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Coming Ashore - Planning for Year 2017 Offshore Deferred Compensation Arrangements: Using CLATs, PPLI and Preferred Partnerships and Consideration of the Charitable Partial Interest Rules

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I. Introduction and Background

For estate and tax practitioners who represent hedge fund managers, the practice can be an interesting one coupled with special challenges from an estate, gift and generation-skipping transfer tax (collectively herein sometimes referred to as "transfer taxes") standpoint as well as from an income tax point of view. It is often the case that the representation of these clients involves issues that straddle both the transfer tax and income tax sides of the law. This is certainly the case when attempting to plan for the fund principal (that is, the principal manager of an investment vehicle such as a hedge fund) to address the looming year 2017 deadline for recognition of income on certain non-qualified deferred compensation arrangements.

As the deadline rapidly approaches for fund managers to recognize income tax on deferred compensation arrangements that are not otherwise subject to an ongoing risk of forfeiture, tax advisors are scrambling to find the best solution or solutions to address the substantial (and in some cases, even massive) income tax burden that the fund principal/client may be facing.

Many clients are not waiting until 2017 to recognize the income on these arrangements and have opted to bring the deferred compensation "on shore" and recognize the income currently. For those clients who may be charitably inclined, planning to address this income tax burden might involve generating a current year charitable income tax deduction to offset at least part of the tax liability. If done by way of a Charitable Lead Annuity Trust ("CLAT") that is a "grantor trust" for income tax purposes,[1] the fund manager may achieve the dual goals of generating a

[1] A charitable lead annuity trust is one described in Section 170(f)(2)(B) of the Internal Revenue Code of 1986 as amended (The "Code"), which provides for annuity payments to be paid to charity for a period of years or until the death of a specified

current charitable income tax deduction, subject to AGI limitations, while at the same time providing for the potential gift tax free passage of wealth to the grantor's beneficiaries (most likely his or her children or trusts for them) at the end of the lead (or charitable) term. While the charitable beneficiary, of course, receives its designated annuity interest, in the case of a so-called "zeroed-out CLAT" (that is, such a trust where the actuarial value of the remainder at the trust's inception is zero, as the value of the annuity interest is essentially the full actuarial present value of the grantor's contribution) the grantor's intended non-charitable beneficiaries can benefit too. If the CLAT earnings significantly out-perform the so-called "Section 7520"[2] rate (which is used to measure the present value of the charitable interest in the trust),[3] this can result in a substantial gift-tax free and estate-tax free transfer to the non-charitable beneficiaries.[4]

Of course, the downside to the fund manager/grantor when a CLAT is created as a grantor trust is that, while the grantor receives an up-front charitable income tax deduction, going forward the grantor must report the income generated by the CLAT on his or her personal income tax return without any further charitable deduction even to the extent such income is paid to charity.[5] Although grantor trust status for the lead trust is generally more beneficial for the remainder beneficiaries of the CLAT (often the grantor's children) than a CLAT that is not a grantor trust, as it allows the CLAT to effectively grow without reduction for income taxes,[6] if the CLAT generates significant taxable income, the income tax liability that the grantor has to absorb may make the arrangement appear to be unattractive to him or her. Even if the fund manager who creates a CLAT that is a grantor trust obtains a significant up-front charitable deduction to offset part or all of that income, the potential magnitude of taxable income generated from that CLAT, and taxed to the grantor each year, could be viewed by the grantor as quite adverse overall.[7]

individual or individuals. *See generally* Jonathan G. Blattmachr, *A Primer on Charitable Lead Trusts: Basic Rules and Uses*, 134 Tr. & Est., Apr. 1995 at 48 [hereinafter Blattmachr 1995]. *See also* I.R.C. § 2642(e)(1) (defining charitable lead annuity trust for generation skipping transfer tax purposes).

2 Unless otherwise indicated, "Section" refers to a section of the Code.

3 *See* I.R.C. § 7520(a).

4 This is explained in detail in Blattmachr 1995, *supra* note 1.

5 *See* I.R.C. § 170(f)(2)(B).

6 The payment of income tax by the grantor of the income imputed to him or her under the grantor trust rules (see Section 671) is not a gift by the grantor. Rev. Rul. 2004-64, 2004-2 C.B. 7.

7 Although the trust could invest in municipal bonds, the income from which, pursuant to I.R.C. § 103, is not included in gross income, the returns generally are low and,

In addition to the ongoing income tax liability of the grantor inherent with a grantor CLAT, there are also significant limitations from a multi-generational transfer tax planning standpoint. This is due to the general inability to effectively allocate generation-skipping transfer tax exemption ("GST exemption")[8] to a CLAT during the annuity term because GST exemption cannot be efficiently allocated to a CLAT from inception.[9]

However, there may be creative ways to structure a grantor CLAT in a manner that makes it much more tolerable to the grantor from an income tax standpoint through the ownership of a private placement life insurance ("PPLI") policy (or possibly through ownership of an interest in an entity that owns a PPLI policy).[10] Properly structured, the PPLI policy will not generate taxable income on its investments; thus, while the policy will be owned by the grantor CLAT, and any taxable income that such CLAT generates will be income taxable to the fund principal/grantor, there should be no taxable income actually generated by the PPLI policy.

In addition, it may be possible to further leverage this CLAT/PPLI planning to permit the possibility of "multi-generational" GST exempt planning by having the CLAT own preferred interests in a preferred "freeze" partnership (the "Preferred Partnership;" collectively, the CLAT/PPLI structure coupled with the Preferred Partnership is sometimes referred to herein as a "Preferred Partnership CLAT"). This variation, which is derivative of a technique called the "Preferred Partnership GRAT"[11] involves adding a third layer of planning using a Section 2701 "compliant" statutory preferred partnership in order to en-

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therefore, would likely reduce the beneficial effects of a CLAT than if there were a higher yield on the CLAT's investments.

8 *See* I.R.C. § 2631(a) (defining the GST exemption).

9 *See Id.* § 2642(e). Even if GST exemption is allocated to the CLAT at its inception (*see id*. § 2632(c)(3)(B)(v)), the amount of GST exemption that is effectively available when the charitable term ends is equal to the GST exemption so allocated increased annually by the Section 7520 rate used to value the charitable interest in the trust at its inception. *Id.* Such an allocation may or may not be efficient depending upon the investment experience, charitable payouts, expenses and income tax (if any) imposed upon the trust during the charitable term.

10 As a general rule, the increase in the cash value (or investment) component of a policy of insurance is not subject to income tax unless withdrawn. *See,* Cohen v. Commissioner, 39 T.C. 1055, 1056 (1963), *acq. in*, 1964-1 C.B. 4; *cf.* I.R.C. § 7702(g) (providing for the increase in net cash surrender value to be includible in gross income of the policy owner if the policy is a policy of life insurance under applicable state or foreign law but does not meet the definition of a life insurance policy under I.R.C. § 7702(a)).

11 For a discussion of a similar type of structure utilizing a GRAT rather than a CLAT, see N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC Journal 289 (2009).

able significant potential future growth to be shifted into a GST exempt trust through the ownership of common "growth" interests in a preferred partnership and in which the CLAT would own the preferred interests. Under this variation, the preferred partnership (rather than the CLAT) would own the PPLI policy. The grantor CLAT would own "frozen" or preferred interests in the partnership with respect to which the preferred interest would be entitled to "qualified payments" the value of which are not subject to the zero valuation rule under Section 2701[12] and/or entitlement to fixed liquidation payments that also are not valued at zero under that Section.[13] Indeed, the qualified payments and/or fixed redemption amounts could be structured to approximate the annuity payments the CLAT is required to make.[14] Rather than having the common "growth" interests in the preferred partnership owned directly by second generation members of the family or trusts for their benefit,[15] the common interests could, perhaps, instead be owned by a GST exempt trust, such as one structured under Alaska law, Delaware law or another jurisdiction that permits perpetual or very long term trusts.[16] In that case, the income and appreciation in the preferred partnership (that owns the PPLI policy) attributable to the common "growth" interests above the fixed preferred coupon and liquidation preference required to be paid under the "preferred" interests to the CLAT (as the owner of the preferred interest) could be allocated to and accumulate inside a perpetual GST exempt trust.

Of course, nothing is ever as simple as it seems, and there are myriad issues that practitioners need to consider whenever attempting to implement this planning. There may be issues to consider from the standpoint of Section 170(f)(10) in connection with the CLAT's owner-

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12 *See* I.R.C. § 2701(a)(3)(B).

13 *See id*. § 2701(c)(2)(B).

14 Unlike a charitable remainder trust described in I.R.C. § 664, the annuity payments from a charitable lead trust may vary from year to year. *See, e.g.,* Treas. Reg. § 1.170A-6(c)(2)(i)(A) (last sentence).

15 As indicated earlier in this article, CLATs usually cannot be used to "leverage" the GST exemption. Hence, the remainder beneficiaries of a CLAT typically are the grantor's children as no generation-skipping transfer tax is imposed when distributions are made to them as contrasted with distributions to more remote descendants. The common interest in the preferred partnership could be owned by inception by a GST exempt trust (one that has a zero inclusion ratio within the meaning of I.R.C. § 2642(a)) that is not a CLAT so GST exemption can be efficiently allocated to this non-CLAT trust that owns the common interests in the preferred partnership. *See* s*upra* notes 8-9, and accompanying text.

16 Other factors often considered in choosing the "situs" of a trust including whether the law of the situs imposes an income tax on trust income and ease of administration of trusts located there.

ship of the PPLI policy if premiums are not paid-up in advance.[17] In addition, there are issues to consider under Section 170(f)(2) and (3) as well as Section 2522(c) as relates to properly structuring the preferred partnership to fully take into consideration any potential risk of disallowance of the charitable income and/or gift tax deduction under the so-called "partial interest rules" of those sections. Moreover, there are potential deemed gift tax issues under Section 2701 as well as valuation issues that will need to be carefully considered when structuring the preferred partnership. Most of these considerations will overlap with requirements under the "adequate and full consideration" exception to the partial interest rule.

II. Income Tax Considerations For Deferred Compensation Arrangements Under Section 457A

Section 457A was added as part of the Emergency Economic Stabilization Act of 2008 and now imposes significant restrictions on arrangements previously used by managers of offshore investment funds to defer the recognition of income.

The policy rationale behind the enactment of Section 457A was to prevent a fund manager from deferring recognition of income attributable to management and incentive fees from offshore funds by simply having that income held by a party that was "indifferent" from an income tax standpoint. In its most basic terms, an "indifferent" party is one who has no concerns as to whether or not, and when, it was entitled to take a deduction for the payment of compensation to the service provider, as it does not otherwise pay income tax. Under the previous tax regime, a service provider (e.g., a fund manager) did not have to include deferred compensation in income until actual receipt of the compensation. Hedge funds with a foreign "feeder" which is taxed as a foreign corporation have been particularly attractive for foreign investors and for tax-exempt institutional investors. As a result, the foreign corporate payor of such deferred compensation could not take a deduction until the recipient included the compensation in income, but such deduction was not meaningful since the foreign "feeder" was not otherwise paying

[17] Under Section 170(f)(10), both any income and gift tax deduction is disallowed if charity directly or indirectly pays (or has paid) a premium on a life insurance policy that may benefit non-charities. I.R.C. § 170(10)(f); *See generally* Jonathan Blattmachr, *Some Recapture Considerations and Other Problems Relating to Charitable Lead Trusts*, Leimberg Info. Services, Feb. 11, 2011, https://internal.nfp.com/webfiles/public/enewsletter/insights/0311/links/172.pdf [hereinafter Blattmachr 2011]. It is uncertain how or whether Section 170(f)(10) applies to a charitable lead trust. However, based upon the language of the statute, it seems clear that it does not apply if a paid up policy is contributed to a charitable lead trust.

United States income tax on its share of earnings from the hedge fund in any event. Section 457A changed this process significantly by taxing certain compensation at the time it vests rather than at the time of receipt.

Specifically, Section 457A, entitled "Nonqualified deferred compensation from certain tax indifferent parties," provides that "any compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity shall be includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation."[18] In other words, once the service provider earns the compensation and the right to payment is no longer conditioned upon the future performance of substantial services by any person, it will be includible in gross income, regardless of whether it is received or not. Section 457A applies the concept of a tax indifferent party by use of the definition of a "nonqualified entity." A nonqualified entity is essentially any (1) foreign corporation unless substantially all of its income is either: (a) substantially connected with the conduct of a trade or business in the United States (and, therefore, subject to current US income taxation), or (b) subject to a comprehensive foreign income tax; or (2) any U.S. or foreign partnership, unless substantially all of the partnership's income is allocated to taxable investors.[19] In almost all cases a foreign corporation "feeder" into a U.S. hedge fund structure is a "nonqualified entity" and the U.S. taxable fund manager has compensation rights with respect to which, although receipt is deferred, the payment right is fully vested.

Section 457A applies to amounts deferred which are attributable to services performed after December 31, 2008. Amounts deferred that are attributable to services performed before January 1, 2009 may continue to be deferred under existing arrangements, but must be included in income on the later of December 31, 2017 or the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation.

As a consequence of Section 457A, over the next few years, investment managers who have deferred compensation arrangements will be required to recognize income taxation in the aggregate of billions of dollars under these arrangements as the ten year grace period expires. Aside from situations in which such compensation is subject to an ongoing risk of forfeiture, there seems to be no "quick fix" to avoid the impo-

[18] I.R.C. § 457A(a).
[19] *Id.* § 457A(b).

sition of this income tax recognition.[20] Thus, advisors and fund principals are, of course, interested in exploring ways to offset this income, or at least part of it.

III. CLATs Coupled with Preferred Partnership

A. CLAT Design

Charitable lead annuity trusts can be effective planning vehicles for a number of reasons. If structured as a grantor trust under subpart E of part 1 of subchapter J of chapter 1 of the Code,[21] the donor's gift of property into the CLAT will generate an upfront income tax deduction to the donor for the full amount of the present value of the charitable lead interest, subject to AGI limitations.[22] Additionally, to the extent that the income generated on the assets in the CLAT outperforms the Section 7520 rate, the remainder of the CLAT will pass to the grantor's intended beneficiaries (even if the actuarial present value of the remainder at the inception of the trust is zero). These amounts can be held typically for the grantor's children or trusts for their benefit, and such asset transfers occur without imposition of additional gift or any estate tax.[23]

The funding level of a CLAT, the selection of the charitable recipient for the charitable lead interest and the schedule for the charitable lead interest payments need to be planned in advance of the contribution to the CLAT. In general, all contributions made by a donor to a CLAT are deemed to be contributions "for the use of" charities and, therefore, any deduction to the donor would be limited to 30% of adjusted gross income.[24] The deduction limit would be decreased to 20% of adjusted gross income if the CLAT were funded with appreciated qualifying long-term capital gain property if the charitable lead interest recipient is not a "public" charity.[25] In most cases, contributions to a

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20 *See* Gerald Nowotny, *In the Money – Deferred Compensation Planning for Hedge Fund Managers After IRC Sec 457A*, JDSupra Bus. Advisor, (Oct. 18, 2012), http://www.jdsupra.com/legalnews/in-the-money-deferred-compensation-pla-74322.

