Nevada Trust Conference
Planning With Derivatives and Private Options
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TABLE OF CONTENTS

Planning With Derivatives and Private Options

1. Client Situations

1.1 Non-Transferable Assets

Client has assets he cannot transfer for legal or other reasons, such as securities law restrictions, shareholder agreements, assets are pledged or held in escrow, or public disclosure issues for executives of public companies. The asset may also be owned by a corporation along with other assets and can't be transferred out without income tax consequences. As a result, the assets cannot be transferred via gifts, sales, GRATs, etc.

1.2 Low-Growth Assets

Client has low-growth, low volatility assets whose returns are not likely to beat the applicable federal rate (AFR) or Section 7520 rate and is not willing to acquire more volatile/risky investments with greater return potential, or is unwilling to sell because of capital gains tax. As a result, wealth cannot be transferred using investment-driven techniques such as GRATs and sales for notes.

1.3 Non-Cash Flow Generating Assets

Client has assets that do not generate cash flow that could be used to make annuity or note payments and is not willing to acquire investments that produce cash flow, or is unwilling to sell because of capital gains tax. As a result, wealth cannot be transferred using investment-driven techniques such as GRATs and sales for notes.

1.4 Unvested Assets

Client has unvested stock/options that, if transferred, would not constitute completed gifts under Rev. Rul. 98-21. As a result, the assets cannot be transferred via gifts, sales, GRATs, etc.

1.5 Junior and Senior Equity Interests

Client has assets subject to Code Section 2701 (*e.g.*, common and preferred stock, or carried and capital interests in a private equity/VC/hedge fund) and is unwilling to transfer a pro rata amount of the "senior" interest. As a result, the assets cannot be transferred via gifts, sales, GRATs, etc.

1.6 Low Basis Assets

Client has assets with very low, zero or even negative basis they plan to hold until death. If they are transferred during life, the step-up will be lost (and Rev. Rul. 2023-3 confirms that assets that are in a grantor trust but not included in the estate do not get a step-up). And transferring low basis assets could have a net negative tax impact even if they appreciate significantly. For example, an asset with basis equal to 50% of its fair market value needs to appreciate by 83% in order for the estate tax savings to exceed the lost savings from basis step-up. Even assets with basis of 80% of fair market value need to appreciate at least 33% before being net ahead.

2. The Solution: Private Derivatives and Options

2.1 Derivatives, Private Derivatives Generally

A derivative is a financial instrument that gives the holder a right to a payment from the counterparty to the instrument if certain events occur during the term of the contract. Derivatives can be tied to the price or performance of a stock (e.g., tracking stocks, cash settled options), or the performance of a portfolio or index (e.g., Dow Jones Industrial Average, Russell 2000, S&P 500, Wilshire 5000, bond indices, HFR index, and industry-specific indices). They can also be tied to commodity prices, changes in the weather, or anything imaginable. Power companies, agribusinesses, airlines and other companies whose revenues and expenses can be affected by the weather and commodity prices use derivatives to hedge risks of their businesses that would otherwise be out of their control. The increasing importance of the derivative market lead to the merger of the Chicago Mercantile Exchange and the Chicago Board of Trade.

I am not suggesting we tell our clients to buy corn futures. The derivatives I am referring to are **"private derivatives":** derivative agreements entered into between family members or trusts for their benefit. A private derivative can be used as a way to transfer wealth from one generation to another based on the financial performance of an asset (whether or not the family owns that asset). The family as a whole will neither make nor lose money on the derivative; the net result will be that assets change hands among the family. Worst case scenario: assets move backwards (i.e., from children to parents).

In each of the structures described below, the client would enter into a contract with an irrevocable "grantor trust." The trust would need to be funded with sufficient funds to purchase the private derivative or option described below. The grantor trust provides three critical benefits:

- Payments pursuant to derivative disregarded. Transactions between the grantor and the trust are disregarded for federal income tax purposes.[1] Thus, the grantor's receipt of the purchase price for the private derivative or option does not constitute taxable income to the grantor, and the trust's receipt of cash or other assets in settlement of the derivative or option does not constitute taxable income or gain to the trust.

