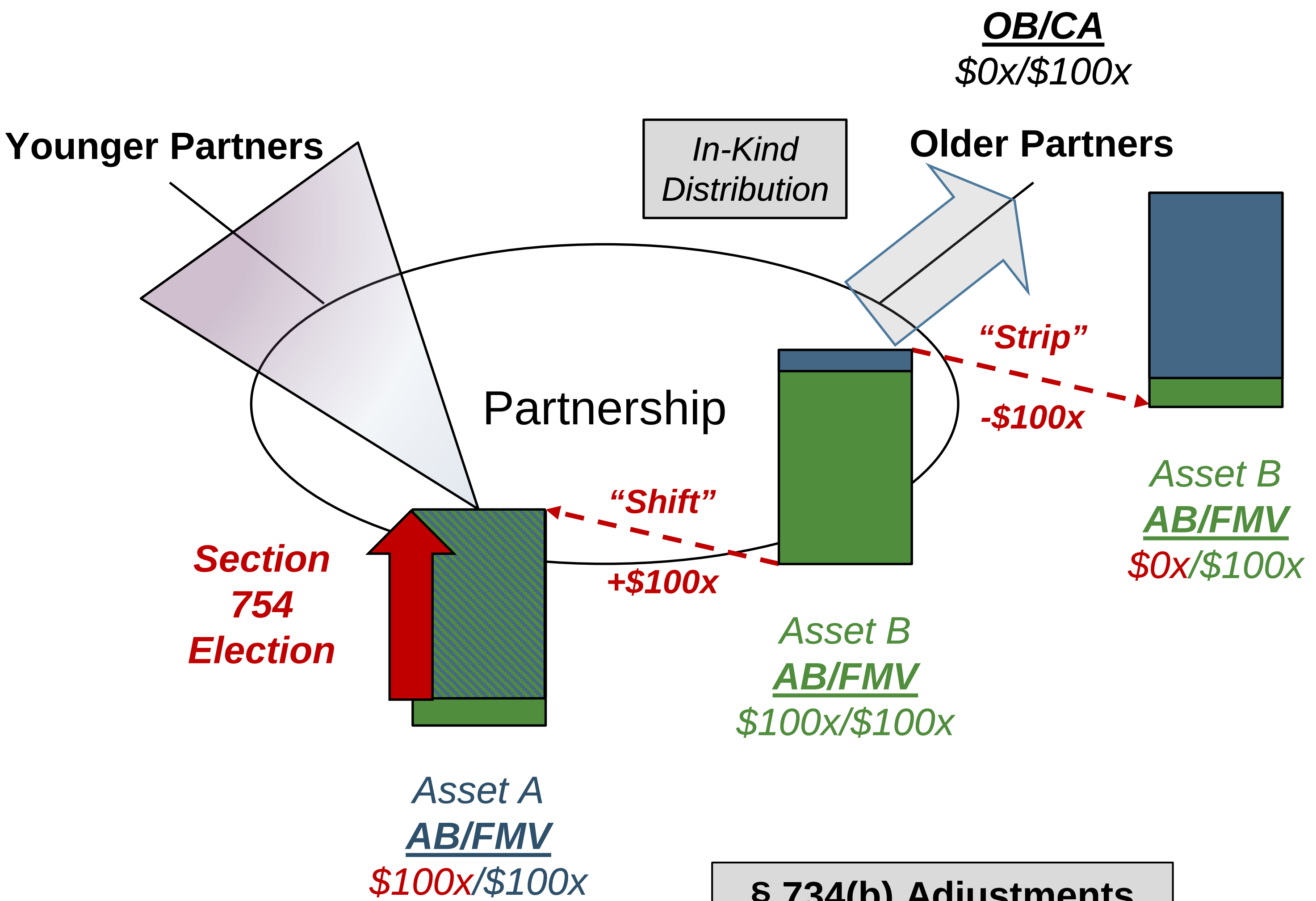
Importance of Partnerships in Tax Basis Management



§ 734(b) Adjustments
To "partnership property"

Inside Basis Adjustments: Current vs. Liquidating Distributions

Current Distributions

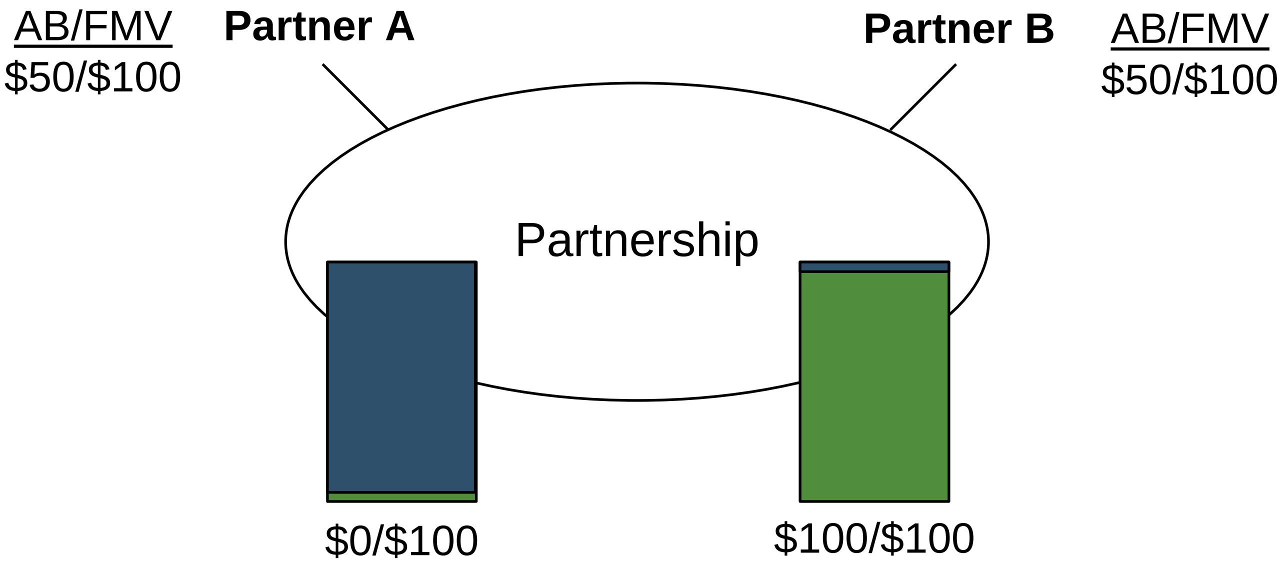
- Only gain (not loss) can be recognized by distributee.
- Basis of in-kind property distributed to a partner is the *lesser* of:
  - Inside basis of the property; and
  - Outside basis of distributee partner.
- When outside basis is less than inside basis, basis of property is reduced or lost to the partnership.
- Only *increases* in partnership property under § 734(b) can occur.

Liquidating Distributions

- Gain *and* loss can be recognized by distributee.
- Under § 734(b), the inside basis adjustment can:
  - Increase the basis of partnership property (for gain); or
  - Decrease the basis of partnership property (for loss).
- Basis of in-kind property distributed to a partner will be the outside basis of the distributee partner.
- Distributions can result in an increase *and* decrease in basis of the property. The inside basis adjustment can:
  - Increase the basis of partnership property (for a reduction of basis in the distributed property)
  - Decrease the basis of partnership property (for an increase of basis in the distributed property)
- Mandatory inside basis adjustment (reduction of basis to partnership property):
  - Partner recognizes a loss of more than $250,000; or
  - Basis of liquidated property is increased by more than $250,000.

Importance
of
Partnership Divisions

Unitary Basis Works Against Efficient Tax Basis Management



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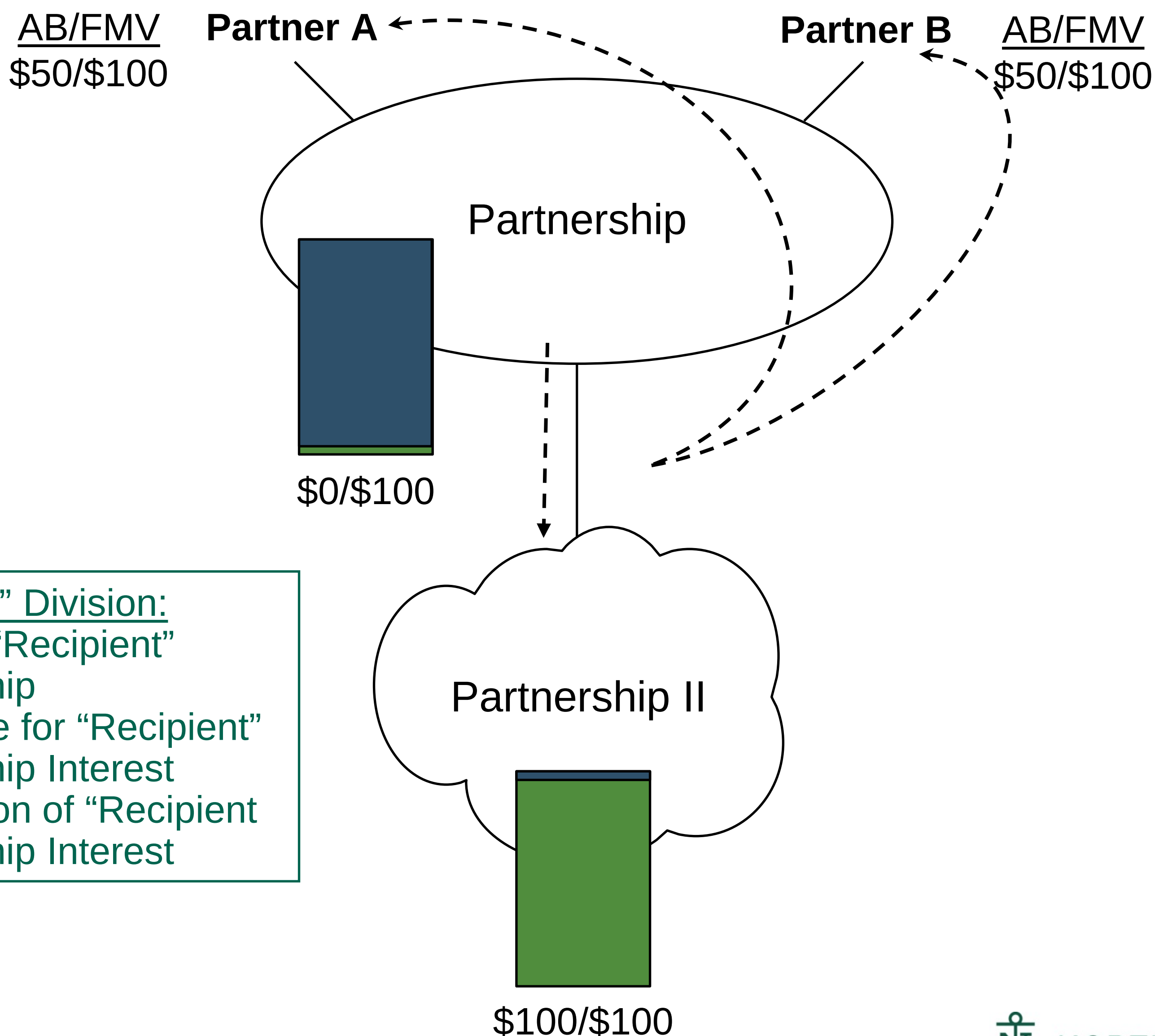
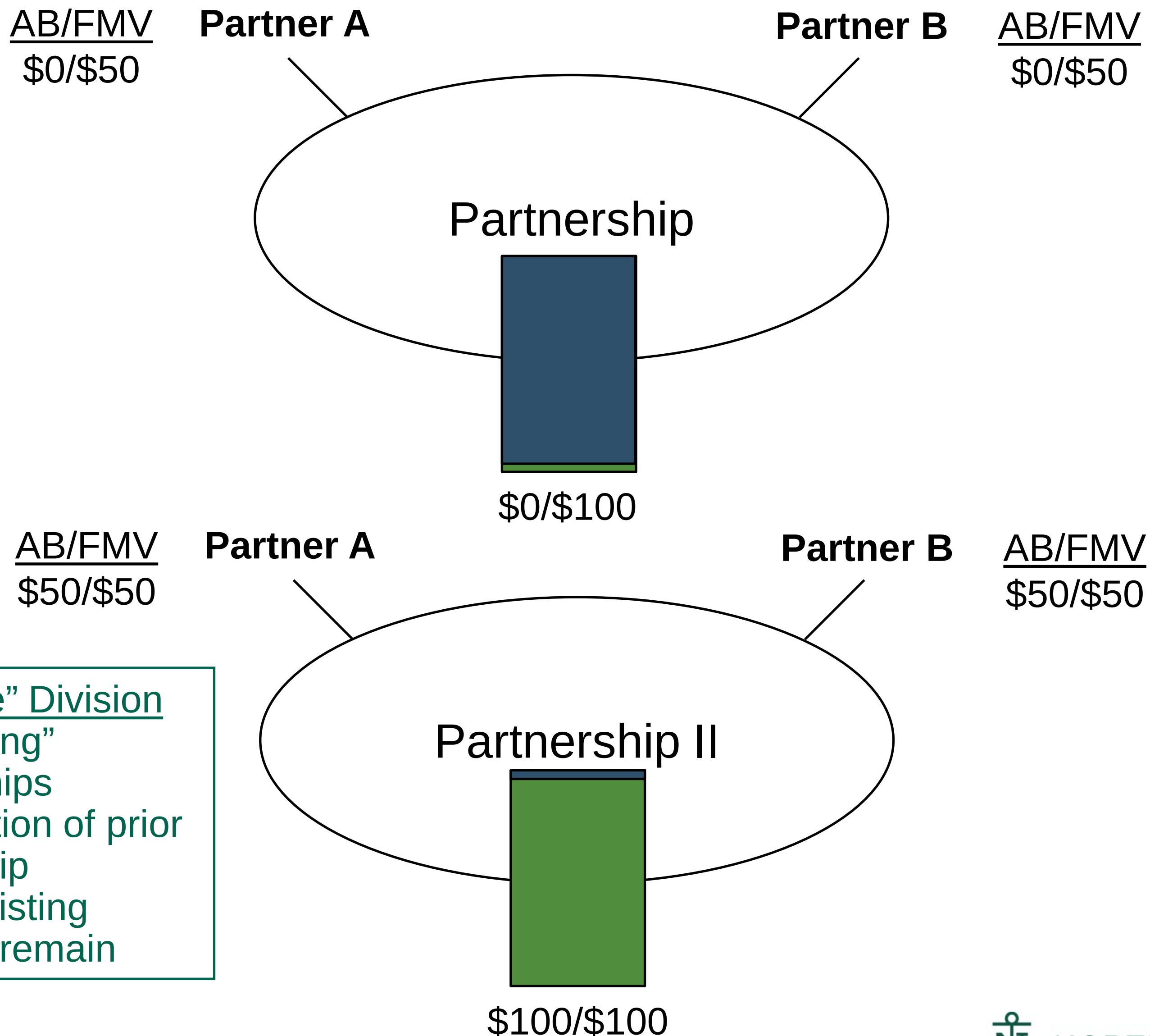
Partnership Division Can Solve Unitary Basis Problem



"Assets-Over" Division:
1. Asset to "Recipient" Partnership
2. Exchange for "Recipient" Partnership Interest
3. Distribution of "Recipient Partnership Interest

Partnership Division Can Create High & Low Outside Basis



<u>"Vertical Slice" Division</u>

1. 2 "Resulting" Partnerships
2. Continuation of prior partnership
3. All pre-existing elections remain

Setting the Stage for Basis Stripping, Shifting & Swapping (Think Evolution)

FLP Evolution: Ancient Alien Theory

No § 754 Election

"Mother Ship"
All Asset
Partnership

7 Years: A Billion Years in Tax Time

No § 754 Election

"Mother Ship"
All Asset
Partnership

Isolated
"Aliens"

§ 754 Election

Ancient Alien Theory: 3 Lines of Evolution?

