TRANSFER PLANNING IN 2012 AND BEYOND

USE IT BEFORE YOU LOSE IT: EFFICIENT AND EFFECTIVE USE OF ALL OF PART OF THE $5 MILLION GIFT EXEMPTION (OR WHATEVER AMOUNT IT IS IN 2013 AND BEYOND)

Steve R. Akers
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February 28, 2012

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I. LEGISLATIVE UNCERTAINTY AND PREDICTIONS.

A. Possibilities; Estate Tax Returns Anticipated For 2011 Decedents with $5 Million Exemption; Possible Legislative Actions. The Tax Policy Center has published a summary of estimates of estate tax returns that will be filed for 2011 decedents. It anticipates 8,600 returns being filed, but only 3,270 taxable returns that will result in estate taxes of $10.6 billion. There are interesting estimates about the very small number of returns that will involve farms or businesses that comprise at least 50% of the gross estate.

All returns where farms and businesses comprise at least 50% of the gross estate: 430 returns, but only 120 taxable returns, reflecting $660 million of estate tax.

Returns where farms and businesses comprise at least 50% of the gross estate *and* the farm or business is less than $5 million: 210 returns, but only 40 taxable returns, reflecting a grand total of $7 million of estate tax.

Possible Congressional actions include:

- Doing nothing, and on January 1, 2013 there will be a $1 million exemption and 55%-60% tax rate. (Many planners think this is likely to occur, in which event there would likely be legislation sometime in 2013.)
- Repeal the estate tax. This cannot be ruled out, though Dennis Belcher thinks it will not happen. (A problem with repeal is that the all estates would receive a step up in basis of death, with no offsetting revenues.)
- Adopt the 2010 approach, with the alternative to elect into carryover basis.
- The Obama Administration's proposal is to use a $3.5 million estate exemption, a $1.0 million gift exemption, and a 45% maximum rate.
- Some other lower exemption. The "Sensible Estate Tax Act of 2011" (discussed immediately below) proposes a $1 million exemption, indexed from 2000). (Jonathan Blattmachr predicts "I think there is a very good chance the $5 million gift exemption will go away.")
- Retain $5 million/35% system. (Jeff Pennell thinks the exemption will not be reduced lower than $5 million; he puts it-"the toothpaste is out of the tube".)
- Canadian type capital gains and death system, though that is very unlikely.

In considering the cost of legislative proposals, projections should factor in not only the income tax effect of stepped up basis but also the income tax effect of additional income tax deductions for administrative expenses that would have been taken on estate tax returns if the estate tax applied to more estates.

B. "Sensible Estate Tax Act of 2011." A bill that was introduced November 17, 2011, which has no chance of passing, has interesting draft language that we may see as forming the basis for transfer tax legislation. The legislation is sponsored by Rep. Jim McDermott (D-WA), who has sponsored similar legislation in prior years that has gone nowhere. H.R. 3467, The Sensible Estate Tax Act of 2011, has several features:

- the estate tax exemption is reduced to $1 million (indexed for inflation since 2000);
- rates are increased above 35% and the brackets are broadened; a 55% rate would apply for taxable estates over $10 million;
- the brackets are also indexed;
- the reduction in the exemption amount presents the potential for "clawback" for a donor who make gifts of $5 million in 2011-2012, but the legislation would eliminate clawback by providing that the applicable exclusion amount used to calculate the hypothetical gift tax to subtract under §2001(b)(2) may never exceed the estate applicable exclusion amount used to compute the "tentative [estate] tax;" in effect, the hypothetical gift tax would be determined using not only the rate table in effect at the decedent's death but also the applicable credit amount in effect at the date of death;
- the state death tax credit is re-instituted and the deduction for state death taxes is removed;
- valuation discounts are limited on nonbusiness assets (this is not the amendment to §2704 that has been in the President's Budget Proposal the last three years; no legislation has ever been submitted for that proposal);
- consistency of basis for estate and gift tax purposes and income tax purposes would be required (§§ 1014(f)(1) and 1015(f)(1) would require that the basis value be no less than the value "as finally determined" for estate or gift tax purposes; §§ 1014(f)(2) and 1015(f)(2) would require that the basis value be no less than the value reported "if the final value … has not been determined;" new § 6035 would require that an executor or donor give a report to transferees regarding values of interest reported on estate or gift tax returns; and penalties would apply for failure to comply with these rules);
- the portability provisions are revised to implement the "Example 3" result from the Joint Committee on Taxation Report of TRA 2010 (to refer to the "applicable exclusion amount" rather than the "basic exclusion amount of the last deceased spouse in the DSUEA definition of § 2010(c)(4));
- GRATs would require a 10-year minimum term, a remainder value greater than zero, and a prohibition on declining GRAT payments;
- the generation-skipping transfer tax exemption term for a trust will be limited by resetting the inclusion ratio to one when the trust is 90 years old;

- the effective date of the bill would be January 1, 2012.

C. Rumors of Reduced Exemption in Fall 2011 Unfounded. There was a flurry of rumors in November 2011 about the possibility of the Supercommittee reducing the gift exemption below $5 million, effective as of November 23, 2011. However, there was never any credible source for these rumors, and indeed they proved to be totally groundless.

D. When Will Congress Act? The most popular prediction position of planners is that it is unlikely that Congress will act before 2013. It is very unlikely that there will be any action before the elections in November. Those elections will have a significant impact on this issue. There could be a shift of control in either the Senate or House. The Senate now has 51 Democrats and two independents that caucus with the Democrats, and there are 47 Republicans. 23 of the 53 Democratic block of Senators are up for reelection, and the Republicans only have 10 seats up for reelection. There could be a shift of control to the Republicans in the Senate.

   In the House, the Republicans are defending a larger number of first-term candidates. It's conceivable that there could be a shift of control in the House. Historically, when a sitting President of one party is up for reelection, the other party loses congressional seats. Two of the last three elections have yielded swings greater than 25 seats.

   Predictions this year of the results of the election are extremely difficult because of many factors, such as Occupy Wall Street, unemployment rates, international finance, etc.

E. Retroactive Law in 2013. Most planners have thought that estate tax legislation in 2013 could be retroactive to January 1 without a challenge, because the law would be more favorable to taxpayers than a $1,000,000/55% system. However, Treasury officials have expressed concern that some disgruntled beneficiary might nevertheless challenge the validity of the retroactivity of the law (for example, the lower rates may cause a shift in who receives benefits under a formula clause, or a shift in amounts that a charity receives). A challenge would take 5 to 7 years to be resolved by the Supreme Court before there would be uncertainty for estates of decedents who died during the period of retroactivity.

F. Budget Proposals for Fiscal Year 2013; Sales to Grantor Trusts Targeted. The Treasury on February 13, 2012 released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals.

   The proposal uses the 2012 system as the assumed "baseline," and proposes returning to a $3.5 million estate tax exemption and $1.0 million gift exemption, with a maximum 45% rate. This is estimated to raise $119 billion over 10 years. (Converting to the 2012 system as the baseline for transfer taxes has a revenue impact of negative $431 billion over 10 years.)

   Portability would be made permanent (as recommended in last year's proposal as well.)

   The Fiscal Year 2013 Plan repeats all of the transfer tax provisions from the 2012 Fiscal Year Plan, including (1) restrictions on valuation discounts, (2) imposing a 10-year minimum term on GRATs, and (3) restricting a trust's GST exemption to 90 years.

There were several new provisions, including: (1) the proposal to require a 10-year minimum term for GRATs also imposes a maximum term equal to the life expectancy of the annuitant plus 10 years (apparently designed to remove the "100-year GRAT" that some have suggested as a planning strategy); and (2) the special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death.

The 2013 Greenbook has a "bombshell" that would eliminate sales to grantor trusts as an estate planning strategy. Under the proposal, if a trust is a grantor trust, the trust assets would be included in the grantor's estate for estate tax purposes, any distribution from the trust is treated as a gift, and conversion to non-grantor trust status is also treated as a gift. The same rules would apply to section 678 trusts if the deemed owner sells assets to the trust (as to the sale transaction assets, income and appreciation therefrom). The transfer taxes are payable out of the trust. The proposal applies to trusts created on or after the date of enactment and the portion of pre-enactment trusts attributable to contributions made on or after the date of enactment. (However, the proposal does not apply to sales made after the date of enactment, thus permitting sales to "grandfathered" grantor trusts as a planning strategy.) This proposal is estimated to raise 910 million over 10 years (which is comparatively small; for example, the 10-year minimum GRAT term provision is expected to raise 3.3 billion over 10 years and the consistency of basis provision expected to raise $2.0 billion over 10 years).

This proposal is a dramatic change and would have far-reaching effects. For example, many irrevocable life insurance trusts are grantor trusts under §677(a)(3). Irrevocable trusts that become foreign trusts by the appointment of a foreign person as trustee would be grantor trusts and therefore included in the gross estate. Irrevocable trusts that become grantor trusts by the appointment of successor trustees such that more than half of the trustees are related or subordinate parties would be included in the gross estate, and that could not be cured by the subsequent appointment of non-related persons as trustees because that would trigger a gift tax on the conversion to non-grantor trust status. Irrevocable trusts with the grantor's spouse as a potential beneficiary [which are grantor trusts under §677(a)(1)-(2)] would be included in the grantor's gross estate.

G. Planning in Light of Legislative Uncertainty. Emphasize to clients that 2012 is the time to act if the client is considering making gifts. Make sure the clients' files point out that clients have been advised to act so that children cannot complain later that the planner did not act appropriately. The $5 million (indexed) gift, estate and GST exemption ($5.12 million in 2012) will end December 31, 2012. This is a wonderful time to make gifts: values are low, interest rates are low, and discounting is more favorable than it may be in the future.

II. OVERVIEW OF TRANSFER PLANNING STRATEGIES.

A. Basics of Gifting Strategies. The basic gifting strategy, particularly in light of the 2001 Tax Act, is to make gifts without generating a federal gift tax.

1. Annual Exclusion and Medical/Tuition Exclusion Gifts. The first level of gifting is to make gifts within the $13,000 annual exclusion amount. I.R.C. § 2503(b)(1). Furthermore, clients may make gifts for medical expenses or tuition expenses directly to the medical care or education provider, without gift or GST tax

consequences. I.R.C. § 2503(e). Annual exclusion gifts are the first level of gifting strategy because if gifts are not made in a particular calendar year to fully utilize the annual exclusion for that year, it is lost forever.