- Settlement in-kind can transfer other assets. The derivative contract can be settled in-kind without causing the grantor to recognize gain. In the virtual stock derivative example below, the grantor can transfer interests in his real estate to the trust to settle the derivative, rather than settling in cash, thereby accomplishing his original objective.

- Future tax-free growth of trust. After settlement of a successful derivative, the grantor's subsequent payment of the taxes on any income or gains from the trust's assets is an indirect tax-free gift to the trust beneficiaries.

[1] See Revenue Ruling 85-13, 1985-1 C.B. 184.

Consideration. A contract is legally binding and enforceable if there is an offer, acceptance and consideration. Therefore, in order to make a private derivative agreement binding and legally enforceable and to avoid a gift upon the sale of the derivative to the trust, the trust should pay the client the fair market value of the derivative, typically determined by a professional appraiser. If the trust does not already have sufficient funds, the client will need to make a cash gift to the trust which it can then use to purchase the derivative.

2.2 Private Options on Public Stocks

One form of private option is a cash-settled call option to transfer the future *increase* in value of an asset (whether or not such asset is actually owned by the client), plus perhaps any distributions or dividends paid during the term of the contract. That is, rather than serving as a proxy for stock or other assets, the derivative would be a contract in which the purchaser will receive the increase in value of the subject asset, if any, over the current value or over a "strike price." The holder of a private option will receive nothing at settlement if the asset does not increase in value above the strike price. Alternatively, it can be structured as a private put option in which the holder profits if the asset decreases in value.

As with virtual asset and carry derivatives, the family does not make or lose money on the private option. The only possible negative consequences are that assets will pass from the senior generation to a junior generation, or vice-versa.

Benefits

Private options can provide the following benefits:

- Significant amounts of wealth can be transferred by a relatively small increase or decrease in value of the subject asset.

- The investment by the trust in the private option is limited to the option premium, which is a small fraction of the value of the underlying asset. As a result, the option can capture the potential upside (or downside) of a much greater amount of the asset for each dollar invested than it would if it purchased the asset directly.

However, options are risky investments. If the subject asset does not attain the strike price before the option expires, the holder will lose his entire investment. Even if it does reach the strike price, the holder of the option will still have a loss to the extent the proceeds from the option do not exceed the premium he paid for it.

Example

John Smith established a trust for his children with $1 million in cash. He has been watching Macy's, Inc. (M) stock for some time. It is currently trading at $49.50, but he believes it will rise by $3 to $5 per share in the next few weeks because of takeover discussions and positive earnings reports. John sells the trust a call option with a strike price of $49.50, expiring in 50 days. In other words, the trust has the right to purchase Macy's stock from John for $49.50 per share until the option expires. Based on the stock's current volatility of 30.54% and other factors, an appraiser or

investment banker tells John that such an option should cost $2.446 per share.[2] So, for $1 million, the trust purchases options on 408,831 Macy's shares ($1 million divided by $2.446/share). In other words, the trust purchased the upside on 408,831 shares for $1 million. Buying that amount of Macy's shares would have cost more than $20.2 million.

If the stock price increases by $1.50 to $51 per share, the trust would net $613,246 upon settlement of the option ($51 - $45.50 strike price x 408,831 shares), but would have lost $386,754 on its $1 million investment. The chart below shows the option proceeds and net profit or loss to the trust at various stock prices:

Stock price	Option Proceeds	Net Profit (Loss) to Trust
$49.50 or less	$0	($1,000,000)
$51.946	$1,000,000	$0
$53	$1,430,908	$430,908
$54	$1,839,738	$839,738
$55	$2,248,569	$1,248,569
$56	$2,657,400	$1,657,400
$57	$3,066,231	$2,066,231

Thus, in a short period of time, the trust's $1 million can grow by 100% as a result of a 15% increase in stock price. But anything less than $49.50 will produce a total loss for the trust.

