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Estate Planning For Private Equity Fund Managers

By Ivan Taback and Jay D. Waxenberg, Partners at Proskauer Rose LLP*

Low interest rates together with continued growth in forming private equity funds make this an ideal time for the private equity fund manager to review estate planning strategies with a goal towards preserving family wealth by minimizing estate and gift taxes. This is the case for both individuals who already have engaged in some degree of estate planning and for those who have not done any planning.

This article highlights important issues for the private equity fund manager to consider in transferring assets as part of an estate plan and describes several gifting techniques that may be of particular value in today's economic environment. Also discussed is a planning technique commonly referred to as the family limited partnership, or FLP (alternatively structured and known as the family limited liability company, or FLLC). In addition, this article analyzes issues raised in recent court cases involving FLP/FLLCs, which provide valuable guidance on the best way to structure these entities.

"Estate Tax Repeal" And Its Impact On Estate Planning

While the private equity fund manager often focuses on income tax planning, estate and gift taxes also should be considered.

Under the law as it existed at the end of 2009, federal estate and gift taxes were imposed upon the transfer of assets during life or at death. Gift taxes were assessed at graduated rates beginning at 41% and reaching a maximum rate of 45%. Estate taxes were assessed at a rate of 45%. These high tax rates resulted in substantial tax liabilities, whether assets were transferred during life or at death, and ultimately reduced the assets available to pass to one's children or grandchildren. For individuals dying in 2009, the exemption from the federal estate tax was $3.5 million.

Effective January 1, 2010, under the Economic Growth and Tax Relief Reconciliation Act of 2001, or EGTRRA, this regime changed dramatically. Under current law, the estates of individual who die in 2010 completely escape federal estate taxation. Taxable gifts above an individual's $1 million gift tax exemption are subject to a rate of 35%.

Notwithstanding the current repeal of the estate tax, it is still important to plan for the estate tax because tax repeal is scheduled to occur only for those individuals who die in 2010. In 2011, all provisions of EGTRRA, including federal estate tax repeal, "sunset" and we revert back to pre-EGTRRA estate and gift tax law for 2011 and beyond, which means a $1 million estate tax exemption and a top federal estate and gift tax rate of 55%. Although it has been the subject of much discussion, Congress so far has failed to eliminate the sunset provision of EGTRRA and the current size of the federal deficit may make it difficult to find sufficient votes in the Senate to approve permanent estate tax repeal. Instead, most estate planning practitioners believe that a compromise will be made, resulting in lower estate tax rates and a larger estate tax exemption amount, effectively eliminating the estate tax for all but the wealthiest individuals.

Even for those who do die in 2010, escaping the estate tax is not yet certain. Discussion in Washington throughout the year has focused on whether estate and gift tax legislation will be "retroactive," meaning that any changes in the law would relate back to January 1, 2010. However, it is questionable whether members of Congress will have the time or the political capital to carry out such a change before the end of the year.

Although those dying in 2010 may end up escaping federal estate tax, estate tax at the state level is still an issue many individuals face. As a result of certain technical changes in the federal estate tax under EGTRRA, many states suffered a loss in estate tax revenue. In response, many states enacted legislation imposing a state level estate tax. The result is that notwithstanding the current repeal of the federal estate tax, clients in some states may still face state estate tax issues that should be addressed (e.g., New York and Massachusetts).

Thus, considering the likely return of the federal estate tax in 2011 and continuing estate taxes at the state level, it is advisable to consider techniques to minimize federal and state estate taxes in connection with the transfer of one's wealth.

Gift Taxes Remain

Unlike the estate tax, the gift tax is not repealed under EGTRRA. Thus, regardless of what happens to the estate tax, private equity fund managers also must be cognizant of the gift tax, which is assessed on lifetime transfers. Two exceptions to the gift tax are the gift tax annual exclusion (pursuant to which a person can give up to $13,000[1] to any number of donees in any calendar year without any gift tax implications) and the lifetime $1 million exemption amount (essentially allowing the first $1 million of taxable gifts – those in excess of $13,000 – to be gift tax free). Prudent and creative use of the gift tax annual exclusion and the $1 million lifetime gift tax exemption amount can eliminate gift tax liability for many lifetime transfers. More sizeable gifts, however, will trigger a federal gift tax. In 2010, gifts are taxed at a rate of 35%.

For private equity fund managers whose estates typically exceed the federal estate tax exemption amount, careful lifetime gifting remains a critical component of estate

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planning in order to remove assets (and future appreciation on those assets) from the taxable estate, thus lowering the estate tax that will be assessed at death. Because the lifetime gift tax exemption is limited to $1 million, certain types of lifetime transfers are more favorable than others. For example, gifts of cash may not be as desirable as gifts of "in-kind" assets, because such assets may have low current values but significant growth potential. Any appreciation occurring after the gift is made escapes taxation in the donor's estate.

In addition, leveraged gifting transactions often are preferable to outright gifts. Certain leveraged gifting techniques maximize the transfer of value (but minimize the use of the gift tax exemption) and may not expose the transferor to significant gift tax liability.

Transfer Issues And Opportunities Unique To The Private Equity Fund Manager – The Transfer Of A Carried Interest

A private equity fund manager's assets typically include a carried interest in a private equity fund and also may include nonpublic stock of fund-backed companies, both of which have the potential for rapid growth and significant appreciation. The growth potential makes these assets ideal for estate planning leveraging techniques such as family limited partnerships and split interest gifts that can reduce or eliminate estate and gift tax liability. Because of certain attributes of these assets, however, they are subject to complex provisions of federal estate and gift tax laws. These transfers should not be undertaken without the supervision of an attorney experienced in the intricacies of these provisions of the Internal Revenue Code, or IRC.

Section 2701 And The Vertical Slice

When a private equity fund manager makes a lifetime gift of an interest in a fund's general partner to a family member or entity (often referred to in the general partnership agreement as an affiliated entity) and retains an interest in the same partnership that is not of the same class (meaning that its rights, other than rights to participate in management, limitations on liability, or non-lapsing differences in voting rights, are different), IRC § 2701 may create an unexpected gift tax liability. This is an important issue when a private equity fund manager gifts to an affiliated entity some portion of his or her carried interest in a fund, because the fund manager typically will retain a subscription (or capital) interest in the general partner of the fund. Because subscription accounts typically have preference over carried interest accounts with respect to allocations and distributions of fund profits, the fund manager's retained interest in the subscription account would not be considered the same class as the transferred carried interest.

As a result, IRC § 2701 may apply to the gift of the carried interest, resulting in a gift not only of the value of the transferred carried interest, but also in a gift of the value of all interests in the fund retained by the fund manager. In other words, the manager's entire interest in the fund, rather than only the value of the transferred carried interest, would be deemed a gift. Under IRC § 2701, additional gifts may be deemed to be made each time the private equity fund manager makes an additional contribution to the capital of the general partner at the time of subsequent capital calls, and the same valuation rules would apply. At those times, the value of the fund, and therefore the gift, could be considerably larger, resulting in a substantial and unexpected gift tax liability.

There are exceptions to the application of IRC § 2701. For example, IRC § 2701 only applies if the fund manager makes gifts to certain family members. A gift of carried interest to nieces and nephews (and more remote relatives) or unrelated individuals is not subject to IRC § 2701.

Another exception is a gift of an interest in the general partner that is structured as a "vertical slice" – or a proportionate amount – of all interests owned by the private equity fund manager in the general partner of the fund (and in the fund directly if the fund manager is investing directly therein). This vertical slice is achieved if the transfer includes not only the desired share of the carried interest, but also a proportionate share of every other economic interest, including any percentage interest in the subscription account and any related obligation to contribute capital, that the fund manager owns in the general partner of the fund (and in the fund directly if the fund manager is investing directly therein). While the fund manager may be reluctant to transfer to an affiliated entity an interest in the subscription account because of its obligation to make future capital calls, through proper planning he or she can later assist in payment of these calls by additional gifts or loans to the affiliated entity.

In determining the vertical slice, it is also important to consider interests the fund manager may own in side funds which make parallel investments. Depending on the structure of the side fund and its relationship to the general partner, a proportionate share of those interests may need to be included in the vertical slice.

The Vesting Issue

The IRS ruled in Rev. Rul. 98-21 that a gift of an unvested employee stock option is not complete for gift tax purposes until the exercise of the option is no longer conditioned upon the performance of services by the employee.[2] In an often-criticized analysis, the IRS stated that until the employee has performed such services, an unvested employee stock option has "not acquired the character of enforceable rights susceptible of valuation for federal gift tax purposes."[3] Furthermore, if "the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option" for gift tax purposes.[4]

Generally, the interest of a private equity fund manager in the general partner's carried interest is subject to a vesting schedule. While Rev. Rul. 98-21 by its terms deals only with nonqualified stock options, the principle – that no enforceable property right exists until vesting occurs upon completion of services – is one which could be analogized by the IRS to the vesting of a fund manager's interest in the general partner. The potential gift tax liability could be quite significant if the gift of the carried interest is held to be complete only in stages, months or years after the actual transfer as vesting occurs.

