Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2827

Date:29-Sep-20

Subject: Stephen M. Breitstone, Mary P. O'Reilly & Joy Spence - Get a GRIP! How to Lock in the Exemption and Still Benefit from It with the Grantor Retained Interest Partnership

"With the November elections looming and uncertainty as to the future of the current levels of Federal transfer tax exemptions if the Democrats obtain control, clients want to take advantage of the $11,580,000 gift tax exemption before they lose it. However, many clients—including those with assets well in excess of the exemption—are nervous about giving up this much money in these uncertain times. They don't want to miss the opportunity to shelter their assets from estate taxes, yet they aren't willing to give up control and access to those assets now. These clients need to get a GRIP!—the Grantor Retained Interest Partnership, where they can intentionally flunk Section 2701 to utilize the special valuation rules to make a deemed gift that is later adjusted in their gross estate, thereby locking in the $11,580,000 exemption while still maintaining maximum control, access and planning flexibility over the assets contributed."

Stephen M. Breitstone, **Mary P. O'Reilly** and **Joy Spence** provide members with commentary that examines the advantages of using a Grantor Retained Interest Partnership.

Stephen M. Breitstone is **Chair** of the **Private Wealth and Taxation Group** at **Meltzer, Lippe, Goldstein & Breitstone, LLP** in Mineola and New York, NY. His approach combines business planning and income tax planning with estate planning for businesses and investments, with a special emphasis on real estate. His clients include domestic and international real estate owners and developers, closely held businesses, public companies, private equity funds, trusts, and charitable organizations. His combination of skills as a transactional and income tax attorney and as an estate planner enables him to effectively advise clients on their individual needs and those of their businesses. He frequently serves as general counsel and financial and business advisor to several of his clients and has been an expert witness in litigation over Section 1031 exchange transactions. He has taught the courses Tax and Business Planning for

Real Estate Transactions and Taxation of Partnerships at Cardozo Law School as an adjunct professor and is a Fellow of both the American College of Trusts and Estates Council and the American College of Tax Council. He has presented papers at the NYU Institute on Federal Taxation, Practicing Law Institute, Notre Dame Tax and Estate Planning Institute, Bloomberg BNA Tax Management, National Multi-Housing Conference, Jeremiah Long Section 1031 Conference, and Federation of (1031) Exchange Accommodators. His style of practice is personal, not institutional; and his clients' goals and objectives are his priority. He has been interviewed on tax and financial topics by local and national media, including the Wall Street Journal, the New York Times, the Washington Post, CBS, ABC, Fox, Fox Business News, and Bloomberg, among others.

Mary P. O'Reilly is **Co-Chair** of the **Trusts and Estates Department** at **Meltzer, Lippe, Goldstein & Breitstone, LLP**. Mary assists individuals and families in the preservation and transfer of wealth with special focus on devising plans that both minimize taxes and help sustain and nurture family relationships and business success through the generations. Her clients include family business owners, real estate investors and developers, investment bankers, private equity fund managers, entertainers, business professionals, and those of inherited wealth. Mary's practice also includes estate and trust administration where she understands the delicate nature of losing a loved one and its impact on the estate administration process. She handles will contests, prepares and files estate tax returns, and represents fiduciaries in estate tax disputes. Mary also advises trustees in their administration of trusts and settling accounts of individual and corporate fiduciaries. She also counsels clients on charitable giving and represents tax-exempt organizations. Mary has spoken at national legal conferences such as the American Bar Association's Real Property, Trusts and Estates Section's Spring Symposia, NYU Institute on Federal Taxation and Practicing Law Institute's Annual Estate Planning Institute. She is a former chair of the Non Tax Group of the American Bar Association's Real Property, Trusts and Estates Section. She received her received her LL.M. in Taxation from New York University School of Law and her J.D., cum laude, from St. John's University School of Law, where she attended law school on a full academic scholarship.