If the seller of the option does not actually own the subject assets, he or she needs to have enough cash or other property to cover the settlement of the option (and be willing and able to part with it). In such cases, the option contract could provide for a cap on the settlement amount, which would have the added benefit of reducing the cost of the option to the purchaser.

The grantor of a trust with little equity should not lend money to the trust to enable it to purchase an option from himself. Otherwise, the grantor "loses" no matter what happens: if the trust makes money on the option, it is at the grantor's expense. If the option is unprofitable, the trust may not be able to pay the note owed to the grantor-- so the grantor loses again. In these circumstances, the IRS may argue the option is a sham because it would not make economic sense for the grantor to sell the option to a trust for a note when the trust has little other equity.

Risks:

As mentioned above, the trust will lose its entire investment if the stock does not attain the strike price before the option expires, and could lose most of its investment if the option proceeds do not exceed the premium paid. The option price increases significantly when using a longer

[2] Calculations provided by the options calculator on the CBOE website.

term or if tied to a volatile stock. Thus, the risk and amount of loss to the trust and "reverse estate planning" is significant. One could transfer a private option to a GRAT, but that has the risk of being attacked as a sham, similar to selling the option for a note: the grantor "loses" no matter what happens: if the GRAT makes money on the option, it is at the grantor's expense. If the option is unprofitable, the GRAT will not be able to pay the annuity owed to the grantor-- so the grantor loses again. It's the same money going in a circle. Perhaps it could be done with the client's spouse as a counterparty.

2.3 Virtual Asset Private Derivatives

Rather than selling an option to the trust on a public stock, one could instead sell a derivative that is intended to mimic ownership of the actual asset. So instead of paying an option premium, the trust effectively pays to acquire the economic rights associated with the asset, but does not acquire the asset itself.

For example, the client enters into a private derivative agreement tied to Apple Inc. common stock. The client doesn't own Apple stock because he doesn't have liquidity or doesn't want to invest a large amount in a single stock, but his financial adviser recommends buying Apple. Assuming Apple stock is trading at $100 per share, the trust purchases a derivative on 50,000 shares for $5 million in cash from the client. The derivative agreement gives the trust rights equal to the economic equivalent of the stock itself: (1) the trust has the right to sell all or any portion of this "**virtual stock**" back to the client at the prevailing market price; (2) the client must pay the trust an amount equal to any dividends paid on 50,000 shares of Apple stock; and (3) the contract will account for stock splits, dividends and corporate reorganizations. The virtual stock is freely transferable by the trust. Thus, the value of a share of the virtual stock should be equal to the value of a share of Apple stock. If at the time of tender by the trust Apple is trading at $150 per share, then the client will owe the trust $7.5 million and the trust will net a profit of $2.5 million (plus the amount of any dividends). The client can settle his obligations under the private derivative agreement by transferring an interest in his real estate to the trust worth $7.5 million, and if the trust is a grantor trust, no gain or loss will be realized by either party upon settlement. The derivative could have a term limit upon which any remaining virtual stock must be "tendered" back to the client, at which time the trust will receive payment for any unsold shares. This can protect the client from having indefinite liability.

No matter what happens to Apple stock, the family's wealth will be unaffected because they don't actually own the stock. But if Apple stock performs well, the client will owe money to the trust, transferring wealth from one generation to the next. On the other hand, if Apple stock declines in value, the trust could lose money on its investment.

The trust's investment is much greater than an option premium, but its risk of total loss is greatly diminished, and it will be profitable to the trust if there is *any* appreciation. With the option, stock must appreciate enough over the strike price to first earn back the option premium before it is profitable.

The trust could purchase several "virtual stocks" to comprise a diversified portfolio. This can be accomplished through multiple derivative agreements, or a single agreement that references a

stated amount of shares of various stocks. The derivative could also be tied to an index, such as the Dow Jones Industrial Average.