2. Applicable Exclusion Amount Gifts. Gifts in excess of the annual exclusion amounts or medical/tuition exclusion for any particular year first "use up" part of the donor's lifetime "applicable exclusion amount". Until 2011, the applicable exclusion amount for gift tax purposes was fixed at $1 million. In 2011-2012, the gift applicable exclusion amount is the same as the estate applicable exclusion amount--$5,120,000 for 2012. Aggregate lifetime gifts up to the "gift exemption amount" can be made without generating current federal gift tax.

3. Excess Gifts. Gifts in a year that are not covered by annual exclusions and that exceed the aggregate lifetime gift exemption amount will be subject to current federal gift taxes, at a maximum 35% rate (through 2012). Even though such excess gifts are subject to the payment of a current gift tax, the overall taxes may be significantly reduced by making transfers subject to the gift tax than by retaining the assets and having them subject to the estate tax. The estate tax is calculated based on the entire estate, including the amount paid as estate taxes, whereas the gift tax rate is applied only to the assets actually passing to donees. In order to get this benefit, the donor must live at least three years after making the gift; otherwise the gift tax is brought back into the estate. I.R.C. § 2035(b). However, most clients want to avoid paying current gift taxes.

B. Freezing Strategies. For the client who has "maxed out" on annual exclusions and applicable exclusion amount gifts, the next strategy is estate freezing. The goal would be to freeze the value of assets to be included in the donor's estate at its current value (or at its current value boosted by a specified interest rate factor.) A classic example would be for a parent to sell assets to a child. The asset that was sold is not included in the parent's estate, but only the note (together with accrued interest) will be in the estate. The problem with a classic installment sale is that income tax can be generated on the sale.

GRATs, sales to a grantor trusts, and CLATs are all techniques for freezing a substantial portion of the current value in the estate without generating a current gift or income tax. For an excellent summary describing and comparing GRATs and sales to grantor trusts, see Blattmachr & Zeydel, "Comparing GRATs and Installment Sales," 41st Annual Heckerling Institute on Estate Planning ch. 2 (2007).

III. GENERAL PLANNING CONSIDERATIONS FOR GIFTS.

A. Overview of Tax Effects of Gifts. The following is a brief summary of the tax effects of gifts.

A donor can make gifts of the full additional gift exemption amount without paying gift tax.

Gifts are not removed from the base for calculating estate tax, but making gifts does not result in increasing the aggregate combined transfer taxes.

Despite the fact that gifts are included in the base for calculating the estate tax, tax advantages of making gifts include:

- removal of appreciation/income of gift assets from the gross estate;
- utilizing fractionalization discounts;

- paying income taxes on income from grantor trusts to further "burn" the donor's gross estate;
- if the donor lives three years, gift taxes paid are removed from the gross estate; and
- the ability to allocate GST exemption so that the same advantages apply for generation-skipping purposes as well;
- removing assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate); and
- removing $1.5 million from the estate without transfer taxes if the exemption amount is later reduced to $3.5 million and if there is no "clawback" of estate tax on the "excess" gift amount.

The most obvious non-tax advantage of making gifts is to allow donees to enjoy the gift assets currently.

Perhaps the most important advantage of the increased gift exemption for many individuals will be the "cushion" effect — the ability to make gifts in excess of $1 million, but considerably less than $5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers. Planners have indicated that some clients who have been reluctant to implement transfer planning strategies in the past, because of fear of the possible assessment of a current gift tax, have completed transfer planning transactions after 2010 in light of the cushion effect of the $5 million exemption.

Gifts can be disadvantageous from an overall tax cost perspective if (i) the gift asset declines in value after making the gift (which uses up gift exclusion based on the date of gift value), or (ii) if the loss of a basis step-up more than offsets the estate tax savings as a result of removing appreciation/income from the asset and the other advantages of gifts listed above.

B. Exemption Amount Increased for 2012. The exemption amount is indexed, and has increased to $5,120,000 for 2012.

C. Taking Advantage of $5 Million GST Exemption. There are no assurances that the GST exemption will remain at $5 million (indexed). Making a $5 million gift and allocating the $5 million of GST exemption that is currently available is one way of assuring that the full $5 million GST exemption can be used. The safest way of utilizing the $5 million GST exemption would be to make direct skip gifts, to as low a generation as is practicable. Even if the TRA 2010 provisions sunset at the end of 2012, and the Code is interpreted as to future generation-skipping transfers as if the provisions of TRA 2010 (or EGTRRA) "had never been enacted," there would be no ability to impose a GST tax retroactively on the direct skip that occurred in 2011 or 2012 when the direct skip gift was made to the trust. On the other hand, if a gift is made to a dynasty trust and $5 million of GST exemption is allocated to the trust and if TRA 2010 sunsets, it is not clear that for purposes of determining the inclusion ratio of the trust as to a generation-skipping transfer that occurs after the sunset date whether the full $5 million of GST exemption could be considered.

D. Clawback. If a gift is made of $5 million in 2011 or 2012 and the estate tax exemption is later reduced below $5 million, will estate tax have to be paid on the difference? Most planners agree there is unlikely to be a "clawback" in that situation. Congressional staffers have indicated that it is not intended, and IRS guidance or further congressional technical corrections could make that clear. (There were no speakers at Heckerling that disagreed on this — all believe that eventually there will likely *not* be a clawback problem if the exemption is reduced in the future.)

1. Generally No Worse Off Even If Clawback Applies. Even if the "clawback" applies, the estate will not pay more estate taxes as a result of making the gift than if the gift assets had been retained (unless the gift assets were to decline in value). In a marital/charitable plan, there may be estate taxes payable, but those same taxes would have been payable if the gift assets had been transferred to the gift donees at death. In effect, the transfer tax is deferred interest-free from the date of the gift to the date of death. The issue would be an apportionment problem — who has to pay the estate tax on the "clawback" amount. (There are conflicting cases regarding attempts to apportion estate taxes to lifetime gifts. *Compare Estate of Necaise*, 915 S.2d 449 (Miss. 2005)(will provision apportioning estate taxes to lifetime gifts not enforceable) *with Estate of Finke*, 508 N.E.2d 158 (Ohio 1987)(state apportionment statute does not apportion state of federal estate taxes to recipients of lifetime gifts). If there is a state law apportionment statute that apportions estate taxes to donees of gifts or if there is an agreement of donees to reimburse the estate for added estate taxes that is respected, that obligation presumably is an estate asset that would be added to the value of the gross estate. If there were insufficient assets in the probate estate to pay the estate taxes, that obligation would be an estate asset that the IRS could pursue for payment.)

2. Could Be Worse Off If Assets Pass to Surviving Spouse or Charity. However, if clawback applies it could skew marital/charitable deduction planning. If the estate would otherwise pass to a surviving spouse or charity, the additional tax is dramatic because the tax itself does not qualify for the marital/charitable deduction and an interrelated calculation dramatically increases the tax cost at the first spouse's death. For example, if there is a $5 million gift in 2011 and the donor dies in a year in which the estate tax exemption has been reduced to $3.5 million and the rate has been increased to 45%, if clawback applies, and if the donor's will leave the entire estate to a surviving spouse or charity, the estate tax will be $1,227,272.73 if the Line 7 gift offset is determined under the Form 706 instructions approach. (Check: [$1,500,000 + $1,227,272.73] x 45% = $1,227,272.73.)

   Carlyn McCaffrey points out that an approach to avoid this estate tax at the first spouse's death if clawback applies is to include provisions in the trust agreement of the trust that receives the gift (i) that give an independent party the right to grant the settlor a testamentary limited power of appointment over the trust (which would cause estate inclusion under §2038), and (2) that cause any trust property included in the settlor's gross estate to pass to a QTIPable trust if there is a surviving spouse at the settlor's death.

3. The Technical Issue — More Detail Than You Wanted. At least one commentator believes the current law is crystal clear even without clarification that clawback does not apply. (Other planners are not so sure.)

The estate tax calculation method under § 2001(b) is as follows:

- Step 1: calculate a tentative tax on the combined amount of (A) the taxable estate, and (B) the amount of adjusted taxable gifts (i.e., taxable gifts made after 1976 other than gifts that have been brought back into the gross estate — just the tax using the rate schedule is calculated, without subtracting any credits). I.R.C. §2001(b)(1).
- Step 2: subtract the amount of gift tax that would have been payable with respect to gifts after 1976 if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts, I.R.C. § 2001(b)(2). (The statute does not say whether to use the gift credit amount that applied at the time of the gift or at the time of death — and this is what leads to the uncertainty. Form 706 instructions for the "Line 7 Worksheet" for years before 2011 clarify that the gift unified credit attributable to the applicable credit amount available in each year that gifts were made is used in calculating the gift tax that would have been payable in that year.)
- Step 3: Subtract the applicable credit amount.
- TRA 2010 amends § 2001 to add new § 2001(g), which clarifies that in making the second calculation (under § 2001(b)(2)), the tax rates in effect at the date of death (rather than the rates at the time of each gift) are used to compute the gift tax imposed and the gift unified credit allowed in each year. The 2011 Form 706 Instructions take the position that the 2011 rates are multiplied by the gift exemption amount that applied in the year the gift was made, but that result is not necessarily mandated by the statute.