“Mother Ship”
All Asset (Ex. Assets)
Partnership

“Mother Ship”
Section 751 “Hot” Assets
Partnership

“Mother Ship”
Marketable Securities
Partnership

No § 754 Election

7 Years: A Billion Years in Tax Time

“Mother Ship”
All Asset (Ex. Assets)
Partnership

“Mother Ship”
Section 751 “Hot” Assets
Partnership

“Mother Ship”
Marketable Securities
Partnership

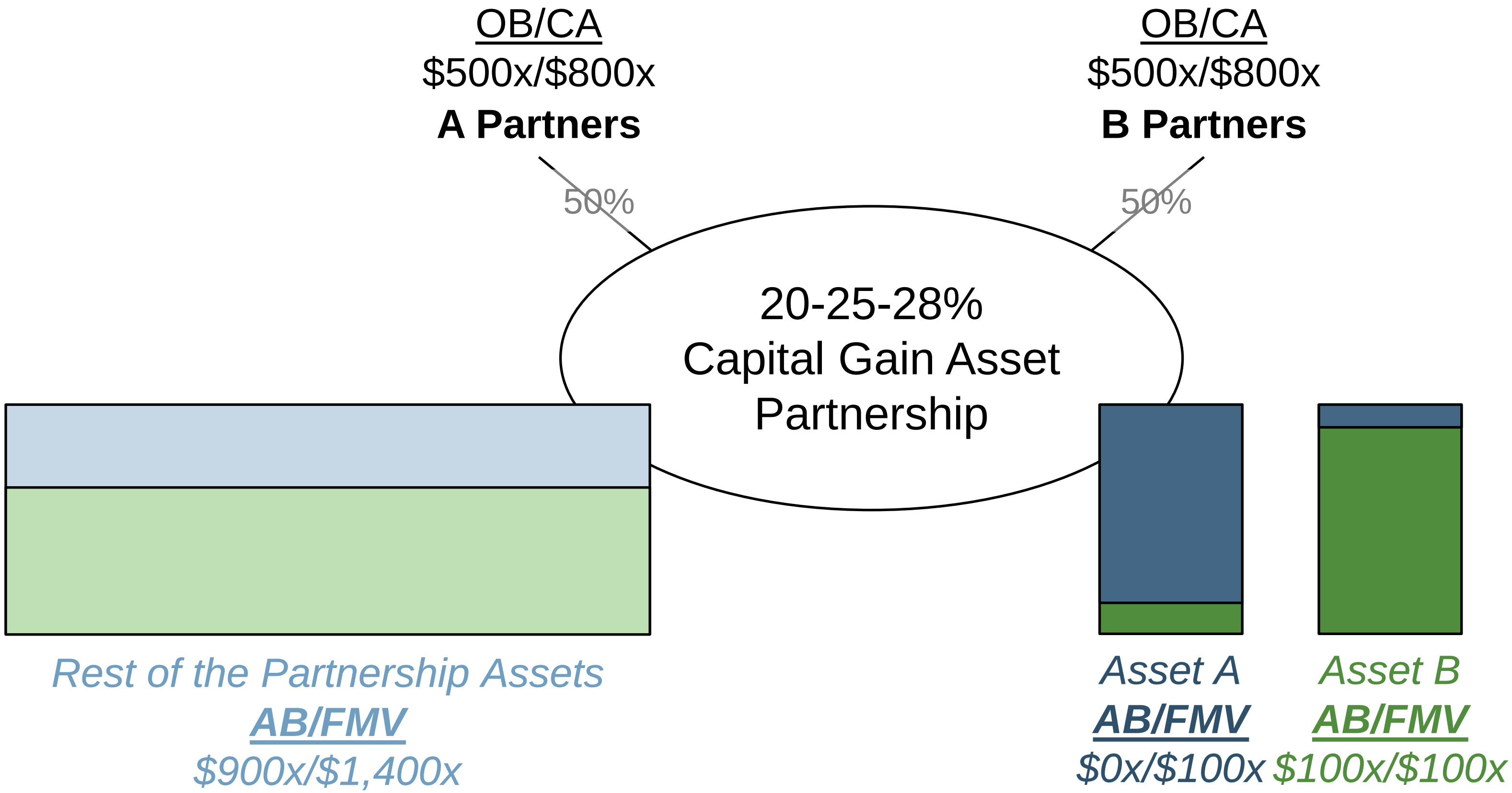
§ 754 Election

Isolated
“Aliens”

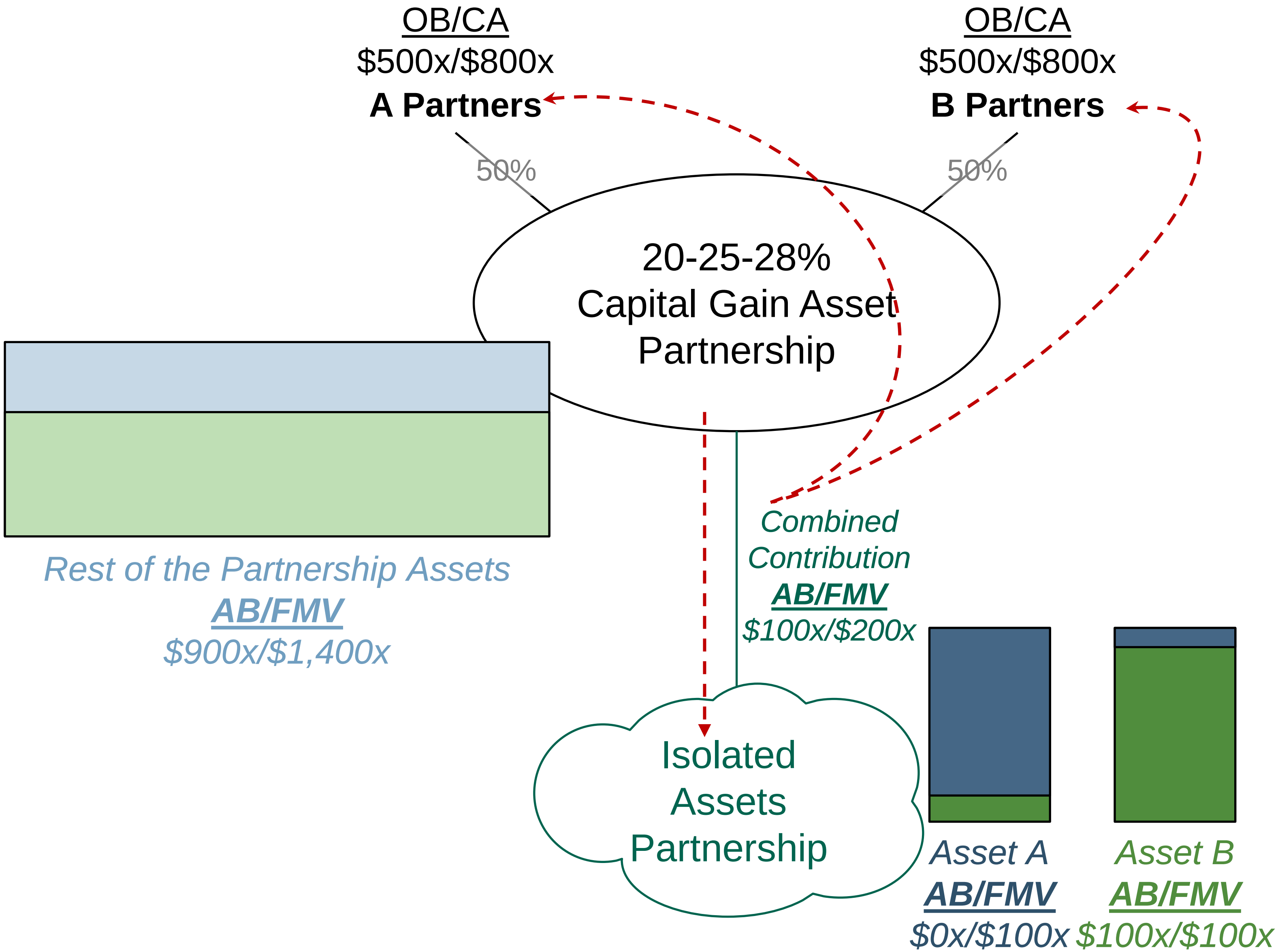
Isolated
“Hot” Assets

Isolated
Securities

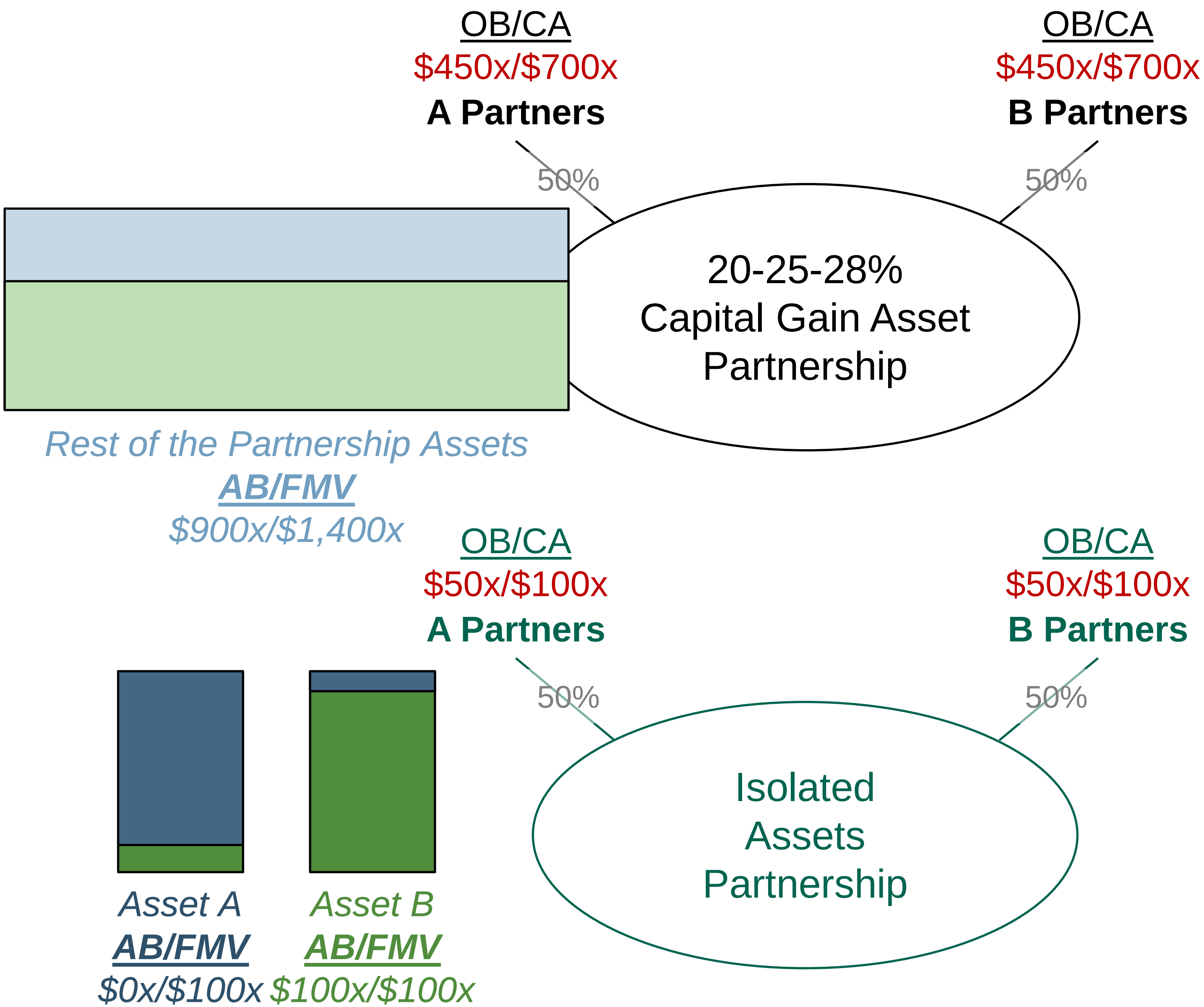
Mother Ship, Isolated Alien Example



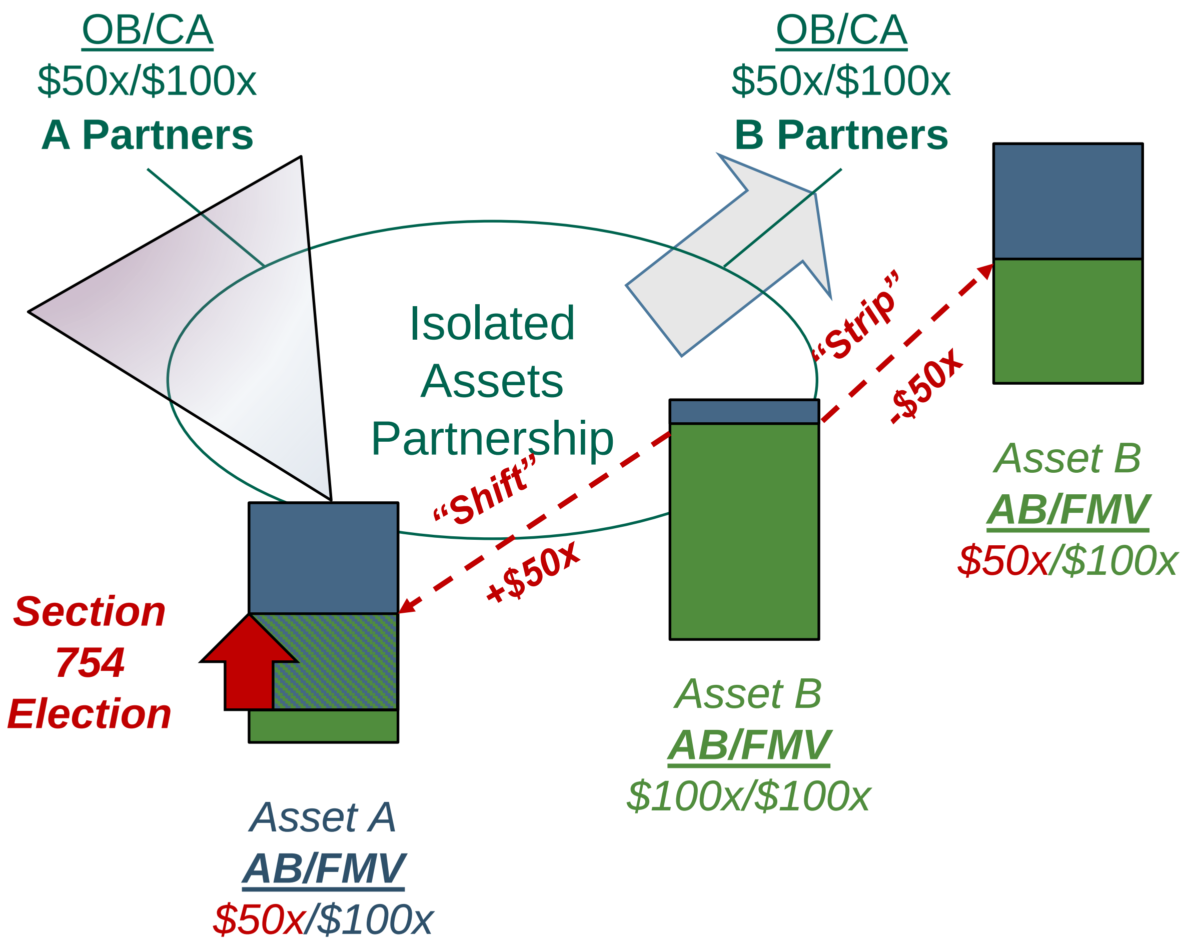
Mother Ship, Isolated Alien Example



Mother Ship, Isolated Alien Example

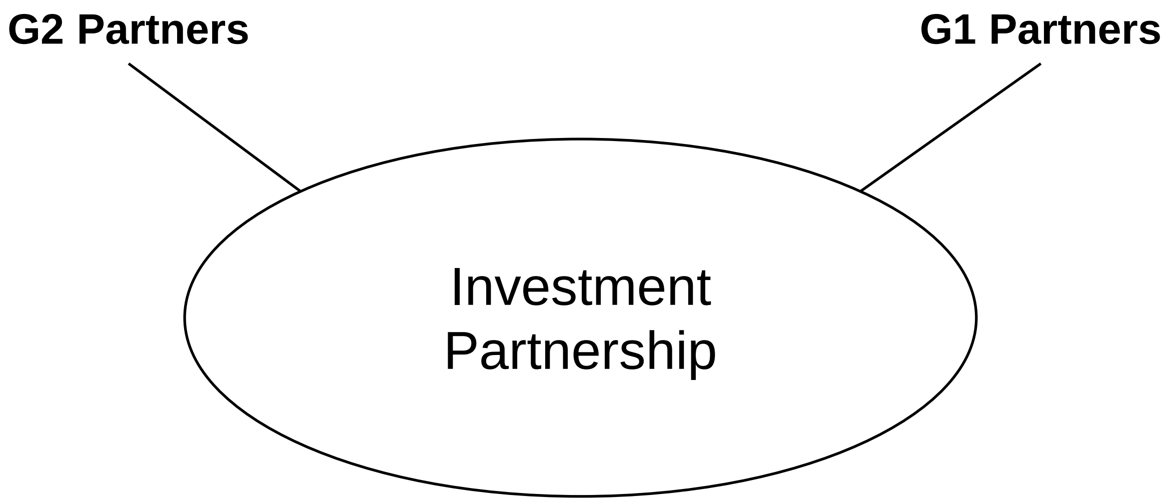


Mother Ship, Isolated Alien Example



Creating, Stripping, and Shifting Basis (Even with Marketable Securities)