Joy Spence is an attorney at **Meltzer, Lippe, Goldstein & Breitstone, LLP** where she focuses her practice primarily on tax law, wealth management, and trusts and estates. She regularly assists clients in developing tailored plans to maximize asset protection and wealth preservation, while minimizing tax exposure. She also counsels individuals and families on developing tax-efficient structures and intra-generational wealth transfer strategies for estate, charitable, and business succession planning needs. She has presented papers at Bloomberg BNA Tax Management, and is a Member of Trusts & Estates Magazine Editorial Advisory Board. She has taught Gift and Estate Tax for the University of San Francisco Law School LL.M. Program. She earned a J.D. from Florida International University College of Law, and an LL.M. in Estate Planning from the University of Miami School of Law.

Here is their commentary:

EXECUTIVE SUMMARY:

With the November elections looming and uncertainty as to the future of the current levels of Federal transfer tax exemptions if the Democrats obtain control, clients want to take advantage of the $11,580,000 gift tax exemption before they lose it. However, many clients—including those with assets well in excess of the exemption—are nervous about giving up this much money in these uncertain times. They don't want to miss the opportunity to shelter their assets from estate taxes, yet they aren't willing to give up control and access to those assets now. These clients need to get a GRIP!—the Grantor Retained Interest Partnership, where they can intentionally flunk Section 2701 to utilize the special valuation rules to make a deemed gift that is later adjusted in their gross estate, thereby locking in the $11,580,000 exemption while still maintaining maximum control, access and planning flexibility over the assets contributed.

COMMENT:

How to Get a GRIP

In a GRIP, the donor (or, since we can't miss this opportunity for a punning acronym, the "Grantor") funds a partnership with property valued at equal or less than the amount of his remaining applicable exclusion amount under Section 2010 in exchange for two classes of interests: (1) the preferred interest and (2) the common interest. The Grantor can retain maximum control and use of the property through the preferred interest, which can be structured to include the right to a non-cumulative fixed return and the ability to get back his initial contribution at any time through a liquidation of his interest in the partnership (the "Preferred Interest"). Any growth in the partnership that exceeds the Preferred Interest is allocated to the junior equity interest (the “Common Interest”), which the Grantor gifts to the next generation (e.g., a dynasty trust for the benefit of the Grantor’s descendants). Because the Preferred Interest retained by the Grantor is not a qualified interest under Section 2701, the special valuation rules treat the Grantor as making a gift equal to his entire contribution to the partnership, thereby using and locking in his entire remaining gift tax exemption.

When the Grantor dies, the Preferred Interest is included in his estate, however, to prevent a double tax on the Preferred Interest, Section 2701(e)(6) and the regulations thereunder provide a reduction in the Grantor’s estate equal to the lesser of (i) the increase in the his initial gift caused by the application of Section 2701, or (ii) the date of death value of the Preferred Interest.[i] As such, assuming the value of the Preferred Interest has not decreased, the GRIP allows the Grantor to lock in the full amount of the current gift tax exemption to offset his estate tax liability when he dies, regardless of the available transfer tax exemption at the time of his death. It also gives the Grantor full access and use of the assets during his life, and at death he has the ability to decide who receives the asset and gets a step up in basis under Section 1014.[ii]

<u>The Estate Tax “Adjustment” to Avoid Double Taxation</u>

The methodology for avoiding double taxation upon inclusion of the Preferred Interest in the Grantor’s estate is found in the regulations under Section 2701, titled “Adjustments To Mitigate Double Taxation.”[iii] Recognizing that the special valuation rules of Section 2701 would cause a double taxation of the same asset—namely, taxing the value of the Preferred Interest when the Common Interest is gifted by attributing its value to the Common Interest and subsequently taxing the inclusion of the Preferred Interest in the Grantor’s gross estate at death—Congress directed the Treasury to issue regulations to formulate an adjustment so as to avoid double taxation.[iv]