If the estate tax exemption is decreased in the future, after the client has already made gifts covered by the $5 million gift exemption amount, it is not clear how Step 2 of the estate tax calculation described above will be interpreted. Following the Form 706 instructions, the hypothetical "chapter 12" offset amount (reported on Line 7 of the Form 706) is calculated using the applicable credit amount "in effect for the year the gift was made," (see the last two lines of the Form 706 Instructions, Line 7 Worksheet for years before 2011; for 2011, the 2011 Form 706 Instructions provide a table of unified credit amounts for each year, redetermined using the 2011 rates — but the gift "exemption" amount for the year of the gift is used.) If the decedent had made a gift in 2011 of $5 million, the credit amount for an applicable exclusion amount of $5 million is what is used to calculate the hypothetical gift tax "payable" on the $5 million adjusted taxable gift. (Similarly, Letter Ruling 9250004 says that "the unified credit that would have been allowed to the decedent *in the year of the gift* is taken into account as a reduction in arriving at the gift tax payable" for purposes of the estate tax calculation.) The change under § 2001(g) says to use the date of death estate tax *rates* in calculating the gift credit amount for this hypothetical gift tax. This seems to connote that the approach in the Form 706 instructions and in Letter Ruling 9250004 would be applied by using the exclusion amount that was used in the year of the gift and determining a hypothetical gift credit amount using the date of death rate. That is precisely what the Instructions to the 2011 Form 706 do. That means that the gift unified credit amount (which is based on a $5 million gift exemption) would fully cover the gift and no gift tax calculated under chapter 12 would be reduced in calculating the tentative estate tax. In effect, the tentative tax (before applying the estate tax unified credit amount at death) would be the tax on the combined amount of the taxable estate plus the adjusted taxable gifts. This would result in estate tax being due with respect to the adjusted taxable gifts if the later estate tax unified credit is less than the gift tax unified credit that had applied previously. (This same analysis would apply for gifts up to $5.12 million in 2012, and the gift unified credit amount would be based on a $5.12 million exemption.)

The commentator who says the current law is clear that clawback would not apply has stated that there would be a credit allowed based on the amount of gift tax that would have been paid using the *date of death* exemption amount, and says the 2011 Form 706 Instructions "get this calculation right." However, the 2011 Form 706 Instructions provide a Table of Unified Credits as Recalculated Using 2011 Rates for each year from 1977-2011. **T**hey clearly say to use the gift credit amount equal to the rate in effect in 2011 times *the gift exemption amount that applied in the year of the gift.*

Even though the Instructions seem to suggest that *clawback would apply* if the estate tax exemption amount is decreased in the future, that has not yet actually happened. It is not clear that the IRS would continue to take that position in that event. That has never happened previously and the Instructions presumably were not written with that contingency in mind.

4. <u>Proposed Legislation Clarifies that Clawback Would Not Apply</u>. A legislative proposal makes clear that clawback would not apply. H.R. 3467, The Sensible Estate Tax Act of 2011, sponsored by Rep. Jim McDermott (D-WA). That proposal is discussed in Item 1.b. above. That legislation has no chance of passing, but the legislative language is indicative of statutory language that may included in other transfer tax legislative proposals. The drafting approach to make this issue clear in H.R. 3467 is to revise §2001(g), which generally says to use the date of death rates in making the calculation of the gift tax (including the determination of both the gift tax rate and the gift tax unified credit) that would be imposed with respect to adjusted taxable gifts that is subtracted under §2001(b)(2) in calculating the amount of the estate tax. Section 2001(g) is reorganized and the following is added as a new subsection:

   > "(2) APPLICABLE CREDIT AMOUNTS. – The amount determined under section 2505(a)(1) [i.e., the gift tax unified credit amount] for each calendar year shall not exceed the estate's applicable credit amount under section 2010(c) [i.e., the tax on the estate tax applicable exclusion amount]."

   This would have the effect of not imposing an estate tax on the amount by which the gift exemption amount at the time of the gift exceeds the estate tax applicable exclusion amount at the donor's death.

E. <u>Reverse Clawback Problem</u>. Assume a donor makes a $2 million gift in a year in which the gift exemption amount is only $1 million, but the estate tax exemption amount later increases to $5 million. In making the estate tax calculation, if the hypothetical gift tax payable on the $1 million gift is based on the exemption amount in the year of death (which is NOT the position taken in the Form 706 instructions but one speaker says that is the law that applies currently), there would be no hypothetical gift tax on the $2 million gift, so there would be estate tax imposed on the full estate plus adjusted taxable gifts, without any credit for the gift tax *that was actually paid* on the $2 million gift. That possible phenomenon would not be a problem under the legislative "fix" in the Sensible Estate Tax Act of 2011, because it says to calculate the hypothetical gift tax payable on the adjusted taxable gift (which is subtracted in determining the estate tax) using the gift credit amount that applied in the year of the gift, *but not exceeding* the estate tax applicable credit amount in the year of death. Therefore, the higher exemption amount would not be used in calculating the hypothetical gift tax payable.

F. <u>Basis Concerns</u>. The differential between the 35% estate tax rate and a 15% (or perhaps increasing to 20%-25%) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 35% estate tax savings on that appreciation to offset the loss of basis step up on the *full* value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue.

Example: a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 15% rate, this means the family will receive net value of $850,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves $150,000. The asset would have to appreciate to $1,750,000 in order for the estate tax savings on the appreciation to offset the loss of basis step up (i.e., $750,000 x 0.35 = 1,750,000 x 0.15).

In making these calculations, consider both federal *and* state income and estate taxes.

There is an example of a collectible in Mahon, *The "TEA" Factor*, TRUSTS & ESTATES (Aug. 2011). If a zero basis collectible worth $5 million is given, there would have to be almost $20 million of appreciation before the estate tax savings exceed the loss of basis step up.

Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like kind exchanges, basis step up is not an important issue.

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step-up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. Blattmachr, Gans & Jacobson, 97 J. TAX'n 148 (Sept. 2002).

G. <u>Basis Step-Up Flexibility; Repurchase of Assets by Grantor, Triggering "String" Provision</u>. Consider steps to build in flexibility for achieving a basis step-up at the death of a transferor. Key to this flexibility will be making the gift to a trust rather than an outright gift.

One traditionally used method to achieve a basis step-up is for the grantor to repurchase appreciated assets from a grantor trust recipient.

Another approach is to draft the trust to give an independent trustee or other independent party the power to grant a testamentary limited power of appointment to the grantor. The limited power of appointment could be as broad or narrow as desired, as long as it allowed the possibility of shifting benefits from beneficiary to another. If so granted, this would cause inclusion in the grantor's estate under § 2038 (and that section is based on powers that the grantor actually holds at death and not on the retention of interests at the time of the original transfer). To protect the independent third party, the instrument might exonerate the independent party from liability with respect to the decision to grant the power of appointment regardless of whether it is exercised. The instrument could provide that the independent third party has no obligation to inquire as to whether the authority should be exercised. Another approach would be to provide that the independent party has no authority to grant the power of appointment until requested in writing to do so by a designated class of persons.

The grant of the testamentary power of appointment to the grantor could conceivably be by a formula. The trust instrument could give the donor a formula testamentary power of appointment to the extent that an amount equal to 35% of the excess of the date of death value over the date of gift value is less than amount equal to 15% of the excess of the date of death value over the basis of the property (substituting the current tax rates). The disadvantage of the formula approach, if it operates immediately after the creation of the trust, is that it creates an ETIP, which would preclude immediate allocation of GST exemption to the trust.

Another possible approach would be to take steps to trigger the "string" provisions of §§ 2036-2038. For example, the parent may continue living in the house in a QPRT without paying rent to trigger § 2036(a)(1). However, the IRS conceivably may not take the position in that type of circumstance that the failure to pay rent, based on the changed circumstances, reflects an implied agreement to retain the interest at the outset (which is a requirement under § 2036(a)(1)). As another example, if a parent has given undivided interests in a vacation home to children, the parent may start using the vacation home exclusively without paying rent in a similar attempt to trigger an implied agreement of retained enjoyment under § 2036(a)(1).

A further extension of this planning would be to leave the flexibility of causing the trust assets to be included in the donee-'s estate for estate tax purposes if there are no estate tax concerns for the donee and if a basis step-up at his or her death would be desirable. These are the same strategies that could be used in creating trusts for a spouse in the testamentary context.

H. Keep in Mind Downside of Depreciation. If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.

I. Avoid December 2012 Crunch. Keep in mind that the $5.12 million gift exemption ends at the end of 2012. Do gift planning with clients throughout the year in order to avoid a workflow crunch in December of 2012.

J. How Much Can The Client Afford to or Want to Give? Desire to Retain Possible Indirect Benefits? Spouses collectively could give up to $10 million without having to pay gift taxes. Clients may have a concern that gifts of $5 million ($10 million from a couple) are too much for their children (or trusts for their children) to receive. Howard Zaritsky (Rapidan, Virginia) gives the following standard cautionary advice to clients contemplating gifts to their children:

"(1) The gifts are likely to save a substantial amount of taxes;

(2) The child will not say 'thank you;'

(3) The parent will not approve of what the child does with the gift; and

(4) The child will not love the parent more for having made the gift."

Furthermore, few couples can afford to give $10 million without potentially impacting their lifestyle in later years. A primary concern will be "Will I have enough left to live on?" How do you define what are "discretionary" assets? That is not for the planner to define. "It's not the actual ability to make a gift that matters — it's the *perceived* ability to make a gift and maintain one's standard of living into the foreseeable future that matters." As a result, donors interested in making large additional gifts may want to consider the possibility of ways to preserve direct or indirect access to gift assets in the event of a "rainy day" financial reversal (strategies are discussed below).

IV. STRATEGIES FOR LEAVING FLEXIBILITY OF POSSIBLE ACCESS TO GIFT FUNDS.

A. "Rainy Day Fund" Considerations; Lifetime Credit Shelter Trust for Donor's Spouse. The donor may wish to make gifts in a way that the donor (or the donor's spouse) could retain some use of the assets in case needed as a "rainy day" fund. A popular way of using the increased gift exemption may be for a donor to make gifts to a "lifetime credit shelter trust" for the benefit of the donor's spouse (and possibly children). The trust would likely be designed to give as much control and flexibility as possible to the surviving spouse without creating tax or creditor concerns.

The trust would be for the benefit of the donor's spouse, containing very similar terms as in standard credit shelter trusts created in wills. The trust may allow very broad control to the spouse but still not be included in the spouse's estate for estate tax purposes and may be protected against claims of both the donor's and spouse's creditors. In some ways, this is the ideal kind of trust for the spouse.

Possible terms could include:

- Spouse as a discretionary beneficiary (perhaps with children as secondary beneficiaries)
- Spouse as trustee (distributions to the spouse would be limited to HEMS)
- Spouse could have a "5 or 5" annual withdrawal power
- Spouse could have limited power of appointment (exercisable at death or in life)
- In case the donee-spouse predeceases, the power of appointment could be broad enough to appoint the assets back to a trust for the donor. (Exercising the power of appointment in the donee-spouse's will to include the donor-spouse as a discretionary beneficiary should not cause inclusion in the donor-spouse's estate under § 2036(a)(1) if there was no pre-arrangement, but that might not prevent the donor's spouse's creditors from being able to reach the trust assets unless the trust is created in a self-settled trust jurisdiction. Several states (Arizona, Delaware,

Florida, Michigan and Wyoming) have passed statutes addressing this situation for inter vivos QTIP trusts, providing that such an appointment in trust for the donor-spouse would not cause the trust assets to be subject to the donor-spouse's creditors. See below for further discussion.