“Old and Cold” Investment Partnership



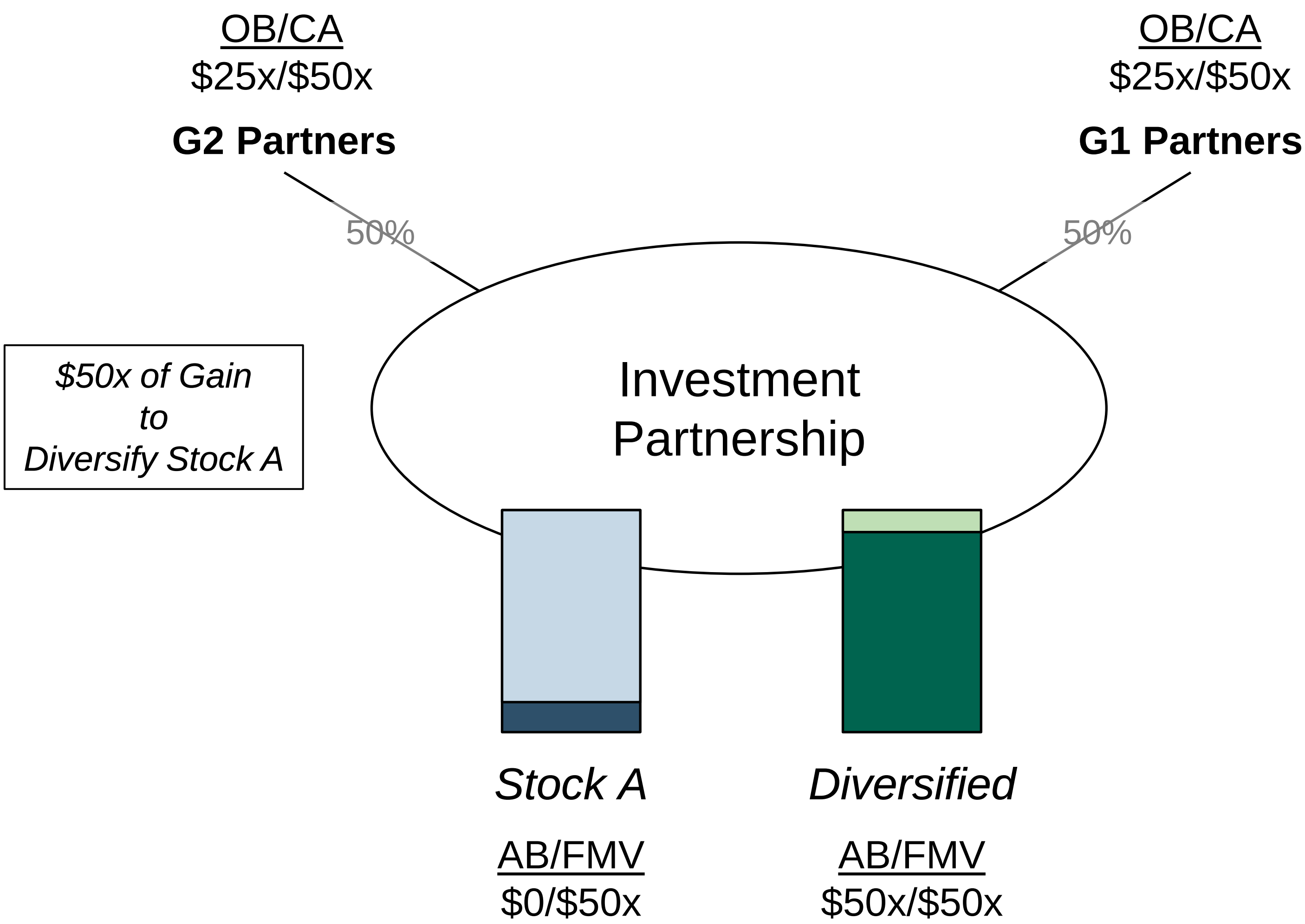
<u>Investment Partnership under § 731(c)(3)(C) of the Code:</u>

- Never engaged in a trade business.
- “Substantially all” (e.g., 90%) assets are (have been):
  - Money
  - Stock in a corporation (including pre-IPO shares)
  - Notes, bonds, debentures, or other debt
  - Derivative financial instruments (e.g., options, futures, short positions)
- All distributions to “eligible partners.”

<u>“Mixing Bowl” and “Disguised Sale” Rules Do Not Apply</u>

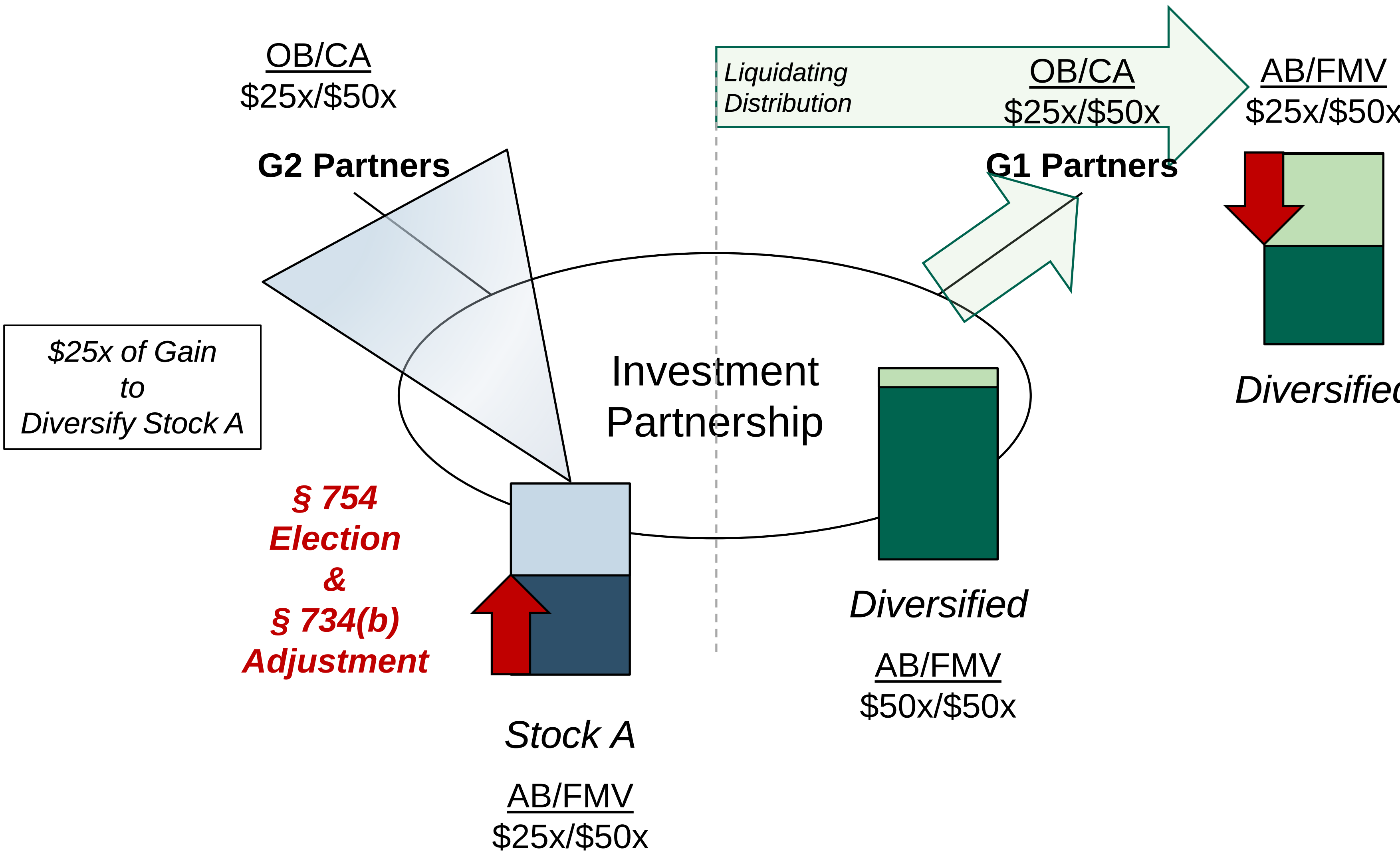
- All assets purchased by partnership or contributed more than 7-years ago

Basis Shift From Diversified to Concentrated

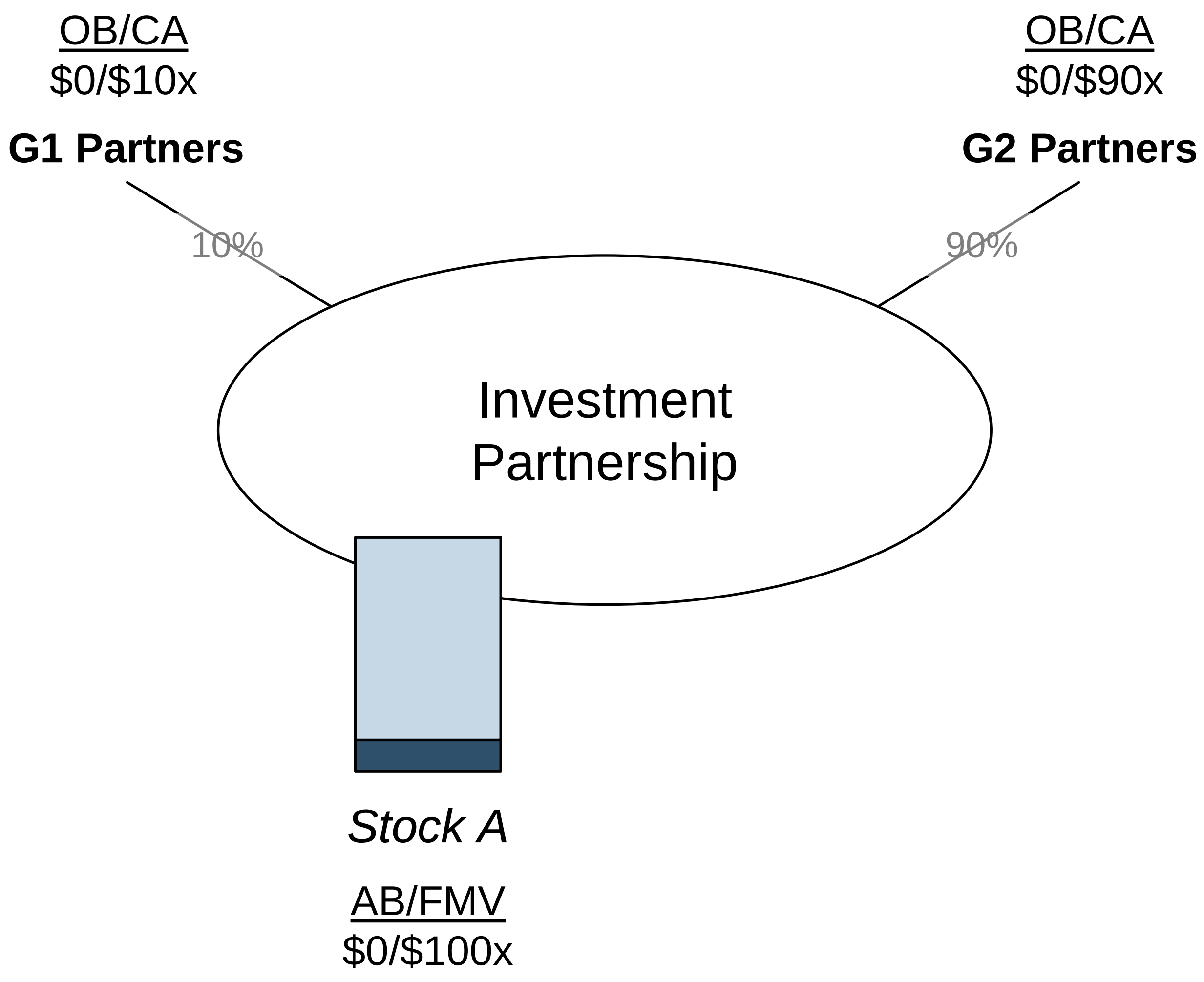


NORTHERN TRUST

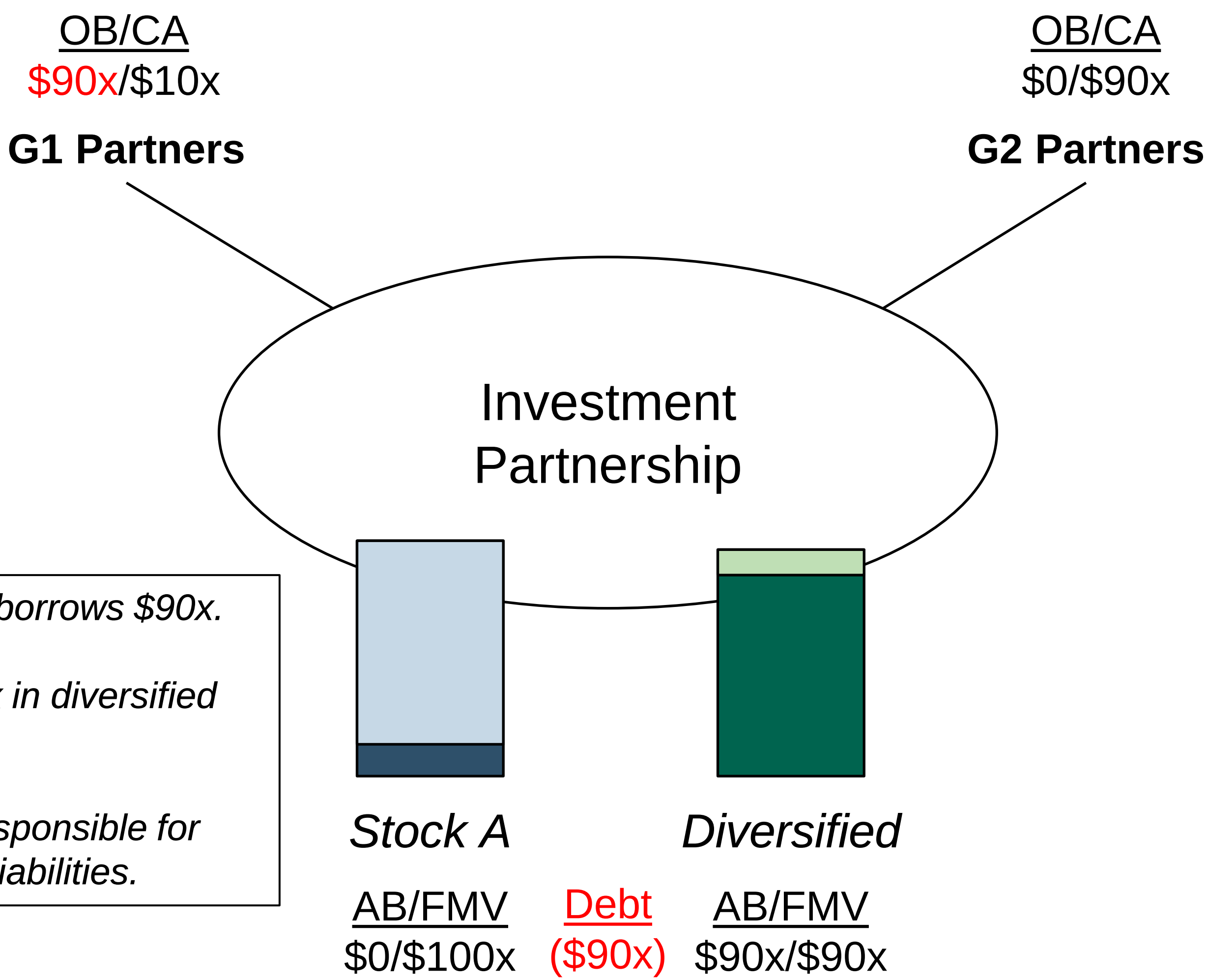
Basis Shift From Diversified to Concentrated