Pursuant to Regulation Section 25.2701-5, when a Section 2701 interest is included in the Grantor’s gross estate, double taxation is avoided through a reduction of the transfer tax base calculated under Section 2001(b).[v] The amount of the reduction (the “Adjustment”) equals the lesser of (i) the increase in the Grantor’s taxable gifts caused by the application of Section 2701 (the “Deemed Gift”) and (ii) the “duplicated amount.”[vi] The “duplicated amount” is the excess of (x) the fair market value of the Preferred Interest at the date of death (reduced by any deduction that would have been available had the Section 2701 interest been included in the transferor's transfer tax base) over (y) the value of the Section 2701 interest at the date of the initial transfer, as determined under the Section 2701 special valuation rules (which is generally zero, since the entire value of the Preferred Interest is allocated to the Common Interest under the special valuation rules).[vii] Example 2 in Regulation Section 25.2701-5(d) provides a clear illustration on how the Adjustment works:

In Example 2, P, an individual, holds 1,500 shares of preferred stock in X corporation worth $1.5 million. The preferred stock bears an annual noncumulative dividend of $100 per share. P gifts $500,000 of common stock to her child. Because the dividend of the preferred stock is noncumulative, it is not a qualified interest under Section 2701 and the $1.5 million of value P retains in the preferred stock is valued at zero for purposes of valuing the gift of the common stock. Pursuant to the subtraction method under Regulation Section 25.2701-5, the value of the common stock gift is $2 million. P continues to hold the preferred stock until death, at which time the preferred stock is still valued at $1.5 million. Although the preferred stock is included in P’s estate, P’s executor is entitled to reduce P’s estate tax base by the $1.5 million Deemed Gift under Section 2701.[viii]

Changes in the Value of the Preferred Interest

Since the Adjustment formula is effectively the lesser of the Deemed Gift and the date of death value of the Preferred Interest, a change in the value of the Preferred Interest may alter the benefits of the GRIP, and thus should be considered when structuring the Preferred Interest in a GRIP. A change in the value of the Preferred Interest is primarily a function of interest rate changes and investment performance as well as the optional rights and features that may be given to the Preferred Interest. Because many clients interested in a GRIP will likely want to receive some fixed rate of return as well as the ability to get back their capital contribution to the partnership, interest rate fluctuation will be a principal factor impacting the value of the Preferred Interest.

For example, if the Preferred Interest is structured to receive a non-cumulative fixed return each year and interest rates increase, then the value of the Preferred Interest will likely decrease. This decrease in the value of the Preferred Interest would result in wasting a portion of the exemption used for the GRIP. To illustrate, assume the Grantor makes a

$10 million contribution to a GRIP reserving a liquidation right and a non-cumulative fixed then market rate return of 5% on the Preferred Interest and gifts the Common Interest, making a Deemed Gift of $10 million. If interest rates increase and the market rate of return at the Grantor's death is then greater than 5%, the Preferred Interest will be worth less in his estate than it was upon the gift of the Common Interest. If we assume that the Preferred Interest is valued at $8 million on the Grantor's death, the Grantor's Adjustment at death is likewise capped at this $8 million value. As such, $2 million of the Grantor's gift tax exemption that was used when making the Deemed Gift will be effectively wasted. However, in the current planning environment where the increased exemption amount is scheduled to sunset on January 1, 2026 (or sooner if repealed after the elections), there is less concern about wasting exemption that is currently set to disappear on its own.

Conversely, if interest rates were to decrease in value, the Preferred Interest in the above illustration would increase in value at the Grantor's death. As such, if we assume the Preferred Interest is valued at $12 million in the Grantor's estate, the Adjustment will be capped at the value of the $10 million Deemed Gift. Thus, the $2 million growth of the Preferred Interest would be exposed to estate tax.