The conservative approach is to transfer only the vested portion of a carried interest. In reality, however, this is often not possible if one seeks, for valuation purposes, to transfer a general partner interest as soon as possible after the inception of the fund (a time when its value is arguably at its low point), when frequently no vesting has occurred. It can be argued, however, that unlike an unvested stock option with no enforceable rights, an unvested general partner interest almost invariably entitles its holder to property rights, including immediate rights to allocations and distributions as if the interest were fully vested. It is not until the fund manager resigns that the vesting schedule is triggered, reducing future property rights in allocations and distributions. In fact, many general partner agreements do not require the private equity fund manager to return capital account allocations or distributions made prior to resignation. The ability to retain pre-vesting allocations and distributions, however unlikely it may be that such allocations and distributions would occur in the early stages of a particular fund, is a property right and creates a basis on which to distinguish the vesting associated with a carried interest from the vesting of stock options. Nevertheless, a fund manager always should review any vesting schedule applicable to a transferred carried interest and evaluate the potential risk. If possible, the fund and general partnership agreement provisions regarding recovery of allocations or distributions previously allocated to an interest which later divests should be structured to minimize the risk of making an incomplete gift.

Management Fee Offset Arrangements

In some structures, private equity fund managers have opted to forego receipt of a portion of management fees in exchange for an offset against capital contributions to the fund. The structure of the offset arrangement must be analyzed with care in the case of a proposed transfer by a private equity fund manager of a portion of his or her interest in the general partner. The offset arrangement could be viewed by the IRS as a series of future gifts by the manager if the offset also applies to later capital contributions required of the affiliated entity.

The management fee that is offset is a fee paid to the general partner for services provided by members of the general partner to the fund. The offset arrangement benefits the general partner by reducing the capital contribution that the general partner otherwise would need to pay to the fund at the time of capital calls. Generally, the offset arrangement at the general partner level benefits only those who are active members of the general partner.

If a member of the general partner retires or resigns from active participation, the general partner agreement usually provides that the retired partner – who upon retirement usually ceases to receive salary or bonuses from the management company – also is no longer entitled to the benefits of the offset arrangement. As a result, he or she must pay cash at the time of capital calls made by the fund from the limited partnership. In turn, affiliated entities that receive the benefit of the offset arrangement only would do so as long as the manager of the private equity fund linked to the entities remains an active member of the general partner. If the manager resigned or retired, any interest in the offset arrangement held by his or her affiliated entities generally would cease. This direct link between the services provided by the manager and the reduction in the cash contribution that otherwise would be required of the affiliated entity could be viewed as an additional gift by the manager to the affiliated entity.

The timing and value of any such additional gift may be subject to debate. If one simply takes the position that the gift occurs at the time the capital call obligation of the affiliated entity is reduced, and that the value of that gift is the reduction in the capital contribution otherwise required, the gift easily can be reported and annual exclusions or use of the manager's lifetime gift tax exemption may make it a non-taxable event. In some instances, however, under the terms of the fund agreement, the economic benefits of the offset arrangement will not be fully realized until there are profits in the fund and so the value for gift tax purposes is harder to quantify, and arguably may be much lower.

An attempt to avoid the gift by treating the reduction in capital contributions required by the affiliated entity as a loan from the manager, which would be evidenced by a note from the entity to the manager, appears problematic because placing an immediate value on the manager's offset could have a negative impact on the beneficial income tax treatment of the offset arrangement.[5]

Ultimately, the best manner of handling a management fee offset arrangement depends on the design of the offset arrangement, the measure for gift tax purposes of the value of the offset, and an analysis of the various risks involved.

Valuing The Carried Interest – Gift Tax Returns, Professional Appraisers And The Formula Gift

Until the private equity fund commences investing, it has no profits. Therefore, if a newly organized fund were liquidated shortly after its formation, the carried interest would have no value. This is the rationale that many private equity fund managers use in support of their assertion that a gift of a carried interest in the general partner just after formation of a fund is a gift of little or no value for gift tax purposes. Relying on the argument that the gift is of no value or that it falls within the $13,000 gift tax annual exclusion amount, many donors question the need for filing a gift tax return to report the gift.

There are a number of good reasons, however, to report this gift on a gift tax return.

One reason is that if the carried interest has no current economic benefit (and thus is not a gift of a 'present interest' in the carried interest), it may not qualify for the gift tax annual exclusion.[6] In Hackl v. Commissioner,[7] the Seventh Circuit Court of Appeals upheld the Tax Court's denial of the use of the annual exclusion for gifts that were deemed to have no immediate economic benefit to the recipient due to transfer restrictions placed on the gifted interests (and thus were not gifts of present interests). The Hackl holding could extend to gifts of a variety of closely held business interests, including a carried interest in an early stage private equity fund. Therefore, instead of relying on the annual exclusion to shelter a gift of the carried interest, one can use a small amount of the $1 million lifetime exemption, which would require the transferor to file a gift tax return reporting the gift. Another alternative is to

structure the transaction so that the donee of the gift has a present interest in it, by including an immediate benefit or right such as including a temporary put option for the recipient. A third alternative is simply to be willing to argue if an audit occurs that distribution or transfer rights associated with the gifted interest differ from Hackl and therefore provide a present interest to the recipient.

Perhaps the most important reason to report the gift on a gift tax return is to start the tolling of the statute of limitations. Treasury Regulations require that a gift must be "adequately disclosed" on a gift tax return to start the three-year statute of limitations period both for purposes of determining gift tax liability for the gift and for purposes of valuing the gift as part of the later computation of estate tax liability (which integrates lifetime taxable gifts).[8] If a gift is not adequately disclosed, the IRS can challenge its valuation at any time during the donor's life or at his or her death. Such uncertainty can expose an individual to interest and penalties on unpaid gift tax that could accumulate for many years and cause havoc with later estate planning.

The adequate disclosure guidelines require that the gift be reported on the gift tax return in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value reported.[9] The Regulations require disclosure of financial information sufficient to explain the method of valuation.[10] It is not clear how extensive this information must be. Arguably, a statement of a company's chief financial officer accompanied by financial statements and balance sheets may be sufficient. Alternatively, the Regulations provide that the requirements will be met by filing an appraisal prepared by a professional appraiser with the gift tax return.[11] Although using a professional appraiser is an additional expense, it may expand the opportunity to utilize valuation discounts (such as a lack of control or lack of marketability discount), as professional appraisers can provide supporting documentation for such discounts while a company's chief financial officer may lack this expertise.

Professional appraisers, in valuing a gift of a carried interest, often will rely upon projected cash flow analyses used by fund managers in marketing their funds, past performances of funds operated by the same fund managers, and historical private equity capital performance to project a return on the investment, and then discount this return to determine a value for the interest on the date of transfer. In general, using accepted and not overly aggressive levels of discounting by the appraiser can result in a value supportable in an estate or gift tax audit and acceptable to the private equity fund manager and his or her attorney in the context of minimizing the taxable gift.

Because valuation adjustments can occur after a gift is made (for example, as a result of an IRS audit), it may be advisable to structure gifts of carried interests as formula gifts to prevent incurring additional gift tax or the unintended use of the gift tax exemption. In this case, the private equity fund manager determines both how much of the general partner interest he or she wants to gift and how much gift tax exemption he or she wants to use. The gift is then described using a formula providing that, if the valuation of the gifted amount is in excess of the intended gift tax exemption amount to be used, the excess will pass to the donor's spouse or a charity (or a trust for either), thereby enabling the excess transfer to qualify for a marital or charitable deduction in determining gift tax liability. Other techniques involve the manager retaining a power over or interest in any excess amount to avoid a completed gift.

Such formula gifts, however, are not without risk. Courts and the IRS have ruled that certain formula adjustments are void as against public policy.[12] These decisions provide support to the IRS in an audit; however, many practitioners believe it is still possible to draft a formula clause distinguishable from the ones that have been held void by the courts and the IRS and that in many gifting situations it is essential to try and take advantage of this protective device.

Finally, because of the potential for revaluation of gifts by the IRS, it is always important to review the amount of an individual's gift tax exemption and to track the statute of limitations on gifts.

Gifting Strategies In A Low-Interest Rate Economy

When making a gift of an annuity, an interest for life or a term of years, or a remainder or reversionary interest, the value is determined using the federal statutory interest rate under IRC § 7520 (the "§ 7520 rate"). The gift component of an installment sale or a low interest loan is calculated using the applicable federal rate under IRC § 7872 (the "§ 7872 rate"). Since many of the gifting techniques discussed in this article require that certain values be calculated using the § 7520 or § 7872 interest rates, the effectiveness of the techniques will be substantially influenced by the interest rate at the time of the transfer. It is often advantageous to implement certain split interest gifting techniques in a low-interest rate market.

