



NORTHERN
TRUST

PUTTING IT ON & TAKING IT OFF: Managing Tax Basis Today For Tomorrow

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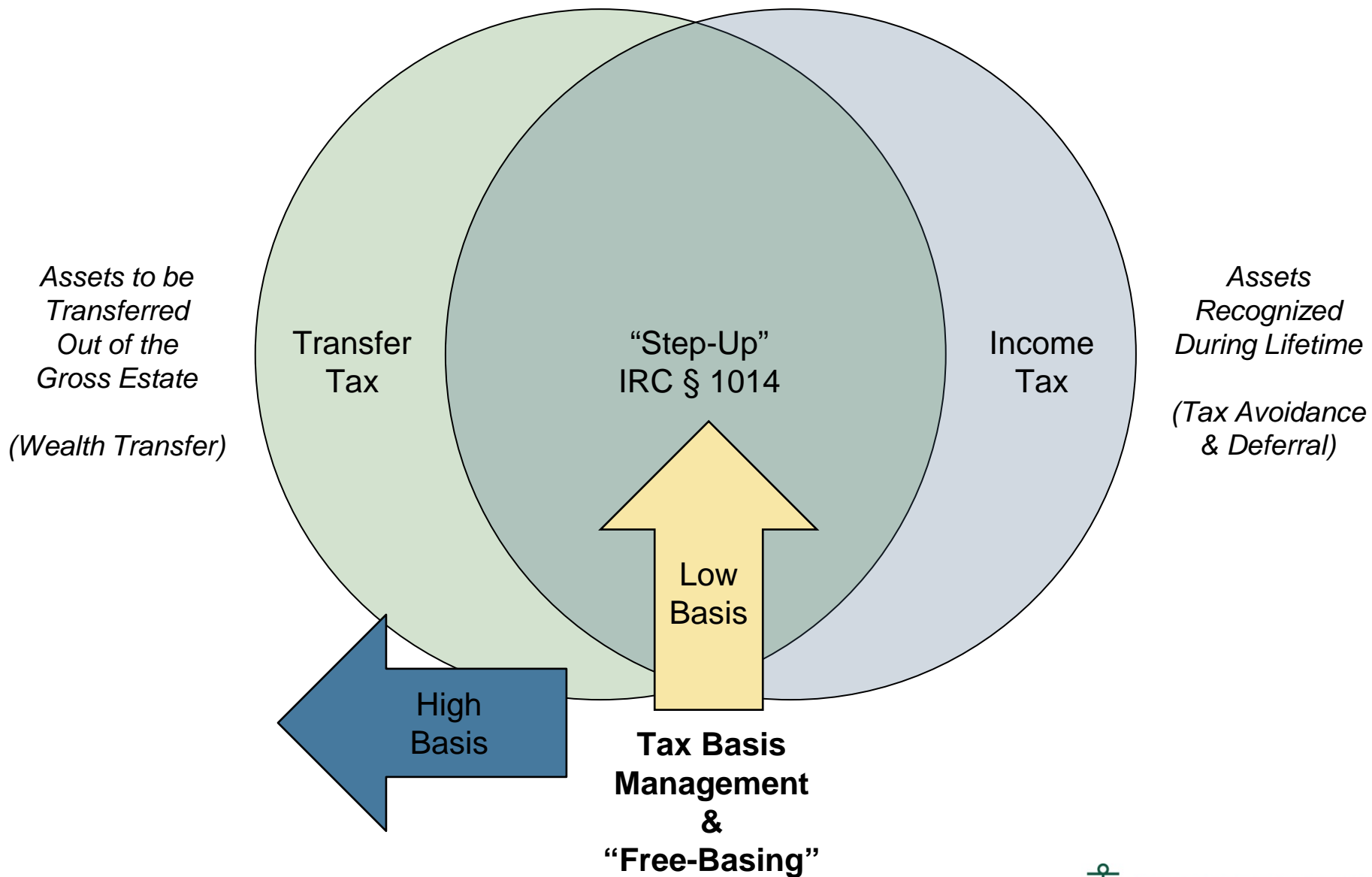
October 1, 2017



Tax Basis Management: Regardless of the Form of “Tax Reform”

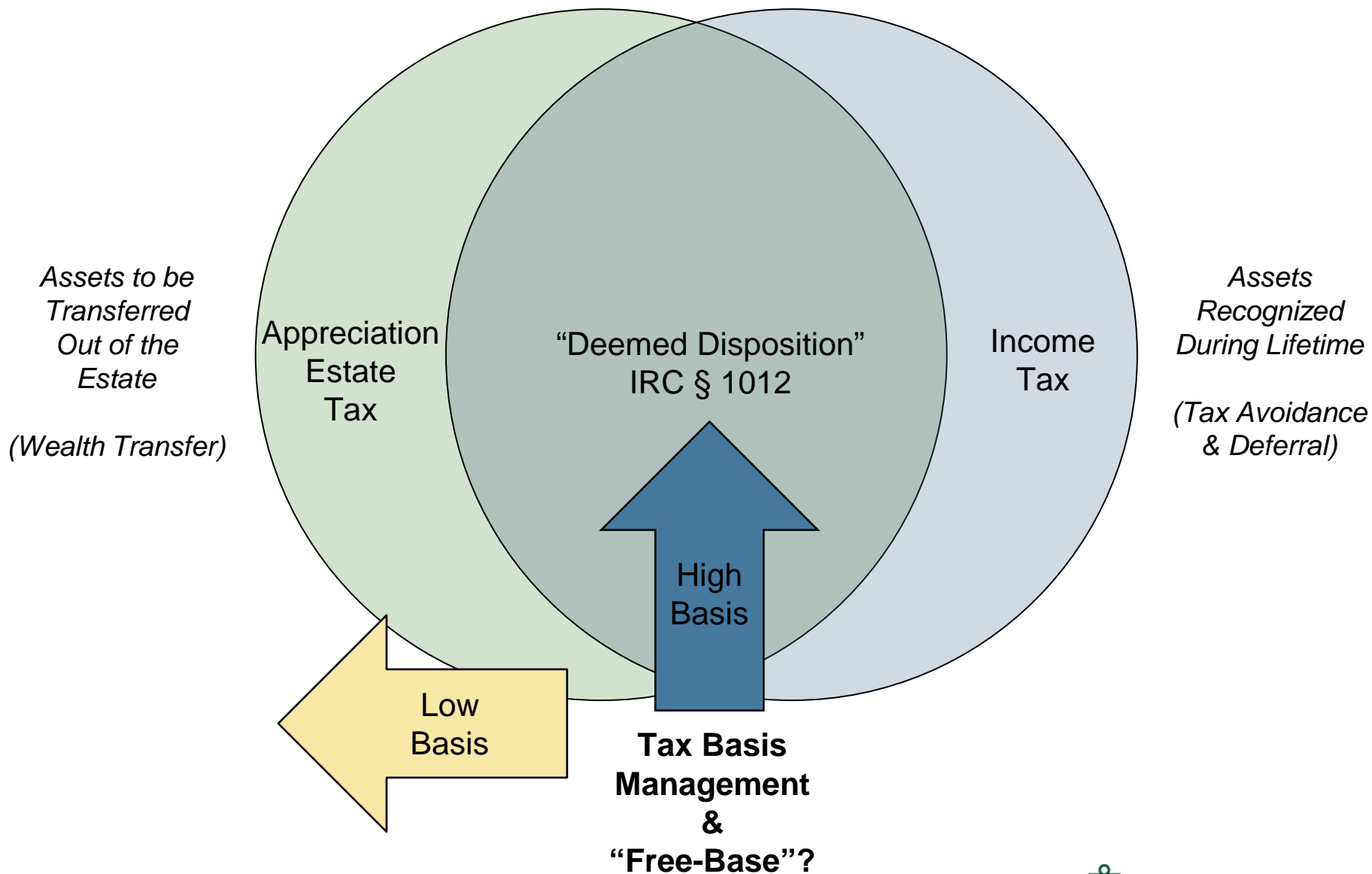


The Current Landscape: Venn Diagram



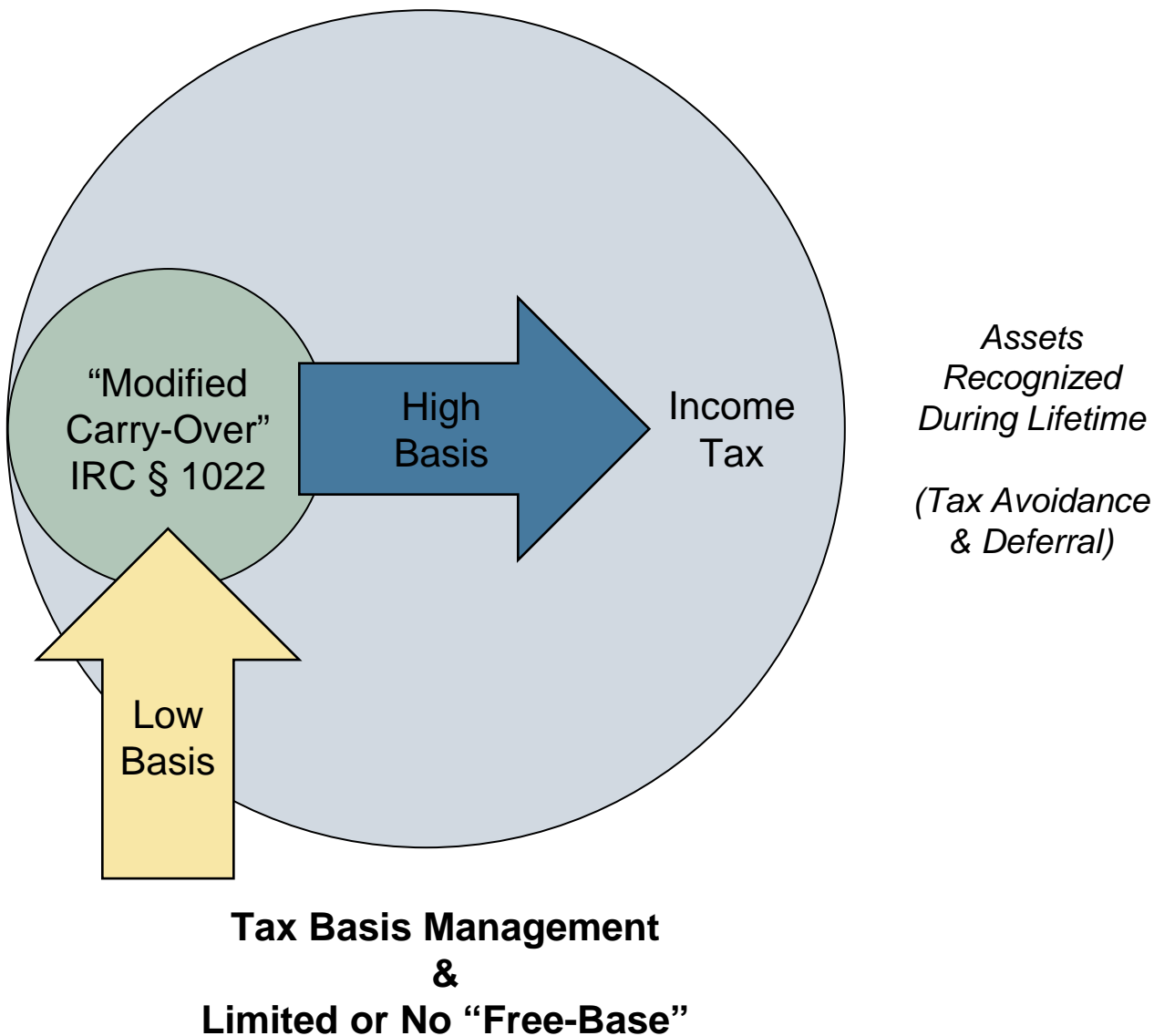


The Future Landscape?: O Canada!





The Future Landscape?: Repeal, Limited or No “Step-Up”





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

“Step-Up” Important



Asset Type

Creator-Owned Copyrights, Trademarks, Patents & Artwork

“Negative Basis” Commercial Real Property LPs

Oil & Gas Investments (Sold)

Artwork, Gold & Other “Collectibles”

Low Basis Stock

Roth IRA Assets

Oil & Gas Investments (Not Sold)

High Basis Stock

Qualified Small Business Stock (QSBS)

Fixed Income

Cash

Passive Foreign Investment Company (PFIC) Shares

Stock at a Loss

Variable Annuities

Traditional IRA & Qualified Plan Assets

Tax Characteristic

Ordinary Transforms to Long-Term

Recapture & >100% Long-Term

§ 1245 Recapture

28% Long-Term

20% Long-Term

Tax Free & No Surcharge

Cost Depletion vs. Percentage Depletion

Minimal Gain

§ 1202 Gain [50, 60, 75 or 100%] Exclusion

Typically Minimal Gain

Basis = Face Value

No “Step-Up”