For those clients that want to ensure their return from the GRIP is sufficient to provide for them regardless of interest rate changes, the fixed return they receive from the Preferred Interest can be structured to follow a recognized interest index such as LIBOR or be tied to the AFR. For example, the GRIP can be structured to give the Preferred Interest a non-cumulative rate of return of the greater of 5% or 300 basis points over the AFR then in effect. This would protect the Grantor against income rate changes while also minimizing changes in the value of the Preferred Interest caused by interest rate fluctuation.

Although there is great flexibility in structuring the GRIP to meet a client's particular goals and financial needs as well as to mitigate against changes in valuation of the Preferred Interest, if the Common Interest has the potential to grow, care must be taken to ensure the Common Interest will not be included in the Grantor's estate. For example, a structure where the Grantor would receive back all of the income of the partnership may result in the entire partnership—including the Common Interest—to be included in his taxable estate under Section 2036. Additionally, if the partnership agreement gave the Grantor powers over the allocation and distributions of profits among the Common Interest holders, this may cause inclusion under Section 2038. Thus, the same care and attention that is given to other lifetime planning structures to avoid estate tax inclusion should be considered in the GRIP as well.

Intentionally Flunking Section 2701

The vital first step in creating a GRIP is intentionally flunking Section 2701 so that there is a Deemed Gift that will result in an Adjustment in the Grantor's estate. This is the feature that allows the Grantor to effectively use the current increased exemption to offset the Grantor's estate tax liability upon his death. Thus, although there is considerable leeway in how the GRIP is structured, care must be taken to ensure the Preferred Interest has a certain preference over the Common Interest as to trigger the special valuation rules of Section 2701.[ix]

A primary requirement for the application of Section 2701 is that the Preferred Interest is an "applicable retained interest."[x] Generally, this means a liquidation, put, call,[xi] or conversion right, or any similar right (regardless of whether it is exercised) that affects the value of the Common Interests (an "extraordinary payment right")[xii] or the right to receive distributions[xiii] from the partnership (a "distribution right") that is not a "qualified payment right" in a controlled entity.[xiv] A qualified payment right is a cumulative dividend or distribution right, payable on a periodic basis and at a fixed rate or amount.[xv] Other rights that are neither extraordinary payment rights nor distribution rights include mandatory payment rights,[xvi] liquidation participation rights, and non-lapsing conversion rights (for purposes of this article, it is presumed that the partnership is a "controlled" entity).[xvii] Thus, the partnership agreement should be structured to ensure the Preferred Interest has an applicable retained right which is not a qualified payment right so that the special valuation rules of Section 2701 will apply.[xviii] This would include the previously discussed liquidation right and the non-cumulative fixed return.

Converting an Existing Freeze Partnership Into a GRIP[xix]

For those who have managed to tackle the complexities and structuring challenges of Section 2701 compliant freeze partnerships (a "Traditional Freeze Partnership"),[xx] there is a simple fix that may be used to effectively lock in the current increase exemption that the GRIP offers within the Traditional Freeze Partnership structure. This can be done by an amendment to the partnership agreement to create a new class of

Preferred Interest (with a value that does not exceed the remaining exemption of the Preferred Interest holder) that lacks the cumulative feature of the traditional Section 2701 compliant Preferred Interest. This would result in a Deemed Gift under Section 2701 equal to the value of the new class of the non-cumulative Preferred Interest. The Traditional Freeze Partnership would continue to serve its intended purpose of transferring appreciation to the holders of the Common Interests and achieving a basis step up on both the original cumulative Preferred Interest and the newer non-cumulative Preferred Interest, while locking in the increased current exemption through the Adjustment at the death of the Preferred Interest holder.