- Another way of addressing the donee-spouse predeceasing the donor would be to have some life insurance on the donee-spouse payable to the donor or a trust for the donor-spouse that has substantially different terms than this trust.
- If the donor were concerned about how the donee-spouse might exercise the power of appointment, the instrument could provide that the power of appointment could be exercised by the spouse only with the consent of a non-adverse third party (such as the grantor's sibling), and the instrument could even provide that the third person's consent would be required in order for the donee-spouse to change an exercise of the power of appointment.
- To address the possibility of a divorce, in which event the donor-spouse may not want the donee-spouse to continue as a beneficiary, the trust could define the "spouse" to be the person to whom the grantor is married to at the time without causing estate inclusion in the donor's estate. *See Estate of Tully Jr. v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (power to alter death benefit plan by terminating employment or divorcing wife not a §2038(a)(1) power); Rev. Rul. 80-255, 1980-2 C.B. 272 (including settlor's after-born and after-adopted children as additional beneficiaries is not the retention of a power to change beneficial interests under §§ 2036(a)(2) or 2038). Therefore, the trust could also be available for the benefit of a new spouse.

With this approach, the trust could still be used for the "marital unit" if the client has concerns that large gifts may unduly impoverish the donor and his or her spouse, but the assets would not be included in the gross estates of the donor or the donor's spouse. Such a trust would likely be a grantor trust as to the grantor under § 677 (unless the consent of an adverse party were required for distributions to the spouse).

1. <u>Application of §§2036-2038 If Donee Spouse Appoints Assets Into Trust for Benefit of Original Donor Spouse</u>. This issue is receiving increased attention by planners. The IRS might argue that §§2036 or 2038 could apply in the donor spouse's estate if it could establish an implied agreement that the donee-spouse would leave the donated assets back into a trust for the benefit of the donor spouse. This is analogous to situations in which one spouse makes a gift to the other spouse, and the other spouse bequeaths the property back into a trust for the benefit of the original donor spouse. *See Estate of Skifter v. Comm'r.*, 56 T.C. 1190, at 1200 n.5 (19172), *aff'd* 468 F.2d 699, 703 (2d Cir. 1972)(life insurance policy transferred to wife and bequeathed back to trust for husband with husband as trustee at wife's death not includible in husband's estate under §2042, reasoning that §§2036 and 2038 would not have applied if an asset other than a life insurance policy had been the subject of the transfer; Tax Court and circuit court both emphasized that if the transfer and bequest were part of a prearranged plan, estate inclusion would have resulted, noting that the bequest back to the husband was made "long after he had divested himself of all interest in the policies"); *Estate of Sinclaire v. Comm'r,* 13 T.C. 742 (1949)(predecessor to §2036 and 2038 applied

where decedent gave assets to her father, who transferred the assets the following day to a trust providing decedent with a life interest and power to appoint the remainder interests); Rev. Rul. 84-179, 1984-2 C.B. 195 (§2036 did not apply because decedent's transfer to the donee and the bequest back to the decedent in trust were unrelated and not part of a prearranged plan); Gen. Couns. Mem. 38,751 (June 12, 1981) (indication that step transaction doctrine will be applied if the decedent's transfer and the donee's bequest for the benefit of the decedent were part of a prearranged plan, and in particular that cases where the donee's transfer occurs shortly after the decedent's initial transfer would invoke the doctrine); *see generally* Gans, Blattmachr & Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP., PROB. & TR. J. 413, 432-33 (2007). To the extent possible, structure the transfer to remove the inferences of such an implied agreement (by allowing the passage of time, not transferring all assets, having the donee-spouse actually exercise a power of appointment rather than just allowing assets to pass back into trust for donor under trust default provisions, etc.).

There is a specific exception in the QTIP regulations providing that the §2036/2038 issue does not apply for gifts to an inter vivos QTIP trust, where the assets are left back into a bypass trust for the benefit of the donor spouse. Reg. §§ 25.2523(f)-1(d)(1) & 25.2523(f)-1(f) Exs. 10-11. However, those examples would not apply because the rationale in them is that there will be estate inclusion in the donee-spouse's estate under §2044.

<u>Jeff Pennell's Observations on §§2036/2038</u>. (1) <u>Section 2038</u>. The real issue is whether the appointment back would trigger under § 2038. The initial reaction might be to apply §2036, but §2036 requires *retention* of enjoyment or control. Here, nothing was retained at the outset, but it came back by the exercise of the power of appointment. Section 2038, on the other hand, can apply to an ability to alter, amend, revoke, or terminate that exists in the trust at the death of the decedent — it did not have to be retained at the outset. So in exercising the non-general power of appointment, be careful not to give the donor spouse anything that would rise to the level of a right to alter, amend, revoke, or terminate. For example, the donor could not have a testamentary power of appointment by reason of the exercise.

(2) <u>Section 2036</u>. The issue is whether the entire transaction and appointment back was pursuant to an implied understanding that these series of transactions would occur. "I think, frankly, it would be difficult for the government to make that case, but of course you could leave a trail of documents — a smoking gun — that could allow the government to say this was all part of a prearrangement, and that conceivably could get you into §2036."

2. <u>Creditor Rights Issue</u>. A totally separate issue is that, despite the tax rules, for state law purposes the donor to the lifetime credit shelter trust may be treated as the donor of the continuing trust for his or her benefit after the death of the donee-spouse. Therefore, for state law purposes, there is some possibility that the trust may be treated as a "self-settled trust" and subject to claims of the donor's creditors. This would seem to turn on what has been called the "relation back doctrine."

> "If, upon her death Debbie exercises a special power to create a credit shelter… trust for Dennis (the original donor), the trust assets appointed to Dennis may be considered as if Dennis created his own trust rather than Debbie being treated as the creator of such trust. The creditor under the Relation Back Doctrine could argue: (i) the exercise of a special power of appointment constitutes a transfer 'from the donor of the power, not from the donee' [citing *In re Wylie,* 342 So.2d 996, 998 (Fla. 4th DCA 1977) (quoting RESTATEMENT (FIRST) OF PROPERTY §318 comment (b) (1940))]; and (ii) the power of appointment is 'conceived to be merely an authority to the power holder to do an act for the creator of the power.' [citing American Law Institute, *Donative Transfers* vol. 2 §§ 11.1-24.4, *in* RESTATEMENT (SECOND) OF PROPERTY 4 (1986)]."
>
> … **[N]one of the reported cases regarding the Relation Back Doctrine address its application to the donor of a QTIP or credit shelter trust who receives trust assets upon the death of the donee spouse through the exercise of a special power of appointment ….**"
>
> Nelson, *Asset Protection & Estate Planning – Why Not Have Both?*, at 15-11 2012 HECKERLING INST. ON EST. PLANNING.

See Alexander Bove, *Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined*, 36 ACTEC L.J. 333, 337 (2010) (after discussing the relation back doctrine in this context concludes, "Thus, it is not clear that a court would actually hold that it was a transfer from the donor to a trust for his own benefit through a power holder's discretionary exercise of a power of appointment, but it is a risk"). *See also Watterson v. Edgerly*, 40 Md. App. 230, 388 A.2d 934 (1978)(husband gave assets to wife and next day wife signed will leaving assets to trust for husband; held that the trust was protected from husband's creditors under the trust spendthrift clause).

Five states have statutes that address this situation in the context of initial transfers to an inter vivos QTIP trust, as opposed to transfers to a lifetime credit shelter trust. Those states are Arizona, Delaware, Florida, Michigan, and Wyoming. The Arizona statute addresses the issue for all inter vivos trusts initially created for the donor's spouse (including the lifetime credit shelter trust strategy discussed in this sub-paragraph) where the assets end up in a trust for the original donor-spouse. It provides:

> "E. For the purposes of this section, amounts and property contributed to the following trusts are not deemed to have been contributed by the settlor, and a person who would otherwise be treated as a settlor or a deemed settlor of the following trusts shall not be treated as a settlor:
>
> > (1) An irrevocable inter vivos marital trust that is treated as qualified terminable interest property under section 2523(f) of the internal revenue code if the settlor is a beneficiary of the trust after the death of the settlor's spouse. *[i.e. inter vivos QTIP trusts]*
> >
> > …

(3) An irrevocable inter vivos trust for the settlor's spouse if the settlor is a beneficiary of the trust after the death of the settlor's spouse. *[i.e., lifetime credit shelter trusts where spouse is a beneficiary]*

(4) An irrevocable trust for the benefit of a person, the settlor of which is the person's spouse, regardless of whether or when the person was the settlor of an irrevocable trust for the benefit of that spouse. *[i.e., reciprocal trusts by the spouses]*

…

F. For the purposes of subsection E, a person is a beneficiary whether so named under the initial trust instrument or through the exercise by that person's spouse or by another person of a limited or general power of appointment. ARIZ. STAT. §14-10505(E)-(F) (parenthetical comments are not in the statute)."

3. <u>Gift From One Spouse With Split Gift Treatment</u>. Some planners have suggested the following as an alternative for making $10 million of gifts from both spouses, but of which the donor's spouse could be a potential discretionary beneficiary, is the following. One spouse could give the entire $10 million to a trust having the other spouse as a discretionary beneficiary. The other spouse would make the split gift election, which treats him or her as the transferor for gift and GST tax purposes (meaning that the spouse's gift and GST exemption could be used) but NOT for estate tax purposes. Therefore, the assets would not generally be included in the spouse's gross estate for estate tax purposes even though he or she was a discretionary beneficiary. The problem with this approach is that split gift treatment is not allowed if the consenting spouse is a beneficiary of the trust to which the gift is made if the standard of invasion is not an ascertainable standard. *See* Rev. Rul. 56-439, 1956-2 C.B. 605; *Wang v. Commissioner*, T.C. Memo 1972-143 (no split gift election allowed where consenting spouse's interest in trust receiving gift assets was not ascertainable); *see generally* D. Zeydel, *Gift-Splitting — A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007).