Capital Loss Erased

Partially IRD

100% IRD

“Step-Up” Not Important

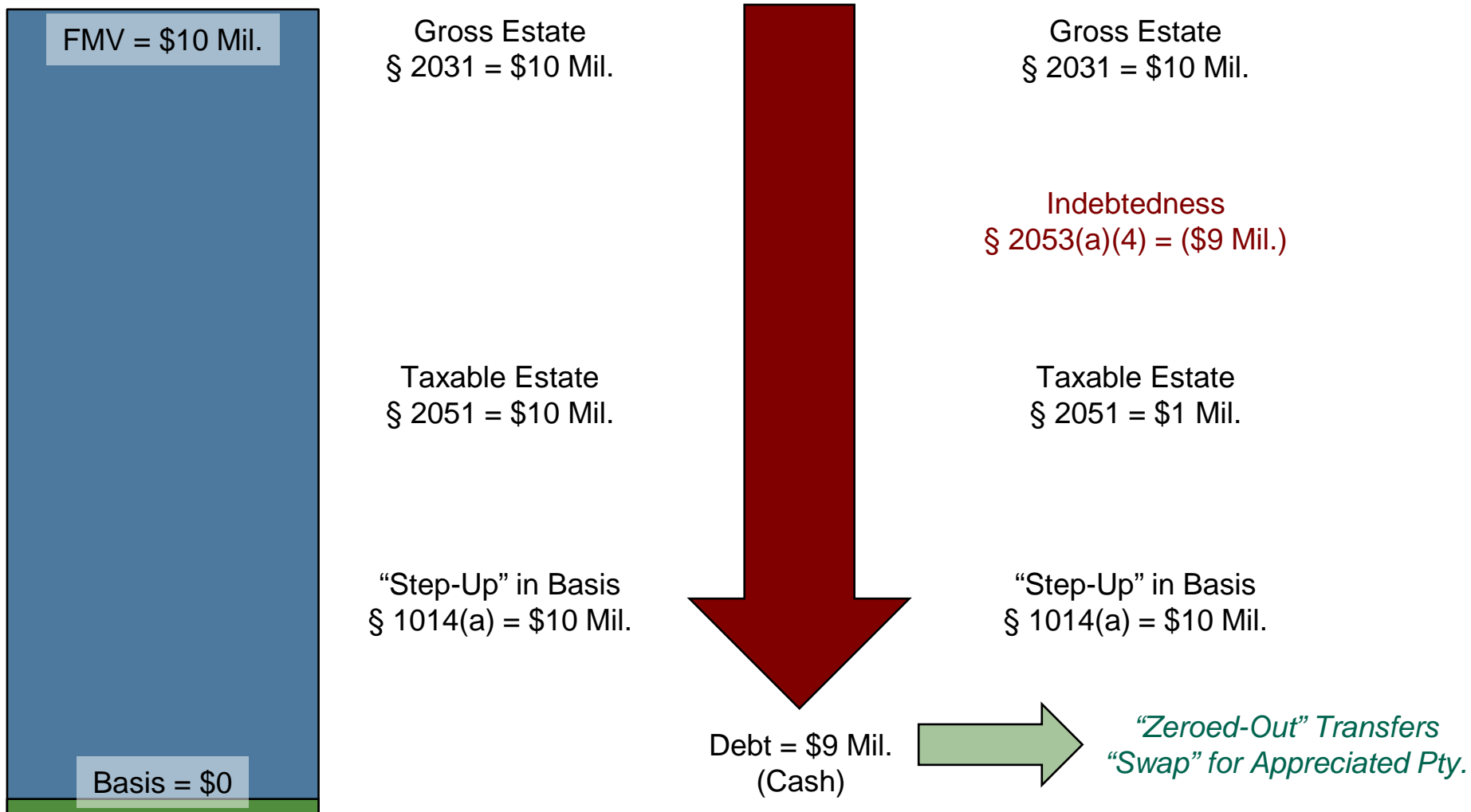




Using Debt to “Multiply” The “Step-Up” In Basis

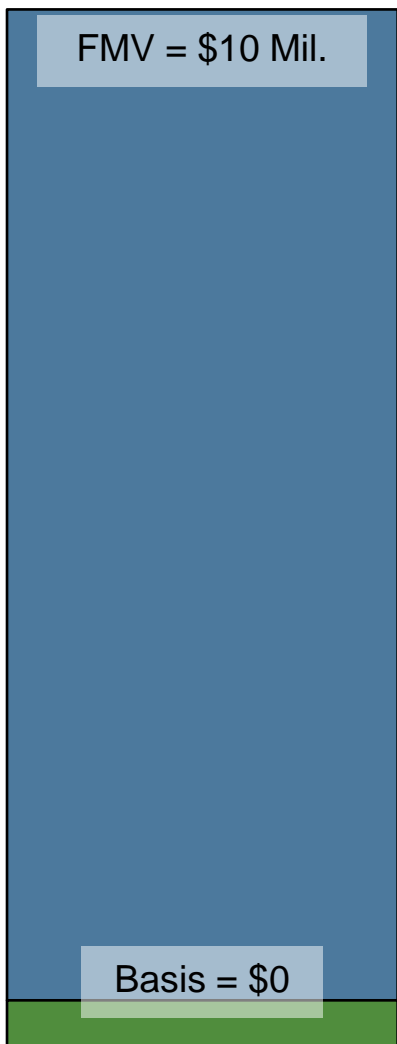


Maximizing the “Step-Up” & Minimizing Estate Tax: Debt





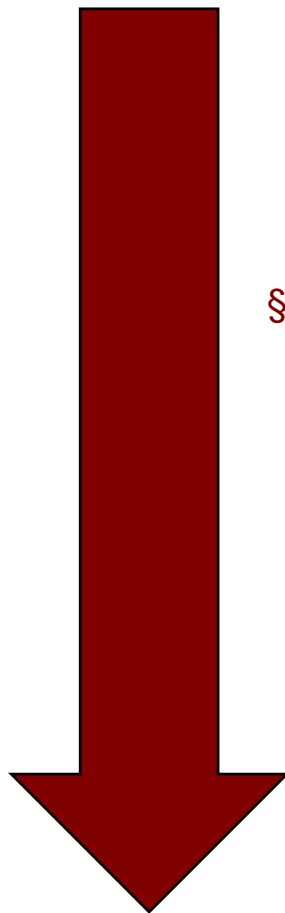
Debt with QTIP Trusts?



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.

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

Amount Includible
§ 2044 = 1 Mil.

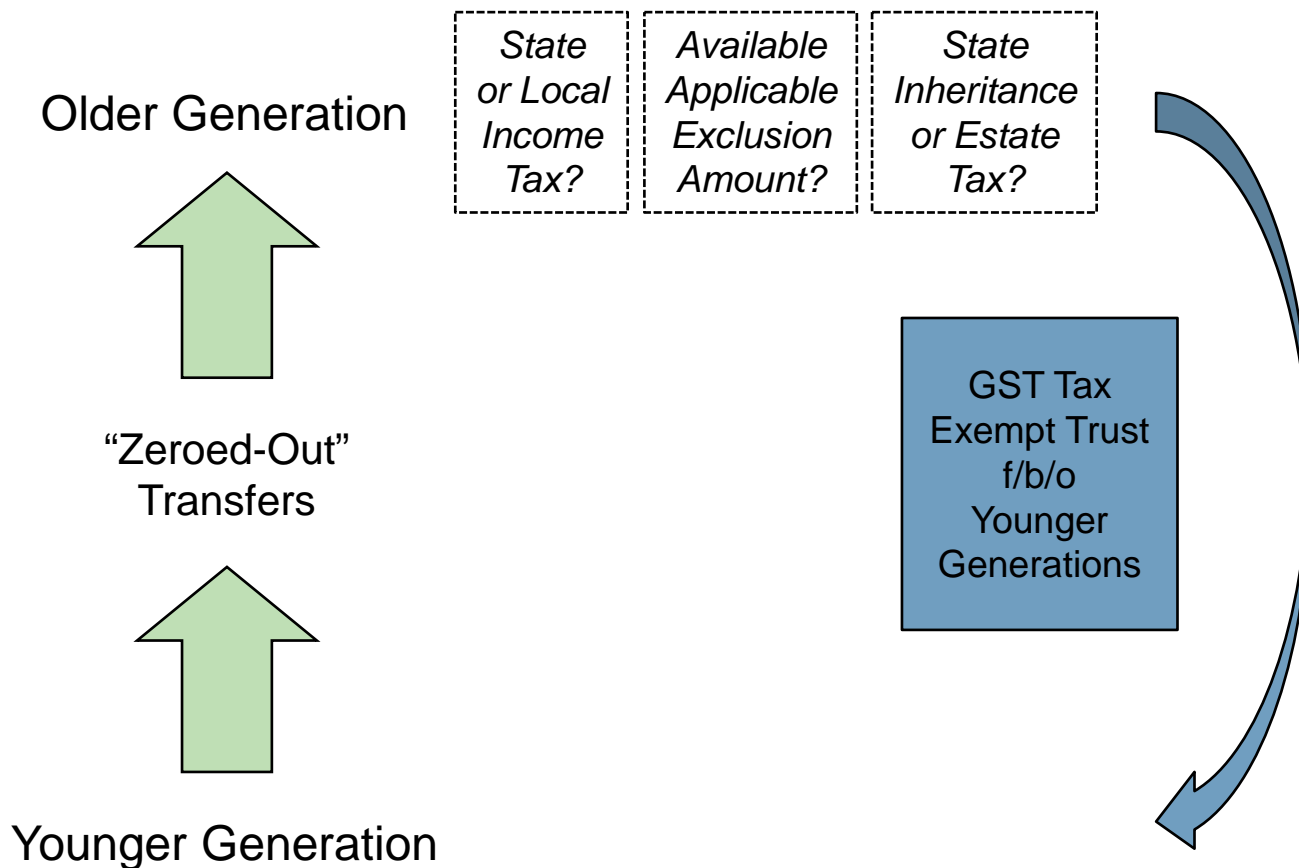
Taxable Estate
§ 2051 = \$1 Mil.



Powers of Appointment & “Reverse” Estate Planning



“Reverse” Estate Planning?





“Reverse” Estate Planning: UpSPAT? Accidentally Perfect?

Older Generation

*Testamentary
General Power of Appointment
(Lapse/Failure of Exercise)*

IDGT/APGT

Available
Applicable
Exclusion
Amount?

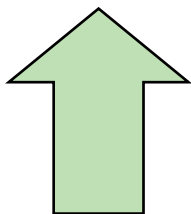
State
Inheritance
or Estate
Tax?

Income Tax
Considerations

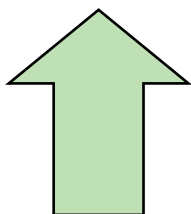
“Step-Up” in Basis
§ 1014(b)(9)

Grantor Trust
§ 1.671-2(e)(5)

GST Tax
Exempt Trust
f/b/o
Younger
Generations



“Zeroed-Out”
Transfers



Younger Generation



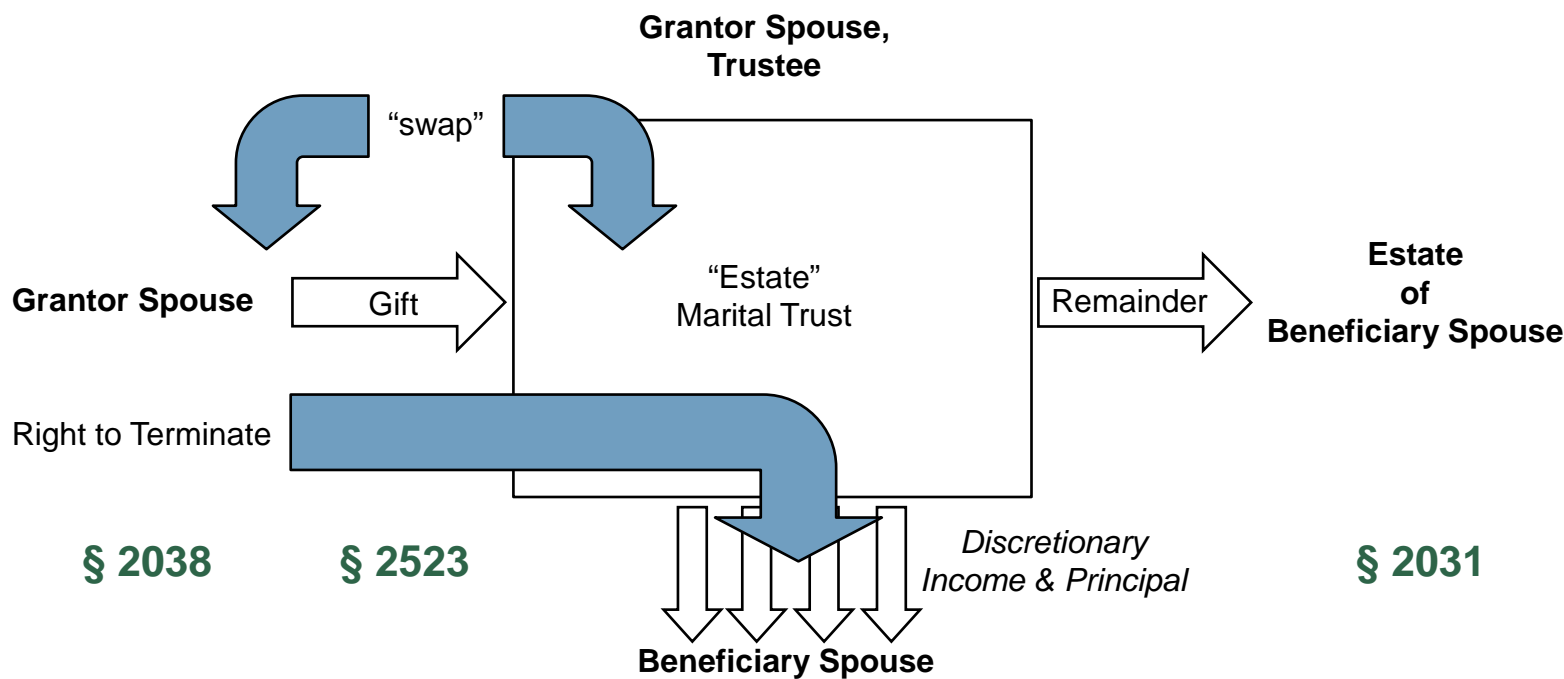


“Double Step-Up” In Basis



“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

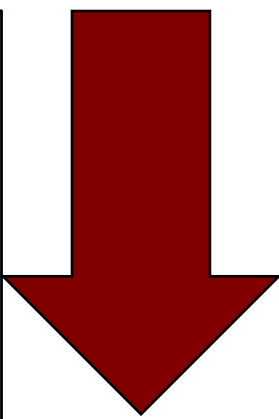
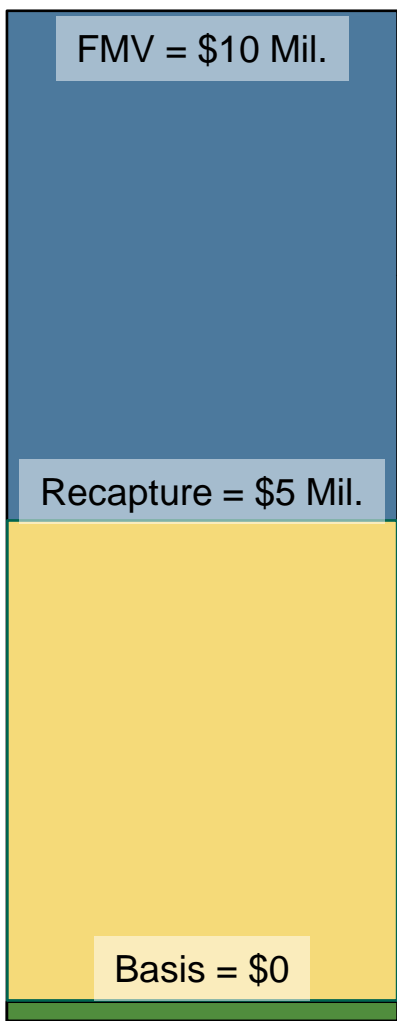




***Using A Contractive Derivative
To “Transfer” But Still Own
The Asset For The “Step-Up.”***



Sell The Appreciation Via Contract, Own The Asset



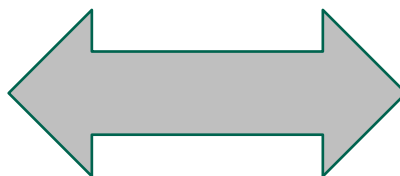
Debt = \$4 Mil.

9-YEAR CONTRACT

Grantor "Sells"/
Personal Obligation to Pay

Total Return =

FMV of Property
LESS Debt
PLUS Net Rental Income



9-YEAR PROMISSORY NOTE

\$6 Mil.
LESS Discount
"Personal Obligation Risk"

BUSINESS REASONS

- Real Property Tax
- Creditor Consent
- Real Estate Transfer Tax
- NIIT/Material Participation
- Expenses of Transfer

IDGT

ISSUES

- Valuation?
- Settled Before Date of Death?
- Estate Tax Deduction?
- Ordinary Income/Deduction?
- Satisfied with What Asset?