21 *See* I.R.C. §§ 671-79.

22 Technically, the limitation is tied to the taxpayer's contribution base defined in Section 170(b)(1)(G) as adjusted gross income ("AGI") without regard to any capital loss carryback. I.R.C. § 170(b)(1)(G).

23 Even if the trust has overall investment performance in excess of the Section 7520 rate used to value the charitable interest in the trust, it may fail if it experiences returns lower than that rate in the initial years of the trust. *Cf.* Jonathan G. Blattmachr & Diana S.C. Zeydel, *Comparing GRATs and Installment Sales*, 41 U. Miami Heckerling Inst. on Est. Plan. 2-1, 2-7, 2-9 (2007) (discussing grantor retained annuity trusts).

24 I.R.C. § 170(b)(1)(B). *See* Treas. Reg. § 1.170A-8(a)(2); Treas. Reg. § 1.170A-8(c)(1)(ii); Treas. Reg. § 1.170A-8(d)(1).

25 Treas. Reg. § 1.170A-8(c).

CLAT are made with cash or high tax basis relative to fair market value assets. Contributions of low tax basis assets even if qualifying for a full fair market value deduction for charitable purposes are not made generally to a CLAT that is taxed as a grantor trust because the gain on the subsequent sale of those assets would be directly taxed to the grantor.

The selection of a charitable beneficiary also needs to be resolved in the governing instrument. In general, the trustee can select a charity or charities, or a charity can be named in the instrument. If the grantor wishes to be named as a trustee, the grantor should not be the person who is selecting the recipient of the charitable payments, since the possession of that power will cause estate tax inclusion problems under Section 2036.[26] Similarly, if the grantor selects, at the time of the trust inception, to direct payments to a private foundation which he and his family as well as the CLAT have and will fund, the operating documents with respect to the foundation will need to be changed so as to restrict grantor selection of charitable recipients for grants from the private foundation so as to eliminate potential Section 2036 problems.[27]

The schedule for the required payments during the charitable lead interest period to a qualifying charity also needs to be considered. In many cases, a fixed payment schedule with level payments for the charitable lead payment period is established in an amount such that the actuarial present value of the lead payments is equal to the fair market value of the contribution. However, in certain cases, the grantor will stipulate a payment schedule that is back-loaded; that is, a schedule that stipulates an increasing annuity payment over the lead payment period. It seems clear that the annuity payments may be determined pursuant to a "word" formula and result in a zero value for the taxable remainder of a CLAT.[28] There is little question that such indexed payments are permitted. Having the annuity payments increase allows for the buffering of investment volatility in the first few years of the CLAT payment period. Some practitioners schedule a 20% annual indexing so as to mirror the increasing annuity payments permitted for so-called "grantor retained annuity trusts" or "GRATs."[29]

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26 *See* Rev. Rul. 72-552, 1972-2 C.B. 525.

27 *See* Rifkind v. United States, 5 Cl. Ct. 362 (1984).

28 *See, e.g.*, PLR 201216045 (January 23, 2012).

29 *See* Treas. Reg. § 25.2702-3(b)(1)(ii). At least two commentators contend that initial extremely small annuity payments will prevent the trust from being treated as a "qualified" CLAT. *See, Charitable Planning Newsletter #162*, LEIMBERG INFORMATION SERVICES, Sept. 21, 2010, https://internal.nfp.com/webfiles/public/enewsletter/insights/1110/links/162.pdf (providing an excerpt from Richard Fox & Mark Teitelbaum, *Validity of Shark-Fin CLATs Remains in Doubt Despite IRS Guidance,* ESTATE PLANNING JOURNAL (Oct. 2010)). But, other commentators disagree. *See, e.g.*, *Charitable Planning Newsletter #163*, LEIMBERG INFORMATION SERVICES, Oct. 5, 2010 (providing commentary

However, from a multigenerational planning standpoint, CLATs do have some inherent limitations due to the fact that it is not possible to get the allocation of the GST exemption to a CLAT "working" during the pendency of the charitable annuity term at any rate above the Section 7520 rate used to determine the value of the charitable interest in the trust.[30] Thus, in most cases, at the end of the annuity term the remainder of the CLAT will pass either to the grantor's children outright or, if in trust, to a trust that will be not be GST exempt (or fully exempt) which means, in general, that distributions to or for more junior descendants than the grantor's children will trigger generation-skipping transfer tax. As a result, CLATs are generally not effective vehicles to achieve multi-generational or "dynastic" preservation of assets, although by reducing overall estate tax, their use may allow other planning which may enhance what is protected from generation-skipping transfer tax.

B. Structuring the Preferred Partnership.

Nevertheless, it may be possible to achieve some of the multi-generational benefits of planning with GST exempt trusts with the benefits of a CLAT through the use of a preferred partnership that is structured to avoid the zero-value rule under Section 2701 pursuant to which a portion or all of certain "preferred" equity interests in an enterprise are valued at zero causing the gift tax value of non-preferred equity interests to be increased by the actual value of the preferred equity.[31] In essence, this type of structure to avoid the zero value rule would involve the creation of a two-class partnership or limited liability company

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by David Pratt, Scott L. Goldberger & Paul S. Lee), https://internal.nfp.com/webfiles/public/enewsletter/insights/1110/links/163.pdf.

30 *See supra* notes 3-4 and accompanying text. As indicated earlier, a CLAT likely is successful only if the investment returns the trust experiences during the annuity term exceed the Section 7520 rate used to determine the value of the charitable interest in the trust. Because the amount of any GST exemption allocated to the CLAT will grow only at that rate, the trust cannot be entirely GST exempt if the investment returns exceed that Section 7520 rate.

31 *See* I.R.C. § 2701. Section 2701 provides a special valuation rule for gift tax purposes when a more "junior" equity interest in a family controlled business enterprise (e.g., a partnership), such as common stock or the equivalent in a partnership, is transferred, directly or indirectly, to or for certain members of the transferor's family if the transferor retains a more "senior" equity interest in the enterprise, such as preferred stock or the equivalent in a partnership. Where the section applies, the gift tax value of the more junior equity is deemed to equal the entire value of the enterprise reduced by the value of the other equity interests in it. As a general rule, where the section applies, the value of these other equity interests (e.g., the preferred interest retained by the transferor) is deemed to be zero so that the gift tax value of the junior equity includes the value of such preferred interests.

("LLC") divided into "frozen" preferred interests as well as common "growth" interests. In most cases, in order to avoid the zero value rule of the Section, the preferred interest would be structured as a "qualified payment right" in accordance with the requirements of Section 2701 which would provide for a periodic payment payable at least annually at a fixed rate,[32] and would also be coupled with a liquidation preference payable at a fixed amount and a fixed time (or times). The common interest would be subordinate and would be entitled to all of the upside appreciation in excess of the annual preferred return and the fixed time/fixed amount liquidation preference.[33]

If structured properly, it may be possible to have the preferred interest owned by a CLAT (and, therefore, avoid application of the zero valuation rule of Section 2701), so that the preferred payments made in connection with the preferred interest (whether qualified payments within the meaning of Section 2701(c)(3) or mandatory liquidation payments)[34] would be paid to the CLAT. These preferred payments could, in turn, be used to satisfy the annuity payments that the CLAT would be required to pay to its charitable beneficiary or beneficiaries. At the termination of the CLAT's charitable annuity term, the preferred interest would pass into either the GST non-exempt remainder trust or, perhaps, to the donor's children. The common "growth" interest, however, could be held by a more GST transfer tax efficient trust such as a long-term GST exempt trust. From a multi-generational planning standpoint, it is generally more advantageous for growth to occur in the GST exempt trust rather than the CLAT. By having the CLAT own the preferred interest, not only does this provide a steady funding mechanism for the CLAT's satisfaction of its annuity payment obligation, but it also can serve to contain the growth of the assets that might otherwise occur in the CLAT that would not be GST exempt in favor of that growth occurring instead in the GST exempt trust.

If it is anticipated that junior family members (such as children or more remote descendants), or the spouse of the grantor will hold common interests in the Preferred Partnership (either directly or as trust

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32 Qualified payment rights are not valued at zero for purposes of Section 2701. *See* Section 2701(a)(3). A qualified payment is defined in Section 2701(c)(3) and "means any dividend payable on a periodic basis under any cumulative preferred stock (or as a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate." *Id.* § 2701(c)(3).

33 The is no statutory value for such a qualified preferred payment so that it may be worth, for gift tax purposes, more or less than the face amount of the preferred equity. *Cf.* I.R.C. § 2702(a)(2)(B) under which an interest in a GRAT has a statutorily determined value under Section 7520.

34 Mandatory fixed amount/fixed time payments rights also are not valued at zero for purposes of Section 2701. *See* I.R.C. 2701(c)(2)(B).

beneficiaries), either from inception or in the future, it is critical that the preferred interest be structured so as to not trigger the special zero valuation rules under Section 2701. Chapter 14 of the Code, consisting of Sections 2701 – 2704, applies to certain transactions occurring after October 8, 1990. Section 2701 applies in the case of "transfers" where a senior generation family member retains senior equity interests, such as a preferred partnership interest, while a junior family member or spouse, either directly or in trust under certain attribution rules, receives a subordinated or common interest in a family controlled entity.[35]

In the context of a Preferred Partnership, where the grantor CLAT would hold preferred interests and the common interest is owned by a GST exempt trust for the grantor's descendants and/or spouses, the attribution rules under Section 2701 will apply to attribute the preferred/senior interest transferred to the CLAT to the grantor.[36] Therefore, it is important that the preferred interest be structured in a manner that does not trigger the deemed gift rules under that section.

Section 2701 values certain retained senior interest in a "controlled entity" at zero for gift tax valuation purposes if the transferor makes a "transfer" to a "member of the family" of the transferor, and a senior family member or an "applicable family member" (essentially senior family members) retains a "distribution right" or certain liquidation or similar rights. Broadly speaking, in the context of a preferred partnership, a preferred interest that is not created within the narrow confines of Section 2701 as a qualified preferred interest or as a mandatory liquidation right has the risk of being valued at "zero," either wholly or in part, in determining the gift tax value of the transferred common/subordinate interest.[37] In other words, if the retained preferred interest

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[35] Treas. Reg. § 25.2701-1(a)(1).

[36] Treas. Reg. § 25.2701-6(a)(4)(ii)(C). During the charitable annuity term, it is not entirely clear whether the trust attribution rules would also attribute ownership of the preferred to the grantor's children as the non-charitable remainder beneficiaries of the CLAT, since, although they do not have any current beneficial interest in the CLAT until the end of the annuity term, it is possible that accumulated income may eventually be paid out to them. In such case, it also is not clear under the "multiple attribution" rules under Treas. Reg. § 25.2701-6(a)(5)(i), with respect to an "applicable retained interest" exactly which attribution would take priority, since the regulations only provide ordering rules in the situation in which both a transferor and an "applicable family member" have attribution; however the regulations appear to be silent and do not provide any such ordering rules when an applicable retained interest is attributed to both a transferor and a "member of the family" such as the grantor's children. In either case, however, grantor would have attribution as to the grantor CLAT; it is only unclear whether this attribution would be exclusive or joint; therefore, in either event it seems Section 2701 would be applicable.

[37] Commentators have noted, however, that the consequence of triggering Section 2701 may not be as dire as the entire preferred interests being valued at "zero" but,

is valued at zero, then under the "subtraction method" of valuation (under which the value of the common/subordinate interest is determined by subtracting from the value of the entire enterprise the value of the retained preferred interest), the potential is that more or possibly all of the entity value will be ascribed to the transferred common interest for purposes of determining whether there is a gift and the value of the gift.

Section 2701 applies not only to gift "transfers" of a subordinate interest to a member of the transferor's family (or a trust for their benefit via the trust attribution rules), but also, to other types of deemed gift "transfers" including capital contributions to a new or existing entity, redemptions, recapitalizations or other changes in the capital structure of an entity.[38] As a result, it is possible for the deemed gift rules of Section 2701 to be triggered in the case of a capital contribution by the grantor or a grantor CLAT to a preferred partnership or a recapitalization of a single-class partnership into a preferred partnership. The Section's application is not limited to just traditional gift transfers, nor is any donative intent required.

In order to ensure avoidance of the zero value rule of Section 2701 in structuring the preferred interest, the most typical approach will be to structure the preferred interest as a "qualified payment right." As explained above, in the case of a partnership or LLC, a qualified payment right is generally a right to receive a cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or at a fixed amount.[39] A qualified payment right prevents that distribution right from being valued at zero under the section but there is no statutory value assigned to such qualified payment rights regardless of the level of dividends (or the equivalent by way of allocations and distributions in a partnership) payable as there is, for example, for a retained interest in a personal residence pursuant to Section 2702(a)(3) or an annuity interest pursuant to Section 2702(b); hence, it may not be possible to ensure the value of the preferred interest will at least equal its face amount for purposes of Section 2701. A qualified appraisal is generally recommended to determine an adequate coupon.

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rather, only the "distribution right" as a component of the preferred interest being valued at zero, but with the associated "liquidation participation right" being accorded full fair market value, which may be significant under certain circumstances in which the subject partnership has a relatively short term. *See generally* Richard L. Dees, *Profits Interests Gifts Under Section 2701: 'I Am Not a Monster,'* Tax Notes, May 11, 2009, at 707, 712.

[38] Treas. Reg. § 25.2701-1(b)(2)(i)(A) to (B).

[39] *Id.* § 25.2701-2(a)(2)(ii).

Presumably, in order for the preferred interest to be at least equal to its face amount, the qualified payment would have to represent a full market rate of return, which likely is impossible to determine with complete accuracy. Similarly, whether the value of a mandatory liquidation right, although not valued at zero for purposes of Section 2701, may cause the value of the preferred interest to equal its face amount, would seem to depend on market rates, unless, perhaps, the right is immediately due. For example, the preferred interest has a face amount of $100. It is entitled annually to an 8% cumulative annual "dividend" and must be redeemed by the partnership for $100 in one year. Whether the cumulative "dividend" and fixed redemption right causes the preferred interest to equal at least $100 depends upon market factors including market rates of return, credit worthiness of the partnership and other factors.[40] Also, regardless of how the preferred interest is valued for purposes of Section 2701 (which would produce an artificial value likely different from its actual fair market value), the actual fair market value would be used for purposes of determining the amount allowed as a gift and income tax charitable deduction.[41]

C. Investing CLAT Assets in a PPLI Policy

As mentioned above, the "trade-off" that the grantor of a grantor CLAT agrees to in exchange for obtaining the upfront charitable income tax deduction for the CLAT contribution is that he or she must recognize the income of the grantor CLAT going forward, which may be undesirable. One creative way to address the income tax liability to the grantor associated with the grantor CLAT's income is by having the CLAT own a PPLI policy as its principal investment. If the CLAT invests "through" a PPLI policy, returns on investments within the PPLI policy will not be taxable to the grantor as long as the PPLI policy continues to be treated as a policy of insurance under Section 7702 and the income is not withdrawn or treated as withdrawn.[42] However, in order to qualify as insurance, a PPLI policy can only invest in an insurance

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40 *Cf.* Rev. Rul. 83-120, 1983-2 C.B. 170 (for the IRS view of how preferred stock should be valued at least in certain circumstances but note that this ruling was issue before the adoption of Section 2701).