Virtual asset derivatives can be used as part of a "sale to grantor trust" strategy. Rather than selling stock to a grantor trust for a note, the client could sell virtual stock to the trust for a note. In the example above, the client entered into a private derivative agreement tied to 50,000 shares of Apple common stock, which is trading at $100 per share. Rather than paying the client $5 million in cash, the trust could issue a $5 million note to the client that bears interest at the appropriate AFR. If in five years, Apple is trading at $150 per share, the client will owe the trust $7.5 million and the trust will net $2.5 million (plus any dividends but minus interest payments on the note) after paying off the note. Thus, the economics of a leveraged sale of virtual stock are identical to any other leveraged sale of assets to a grantor trust. As with any leveraged sale, the trust should have sufficient equity (*e.g.*, 10 percent) to help service the debt. And, based on Revenue Ruling 85-13, no gain is recognized upon the grantor's sale of the derivative to the grantor trust, and the trust can satisfy its obligation on the note without income tax consequences.

2.4 Discounted Virtual Assets

The virtual asset derivative is designed mimic the economic rights of a public stock, and has the financial risks to the trust (but not to the family as a whole) associated with owning that stock. A variation on this, especially for a stock the client owns and plans to hold for the foreseeable future, is to structure the derivative as a fixed-term, multi-year agreement, instead of a freely-transferable contract right that can be "cashed in" at any time by the trust.

For example, the trust could purchase a derivative tied to the price of 50,000 shares of Apple stock at the end of three years: the client owes the trust whatever 50,000 shares of Apple are worth in three years. Like the virtual asset, the trust will realize whatever the stock is worth, but the trust cannot cash in before three years and cannot transfer or assign the contract. In effect, the trust is locked-in to the Apple stock for three years. This might bring to mind stock subject to trading restrictions under Rule 144, which generally lasts for 6 months. Studies cited in appraisals say that such restrictions cause the stock to be worth 20-28% less than the public stock price. If so, then a 3-year restriction could result in a much greater valuation discount. In other words, the price for a 3-year agreement tied to 50,000 Apple shares trading at $150 per share ($7,000,000 value) could be discounted by 30%, or cost $5.25 million. The discount will depend on the term of the agreement, the volatility of the stock, and whether the trust is entitled to receives the dividends during that time. In this example, the trust has a $1.75 million cushion against a decline in the stock price, and an additional $1.75 million gain if the stock appreciates during the three years.

This too has far less financial risk to the trust than a private option, and reduces the price even further, but at the cost of being locked into the stock for a fixed period.

2.5 Private Derivatives on Private Stocks

Finally, a private derivative can be used with stock in a private company owned by client. Like the others, the client sells the derivative to a grantor trust which requires him or her to pay the trust on or before a fixed date an amount based on the appreciation of the stock. (Typically, the payment

amount does not take into account any dividends paid between the date of the derivative agreement and the settlement date.)

For example, if the derivative agreement is based on 100,000 shares of Acme stock and the Acme shares were valued at $50 per share on the date of the derivative agreement and at $100 per share on the settlement date, the client would owe his trust $5,000,000 ($50 of appreciation x 100,000 shares). After the payment on the settlement, the derivative agreement terminates.

In selecting the length of the derivative agreement, one should balance a period of time that is long enough to capture sufficient appreciation, but balances against mortality risk (discussed below). Also, the longer the term, the higher the purchase price for the trust (requiring a larger gift).

The derivative could include downside protection for the trust, which may mean a payment on the settlement date at least equal to the purchase price of the derivative agreement if the Acme shares decline in value greater than some percentage. You may also incorporate a tradeoff on the upside for the trust (like the cap). One might want to cap the amount payable to the trust in order to protect one's personal liquidity. The price of a derivative on a private company is typically lower than one on a publicly traded stock because its value is less volatile.

2.6 The Carry Derivative

A final variation of the private derivative covered here is the "carry derivative," which can be extremely beneficial for clients who are principals in private equity, venture capital or hedge funds. For example, the client holds a capital interest and a carried interest (profits interest) in a newly formed PE fund through an ownership interest in the fund's general partner. Currently, her carried interest has a relatively small value because the fund is in its early stages and her carried interest will provide a return to her only after the outside investors realize a certain rate of return. However, if the fund is successful, her carried interest could be worth hundreds of times its current value.