**Depreciated
Real Property**



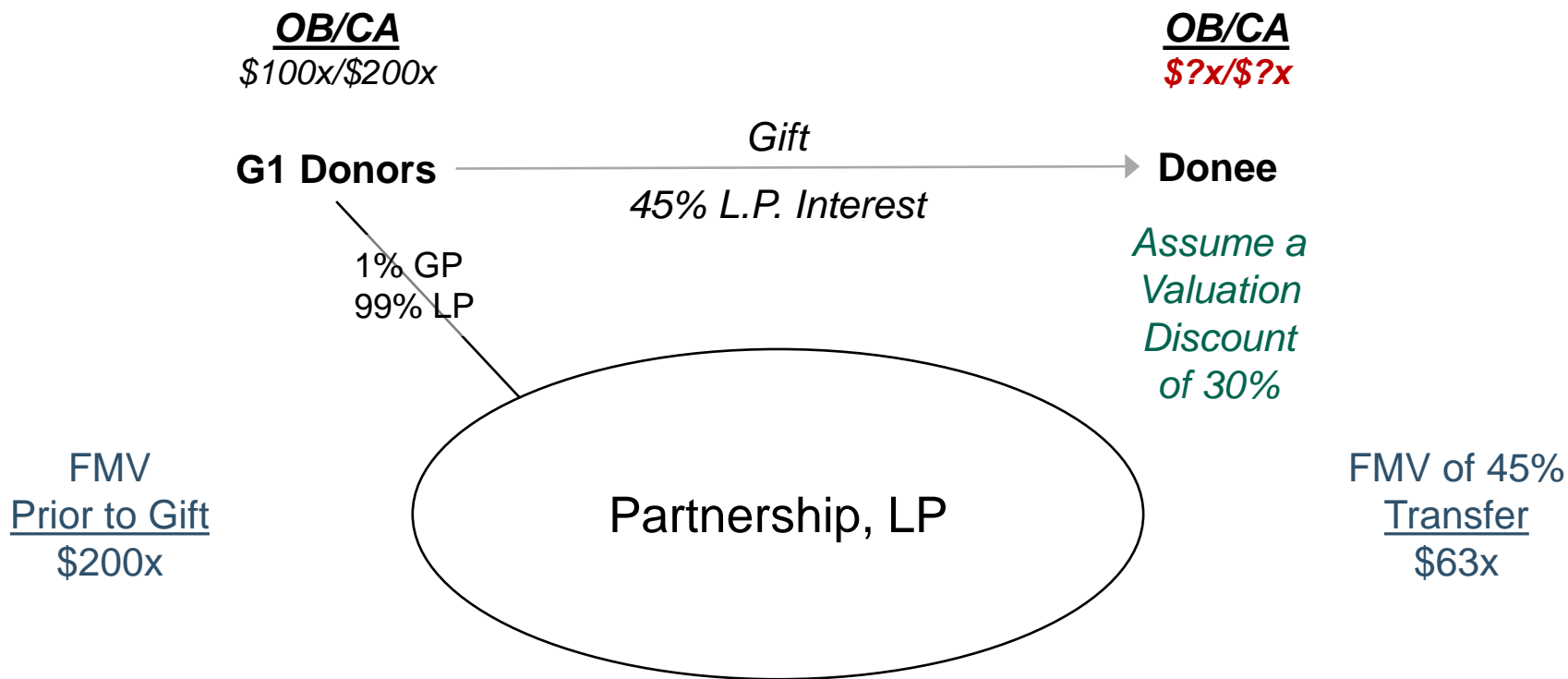
***Partnerships: The Most Powerful
Tax Basis Management Tool
in Today's (and Tomorrow's)
Planning Landscape***



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)(I). See Treas. Reg. § 1.704-1(b)(5), Ex. 13.

$$\begin{array}{rcccl}
 \text{Transferor's} & & & & \text{Transferee's} \\
 \text{Capital Account} & & \text{Percentage} & & \text{Capital Account} \\
 \underline{\$200x} & \times & \underline{\text{Transferred}} & = & \\
 & & 45\% & & \underline{\$90x}
 \end{array}$$

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.

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



Less Basis is Transferred

OB/CA
\$69.50x/\$110x

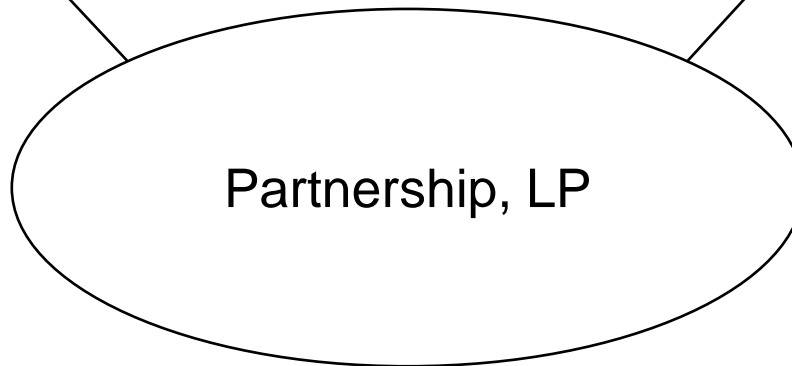
OB/CA
\$31.50x/\$90x

G1 Donors

Donee

1% GP
54% LP

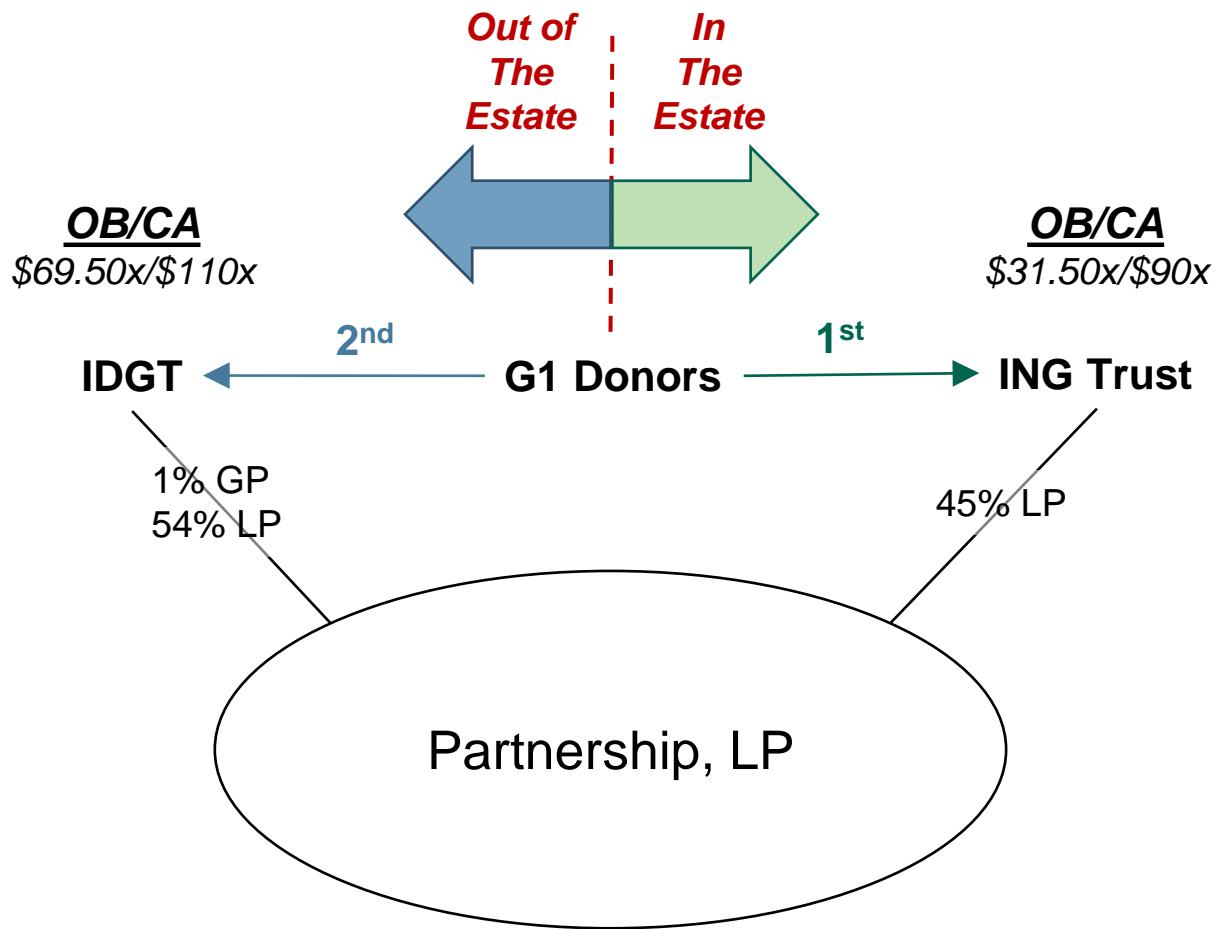
45% LP



Proposed Section 2704 Regulations
Change transferred tax basis result here?
Fair market value ≠ value under Section 2704



Incomplete Gift to Non-Grantor Trusts First?

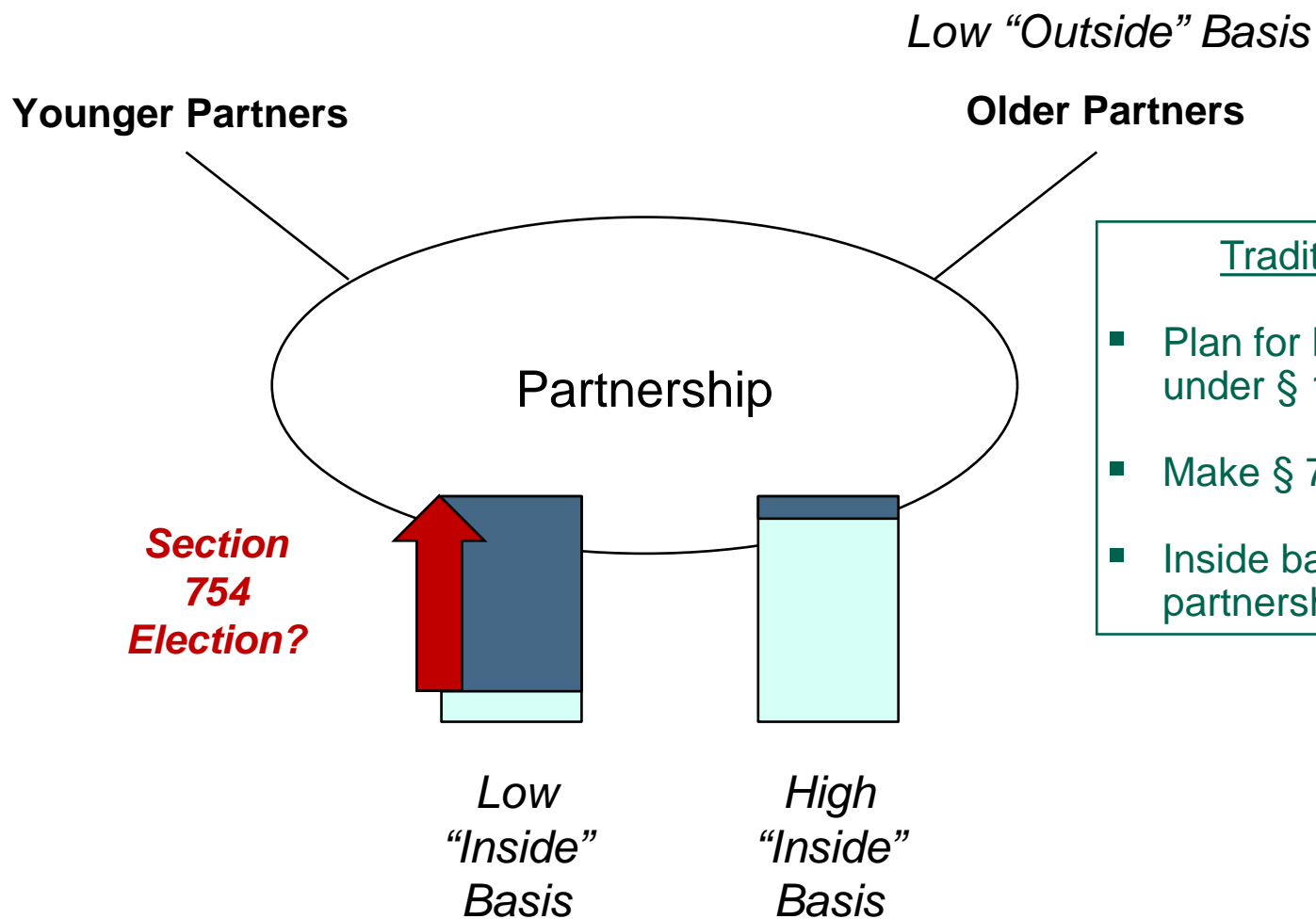




*Inside Basis Adjustments,
“Basis Stripping,” and
“Basis Shifting”*



Importance of Partnerships in Tax Basis Management

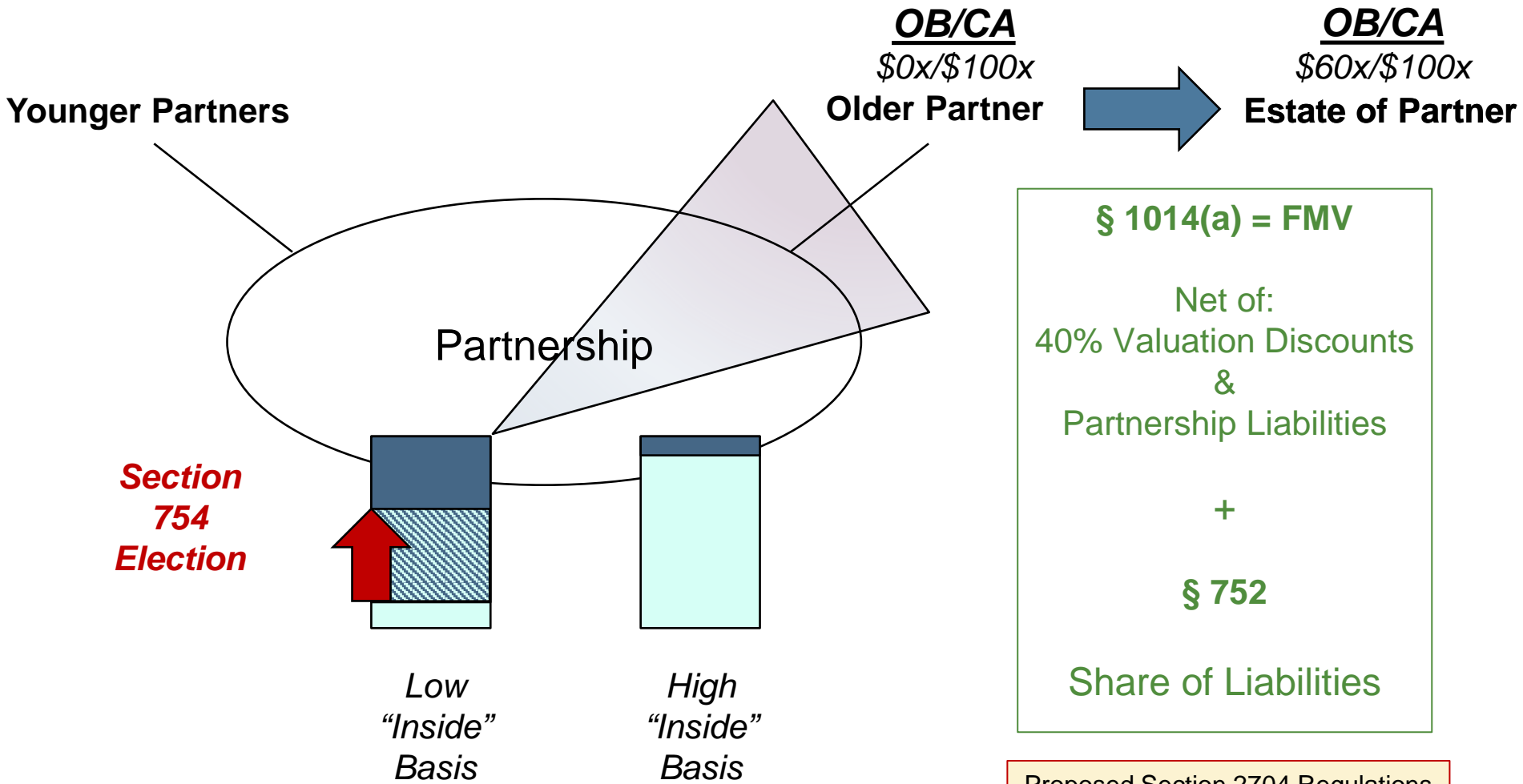


Traditional Advice:

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



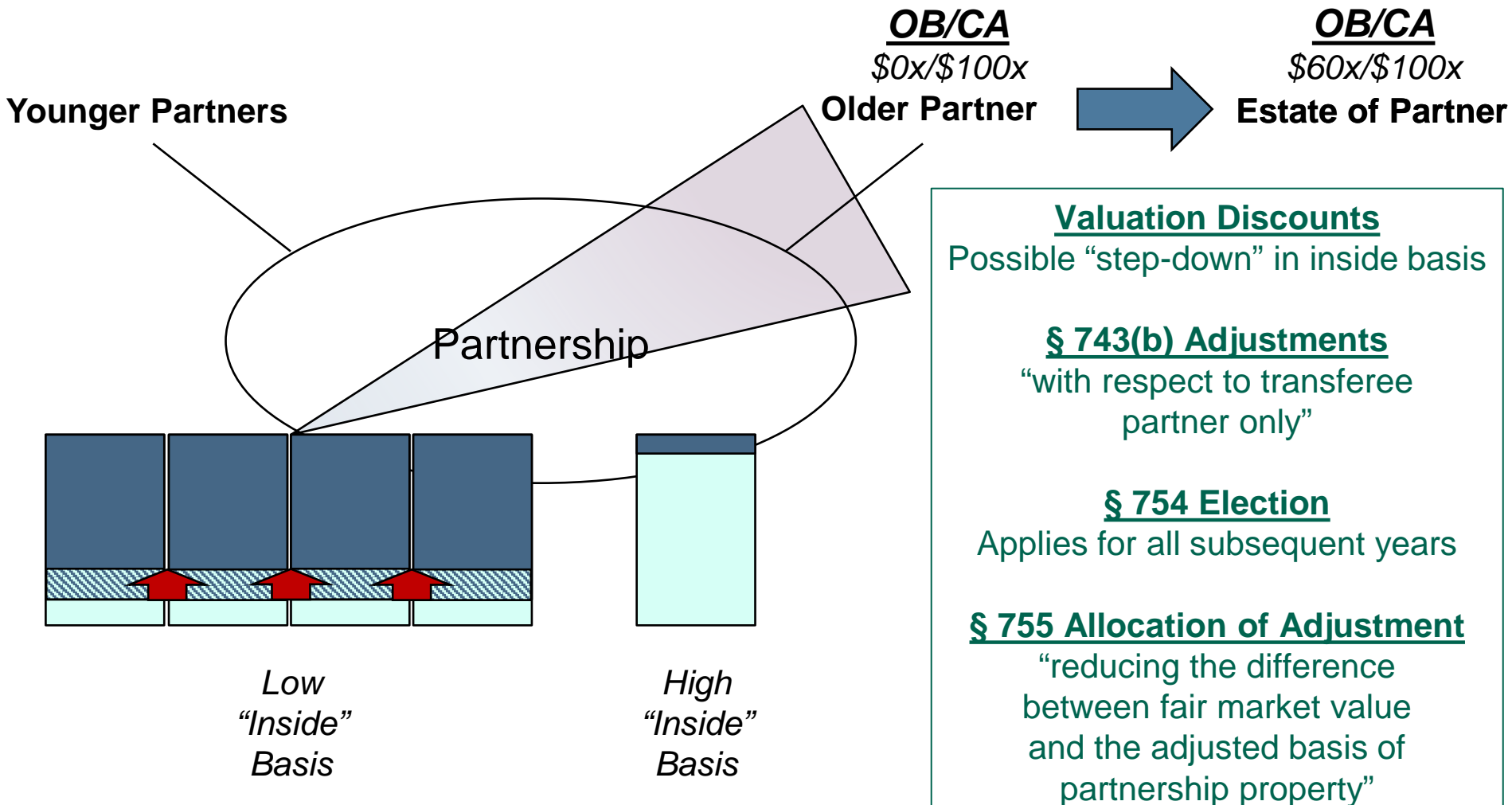
Limits of 754 Election and Basis Adjustment at Death (§ 743)



Proposed Section 2704 Regulations
No valuation discount now?

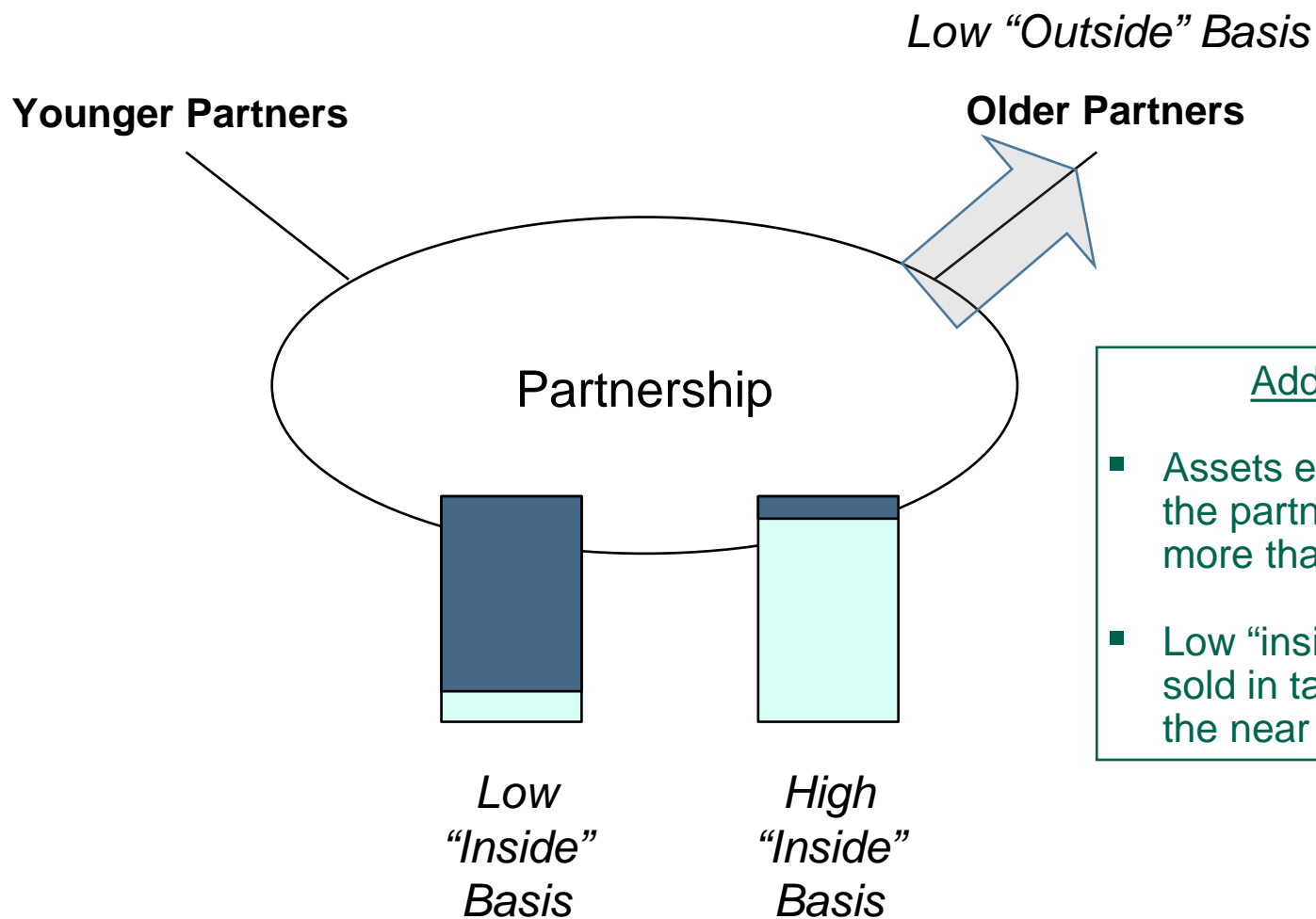


Other Limits of Inside Basis Adjustment under § 743





Importance of Partnerships in Tax Basis Management

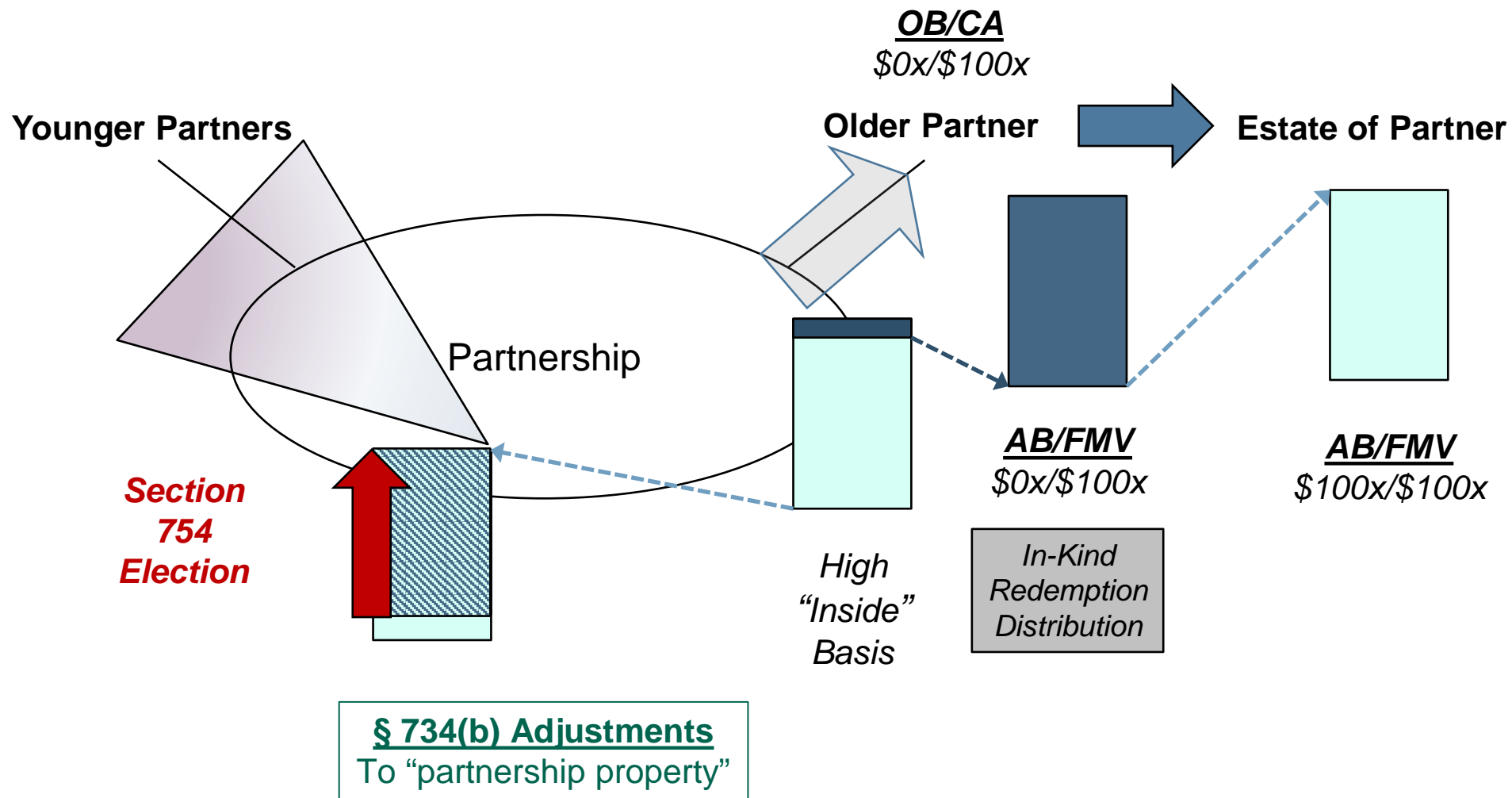


Additional Facts:

- 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.



Maximizing “Step-Up” and Moving Tax Basis (§ 734)





Inside Basis Adjustments: Current vs. Liquidating Distributions

Current Distributions

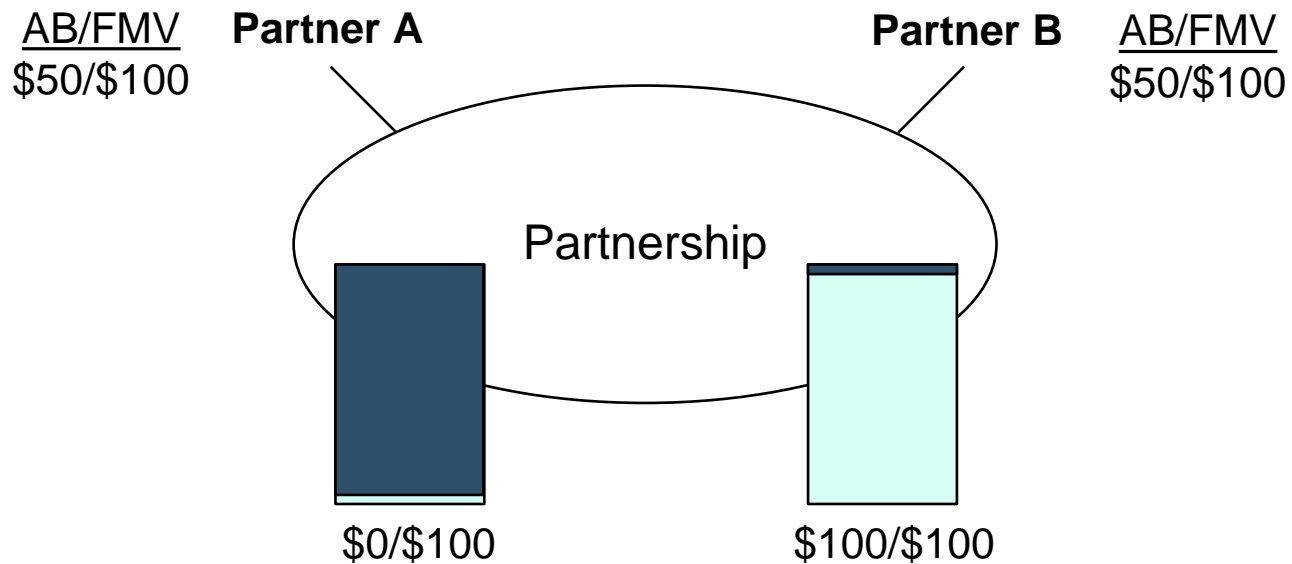
- Only gain (not loss) can be recognized by distributee.
- Basis of in-kind property distributed to a partner is the *lesser* of:
 - ◆ Inside basis of the property; and
 - ◆ Outside basis of distributee partner.
- When outside basis is less than inside basis, basis of property is reduced or lost to the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