Split Interest Gifts – The Grantor Retained Annuity Trust

Individuals holding stock in private companies or stock whose current price is deflated may wish to transfer large amounts of the stock, but avoid using the lifetime gift tax exemption or paying gift tax. This can be accomplished by using a leveraged gifting technique known as the grantor retained annuity trust, or GRAT.

A GRAT is an irrevocable trust to which an individual (the grantor) transfers assets, retaining the right to receive fixed payments (the annuity), payable not less than annually, for a term of years.[13] The annuity payment can be stated as a fixed dollar amount or as a percentage of the initial value of the assets contributed to the trust. At the end of the term, the property remaining in the trust passes to the beneficiaries named in the trust instrument (the remainder beneficiaries) with no further gift tax consequences.

Since the grantor retains the right to receive annuity payments from the GRAT, the value of the gift is not the full value of the assets contributed to the trust. Rather, the value of the gift is the value of the interest passing to the remainder beneficiaries, which is calculated by subtracting the present value of the grantor's retained right to receive the annuity payments from the total value of the assets contributed to the trust. The present value of the grantor's retained interest depends upon a number of factors,

including the value of the assets contributed, the annuity payment rate, the term of the GRAT, the § 7520 rate, and in some instances the grantor's age.

Typically, a GRAT is structured so that the value of the remainder gift is reduced to a nominal amount (a zeroed-out GRAT), resulting in the use of a very small portion of the grantor's gift tax exemption.[14] Thus, a zeroed-out GRAT is an estate planning technique with substantial upside potential and virtually no downside. If the GRAT assets appreciate at a rate exceeding the § 7520 rate used at the initial transfer, the excess appreciation passes to the remainder beneficiaries gift-tax free. If the assets of a zeroed-out GRAT fail to beat the § 7520 rate or decrease in value, all of the trust assets will return to the grantor as annuity payments and he or she will be in the same position economically as if he or she had never made the transfer.

Minimizing the use of one's gift tax exemption (by using a zeroed-out GRAT) is a particularly important goal if (1) the grantor's entire $1 million lifetime gift tax exemption amount already has been used by previous lifetime gifts (or the grantor does not wish to use any of his or her exemption) or (2) there is significant volatility in the asset transferred, thereby creating the risk that gift tax exemption will be wasted if the asset declines in value after the date of transfer.

Several legislative proposals have been raised recently that would require a minimum term of ten years for a GRAT. However, these proposals have been unable to garner enough support in the Senate to pass. A ten-year minimum would increase the so-called "mortality risk" involved in using a GRAT. This is because if the settlor of a GRAT dies during the term of the GRAT, the assets of the GRAT come back into the settlor's estate for estate tax purposes. Traditionally, shorter-term GRATs have been used to help reduce this risk. Setting up a GRAT now, rather than waiting to see whether the ten-year minimum become a reality, may be advantageous.

GRATs are especially successful in times of low interest rates because they are effective when the assets contributed to them appreciate at a rate greater than the § 7520 rate at the date of transfer.

Advantages Of The GRAT For The Private Equity Fund Manager

There are many reasons a GRAT is an ideal gifting technique for the private equity fund manager. The private equity fund manager often holds portfolio company stock or other assets where large amounts of appreciation may occur within a short time frame. A zeroed out GRAT makes possible a potentially large gift of the appreciation to the remainder beneficiaries at virtually no gift tax or exemption cost.

Another major advantage to GRATs is that they are usually drafted using a percentage for the annuity amount, removing the risk of an individual using more exemption or paying gift tax as a result of a revaluation of the contributed assets. If the value of the assets contributed to the GRAT is increased on audit of the gift tax return, then the annuity amount due to the grantor from the GRAT would be increased by the same percentage on the increased value, which in most cases should not materially affect the amount of the gift resulting from the GRAT.

Finally, a GRAT is an ideal gifting technique for assets that may be subject to fluctuations in value driven by the economy or markets. If the contributed stock unexpectedly suffers a downturn in value during the term of the GRAT, the GRAT fails, in the sense that all the stock may be required to be distributed back to the grantor as part of the annuity payments due to him or her. However, because the value of the remainder interest is nominal, there is no gift tax cost or loss of exemption associated with the downturn in value of the gifted stock as there would be in the case of a direct gift of the same stock. This is an important consideration since current gift tax law provides for a limited gift tax exemption.

There also are income tax benefits to creating GRATs. GRATs are grantor trusts for income tax purposes, meaning the grantor is treated as the owner of the underlying trust assets. As a result, transactions between the grantor and the GRAT are ignored for income tax purposes. Therefore, no capital gains are triggered upon the grantor's contributing assets to the trust or upon distribution of in-kind assets from the trust to the grantor in satisfaction of annuity payments. Furthermore, capital gains on any sale of assets in the GRAT during the trust term are taxable to the grantor. By the grantor (and not the GRAT) paying these income taxes, the GRAT assets essentially are allowed to appreciate tax-free for the benefit of the remainder beneficiaries. Additionally, when the grantor pays the income taxes attributable to the trust, the income tax payments are not considered taxable gifts to the remainder beneficiaries.[15] The payment of the income tax by the grantor essentially is a tax-free gift to the trust beneficiaries.

Additional Considerations In Any GRAT Transaction

As noted above, a GRAT is effective only if the grantor survives the term of the GRAT. If the grantor dies during the term of the GRAT, all the property in the GRAT will be included in his or her estate.[16] For this reason, long-term GRATs are often not as attractive as short-term ones and it is always important to consider the grantor's health in setting the term. One can structure a GRAT with a term of as short as two years, which may be sufficient time to capture a large amount of appreciation in an asset and move it to remainder beneficiaries. One also might consider dividing assets to be gifted between spouses so that each spouse can establish a separate GRAT with a portion of the assets, thereby spreading the mortality risk between them.

The grantor of a GRAT always should consider the generation-skipping transfer, or GST, tax[17] in selecting the remainder beneficiaries of the GRAT. It is not possible to allocate GST exemption to the initial contribution to the GRAT, so the leveraging opportunity available with the gift tax is not available with respect to the GST tax.

In general, allocation of GST exemption only can be made at the termination of the GRAT. If, at the termination of a GRAT, a distribution is made to a remainder beneficiary who is a "skip person," such as a grandchild, GST tax will be assessed. In a successful GRAT, this may result in unintended use of the grantor's GST exemption or a substantial generation-skipping transfer tax liability if no exemption is available. Also, under GST exemption allocation

rules, GST exemption automatically will be allocated at the termination of a GRAT if the remainder beneficiary of the GRAT is deemed to be a generation-skipping trust. Again, this automatic allocation may not be desired or intended. The issue should be reviewed by counsel no later than the year of termination of any GRAT that has a trust as a remainder beneficiary to determine if an election out of the automatic GST exemption allocation rules is appropriate.

If the assets of the GRAT do not consist of cash or marketable securities at the time the annuity payment is due, the mechanics of making payments can be very difficult. Treasury Regulations forbid the use of a note, other debt instrument, option or other similar financial arrangement to pay the annuity due to the grantor.[18] If there is insufficient liquidity to pay an annuity due the grantor (e.g., the fund has not yet begun to pay out carry) and the trust satisfies the annuity by paying in-kind assets to the grantor, it is very important that the valuation of the in-kind assets used to make the annuity payment be fully supportable. Thus a GRAT may be more appropriate in the context of a "mature" fund where there may be liquidity available to fund the annual annuity payments. If the asset is found to have been overvalued, the required annuity payment would be treated as not having been made in full and the trust could be disqualified. Overvaluation of its assets for purpose of paying the annuity amount could also be viewed as a constructive addition to the trust, in violation of the prohibition against adding property to a GRAT. In either case the disqualification of the GRAT as a result of improper administration could result in an unexpected and substantial gift tax liability for the grantor.

Finally, while the grantor of a GRAT may serve as the trustee of his or her GRAT during the GRAT term, this is not advisable when the grantor transfers stock of a corporation which he or she controls. The estate tax provisions of the IRC provide that the retention of certain powers (such as voting control of stock in a controlled corporation) by a grantor over transferred assets can result in the inclusion of those assets in the grantor's estate.[19]

Charitable Lead Annuity Trusts

The charitable lead annuity trust, or CLAT, offers many of the same advantages of the GRAT in a low interest rate environment. The concept is similar to a GRAT, but the lead annuity interest is paid to a charity rather than retained by the grantor. The term of the charitable lead interest can be for a term of years or a term measured by the life of one or more individuals.[20] Like a GRAT, a CLAT may be more appropriate in the context of a mature fund where they may be liquidity available to fund the annual annuity payments to charity rather than having to value in-kind property distributions.