B. <u>"Rainy Day Fund" Considerations; Lifetime Credit Shelter "Non-Reciprocal" Trusts</u>. Some clients may want to go further and have each of the spouses create credit shelter trusts for the other spouse; the issue would be whether such trusts could be structured to avoid the reciprocal trust doctrine and therefore avoid estate inclusion in both spouses' estates.

If A creates a trust for B, and B creates a trust for A, and if the trusts have substantially identical terms and are "interrelated," the trusts will be "uncrossed," and each person will be treated as the grantor of the trust for his or her own benefit. *United States v. Grace*, 395 U.S. 316 (1969). In *Grace*, the trust terms were identical, the trusts were created 15 days apart, and the trusts were of equal value. The Court reasoned:

"Nor do we think it necessary to prove the existence of a tax-avoidance motive. As we have said above, standards of this sort, which rely on subjective factors, are rarely workable under the federal estate tax laws. Rather, we hold that application of the reciprocal trust doctrine requires only that the *trusts be interrelated*, and that the arrangement, *to the extent of mutual value*, leaves the settlors in approximately

> the *same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries." (emphasis added)

If the terms of the two trusts are not substantially identical, the reciprocal trust doctrine does not apply. *See Estate of Levy v. Commissioner*, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and other trust did not; taxpayer's attorney has indicated informally that the spouses had reciprocal income interests in each other's trust; IRS conceded in its brief that if the special lifetime power of appointment was valid under local New Jersey law the reciprocal could not apply); Letter Ruling 200426008 (citation to and apparent acceptance of *Estate of Levy*; factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) several powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries); *but see Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995)(Jones, J. dissenting)(identity of beneficiaries is not a prerequisite to application of reciprocal trust doctrine; retained mutual powers to control timing of distributions should be sufficient to invoke the doctrine).

Possible distinctions that could be built into the trusts include:

- Create the trusts at different times (separated by months, not 15 days as in *Grace*)
- Fund the trusts with different assets and different values (observe that *Grace* holds that just having different assets is not sufficient to avoid the doctrine, but it applies to the extent of mutual value)
- One trust allows distributions without any standard but the other trust imposes a HEMS standard
- One trust might require considering the beneficiary-spouse's outside resources and the other would not
- One trust includes the donor's spouse as a discretionary beneficiary but the other trust would merely give an independent party, perhaps after the passage of some specified time, the authority to add that donor's spouse as a discretionary beneficiary
- One trust allows conversion to a 5% unitrust but the other trust prohibits that
- Different termination dates and events
- Inter vivos power of appointment in one trust and not the other (like *Levy)*
- Different testamentary powers of appointment (maybe one trust has one and the other does not or perhaps there are different classes of permitted appointees or perhaps in one trust exercisable only with the consent of a non-adverse party)
- Different trustees
- Different removal powers (one allows the grantor to remove and comply with Rev. Rul. 95-58 but the other puts removal powers in the hands of some third party)

Jonathan Blattmachr suggests that there can be an advantage to making the primary beneficiary the Settlors' grandchildren, and including each other only as secondary beneficiaries.

Consider not having each of the spouses serve as trustee of the other's trust. Reciprocal dispositive powers may be sufficient to invoke the reciprocal trust doctrine if the trusts are sufficiently interrelated; reciprocal economic interests may not be required. *See Bischoff v. Commissioner*, 69 T.C. 32 (1977); *Exchange Bank & Trust v. United States*, 694 F.2d 1261 (Fed. Cir. 1982). (This issue is discussed further below.)

For a discussion of the reciprocal trust doctrine generally see M. Merric, *The Doctrine of Reciprocal Trusts*, LEIMBERG ASSET PROTECTION PLANNING NEWSLETTER (2008)(five- part article); P. Van Horn, *Revisting the Reciprocal Trust Doctrine*, 30 TAX MGMT. EST. GIFTS & TR. J. 224 (2005); G. Slade, *The Evolution of the Reciprocal Trust Doctrine Since* Grace *and Its Current Application in Estate Planning*, 17 TAX MGMT. EST. GIFTS & TR. J. 71 (1992). For an extended discussion of the reciprocal trust doctrine in the context of spouses creating lifetime QTIP trusts for each other, see M. Gans, J. Blattmachr & D. Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52, 57-60 (July/August 2007).

The *Grace* case involved reciprocal interests rather than powers. Subsequent cases have differed regarding whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under §§2036(a)(2) or 2038. *Estate of Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to §§2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Comm'r*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

If trusts of unequal value are reciprocal, the values to be included in either grantor's estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm'r*, 140 F.2d 636 (8th Cir. 1944).

Creditors Rights Issue? A possible concern with "non-reciprocal" trusts by each of the spouses for each other is that they may not be respected for state law purposes with respect to claims of creditors against the settlors. *Cf. Security Trust Co. v. Sharp*, 77 A.2d 543 (Del. Ct. Ch. New Castle 1950)(the court "uncrossed" the trusts for state law purposes; husband made assignment of assets from trust created by wife for husband despite existence of spendthrift clause that prohibited him from alienating property; trust was identical to trust that husband created for wife on the same day; trusts were treated as reciprocal trusts; each party indirectly created a trust for his own benefit, so husband was treated as creating the trust for his benefit and he was not prohibited from assigning assets by reason of a prohibition on alienation in a trust that he is deemed to have created).

Although this is a theoretical concern, few if any reported cases have allowed creditors access to reciprocal trusts under this theory. Perhaps the closest is *Security Trust Co. v. Sharp* (summarized in the parenthetical above). It did not involve a creditor attack on a reciprocal trust, but suggested in dictum that reciprocal trusts would be subject to attack by creditors:

> "Being practically identical in both purpose and objective, the court — looking to substance — will say that each party, by indirection, created a trust for his own benefit. Moreover, it is not unlikely that the same approach would be taken by the

> courts when such trusts are attacked by creditors. See the dictum in Provident Trust Co. v. Banks, 24 Del. Ch. 254, 9 A.2d 260."

That was over 60 years ago, and it is difficult to locate any reported case in which creditors have attacked a reciprocal trust under this theory.

State legislatures may address this issue. An Arizona statute provides protection from a reciprocal trust attack when spouses create trusts for each other. ARIZ. REV. STAT. §14-10505(E). (The statute is quoted in Item5.i.(2) above.)

The possibility of creditors attacking reciprocal trusts should not be a problem if the trusts are created under the laws of states that have adopted "self-settled spendthrift trust" provisions (as discussed in the following paragraph).

If the donors' creditors can reach the trust assets, that would cause inclusion in the donors' estates for estate tax purposes under §2036.

As to the creditors' rights issue, Jonathan Blattmachr advises that spouses should create mutual but non-reciprocal trusts for a primary reason of asset protection:

> "Many spouses should do trusts for each other. There is a huge bonus — you have taken the property out of the reach of your creditors. Even if you're as selfish as I am, you ought to do this with your spouse not only to get estate protection for your kids and GST protection for your grandkids, but you also eliminate the assets from being subject from claims of creditors — provided you do not walk into the reciprocal trust doctrine."

Jonathan points out that this should be entitled to protection under §548(e) of the U.S. Bankruptcy Act because it is not done to avoid creditors but to take advantage of the special $5 million gift exemption that exists in 2011-2012.

C. <u>"Rainy Day Fund" Considerations; Discretionary Trusts in Self-Settled Trust States</u>. Self-settled trusts may be considered in jurisdictions that allow distributions to the settlor in the discretion of an independent trustee without subjecting the trust to claims of the settlor's creditors (and therefore estate inclusion). This will raise the issue of whether a client can create a trust, with the possibility of it serving as a "rainy day fund" in the unlikely event that financial calamities occur, without triggering §2036(a)(1) (a transfer with an implied agreement of retained enjoyment).

Twelve states have adopted varying approaches regarding "self-settled spendthrift trusts": Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Self-settled trusts, with the grantor as a discretionary beneficiary, can be used to overcome the concern of some clients that they will run out of money. Establish the trust in one of those states so that creditors do not have access to the trust. This will help alleviate concerns that §2036 may apply to the trust. Furthermore, the trust could be structured to include only the settlor's spouse as beneficiary as long as the settlor is married — so that the settlor is not even a direct beneficiary as long as he or she is married. The potential §2036 concern could be further ameliorated by giving someone the power to remove the settlor as a beneficiary, and that power could be exercised when the settlor is near death. Whether a retained enjoyment exists under §2036 is tested at the moment of death, and §2035 should not apply because the settlor has nothing to do with removing himself or herself as beneficiary (as long as no prearrangement exists). *See* Tech. Adv. Memo. 199935003 (§2035 will apply if pre-planned arrangement).

Private Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot re-vest beneficial title or change the beneficiaries. (Various cases have held that the settlor has not made a completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.) The ruling also discussed §2036. The "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under §2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." Although this is only a private letter ruling that cannot be relied on by other taxpayers, it is comforting that PLR 200944002 relied on a published ruling. Revenue Ruling 2004-64, 2004-2 C.B. 7 holds that a discretionary power of a trustee to reimburse a grantor for paying income taxes attributable to a grantor trust, whether or not exercised, would not cause inclusion in the gross estate under §2036. However, Revenue Ruling 2004-64 observes (in Situation 3 of that ruling) that giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if an understanding or pre-existing arrangement existed between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law.

The ruling does not address the result if the grantor is not a resident of Alaska. Many commentators view the analysis as applying even if the grantor does not reside in the state in which the trust is created. *See* Letter Rulings 9332006 (U.S. grantors created self settled spendthrift trusts under the laws of a foreign country and IRS held no estate inclusion) & 8037116; *Estate of German v. United States*, 7 Ct. Cl. 341 (1985) (Maryland trust created by Florida grantor). However several bankruptcy cases have denied a discharge to grantors of a foreign situs self-settled spendthrift trust apparently because the law of the grantor's domicile did not permit such trusts.

The position that the self-settled trust will not be included in the gross estate of the grantor may be the strongest for self-settled trusts created in Alaska and Nevada. In all of the other self-settled trusts states, some creditors can reach the trust assets (for example, for certain family obligations such as for alimony or child support), and that may jeopardize the "no inclusion" argument. *See* Rothschild, Blattmachr, Gans & Blattmachr, *IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate*, 37 EST. PL. 3, 11-12 (Jan. 2010).