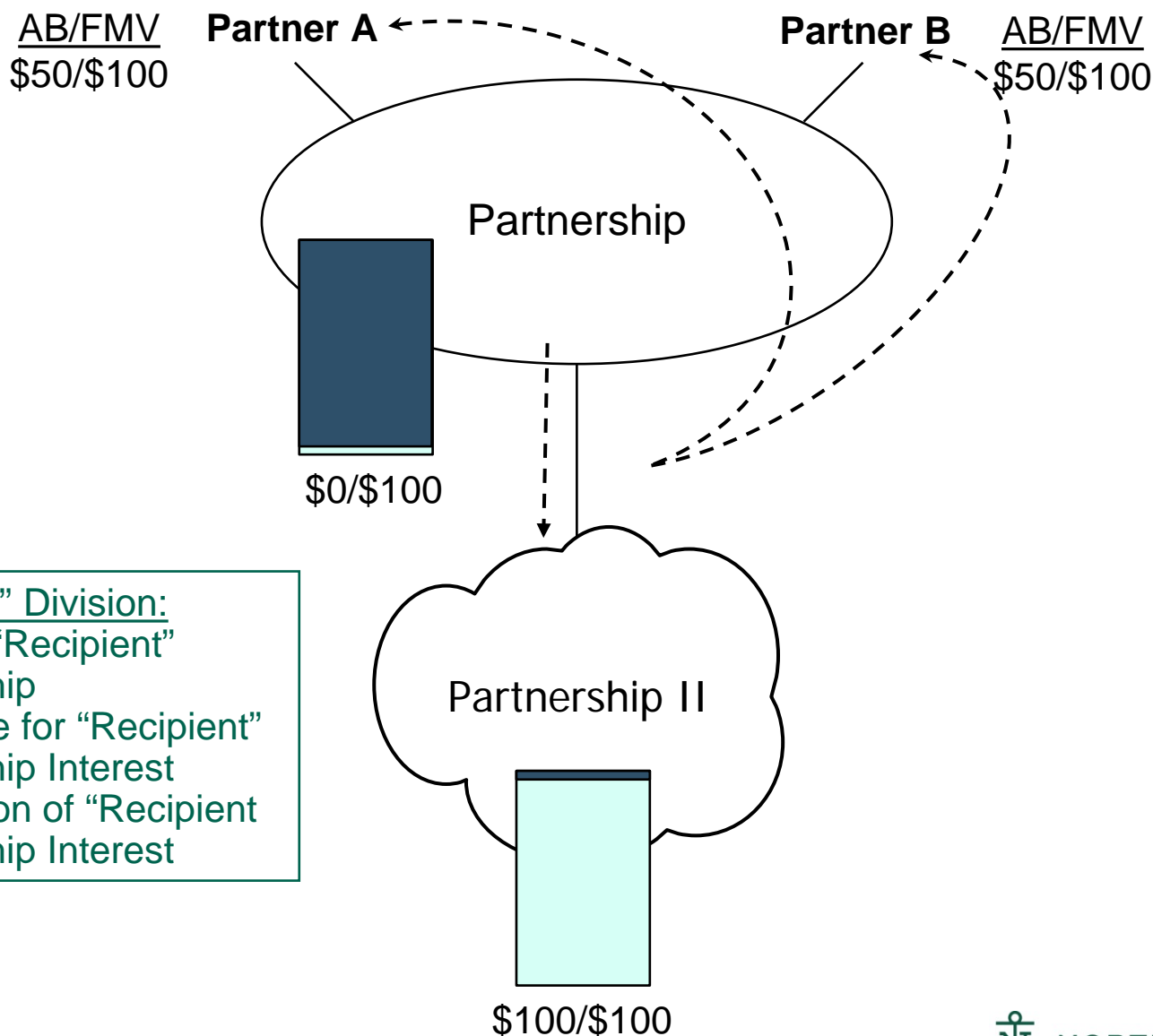


Unitary Basis Works Against Efficient Tax Basis Management





Partnership Division Can Solve Unitary Basis Problem

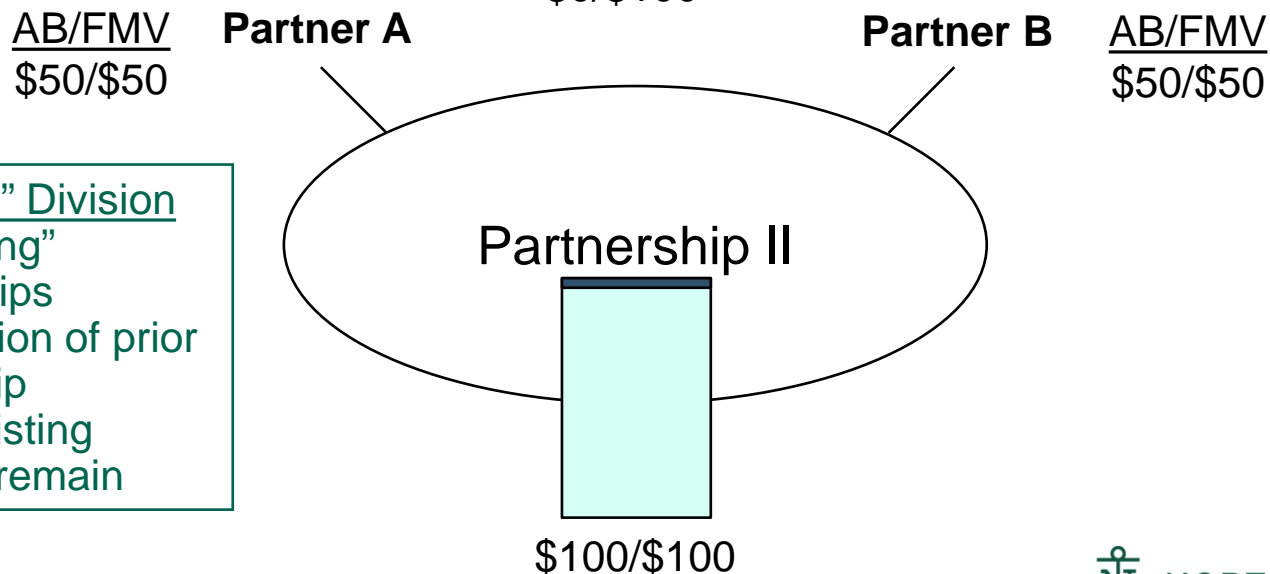
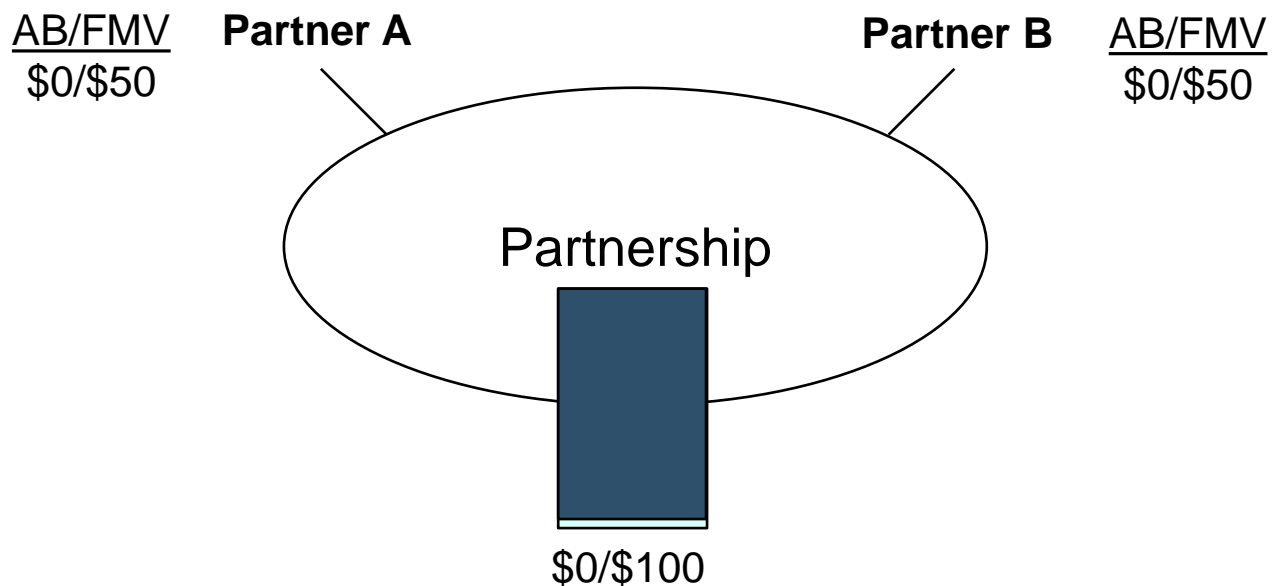


“Assets-Over” Division:

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



"Vertical Slice" Division

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



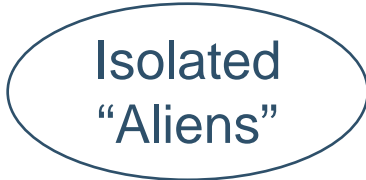
FLP Evolution: Ancient Alien Theory

No § 754 Election



Bourbon: “Age for at Least 7 Years”

No § 754 Election



§ 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

Bourbon: “Age for at Least 7 Years”



No § 754 Election

“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



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



“Old and Cold” Investment Partnership

G2 Partners

G1 Partners



Investment Partnership under § 731(c)(3)(C) of the Code:

- 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)

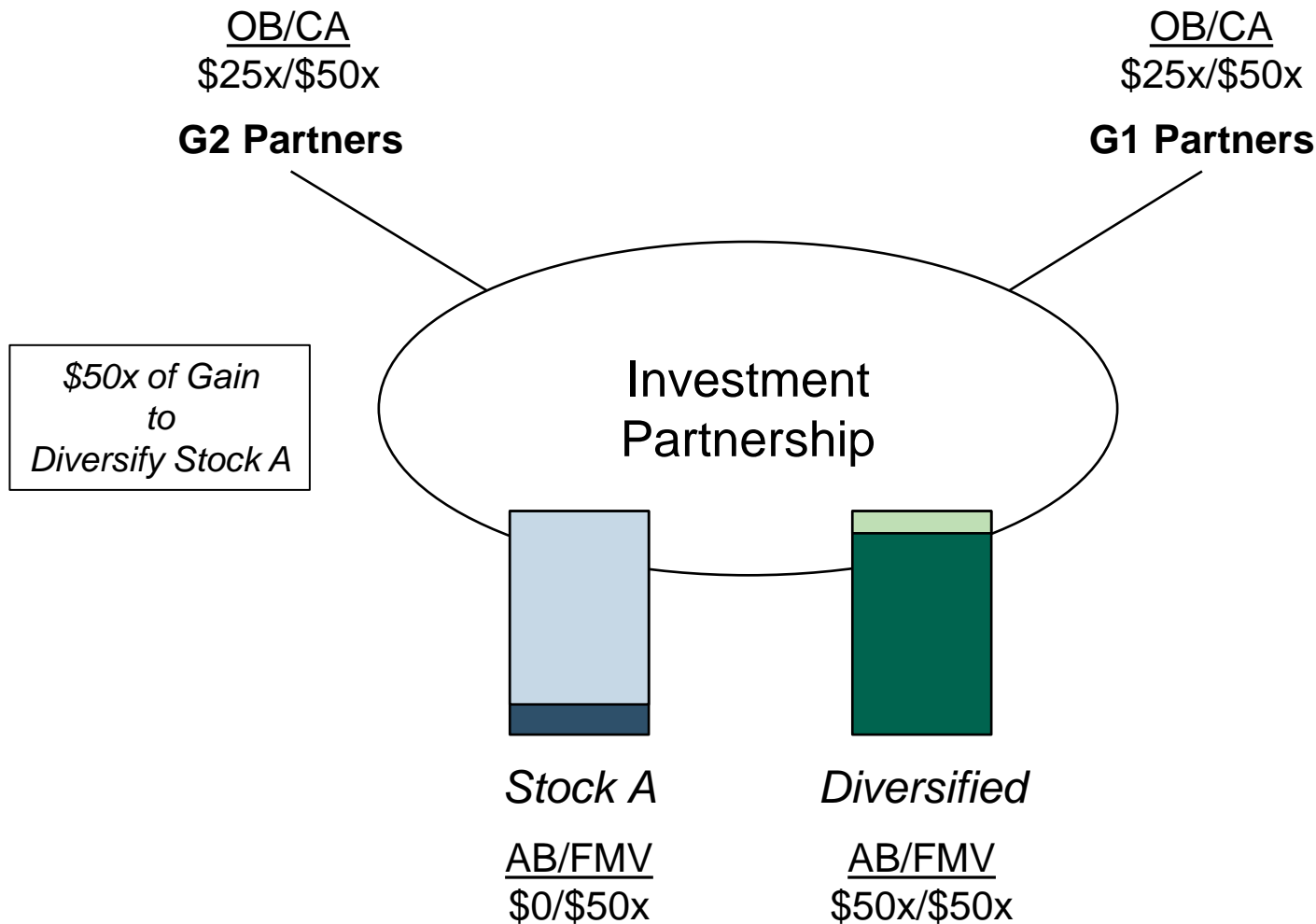
- All distributions to “eligible partners.”