For example, if a donor transfers $1 million to a CLAT with a 7% payout to charity, $70,000 will be paid to charity each and every year of the trust. The valuation of the charitable deduction is based on the § 7520 rate. The amount of the deduction is determined by the rate of payment to charity and the length of the trust. The negative effect on the tax deduction of a low percentage annuity can thus be offset by lengthening the charitable payout period. Conversely, a higher payout rate would permit a shortening of the trust term. Because the lead interest payable to the charity qualifies for the gift tax charitable deduction, the taxable gift is the value of the remainder interest in the trust and, as in the case of a GRAT, the annuity payable to the charity can be set at a rate sufficiently high to reduce the taxable gift to a minimal amount. For example, for a trust created in September 2010, an annuity payable to charity each year equal to 6.355% of the initial value of the trust principal for 20 years will allow the remainder of the trust to pass to family members at the end of the 20-year term free of all gift tax. While this may be extreme, it is often possible to obtain deductions of 60% to 70% without having the annuity amount exceed a reasonable rate of return.

Furthermore, any future appreciation in the trust principal inures to the benefit of the trust remaindermen (e.g., the donor's children), and that enhancement would not be taxed in the donor's estate.

Alternatives To Gifts: Intra-Family Loans Or Sales

When a family member or entity needs cash immediately, an intra-family loan can be an ideal alternative to an outright gift, which would require use of the annual exclusion or lifetime gift exemption, or a more complicated split interest transaction. For example, a loan can be made to a family member, an irrevocable family trust or a family limited partnership that holds a private equity fund interest and requires funds to meet its capital call obligation. The terms of the loan can provide for periodic or a single balloon payment of interest and/or principal. It also can include prepayment options for the borrower and allow flexibility to renegotiate the loan if interest rates change. Demand loans, while presenting the most options for the lender, present more complicated administrative and gift tax issues than term loans.

Intra-family loans are governed by IRC § 7872, which requires that the applicable federal interest rate, or AFR, be used to calculate the interest on the loan. Such rates are issued monthly and vary depending on the term of the loan and the interest compounding period. It is important that the § 7872 provisions are followed to avoid the loan being treated as a gift loan, resulting in the interest being deemed a gift from the lender to the borrower.

Intra-family loans are effective if the loan proceeds can be invested to produce a higher return than the AFR, because that difference goes to the borrower without any gift or estate tax consequences to the lender.

However, there are income tax issues for the lender and borrower in any term or demand loan arrangement. The original issue discount rules generally will require the lender to report in each calendar year a pro rata share of the interest accrued even if no payment is required of the borrower. In some cases, interest payments also may be a deduction to the borrower.[21]

Another estate planning technique ideal in a low interest environment is known as the installment sale to an intentionally defective grantor trust. In this technique, assets are sold by an individual to an irrevocable trust created for his or her family members (sometimes referred to as a family trust), which is a grantor trust for income tax

purposes, in return for a promissory note. As in the case of an intra-family loan, the terms of the note must provide an interest rate that is at least equal to the AFR in effect at the time of the sale to avoid the transaction being viewed as part sale and part gift. Because the family trust is a grantor trust, as in the case of a GRAT, the grantor is treated for income tax purposes as the owner of the underlying family trust assets. Thus, transactions between the grantor and the trust are ignored for income tax purposes - so there is no reporting of gain on the sale of assets by the grantor to the trust or of interest income on the note.

The required interest rate to be used on a promissory note which has a term of nine years or less is less than the § 7520 rate required for a GRAT; therefore these transactions can offer the advantage of allowing for more leverage than a GRAT. Unlike GRATs, whose terms are clearly defined by the IRC and Treasury Regulations, there is no road map provided in the IRC and Regulations as to how to structure an installment sale. As a result, an installment sale to an intentionally defective grantor trust as an estate planning technique can involve more risk and exposure on audit. In particular, issues may arise on audit if the purchasing trust lacks sufficient seed money (i.e., assets of its own, possibly received as a gift by the grantor)[22] or income-producing assets to support the loan payments. If the IRS successfully argues that a valid loan arrangement does not exist, the transaction may be recharacterized as a gift with a retained interest, which could result in an unexpected and substantial gift tax liability.

Estate Planning Techniques To Consider If Interest Rates Increase

Given the historically low interest rates, two planning techniques which have been out of favor during times of low interest rates should be reconsidered as interest rates increase likely begin to rise.

Qualified Personal Residence Trusts. A qualified personal residence trust, or QPRT, is a gifting technique where an individual transfers an interest in a personal residence to a trust, making a gift of the remainder interest while retaining the exclusive use of the residence for a term of years.[23] Vacation homes as well as primary residences can be used. A QPRT is most advantageous where a residence is likely to appreciate in value. Because the gifted remainder interest in the residence has a carryover basis for income tax purposes (rather than a stepped-up basis which would occur if the residence passed at death), it is also a better technique for a residence which an individual anticipates his or her children (or other heirs) will retain rather than sell.

When a personal residence is transferred to the QPRT, the value of the gift is the value of the remainder interest. The value of the remainder is based on the length of the grantor's retained interest – i.e., the right of the grantor to reside in the home (the longer the term of the retained interest, the less the value of the remainder interest). The value of the grantor's retained interest (which is his or her retention of the right to live in the residence) is measured by the term of the trust and the § 7520 rate on the date of the creation of the trust. Therefore, as the § 7520 rate increases, the value of the retained interest is deemed to be higher and the gift of remainder interest less.

For example, assume that a 50-year-old individual transfers a residence worth $1.5 million to a QPRT with a 20-year term. Under the AFR for September 2010, the amount of the gift would be $745,980 (and not $1.5 million). In this example, if the residence appreciates at 4% per year, a 20-year QPRT could result in an estate tax savings of approximately $1.14 million (assuming a 45% estate tax rate).

As in the case of a GRAT, using a QPRT involves mortality risk. If the grantor dies during the term of the QPRT, the entire value of the property is brought back into his or her estate.

For many clients, using a QPRT can result in the removal of valuable residential real estate from the client's taxable estate at very little gift tax cost.

Charitable Remainder Trusts. A charitable remainder trust, or CRT, essentially is the reverse of a charitable lead trust. A CRT is an irrevocable trust that pays an amount annually to an individual or individuals for a specified term and, at the end of the term, pays the remainder interest to qualified charitable organizations. In order to qualify as a CRT, the annual income interest must be in the form of either an annuity payment (an annual payment fixed as a percentage of the amount contributed, known as a charitable remainder annuity trust) or a unitrust payment (a percentage of the fair market value of the assets of the trust valued each year, known as a charitable remainder unitrust). The percentage of the annuity or unitrust payment amount must be fixed between 5% and 50%, and the remainder interest must equal at least 10% of the fair market value of the assets contributed to the trust.

The CRT itself is a tax-exempt entity. As a consequence, none of the transactions entered into by the CRT will be subject to income taxes at the trust level. However, upon receipt of the annuity or unitrust payment each year, the designated recipient may have taxable income. So in effect, this may be an income tax deferral strategy. Each year the annuity or unitrust payment is deemed to consist of assets from the CRT that are first, ordinary income, second, capital gain property, and finally, tax-exempt income or principal. The character of the assets remains the same in the hands of the recipient as in the CRT. Therefore, the recipient of the annuity or unitrust payment must report either the ordinary or capital gain income on his or her individual income tax return in the year of the receipt.

As in the case of a QPRT, the value of the retained and remainder interests are measured by taking into account the § 7520 rate at the time of creation of the trust (or at the grantor's option in either of the preceding two months). The assets contributed are assumed to have the § 7520 rate of return over the term of the trust. Thus, a higher rate of return will provide more income to pay the retained annuity or unitrust amount, thereby increasing the value of the assets remaining for the charitable remainder interest. The remainder value determines the charitable income, estate and gift tax deduction available to the grantor.

The CRT is especially beneficial for highly appreciated assets owned by an individual. The individual would transfer the appreciated assets to the CRT and then the CRT would sell the assets. Once sold, the full value of the assets can be used to produce an income stream (in the form of the annuity or unitrust payment) for the grantor or

another designated individual during the CRT term. Only as the grantor or other designated individual actually receives the annuity or unitrust payment will he or she recognize the capital gain which occurred when the CRT sold the assets.