PLR 200944002 is consistent with prior cases that have analyzed gross estate inclusion under §2036 in part based on whether trust assets can be reached by any of the grantor's creditors. *Estate of Uhl v. Comm'r*, 241 F.2d 867 (7th Cir. 1957)(donor to receive $100 per month and also to receive additional payments in discretion of trustee; only trust assets needed to produce $100 per month included in estate under §2036(a)(1) and not excess because of creditors' lack of rights over other trust assets under Indiana law); *Estate of Paxton v. Comm'r*, 86 T.C. 785, 818 (1986)(self-settled trust assets included under § 2036 because grantor's creditors could reach income and corpus); *Outwin v. Comm'r*, 76 T.C. 153 (1981) (trustee could make distributions to grantor in its absolute and uncontrolled discretion, but only with consent of grantor's spouse; gift incomplete because grantor's creditors could reach trust assets, and dictum that grantor's ability to secure the economic benefit of the trust assets by borrowing and relegating creditors to those assets for repayment may well trigger inclusion of the property in the grantor's gross estate under §§ 2036(a)(1) or 2038(a)(1)); *Estate of German v. U.S.*, 7 Cl. Ct. 641 (1985) (denied IRS's motion for summary judgment, apparently based on §2036(a)(1), because grantor's creditors could not reach trust assets if trustee could distribute assets to grantor in trustee's uncontrolled discretion, but only with the consent of the remainder beneficiary of the trust and a committee of non-beneficiaries). Interestingly, the PLR does not cite any of the case law in support of its conclusion, but relies on Revenue Ruling 2004-64.

Caution Regarding Letter Ruling 200944002: Last year, a financial institution engaged counsel to attempt to obtain a Delaware private letter ruling comparable to PLR 200944002. In late 2011, IRS representatives told counsel that the Service is not willing to issue the ruling. According to counsel, the Service's unwillingness to rule is not attributable to Delaware's family exceptions, etc. Rather, the Service appears to be troubled by commentary about the *Mortensen* Alaska bankruptcy case. The folks at the Service said that PLR 200944002 probably wouldn't have been issued if they were looking at it now and that the Service since has declined other Alaska ruling requests.

(*Battley v. Mortensen*, Adv. D.Alaska, No. A09-90036-DMD (2011) allowed the bankruptcy trustee to recover assets transferred to an Alaska "self-settled trust" under the 10-year "clawback" provisions of §548(e) of the Bankruptcy Act.)

D. <u>"Rainy Day Fund" Considerations; Sale for Note or Annuity</u>. A sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). For example, a client may make a smaller gift to a grantor trust, but make a sale of $10 million. The client continues to have access to principal and interest on the $10 million note, as compared to a $10 million outright gift where there is no retained benefit. A "leaky" freeze may not be perfect from an estate planning perspective, but the client may be much more comfortable. "Don't let the perfect get in the way of the good if the only way to get anything done is a leaky freeze."

If a client has long ago made transfers to a grantor trust, the client might consider selling substantial assets to the trust in return for a lifetime annuity. An "old and cold" trust should be used to build the best arguing position that the transfer is made for full consideration so that § 2036 should not apply. The trust would have to contain sufficient assets to satisfy the "exhaustion" test described in Reg. §§ 25.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 1.7520-3(b)(2)(i), which assumes that the measuring life will live to age 110. If the trust does not have sufficient assets to cover all of the exhaustion test, it may be possible for individuals to guarantee the annuity to avoid the impact of the exhaustion test.

V. <u>SPECIFIC GIFTING STRATEGIES TO TAKE ADVANTAGE OF $5 MILLION EXEMPTION AMOUNT WHILE IT LASTS—OVERVIEW</u>.

A. <u>Forgiveness of Outstanding Loans to Children</u>. Many clients will be interested in forgiving existing loans to children as an easy way of utilizing the $5 million gift exemption. A possible concern exists if parents have engaged in a repeated pattern of forgiving loan payments. If the IRS can establish intent from the outset that the entire loan would be forgiven eventually, the IRS may treat the gift as occurring all in the year of the initial advance. *E.g.*, Rev. Rul. *77-299, 1977-2 C.B. 343;* Letter Ruling 200603002; Field Service Advice 1999-837. Utilizing the newly granted increased gift exemption may help rebut the "original intent" implication. Typically, the forgiveness will not result in discharge of indebtedness income. Rev. Rul. 2004-37, 2004-1 C.B. 583 ("debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules").

For a more detailed discussion of loan forgiveness issues, see Section VI of this outline, below.

B. <u>Gifts to Grantor Trusts</u>. Making transfers to grantor trusts, for which the donor continues to pay income taxes on the trust income, has a huge impact on the amounts that can be transferred over time. The trust assets compound free of income tax, and the payment of income taxes by the donor further depletes his or her estate (substantially over time). Simple $5 million (or $10 million for couples) gifts to grantor trusts can move huge amounts of value out of the donor(s)' gross estates over time.

C. <u>Gifts to Grantor Trusts Leveraged With Loans</u>. A very simple additional strategy would be to make a $5 million (or $10 million for couples) gift to a grantor trust and then loan up to nine times that with a very low interest AFR note to the trust, substantially leveraging the amount of future income and appreciation that could be shifted to the trust.

D. <u>Gifts and Sales to Grantor Trusts</u>. Sales to grantor trust transactions are often complicated by the difficulty of transferring sufficient equity to the trust (typically by gifts) to justify selling large values to the trust for installment notes from the trust. The $5 million gift exemption ($10 million for couples) relieves many of those difficulties. For example, a couple could give $10 million to grantor trusts, and sell $90 million of assets to the trusts with extremely low interest rate notes. The couple would continue to pay all of the income taxes on the grantor trusts, further depleting their estates and allowing the trusts to compound tax-free. Huge estate tax savings could result over time from freezing future appreciation from coming into the estate and from "burning" the estate by making the income tax payments. The grantor trust status could be left intact until the grantor had depleted the estate as much as he or she was willing to deplete it.

If prior sale to grantor trust transactions have been structured using guarantees to provide "seed" equity to justify the sale, the clients might make additional gifts to the trust and terminate the guarantee agreements.

The sale transaction is a "leaky" freeze, but may leave the client in a much more comfortable position than making gifts of $5 million (or $10 million for couples). Similarly a sale to an "old and cold" grantor trust for a lifetime annuity may leave the donor in a more comfortable position than making a large gift. See the discussion in Section IV.D of this outline, above.

E. <u>Highly Volatile Assets; GRATs or Gift/Sales Transactions With Minimal "Seed" Gift or "Generous" "Seed" Gift</u>. For highly volatile assets, a preferable approach may be to use GRATs rather than gift/sale transactions to avoid the possibility of wasting the client's gift exemption if the volatile asset becomes worthless. For highly volatile assets, the gift element in the gift/sale transaction should be minimized. This minimizes the risk of the highly volatile asset declining in value substantially, which may eliminate the value of the trust, and result in having wasted the client's gift exemption. For example, if a couple might be interested in selling $30 million of assets to a grantor trust, do not fund that trust with a $10 million gift, but only fund it with a gift of $3,333,000. Using a 9 to 1 ratio, that would still justify a sale of assets for $30 million. If the couple wants to utilize the full $10 million gift exemptions, give the remaining $6,667,000 to another trust. This approach does not expose the other $6,667,000 to the sale transaction in case the assets decline in value. (Alternatively, one grantor trust could be used, but the $3,333,000 amount needed to support the sale would be contributed to an LLC, the member interests in the LLC would be given to the trust, and the sale would be made to the LLC, thus not putting at risk the other $6,667,000 assets given to the trust.) Mil Hatcher observed: "A problem in the past was not coming up with enough seed money. In the future, the problem may be having too much seed money."

An alternate approach of some planners has been to fund the trust purposefully with a gift of substantially greater than the 10% rule of thumb amount to help thwart a possible argument by the IRS that the sale transaction should be ignored for tax purposes because of its non-commercial character. The additional gift exemption allows a greater equity gift to the trust with the goal of structuring a more conservative transaction.

F. Equalizing Gifts to Children or Grandchildren. A frequently recurring request is to make gifts to equalize gifts to all of the children or grandchildren. The extra $4 million of gift exclusion may permit some donors to equalize gifts when they have not had enough gift exclusion to do so in the past.

G. Gifts to Save State Estate Taxes. A few states have state gift taxes. At least one state, Maine, requires that gifts made within one year of death be added to the gross estate for state estate tax purposes. In other states, gifts within the $5 million gift exemption would be free of federal and state gift taxes. However, the gift assets would no longer be subject to state estate taxes (as long as there were no retained interests in or powers over the gift assets that would cause estate inclusion for state estate tax purposes). Even deathbed gifts could result in substantial state estate tax savings. A disadvantage is that the gift assets will not be eligible for a step-up in basis at the donor's death, but that would not be a disadvantage for a gift of high basis assets.

H. GRATs. GRATs may not be as favored when clients can make gifts of up to $5 million without paying gift taxes and without using sophisticated planning strategies. However, GRATs have the advantage of allowing transfers of future appreciation without incurring gift taxes *or utilizing any gift exemption.* Everything else being equal, it would be advantageous to transfer the desired amount to family members via a GRAT without making any taxable gifts, if possible.

Furthermore, for transferring hard-to-value assets, GRATs offer a unique significant advantage of being able to use a built-in valuation savings clause approach that is recognized in the GRAT regulations for the initial transfer to the GRAT. (However, the valuation uncertainties would exist for in-kind payments of the annual annuity amounts if the annuity amounts cannot be made in cash.)

The $5 million gift exemption opens up the possibility of another strategy that would minimize the valuation risks in making annuity payments. For example, a client might give some of the $5 million gift exemption amount to the grantor trust that will be the remainder beneficiary of a GRAT. When the annuity payment is due, the grantor trust might loan funds to the GRAT which it could use to make the annuity payment, without having to make an in-kind distribution. There would be no gift valuation risk with respect to annuity payments that could be funded with such loan proceeds.

The 10-year minimum term provision was not included in TRA 2010. Does that mean that rolling two-year GRATs can be created until the end of 2012 when TRA 2010 sunsets? We cannot be sure. Congress may have simply wanted to save the GRAT 10-year minimum term revenue raising provision for some subsequent bill that needs a revenue raiser to offset the cost of some new bill**.**

For a detailed discussion of planning considerations for GRATs, see Section VII of this outline, below.