41 *See* Treas. Reg. § 1.170A-1(c)(2).

42 A contract that is a life insurance policy under applicable state of foreign law but fails, at any time, to meet the definition of a life insurance policy under Section 7702(a) falls under the treatment specified in Section 7702(g) (a so-called "Section 7702(g) policy"), under which the annual increase in net cash surrender value of the policy (above premiums paid) and the yearly income deemed used to pay the annual cost of term insurance under the policy are included in the owner's gross income annually. By keeping the net cash surrender value "frozen" at no more than premiums paid, the income earned "inside" the Section 7701(g) policy is not included in gross income although income

dedicated fund or funds or through an appropriate asset allocator structure (as is discussed below). These structures must also be operationally sufficient to satisfy prohibitions on the policy owner controlling investments within the policy (the "Investor Control" rule).[43] In addition, there are other requirements that such a policy must meet, including, in particular, a requirement that the investments be properly diversified (the "Diversification" rule).[44]

D. Applying PPLI Principles to Investments.

1. *General Description of a PPLI Policy*

A PPLI policy is one in which the owner of the insurance policy selects an investment program for the policy to invest the policy's assets. However, in order to avoid violating the Investor Control rule, the management of that program is handled independently through an independent investment advisor in one of two ways: (1) directly using a so-called allocator ("Allocator") approach, which is a person or an entity that selects the investments within the policy (discussed below); or (2) by way of an insurance dedicated fund ("IDF") approach, which is a fund that specifically allows investments only by insurance companies through policies they issue (also discussed below). The PPLI policy's investments, by statute and by company mandate, must be maintained in a segregated account rather than in the insurance company's general account, which protects those assets from claims of the insurance company's general creditors.[45] If properly structured so that the policy quali-

earned inside the policy that used to pay the "term" component of the policy is included in gross income. *See* I.R.C. § 7702(g)(1)(D).

43 The so-called "investor control" rule seems to be a doctrine the IRS has attempted to develop under which the income earned on investments made inside a life insurance or annuity contract will be included in the gross income of the policy owner if the owner exercises certain control over the investments. *See, e.g.*, Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 2003-92, 2003-2 C.B. 350.

44 The diversification of investments rule is contained in Section 817(h) and fleshed out in the regulations promulgated under that subsection. *See* I.R.C. § 817(h); Treas. Reg. § 1.817-5. If a contract fails to meet the definition of a life insurance contract under Section 7702(a), so the tax treatment of income it earns is determined under Section 7702(g), the diversification rule should not apply. However, it is generally still recommended that a Section 7702(g) policy meet the diversification rule in order to further support the position that the policy is an insurance policy for U.S. tax purposes.

45 As a general rule, the net amount at risk (or term) component is not held in a segregated asset account and, therefore, may be subject to claims of the insurer's creditors. Not only does that mean that the death benefit may not be paid but it could also mean, if the net amount at risk is attached by the insurer's creditors, that the policy no longer meets the definition of insurance under Section 7702. In Bermuda, some companies domiciled there even have the net amount at risk held in a segregated asset account to avoid those problems and at least one insurer domiciled in Texas also has that protec-

fies as life insurance, returns on the investments in the policy will not be subject to income tax currently. Generally, for federal income tax purposes, in order for a life insurance policy to constitute a life insurance contract, the segregated account's assets must be considered owned by the insurance company rather than by the policy owner. Failure to satisfy this requirement will cause the policy's owner to instead be deemed the owner of the segregated account, and will result in the loss of the policy's income tax advantaged status as a life insurance contract.

2. *Investor Control*

Perhaps the biggest practical limitation for some taxpayers that may make them shy away from obtaining a PPLI policy is the so-called "investor control" doctrine.[46] While a PPLI policy may indeed provide a more efficient way to invest in otherwise tax inefficient investments such as those producing ordinary income or short-term capital gain,[47] inherent with any PPLI policy is a prohibition on the policy owner controlling investment decisions. As a result, the policy owner cannot make investment decisions with respect to the assets in the segregated account. Rather, the insurance company that issued the policy (or an investment manager it chooses) must make those decisions. Failure to adhere to the "investor control" restrictions will result in the IRS treating the policy owner (rather than the insurance company) as the owner of the assets in the segregated account, which will result in the loss of the PPLI policy's status as a life insurance contract and the associated income tax free receipt of income and gains.

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tion for the net amount at risk under its PPLI policies. *See, e.g.*, Evergreen Life Limited Act 2008, No. (xi) (Berm.) *available at* https://www.evergreen.bm/ELL/Evergreen_Life_Limited_Act_2008.PDF.

[46] *See generally* Giordani and Chesner, *870 T.M., Private Placement Life Insurance and Annuities*, BNA.COM (last visited June 1, 2014), http://www.bna.com/portfolio-8701st-private-p17179882261.

[47] Whether the PPLI structure will enhance "after tax" returns depends upon whether the returns in the policy, after expenses, exceed what the after income tax returns would have been in a taxable environment. One simple way to determine if the return will be greater inside the policy is to divide the estimated effective income tax rate into the cost of the policy. For example, if the effective rate of tax on a particular investment is 50% and the annual cost of the policy is 1.25%, then 1.25 divided by .50 is 2.5%. So, if that investment produces more than 2.5% a year, the policy will produce a higher yield. But this is simplistic in several ways. For example, certain investments cannot be made inside the policy (*e.g.,* on account of diversification, the investor control rules and liquidity needs to pay death benefits and costs incurred inside the policy). On the other hand, some investment advisors have claimed that they could achieve a higher gross return if they were investing in an entirely income tax exempt environment, in that they have greater flexibility to acquire and dispose of assets without tax friction so as to achieve the highest absolute return for the applicable risk tolerance of the investor.

The IRS issued a number of revenue rulings beginning in the 1970's in order to provide some guidance as to when a policy owner would be considered to be the owner of assets held in a variable life insurance contract or a deferred variable annuity. These rulings generally relied upon an analysis of whether or not a policy owner had control over investment decisions.[48] In many cases the IRS rulings also related to whether the investment choices within the policy were also available to the general public without an investment in a variable contract.

There is virtually no case law addressing the issue of investor control. However, in *Christoffersen v. Commissioner*,[49] the United States Court of Appeals for the Eighth Circuit held that, because the owners of a deferred variable annuity held numerous investment and other rights with respect to the policy assets (including the right to select which mutual funds the contract would invest in and the right to change such investment, as well as the right to withdraw such investment on seven days notice), the owners were treated for federal income tax purposes as owning the mutual funds held in the segregated account. Consequently, the owners were currently taxable on all income generated by the account assets. Although the owners of the annuity contract in that case had control over the investments, the Court of Appeals did not rely on that fact alone to conclude that the taxpayers had to include the income earned inside the annuity contract in gross income. Rather, similar to what the IRS itself said in Rev. Rul. 75-85, *supra,* the Court of Appeals stated:

> The Christoffersens have surrendered few of the rights of ownership or control over the assets of the sub-account. . . . The Christoffersens have access to all of the assets in the account at any time. The fact that the Christoffersens chose to reinvest, rather than withdraw, the income from the assets of the account should not affect their tax liability. Under the long recognized doctrine of constructive receipt, the income generated by the account assets should be taxed to the plaintiffs in the year earned, not at some later time when the Christoffersens *choose to receive it*.[50]

48 *See,* Rev. Rul. 2007-7, 2007-1 C.B. 468; Rev. Rul. 2003-92, 2003-2 C.B. 350; Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 81-225, 1981-2 C.B. 12; Rev. Rul. 80-274, 1980-2 C.B. 27; Rev. Rul. 77-85, 1977-1 C.B. 12; *but see*, Investment Annuity, Inc. v. Blumenthal, 442 F. Supp. 681 (D.D.C. 1977), *rev'd on other grounds*, 609 F.2d 1 (D.C. Cir. 1979) *overruling* Rev. Rul. 77-85 1977-1 C.B. 12 (overruled on jurisdictional grounds with the D.C. Circuit Court).

49 Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984).

50 *Id.* at 516 (emphasis added).

The IRS appears to have tried to expand the reach of the Investor Control rule in CCA 200840043[51] (the "2008 CCA Memo"). There, the IRS determined that the owner of an insurance policy (rather than the insurance company) was the owner of the segregated account assets in the situation in which the insurance company held the assets of a segregated account and permitted an independent investment manager to directly invest segregated account assets in investments that were available to the general public.[52]

The logic of the 2008 CCA Memo, however, has been criticized as being an incorrect application of the investor control rule. Three primary criticisms were raised against the 2008 CCA Memo in a letter to the Office of the Associate Chief Counsel for Financial Institutions and Products, dated April 3, 2009, articulating the position of the Committee of Annuity Insurers (the "CAI").[53] First, the CAI argued that the 2008 CCA Memo based its determination on the availability of investments to the general public, rather than upon investor control, which the CAI contended, correctly it seems, are different concepts. This apparent standard of availability of investments to the public, as a basis to determine the existence of investor control, reflected a significant expansion of the prior rulings that determined policy owner ownership of segregated account assets. The prior rulings determined that investor control existed due to the policy owner's investment authority being essentially the same as if the owner had purchased the assets directly.[54]

Additionally, the CAI also asserted that the diversification rule under Section 817(h) was intended to apply so as to preclude a policy from being an insurance contract where the holding is the equivalent to an investment in one asset or, perhaps, a small number of assets, and that the 2008 CCA Memo is not consistent with this intention. It argued that Congress contemplated Section 817(h) to allow a segregated account to hold directly individual securities or shares of public mutual funds, provided that there were a sufficient number of investments,

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51 I.R.S. Chief Couns. Adv. Mem. 200840042 (June 10, 2008).

52 *Id.* Chief Counsel Advice is written advice or instructions prepared by any component of the IRS Chief Counsel's Office to field employees of the Office of Chief Counsel that conveys a legal interpretation of a revenue position, an IRS or Chief Counsel position or policy concerning a revenue position, or a legal interpretation of state law, foreign law, or other federal law relating to the assessment or collection of liabilities under revenue provisions. IRC § 6110(i)(1)(A). A Chief Counsel Advice may not be cited or used as official precedent. IRC § 6110(k)(3).

53 *See,* Letter from Joseph F. McKeever, III & Bryan W. Keene, Davis & Harman LLP, to Sheyl B. Flum, Esq., I.R.S. Assoc. Chief Couns. Off. (April 3, 2009) (on file with author).

54 *See* Rev. Rul. 81-225, 1981-2 C.B. 12, *clarified by* Rev. Rul. 82-55, 1982-1 C.B. 12, *modified by* Rev. Proc. 99-44, 1999-2 C.B. 598, *and clarified and amplified by* Rev. Rul. 2003-92, 2003-2 C.B. 350, *and by* Rev. Rul. 2007-7, 2007-1 C.B. 378.

which represented different issuers and those investments were not directed by the policy owner.[55]

Finally, the CAI argued that the 2008 CCA Memo essentially reverses the "substance over form doctrine." Essentially, the CAI's position was that if the implication of the 2008 CCA is that a segregated account must be invested by way of an IDF as the only way to avoid investor control, such an interpretation forecloses the possibility that certain arrangements do not on the merits result in Investor Control by the owner of the policy.

a. *Asset Allocator Structure within PPLI*

For many years, insurance companies have offered PPLI policy owners the choice of selecting an investment manager from an approved list of professional investment managers who would in turn manage the segregated account of the insurance company for the benefit of the policy owner. This "investment allocator" would select various securities or investment funds otherwise available to the general public. As discussed previously, this model was put into question as a result of the release of the 2008 CCA Memo, discussed above. As a consequence, in many instances, advisors to PPLI clients have advised against the investment allocator approach.

Subsequent PLRs have reflected a less restrictive interpretation of the investor control doctrine being applied by the IRS than the 2008 CCA Memo, and some appear to sanction the investment allocator approach.[56] In PLR 200915006, the IRS determined that the holders of deferred variable annuities or variable life insurance policies that held shares of mutual funds that were available to the general public by way of IDFs did not constitute investor control where the IDFs were only available through the purchase of an annuity or life insurance policy. The reasoning was that, while the underlying mutual fund shares were

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55 Staff of the S. Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 608 (Comm. Print 1984); See also Staff of the S. Comm. on Tax'n, 98th Cong., Explanation of the Provisions approved by the Committee on March 21, 1984 546 (Comm. Print 1984).

56 Although Section 6110(k)(3) currently prohibits the use of a private letter ruling as precedent, private letter rulings often serve as evidence of the IRS's position with respect to particular transactions and have been cited by both taxpayers and the courts on occasion in support of conclusions. *See, e.g.*, Wolpaw v. Commissioner, 47 F.3d 787 (6th Cir. 1995). While a private letter ruling is not official precedent and cannot be relied on by anyone other than the taxpayer to whom it was issued, it is indicative of the views of the IRS and is relevant for determining whether a taxpayer had reasonable cause for taking a position. *See id.* at 792.

available to the public, the IDFs were only available through purchase of a variable contract.

Additionally, in PLR 201105012, investor control was determined not to exist with respect to assets held in certain funds that were available to the general public with respect to variable annuity contracts.[57] An investment manager made all investment decisions in its sole discretion, and the holder of the contract had no ability to make such decisions. Additionally, there was no agreement between the insurance company or the investment manager and the contract owner as to investment decisions.

Despite the IRS' view as expressed in the 2008 CCA Memo and other pronouncements, the better view would appear to be that the investor control rule has its origins in the doctrine of constructive receipt.[58] As such, the better argument is that where the facts do not give rise to the application of the constructive receipt doctrine in the case of a life insurance policy using the investment manager (or allocator) approach, the mere fact that investments within the policy may consist of those also available to the general public should not result in investor control, if the arrangement imposes adequate limitations on the policy holder's control of investments.

There is further support for this conclusion in the IRS' determination in PLR 201105012. In that ruling, it was determined that the holder of the contract did not have control over investments of the assets in the insurance contract. The IRS considered whether the holder had control or influence over the investment decisions of the segregated asset account of the insurance contract or any particular information regarding the assets in the account. The fact that the assets in the segregated account were also available to the general public did not appear to influence the conclusion.

In any event, the investor control restrictions are not "black and white" and a determination of whether such control exists requires an evaluation of the extent of the control between the policy owner and the

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57 *See* PLR 201105012 (February 4, 2011). The ruling involved so-called lifecycle insurance funds (funds that invest based on the approximate year of the contract holder's retirement) managed by a life insurance company under a deferred variable annuity contract.