For example, if an individual contributes $1 million of low basis stock into a charitable remainder annuity trust paying him or her $50,000 a year for 20 years, the income tax charitable deduction in the year the trust is created would be $269,695, based on the AFRs for September 2010. If the Trustees, after the trust was created, sold the low basis stock, there would be no capital gain realized by the trust. Additionally, if the individual creates a charitable remainder unitrust (where the annuity retained is a percentage of the fair market value of the assets of the trust valued each year) and the trust assets grow at a rate more than the § 7520 rate, it creates the possibility for an increased annuity payable to the annuitant. This is not available in a charitable remainder annuity trust where the annuity payments are fixed at the trust's inception.

Retaining Control And The Estate Tax Inclusion Risk – Is The Family Limited Partnership Or Limited Liability Company A Solution?

Retaining control over a transferred economic interest in the general partner is frequently of critical importance to the individual private equity fund manager, as well as to his or her partners in the general partner and the limited partners of the private equity fund. Direct transfers to children or spouses often are not feasible because of this issue. Transfers to irrevocable trusts, to be effective for estate tax purposes, require that the irrevocable trust (other than a GRAT) have a trustee other than the private equity fund manager.

A frequently used solution to accomplish the private equity fund manager's goal of maintaining oversight and remaining involved in the overall management of the transferred general partner interest without estate tax inclusion is the creation of a Family Limited Partnership, or FLP, or Family Limited Liability Company, or FLLC, to receive the transferred general partner interest. The use of a FLP/FLLC also offers an additional gift tax advantage as it may permit a discounting for gift tax purposes of the value of the underlying assets held in the FLP/FLLC when limited partnership interests in the FLP or membership interests in the FLLC are transferred.

For years, the prevailing view was that the private equity fund manager could serve as the general partner or manager of the FLP/FLLC without the same estate tax inclusion risks associated with his or her retention of control as trustee of a trust to which he or she transferred assets. Recently, however, the IRS has been successful in challenging FLPs and FLLCs when an individual dies owning an interest in that entity. These successful challenges have resulted in the inclusion for estate tax purposes (under Section 2036 of the Code) of the full value of the assets owned by the FLP/FLLC at time of the individual's death in the individual's estate.

Section 2036 of the Code causes inclusion of assets in an individual's estate where that individual transfers assets but either (1) retains the possession or enjoyment of, or the right to income from, the transferred assets, or (2) retains the right, alone or in conjunction with another person, to designate who would possess or enjoy such property or the income therefrom. Challenges to FLPs/FLLCs have focused on both of these elements.

Under Section 2036(a)(1) of the Code, FLPs/FLLCs have been challenged on the theory that the decedent retained a beneficial interest in the partnership assets and, thus, the partnership form should be ignored and the contributed assets should be included in the donor's estate at their full undiscounted value. Under Section 2036(a)(2) of the Code, FLPs/FLLCs have been challenged on the theory that the decedent's gross estate includes property over which the decedent retained the right, either alone or in conjunction with any person, to designate the persons who will possess or enjoy the property or the income from the property, and that the decedent's ownership of a partnership or membership interest, depending on the language of the governing partnership agreement, enables the decedent to do so.

In addition, recent cases in this area have focused on the threshold issue of whether Section 2036 is inapplicable to a particular situation (thereby not even reaching an analysis under Section 2036(a)(1) or (a)(2)) on account of the decedent's transfer of property to the FLP/FLLC having constituted a "bona fide sale for full and adequate consideration in money or money's worth", an exception contained in Section 2036 (the bona fide sale exception). Each of these theories is addressed in turn below.

IRC § 2036(a)(1)

Under IRC § 2036(a)(1), the underlying assets owned by the partnership will be included in a decedent's gross estate if the decedent retained the possession or enjoyment of, or the right to the income from, such assets. Until recently, the IRS was only successful in certain extreme fact situations (usually involving deathbed transfers by elderly donors) where the partnership entity appeared illusory and of no substance. These included cases where a decedent who was the principal contributor to a partnership retained personal use of partnership assets or failed to segregate partnership assets from his or her own funds; or the court concluded that there was an implied agreement with the other partners that the decedent would retain the economic benefit or control of assets transferred to a partnership.[24] It was believed that similar challenges easily could be avoided by careful administration of the partnership.

Recently, however, the IRS has had increased success in challenging the use of FLP/FLLCs. Two lower court decisions in Estate of Strangi v. Commissioner,[25] a Tax Court memorandum case, and Kimbell v. United States,[26] a District Court case from Texas, raised new concerns regarding the use of FLP/FLLCs, including that the concept, which had been the basis of the prior private letter rulings, that a general partner's fiduciary duty to his limited partners protected the general partner from falling within the realm of Section 2036, was inapplicable in the FLP/FLLC context. To a certain extent, some of these concerns were dispelled in May 2004, when the Fifth Circuit Court of Appeals reversed the District Court's decision in favor of the taxpayer in Kimbell and remanded the case.[27] Nevertheless, Strangi and Kimbell opened the door for countless later decisions holding that, without proper

formation and administration of FLPs/FLLCs, interests in such entities would be includable in a decedent's estate under Section 2036 of the Code.[28] (These cases will be discussed in further detail below in the context of IRC § 2036(a)(2) and the bona fide sale exception.)

Over the course of the last 10 years, appellate decisions in Estate of Thompson v. Commissioner,[29] Strangi and Estate of Abraham v. Commissioner[30] and Tax Court decisions in Estate of Hillgren v. Commissioner,[31] Estate of Rosen v. Commissioner,[32] Estate of Disbrow v. Commissioner,[33] Estate of Erickson v. Commissioner,[34] Estate of Sylvia Gore v. Commissioner,[35] Estate of Rector v. Commissioner,[36] Estate of Jorgensen[37] and Estate of Malkin[38] were all decided against the taxpayer, resulting in the inclusion of partnership assets in the respective decedent's estates. As a result, such cases provide excellent guidance on what not to do when structuring and operating FLP/FLLCs. In each of these cases, the decedent-transferor continued to enjoy the right to support and maintenance from the partnership's income and assets. For example, in Strangi and Disbrow, the decedent continued to live in the residence that he or she transferred to the partnership without the proper lease/rent arrangement being respected. In Thompson, the decedent did not retain sufficient assets to support himself outside the partnership, and his children testified that they would not have denied the decedent's request for distributions from the partnership.[39] In Malkin, almost all of the partnership's assets were pledged toward a personal debt of the decedent in exchange for a minimal fee paid to the partnership by the decedent, a fact which the court held indicative of an implied agreement of retained enjoyment. Lastly, in Erickson, because assets from the partnership were used for the payment of the estate taxes, it was considered a retained right of enjoyment.[40]

Furthermore, these cases show that the FLP/FLLC structure will not be respected when the formalities imposed by state law are not respected. For example, in Hillgren, there was commingling of funds and a complete disregard for the partnership form. In Rosen, Thompson and Jorgensen, the partnership failed to maintain books or records and no minutes of meetings were ever kept. In addition, in each of those cases, disproportionate distributions were made to the decedent from the partnership, in order to enable the decedent to make cash gifts or pay for living expenses.

One of the main themes that runs through all of these cases is that, at a minimum, the FLP/FLLC must be properly structured and operated in order for it to be respected for estate tax purposes. Estate of Stone v. Commissioner[41] provides an example of the proper formation and operation of a partnership. In Stone, each member of the Stone family was represented by independent counsel in the negotiation of the partnership agreement and had input as to the structure and funding of the partnership. The transfers to the partnership were motivated by investment and business concerns relating to family assets and the resolution of litigation amongst the Stone children. Sufficient assets were retained outside the partnerships to maintain the partners' standards of living, and the partnership was administered properly in accordance with the corporate formalities required by state law. Estate of Murphy v. United States[42] provides another example -- the decedent formed the FLP at issue for legitimate, non-tax reasons, the decedent retained assets worth about $130 million outside of the FLP (compared to approximately $90 million worth of assets that were contributed to the FLP) and the formalities of the partnership were observed.

IRC § 2036(a)(2)

Under Section 2036(a)(2), property may be included in a decedent's gross estate if the decedent retained the right, alone or in conjunction with another person, to designate who would possess or enjoy such property or the income therefrom. Typically, the Section 2036(a)(2) argument was considered an alternate argument to estate tax inclusion under Section 2036(a)(1). Relying on Section 2036(a)(2), the courts have implied that the mere retention by a decedent of a right to control distributions or the liquidation of the FLP/FLLC (either solely as a general partner or manager or even, along with others, as a limited partner or member) can result in inclusion for estate tax purposes of assets contributed by the decedent to the FLP/FLLC at their full undiscounted value at the time of death.