I. Life Insurance Transfers. A limit on the amount of life insurance that can be acquired by an irrevocable life insurance trust is the amount that the insured can give to the trust to make future premium payments. Having $5 million ($10 million per couple) of gift exemptions to cover life insurance premium payments can buy a very large amount of life insurance coverage that can pass free of transfer tax to younger generations. For example, a $2 million premium can often purchase $20 million of second-to-die life insurance coverage.

Split dollar agreements were often used in the past to help finance the payment of large premiums by an irrevocable life insurance trust where the insured could not make gifts to the trust large enough to cover the premiums without having to pay current gift taxes. If split dollar arrangements have been used, large gifts (within the $5 million gift exclusion amount) could be made to the trust to roll out of the split dollar arrangement and simplify the planning.

Consider making a large gift to the trust currently (while the $5 million gift exclusion still exists), rather than just making increased gifts as premiums become due. Lock in the ability to make a $5 million transfer to pay future premiums without having to pay a current gift tax. There is always the possibility that the gift exclusion returns to $1 million after 2012.

Some clients may be inclined to drop coverage, under the theory that they have no estate tax concerns with a $5 million ($10 million for a couple) exclusion from the estate tax. Those clients should understand that they may not qualify for insurance if they subsequently find they have a need for it. Furthermore, the estate tax system is in a state of flux, and anything could happen in 2013 (including the unlikely possibility of going back to a $1 million exemption/55% system).

J. Lapsing General Power of Appointment Held by Person With Modest Assets to Utilize That Person's GST Exemption. Consider providing that the client's parent would be a discretionary beneficiary (together with the client's issue) and have an inter vivos general power of appointment over the trust, which will lapse at some point in 2012 (when the gift exemption amount is still $5 million). The lapse of the general power of appointment is treated as a gift by the parent, but the parent's $5 million gift exemption would fully cover the gift and no estate tax concerns would arise at the parent's death if the parent's other assets, even when added to the gift amount, would not be sufficient to cause the estate tax to apply at the parent's death. (Of course, this depends on what the estate tax exemption amount is at the parent's subsequent death.) When the parent makes a transfer subject to transfer tax, the parent is treated as the transferor of the trust for GST purposes (I.R.C. § 2652(a)(1)), and the parent could allocate his or her GST exemption to the trust. In that situation, the parent should not continue as a beneficiary of the trust after the lapse of the general power of appointment if the trust is not created in a "self-settled trust state", or else the parent's creditors might be able to reach the trust assets which might cause inclusion in the parent's estate under §2036(a)(1) and cause an ETIP, which would preclude the parent from being able to allocate the parent's GST exemption until the end of the ETIP.

K. Deemed §2519 Gifts from QTIP Trusts. One way to make use of the $5 million gift exemption is triggering §2519 with QTIP trusts. A gift of the income interest will result in a deemed gift of the remainder interest of the QTIP under § 2519. This may be a way for a surviving spouse who is a beneficiary of a QTIP trust to make use of the $5 million gift exemption if the QTIP trust is no longer needed. A gift of a small portion of the income interest in a QTIP trust can also result in a gift of the entire remainder interest under §2519. However, §2036(a)(1) would likely cause inclusion of the trust assets attributable to the portion of the income interest that was retained. *See* Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING ON EST. PLAN. ch. 12 ¶ 1202.3 (2010).

For example, if the spouse makes a gift of 0.1% of the income interest, retaining the other 99.9%, it is likely that 99.9% of the trust assets would be included in the spouse's estate under §2036(a)(1). A possible planning approach would be for the spouse to sell the income interest, rather than making a gift of it, to avoid §2036(a)(1) inclusion. The spouse would continue to receive payments on that note (rather than a fluctuating income entitlement). That could result in freezing the value of the QTIP trust assets for transfer tax purposes. This was the fact situation in Letter Ruling 201024008, but a ruling on the §2036(a)(1) issue was not requested or given. (A sale of the income interest may result in the spouse having a zero basis in the income interest under §1001(e)(1) for purposes of determining how much gain is recognized on the sale transaction. Section 1001(e)(1) should not be triggered by a gift of some or all of the income interest.)

L. QPRTs. One of the disadvantages of a qualified personal residence trust (QPRT) is the significant (though highly discounted) gift element. The $5 million ($10 million for a couple) gift exemption may permit the transfer of even very valuable residences to a QPRT while still allowing the gift element to be covered by the gift exclusion to avoid having to pay gift taxes when the QPRT is created. (Of course, QPRTs are not as favorable in the current very low AFR environment as they are with a higher AFR.)

M. Same-Sex Couples. Planning for same-sex couples is difficult because of the lack of a gift or estate tax marital deduction. The increased $5 million gift tax exclusion opens up significant possibilities for transferring assets between the partners without current gift tax consequences.

VI. FORGIVENESS OF LOANS.

A. Upfront Gift If Intent to Forgive Loan?

1. IRS Position. Revenue Ruling 77-299 announced the IRS position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.[1] However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the door will have made a gift only at the time of the forgiveness.[2]

   The IRS relied on the reasoning of *Deal v. Commissioner*,[3] for its conclusion in Rev. Rul. 77-299. In *Deal*, an individual transferred a remainder interest in unimproved non-income-producing property to children, and the children gave the individual noninterest-bearing, unsecured demand notes. The Tax Court held that the notes executed by the children were not intended as consideration for the transfer and, rather than a bona fide sale, the taxpayer made a gift of the remainder interest to the children.

   The IRS has subsequently reiterated its position.[4]

2. Contrary Cases. The Tax Court reached a contrary result in several cases that were decided before the issuance of Rev. Rul. 77-299 (and the IRS non-acquiesced to those cases in Rev. Rul. 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance. The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable.

   In *Haygood v. Commissioner*,[5] a mother deeded to properties to each of her two sons and in return took a vendor's lien note from the son for the full value of the property, payable $3000 per year. In accordance with her intention when she transferred the properties, the mother canceled the $3,000 annual payments as they became due. The IRS cited the *Deal* case in support of its position that a gift was made at the outset without regard to the value of the notes received. The Tax Court distinguished the *Deal* decision: (1) *Deal* involved the transfer of property to a trust and on the same date the daughters (rather than the trust) gave notes to the transferor; and (2) the daughters gave non-interest-bearing unsecured notes at the time of the transfer to the trust as compared to secured notes that were used in *Haygood*. The court in *Haygood* held that the amount of the gift that occurred at the time of the initial transfer was reduced by the full face amount of the secured notes even though the taxpayer had no intention of enforcing payment of the notes and the taxpayer in fact forgave $3,000 per year on the notes from each of the transferees.

   The Tax Court reached the same result 10 years later in *Estate of Kelley v. Commissioner*.[6] Parents transferred real estate to their three children in return for

[1] Rev. Rul. 77-299, 1977-2 C.B. 343.
[2] Rev. Rul. 81-264, 1081-2 C.B. 186.
[3] 29 T.C. 730 (1958).
[4] *See e.g.*, Field Service Advice 1999-837 (donor makes gift of full amount of loan initially if donor intends to forgive the loan as part of a prearranged plan); Letter Rul. 200603002 (transfer of life insurance policies to trust in return for note in the amount of the difference between the combined value of the policies and the amount sheltered by gift tax annual exclusions; several months later the donors canceled the note and forgave the debt; taxpayer did not request a ruling on this issue, but IRS stated that it viewed the donors as having made a gift at the outset in the amount of the note where there was a prearranged plan that it would be canceled).
[5] 42 T.C. 936 (1964).
[6] 63 T.C. 321 (1974).

valid notes, secured by vendor's liens on the real properties. The parents extinguished the notes without payment as they became due. The IRS argued that the notes "lacked economic substance and were a mere 'façade for the principal purpose of tax avoidance.'" The court gave two answers to this argument. First, the notes and vendor's liens, without evidence showing they were a "façade," are prima facie what they purport to be. The parents reserved all rights given to them under the liens and notes until they actually forgave the notes and nothing in the record suggests that the notes were not collectible. Second, "since the notes and liens were enforceable, petitioners' gifts in 1954 were limited to the value of the transferred interests in excess of the face amount of the notes."

The court distinguished *Haygood* and *Kelley* in a §2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. *Estate of Maxwell v. Commissioner.*[7] The court reasoned the in *Haygood* and *Kelley*, the donor intended to forgive the note payments, but under the facts of *Maxwell*, the court found that, at the time the note was executed, there was "an understanding" between the parties to the transaction that the note would be forgiven. Other cases have criticized the approach taken in *Haygood* and *Kelley* (though in a different context), observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth.[8]

3. Which is the Best Reasoned Approach? One commentator gives various reasons in concluding that taxpayer position is the more reasoned position on this issue.

> "The IRS has not done well with this approach, and there are reasons for this. Even if the lender actually intends to gradually forgive the entire loan, (1) he is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. Therefore, if the loan is documented and administered properly, this technique should work, even if there is a periodic forgiveness plan, since the intent to make a gift in the future is not the same as making a gift in the present. However, if the conduct of the parties negates the existence of an actual bona fide debtor-creditor relationship at all, the entire loan may be recharacterized as a gift at the time the loan was made or the property lent may be included in the lender's estate, depending on whether the lender or the borrower is considered to "really" own the property.
>
> …
>
> If the borrower is insolvent (or otherwise clearly will not be able to pay the debt) when the loan is made, the lender may be treated as making a gift at the outset."[9]

Other commentators agree that the Tax court analysis in *Haygood* and *Kelley* is the preferable approach.[10]

4. Planning Pointers. While the cases go both ways on this issue, taxpayers can clearly expect the IRS to take the position that a loan is not bona fide and will not

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[7] 3 F.3d 591 (2nd Cir. 1993).

[8] *E.g.*, Miller v. Commissioner, T.C. Memo 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997); Estate of Musgrove v. United States, 33 Fed. Cl. 657, 664 (1995).

[9] HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.05[2][a](WARREN GORHAM & LAMONT 1997).

[10] ***E.g.***, Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, §12.03 (2d ed. 1997).

be recognized as an offset to the amount of the gift at the time of the initial transfer if the lender intends to forgive the note payments as they become due. Where the donor intends to forgive the note payments, it is especially important to structure the loan transaction to satisfy as many of the elements as possible better discussed above in distinguishing debt from equity. In particular, there should be written loan documents, preferably the notes will be secured, and the borrower should have the ability to repay the notes. If palatable, do not forgive all payments, but have the borrowers make some of the annual payments.