58 The constructive receipt doctrine is set forth in Treas. Reg. § 1.451-2(a). The doctrine of constructive receipt is a doctrine to the effect that a cash method taxpayer cannot postpone the reporting of amounts into gross income merely by his or her failure to exercise his or her unrestricted power to collect such amounts. Income is not constructively received if a valuable right or privilege must be relinquished to receive such entitlement until the time of relinquishment. *Id.* Under Treas. Reg. § 1.451-2(a) an amount is not constructively received if the taxpayer's control over the amount is "subject to substantial limitations or restrictions.

independent investment manager. The most conservative approach is for the policy owner to only provide a general investment mandate or choice of program to the insurance company. The insurance company would independently select an investment manager who would have no communication with the policy owner. It is not entirely clear, however, whether and to what extent some limited communication between the policy owner and the investment manager will violate the investor control restrictions and jeopardize the status of the policy.

b. *The IDF Structure within PPLI.*

As an alternative to the investment allocator approach described above, for purposes of managing investment within a PPLI contract, the predominant method of investing PPLI assets is now through the use of "IDFs." The IDF model appears to be a "safe-harbor" for purposes of avoiding application of the investor control doctrine as a result of the issuance of Rev. Rul. 2003-92.[59] That ruling describes various scenarios where the assets in variable contracts are invested in a private partnership (not SEC registered). If the assets in the segregated asset account are invested into the partnership which interests can be purchased only by a policy owner's purchase of a variable life insurance contract or a variable annuity contract then the IRS has specifically ruled that the policy owner was not the owner of the segregated asset account. The use of an IDF also permits a look-through to the underlying assets of the IDF for diversification testing (as described below). The conclusions reached in Rev. Rul. 2003-92 were recently reaffirmed with the issuance of PLR 201417007, which ruled that an IDF was permitted to invest in retail funds otherwise available to the public without causing a variable contract holder to be treated as the owner of the IDF's assets for income tax purposes.[60]

3. *Diversification*

In addition to the Investor Control restrictions, Section 7702(a) requires that the "Diversification" rules under Section 817(h) be satisfied with respect to a variable insurance policy's segregated account for it to be considered a life insurance contract for income tax purposes. The diversification rules for a segregated account are satisfied if, determined on a quarterly basis:

A. No more than 55% of the value of the total assets of the account is represented by any one investment;

[59] *See generally,* Rev. Rul. 2003-92, 2003-2 C.B. 350.
[60] See PLR 201417007 (April 25, 2014).

B. No more than 70% of the value of the total assets of the account is represented by any two investments;
C. No more than 80% of the value of the total assets of the account is represented by any three investments; and
D. No more than 90% of the value of the total assets of the account is represented by any four investments.[61]

For purposes of the Diversifications rules, an investment is any single investment (stocks, bonds, treasuries, cash) or an investment entity (mutual fund or investment partnership) that cannot be regarded as a look-through entity under the diversification Treasury Regulations.[62] The Treasury Regulations do not permit look-through treatment for investment partnerships (and entities that hold investment partnerships as a single investment), unless all of the beneficial interests are held by one or more segregated asset accounts of one or more insurance companies and public access to such investment entity is available exclusively through purchase of a variable contract.[63] Limited other investors can also invest in these funds.[64] The obvious advantage of this type of fund is that under look-through treatment, the ability to test for diversification is made significantly easier.

These Diversification rules are only applicable with respect to a "variable contract" under Section 817(d). As this applies to a life insurance contract, this means a contract:

1. which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company; and

2. the amount of the death benefit (or period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account.[65]

While the Code makes reference to the term "State law,"[66] the IRS has indicated that "State," for purposes of Section 817(d), also includes a jurisdiction exercising statutory or regulatory authority over the separate accounts of a foreign life insurance company.[67]

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[61] Treas. Reg. § 1.817-5(b)(1)(i).
[62] *See id.* § 1.817-5(f).
[63] *See* Treas. Reg. § 1.817-5(f)(2).
[64] *See id.* § 1.817-5(f)(3).
[65] I.R.C. § 817(d).
[66] *Id.* § 7701(a)(9), (10).
[67] PLR 201027038 (March 1, 2010). Although the ruling dealt with a foreign life insurance company that had made the election under Section 953(d) to be treated as a United States life insurance company for United States income tax purposes, it does not seem that this fact was critical to the IRS' conclusion. See also PLR 200246022 (March

A variable contract that is diversified under Section 817(h) is not treated as a life insurance contract for that year and all subsequent years even if the variable contract is subsequently diversified. In such event, the policy owner would be taxable annually on the income on the contract equal to the increase in the cash surrender value (i.e., often called the "inside buildup").

E. PPLI as a Vehicle for Investing in Real Estate.

The structure with the combination of the CLAT coupled with the PPLI policy, or perhaps that structure further combined with the Preferred Partnership (in which the CLAT would own the "frozen" preferred partnership interest, with perhaps a GST exempt trust holding the common interest) could provide an attractive structure for individuals interested in investing in commercial real estate.

This could be achieved to the extent that the PPLI policy that is either owned by the CLAT or the Preferred Partnership (depending upon the structure) invests its assets into an IDF that invests its assets into various commercial real estate investments. Subject, of course, to compliance with the Investor Control and the Diversification rules that have been discussed at length above, this structure could provide a very tax efficient way to invest in commercial real estate.[68] By having the PPLI policy investing into an IDF that invests in commercial real estate, the structure would enable income generated from the real estate to be income tax free. Of course, due to the Investor Control issues, the owner of the PPLI policy (either the Trustees of the CLAT or the Preferred Partnership) cannot have any involvement in the investment decisions of the IDF, which would otherwise risk the loss of the income tax free treatment of the PPLI policy. However, the owner of the policy may select the general types of investment that it would like the insurance company to select when evaluating various IDFs in which to invest the assets of the policy, and then utilize an independent real estate manger as the IDF manager.

As mentioned above, to the extent that the structure is implemented in conjunction with the Preferred Partnership, any growth above the preferred coupon and liquidation preference required to be paid to the CLAT will inure to the benefit of the holders of the common "growth" interests (ideally a GST exempt trust). To this end, because the PPLI policy would enjoy income tax free growth, this would enable more assets to remain in the GST exempt trust. To the extent that the

22, 2002) and PLR 201410012 (March 7, 2014), in which the IRS reached the same conclusions under similar facts.

[68] *See supra* note 44 and accompanying text.

selected IDF employs leverage in order to acquire additional real estate investments having significant growth potential, the preferred return coupon required to be paid to the CLAT could be significantly less than the return on investment of the preferred partnership assets, and thereby shift greater growth to the common interest holders.

F. Paying the CLAT Required Annuity Payments with PPLI Policy Loans: MEC vs. Non-MEC.

So long as the PPLI policy is not a modified endowment contract ("MEC") within the meaning of Section 7702A, the CLAT may withdraw from or can borrow against the cash value of the policy to make charitable payments or other investments outside of the insurance policy, without the imputation of gross income attributable to the increase in cash value in the policy.[69] A policy is characterized as a MEC if the premiums are paid in too rapidly. If the life insurance policy is a MEC, the policy owner's withdrawals from the policy are taxed as ordinary income to the extent of any growth in the cash surrender value over the investment in the insurance contract.[70] Essentially, a life insurance policy, if properly designed, can qualify as a non-MEC if the accumulated amount paid under the contract during the first seven years of the contract does not exceed the sum of the net level premiums that would have been paid on or before that time had the contract provided to be paid-up after 7 years. This is known as the "7-pay test."[71]

The purposes of the MEC limitations include ensuring that the contract is one of insurance and not investment. Prior to the June 21, 1988 effective date of the MEC legislation, it was common to pay the premium for an insurance contract in one up-front payment. The MEC legislation limits non-taxable withdrawals from the variable policy during the lifetime of the insured, but since the MEC contract conforms to the life insurance definition under Section 7702(a), the receipt of death benefit at the insured's death is income tax-free under Section 101. As a practical matter, after the MEC legislation most non-MEC insurance policies are funded with level premiums paid over a period from 3 to 7

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69 I.R.C. § 7702(g). If the taxation of the policy is governed by Section 7702(g) as opposed to Section 7702(a) and if net cash surrender value does not exceed premiums paid, the owner can borrow (up to the amount of net cash surrender value) without any imputation of gross income. It seems that a policy whose taxation is governed by Section 7702(g) cannot be a modified endowment contract, as MEC status can apply only to a policy whose taxation is governed by Section 7702(a). Hence, if the CLAT holds a so-called "Section 7702(g) policy," it should be able to borrow up to the net cash surrender value without incurring gross income and use the borrowings to make the annuity payments to the extent of such borrowing.

70 I.R.C. § 72(e)(10)(A).

71 I.R.C. § 7702A(b).

years. In the case of a level premium schedule less than 7 years, an actuarial calculation is necessary so as to purchase more life insurance protection for the initial years of the policy, followed by a drop in pure insurance protection following the expiration of the 7-pay period.

G. Concerns Under Section 170(f)(10).

There are several important tax issues that must be carefully considered, including potential denial of any charitable gift or income tax deduction and the potential imposition of a significant excise tax if the CLAT pays premiums on a policy it receives as a contribution or that it acquires.[72]

Section 170(f)(10) disallows any charitable deduction if any charity "directly or indirectly" pays (or has paid) any premium on any "personal benefit contract" or there is an understanding or expectation that "any person" will directly or indirectly pay any premium on any personal benefit contract.[73] In addition, a 100% excise tax is imposed on any charity equal to the premiums it pays on such a personal benefit contract.[74] The effect of falling under the section is extremely adverse: no income tax deduction; gift tax due on the entire amount contributed; and confiscation, as a practical matter, by the IRS of the policy.

A "personal benefit contract" is any life insurance, annuity or endowment contract if any "direct or indirect" beneficiary is the transferor, any member of the transferor's family or anyone (other than a charity) designated by the transferor.[75] The section clearly indicates that it applies to a charitable remainder trust (unless falling under a narrow exception the section contains).[76] Additionally, while there does not appear to be any provision under Section 170(f)(10) that specifically applies the section to a charitable lead trust, the potential risk is that if the remainder beneficiaries of the CLAT are members of the transferor's family or are persons designated by the transferor (i.e., the grantor of the CLAT), then it is possible that the section could apply. While the application of the section to a CLAT is not entirely clear, if it is envisioned that a CLAT will hold an insurance policy with respect to which premium payments will be due, it is important that this issue be carefully considered.[77]

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72 *See id.* § 170(f)(10)(A).

73 *Id.* § 170(f)(10)(A).

74 *Id.* § 170(f)(10)(F)(ii).

75 *Id.* § 170(f)(10)(B).

76 *See* I.R.C. § 170(f)(10)(C).

77 *See generally* Donald O. Jansen, Charitable Lead Trusts: The Underused Family Wealth Transfer And Income Tax Technique For The Charitably Inclined, HOUSTON BUS. & ESTATE PLANNING COUNCIL (April 20, 2012), available at http://www.estateplan-

Arguments can be made that Section 170(f)(10) should not be applicable to a CLAT. While the legislative history to the section does make reference and specifically provides for applicability to charitable remainder trusts that hold insurance policies, no such reference is made to charitable lead trusts. Indeed the entire subsection applies to tax-exempt Section 170(c) organizations; however, a charitable lead trust is a taxable entity. While one or more organizations described in Section 170(c) will receive the charitable annuity, the amount to be received by such organizations is fixed by the terms of the trust and thus is unaffected by the purchase of a PPLI policy. It is thus far from clear that any charity is even "indirectly" paying the premiums of the PPLI policy. Additionally, the legislative history indicates that the perceived abuse to be prevented by the statute involved the situation in which money was transferred to a charity, thereby providing a charitable deduction to the transferor; however, those funds were then applied by the charity for the payment of insurance premiums on a policy some or all of the proceeds of which were payable to or for the benefit of the transferor's family members. The concern expressed was that the charity was being used primarily as a conduit for the payment of premiums while generating a deduction, but it would receive very little benefit from the arrangement as all it would receive upon maturity of the policy was the premiums paid with the excess death benefit passing to the transferor's family members.

In the context of a charitable remainder trust, a narrow exception exists that provides that a person shall not be treated as an indirect beneficiary under a life insurance contract held by a charitable remainder annuity trust or unitrust solely by reason of being the recipient of such annuity or unitrust payments if such trust is the owner and beneficiary. The relevant legislative history provides that:

> The provision . . . provides that a person is not treated as an indirect beneficiary solely by reason of being a noncharitable recipient of an annuity or unitrust amount paid by a charitable remainder trust that holds a life insurance, annuity or endowment contract. The rationale for these rules is that the amount of the charitable contribution deduction is limited under present law to the value of the charitable organization's interest.[78]

In the case of a CLAT that pays premiums, a similar argument could be made by analogy that because a charitable deduction is determined based upon the value of the charitable interest, which in the case

ningcouncilofmanateecounty.org/assets/Councils/Manatee-FL/library/Charitable%20 Lead%20Trust%20Outline.doc.

78 S. Rep. No. 106-201 (1999).

of a zeroed-out CLAT is essentially the entire amount of the CLAT, then, actuarially, the remainder beneficiaries (who presumably are family members of the transferor) should not be considered to be direct or indirect beneficiaries under the insurance contract and, thus, Section 170(f)(10) should not apply.

Additionally, in the context of the Preferred Partnership CLAT structure, it is also uncertain whether the CLAT would even be treated as directly or indirectly paying a premium if the partnership that owns the policy, of which the CLAT is only a limited partner and has no control over investment or distribution decisions, pays the premiums on a policy (rather than the CLAT paying the premiums), while the CLAT merely holds a preferred interest in the partnership.

If, however, it is determined that Section 170(f)(10) applies, then a CLAT should not buy a policy (or even receive it as a contribution unless fully funded) and then pay the premiums over a period of years on a schedule designed to avoid the policy being classified as a MEC without the risk of triggering the Section.

If, however, the grantor of the CLAT already owned a policy that was not a MEC, and that was fully "paid-up," it appears it could be contributed to the CLAT without loss of the income and gift tax deductions and without imposition of the excise tax. Because the premiums would not, in fact, have been paid by the CLAT and the fact that they were paid before the trust was even created should mean, based upon a plain reading of the statute that the Section should not apply. However, ordinarily, most taxpayers likely would not readily have such a non-MEC policy that is an appropriate asset to contribute to a CLAT.[79]

As discussed above, it may be able to plan in advance of the end of 2017 to begin to annually fund a PPLI policy so as to be a non-MEC. However, this may require the acquisition of greater insurance coverage than is desired.

Perhaps, the best of all possible worlds is to structure the CLAT payments to mirror the expected receipt of death proceeds from the policy (even it is a MEC) which are income tax free under Section 101(a)(1) which could be used to fund the annuity payments. Of course, because the amount of each annuity payment must be specified at the

[79] The adverse consequences of Section 170(f)(10)(A)(i) and (ii), among other things, apply only if "(i) the [charitable] organization directly or indirectly pays, or has previously paid, any premium on . . . [the insurance] contract with respect to the [donor] . . . or (ii) there is an understanding or expectation that any person will directly or indirectly pay any premium on . . . [the insurance] contract." Hence, if the policy is already fully "paid up" (that is, no expectation of further premium payments) at the time the policy is transferred to the charitable lead trust, and before the trust is created, it seems the section could not apply.

inception of the CLAT, it will be difficult to have the annuity payments track the estimated death proceeds unless there is such a large number of lives insured that their deaths can be reasonably forecast actuarially.