Making a direct gift of the client's carried interest to a trust for her children would pose a unique set of complexities, a complete discussion of which exceeds the scope of these materials. One such complexity, however, is dealing with Code Section 2701, which would value a gift of x% of the client's carried interest as a gift of x% of the client's carried interest AND x% of the client's capital interest. The client could actually transfer a proportionate amount of her carried and capital interests in the fund (a "vertical slice") to the trust, but this would substantially increase the value of the gift (and the resulting use of exemption and/or amount of gift tax due). Moreover, the capital interest has less appreciation potential than the carried interest and the trust would be obligated to fund the capital calls associated with its capital interest.

Rather than transferring her carried interest itself, the client and the trust could enter into a carry derivative contract with respect to some or all of the client's carried interest. Under this contract, the trust would purchase from the client the right to receive, at a stated future date or dates, an amount tied to the total return of the client's carried interest during the contract term. This would allow the client to transfer the economic benefit of her carried interest without transferring the carried interest itself.

1. Example

A client has 10% of the carry in a new PE fund. He sells a carry derivative contract to the trust in which he is required to pay the trust 50% of the amount distributed with respect to 10% of the carry, after the first $5 million. Typically, the payments are made at specified dates (e.g., 6th, 8th and 10th year). The contract could also provide for a cap on the amount payable at settlement. On the final settlement, it could include the amount that would be distributed with respect to the carry if all the remaining investments were sold.

2. Customization

A carry derivative contract can be customized to suit the client's needs and objectives. For example, the contract can provide that the trust only receives a payment after a specified amount of cash generated from the carried interest, such as retaining for the client the first $5,000,000. Conversely, the contract can limit the maximum amount payable to the trust, thereby limiting the client's exposure and the amount that can be transferred. Adding any of these variations will lower the derivative's value. It allows the client to effectively specify the amount of wealth he wants to retain and transfer, subject to the fund's success. It also gives the client the ability to retain enough carry proceeds to cover the income tax liability associated with the carry, which he or she will still own.

At the other extreme, one could maximize the wealth transfer by providing that the trust receives a multiple of the carry distributions (e.g., the trust would receive an amount equal to 2x or 3x of all carry distributions over the hurdle amount).

3. Treatment Under 2701

The IRS could argue that the trust should nonetheless be viewed as acquiring the carried interest, and that Code Section 2701 should apply. It is unlikely that this argument would be successful because derivatives are not stock or partnership interests, and several private letter rulings have held that an option to acquire an equity interest is not an equity interest to which Section 2701 would apply.[3] The carry derivative is even further removed from the carry than an option to acquire the carry. Also, analogous arrangements have been used and blessed by the IRS.[4]

[3] E.g., PLRs 9350016, 9616035, 9722022, 199952012, 199927002 and 200913065.

[4] In PLRs 201408034, 201311036, 201218015, 200711037, 200711034, 200711025, 200704036, 200352019, 200352018, 200352017 and 200913065, rather than investing directly in a university's endowment, charitable remainder trusts ("CRTs") purchased a contractual right for a proportionate share, or "units," of a university's endowment in order to avoid unrelated business taxable income ("UBTI"). The contract right entitled the CRTs to receive periodic payments based on the number of units owned and the endowment's investment performance. The market value of each unit would initially equal the total value of the endowment investments divided by the number of outstanding units and would subsequently be adjusted in accordance with the market value of the endowment. Thus, the CRTs would be able to achieve an investment return equal to that of the endowment without having an actual interest in the underlying investment assets of the endowment that produce UBTI. The IRS ruled that the issuance of such units to the CRTs, the making or receipt of payments based on the units, and the holding or redemption of the units, will not generate UBTI to the university or to the CRTs. The IRS did not re-characterize the units issued to the CRTs as a direct investment by the CRTs in the endowment's underlying investments. Thus, the IRS would likely not re-characterize the carry derivative as a transfer of the carried interest itself.