Debt to Exchange Concentrated for Diversified Position

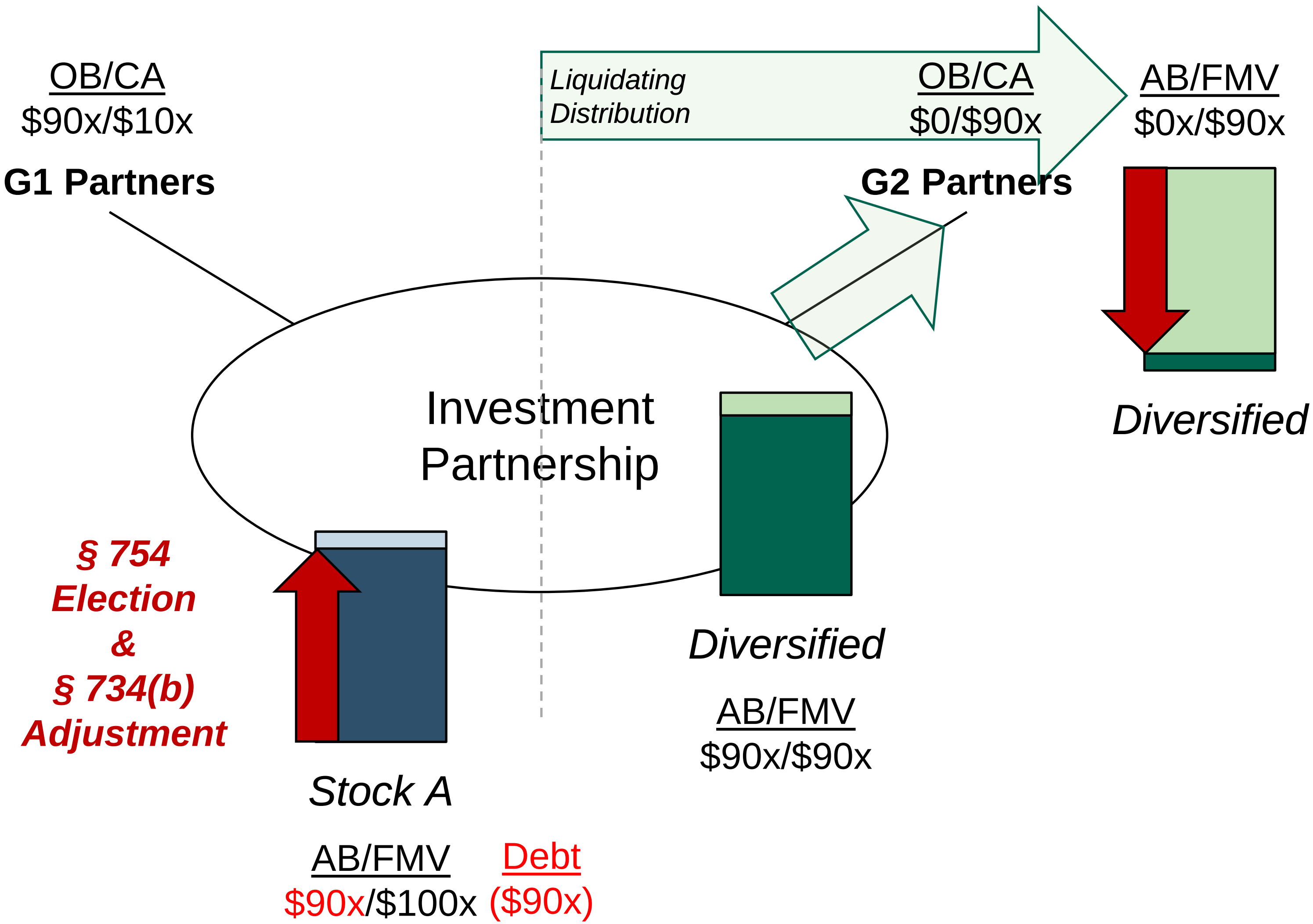


Debt to Exchange Concentrated for Diversified Position

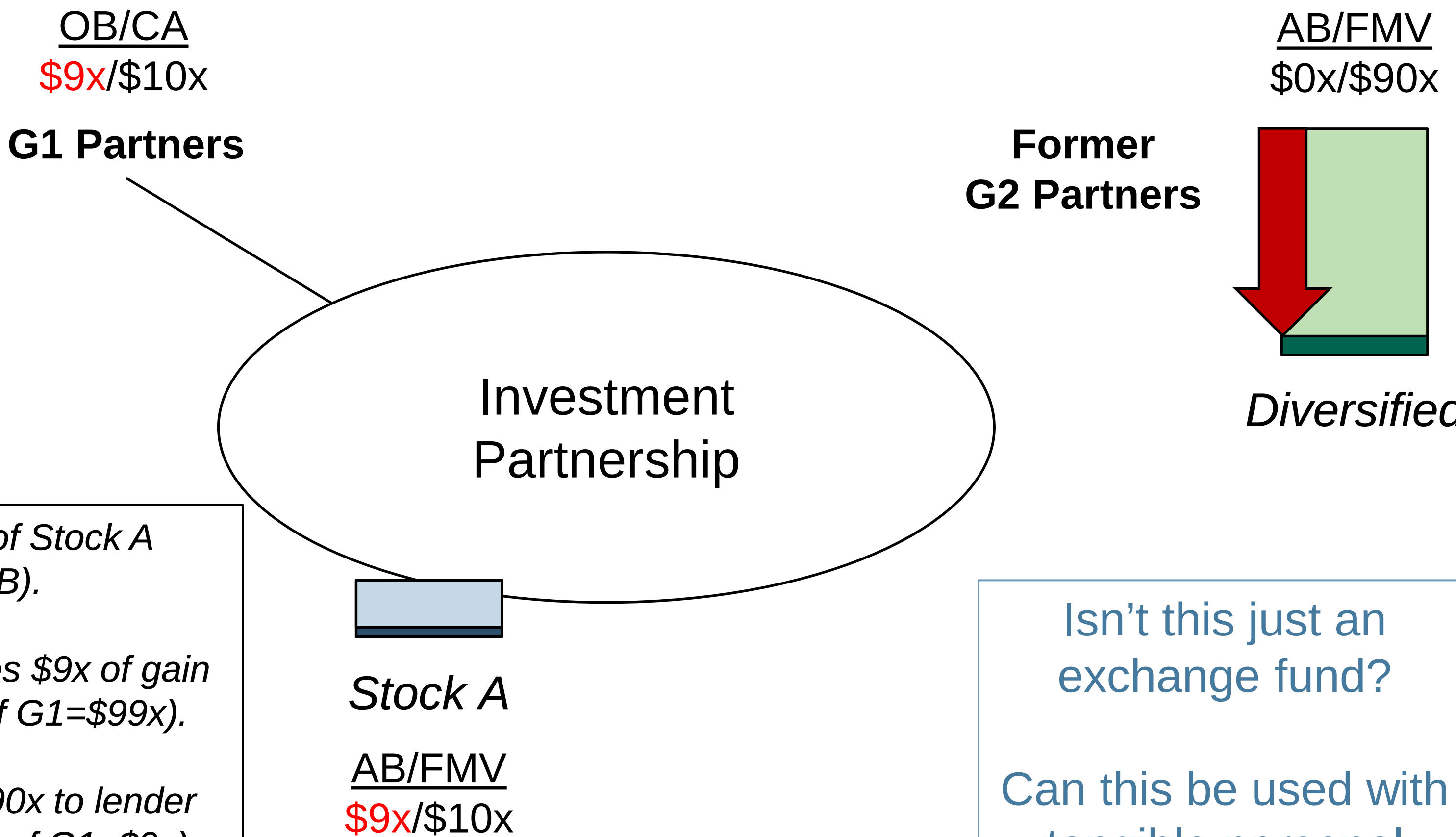


1. *Partnership borrows $90x.*
2. *Invests $90x in diversified portfolio.*
3. *G1 solely responsible for partnership liabilities.*

Debt to Exchange Concentrated for Diversified Position



Debt to Exchange Concentrated for Diversified Position



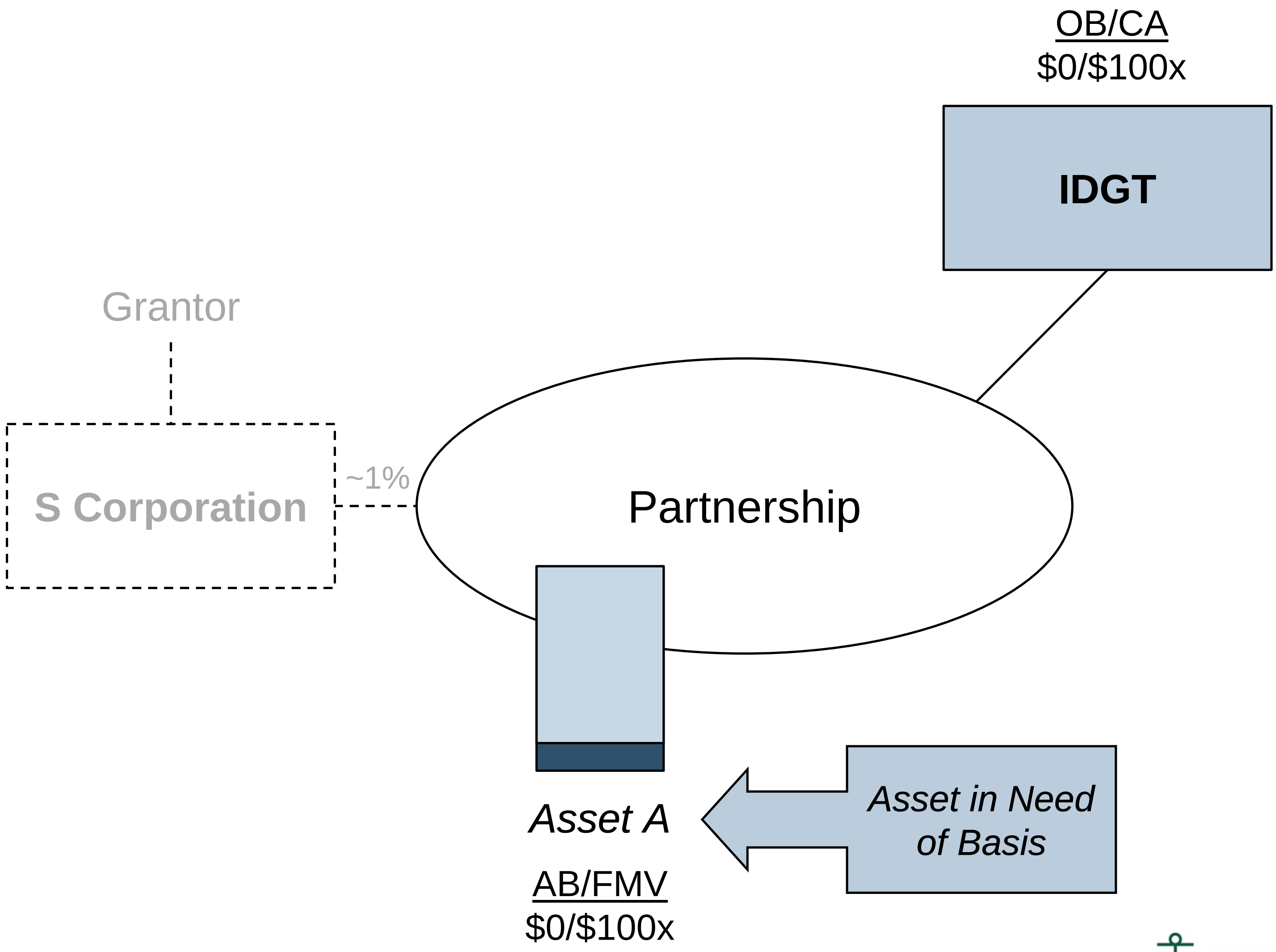
1. *Sells 90x of Stock A ($81x of AB).*
2. *Recognizes $9x of gain (+9x OB of G1=$99x).*
3. *Repays $90x to lender (-$90x OB of G1=$9x).*

Isn't this just an exchange fund?

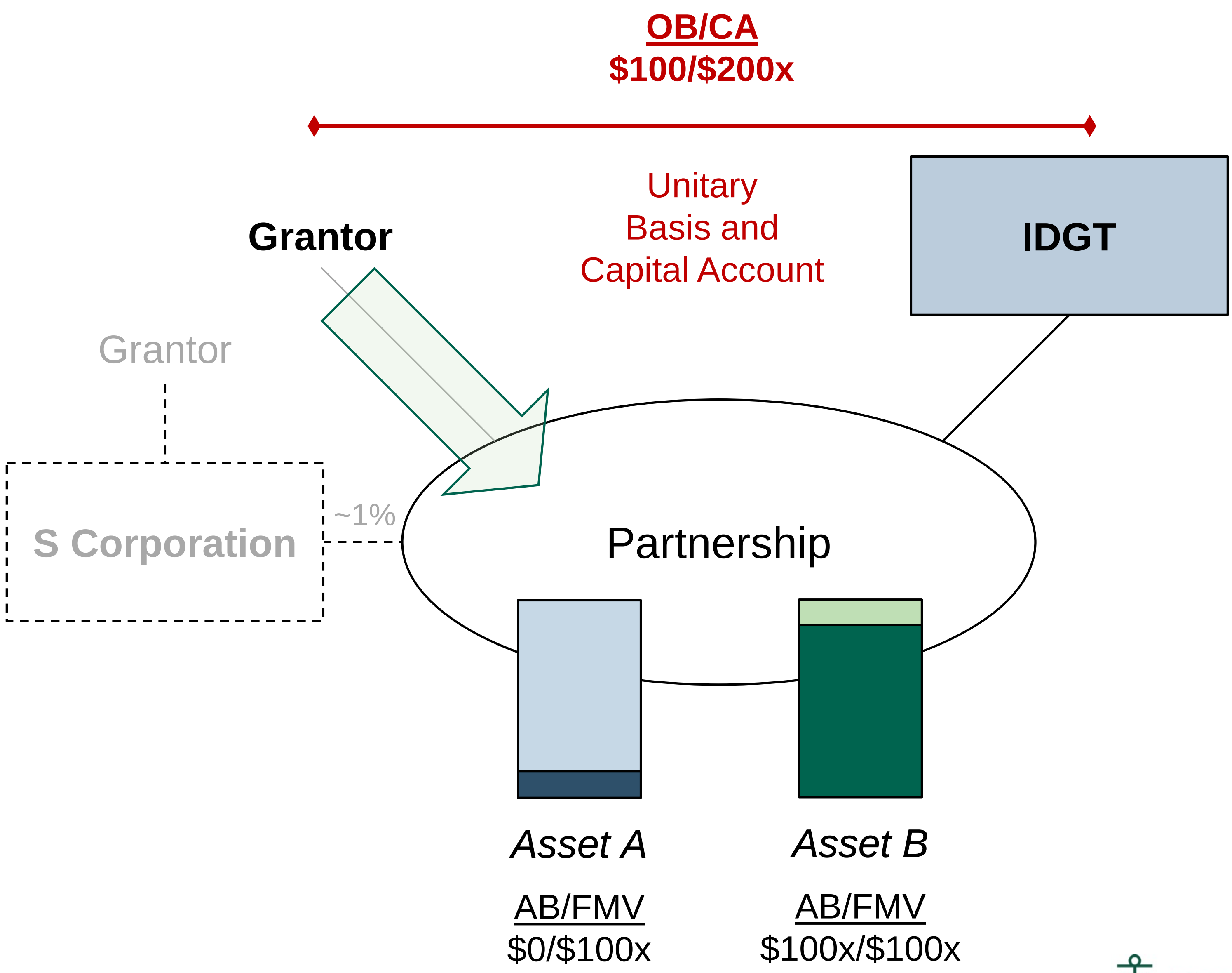
Can this be used with tangible personal property in lieu of a "like-kind" exchange?