Some have suggested the use of a so-called "shark-fin" CLAT under which small annuity payments are made annually until a specified time or an event (such as the death of the insured of the policy held by the CLAT) dies.[80] There have been questions raised about shark-fin CLATs that will make a huge (at least in a relative sense) payment at a particular point in time (such as the death of the insured). The use of a carefully structured and administered shark-fin CLAT appears viable; however, several unresolved issues should be considered.[81]

IV. Split Interest Rules

In addition to the issues under Section 2701 and Section 170(f)(10), discussed above, planning with the Preferred Partnership CLAT necessarily will involve navigating the complicated rules under Section 170(f)(2) and Section 170(f)(3) as well as the partial interest gift tax rules under Section 2522(c). The Code provides that a deduction is allowed for qualifying contributions to charitable organizations for income and gift tax purposes during lifetime and for estate tax purposes at death.[82] Contributions that are not described in the applicable section are not deductible. Hence, a transfer of property by a taxpayer during lifetime to a charity that is not in a qualifying form described in Section 2522 is considered a taxable gift. It may seem surprising but the provisions of the Code allowing a deduction for estate, gift and income tax purposes are not identical. For example, there is no complete overlap among the organizations that qualify for income, estate and gift tax purposes.[83] Moreover, although all three sections have rules that deny any deduction for certain donations of partial interests in property, they vary in some important ways and each permits a charitable deduction for donations of certain partial interests.

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[80] *See*, Lee & Berry, *Reeling, Rolling and Reining In "Shark-Fin" CLATs*, 51 Tax Mgm't. Memorandum No. 25, 435 (Dec. 6, 2010).

[81] *See* Blattmachr 2011, *supra* note 17 (providing a discussion of the unresolved issues when using shark-fin CLATs).

[82] *See Id.* §§ 170, 2522, 2055. Note that under Section 642(c), an estate or a trust may be entitled to an income tax deduction for its gross income paid pursuant to the terms of its governing instrument paid, or in some cases permanently set aside, for a charitable purpose specified in Section 170(c).

[83] Among other distinctions, contributions to certain cemetery companies qualify for the income tax but not the estate or gift tax deductions; certain contributions to employee stock ownership plans qualify for the estate tax but not the income tax or gift tax deduction; contributions to certain war veterans qualify for gift tax purposes but not income or estate tax purposes. *Id.* §§ 170, 2055, 2522.

1. *General Comparison of Partial Interest Rules for Income and Gift Tax Purposes*

Both the gift tax and income tax charitable contribution provisions contain similar partial interest rules. Both, in general, disallow any deduction for a contribution of a partial interest in property although both permit a deduction if the only interest the taxpayer holds is the partial interest. However, for income tax purposes, the rule disallowing a deduction for the partial interest applies even if that is the only interest the taxpayer held in the property if it was divided to avoid the partial interest disallowance rule even if the division occurs by a sale for full and adequate consideration.[84] It seems quite certain that if the property was not divided to avoid the partial interest disallowance rule, an income tax deduction is allowed for the contribution of the partial interest.

Nonetheless, for gift tax purposes, the disallowance applies regardless of the reason for the division if the interest not contributed to charity is retained by the donor or has been transferred to anyone for less than an adequate and full consideration in money or money's worth.[85] Yet, for gift tax purposes, if the transfer is for full and adequate consideration, the gift of the remaining interest is allowed even if the motivation is to avoid the partial interest rule.

2. *Income Tax Partial Interest Rules*

Essentially, for income tax purposes, there are two distinct and apparently mutually exclusive partial interest rules.[86] Section 170(f)(2) deals with contributions in trust where charities and a non-charities have an interest—in other words, where part of the trust is dedicated to charity and part is not. Under Section 170(f)(2)(A), a deduction is permitted for a contribution for the remainder in a trust only if the trust is in the form of a charitable remainder trust ("CRT") described in Section 664 or a pooled income fund described in Section 642(c)(5). Under Section 170(f)(2)(B), the value of certain annuity and unitrust streams payable from a trust (a so-called "charitable lead trust" or "CLT") that is a grantor trust for purposes of Section 671, are deductible. That, in effect, is the scope of the rule: a deduction for the remainder in a CRT or pooled income fund, or a deduction for a leading interest (consisting of the right to an annuity or annual unitrust payment) from a grantor CLT. No other interest in a trust is permitted even if it were the same as a partial interest in property that is not in trust, such as the remainder in a

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[84] *Id.* § 170(f)(3).

[85] *Id.* § 2522(c).

[86] *See Id.* § 170(a)(3) (partial interest rule relating to future interests in tangible person property). Other parts of Section 170 contain other partial interest rules, such as a contribution of a qualified conservation contribution described in Section 170(h).

personal residence, permitted under Section 170(f)(3)[87]—in other words, a deduction for the value of the remainder interest transferred to charity in a trust that holds a personal residence for the use of a taxpayer is not allowed.

Under Section 170(f)(3), in the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction is allowed only to the extent that the value of the interest contributed would be allowable as a deduction under Section 170(f) if such interest had been transferred in trust or falls under another exception (such as the contribution of a remainder interest in a farm or personal residence,[88] the contribution of an undivided portion of the taxpayer's entire interests in property, or a qualified conservation contribution).[89] Of course, if the property transferred is not a partial interest, the disallowance for the contribution under the section does not occur.

In other words, Section 170(f) has one set of rules for charitable contributions by a transfer in trust (or, in other words, giving charity a partial interest in the trust) and contributions of a partial interest in the property that is not in trust. At least some of the distinctions between the two are fleshed out in the regulations.

Treas. Reg. § 1.170A-6, entitled "Charitable Contributions in Trust," provides that no deduction is allowed under Section 170 for a charitable contribution of any interest in property which is less than the donor's entire interest in the property and which is transferred in trust unless the transfer is in the form of a charitable remainder trust, a pooled income fund or a charitable lead trust.[90] But the regulation does not discuss the type of property that may or may not be contributed to such a trust or fund, nor does it suggest that the property contributed to the trust must itself not constitute a partial interest that, if it were not transferred in trust, would be disallowed for a deduction by reason of Section 170(f)(3).

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87 *See id.* § 170(f)(2)-(3).

88 *See id.* § 170(f)(3)(i); *cf.* Treas. Reg. § 20.2056(b)-5(f)(4)("a power to retain a residence. . .for the personal use of the spouse will not disqualify the interest passing in trust" for the marital deduction). In other words, for marital deduction purposes, the residence rule applies even if it is in trust but apparently not for charitable deduction purposes if in trust. That is, Section 170(f)(3) allows a deduction for a transfer, by way of example of a remainder interest in a home, not in trust, but apparently not if the home is placed in trust (where a non-charity may have the use of the home) with the remainder over to charity—for transfers in trust, a charitable deduction is permitted for a partial interest in the trust only if it is in the form of a CRT, CLT or a pooled income fund.

89 I.R.C. § 170(f)(3)(B)(ii)-(iii).

90 Treas. Reg. § 1.170A-6(b)(1).

Treas. Reg. § 1.170A-7, entitled "Contributions Not in Trust of Partial Interests in Property," provides, in part, that, in the case of a charitable contribution not made by a transfer in trust of any interest in property, which consists of less than the donor's entire interest in such property, no deduction is allowed under Section 170 for the value of such interest, unless the interest is an undivided interest in the property, a remainder interest in a farm or person residence, a qualified conservation contribution or a transfer that would be deductible if it had been made in trust (e.g., an annuity stream of the type described in a qualified charitable lead trust).[91]

Treas. Reg. § 1.170A-7(a)(2) provides that the deduction is not disallowed if the property contributed is the taxpayer's entire interest in the property even if that interest is itself a partial interest. However, the regulation qualifies this by providing that "[i]f, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A) [the disallowance for a contribution not in trust of a partial interest rule], the deduction will not be allowed."[92] Therefore, if the property was divided for another reason and then the retained interest is contributed to charity, the deduction will be allowed for income tax purposes. Thus, it seems that if the motivation for the division was the defeat of the partial interest rule, the income tax deduction is disallowed, apparently even if the division occurred by a full value sale of the interest transferred by the taxpayer. So, by way of example, if the taxpayer sold an income interest to a relative for its full value and contributed what remains in his or her hand, the deduction would be disallowed for income tax purposes if the motivation was to defeat the partial interest rule of Section 170(f)(3).

a. *Example of Partial Interest Transfers for Income Tax Purposes*

Partial Interest in a Partnership. As an example of the potential application of the Section 170(f)(3) partial interest rule, consider a partnership in which the taxpayer holds both preferred and common type interests. Even if the taxpayer formed the partnership, each of the preferred and the common interests would seem to be separate property, not partial interests in the same property (that is, the property in the partnership or its assets). Indeed, it seems nearly impossible to contemplate that the IRS would take the position that a contribution of pre-

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91 *Id.* § 1.170A-7(a)-(b). Note that for gift tax purposes, a deduction is allowed for an annuity or unitrust stream only if paid from a trust or by an insurance company or by an organization regularly engaged in issuing annuity contracts. *Id.* § 25.2522(c)-3(c)(2)(vi)(c). There does not seem to be a similar rule for income tax purposes.

92 *Id.* § 1.170A-7(a)(2)(i).

ferred stock in a public company is a partial interest where the contributor also owns common stock in the same company, regardless of the taxpayer's motivation in acquiring preferred and common stock and even if the taxpayer acquired them simultaneously and with an intent to contribute only the preferred (or only the common) to charity. Of course, for a public company's preferred and common stock, it seems unlikely the IRS would contend that they were acquired to avoid the partial interest rule of Section 170(f)(3). The result might not seem to be different if the taxpayer formed the partnership and intended to contribute one type of equity to charity from inception based, at least, on the reasoning express in a concurring opinion in *McCord v. Commissioner,*[93] and, perhaps, other authority.

In *McCord*, the taxpayers formed McCord Interest, Ltd., L.L.P ("MIL"). The taxpayers held Class A limited partnership interest and the taxpayers and another partnership formed by the taxpayers' children held Class B limited partnership interest.[94] The Class A and Class B interests were not identical. After assigning their Class A interests to one charity, the taxpayers later assigned their Class B limited partnership interests to separate trusts for their children, and two other charitable organizations. Under the assignment agreement of their Class B interests, the taxpayers relinquished all dominion and control over the assigned partnership interests and assigned all their rights with respect to those interests to the charitable assignees.[95] The assignment, however, did not contain any language to indicate that the assignees either would become or had the partnership's approval to become Class B Limited Partners. Under the partnership agreement, no assignee of a partnership interest could attain the legal status of a partner in MIL without the unanimous consent of all MIL partners.

The majority in *McCord* held that the assignees were only given economic rights to the partnership, rather than partnership interest.[96] However, the court reasoned that the term "partnership interest," as defined in the governing state law and the partnership agreement, meant interest only in the economic sense.[97] Furthermore, the circumstances of the transactions did not warrant the court to infer that the

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[93] McCord v. Comm'r, 120 T.C. 358 (2003), *rev'd and remanded*, 461 F.3d 614 (5th Cir. 2006).

[94] *Id.* at 361.

[95] *Id.* at 364.

[96] *Id.* at 373.

[97] *Id.* at 363. The Texas Revised Limited Partnership Act provides that "an assignment of partnership interest entitles the assignee to distributions and allocations, but the assignor continues to be a partner and to have the power to exercise any rights or powers of a partner, until the assignee becomes a partner." *Id.* at 372 n.7. The MIL partnership agreement defines "partnership interest" as an "interest in the partnership presenting any

taxpayers had intended to transfer *all* their rights and that the partnership had effectively consented to the admissions of the assignees as partners.[98] The court then determined the value of the charitable donation to one of the charities (the donation to the other was not contested) and granted a gift tax charitable deduction under Section 2522.

The concurring opinion by Judge Swift in *McCord* noted the absence of a partial interest argument and held that had the IRS argued in the alternative that the partial interest rules of Section 2522(c)(2) applied, then "it would appear that the [taxpayers'] claimed charitable deduction herein would have been completely disallowable."[99] In order for the majority opinion to stand, the concurrence explained that the partnership interests must be interpreted to consist of two separate and distinct interests (an economic and noneconomic interest) where the taxpayers had transferred an undivided portion of the separate economic interest to charity.[100] However, the concurring opinion conceded that the correct analysis would be to treat the assigned interest as one interest consisting of both economic and noneconomic rights, of which the taxpayers transferred only a partial interest to charity and, therefore, would be disqualified from the gift tax deduction pursuant to Section 2522(c)(2).[101]

The *McCord* majority and concurring opinions suggest that a partnership interest can be construed as either separate or partial interests.[102] The distinction will depend on the language of the governing statutes, the partnership agreement and the nature of the transfer. In particular, the concurrence noted that the assignees were not given the right to vote, veto, redeem the partnership interest, inspect proprietary information, or access properties owned by the partnership.[103] Such rights constituted "substantive and significant limitations" which rendered the transferred interest to be a separate and distinct interest.[104]

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partner's right to receive distributions from the partnership and to receive allocations of partnership profit and loss." *Id.*

98 *Id.* at 373.

99 *Id.* at 405.

100 *Id.* at 410.

101 *Id.* at 411.

102 The issue of partial interest was addressed only by Judge Swift's concurrence. One could argue that other judges agreed *sub silentio* with Judge Swift's conclusion of partial interest. However, without direct support from the court, Judge Swift's conclusion may not be definitive.

103 *McCord*, 120 T.C. at 406.

104 *Id.* at 407. Voting rights appear to be an important distinction when categorizing an interest as a separate interest. In Rev. Rul. 81-282, 1981-2 C.B. 78, the Service denied a deduction where the taxpayer contributed stocks to a charity but retained the voting rights. The Service stated that voting right was a substantial interest and by retaining such right, the taxpayer distributed only a partial interest in the property, which was not

In light of the *McCord* ruling, it might seem there is some risk that an argument could be made that one type of a partnership interest could be treated as a partial interest for purposes of Section 170(f)(3) where the donor holds another type of partnership interest unless the donor can establish that the formation of the partnership with the two types of interests was not done to avoid the partial interest division rule as set forth in Treas. Reg. § 1.170A-7(a)(2).

While the concurring opinion in *McCord* may initially give one pause to consider the risks associated with the partial interest rule, it does not appear that the logic of the concurrence should apply to a two-class preferred partnership arrangement, in contrast to a division of a partnership interest and its economic rights, as in *McCord*. Although it is possible that the transfer of a preferred interest to a charity while the donor retains the common interest could conceivably be argued to be the transfer of a partial interest in the partnership, with the donor retaining another partial interest, in the form of the common interest, it is not certain. In fact, two aspects of Judge Swift's concurring opinion and the absence of its mention in the majority opinion suggest that different classes of partnership interests are different properties, not partial interests in one property.

In *McCord,* the majority seemed to find that not all Class B partnership rights (only its economic rights) were transferred to the two charities. Neither Judge Swift nor the majority discussed the fact that the donors had previously given away their Class A partnership interests which were different than the Class B ones. If the two classes of partnership interests were considered to be partial interests in the same property, no gift tax deduction would have been permitted for the gift of either: as to the first gift of the Class A interest because the donors retained the Class B interests; and, as to the second gift, the donors had already transferred the Class A interest to charity for no consideration at all.

Hence, *McCord* supports the conclusion that preferred and common interests in a partnership are two different property interests, rather than partial interests in one property.