The two prominent cases addressing Section 2036(a)(2) are United States v. Byrum[43] and Strangi. In Byrum, the assets transferred to an irrevocable trust were not included in the decedent's gross estate under Section 2036(a)(2). The decedent transferred shares of stock in three closely held corporations to an irrevocable trust, of which a bank was appointed as trustee. Prior to the transfer, the decedent owned at least 71% of the outstanding stock of each corporation. Decedent's children or more remote descendants were the beneficiaries of the trust. The other shareholders in each corporation were unrelated to the decedent. Although the trustee maintained broad and detailed powers with respect to the control of the trust property and such powers were exercisable in the trustee's sole discretion, the decedent reserved certain rights with respect to the trust property, including the right (i) to vote the shares of unlisted stock held by the trust; (ii) to disapprove the sale or transfer of any trust assets, including the shares of stock transferred to the trust; (iii) to approve investments and reinvestments; and (iv) to remove the trustee and appoint another corporate trustee in its place.

The Supreme Court, in Byrum, determined that the decedent retained no right in the trust instrument to designate the enjoyment of trust property under Section 2036(a)(2), other than the power to use his majority position and influence over the corporate directors to regulate the dividend flow to the trust. Such right was neither ascertainable nor legally enforceable.

Although the decedent retained the legal right to vote shares in the corporations held by the trust and to veto investments and reinvestments, it was the corporate trustee, not the decedent, who had the sole right to distribute or withhold income and designate which beneficiaries enjoyed such income pursuant to the terms of the trust. The decedent's power to regulate the dividend flow was not specified by the trust instrument, but was granted to him because he could elect a majority of the directors of the corporations. The decedent's power to elect directors did not compel them to pay dividends.

The concept of fiduciary duty was also addressed in Byrum. A majority shareholder has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests. In addition, the directors have a duty to preserve the interests of the corporation. Although the decedent may have had influence over the corporate directors, their responsibilities were to all stockholders (there were additional stockholders who were unrelated to the decedent) and were legally enforceable, separate from any needs of the decedent and the trust. Similarly, the decedent was also inhibited by fiduciary duty from abusing his position as majority shareholder for personal or family advantage to the detriment of the corporation or other stockholders. Thus, if the decedent violated his fiduciary duties, the minority shareholders, who were unrelated to the decedent, would probably initiate a cause of action against him.

In comparison, in Strangi, the property that the decedent transferred to a partnership was includable in his gross estate under Section 2036(a)(2). The decedent retained a right to designate who enjoyed the property and income from the partnership and the general partner. The partnership agreement named a corporation as the general partner; the management agreement gave decedent's son-in-law the right to direct distributions. Pursuant to the partnership agreement, the partnership would be dissolved and terminated upon a unanimous vote of the limited partners and the unanimous consent of the general partner. The general partner's shareholders agreement provided that a dissolution of the partnership would require the affirmative vote of all shareholders. If dissolution occurred, liquidation of partnership assets would be accomplished pursuant to the partnership agreement at the direction of the managing general partner (decedent's son-in-law). Accordingly, the Fifth Circuit Court of Appeals reasoned that the decedent, with the other shareholders, could revoke the partnership and accelerate present enjoyment of the partnership assets. Because the decedent was the 99% limited partner, the majority of the partnership assets would be re-distributed to himself.

In Strangi, the decedent had the right, in conjunction with other directors of the general partner, to declare dividends. The bylaws of the general partner authorized the board of directors, by majority vote at a meeting with a quorum present (a quorum consisting of three (3) members), to declare dividends. Because the general partner had five (5) directors, decedent, through his son-in-law pursuant to the durable power of attorney, and one other director could potentially act to declare a dividend.

Many facts were addressed by the Strangi Court to distinguish Byrum. While Byrum had an independent trustee of the irrevocable trust, all decisions for the Strangi partnership were made by the decedent's son-in-law. In Byrum, the corporation was subject to economic and business realities which were not present in the case of the Strangi partnership, which held only monetary or investment assets. Lastly, the fiduciary duties in Byrum applied to a significant number of unrelated parties which promoted action in the best interests of the entity. In Strangi, the decedent's son-in-law stood in a confidential relationship, and owed fiduciary duties, to decedent personally as his attorney in fact, and to the extent that the partnership's interest might diverge from those of decedent, the son-in-law's obligation to the decedent would take precedence.

Based upon the facts and holding in Byrum, and the Strangi decision resulting in the inclusion of assets in the decedent's gross estate under Section 2036(a)(2), precautions must be taken when forming and maintaining the partnership to avoid such adverse result. For example, a partnership that is not engaged in an active trade or business should consider doing so to impose fiduciary duties that may not otherwise exist for partnerships that may solely own marketable securities and no other assets. The provisions of the partnership agreement for the partnership must be specifically tailored so that the individual who contributes the majority of the assets to the partnership does not participate in any decision with respect to partnership distributions or the timing of such distributions. In addition, the general partner's fiduciary duty to the limited partners should be affirmatively stated in the partnership agreement. Lastly, more than an insignificant amount of limited partnership units should be transferred to unrelated parties and the individual should consider transferring all interests in the limited partnership during life, including any interests indirectly held (i.e., through a corporate general partner).

Bona Fide Sale Exception

Under Section 2036, if the decedent made a transfer of assets during his or her life to a FLP/FLLC that is categorized as a bona fide sale for adequate and full consideration in money or money's worth, an analysis of Sections 2036(a)(1) or (a)(2) is not required because Section 2036 would not apply. In other words, if the bona fide sale exception is met, the transferred assets would not be included in the decedent's gross estate under Section 2036.

The courts have enunciated various tests to determine whether the bona fide sale exception will be satisfied. For example, the Tax Court in Harper, Thompson, Hillgren, and Estate of Bongard v. Commissioner[44] held that the bona fide sale exception would not apply when there is a "circuitous recycling of value," meaning that there is no change in the pool of assets contributed to the partnership. On appeal, in addition to stating that the bona fide sale exception would not apply when there is a circuitous recycling of value, the Third Circuit in Thompson held that the transaction must be entered into in good faith and provide some potential for benefit other than estate tax benefits with no business purpose. In Kimbell and Strangi, the Fifth Circuit held that the transfer is for adequate and full consideration when (1) partners receive partnership interests proportionate to the fair market value of the assets contributed to the partnership; (2) capital accounts of the partners are properly credited when the assets are contributed to the partnership; and (3) partners receive assets from the partnership equal to their capital accounts upon the termination or dissolution of the partnership.

In addition, the transfer is considered a bona fide sale if it serves a "substantial business or other non-tax purpose." In Bongard, Murphy, Estate of Bigelow v. Commissioner,[45] Estate of Korby v. Commissioner[46] and Estate of Schutt v. Commissioner,[47] the courts held that the bona fide sale exception would apply where there was a legitimate and significant non-tax reason for creating the partnership, which, in such cases, included reasons such as preserving a specific investment philosophy and central assets in order to "shop" the company by a single seller rather than multiple trusts.[48] The recent case Estate of Mirowski v. Commissioner[49] held that the bona fide sale exception for full and adequate

consideration applied where the legitimate and significant non-tax reasons for creating the partnership were (1) the joint management of family assets and family cohesiveness was achieved and (2) the pooling of assets was a vehicle to take advantage of lower investment management fees and promote additional investment opportunities. Importantly, contrary to the IRS position that lifetime gifting can never be a significant non-tax reason, the Mirowski court found that facilitating lifetime gifting was a significant non-tax reason to form and fund the entity. It should be noted, however, that, in each of these case, the courts found that contemporaneous, factual evidence showed that the non-tax reason was a significant factor that motivated the creation of the partnership.

Individuals must be careful to structure and maintain the FLP/FLLC to avoid the application of Sections 2036(a)(1) and (a)(2), based upon the tests discussed above. Moreover, extreme care must be taken when forming and maintaining the FLP/FLLC to potentially avoid the application of Section 2036 altogether by satisfying the bona fide sale exception. For example, the non-tax reasons for establishing the entity should be documented contemporaneously in memoranda and correspondence related to the partnership's formation, as well as in the partnership/operating agreement, and should be implemented. The partners/members of the FLP/FLLC should conduct regular meetings of the partners, of which minutes should be maintained, as well as meetings with their investment advisers. In that regard, actual investments should be made through the entity and the composition and the management of the assets should change after the initial contribution of the assets to the entity by the partners/members. Having the FLP/FLLC engage in an active business may be one of the best ways to satisfy the bona fide sale exception. For example, the FLP in Kimbell was unique in that it held working interests in oil and gas properties, which required active management. Similarly, the FLP in Murphy consisted of interests in timber and farmland, a family business that the decedent's youngest son actively managed. Finally, similar to the discussion with respect to avoiding inclusion under Section 2036(a)(1), the bona fide sale exception may also gain credibility when the partner/member retains sufficient assets outside of the FLP/FLLC structure for his or her personal expenses, does not commingle personal and company assets and adheres to the formalities of the formation and maintenance of the FLP/FLLC.

Based upon the foregoing, if structured and operated properly, the FLP/FLLC technique may continue to provide an efficient means of transferring wealth to younger generations.