Repercussions of the GRIP Beyond 2020 Planning

The special valuation rules of Section 2701 provide the opportunity to do the very thing that the gift tax rules are meant to prohibit, namely, making a completed gift while still having full access and control during life and final say where they go at death. Much like how the grantor trust rules—which were enacted to eliminate a perceived income tax abuse—have been used by taxpayers to their advantage in lifetime planning with grantor trusts, the special valuation rules of Section 2701—which were designed to curb the ability to shift assets to descendants—can be used by taxpayers to their benefit to reduce their estate tax without giving up control. Using a GRIP to take advantage of the currently increased gift exemption is one strategy that takes advantage of the fact that the special valuation rules attribute the value of the retained Preferred Interest to the completed gift of the Common Interest while providing an Adjustment at death, and there may be many other ways practitioners discover to capitalize on these rules in the future. For now, if you have clients who want to lock in their gift tax exemption, but are not yet ready to give up control and use of their assets—you can finally tell them to get a GRIP!

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Stephen M. Breitstone

Mary P. O'Reilly

Joy Spence

CITE AS:

CITATIONS:

---

[i] Reg. § 25.2701-5. *See infra* discussion at footnotes 5-7. See also S. Stacy Eastland, Best Estate Planning Techniques Under TCJA—Part 5: IDPIP, 45 Estate Planning Journal (2018) for further illustrations of the mechanics of the Adjustment.

[ii] Note the partnership can be structured to allocate the partnership liabilities to the Preferred Interest, including any liabilities in excess of basis, so that the basis step up would include any so-called "negative capital." *See* Stephen M. Breitstone, Estate Planning for Negative Capital, TRUSTS & ESTATES, May 2012, at 26, for a detailed discussion on structuring a freeze partnership to maximize the step up in basis attributable to the Preferred Interest. Note, one of the Democratic proposals would be to eliminate any step-up in basis at death, so this benefit of the GRIP would be lost in the event that is enacted.

[iii] Reg. § 25.2701-5.

[iv] Section 2701(e)(6).

[v] Reg. § 25.2701-5(a)(1).

[vi] Reg. § 25.2701-5(b).

[vii] Reg. § 25.2701-5(c).

[viii] Note, although there are differences in opinion as to whether a change in the anti-clawback rules under Regulation Section 20.2010-1(c) would cause the Adjustment in Regulation Section 25.2701-5 to fail to recognize the higher exemption amount, if the Adjustment was in fact reduced to the lower exemption as a result of a change in the anti-clawback regulation by Treasury, the Grantor could simply gift the Preferred Interest during life. *See* Carlyn McCaffrey and Jonathan Blattmachr, *The Estate Planning Tsunami of 2020*, Steve Leimberg's Estate Planning Email Newsletter Archive Message #2820, Sept. 3, 2020, which raises the IRS or Treasuring making this change to the anti-clawback regulation as a potential risk of the GRIP structure, but concludes that if that were to happen, the risk could be avoided by gifting the Preferred Interest shortly before death.

[ix] § 2701(a)(2)(B), § 2701(a)(2)(C); Reg. §25.2701-1(c)(3).

[x] Reg. §25.2701-2(b).

[xi] A call right includes any warrant, option, or other right to acquire one or more equity interests. *See* Reg. §25.2701-2(b)(2).

[xii] Reg. §25.2701-2(b)(2).

[xiii] A distribution right is the right to receive distributions with respect to an equity interest but not any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest. Thus, it is by operation of this definition that partnerships that provide strictly proportionate allocations are generally not subject to Section 2701.

[xiv] Reg. §25.2701-2(b)(3).

[xv] Reg. §25.2701-2(b)(6)(i).

[xvi] Under Section 707, guaranteed payments are payments made to a partner by a partnership without regard to the income of the partnership. An example of a guaranteed payment is the payment of interest on capital invested by a partner.

[xvii] Reg. §25.2701-2(b)(4).

[xviii] § 2701(a)(3)(C).

[xix] For a discussion of the planning with freeze partnerships for real estate with liabilities in excess of basis, see Stephen M. Breitstone, Estate Planning for Negative Capital, TRUSTS & ESTATES, May 2012, at 26.

[xx] *Id*.