Moreover, the carry derivative has significant economic differences from actual carried interests:

- ✓ The trust does not have the right to acquire the carried interest and does not become a partner. Thus, the trust does not have whatever voting, information and other rights are accorded a carried interest holder (except with respect to information rights at the time of settlement).
- ✓ The contract has a limited term, typically shorter than the expected fund life.
- ✓ The Fund's post-settlement gains will not be included in the settlement amount, and post-settlement clawbacks are not repaid by the trust.
- ✓ The trust's potential loss is limited to the contract price paid, which is less than its potential loss if it acquired the carried interest itself.
- ✓ The client will receive and have the use of the distributions on account of the carried interest as they are made, whereas the trust will only receive an economic benefit if it receives funds upon settlement.
- ✓ The trust is entitled to be paid based on a fixed amount of carry irrespective of how much carry the client owns.
- ✓ The client will receive whatever property is distributed by the GP on account of the carry, which may include distributions in-kind of stock, while the trust is only entitled to receive cash or other property acceptable to the trust with a value equal to the distributions made with respect to the carry.
- ✓ The client's contractual obligations to the trust under the contract remain unchanged irrespective of whether he owns the carried interest.
- ✓ The trust's right to receive a payment under the contract is subject to risk of the client's creditworthiness.

3. Risks and Considerations for all Derivatives

3.1 Liquidity Risk

In all of these variations, the client must be comfortable that he or she has sufficient personal liquidity to satisfy the payment on the settlement of the derivative. The payment may be satisfied in kind, but the client may not be able to transfer the underlying asset, which is why the derivative was used in the first place. One could satisfy the payment with a promissory note issued to the trust, to be paid when the client has sufficient liquidity or other assets that can be transferred. A cap on the amount payable to the trust under the terms of the derivative agreement will help mitigate against this risk, especially if asset outperforms expectations.

3.2 Mortality Risks

a. **Taxable Gain**: The trust will cease to be a grantor trust upon the client's death, and thereafter will be a separate taxpayer. As previously mentioned, while the trust is a grantor trust payment under the derivative agreement is not taxable income to the trust. However, if the client dies during

the term of the derivative agreement, the payment by the estate to the trust upon settlement may constitute taxable income or gain to the trust to the extent it exceeds the purchase price. This obviously reduces the after-tax benefit of the derivative agreement (and, if state and federal tax rates exceed the state and federal estate tax rates and/or the estate is sheltered from estate tax liability because of applicable exemptions and deductions, could be detrimental to the overall estate plan). There are arguments that the trust continues to be a grantor trust on the date of death, and we have used a "springing note" to make the settlement payment on that date. But if one's health declines during the derivative term, the trustee may choose to settle the derivative earlier than otherwise planned (where permitted by the derivative), but this could result in a smaller wealth transfer. Alternatively, one may choose to limit the payment on the settlement date to the purchase price in order to eliminate the risk of gain at death, but also gives up any estate tax benefits.

b. **Estate Tax Deduction**: The derivative agreement should provide that it must terminate and be settled upon the client's death, if not terminated earlier. By making the obligation to pay the trust mature at death, the amount of the estate's obligation to pay the trust under the derivative contract should be deductible under Section 2053 "to the extent" that the trust's claim is founded on a promise or agreement contracted bona fide and for an adequate and full consideration in money or money's worth.

Code Sections 2053(a) and (c) provide:

> (a) GENERAL RULE.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—
>
> 1. for funeral expenses,
>
> 2. for administration expenses,
>
> 3. for claims against the estate, and
>
> 4. for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,
>
> as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.
>
> (c) Limitations.—
>
> (1) Limitations applicable to subsections (a) and (b).—
>
> (A) CONSIDERATION FOR CLAIMS.—The deduction allowed by this section in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth; except that in any case in which any such claim is founded on a promise or agreement of the decedent to make a contribution or gift to or for the use of any donee

> described in section 2055 for the purposes specified therein, the deduction for such claims shall not be so limited, but shall be limited to the extent that it would be allowable as a deduction under section 2055 if such promise or agreement constituted a bequest.