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deductible under Section 170(f)(3). Similarly, in PLR. 9022010, the Service ruled that nonvoting shares and voting shares of a corporation were each a separate property interest so that the split-interest rules did not apply. These rulings are consistent with the factors listed in the *McCord* concurrence.

Some further guidance, perhaps, may be gleaned from the opinions in the *Church v. United States*[105] and *Strangi v. Commissioner*[106] cases under Section 2703. In both of those cases, the IRS attempted to argue that, for estate tax valuation purposes, the partnership arrangement, which would otherwise support an estate tax valuation discount, should be ignored under Section 2703 as being a restriction on the use of the decedent's property.[107] In both cases, the IRS unsuccessfully argued that the subject "property" was the underlying asset of the partnership, and that the partnership arrangement itself was the "restriction" that should be disregarded under Section 2703. In both cases, however, the Tax Court rejected this argument and refused to recharacterize the nature of the assets the decedent owned, which was a partnership interest (not an interest in the underlying assets of the partnership) so as to then apply Section 2703 to disregard the partnership arrangement as the "restriction" on such property. In other words, *Church* and *Strangi* suggest that a partnership interest is a separate property interest, which, in turn, seems to support the notion that each type of partnership interest (e.g., preferred or common) is itself a separate property interest rather than a partial interest in some other property.

Although, as this article details, the partial interest rules for estate and gift tax purposes, on the one hand, differ in many respects from those for income tax purposes, it seems the meaning of "partial interest" is the same for all such purposes.[108]

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[105] Church v. United States, 85 AFTR 2d 2000-804 (W.D. Tex. 2000), *aff'd,* 268 F.3d 1063 (5th Cir. 2001).

[106] Estate of Strangi v. Comm'r, 115 T.C. 478 (2000), *aff'd in part and remanded in part*, 293 F.3d 279 (5th Cir. 2002), *on remand*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F3d 468 (5th Cir. 2005).

[107] *Estate of Strangi*, 115 T.C. at 487; *See Church*, 85 AFTR 2d at 2000-808.

[108] As another example, assume a woman intends to acquire life insurance on her life to provide a death benefit to her surviving family members. She wishes to have the policy held by a so-called "irrevocable life insurance trust" or "ILIT" so the proceeds paid on her death will not be included in her gross estate for Federal estate tax purposes. In order to reduce the amount of the large taxable gift that she would be making if she paid a single premium and the policy were owned by the trust, she enters an "economic benefit" split dollar arrangement described in Treas. Reg. § 1.61-22(a) and (b)(3) and under which the ILIT will be "endorsed" the net amount at risk (a/k/a the term component) and under which the ILIT will annually pay the tax value of the term component. The woman will own the entire cash value component. The annual amount the ILIT must pay under the arrangement without either party being deemed to have made a transfer for tax purposes to the other will equal the amount be based upon Table 2001 or, if lower, the insurance carrier's rates that meet the requirements of IRS Notice 2002-10, 2002-1 C.B. 398. The woman later learns that, even if she only owns an interest in the cash value component in the policy at her death, not only the cash value but the term component as well may be included in her gross estate for federal estate tax purposes. *See* Rev. Rul. 79-129, 1979-1 C.B. 306. Therefore, she decides to give her interest in the policy to charity

b. *Formation of Partnership by Spouses.*

Perhaps, one way to add a second level of insulation from the potential application of the partial interest rule would be to ensure that no partner ever owns more than a single class of interest in the preferred partnership.

Suppose the taxpayer never held more than one type of interest in the partnership such as where a husband and wife form the partnership (alone or with others) and each receives a different type of partnership interest (*e.g.,* the husband received only a preferred interest and the wife only a common one) from inception.[109] It seems that neither should be viewed as dividing the interests, even if they formed it with an intent to avoid the partial interest rule as discussed in Treas. Reg. § 1.170A-7(a)(2).[110]

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so she will not hold any incident of ownership in the policy at death, which would cause the proceeds paid upon her death to be included in her gross estate (although under Section 2042 there will be inclusion if she dies within three years of the gift of the cash value to charity by way of Section 2035(a)(2)). There are at least two reasons why she should be entitled to an income tax deduction for the contribution to charity. First, all she ever owned was the cash value component of the policy as both her interest and the ILIT's interest arose when the policy was issued. Although she held a partial interest, it seems that the "divided the property to avoid the split interest rule" applies only if the taxpayer effected the division. See the Example in Treas. Reg. § 1.170A-7(a)(2). Second, even if it is viewed that she did effect the division, she certainly did not do it to avoid the partial interest rule; rather, she divided to avoid being deemed to have made a large taxable gift.

109 A partnership with preferred and common interests, of course, could be formed by any two taxpayers. In any case, it is critical that the preferred partnership be structured to be "compliant" with Section 2701, where the person with whom the partnership is formed is a "member of the family" (such as a spouse or child), because the capital contribution into the partnership in exchange for the preferred interests will be a "transfer" for purposes of Section 2701.

110 This is not certain, however. There is a strong indication in the regulations that if the taxpayer donates the only interest he or she has ever held in property, it is deductible for income tax purposes.

> For example, assuming that in 1967 B has been given a life estate in an office building for the life of A and that B has no other interest in the office building, B will be allowed a deduction under section 170 for his contribution in 1972 to charity of a one-half interest in such life estate in a transfer which is not made in trust. Such contribution by B will be considered a contribution of an undivided portion of the donor's entire interest in property.

Treas. Reg. § 1.170A-7(b)(1)(i). Although the basic "divide to avoid" rule of Treas. Reg. § 1.170A-7(a)(2)(i) is phrased broadly, the examples involve a division made by the donor. Treas. Reg. § 170A-7(a)(2)(i) (noting that "if, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), the deduction will not be allowed").

c. *A Contribution of the Preferred Partnership Interest Will Likely Not Be Construed as a Partial Interest under Section 170(f)(3)*

As mentioned above, the *Church* and *Strangi* cases seem to suggest that a partnership interest is a separate property interest, which, in turn, seems to support the notion that each type of partnership interest (*e.g.,* preferred or common) is itself a separate property interest and not a partial interest in some other property. *McCord* can also be read to support this conclusion. Of course, those cases are transfer tax decisions, and not income tax decisions. That would not seem to matter because, although the partial interest rules for income tax purposes are not the same as the gift tax partial interest rules, the basic meaning of partial interest for both seems to be the same for those purposes.

Additionally, considering the general treatment of partnerships and partnership interests for income tax purposes, it seems that a taxpayer's contribution of his or her preferred partnership interest, including all the rights associated with it, will likely not be construed as a partial interest, assuming that is the only type of partnership interest he or she ever held.

The nature of partnership can be approached from an "aggregate" or and "entity" approach.[111] In an aggregate approach, the partnership is considered an aggregate of individuals, with each partner owning an undivided interest in the partnership assets and operations.[112] The aggregate concept is prevalent in the tax treatment of partners' income, non-recognition provision for contribution to and distributions from the partnership.[113]

The entity approach treats the partnership as a separate entity from the partners.[114] Federal income tax laws treat the transfer of partnership interests as a transfer of interests in a separate entity rather than a transfer of the assets of the partnership.[115] The gain, loss, basis and the holding period are calculated with respect to the transferred partnership interest, not the underlying partnership asset.[116] This type of tax treatment resembles the entity approach of a corporation. Therefore, in terms of interest transfers, partnerships are treated like corporations. As mentioned above, transfers of different classes of corporate stock do not seem to be considered transfers of partial interests in the corpora-

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111 McKee et al., Federal Taxation of Partnerships and Partners § 1.02 (3d ed. 1997).
112 *Id.*
113 *Id.*
114 *Id.* § 1.02(3).
115 *Id.*
116 *Id.*

tion (provided, for example, voting rights in the voting stock are not withheld).[117] By analogy, transfers of preferred partnership interests also would not seem to be considered partial interests as long as voting rights or other substantial interests in the preferred interests are not withheld.

d. *Contribution to a Charitable Remainder or Lead Trust of a Partial Interest Avoids the Partial Interest Rule of Section 170(f)(3)*

Nevertheless, even if forming the partnership with preferred and common interests is viewed as a division within the meaning of Treas. Reg. § 1.170A-7(a)(2), the taxpayer may avoid the partial interest rule of Section 170(f)(3) by contributing the separate partnership interest to a charitable remainder trust or charitable lead trust.

The plain reading of Section 170(f)(2) and Section 170(f)(3) suggests that the two sections are mutually exclusive. Section 170(f)(2) refers specifically to "property transferred in trust," while Section 170(f)(3) refers to "contribution (not made by a transfer in trust)." Furthermore, Section 170(f)(3) allows for a deduction "to the extent that the [interest] would be allowable as a deduction . . . if such interest had been transferred in trust."[118] If Section 170(f)(3) was meant to apply to Section 170(f)(2), then it would be unnecessary to include the parenthetical "(not made by a transfer in trust)" and the separate provision that addresses interests that would have been deductible if it was transferred in a trust.

Treas. Reg. §§ 1.170A-6 and 1.170A-7, the regulations promulgated under Section 170(f)(2) and Section 170(f)(3), respectively, are entitled "Charitable Contributions in Trusts" and "Contributions Not in Trust of Partial Interests in Property" respectively. These titles themselves make a plain distinction between the two sections: Treas. Reg. § 1.170A-6, which fleshes out Section 170(f)(2), applies to contributions in trust, while Treas. Reg. § 1.170A-7, which fleshes out Section 170(f)(3), applies to contributions not in trust and of partial interests. Both regulations provide the same examples of when a deduction would be allowed or disallowed. The wordings are almost exactly identical. The substantive difference lies in the words "in trust" as used in Treas. Reg. § 1.170A-6 and the words "not in trust" as used in Treas. Reg. § 1.170A-7.[119] This suggests that the difference between § 1.170(f)(2) and

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117 *See supra* note 103.

118 I.R.C. § 170(f)(3)(A).

119 *Compare* Treas. Reg. § 1.170A-6 ("[if] property is transferred *in trust* with the requirement that the income *of the trust* be paid for a term of 20 years to a church and thereafter the remainder be paid to an educational organization . . . a deduction is al-

§ 1.170(f)(3) is that § 1.170(f)(2) applies to transfers "in trust", while § 1.170(f)(3) applies to transfer "not in trust."

The structure of Treas. Reg. § 1.170A-7 also supports the proposition that §170(f)(3) only applies to transfers "not made in trust." In Treas. Reg. § 1.170A-7(b), it is stated that "[a] deduction is allowed under section 170 for a contribution *not in trust of a partial interest* which is less than the donor's entire interest in property and which qualifies under one of the following subparagraphs:"[120] The regulation then lists five subparagraphs: (1) undivided portion of donor's entire interest; (2) transfers where deduction would have been allowed had such interest been transferred in trust; (3) personal residence; (4) farm; and (5) qualified conservation contribution. By placing the "not in trust" language under subheading (b), the regulation suggests that "not in trust" is a prerequisite to subparagraphs (1)-(5). *Only if* the interest is not transferred in trust, *and* the transfer falls into one of the subparagraphs, then a deduction will be allowed under the regulation. The use of the phrase "not in trust of a partial interest" is also important. If Section 170(f)(3) was meant to apply to every partial interest, regardless of whether it is given in trust, or not in trust, then it would be unnecessary to include the words "not in trust" in this sentence. The requirement "not in trust" seems to be the key (that is, the prerequisite) to being under Section 170(f)(3).[121]

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lowed for the value of such property") (emphasis added); *with Id.* § 1.170A-7 ("[if] an income interest in property is given *not in trust* to a church and the remainder interest in the property is given *not in trust* to an educational organization . . . a deduction is allow for the value of such property") (emphasis added).

120 *Id.* § 1.170A-7(b) (emphasis added).

121 Some revenue rulings and private letter rulings further illustrate the application of the partial interest rule. In Rev. Rul. 77-97, 1977-1 C.B. 285, the decedent directed his residuary estate to be placed in a trust, with 50% of the trust income to his spouse and the other 50% to a charitable organization X. The remainder of the trust was to be distributed 50% to the decedent's children and 50% to X. The decedent's estate sought to qualify X's charity interest for a Section 2055 estate tax deduction as an undivided portion of the decedent's entire interest in property pursuant to the Section 170(f)(3) exception in Section 2055(e)(2) (the partial interest rules, under Sections 2055(e) and 2522(c), for estate and gift tax purposes, respectively, are essentially identical). The Service denied the deduction because Section 170(f)(3) only refers to transfers "not in trust" and, therefore, does not apply to decedent's estate. This ruling illustrates the distinction the Code makes between "in trust" of Section 170(f)(2) and "not in trust" of Section 170(f)(3).

In Rev. Rul. 76-143, 1976-1 C.B. 63, the taxpayer sought a deduction for contributing the cash surrender value of a life insurance policy to a charity. In denying the deduction, the Service ruled that "Section 170(f)(3)(A) of the Code . . . denies a charitable contribution deduction in the case of certain contributions (not made by a transfer in trust) of partial interests in property made after July 31, 1969." The language suggests that §170(f)(3) applies only to "certain contributions"—contributions that are "not made by a transfer in trust."

e. *Legislative History*

A review of the Congressional history of the Tax Reform Act of 1969 indicates that Congress enacted Section 170(f)(2) and Section 170(f)(3) out of concerns that the deduction for charitable contributions did not correspond to the value of the benefits that were ultimately received by charity.[122] Allowing a deduction for a partial partnership interest contribution to a charitable remainder trust does not defeat this purpose. Because the deduction is sought only for the remainder portion given to charity, the value of the deduction will still correspond to the value of the benefit ultimately received by the charity.

The Senate believed that the bill, as presented by the House, was too restrictive and might discourage legitimate charitable contributions. As a result, the Senate provided for additional exceptions to §170(f)(3), namely the undivided income and primary residence exceptions found in §170(f)(3)(B), in order to allow for more flexible charitable gifts. One may question, why despite its concern for being over restrictive in disallowing deductions, the Senate failed to add the same type of exceptions to Section 170(f)(2). A possible answer is that such exceptions are unnecessary for Section 170(f)(2) because any property (including undivided income and primary residence), if transferred into a charitable remainder trust, would be deductible. This further suggests that Section 170(f)(2) and Section 170(f)(3) are mutually exclusive.

In discussing Section 170(f)(3), the Senate Report explained that the subsection "had the effect of denying a charitable contributions deduction in the case of a *nontrust gift* of a remainder interest to charity."[123] If the partial interest rule of Section 170(f)(3) applies also to property made in trust, then the Senate Report would not have limited its explanation to just "nontrust" gifts. Instead, it would have read "the subsection had the effect of denying a charitable contributions deduction in the case of a *gift* of a remainder interest to charity."

PLR 9124031 further lends support to the argument. There, the taxpayer assigned his annuity interest in a charitable remainder annuity trust to a charity. The Service permitted the deduction and stated, "the donation will be subject to the provisions of Section 170(f)(3) of the Code, applying to contributions of property not made by a transfer in trust, rather than Section 170(f)(2), applying to contributions made in trust." The plain reading of this language states that Section 170(f)(3) applies to property that are not made in trust while Section 170(f)(2) applies to contributions made in trust.