Other FLP/FLLC Planning Considerations For Private Equity Fund Managers

It should be noted that the cases discussed herein are estate tax cases and the issues raised therein are estate tax inclusion issues. Therefore, they are of primary concern for a client who dies holding an economic interest, or a position of control, in an FLP/FLLC.[50] Many private equity fund managers who use the FLP/FLLC structure may feel comfortable relinquishing control and economic interest in the family entity at a later point in time when the FLP/FLLC no longer holds an interest in a private equity fund or other closely held business assets. Therefore, at death, these clients may not hold an economic interest or position of control and will avoid the issues raised by these cases. The FLP/FLLC will have still been a very effective estate planning technique during life because of the discounts permitted in valuing the interests for gift tax purposes.

For the older client or those concerned about mortality risk, it may be appropriate to consider options that involve shifts in control and economic interest in the FLP/FLLC to others (by gift or sale).

For the private equity fund manager who is unable or unwilling to relinquish complete control of the FLP/FLLC, there are other options. It may be possible to appoint a co-general partner or manager and then assign only to that other individual particular areas of control which might otherwise trigger an IRS argument for estate tax inclusion, such as the right to determine distributions and the liquidation of the partnership. This technique is commonly used in trust situations to protect a grantor of a trust who is one of the trustees from holding powers which may result in estate tax inclusion. In situations where a trust with an independent trustee or an unrelated third party holds a significant portion of the FLP/FLLC interest, there is an argument that the presence of this independent trustee will force the general partner or manager to adhere to the fiduciary duty rules that the courts felt were illusory and of no substance in Kimbell (at the District Court level) and Strangi. In addition, the discretion of the independent trustee as to distributions from the trust is a buffer between the partnership distributions and further distributions to the trust beneficiaries and so counters the argument that the FLP/FLLC general partner/manager retains control of the economic benefits of the assets of the FLP/FLLC. Moreover, the terms of the operating agreement of the FLP/FLLC can be revised to clearly require adherence to fiduciary and ascertainable standards by the private equity fund manager as general partner or manager. Furthermore, the FLP/FLLC interest can be transferred to an irrevocable trust which has an independent trustee and the individual can retain the right to fire the independent trustee and appoint a replacement independent trustee.[51] While none of these techniques offer the surety gained by a private equity fund manager of simply giving up control, they may lead to a significantly better result on audit.

For the client who does not care about retaining control, but does wish to retain an economic interest in his or her FLP/FLLC, it may be possible to create a class of economic interest in the FLP/FLLC which holds no voting or other material rights. Structuring a FLP/FLLC in this fashion may make it more difficult for the IRS to argue for estate tax inclusion of the underlying assets of the FLP/FLLC because the client has retained no ability whatsoever to control these interests.

As always, to avoid successful challenges by the IRS based on improper partnership administration, attention must be given to the operation of the FLP/FLLC as a separate entity and not simply an extension of an individual partner's own bank and investment accounts. In addition to the establishment and maintenance of separate bank accounts and accounting records, filing tax returns and issuing K-1s to the limited partners or members of the FLP/FLLC is essential.

As mentioned above, the FLP/FLLCs that are best suited to withstand IRS scrutiny are those that have been established to serve a substantial business or other non-tax purpose.

Business and non-tax purposes can include asset protection, creating a joint investment vehicle for the partners of the FLP/FLLC, and permitting centralized and active management of "working assets" (e.g., managed real estate) that may be owned by the FLP/FLLC.

There are additional provisions that could be included in the partnership or LLC agreement which may help to prevent adverse tax consequences for an individual who contributes assets to an FLP/FLLC. For example, the partnership or limited liability agreement should require the general partner or manager to be held to the fiduciary duty of a general partner under applicable state law. It is also recommended that decisions as to the timing and amount of distributions from the partnership be governed by a standard (e.g., amounts will be distributed which are not required for expenses and reasonable reserves) rather than left to the uncontrolled discretion of the general partner or manager. All of these recommendations continue to be important in the establishment and administration of any FLP/FLLC.

Finally, the issues raised in the recent court cases may be distinguishable to FLP/FLLCs formed by a pooling of interests of individuals or entities for investment purposes where no subsequent gifts occur. Therefore, the use of the FLP/FLLC remains an important option when an extended family (or trusts) wishes to pool their interests within an FLP/FLLC entity so as to qualify for accredited investor or qualified purchaser status required to make certain investments.

It is important to maintain a balanced view of FLP/FLLC planning and how the objectives of the private equity fund manager can be accomplished while minimizing the risks raised by these cases. The most cautious response would be only to form FLP/FLLC entities where there is a third party in control as general partner or manager. In those instances where a partnership or limited liability company already exists in which the principal contributor is the general partner or manager, consideration should be given to replacing him or her. There may be other options for those clients who are unable to accept such a solution. One must also keep in mind that the recent court decisions are very fact specific.

Voting Control And Estate Tax Inclusion Issues

Another potential area of concern for the private equity fund manager who wishes to serve as the general partner or manager of the FLP/FLLC arises under IRC § 2036(b). That section states that a decedent's retention of the right to vote (directly or indirectly) shares of stock in a controlled corporation is considered a retention of the enjoyment of transferred property, resulting in estate tax inclusion. A controlled corporation for these purposes is one in which the decedent owns at any time after transfer and during the three-year period ending on the date of the decedent's death, or had the right to vote, stock possessing at least 20% of the total combined voting power of all classes of stock.

If a private equity fund manager has voting control of the general partner (meaning he or she possesses at least 20% of the total combined voting power) and retains control of the voting rights of an interest in the general partner transferred to the FLP/FLLC, estate tax inclusion of the transferred interest due to the application of IRC § 2036(b) is a risk. The same issue may arise if the fund's general partnership agreement provides that a partner who transfers an interest to an affiliated entity retains the voting rights associated with such interest. The IRS has applied IRC § 2036(b) in a case where a transferor in his capacity as general partner of a partnership retained voting rights of stock of a controlled corporation.[52] It is not clear if the IRS would attempt to extend this provision of the IRC to a situation involving retained voting rights of a partnership interest rather than of corporate stock, or, if it did, whether a court would uphold it. Furthermore, it is questionable if the voting rights attached to an interest in the general partner that would be transferred or retained (typically those of a limited partner or non-managing member) are the type of rights to which IRC § 2036(b) applies. The proposed regulations at Section 20.2036-2(a) indicate that voting rights in only extraordinary matters, such as a merger or liquidation, are not subject to the provisions if held in a fiduciary capacity, as would arguably be the case if held in one's capacity as general partner or manager of the FLP/FLLC. In many instances, the voting rights associated with a limited partnership or non-managing membership interest in a limited partnership are limited to such a degree that they would fall within this exception.

This issue also must be considered if the private equity fund manager contributes to an FLP/FLLC, of which he or she is the general partner or manager, any stock of a portfolio company. The 2036(b) voting control analysis is determined by aggregation of the different forms of ownership and attribution rules apply. Therefore, this analysis should take into account both the percentage control owned by the private equity fund manager individually, and also that amount which will be attributed to him or her as a partner of the general partner of the fund.

The Possibility Of Avoiding Transfer Issues Altogether By Establishing A Trust Or FLP/FLLC Prior To The Formation Of The Private Equity Fund

Many of the estate and gift tax issues discussed might be avoided if planning is done in advance, so that the investment or purchase in a private equity fund can be made by an estate planning entity itself and not involve a transfer by the private equity fund manager. Such planning could involve the establishment of a FLP/FLLC or trust prior to the fund closing. Such entity could be an initial limited partner or member of the general partner of the fund or private equity investor.[53] The private equity fund manager would hold no partnership, membership or other economic interest in the estate planning entity, nor should he or she simultaneously contribute assets to it to be used for that investment. In such a case, arguably there is no transfer of an interest made to the family entity by the private equity fund manager, and so the estate tax inclusion issues raised in the recent court cases, which are triggered by the retention of powers or rights in transferred assets, should not apply. One must make sure the estate planning entity has sufficient independent assets of its own so that it can meet any subscription account contribution required by the partners of the limited partnership at the closing. The private equity fund manager can provide the funds required of the FLP/FLLC or trust by loan to that entity; however, if such a loan is made simultaneously with or just prior to the

closing, this can strain the argument that no gift or contribution to the family entity has occurred.

Certainly the position that no transfer occurs is not free from doubt; query whether there is a transfer attributable to the opportunity provided by the private equity fund manager to the FLP/FLLC to become a limited partner of the general partner of the fund or an investor in another private equity fund.

Finally, the gift tax issues arising under IRC § 2701 and the use of a vertical slice exception may remain applicable to the above described situation even if no transfer occurs. That is because the IRC § 2701 provisions apply when simultaneous investments are made by senior and junior family members in a partnership.