In TAM 8204017,[5] the Service addressed whether unexercised and unmatured stock options are liabilities on the date of the decedent's death within the meaning of section 2053(a)(3) of the Code. The decedent had sold uncovered (naked) stock options. The executors deducted as a liability on schedule K of the estate tax return what would have been the cost of executing closing transactions on the date of the decedent's death to eliminate the estate's potential obligations under all outstanding options. The Service stated:

> Section 20.2053-4 of the Estate Tax Regulations provides that a claim does not have to be matured at the time of the decedent's death in order to be deductible. Moreover, contingent claims are deductible if it is reasonably certain that they will be paid. See *Estate of Mary Redding Shedd*, 37 T.C. 394 (1961) aff'd without discussion of this point 320 F. 2d 638 (9th Cir. 1963). However, no deduction is allowable if it is not shown that the decedent was liable for any amount at the time of his death. Thus, a contingent claim where the contingency makes it uncertain whether the decedent's estate will ever be called upon to pay the claim cannot be deducted.

In the TAM, at the date of the decedent's death, the profit or loss was an uncertain contingent liability because the options were not presently exercisable. The Service cited *Estate of W.A. May*,[6] in which the court discussed future liabilities and concluded that they are not deductible:

> The record does not justify that the decedent was liable at the time of his death for any certain amount . . . It does not show that the decedent would ever be called on to pay anything.[7]

The Service concluded that, based on the regulations and case law, no deduction is allowable on the estate tax return for the cost of executing closing transactions to eliminate uncertain, contingent obligations of the estate, such as unmatured, unexercisable options.

Thus, because the contract is settled at the grantor's death, the cost of settlement under the derivative contract is a liability of his estate that should be deductible under Section 2053.

3.3 Valuation Risk

a. **General**: The IRS could argue that the value of the derivative agreement is greater than the price paid by the trust (determined by the appraiser), resulting in a gift of the difference. The derivative agreement could incorporate an adjustment clause on the purchase price in order to reduce the risk of a perceived gift to the trust. This will reduce the economic benefit to the trust

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5 October 2, 1981.

6 8 T.C. 1099 (1947).

7 See also *Estate of Inez G. Coleman*, 52 T.C. 921, 924, 925 (1969).

of the derivative agreement if the IRS successfully challenges the value (*i.e.*, the trust will owe more for, and therefore net less from, the derivative agreement).

b. Section 2703: Under Code Section 2703(a), the value of property (for gift and estate tax purposes) is determined without regard to any option, agreement or other right to acquire or use the property at a price less than the fair market value of the property, unless the agreement creating the restrictions satisfies certain requirements under Section 2703(b). The Service could argue that the value of the property paid at settlement of any of the private derivatives discussed above is being reduced by virtue of the derivative contract in order to avoid a gift, which reduction is impermissible under Code Section 2703. As a result, a gift is made of the amount by which the settlement payment exceeds the purchase price of the derivative.

In Revenue Ruling 80-186,[8] the IRS considered whether a transfer to a related party for nominal consideration of an option to purchase real property for a specified period was a completed gift on the date the option was transferred or on the date the option was exercised. The IRS held that a completed gift occurred on the date the option was transferred if under state law the option was binding and enforceable on such date, and not when the option was subsequently exercised.[9] Similarly, in Revenue Ruling 84-25,[10] the IRS stated that, "In the case of a legally enforceable promise for less than an adequate and full consideration in money or money's worth, the promisor makes a completed gift under section 2511 of the Internal Revenue Code on the date when the promise is binding and determinable in value rather than when the promised payment is actually made." The foregoing rulings support the position that settlement of any of the private derivatives discussed above does not give rise to a gift; rather, the gift would be made when the contract is entered into if the trust does not pay full and adequate consideration. On the other hand, these rulings pre-date Section 2703 and arguably only address when an option or promise is a completed gift and not whether the settlement of an option (or other derivative agreement) gives rises to a gift.