“Mixing Bowl” and “Disguised Sale” Rules Do Not Apply

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

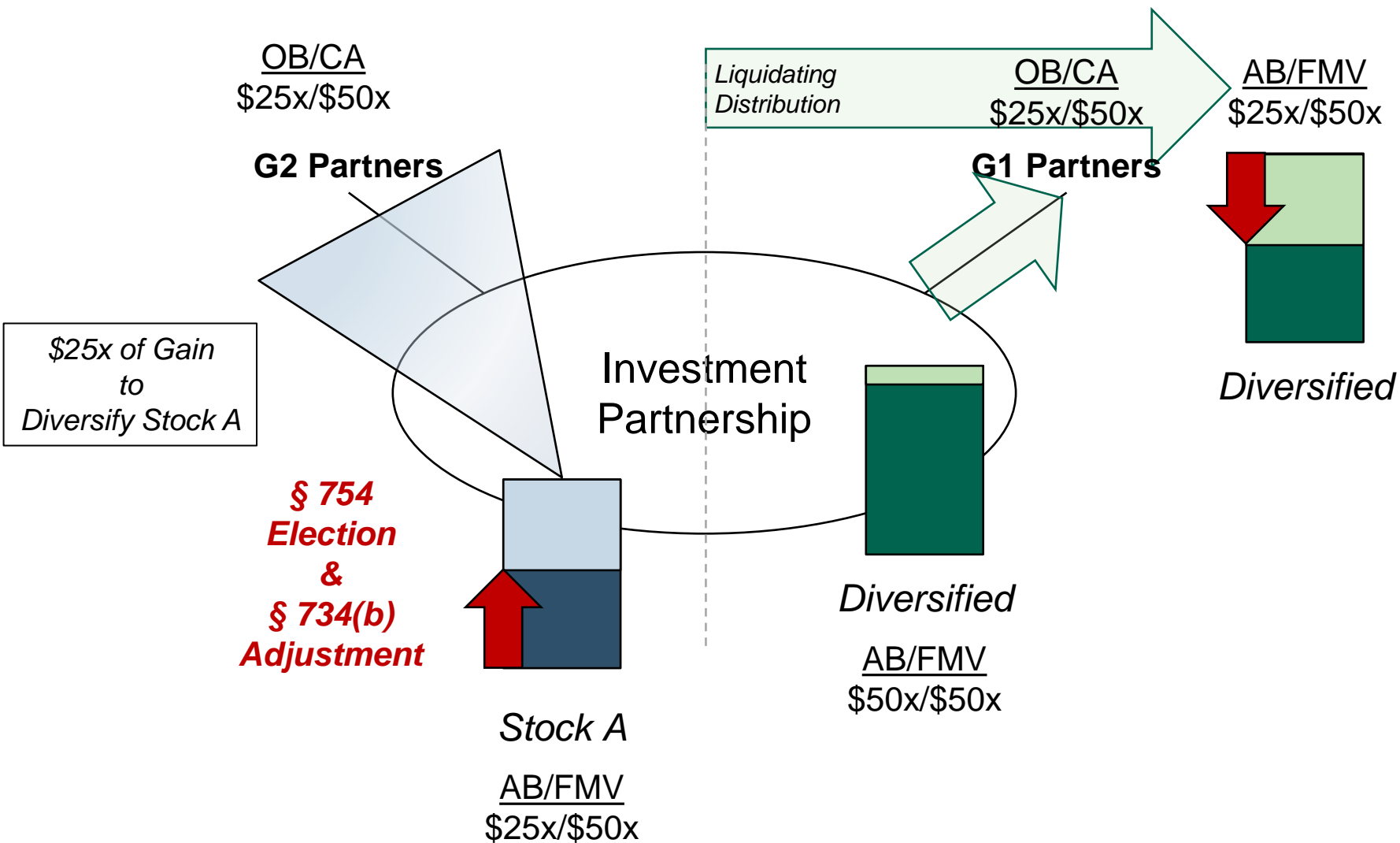


Basis Shift From Diversified to Concentrated



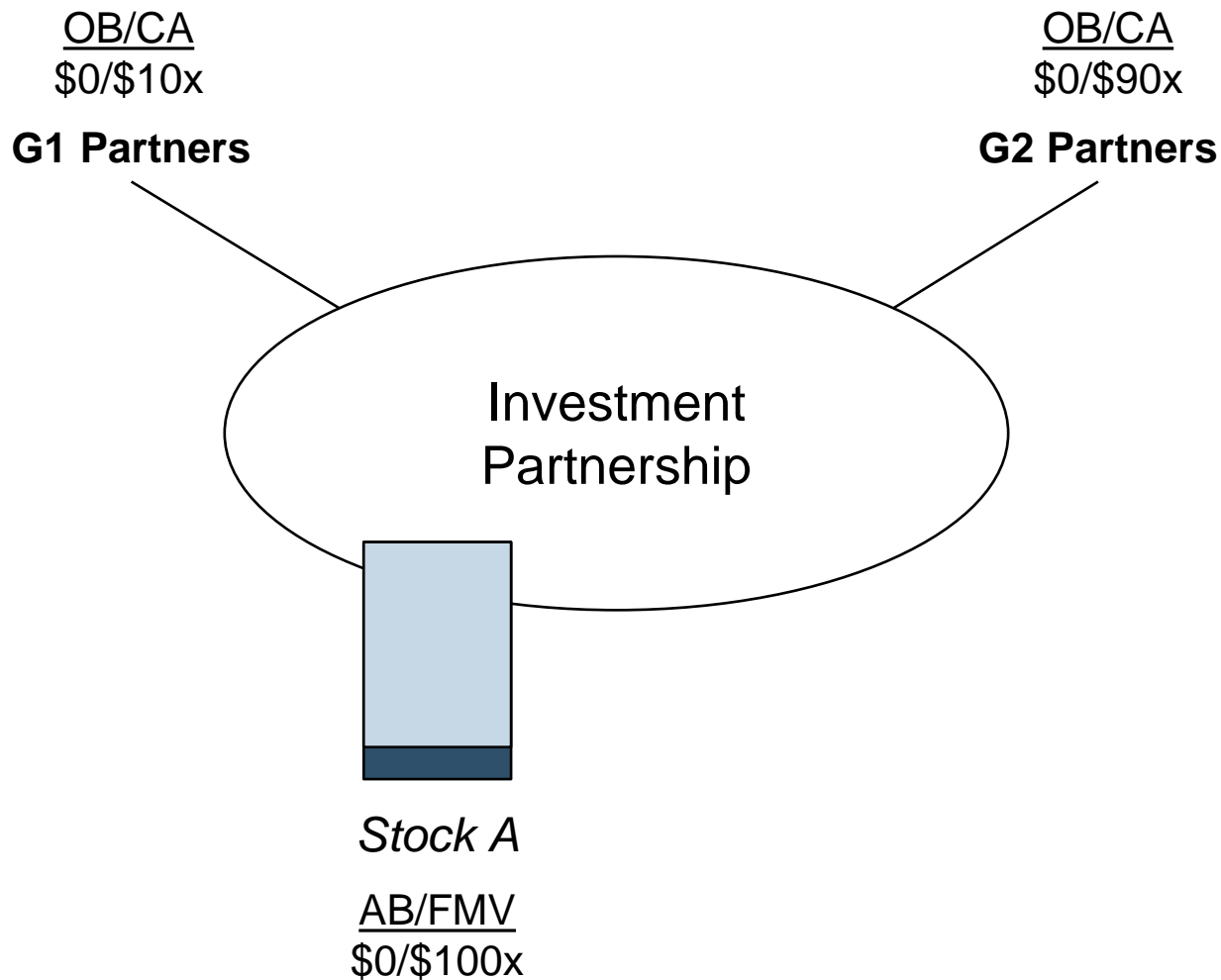


Basis Shift From Diversified to Concentrated



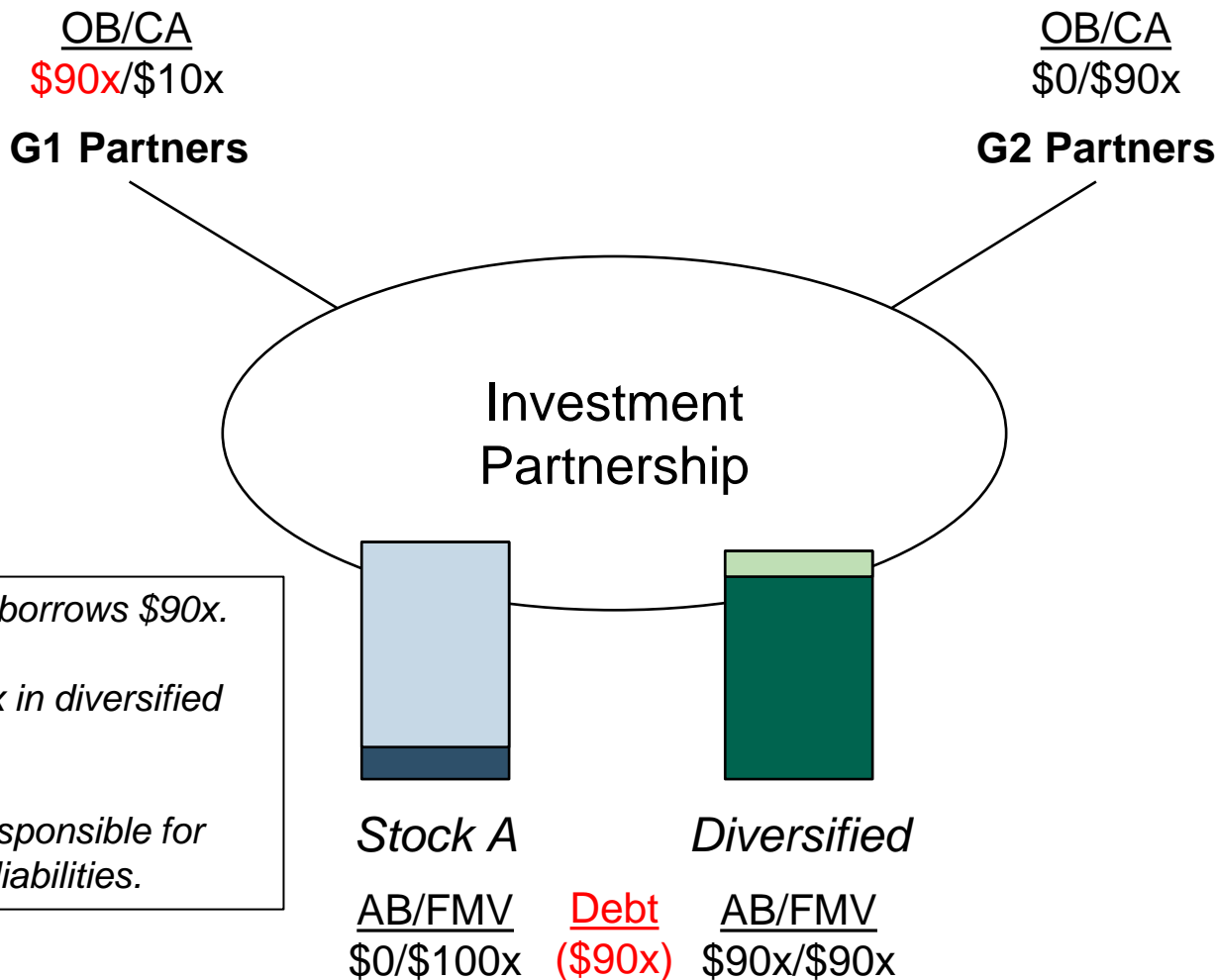


Debt to Exchange Concentrated for Diversified Position





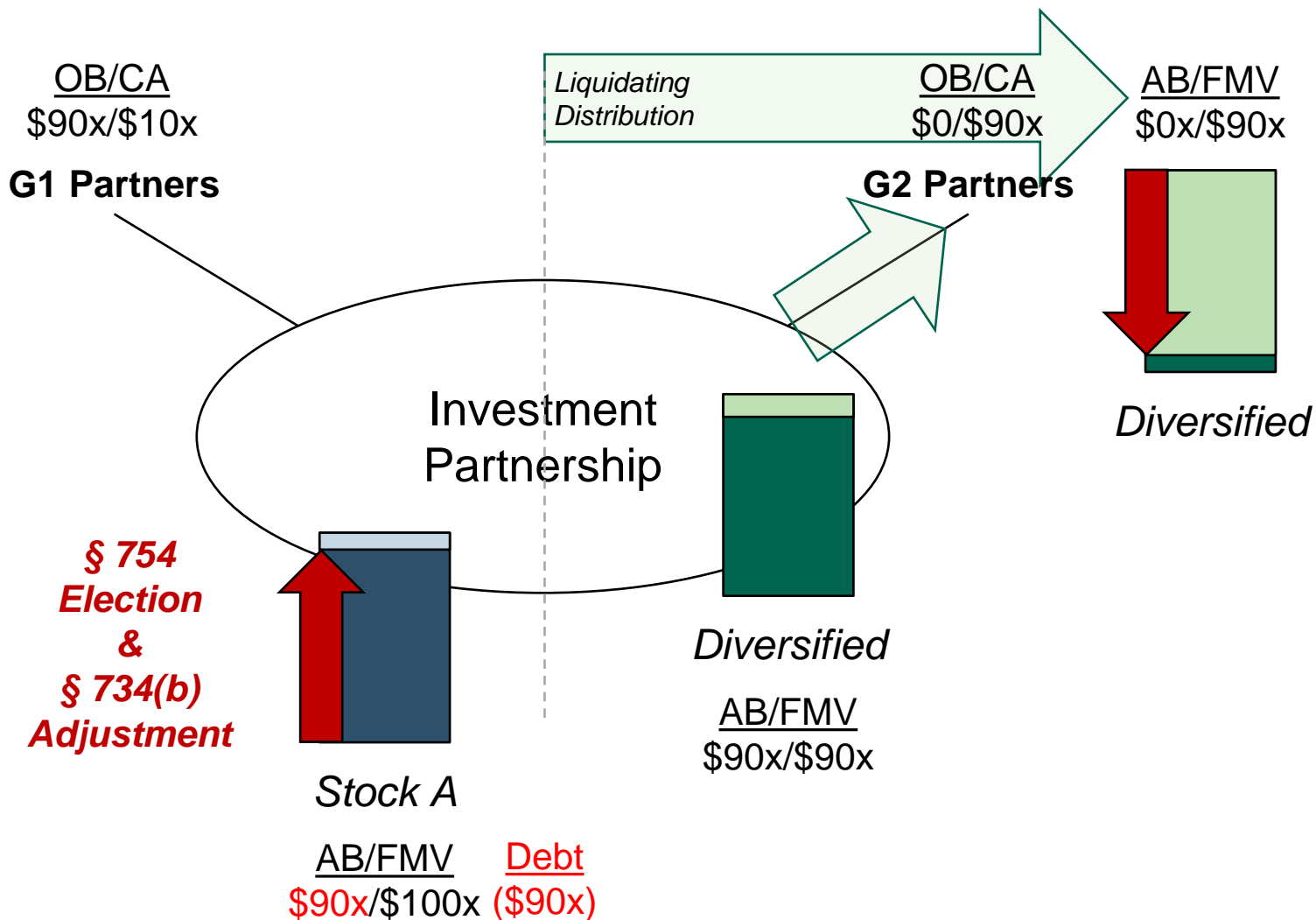
Debt to Exchange Concentrated for Diversified Position



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



Debt to Exchange Concentrated for Diversified Position

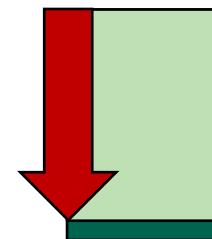
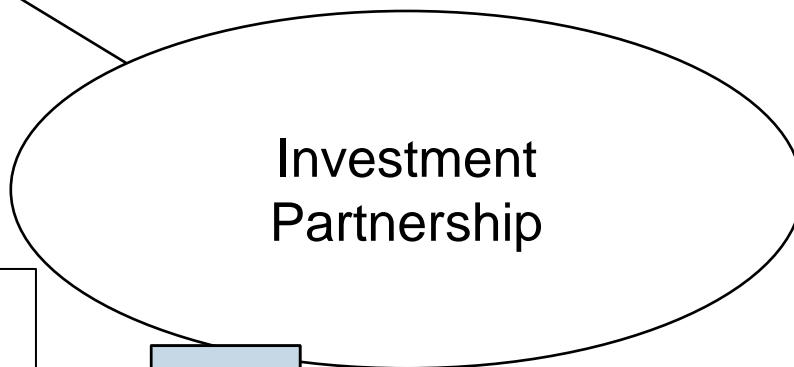