Basis Shifting With Grantors And Grantor Trusts

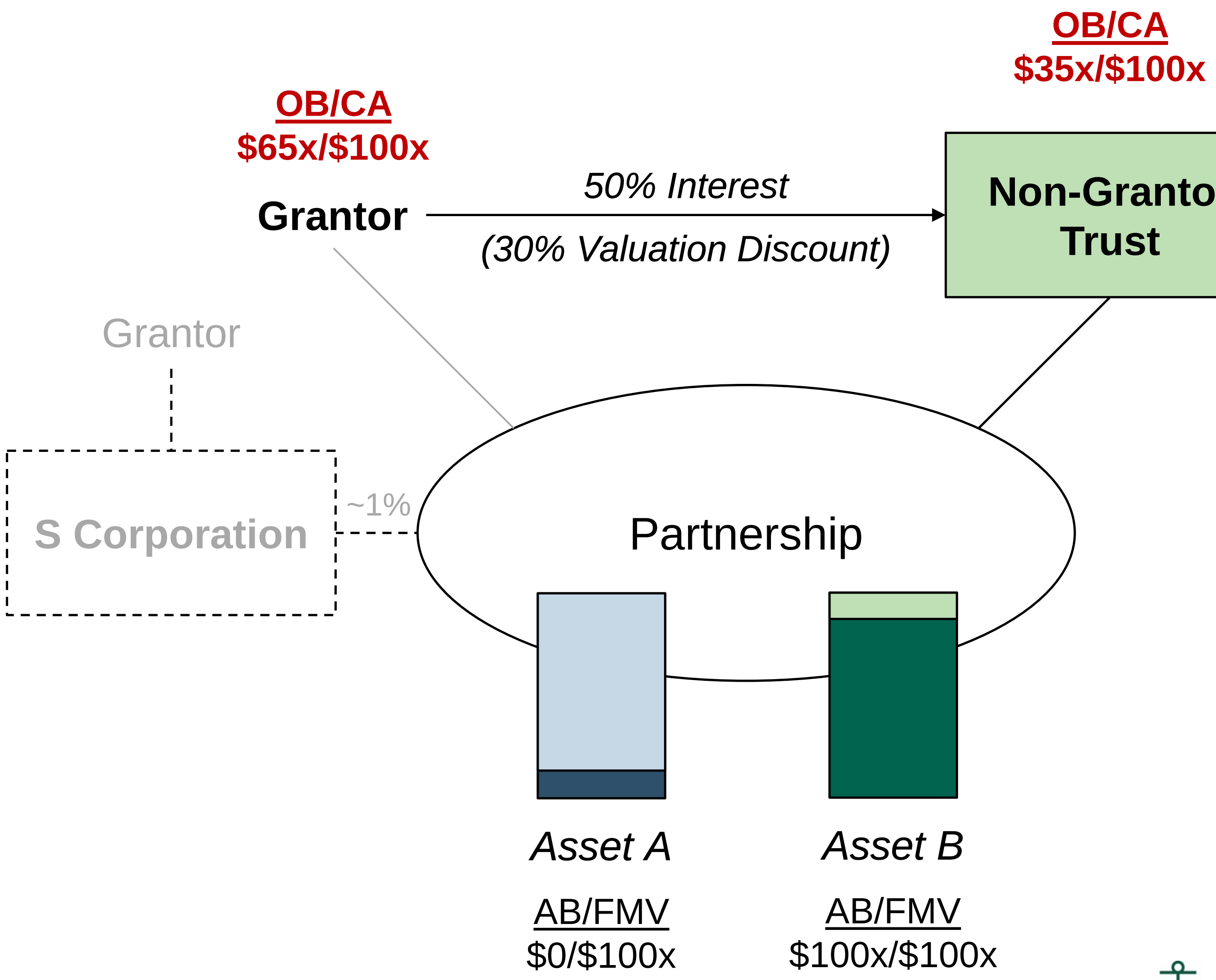
Grantors, Grantor Trusts, and Partnerships



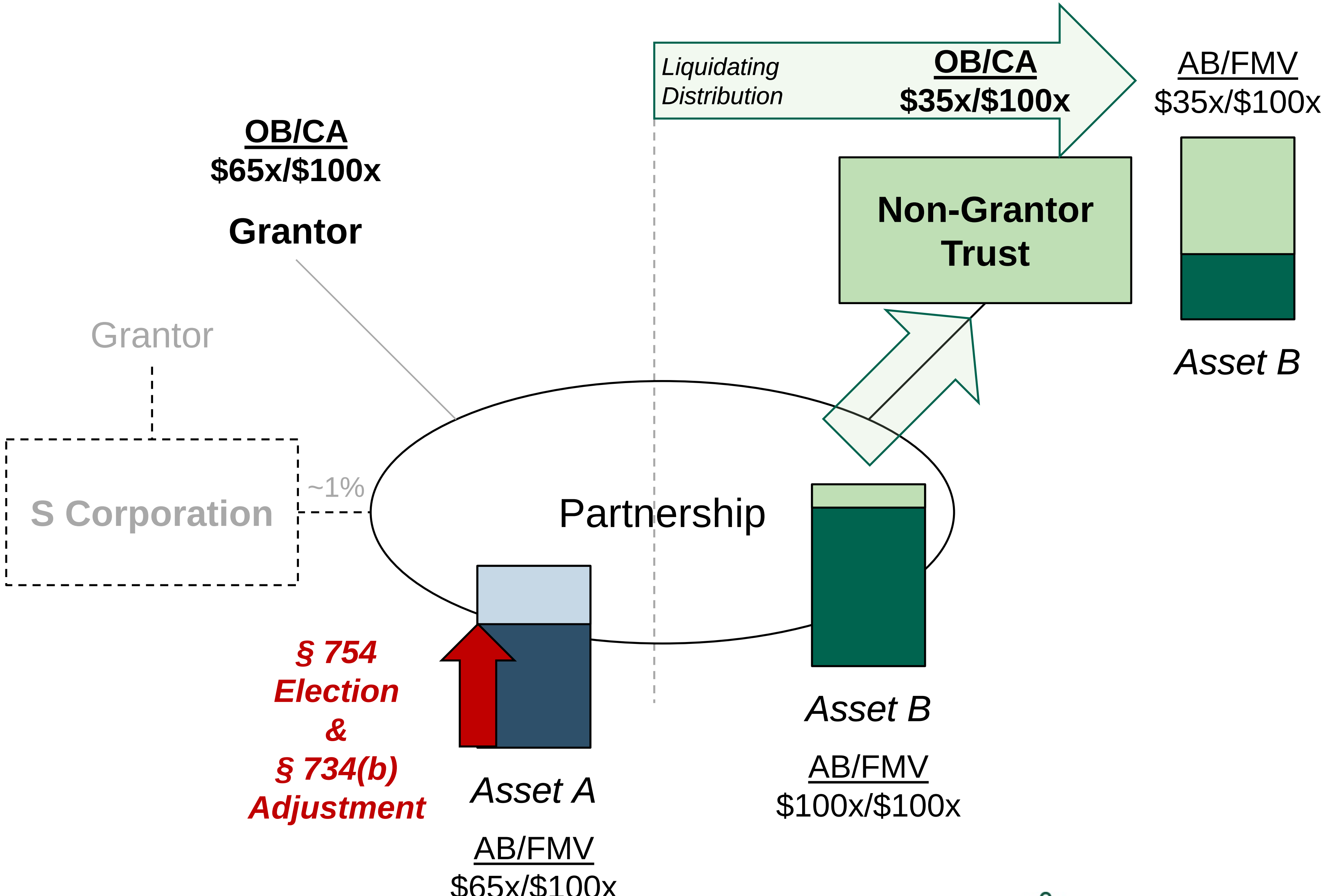
Grantors, Grantor Trusts, and Partnerships



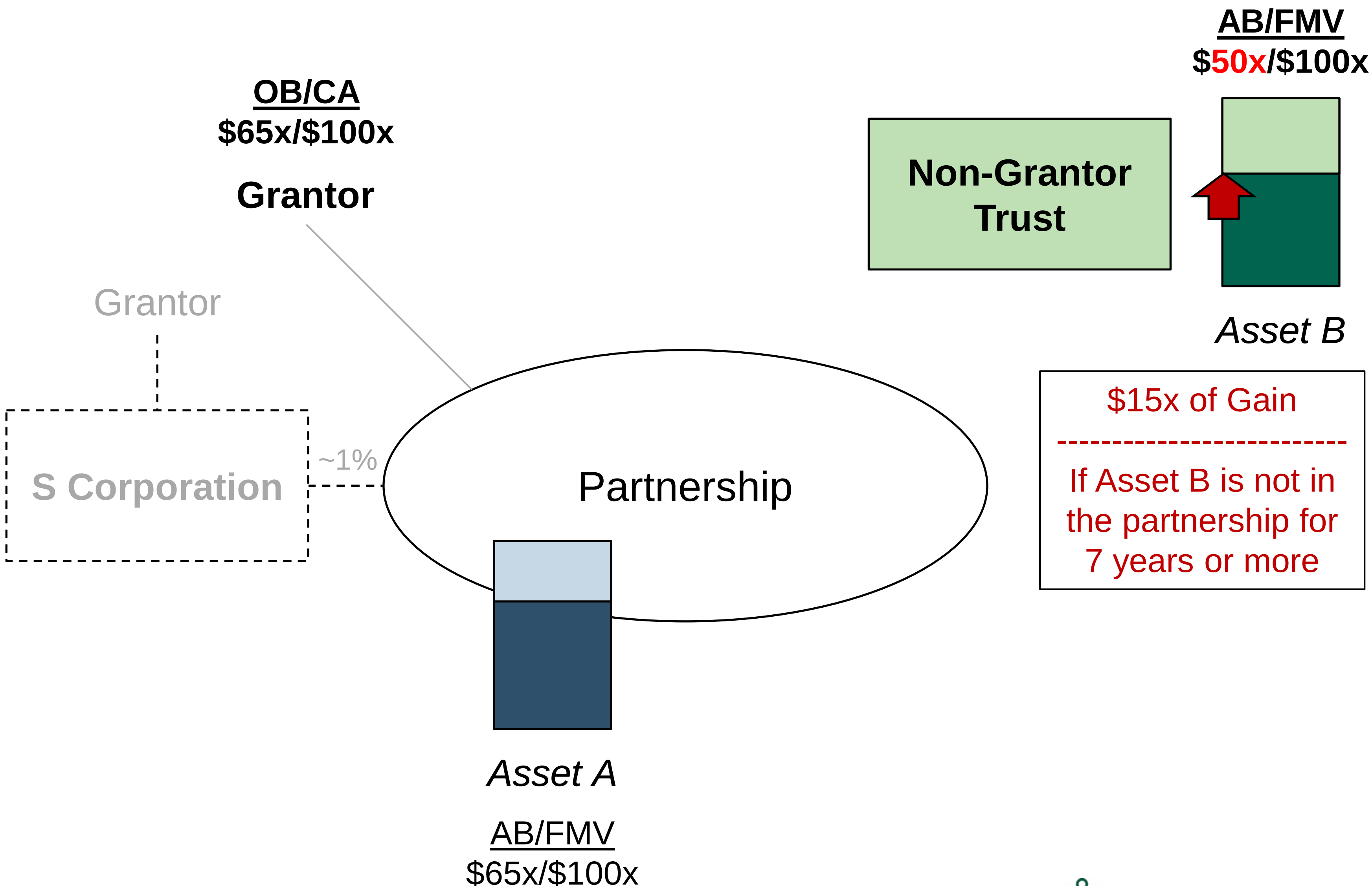
Loss of Grantor Trust Status Is a Deemed Transfer



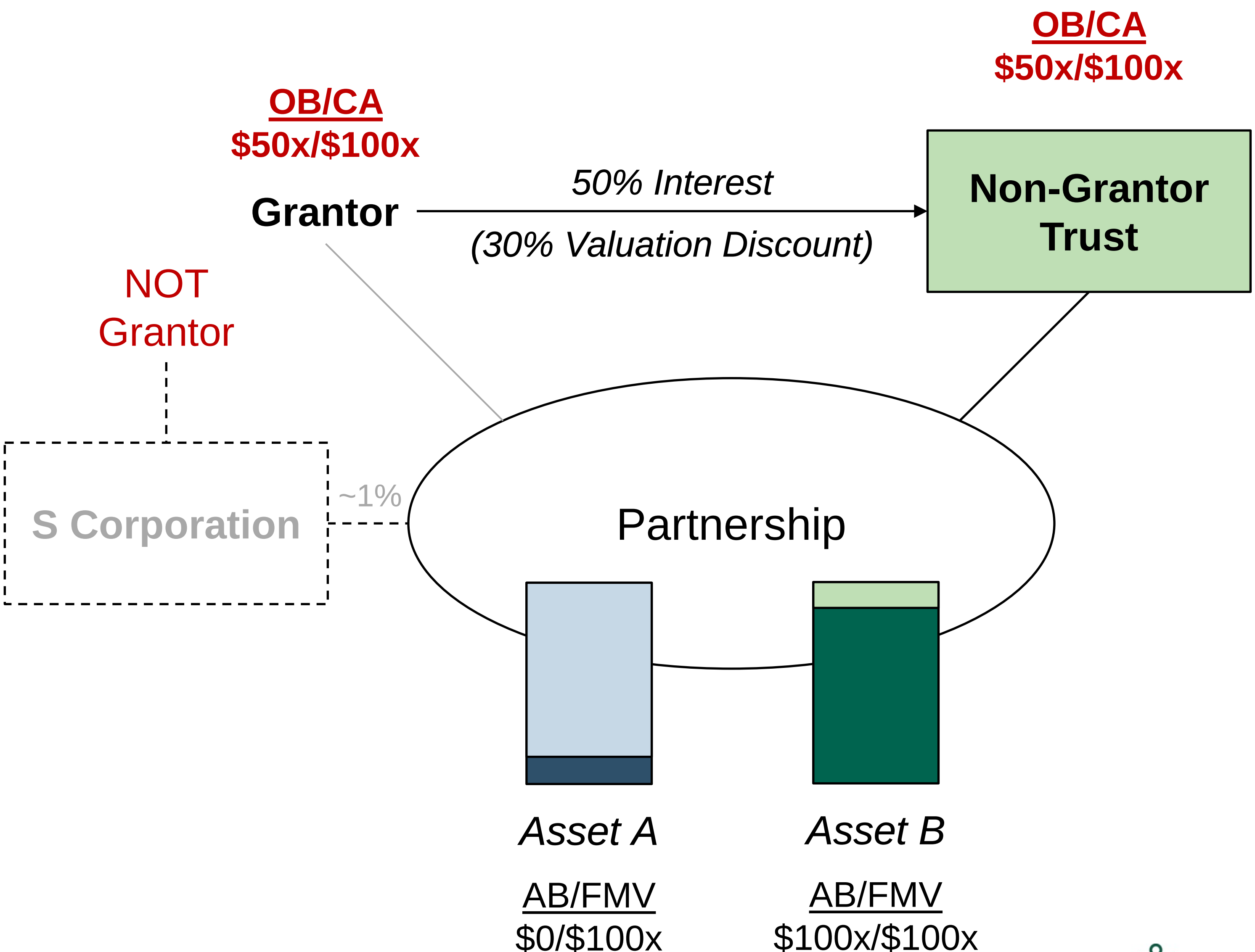
Grantors, Non-Grantor Trusts, and Partnerships



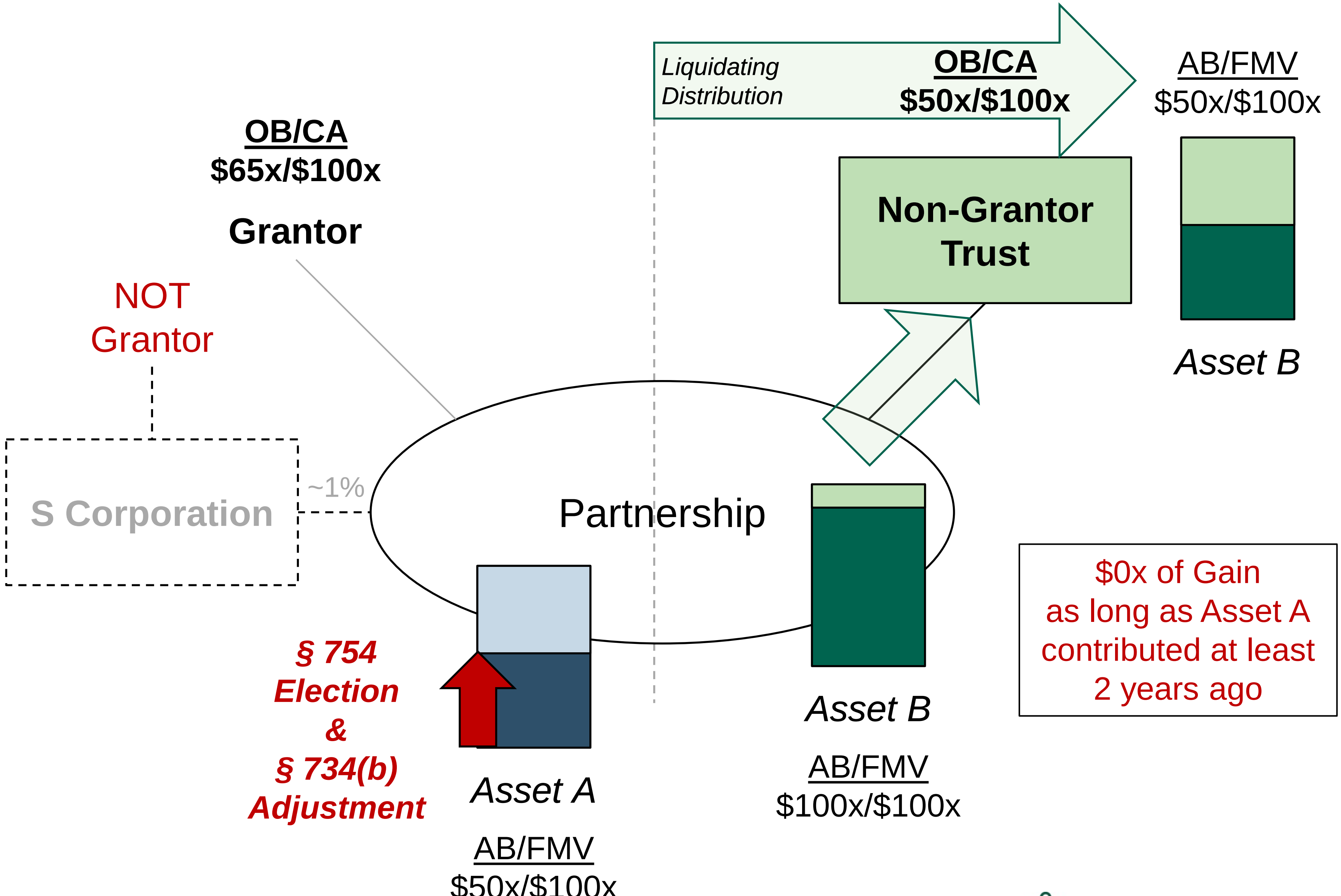
Possible "Mixing Bowl" Complications



If Deemed Transfer Had Discount on Both Sides



No Resulting Gain But Less Basis to Shift



Asset Considerations When Stripping & Shifting Basis

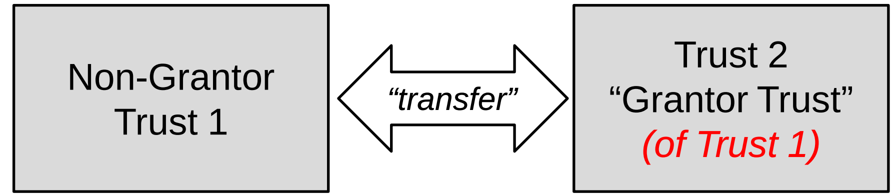
- Capital Gain Property
  - Basis of 20% property can be shifted to 25% and 28% property.