[122] *See generally* H.R. Rep. No. 91-413 (1969); S. Rep. No. 91-552 (1969).

[123] S. Rep. No. 91-552, at 87 (1969) (emphasis added).

f. *IRS Administrative Rulings Suggest that Partial Partnership Interests Are Deductible When Contributed to a Charitable Remainder Trust*

Although there is no case law or administrative ruling directly on point, there is material suggesting that a partial partnership interest can be deductible when placed in a charitable remainder trust.

In PLR 9114025, the taxpayers formed a limited liability partnership of which they contributed 15% of the undivided partnership interest into Trust 1, another 15% of the undivided partnership interest into Trust 2, and the remaining 70% into Trust 3. All three trusts were charitable remainder trusts. The Service ruled that the trusts were exempted from excess business holding tax under Section 4943 because they qualified for deductions under Section 170(f)(2).[124] Based on this ruling, a charitable remainder trust consisting of undivided partnership interests qualifies for a charitable deduction under Section 170(f)(2).

Although Rev. Rul. 77-97, *supra,* where the Service denied a charitable deduction for a trust that granted 50% of the income and 50% of the remainder to a charity, did not address the issue, the interest contributed to the charity was a partial interest within the meaning of Section 2055(e)(2)—an interest has passed to a charity, and an interest in the same property has passed to someone who is not a charity, the spouse and the children. After the IRS denied the deduction because the Section 170(f)(3) exception did not apply, it added that "the trust is neither a charitable remainder annuity trust or unitrust nor a pooled income fund . . . . The transfer thus fails to meet the requirements of section 2055(e)(2)(A) or (B)."[125] This suggests that if the trust were a charitable remainder trust, then a deduction would have been allowed. Therefore, even if the partnership interest is a partial interest, a deduction is allowable as long as it is transferred into a charitable remainder trust or presumably a charitable lead trust.

A fair reading of revenue and private letter rulings suggest that the IRS has adopted a rather straightforward approach when approving or denying deductions under Section 2055 or Section 2522. The IRS often uses language such as:

> Under section 2522(c)(2) of the Code, if a donor transfers an interest in property . . . to a charitable organization, and if the donor also retains an interest in the subject property, no de-

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[124] *See* I.R.C. § 4943(a) (imposing an excise tax on a private foundation's excess business holdings, does not apply to trusts in which a deduction is allowed, in part, under Section 170, for the amounts payable to the remainder beneficiary); *See also Id.* § 4947(b)(3); PLR 9114025 (January 7, 1991).

[125] Rev. Rul. 77-97, 1977-1 C.B. 285.

> duction is allowable with respect to a charitable remainder interest *unless that interest is in a charitable remainder annuity trust or unitrust or in a pooled income fund*[126]

The language seems sufficiently clear on its face: if a taxpayer makes a partial interest contribution to charity, it is not deductible unless it falls within certain exceptions, one of which is a charitable lead trust. The IRS has not suggested any additional qualification or exceptions to this rule.

The conclusion that a transfer of a partial interest that would not be deductible under Section 170(f)(3) is deductible under Section 170(f)(2) if contributed to a charitable remainder trust, pooled income fund or charitable lead trust seems further supported by the structure of the gift tax rules, which are discussed in more detail below.

Section 2522(c) provides that no deduction is permitted for a contribution of a partial interest (in general) unless it falls under an exception. It does not distinguish *per se*, as Section 170(f)(2) and Section 170(f)(3) do, between transfers in trust and transfers not in trust. Indeed, Section 2522(c) provides that, if a partial interest is transferred (subject to a full and adequate consideration exception and exceptions by express reference in Section 2522(c) to Section 170(f)(3)(B) relating to remainders in farms and personal residences and qualified conservation contributions), no deduction is allowed, unless

> (A) in the case of a remainder interest, such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (described in Section 664 or a pooled income fund (described in Section 642(c)(5)); or
> (B) in the case of any other interest, such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly).[127]

It will be noted that a remainder (other than in the case of a farm, personal residence or qualified conservation contribution) must be in charitable remainder trust whereas under Section 170(f)(2) and (3) it must be in the charitable remainder trust or the equivalent not in trust. It may be further noted that under Section 170(f)(3), a "lead" interest can be outright as opposed to the same interest in trust (a charitable lead trust as it is under Section 170(f)(2)) while under Section 2522(c), it can be in trust or outright (as fleshed out in the regulations) and it makes no distinction per se between transfers in trust (a charitable lead trust) or out-

126 Rev. Rul. 79-295, 1979-2 C.B. 349 (emphasis added); See also PLR 9318027 (Feb. 5, 1993); PLR 9110016 (Nov. 30, 1990) (using similar language).

127 I.R.C. § 2522(c)(2)(A)-(B).

right (although, as mentioned above, Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(c) requires that if the annuity or unitrust payment is not from a trust it must be from an insurance or annuity company).

3. *Gift Tax Partial Interest Rules*

Section 2522(c) disallows the gift tax charitable deduction for a gift of a partial interest in property unless it falls under one or more of certain exceptions some of which are the same as for partial interest contributions for income tax purposes (undivided interest, qualified conservation contribution, remainder interest in a farm or ranch or to a charitable remainder trust or charitable lead trust). But the rules are not identical. As explained above, the division of property into two or more partial interest will result in a denial of any income tax deduction even if the taxpayer is contributing his or her only interest if the taxpayer divided the property to defeat the partial interest rule of Section 170(f)(3).[128] If, however, the taxpayer was not effecting the division for that purpose, the deduction for income tax purposes to charity of his or her remaining interest is not disallowed under the regulation. However, under Section 2522(c), no gift tax deduction is allowed where a donor transfers an interest in property to a charity and an interest in the same property is retained by the donor or interest in the same property is transferred or has been transferred (for less than an adequate and full consideration in money or money's worth) from the donor to a person other than charity (unless falling under an exception such as for a transfer to charity of a remainder in a charitable remainder trust).

For example, assume a taxpayer contributed a ten year right to the income from a building he owns to his daughter to provide her with adequate resources to go to college and graduate school and start her own business. He has no thought or intention of donating his remaining interest in the building to charity. Nonetheless, if prior to the expiration of the ten-year term, the taxpayer contributes his interest to charity, the

128 Treas. Reg. § 1.170A-7(a)(2). As mentioned earlier in this article, although not entirely clear, it seems that, in order for the disallowance of the deduction under Section 170(f)(3) to occur by reason of a desire to avoid the section, it must be the donor who effected the division. The illustrations in Treas. Reg. § 1.170A-7(a)(2)(i) involve a division by the donor. However, the general rule is not expressly so limited because, unlike the illustrations in the regulation, it does not say the division is by the donor. The general rule states, "If, however, the property in which such partial interest." Treas. Reg. § 1.170A-7(a)(2)(i). The conclusion that it must be the donor who effected the division in order to fall under the "divided to avoid the Section 170(f)(3) rule" seems supported by Treas. Reg. § 25.2522(c)-3(c)(2)(i), dealing with gift tax partial interest rule. In any case, as explained above, if the partial interest is contributed to a split-interest trust described in Section 170(f)(2) (e.g., a charitable lead trust), an income tax deduction for the value of the partial interest committed in the trust for charity should be allowed.

gift tax deduction is disallowed (even though the income tax deduction would be permitted.)

However, if the taxpayer sells the interest to another for full and adequate consideration in money or money's worth and contributes to charity what he or she has not sold, a gift tax deduction should be allowed. For example, in PLR 8008105, an art collector sold a remainder in the collection for its actuarial value (using the standard gift tax valuation principles for valuing a remainder), retained the right to the property for 17 years and immediately donated the 17-year use to charity.[129] The IRS found the gift of the remainder held by the taxpayer qualified for the gift tax charitable deduction because the portion transferred to the non-charity was sold for full and adequate consideration.

Hence, if the taxpayer in the last example posited above (not the one in PLR 8008105) sold the ten-year income interest to his daughter for its full value, the contribution to charity of what he retained would be allowed. Indeed, unlike the income tax partial interest rule, the taxpayer's motivation for making the division (by sale) does not matter. The only issue is whether the interest transferred to another was for full and adequate consideration.[130] Of course, in the gift tax context, what constitutes "full and adequate consideration" often is not certain.

a. *Gift Tax Issue Where Value Is Not Certain*

In PLR 8008105, the taxpayer sold a remainder interest in art to individuals and then contributed the retained term interest in the art to charity. As long as the remainder was sold to the children for full and adequate consideration, the gift tax deduction would be allowed. But with any asset, other than a marketable security, the total value is uncertain so the value of a partial interest also would be uncertain. However in certain circumstances, "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be consid-

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[129] PLR 8008105 (Nov. 29, 1979).

[130] In PLR 8008105, the taxpayer, prior to making the sale of the remainder, obtained from a qualified independent appraiser an appraisal report setting forth the then fair market value of art and was to sell it for the value of the art using the gift tax valuation principles for valuing a remainder interest. The IRS concluded the gift of the retained term would qualify for the gift tax charitable deduction because, and without discussing whether the appraised value would actually represent the value of the art, "the earlier transfer of the remainder interest will be for adequate and full consideration." Section 2702, which became effective October 9, 1990, might apply today if the sale of the remainder were to a family member within the meaning of that section. Presumably, if the sale to family members for full and adequate consideration and the donation to charity occurred simultaneously, the section would not apply.

ered as made for an adequate and full consideration in money or money's worth."[131]

As courts have stated many times, transfers to family members are presumed to be a gift and, therefore, falling under the "ordinary course of business" rule is difficult, although some taxpayers have been successful.[132] Nonetheless, where the parties are unrelated and it is certain neither is intending to provide a gratuitous benefit to the other, the transaction should fall under the ordinary course of business rule. That should mean that if a partial interest in property is transferred to another in a transaction that is bona fide (real), at arm's length (each acting on its own behalf only) and free of donative intent, the donation to charity of the remaining interest held by the transferor either simultaneously or thereafter should qualify for the gift tax charitable deduction.

Even if the parties are related so the likelihood of the ordinary course of business exception contained in Treas. Reg. § 25.2512-8 could not be relied upon, the full and adequate consideration exception contained in Section 2522(c) should apply if the parties form a partnership and each contributes his or her own assets for his or her preferred or common interest in the partnership.[133] The courts seem to have concluded that the transfer will be deemed to have been for full and adequate consideration in money or money's worth if the transferor receive back a proportionate interest in the income and equity of the entity (e.g., the amount contributed by a partner is fully reflected in the partner's capital account and represents a proportionate part of all contributions to the partnership and distributions are made in accordance with the partners' interests.[134] Although for purposes of falling under the "bona fide sale for an adequate and full consideration in money or money's worth" exception to Section 2036, the courts have concluded

131 Treas. Reg. § 25.2512-8.

132 *See, e.g.,* King v. United States, 545 F.2d 700, 706 (10th Cir. 1976) ("Under the facts found, King is not subject to the gift tax . . . because the transaction was made in the ordinary course of business at arm's length, free from any donative intent."); *cf.* Estate of Constanza v. Comm'r, 320 F.3d 595 (6th Cir. 2003) (court found house sale from father to son as not donative and therefore not under purview of the gift tax)

133 I.R.C. § 2522(c)(2). If one party gives the assets to the other which such other uses as his or her contribution to the partnership, the IRS might argue that, in substance, the one party provided all the consideration and received both the preferred and common interests and made a gift to the other of one of such interest which could foreclose the full and adequate consideration exception of Section 2522(c) from applying. *See* Brown v. United States, 329 F.2d 664, 672 (9th Cir. 2003) ("When a party acts as a mere conduit of funds – a fleeting stop in a predetermined voyage toward a particular result – we have readily ignored the role of the intermediary in order appropriately to characterize the transaction").

134 *See, e.g.,* Estate of Bongard v. Comm'r, 124 T.C. 95 (2005); Estate of Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005).

that the taxpayer, in order to satisfy the "bona fide" condition of the exception, must also demonstrate that there was a significant and legitimate non-tax reason for the formation of the partnership.[135] However, the only requirement actually needed to fall under the exception to the Section 2522(c) partial interest rule is that the transfer be for full and adequate consideration. Hence, if two parties (even if they are related) form a partnership under which each has his or her capital account fully credited with his or her contribution, there should be no transfer deemed to occur from one to the other for less than full and adequate consideration.

Perhaps, however, the IRS might contend that, if the party who received preferred partnership interests and who later donates them to charity received back preferred interest that were disproportionately lower than the common interests the other partner received, or perhaps received a less than adequate preferred coupon, the partner who received the preferred made a transfer upon formation to the other thereby failing to fall under the full and adequate consideration exception to Section 2522(c). However, it seems that, if there were a transfer from the preferred partner to the common partner upon formation, it would not be a transfer of part of the preferred interest.[136] First, the common partner never received any preferred interest, only common ones. Second, it is the position of the IRS and apparently the courts that, if there is a gift upon formation under which one partner making a contribution enhances the capital account of the other partner or partners, the partner deemed making the gift is treated as though he or she made a gift of the contribution and not of any partnership interest.[137]

b. *"Belt and Suspenders" Withdrawal Right Approach*

To the extent that the foregoing does not provide enough comfort that the common interest holder has provided "full and adequate consideration," if the preferred partnership interest allows its owner or owners to immediately redeem the interest for the full amount of the contribution to capital for the interest, there could be no gift. Although such a right would be disregarded for purposes of Section 2701 to determine the value of preferred interest to have the value of the common determined under the subtraction method of valuation under the sec-

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[135] *See Bongard*, 124 T.C. at 118.

[136] While a capital contribution is considered a "transfer" for purposes of Section 2701, such definition would apply only with respect to determining if a deemed gift has occurred for purposes of Section 2701, not for purposes of the Section 2522(c) full and adequate consideration exception to the partial interest disallowance rule of that section.

[137] *See* Shepherd v. Comm'r, 283 F.3d 1258, 1260-61 (11th Cir. 2000); *see also* Senda v. Comm'r, 433 F.3d 1044 (8th Cir. 2006);.

tion, the right should not be disregarded for purposes of Section 2522(c) where there is no such subtraction method of valuation.

More specifically, the preferred partnership agreement, perhaps, could provide additional provisions to ensure liquidity, such as a put right exercisable immediately and at any time entitling the preferred interest holder to be paid cash upon exercise equal to an amount of his or her capital contribution. In such case, it seems inconceivable that any credible argument could be made that the preferred interest received by the holder in exchange for his or her capital contribution in the preferred partnership would represent anything but "full and adequate consideration" for the amount paid for the preferred interest as it could be obtained back at any time without restriction.