Debt to Exchange Concentrated for Diversified Position

OB/CA
\$9x/\$10x
G1 Partners

AB/FMV
\$0x/\$90x
Former G2 Partners



Diversified

Stock A
AB/FMV
\$9x/\$10x

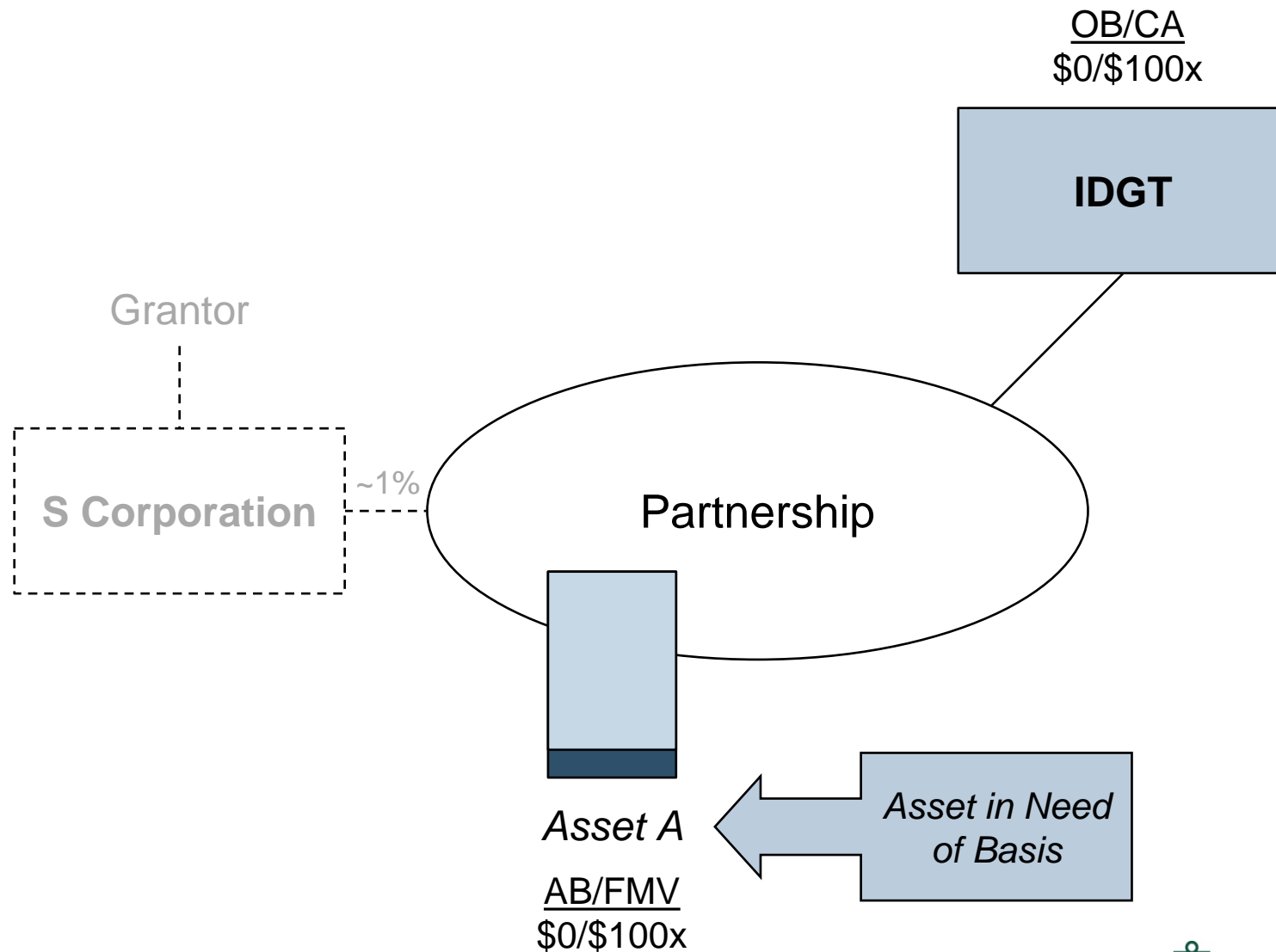
1. Sells 90x of Stock A (\$81x of AB).
2. Recognizes \$9x of gain (+9x OB of G1=\$99x).
3. Repays \$90x to lender (-\$90x OB of G1=\$9x).