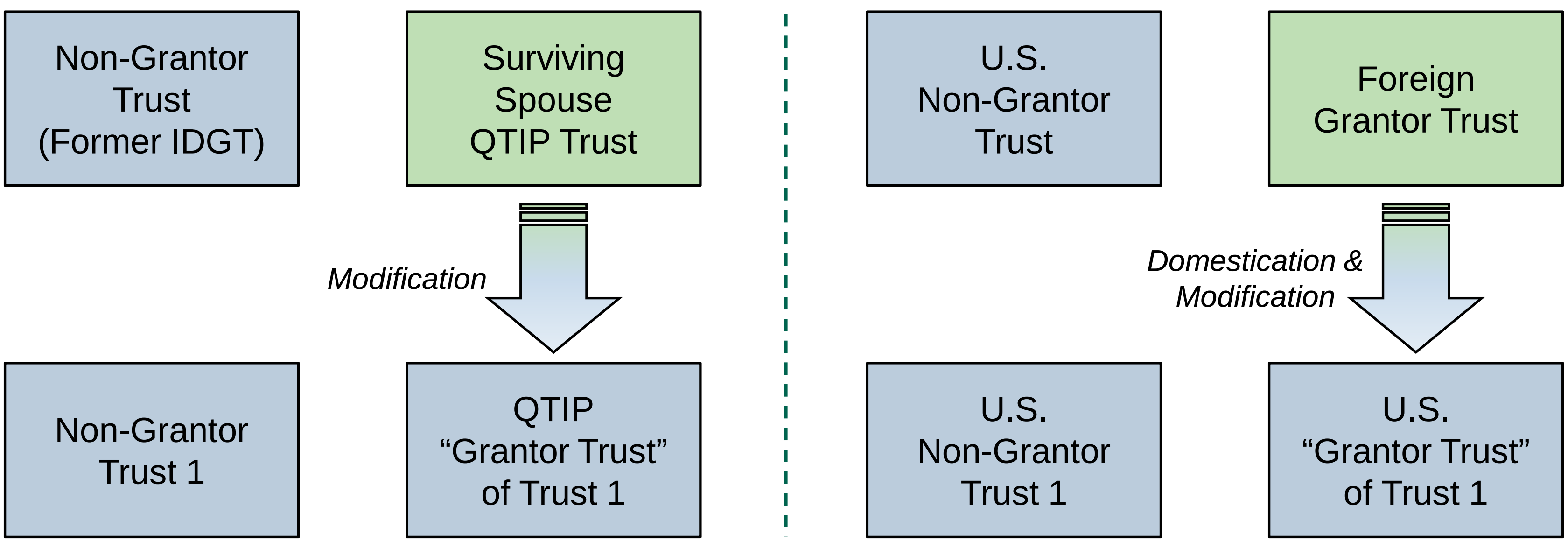
- Life Insurance Policy
  - Policy with cash value or other internal account (whole life, variable, universal, etc.).
  - Policy meant to be held until maturity.
  - Owner does not intend on borrowing or otherwise taking distributions from the policy.
  - Owner does not intend on exchanging or otherwise selling the policy during the life of the insured.
  - TCJA reversed Rev. Rul. 2009-13 with respect to reductions in basis for mortality charges.

- ESOP Note
  - Can borrow up to 95% of face value of note.
  - Allows reinvestment of borrowed funds with tax basis.

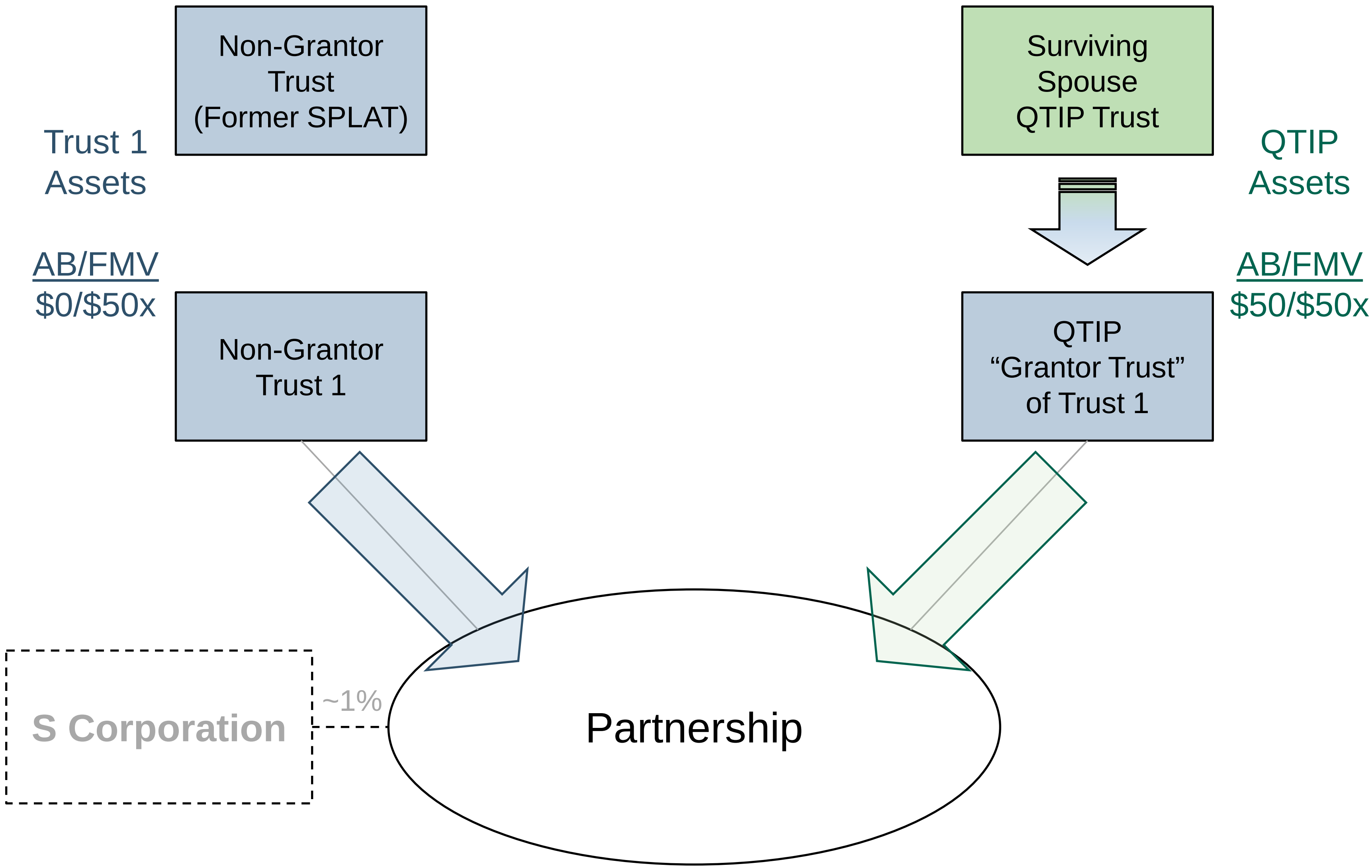
Making a Trust a "Grantor Trust" as to Another Trust?

- PLR 201633021
  - Trust 1
    - Grantor deceased.
    - F/B/O children, spouse, and issue.
    - Trustee proposes to transfer assets to Trust 2.
  - Trust 2
    - F/B/O children, spouse, and issue.
    - Trust 1 retains sole power to revest net income of Trust 2.
    - Lapses on the last day of the calendar year.
    - "Net income" includes income under § 643(b) and capital gain.

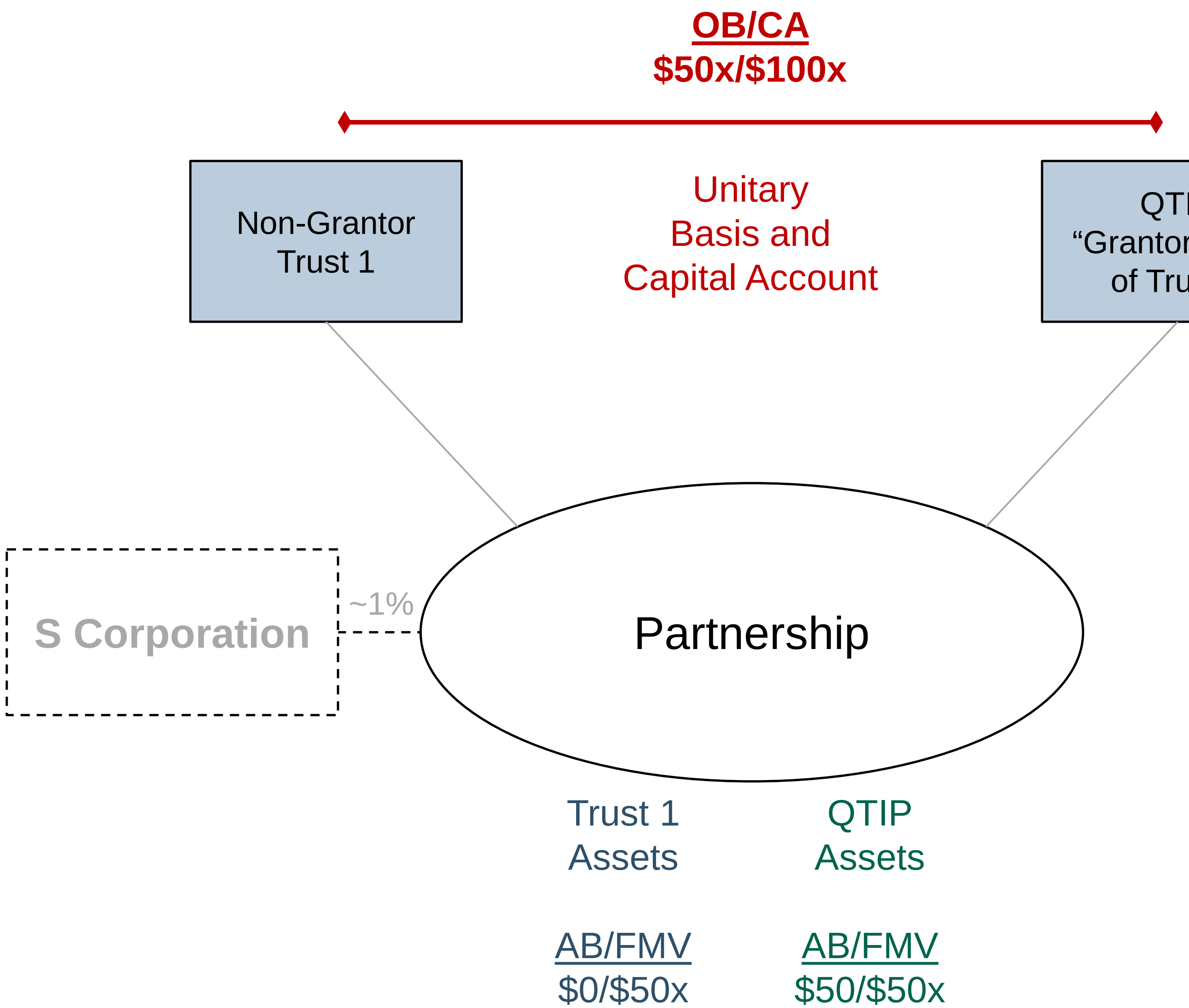




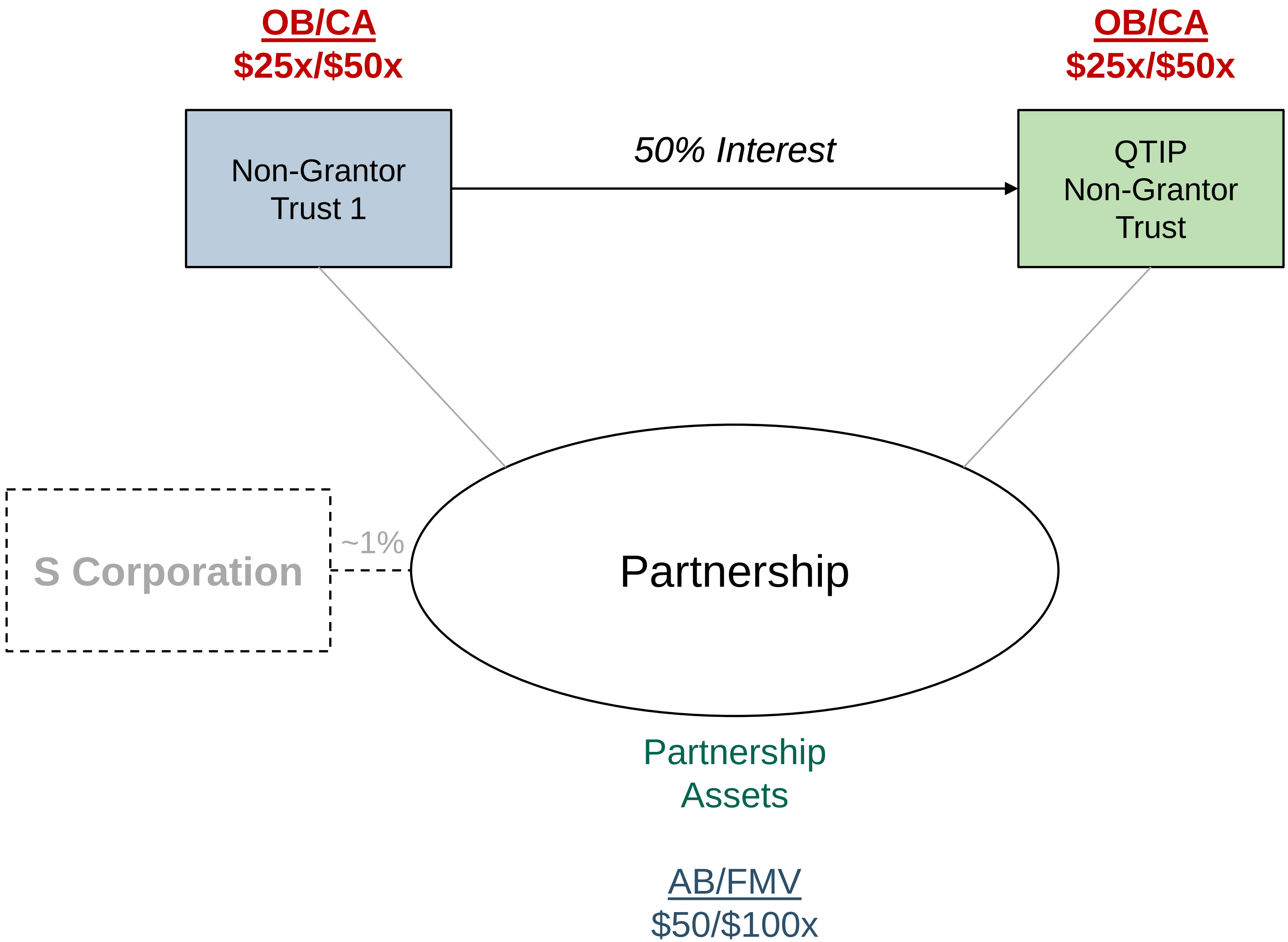
Sharing Basis Between Non-Grantor Trusts