Conclusion

The private equity fund manager has the opportunity to transfer wealth to younger generations while minimizing estate and gift taxes. The techniques discussed herein, namely family limited partnerships and certain split interest techniques, such as grantor retained annuity trusts, are particularly useful in the private equity setting. These techniques maximize use of one's available gift tax exemption and take advantage of low federal statutory interest rates and the potential for significant growth in the gifted assets. Any program to transfer wealth, however, must be analyzed in the context of the current estate and gift tax sections of the IRC, the Treasury Regulations, other IRS rulings and current case law to determine whether the desired estate planning results can be achieved without triggering any unintended adverse tax consequences.

Ivan Taback is a partner in Proskauer Rose's Personal Planning Department and a member of the firm's Private Investment Funds Group. Ivan concentrates his legal practice in the fields of federal estate, gift and generation-skipping taxes, representing owners of closely-held businesses, principals of private equity/venture capital/hedge funds, executives and families of significant wealth, and establishing and administering private foundations and public charities. His practice extends to matters involving all aspects of sophisticated planning and wealth preservation for families and individuals. Ivan has extensive experience in the preparation and administration of wills and trusts, and the formation and reorganization of closely held corporations, partnerships and limited liability companies. Ivan has counseled clients in connection with estate planning for private equity and hedge fund managers and is a well-known author and lecturer on this topic.

Jay Waxenberg has been with the Proskauer Rose Personal Planning Department since 1984 and he is currently Chair of the Department. The focus of his practice is estate and tax planning and estate and trust administration. He primarily represents individuals and their estates and is involved in the full range of his clients' economic and personal concerns including closely held businesses, commercial and residential real estate holdings, artistic collections and philanthropy. In particular, Jay has helped his clients structure new ventures; restructure existing ventures with an emphasis on shifting appreciation potential to younger generations; and has guided the sale and liquidation of businesses.(1) The annual exclusion is adjusted each year for inflation pursuant to § 2503(b)(2) of the Internal Revenue Code of 1986, as amended (hereinafter IRC).

Footnotes

(2) 1998-18 IRB 7 (1998).
(3) Id.
(4) Id.
(5) The offset arrangement is intended to potentially reduce the overall income tax liability of the partners of the general partner.
(6) IRC § 2503(b) requires that in order for a gift to qualify for the annual exclusion, it must be a gift of a "present interest."
(7) 335 F.3d 664 (7th Cir. 2003), aff'g, 118 T.C. 279 (2002).
(8) Treas. Reg. Sec. 301.6501(c)-1(f)(1). See also IRC § 2001(f); Treas. Reg. Sec. 20.2001-1(b), (c).
(9) Treas. Reg. Sec. 301.6501(c)-1(f)(2).
(10) Id.
(11) Treas. Reg. Sec. 301.6501(c)-1(f)(3).
(12) See, e.g., Commissioner v. Procter, 142 F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944); McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006); Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009); Estate of Petter v. Commissioner, T.C. Memo 2009-280; Ward v. Commissioner, 87 T.C. 78 (1986); Rev. Rul. 86-41, 1986-1 C.B. 300; FSA 200122011; TAM 200245053; PLR 200337012.
(13) GRATs are governed by IRC § 2702 and Treas. Reg. Sec. 25.2702-2 and Sec. 25.2702-3.
(14) The use of a zeroed-out GRAT was sanctioned under Walton v. Commissioner, 115 T.C. 589 (2000), acq. on desc., 2003-44 I.R.B. 964 (Nov. 3, 2003).
(15) Rev. Rul. 2004-64.
(16) Final Treasury Regulations were recently issued to provide guidance on the valuation of the inclusion of the corpus remaining in a grantor's estate for GRATs (as well as other types of trusts). The purpose of the regulations is to value the corpus remaining in the estate of the grantor as a potentially reduced amount based on the annuity value payable to the grantor. The formula for determining the inclusion amount of a GRAT is the annual annuity (adjusted by any monthly, quarterly or semi-annual factor) divided by the Section 7520 rate on the date of death (or alternative valuation date). Treas. Reg. Sec. 20.2036-1(c).
(17) A complete explanation of the GST tax is beyond the scope of this article. In general, the tax is imposed on direct transfers, or transfers from trusts, to skip persons (those persons more than one generation younger than the transferor or donor to the trust). The tax is imposed at a flat rate equal to the then highest estate tax rates (in 2009 this rate was 45%). Each individual is entitled to a generation-skipping transfer tax exemption which can be applied to lifetime or death transfers (in 2009 this amount was $3,500,000). Like the estate tax, the GST tax does not apply in 2010. In 2011, the EGTRRA sunset will result in a GST tax exemption of $1,000,000. For those individuals who wish to transfer assets for the benefit of grandchildren and younger generations, alternative planning techniques exist such as the installment sale to an intentionally defective grantor trust.
(18) Treas. Reg. Sec. 25.2702-3(d)(6).
(19) See, e.g., IRC § 2036(b).
(20) Treas. Reg. Sec. 1.170A-6(c) and Reg. Sec. 25.2522(c)-3(c)(2)(vi) outline the requirements for charitable lead trusts.
(21) IRC § 7872(b); Treas. Reg. Sec. 1.7872-7.
(22) It is strongly recommended that the purchasing trust have assets of its own valued at least at 10% of the value of the assets being purchased.
(23) Treas. Reg. Sec. 25.2702-5.
(24) See Estate of Thompson v. Commissioner, 382 F.3d 367 (3rd Cir. 2004), aff'd, T.C. Memo 2002-246; Estate of Harper v. Commissioner, T.C. Memo 2002-121; Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Schauerhamer v. Commissioner, T.C. Memo 1997-242.
(25) T.C. Memo 2003-145, aff'd, No. 03-60992, 5th Cir. (July 15, 2005).
(26) 244 F.Supp. 2d 700 (N.D. Tx. 2003), vacated and remanded, 371 F.3d 257 (5th Cir. 2004).
(27) See supra note 28.
(28) It should be noted that both Kimbell and Strangi involve controversial extensions by the courts of estate tax legal concepts. In addition, both cases have poor fact patterns of the type found in the prior partnership cases and thus arguably could be limited on this basis. However, the IRS's recent string of successes in challenging the use of FLP/FLLCs under Section 2036(a)(1) is a call for caution when using FLP/FLLCs as a planning option.
(29) See supra note 28.
(30) T.C. Memo 2004-39, aff'd, No. 04-1886, 1st Cir. (May 25, 2005).
(31) T.C. Memo 2004-46.
(32) T.C. Memo 2006-115.
(33) T.C. Memo 2006-34.
(34) T.C. Memo 2007-107.
(35) T.C. Memo 2007-169.
(36) T.C. Memo 2007-367.
(37) T.C. Memo 2009-66.
(38) T.C. Memo 2009-212.
(39) Similarly, in Rosen, the decedent used partnership funds for her living expenses after the transfer of assets to the partnership rendered the decedent unable to satisfy her financial needs.
(40) Though the Tax Court, in Mirowski v. Commissioner (T.C. Memo 2008-74), suggested that the payment of estate taxes from a partnership's assets does not necessarily negate the applicability of the bona fide sale exception to prevent inclusion under section 2036, cases that have come afterward, such as Jorgensen, have followed the holding in Erickson, that such payments of estate taxes reflect an implied agreement of retained enjoyment of partnership assets triggering section 2036.
(40) T.C. Memo 2003-309.
(42) Case No. 07-CV-1013 (W.D. Ark. October 2, 2009)
(43) 408 U.S. 125 (1972).
(44) 124 T.C. No. 8 (2005).
(45) T.C. Memo 2005-65.
(46) T.C. Memo 2005-102; T.C. Memo 2005-103.
(47) T.C. Memo 2005-126.
(48) Other legitimate, non-tax reasons for forming an FLP/FLLC that have been upheld by courts have included settling family hostilities (Stone), protecting family assets from divorce proceedings (Keller v. United States, Civil Action No. V-02-62 (S.D. Tex. August 20, 2009)) and centralizing management and preventing dissipation of family "legacy assets" (Murphy).
(49) T.C.Memo 2008-72.
(50) These cases also are relevant in connection with a donor who relinquishes an economic interest, or a position of control, in an FLP/FLLC within three years prior to his or her death. See IRC § 2035.
(51) This 'fire and hire' right will not result in inclusion of the trust assets in the grantor's estate so long as the permissible trustees are limited to persons who are not related or subordinate to the trust grantor within the meaning of IRC § 672(c). Rev. Rul. 95-58, 1995-2 C.B. 191, 1995-36 I.R.B. 16.
(52) See TAM 199938005.
(53) Accredited investor and qualified purchaser rules can provide hurdles for family planning entities and can prevent their participation as investors in certain types of private equity funds or companies.