Basis Shifting With Grantors And Grantor Trusts

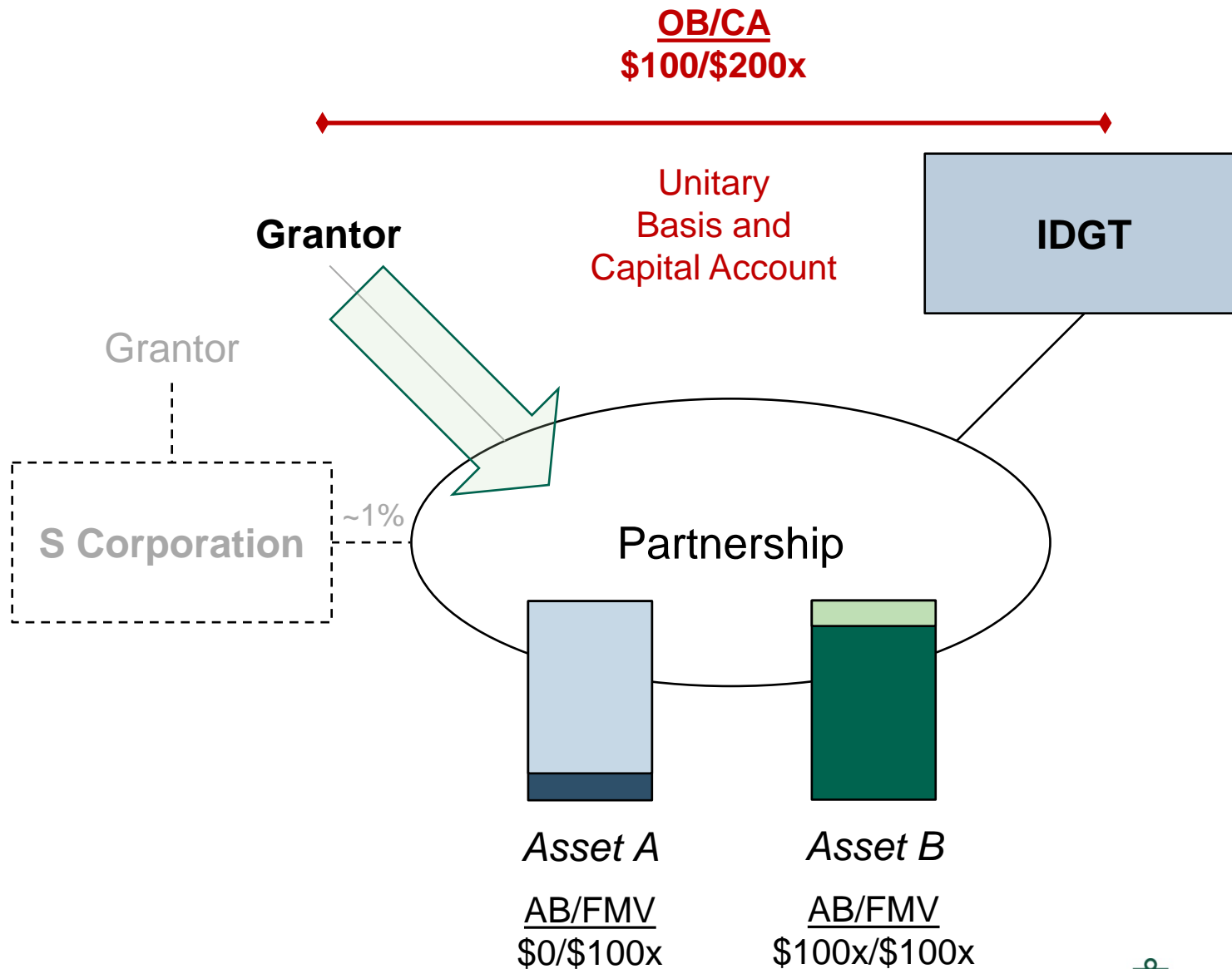


Grantors, Grantor Trusts, and Partnerships



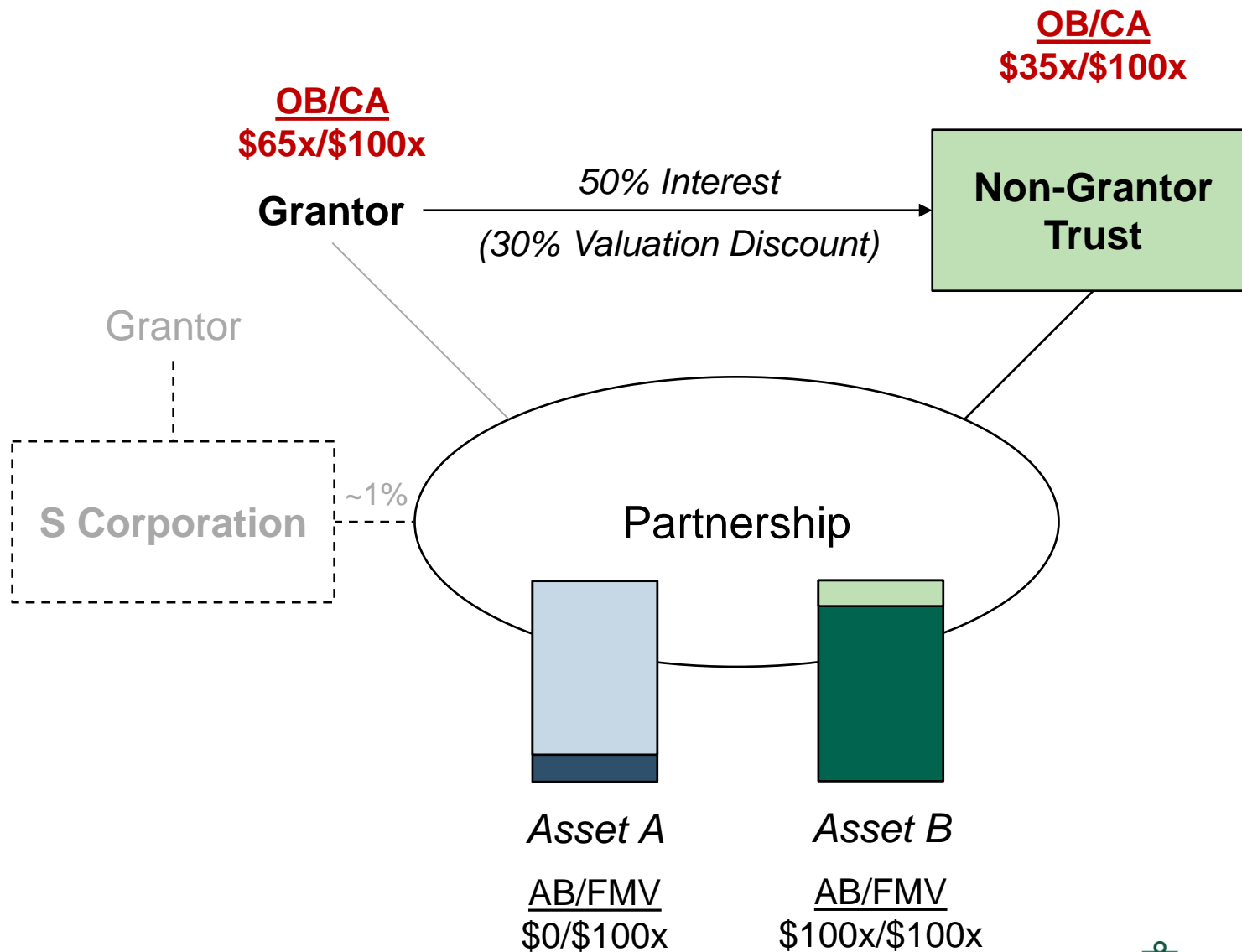


Grantors, Grantor Trusts, and Partnerships



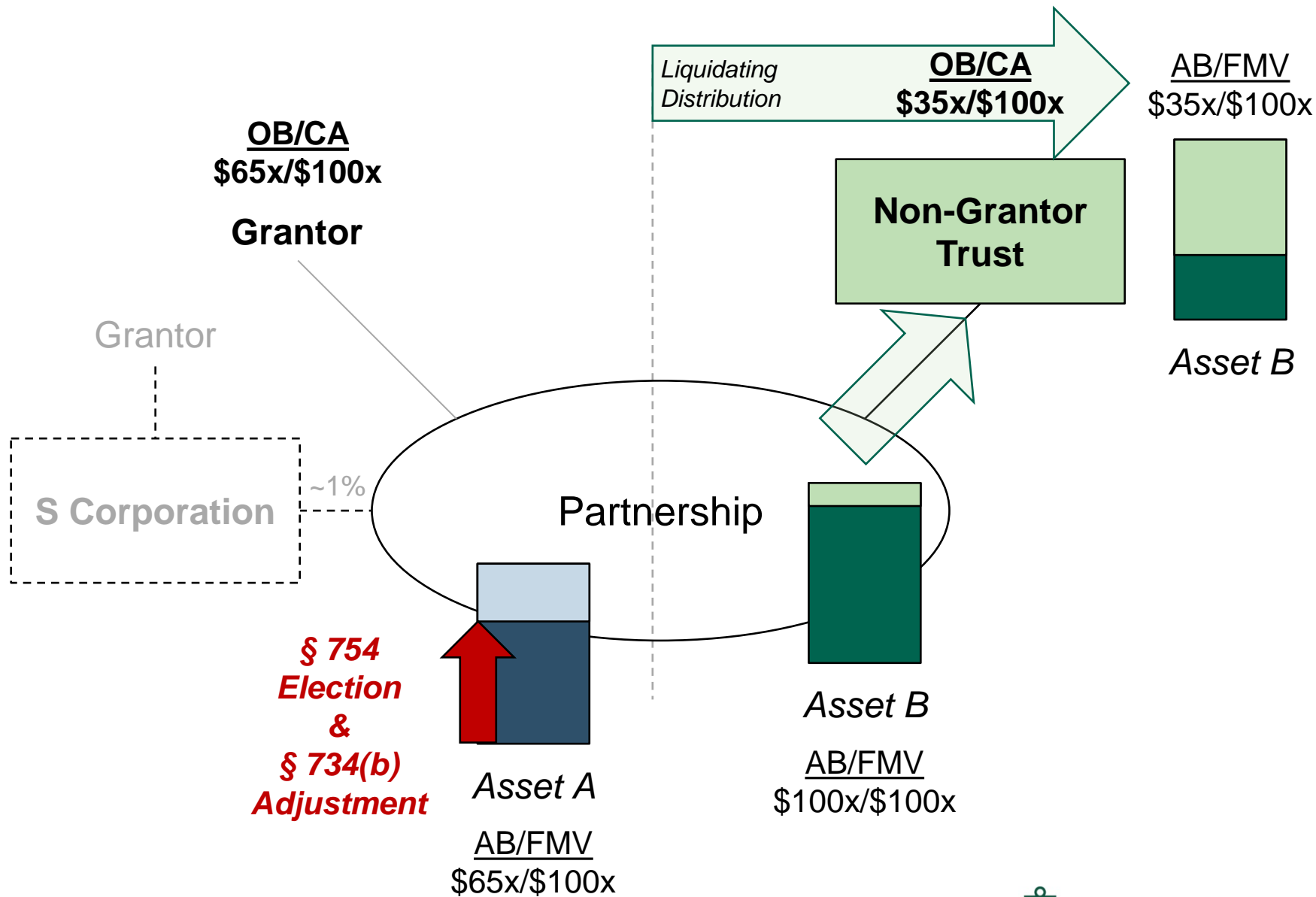


Loss of Grantor Trust Status Is a Deemed Transfer



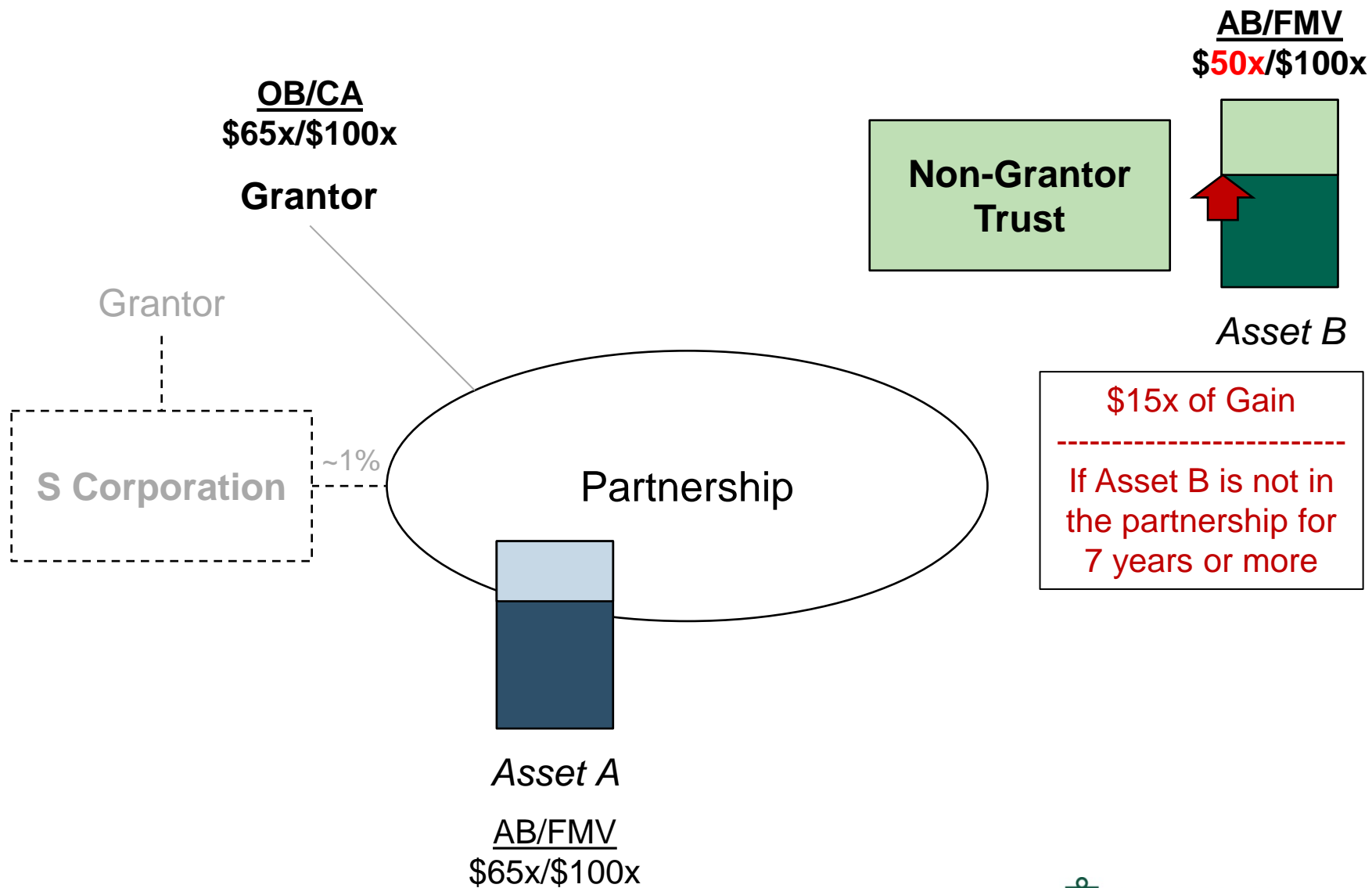


Grantors, Non-Grantor Trusts, and Partnerships



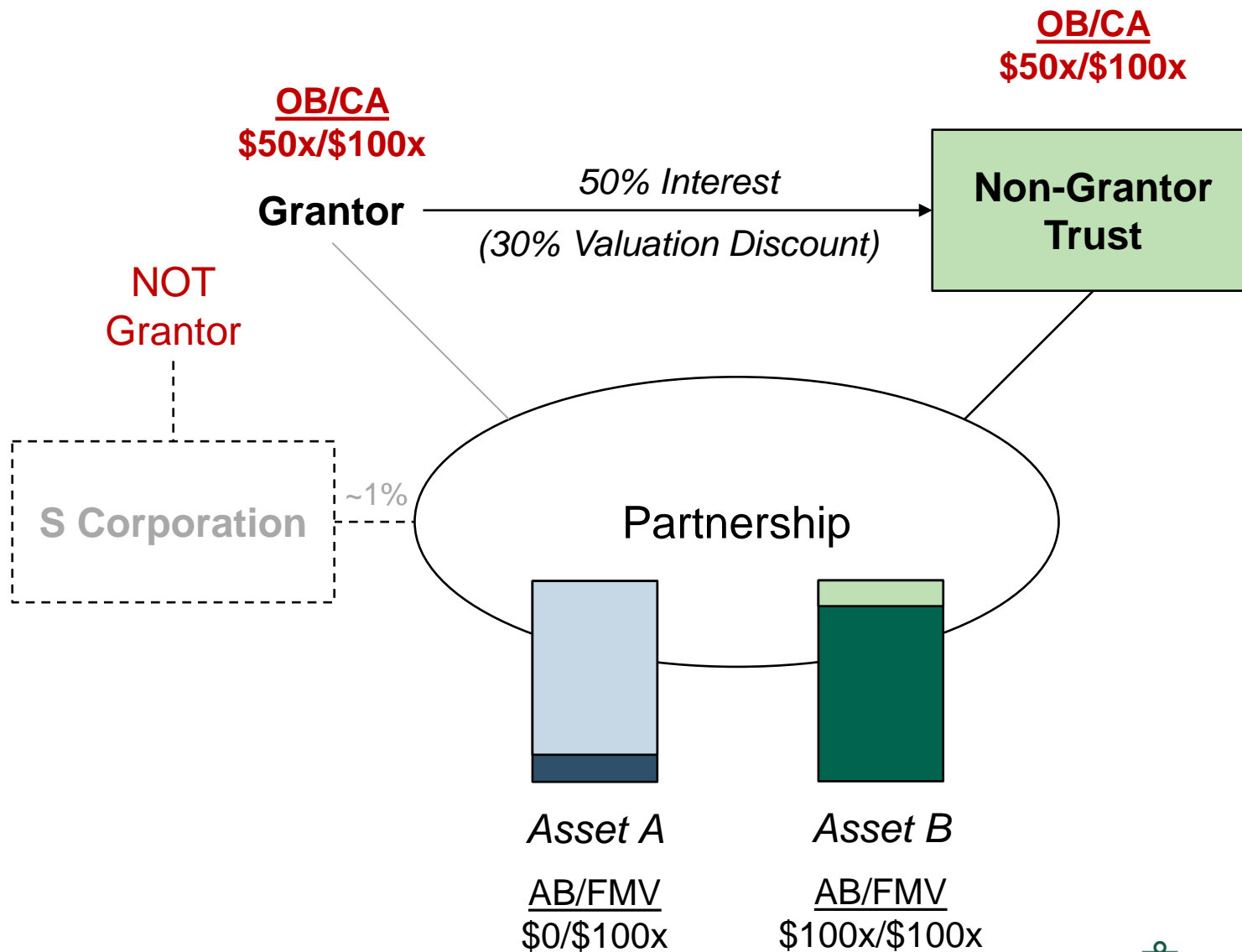


Possible "Mixing Bowl" Complications



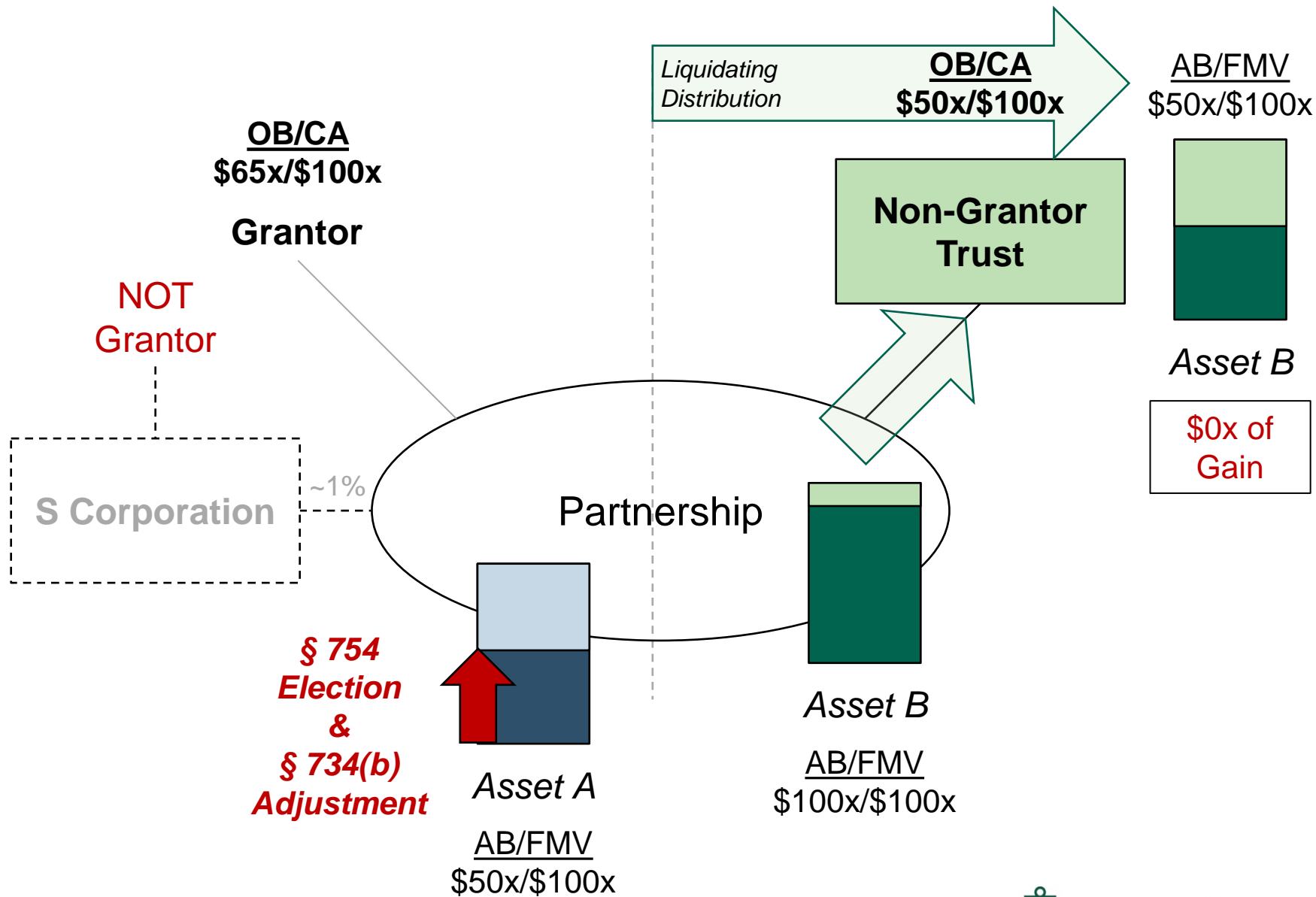


If Deemed Transfer Had Discount on Both Sides





No Resulting Gain But Less Basis to Shift





Asset Considerations When Shifting/Stripping 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.

■ 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?

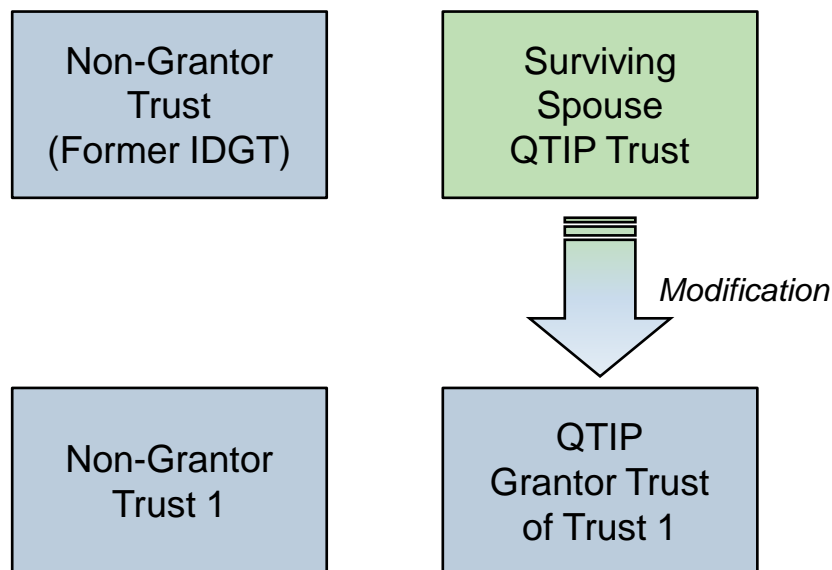
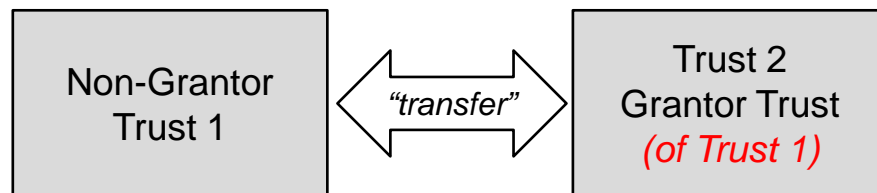
■ PLR 201633021

◆ Trust 1

- ▶ Grantor deceased.
- ▶ F/B/O children, spouse, and issue.
- ▶ Trustee proposes to transfer assets to Trust 2.

◆ Trust 2

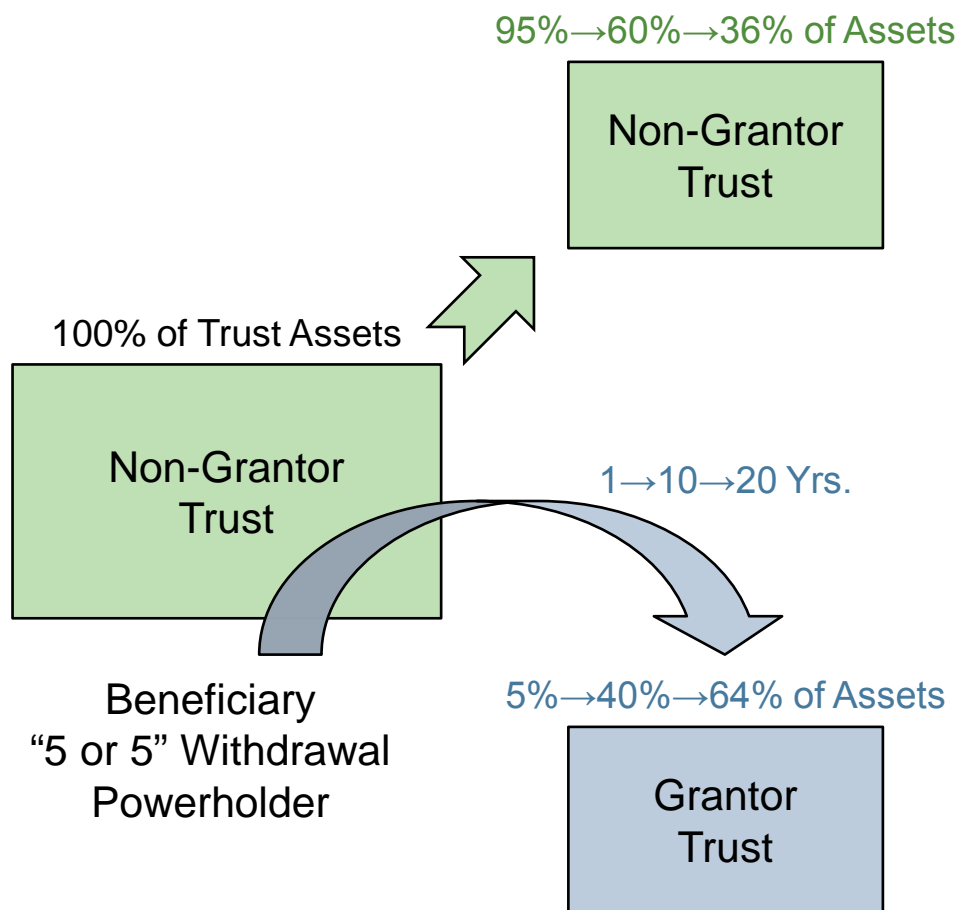
- ▶ F/B/O children, spouse, and issue.
- ▶ Trust 1 retains sole power to revest net income of Trust 2.
- ▶ Lapses on the last day of the calendar year.
- ▶ “Net income” includes income under § 643(b) and capital gain.





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).





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