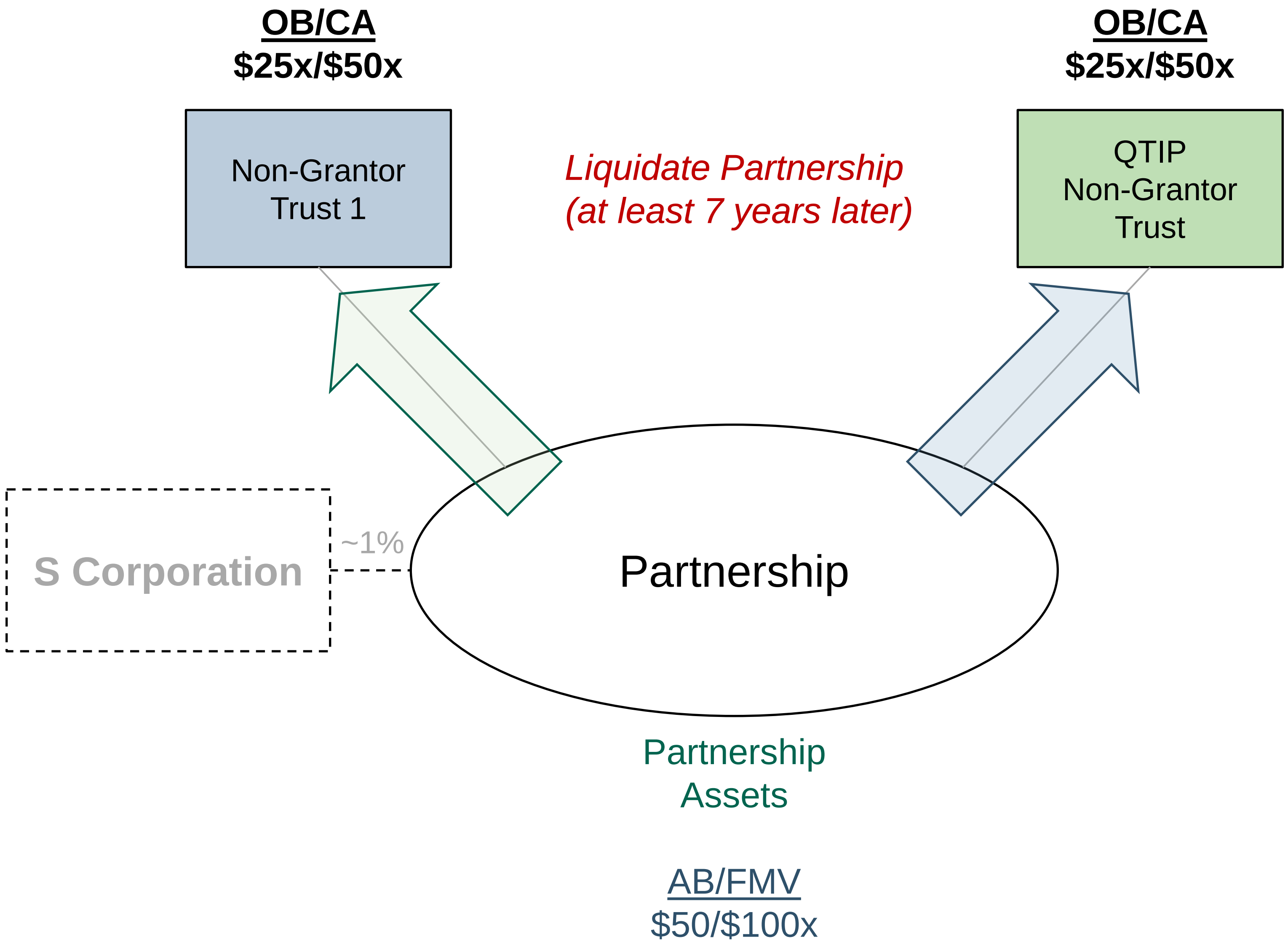
Sharing Basis Between Non-Grantor Trusts



Sharing Basis Between Non-Grantor Trusts



Sharing Basis Between Non-Grantor Trusts



Sharing Basis Between Non-Grantor Trusts

Non-Grantor Trust 1

QTIP Non-Grantor Trust

Trust 1 Assets

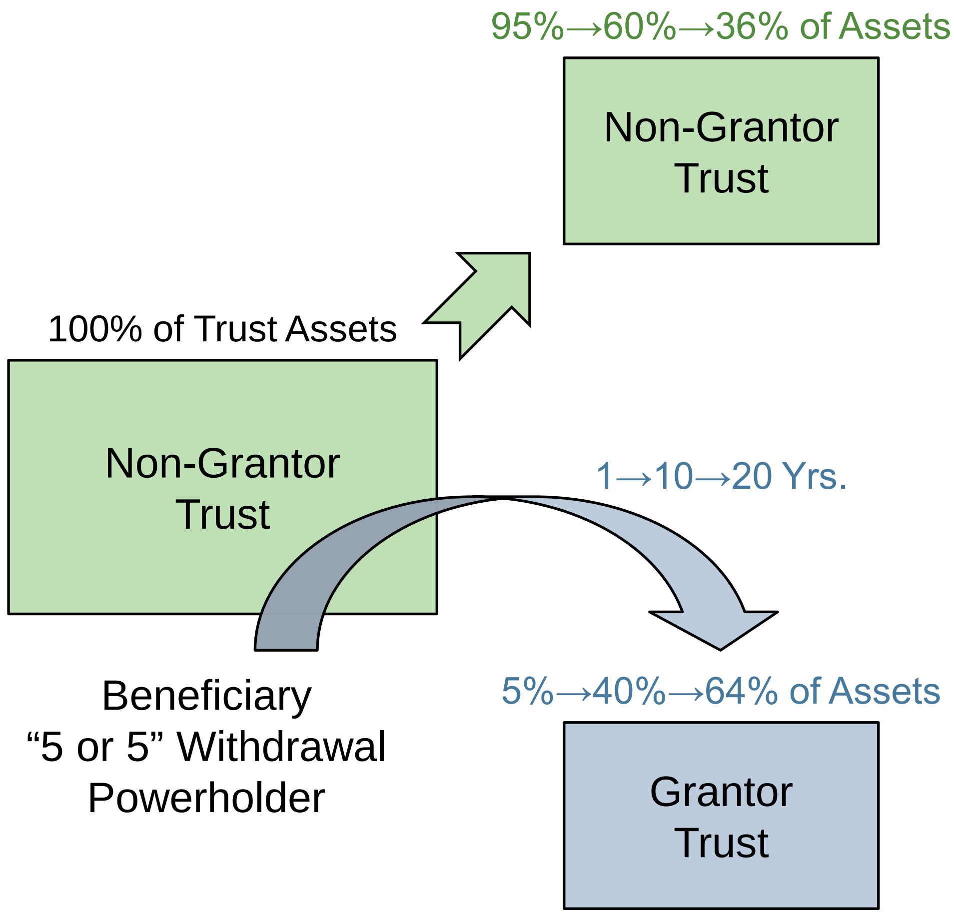
AB/FMV
$25/$50x

QTIP Assets

AB/FMV
$25/$50x

Lapses of Withdrawal Power To Create Grantor Trust Status

- Lapse of Power of Withdrawal
  - Not a release of general power if does not exceed “$5,000 or 5%” of value of assets out of which power could be satisfied.
- Conversion to Grantor Trust
  - § 678(a) third party grantor trust status includes “release” of withdrawal power.
  - Treated as withdrawal and recontribution and grantor trust under § 677(a).



Basis Planning with Foreign Trusts and Entities

U.S. Estate Tax of Non-U.S. Citizens and Domiciliaries

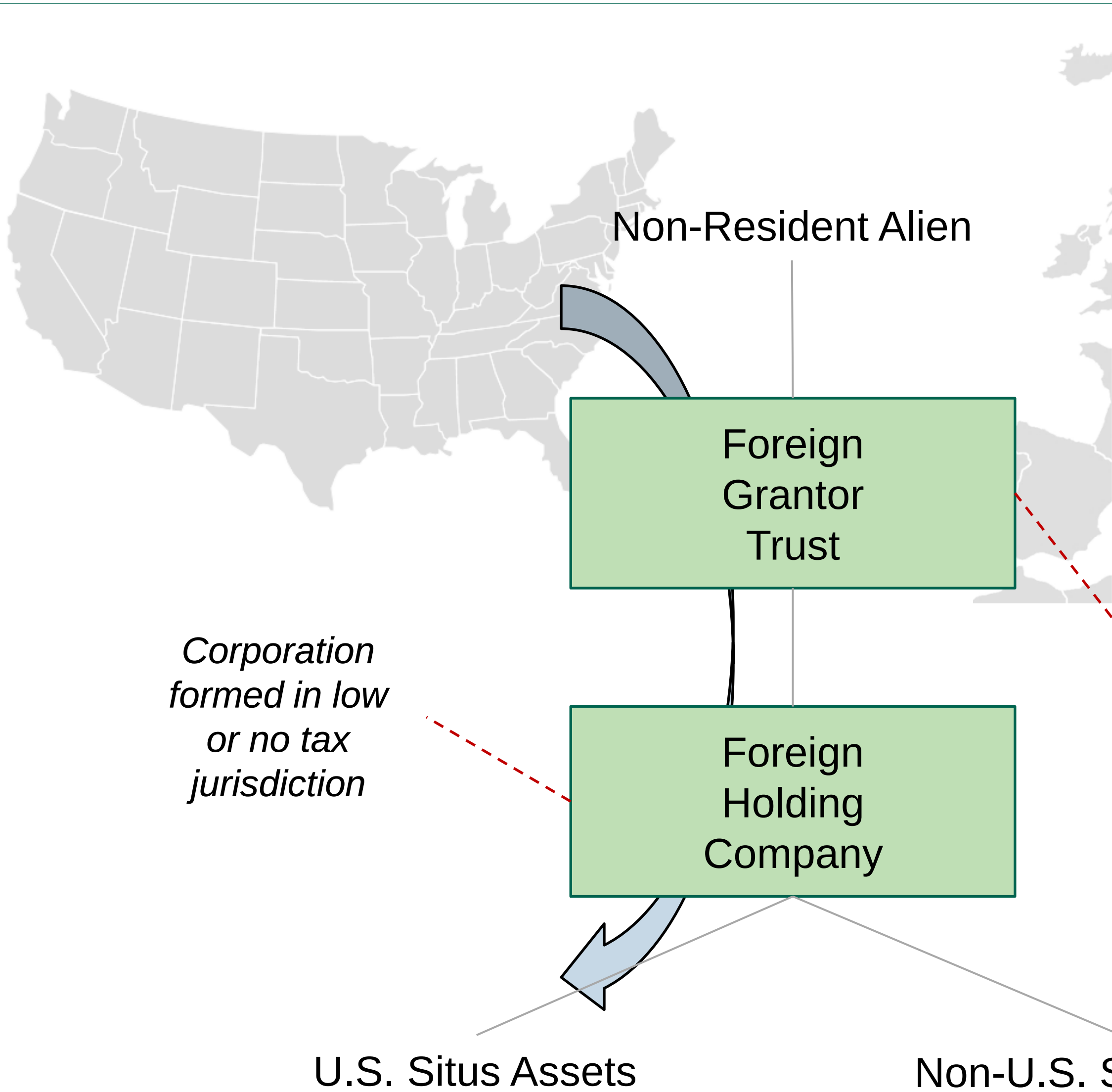
U.S. Estate Tax: U.S. Situs Assets

- Real and tangible property located in the U.S.
- Stock of U.S. corporations
- Debt obligations of U.S. persons, except:
  - U.S. bank deposits
  - Portfolio debt
- Interest in partnerships (possibly)
  - Holding U.S. situs assets
  - Organized in the U.S.
  - Doing business in the U.S.
- Trusts
  - Look through to underlying assets

No U.S. Estate Tax: Non-U.S. Situs Assets

- Real and tangible property located outside the U.S.
- Stock of foreign corporations
- Debt obligations of Non-U.S. persons
- Stock of a Non-U.S. corporation
- Life insurance on non-resident alien insureds

Foreign Grantor Trusts and Foreign Holding Companies



§ 672(f)—Foreign Grantor Trust if:

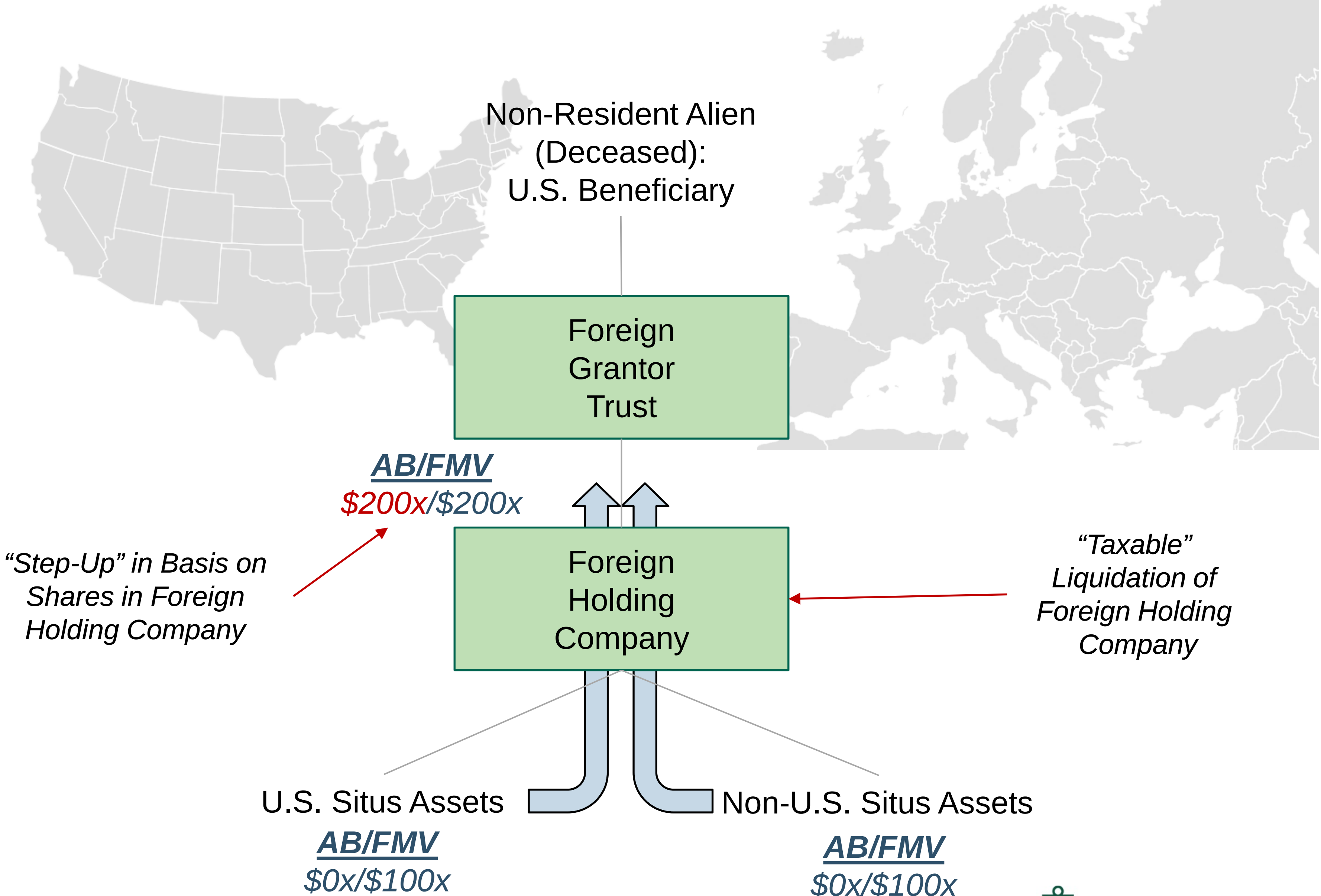
- "[P]ower to revest absolutely in the grantor title to the trust property… exercisable solely by the grantor without the approval or consent of any other person or without the consent of a related or subordinate party who is subservient to the grantor," or
- "[O]nly amounts distributable…during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor."