Of course, in such case, there are implications under Section 2701 that would need to be considered with the so-called "lower of" rule.[138] The "lower of" rule provides that if a senior family member holds a Qualified Payment Right and one or more Extraordinary Payment Rights, the value of all of these rights is determined by assuming that each Extraordinary Payment Right is exercised in a manner resulting in the lowest total value being determined for all the rights.[139] Extraordinary Payment Rights, in general, include liquidation, put, call and conversion rights the exercise or non-exercise of which would affect the value of the transferred common interest when the holder of such rights has discretion as to whether (or when) to exercise them.[140] A call right includes any warrant, option, or other right to acquire one or more equity interests.[141] This, however, should not present a problem in the case in which the preferred interest is structured as a Qualified Payment Right, and when the put right, which is an Extraordinary Payment Right, is structured to equal the par value determined for the Qualified Payment Right. In such case, even with the application of the "lower of" rule, the value of the preferred interests would be determined to be the same value; which would equal the value of the capital contribution and, therefore, "full and adequate consideration."[142]

Therefore, it seems that if two parties, whether or not related and regardless of their motives, form a partnership where one obtains a preferred interest and the other the common, a donation of the preferred interest will not fall under the partial interest rule of Section 2522(c) because it was the only interest the preferred interest holder ever held

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138 I.R.C. § 2701(a)(4)(A).

139 Treas. Reg. § 25.2701-2(a)(3).

140 *Id.* § 25.2701-2(b)(2) (1992).

141 *Id.*

142 As noted above, the artificial valuation rules of Section 2701 seem to have no application for purposes of value under Section 2522(c).

in the partnership and because that partner never transferred an interest in the partnership for less than full and adequate consideration.[143]

c. *Full and Adequate Consideration Guidance in the Estate Tax Context*

While not directly on point, some guidance also may be gleaned from certain estate tax cases dealing with the adequate and full consideration exception to Section 2036 and 2035. In the Section 2036 context, there is a division of authority; however, the more modern line of cases appears to be more taxpayer friendly.

The older, less taxpayer-friendly position was articulated in *Gradow v. United States*.[144] That case held that, in order to constitute adequate and full consideration for the sale of a remainder interest, the donor must receive the full value of property transferred rather than the actuarial value of the remainder interest.

The more modern line of cases is found in *Wheeler v. United States*,[145] *Magnin v. Commissioner*,[146] and *D'Ambrosio v. Commissioner*.[147] The *Wheeler* case involved the sale by the taxpayer of the

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[143] It seems relatively certain that if the donor never held any interest in the property other than what he or she donates to charity, the donation will qualify for the gift tax charitable deduction. Treas. Reg. § 25.2522(c)-3(c)(2)(i) provides examples of the rule by contrasting one situation to another:

> For example, if the donor gave a life estate in an office building to his wife for her life and retained a reversionary interest in the office building, the gift by the donor of one-half of that reversionary interest to charity while his wife is still alive will not be considered the transfer of a deductible interest; because an interest in the same property has already passed from the donor for private purposes, the reversionary interest will not be considered the donor's entire interest in the property. *If, on the other hand, the donor had been given a life estate in Blackacre for the life of his wife and the donor had no other interest in Blackacre on or before the time of gift, the gift by the donor of one-half of that life estate to charity would be considered the transfer of a deductible interes*t; because the life estate would be considered the donor's entire interest in the property, the gift would be of an undivided portion of such entire interest. (emphasis added).

Hence, if the donor's spouse formed the partnership (without the donor) and received both common and preferred interests, the latter of which the spouse gave to the donor, the donor's donation of the preferred interest to charity would appear to be deductible for gift tax purposes.

[144] Gradow v. United States, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990).

[145] Wheeler v. United States, No. SA-94-CA-964, 1996 U.S. Dist. LEXIS 20531 (W.D. Tex. Jan. 26, 1996), *rev'd*, 116 F.3d 749 (5th Cir. 1997).

[146] Magnin v. Commissioner, 71 T.C.M. (CCH) 1856 (1996), *rev'd*, 184 F.3d 1074 (9th Cir. 1999).

[147] D'Ambrosio v. Commissioner, 105 T.C. 252 (1995), *rev'd*, 101 F.3d 309 (3d Cir. 1996).

remainder interest in a ranch to his sons in exchange for the actuarial value of the remainder interest. The United States District Court for the Western District of Texas followed the holding of the United States Claims Court in *Gradow* and determined that, for purposes of Section 2036(a), in order to constitute adequate and full consideration, the decedent was required to have received the entire value of the underlying property that he had transferred rather than the actuarial value of the remainder interest. The United States Court of Appeals for the Fifth Circuit reversed the decision of the District Court, holding that the actuarial value of the remainder interest paid to the taxpayer satisfied the adequate and full consideration exception.[148]

In *Magnin,* the decedent entered into an agreement with his father whereby his father promised to bequeath to him his stock in the family corporations in exchange for the decedent's promise to bequeath his remainder interest in the family corporations to his children. The Tax Court determined that the adequacy of the consideration for the transfer should be based upon the entire value of the stock at the time of the transfer, rather than the actuarial value of the remainder interest that the children would receive.[149] The United States Court of Appeals for the Ninth Circuit reversed the holding of the Tax Court. The Court indicated, based upon its reading of the language of Section 2036(a) as well as the principal that "time appreciates value," that the phrase "adequate and full consideration" is measured by the actuarial value of remainder interests rather than the fee simple value of the property transferred to a trust.[150]

In *D'Ambrosio*, the decedent transferred a remainder interest in preferred stock back to the issuing corporation in exchange for a private annuity that had an actuarial value equal to the remainder interest. The decedent died a few years later having received significantly less than the fair market value of the annuity interest at the time of the transfer. The Tax Court followed the holding of *Gradow* and determined that the decedent had not received adequate and full consideration under the exception to Section 2036(a).[151] The United States Court of Appeals for the Third Circuit reversed the holding of the Tax Court, rejecting the *Gradow* case's construction of the exception under Section 2036(a). It indicated that, considering time value of money principles, the actuarial

148 *Wheeler*, 116 F.3d at 767.

149 *Magnin*, 71 T.C.M. (CCH) at *11. THE TCM USES A UNIQUE PAGINATION THAT I MUST VERIFY IN THE LIBRARY FOR THE PINCITE.

150 *Magnin*, 184 F.3d at 1080.

151 *D'Ambrosio*, 105 T.C. at 255-256.

value of the remainder interest on the date of the sale would equal the value of the underlying property on the date of the seller's death.[152]

There is also some sparse authority under Section 2035. In *United States v. Allen,*[153] the United States Court of Appeals for the Tenth Circuit determined that, to satisfy the adequate and full consideration exception to Section 2035, the consideration required to be paid was the amount that would otherwise have been included in decedent's gross estate. The Tenth Circuit determined that the sale by a mother to her son of her retained life income interest in an irrevocable trust for the actuarial value of her income interest (approximately $140,000) did not satisfy the exception to Section 2035 because the sale price required to satisfy the exception was the full value that would have been included in her estate at death (approximately $900,000). The theory of the Tenth Circuit was that in order to constitute adequate and full consideration, the estate must be placed in the same economic position as if the sale had not taken place.

Therefore, whether or not the sale of a remainder interest in property for its actuarial value (as opposed to the full fair market value of the entire property) avoids the application of Section 2036 (as it did in *Wheeler, Magnin* and *D'Ambrosio* but not in *Gradow* and, perhaps, *Allen),* it does not mean the transfer was not for full and adequate consideration within the meaning of Section 2522(c) so the transfer of the retained interest to charity would be deductible for gift tax purposes (although not for income tax purposes if the sale was to avoid the partial interest rule of Section 170(f)(3)). More to the point, *Gradow* and *Allen*[154] certainly do not seem to foreclose using the full and adequate consideration exception under Section 2522(c) where two parties, using their own assets, form a partnership and one receives preferred interests and the other common and one of them contributes his or her interest to charity.

d. *Split Dollar Arrangements*

The split dollar regulations under Treas. Reg. § 1.61-22 provide a rule for valuing the so-called "term" or net amount at risk component of a life insurance policy in which one taxpayer holds in an economic benefit arrangement. Essentially, it is the lesser of the amount set forth,

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152 *D'Ambrosio*, 101 F.3d at 316-17.

153 United States v. Allen, 293 F.2d 916 (10th Cir. 1961).

154 Arguably, *Allen* is an entirely different case as, unlike the other cases (*e.g., Gradow* or *Wheeler*), the value of the price paid for the taxpayer's interest would not grow over time back to the value of what had been owned to fully "restore" the value back into the taxpayer's gross estate. Indeed, *Allen* involved the sale of an income interest, not a remainder one. *See Allen*, 293 F.2d at 916.

based upon the age of the insured for the year, under Table 2001 (set forth in IRS Notice 2001-10[155]) or the insurance company's one-year term rates that comply with IRS Notice 2002-8.[156]

Where the party to the split-dollar arrangement acquires that interest in an arm's length situation (that is, not a involving family members, but, for example, involving an independent contractor and the user of the services of the contractor) and provides something other than cash which is not easily valued in terms of money and money's worth for the term insurance component, there should not be deemed to be a gift from one party to the other on account of the ordinary course of business rule contained in Treas. Reg. § 25.2512-8.[157]

e. *More on Partnership Interests*

As mentioned previously, a more assured way to avoid the partial interest disallowance of deduction rule of Section 2522(c) is to have one taxpayer (e.g., the spouse of the person who may make a donation) form the partnership[158]and have that taxpayer give or sell the preferred interest to another taxpayer (e.g., the other spouse) who might then make a donation to charity of the preferred interest. Whether the transfer to the donor was by gift or sale, it does not seem that the preferred interest donated to charity could be partial interest in of property the donor owns or did own. Perhaps, the IRS might contend that the donor is merely a "straw man" for the taxpayer who formed the entity and, therefore, it is the taxpayer who formed the partnership is the donor which could raise the question of whether that taxpayer made a gift of a partial interest as he or she would still own the common interest in the partnership. However, as mentioned earlier it seems that preferred and common interests should be viewed as separate property for purposes of

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155 I.R.S. Notice 2001-10, 2001-1 C.B. 459.

156 I.R.S. Notice 2002-8, 2002-1 C.B. 398; Treas. Reg. § 1.61-22(d)(3)(ii).

157 For example, if the owner of a policy endorses the term insurance component in a policy to an unrelated independent contractor in exchange for unique services the contractor agrees to provide that cannot be readily valued, the ordinary course of business exception should apply so neither is treated as making a gift to the other even if it later is determined that the term insurance component and the services have different values.

158 For tax purposes, an entity (other than a corporation formed in the United States) that has only one owner is disregarded for Federal tax purposes (see Treas. Reg. § 301.7701-3(f)(2)), unless it elects to be taxed as a corporation. Hence, if the spouse forms an entity and he or she is the only owner, the entity will not be deemed to exist. However, when and if the owner transfers the preferred interests (previously disregarded for Federal tax purposes) to his or her spouse, the partnership will become recognized (as the husband and wife will be the two owners). At that point, the spouse who holds the preferred partnership interest will never have held any other interest in the partnership and, therefore, a donation to charity of the preferred interest could not be a partial interest of what the donor owns or has owned.

Section 2522(c). In any case, if the donor takes full control of the preferred interest and adequate time passes, it is difficult to think such a straw man argument by the IRS could be successfully made. Perhaps, overall it would be more conservative if, as suggested earlier, the two taxpayers (e.g., two spouses) use their own cash or other property to form the partnership under which one of them would receive a common interest and the other would receive a preferred interest.[159] It is appropriate to note that there is no spousal unity rule for purposes of either Section 170(f) or 2522(c). Hence, the retention or transfer of the common interests in the partnership should not, it would seem, be attributed to the spouse who donates the preferred interests being the only interest in the partnership he or she has held.

V. Summary and Conclusions

A fund manager can, of course, reduce his or her taxable income attributable to income that must be brought on shore through charitable contributions. That may be inefficient as the amount of income tax saved will be less than what the after tax income would have been if the charitable donation had not been made. A more efficient manner for the manager to generate an income (and gift) tax deduction may be to create a charitable lead annuity trust that is a grantor trust for income tax purposes. Although that will require the manager to include in gross income all the gross income generated in the trust, that effect can be ameliorated if the manager acquires a private placement life insurance policy because the income the policy generates is not included in gross income. However, neither the grantor nor the non-charity beneficiaries can benefit from the charitable lead trust until the charitable term ends. In addition, it almost never is efficient to attempt to make such a trust generation-skipping transfer tax exempt. However, if the manager forms a partnership with another (such as the manager's spouse) and receives only preferred interest and the other acquires only common interests, the manager can contribute the preferred interest to the partnership and the other can receive distributions with respect to the common interests and/or the other can transfer the common interests to a trust that is generation-skipping transfer tax exempt. The manager (and the other) could make contributions to the partnership with a fully paid-up private placement life insurance policy, thereby avoiding the possible application of Section 170(f)(10) altogether. However, if the policy is

[159] It seems appropriate to mention that, in some cases, spouses are treated, essentially as one taxpayer. For example, under the multiple trust rule of Section 643(f), and under the grantor trust rules pursuant to Section 672(g), a husband and wife are treated as one person. Many of these "spouses are one taxpayer" rules arose after the unlimited gift tax deduction became effective after 1981. *See* I.R.C. §§ 643(f), 2523(a).

not paid-up, then a careful analysis must be undertaken under that Section.

Among other issues that the manager and his or her advisors must consider is whether an income and gift tax deduction will be allowed if the manager contribute the preferred interests to a charitable lead trust. It seems that an income tax deduction should be allowed if the CLAT is structured as a grantor trust. The income tax deduction should be allowed, even if funded only with the investor's interest in the policy (the cash value component), on at least one of two grounds.

First, the income tax provision that disallows a deduction for a transfer of a partial interest in property pursuant to Section 170(f)(3) does not apply if the taxpayer has only held at all times the partial interest that is contributed to charity. At the inception of the partnership, the manager will hold only preferred interests.

Second, the rule that disallows a deduction for a donation of a partial interest in property applies only to transfers not made in trust. The rules relating to the allowance of a deduction for a transfer of a partial interest in a trust are contained in Section 170(f)(2), not Section 170(f)(3). As long as the charitable interest in the CLAT comply with the provisions of Section 170(f)(2), the deduction should be allowed and not disallowed by reason of the provisions of Section 170(f)(3) even if a partial interest in property is contributed to the CLAT.

It also seems that a gift tax deduction should be allowed for the interest committed to charity in the CLAT for at least one of two reasons. First, the partial interest rule Section 2522(c), just like that of Section 170(f), does not apply where the taxpayer contributes a partial interest in property if that partial interest is the only interest in the property the taxpayer ever held. As explained above, the taxpayer will have held, from the inception of the partnership, only a preferred interest. Hence, just as the contribution of the interest should be not disallowed for income tax purposes, it similarly should not be disallowed for gift tax purposes.

Second, although an income tax deduction for a contribution of a partial interest is allowed, even if the partial interest held arose from a division of the property, if the division was not to avoid the partial interest rule, the gift tax partial interest rule has no similar exception. Essentially, if the taxpayer transfers a partial interest to charity and retains, transfers or has transferred another interest in the property in property to a person or entity that is not a charity, the deduction under Section 2522(c) is disallowed regardless of the motivation for the division. Nonetheless, if the taxpayer has transferred or does transfer to someone other than charity an interest in the property for full and adequate consideration, a deduction for the donation of the taxpayer's contribution of the partial interest is not disallowed under the Section. As explained above, the formation of the partnership, under which the manager would receive preferred partnership interests only and another receives common interest by reason of their contributions of their own property to the partnership, cannot be viewed as a transfer of interests in the partnership to the other for less than full and adequate consideration in money or money's worth.