Section 2703 could be applied to a private option agreement that entitles the holder to purchase specific property (e.g., stock) from the seller for a strike price that is less than the property's fair market value at the time of exercise. In these circumstances, the IRS could argue that the property is being sold at a price less than its fair market value because of the option and, as a result of the application of Section 2703 (which would value the property without regard to the option), the holder received a gift equal to the difference between the property's fair market value and the strike price. However, such an arrangement is clearly distinguishable from the arrangements discussed above in which the holder purchases a contractual right to receive a future *payment* if certain events occur. The transfer of cash or other property in settlement of such contract is not a right to acquire an asset for less than its current fair market value; it is merely the payment that is required under the terms of a bona fide contract (for which the holder paid full and adequate consideration). And, the cash or other property used to make such payment is not to be valued at anything other than its fair market value. In these circumstances, Section 2703 (a valuation rule) has no application. (See Technical Advice Memorandum 9842003 in which the Service stated, "We believe that a 'device' under §2703(b)(2) is reasonably viewed as including any restriction

[8] 1980-2 C.B. 280.

[9] See also Rev. Rul. r 69-347, 1969-1 C.B. 227; Rev. Rul. 81-110, 1981-1 C.B. 479; Rev. Rul. 84-25, 1984-1 C.B. 191.

[10] 1984-1 C.B. 191.

that has the effect of artificially reducing the value of the transferred interest for transfer tax purposes without ultimately reducing the value of the interest in the hands of the transferee-family member.")

Settlement of any of the private derivatives discussed above is settlement of an executory contract and, consistent with the revenue rulings cited above, a gift would be made when the contract is entered into if the trust does not pay full and adequate consideration, and not upon settlement. Both are investments, the very nature of which requires a future payment or property transfer in the event the investment is fruitful.

Further, if an option, agreement, right, or restriction which meets each of the following requirements under Section 2703(b), then Section 2703(a) would not apply:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

Intra-family agreements such as derivatives may be bona fide business arrangements comparable to similar arrangements entered into by persons in an arms' length transaction, but proving the agreement is not a "device" to transfer property for less than adequate consideration may be more difficult when it could result in one party making money off of the other.

However, the U.S. District Court in *Kress v. U.S.*, 123 AFTR 2d 2019-12245 (E.D. Wis. March 26, 2019) held that the Section 2703(b)(2) "device" test does not apply to lifetime transfers. The court stated, "Although Chapter 14 is intended to generally address transfer tax avoidance schemes, it is clear from the statute itself that the phrase "members of the decedent's family" unambiguously limits its application to transfers at death." The court cited Black's Law Dictionary (defining "decedent" as a "dead person, especially one who has died recently"), and *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at *6 (W.D. Pa. June 30, 2004) (noting that "one of Congress's primary concerns [in enacting § 2703(b)(2)] was the free passage of wealth to family members through a device that is testamentary in nature"). The court also stated, "Although Congress has attempted to amend § 2703(b)(2) to conform with the agency regulations, no such legislation has been enacted. See Smith, 2004 WL 1879212, at *6 n.3 (citing HR Conf. Rep. 1555, 102d Cong., 1st Sess. (1991); The Revenue Bill of 1992, HR Conf. Rep. 11, 102d Cong., 2d Sess. (1992)); see also Holman, 601 F.3d at 781 (Bean, J., dissenting) ("I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase 'members of the decedent's family' with the Commissioner's phrase 'natural objects of the transferor's bounty.'").'"

4. Gift Tax Reporting

Because the derivatives discussed above are purchased, and not transferred via gift, the client is not required to report such transactions on a gift tax return. We recommend that clients report the sale

of the derivative agreement on a gift tax return (as a "non-gift") in order to start the statute of limitations running on the IRS' ability to challenge the value of the derivative agreement.

5. Conclusion

Private derivatives, whether in the form of virtual stock, carry derivatives or private options can be extremely effective to transfer wealth, often regardless of the form of the client's assets, their rate of growth, cash flow or legal restrictions imposed thereon. As long as the assets that are the subject of the private derivative agreements generate a positive return, wealth can be tax-efficiently transferred out of one's estate. One doesn't need to own the subject assets to employ virtual stock and private options, and any gains and losses from any of these private derivative strategies remain within the family. Planners need to think outside the box, and not limit planning alternatives to the universe of assets held by our clients.

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