“Step-Up” in Basis

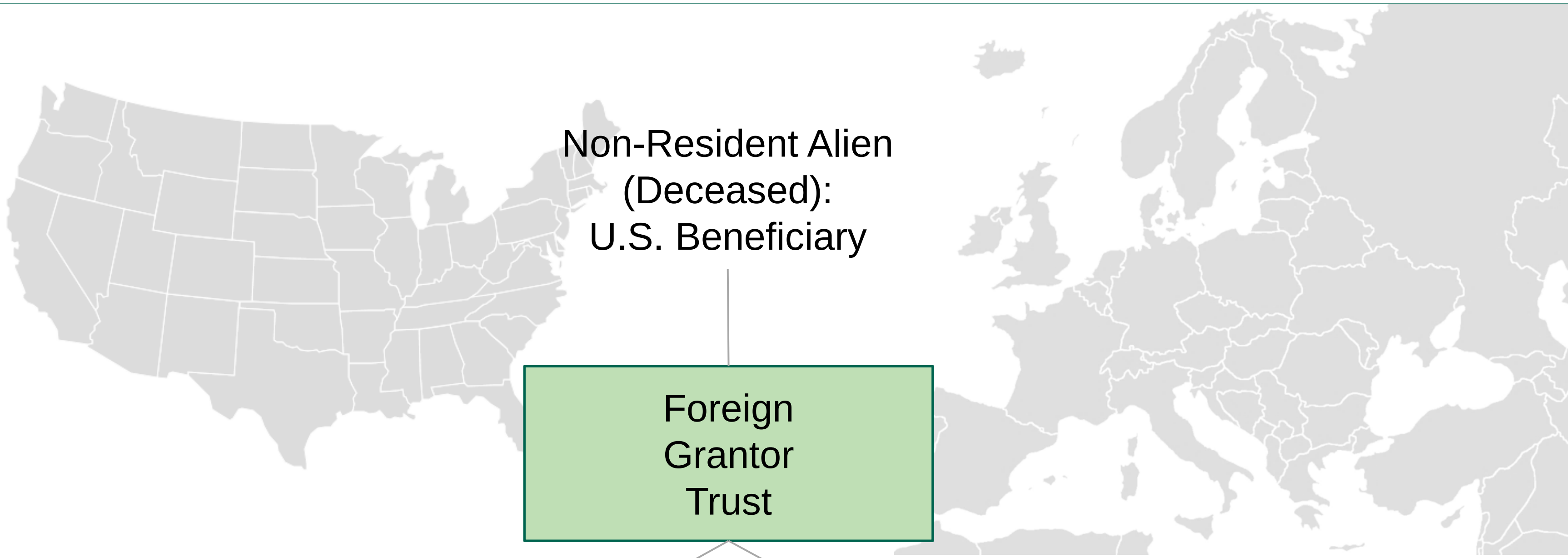
“Step-Up” in Basis Without U.S. Estate Tax Inclusion

- § 1014(b)(2): Revocable and Retained Income Trusts
  - “Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust.”
- § 1014(b)(3): Retained Control Trusts
  - “[P]roperty transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.”
- § 1014(b)(4): Exercised Testamentary General Power of Appointment
  - “Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.”

"Basing-Up" With Foreign Holding Companies



"Basing-Up" With Foreign Holding Companies



Non-Resident Alien (Deceased): U.S. Beneficiary

Foreign Grantor Trust

U.S. Situs Assets

AB/FMV

$100x/$100x

Non-U.S. Situs Assets

AB/FMV

$100x/$100x

Check-the Box, Timing, CFC, and PFIC Issues

Non-Resident Alien (Deceased): U.S. Beneficiary

Foreign Grantor Trust

Foreign Holding Company

U.S. Situs Assets

Non-U.S. Situs Assets

<u>Sec. 14215 of TCJA:</u>

Section 951(a) is amended by striking “for an uninterrupted period of 30 days or more” and inserting “at any time”

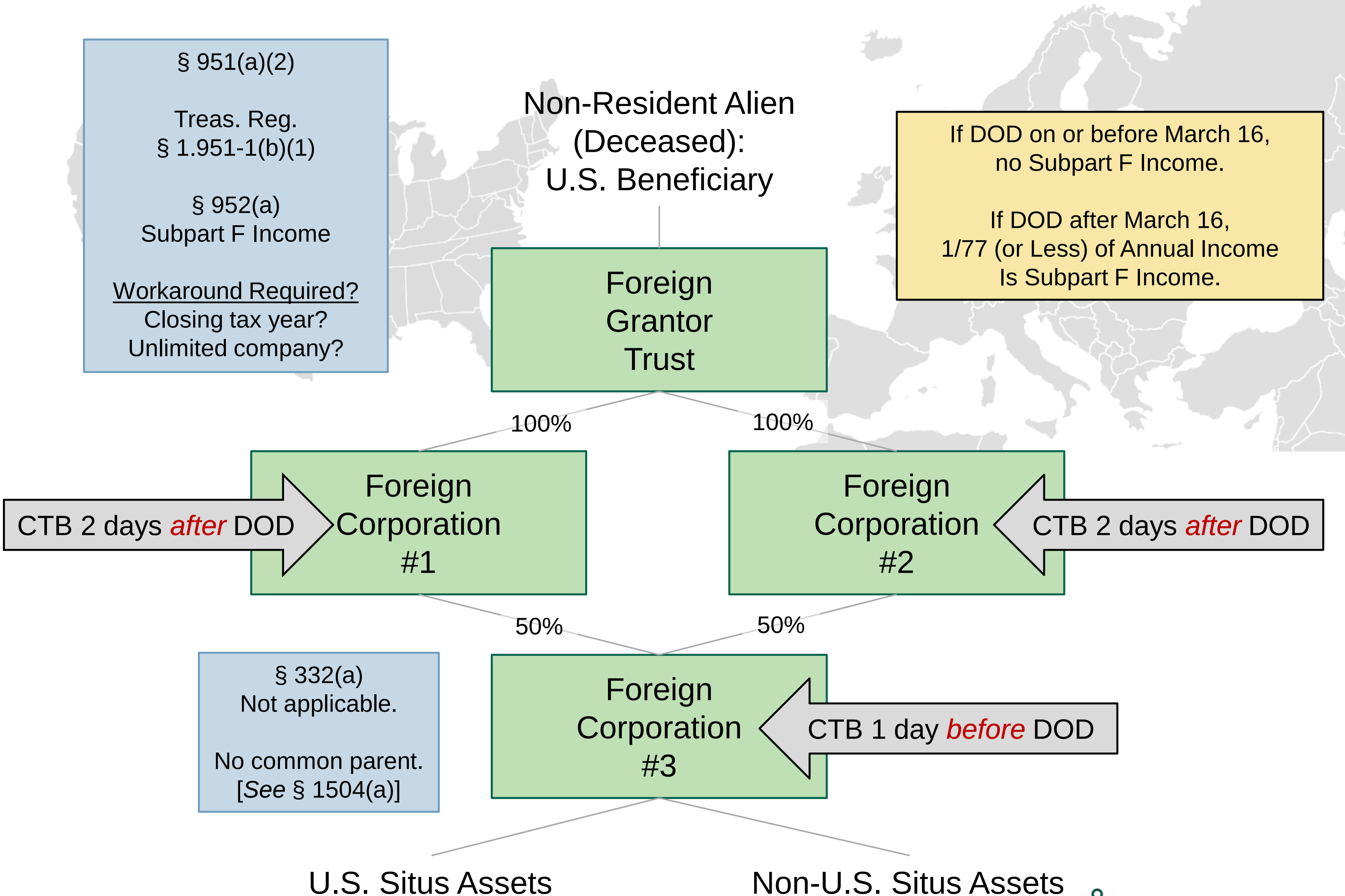
Controlled Foreign Corporation & <u>Passive Foreign Investment Company</u>

U.S. shareholder subject to current income taxation and upon liquidation, causing U.S. shareholder to be taxed on the appreciated assets of the foreign holding company.

<u>Check-the-Box Election</u>

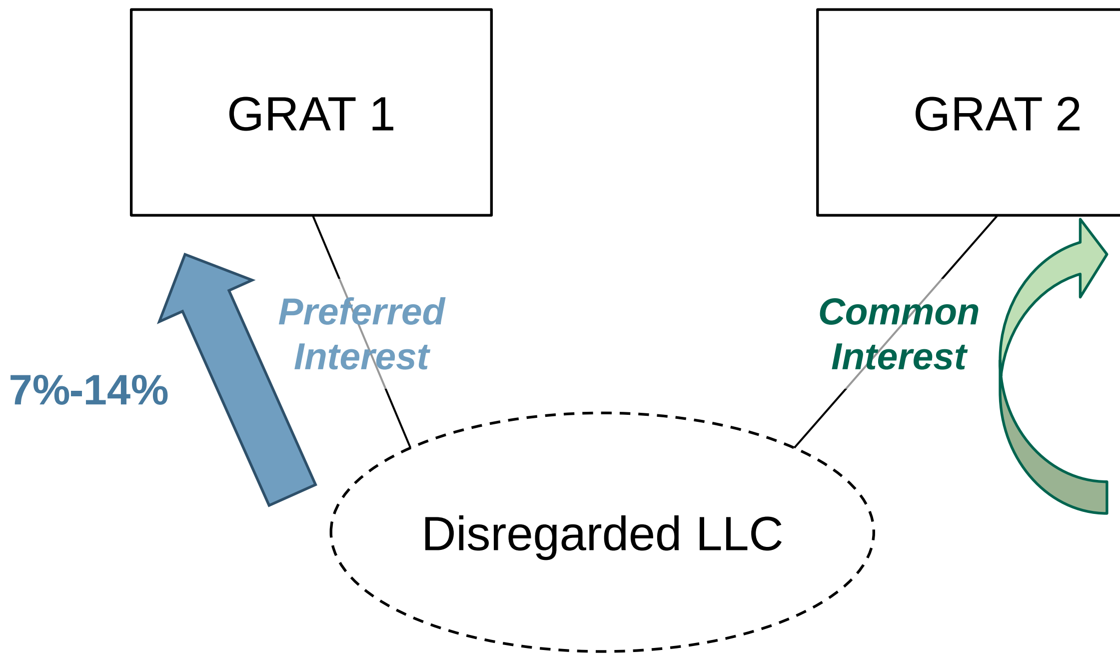
- If holding company qualifies for a CTB election, entity becomes either disregarded entity or a partnership.
- If classification of the entity was relevant for U.S. tax purposes, the election is treated as a deemed liquidation.

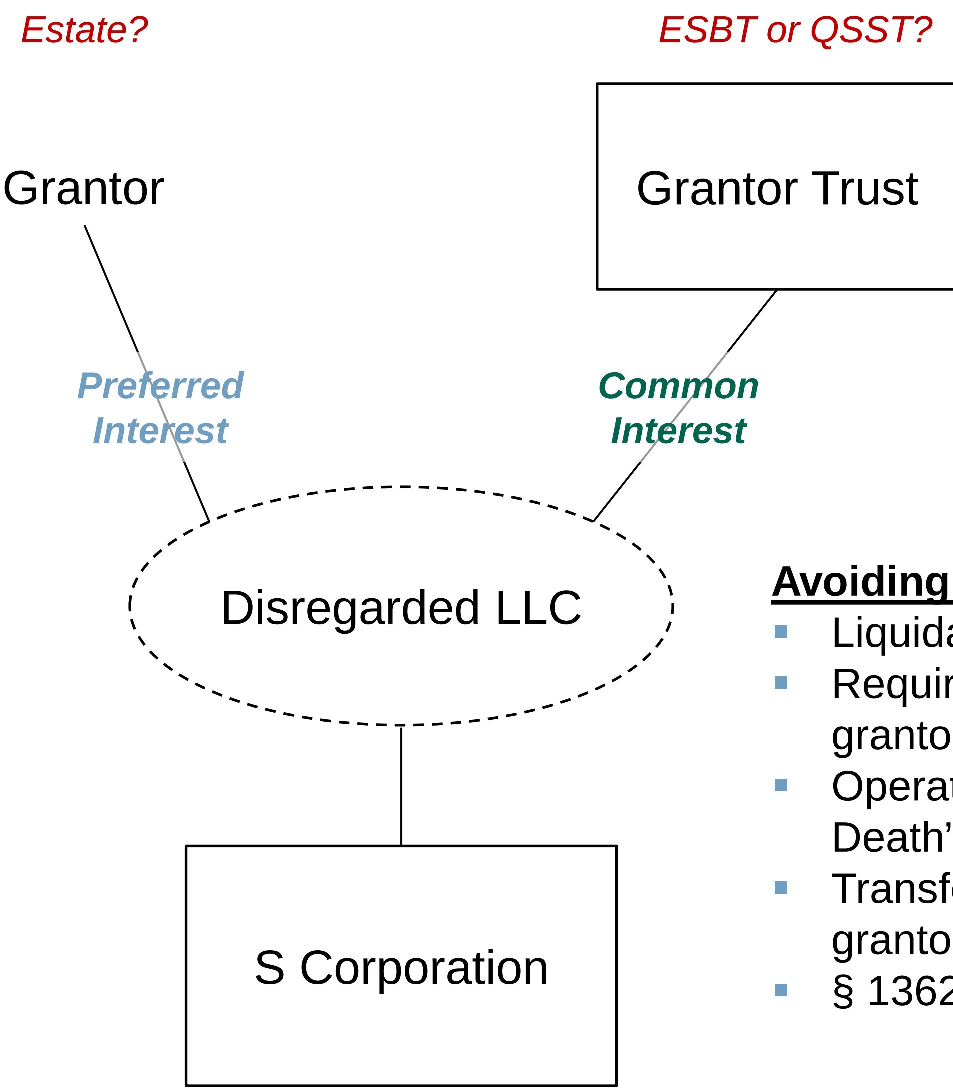
Possible Solution: Tiered Structure



Disregarded Entities

Disregarded Entities: GRATs

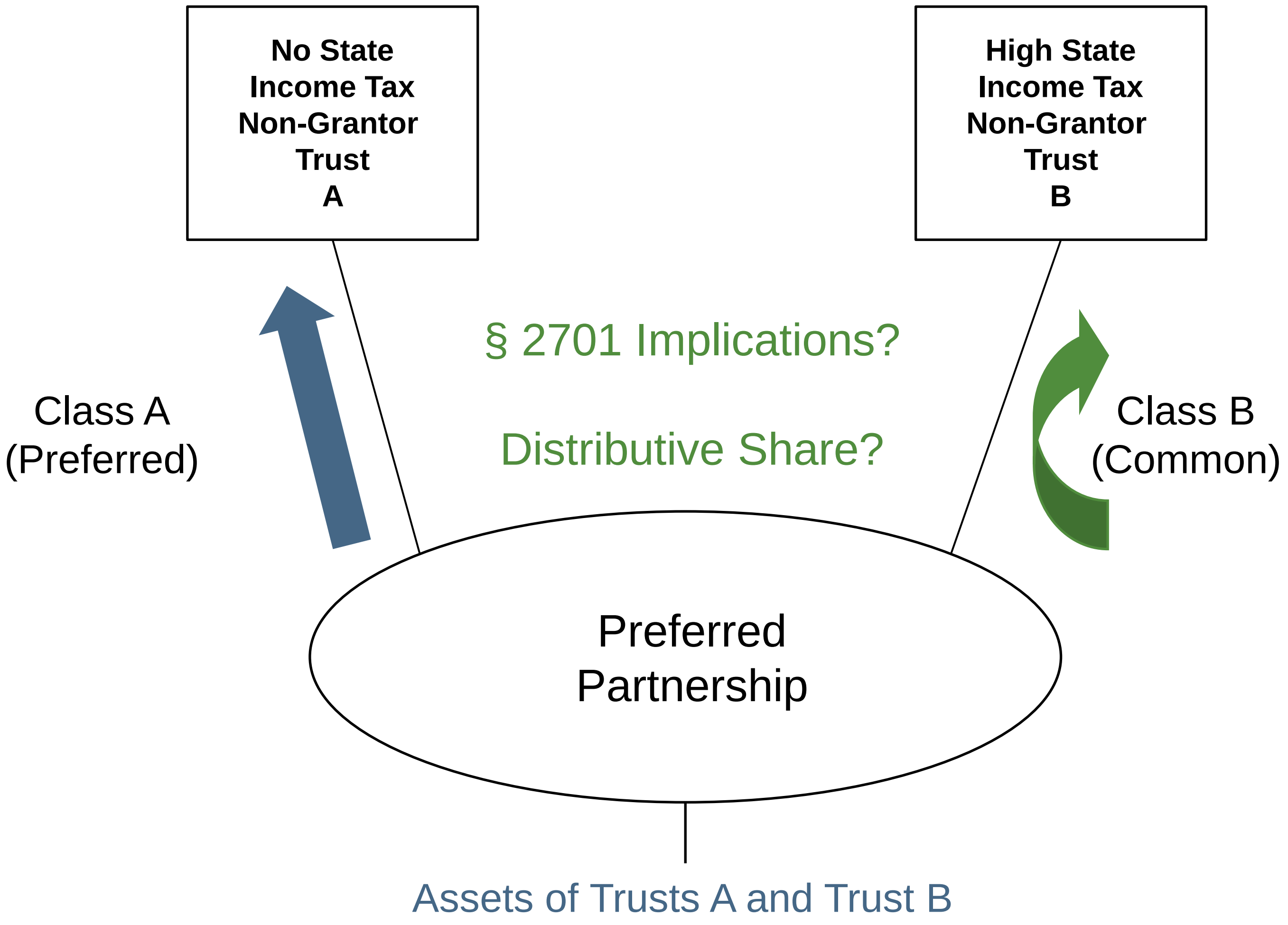




Avoiding Termination of S Election

- Liquidation of LLC before grantor's death
- Required liquidation/termination of LLC at grantor's death
- Operating agreement "Transfer On Death" provision to trust
- Transfer provision in revocable trust of grantor's interest to trust
- § 1362(f) relief (PLR 200841007)

Trust to Trust Preferred



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