B. <u>No Discharge of Indebtedness Income for Promissory Notes</u>. If the forgiveness or cancellation of the loan (other than an installment sale note) is in the nature of a gift, there is no discharge of indebtedness income, because §102 excludes from the definition of gross income any amount received as a gift or bequest, and this overrides § 61(a).[11] The forgiveness of a family loan is typically intended as a gift. Section 108 contains special rules regarding discharge of indebtedness income. The Senate Finance Report accompanying the passage of §108 specifically states that "debt discharge that is only a medium for some other payment, such as gift or salary, is treated as that form of payment rather than under the debt discharge rules."[12]

If the borrower is insolvent when the loan is forgiven with no further prospect of being able to repay the loan, the forgiveness may not be a gift but just a reflection of economic reality. There should be no discharge of indebtedness income if the forgiveness occurs when the obligor is insolvent.[13] In that circumstance, the lender may be able to take a bad debt deduction for the year in which the loan becomes worthless.[14] If the loan was made in the ordinary course of the lender's trade or business, it may result in a business bad debt deduction, which results in ordinary losses.[15] Much more common, in the intra-family loan context, is that the loan is a nonbusiness debt, which results in short term capital loss.[16] However, special scrutiny applies to intra-family loans, and unless the lender can overcome the presumption that the loan was a gift when made, no bad debt deduction is allowed.

Section 108 provides various exceptions in which discharge of indebtedness does not result in taxable income, including if the discharge occurs in a Title 11 bankruptcy case or when the taxpayer is insolvent.[17] If the obligor is insolvent, a cancellation of the note could also be covered under that section.

If a parent loaned cash to a non-grantor trust for the parent's children and the trust becomes insolvent, the parent should be able to cancel the note and avoid discharge of indebtedness income by the trust under §108(a)(1)(B) even without taking the position that the cancellation is a gift. Indeed, arguably the cancellation is not a gift because the

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[11] I.R.C. § 102(a). *See* Helvering v. American Dental, 318 U.S. (1943) (interpreting predecessors to §§102 and 61); Bosse v. Commissioner, T.C. Memo 1970-355 (§102 applied because forgiveness was gratuitous).

[12] *See generally* Rohrbach, *The Disposition of Property Secured by Recourse and Nonrecourse Debt*, 41 BAYLOR L. REV. 231, 253 (1989).

[13] I.R.C. § 108(a)(1)(B).

[14] *See generally* KATHRYN HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.05[2][b](WARREN GORHAM & LAMONT 1997). Courts have interpreted the wholly worthless requirement strictly in the intra-family context. *See e.g.,* Buchanan v. U.S., 87 F,3d 197 (7th Cir. 1996).

[15] I.R.C. § 166(d)(2).

[16] I.R.C. § 166(d)(1). The deduction can be taken only in the year the debt becomes totally worthless. (Because of the difficulty in pinpointing when that occurs, there is a special 7-year statute of limitations for refunds due to nonbusiness bad debt losses. I.R.C. § 6511(d)(1).) The lender will need to establish the worthlessness of the debt, perhaps by proving that the borrower is insolvent or that the lender attempted to collect on the debt with demand for repayment which was not forthcoming.

[17] I.R.C. § 108(a)(1)(B).

note is worthless in any event. (However, if the note arose as a result of an installment sale, there are special rules that apply when installment sale notes are cancelled.[18])

For a grantor trust, a note from the grantor trust to the grantor (in return for a cash loan of a sale of assets) can be forgiven by the grantor without causing discharge of income taxable income because the debt is treated as owned by the grantor for income tax purposes (i.e., a loan from the grantor to the grantor).[19] That is most helpful because the exception for insolvent taxpayers under §108(a)(1)(B) would not apply even if the grantor trust is insolvent unless the grantor were also insolvent under proposed regulations. Proposed regulations provide that grantor trusts and disregarded entities will not be considered the "taxpayer" under §108, but the grantor trust or entity owner is treated as the taxpayer.[20] Therefore, the §108 exceptions are available for grantor trusts and disregarded entities only to the extent that the owner is insolvent or undergoing bankruptcy.

C. Special Rules for Cancellation of Installment Note. There are special rules governing the cancellation or forgiveness of an installment sales note, designed to prevent a seller from being able to avoid income recognition from the initial sale.[21]

D. Possibility of Avoiding Having to Recognize Unpaid Interest Income Upon Loan Forgiveness. Even though there is not discharge of indebtedness income on the forgiveness of a loan, that does not necessarily address whether the lender must recognize accrued but unpaid interest as taxable income. Section 7872 addresses the income and gift tax implications of below-market loans, but §7872(i)(1)(A) specifically authorizes the issuance of regulations to provide that adjustments will be made to the extent necessary to carry out the purposes of §7872 if there are waivers of interest.

The proposed regulations to §7872 discuss the effect of forgiving interest payments.[22] While §7872 generally applies to below-market loans, the proposed regulation appears to apply to loans with adequate interest and that are not below-market loans. (The regulation states that it applies to loans with stated interest that initially would have been subject to §7872 had they been made without interest.)

The somewhat strangely worded regulation operates by negative implication. It says that a waiver of interest payments will be treated as if interest had been paid to the lender (requiring the lender to realize interest income) and then retransferred by the lender to the borrower (as a gift where the forgiveness is in the nature of a gift) *but only if* three conditions are satisfied:

> "(1) the loan initially would have been subject to section7872 had if been made without interest;
>
> (2) the waiver, cancellation or forgiveness does not include in substantial part the loan principal; and
>
> (3) a principal purpose of the waiver, cancellation, or forgiveness is to confer a benefit on the borrower, such as to pay compensation or make a gift, a capital contribution, a distribution of money under section 301, or a similar payment to the borrower."[23]

[18] I.R.C. § 453B(a).
[19] Rev. Rul. 85-13, 1985-1 C.B. 184.
[20] Prop. Reg. § 1.108-9.
[21] I.R.C. § 453B(a).
[22] Prop. Reg. § 1.7872-11.
[23] Prop. Reg. § 1.7872-11(a)(emphasis added).

Where a family loan is forgiven as a gift, the first and third requirements are satisfied. Therefore all three requirements will be satisfied (and the waived interest will have to be recognized as income by the lender) *only if* "the waiver, cancellation or forgiveness does not include in substantial part the loan principal." Stated a different way, this proposed regulation indicates that the lender will not be treated as having received interest that is forgiven if the forgiveness includes not only interest on the loan but also "in substantial part the loan principal."

One respected commentator reasons that forgiveness of principal and accrued interest will be treated the same as if the principal had been forgiven before the interest accrued, so that no interest income will be recognized by the lender:

> "Forgiveness of all principal and accrued interest has an economic consequence similar to an outright payment or forgiveness made before the interest accrued, and the authors of the proposed regulations apparently decided that taxpayers should neither be penalized nor given the opportunity to increase interest deductions when they execute a forgiveness later rather than sooner."[24]

There are various limitations and uncertainties regarding the ability to avoid having to recognize accrued but unpaid interest by forgiving the interest:

1. <u>Current Year Accrued Interest Only</u>? Because stated interest that is not paid in a year generally must be recognized each year under the OID rules,[25] it may be only the current year accrued interest that can avoid recognition under this forgiveness approach, because accrued interest from prior years may have already been recognized as taxable income.

2. <u>How Much Principal Must be Forgiven</u>? There is inherent ambiguity over how much of the principal must be forgiven when the accrued interest is forgiven. The regulation uses the nebulous phrasing that the forgiveness includes "*in substantial part* the loan principal." For example, if the accrued interest for the year is $30,000 on a $1 million outstanding loan, can the forgiveness be for $60,000, forgiving $30,000 of principal and the $30,000 of accrued interest? Does "substantial part" mean that the forgiveness of principal is only about 25% or more of the total forgiveness? Many would say that 25% of something is a "substantial part" of that thing. Or is 50% of more required for this purpose? Or does the forgiveness have to include a substantial part of the outstanding principal on the loan (such as 25% of the full $1 million loan amount?) The language of the proposed regulation seems to refer to the principal forgiveness being a substantial part *of the forgiveness* and not a substantial part of the loan principal.

3. <u>Proposed Regulation, But Provides Substantial Authority For Avoiding Penalties</u>. This position is based merely on a proposed regulation that has never been finalized. But the fact that the proposed regulation has stood unchanged for decades and that there has been no case law rejecting this analysis over those decades appears to provide comfort in taking the position that the forgiveness of

[24] BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 58.4 (2d ed. 1993). Interestingly, the third edition of this treatise does not include that discussion.

[25] If interest accrues but is not actually payable, the original issue discount (OID) rules will apply, and they generally require that a pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. I.R.C. §§ 1272-1273; *see generally* Henkel, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.04(WARREN GORHAM & LAMONT 1997). The amount of OID included in income each year is generally determined under a "constant yield method" as described in the §1272 regulations. Treas. Reg. §1.1272-1(b)(1).

accrued interest in that manner can avoid ever having to recognize that accrued interest as income.

Proposed regulations are considered in determining whether there is "substantial authority" for purposes of avoiding taxpayer or preparer penalties.[26]

4. Consistently Forgiving Accrued Interest Each Year May Not be Advisable. If the accrued interest must be recognized each year under the OID rules, the only way to avoid the recognition of all interest under the note would be to forgive the accrued interest each year (in connection with a forgiveness in substantial part of the loan principal). However, if the accrued interest is forgiven each year, that is a factor that may be considered in refusing to recognize the loan as a bona fide loan rather than as an equity transfer. The factors listed in *Miller v. Commissioner*[27] include (1) whether interest was charged, (2) whether a demand for repayment was made, and (3) whether any actual repayment was made. Consistently forgiving all interest payment would seem inconsistent with those factors.

   Furthermore, an IRS response to a letter from a practitioner suggests that having a plan to forgive the interest in each year may result in recasting the transaction as an interest-free loan under the §7872 rules, which would seem to mean that the imputed forgone interest would be recognized each year):

   > "The legislative history of section 7872 reveals that the conferees recognized that a term loan with deferred interest at a rate equal to or greater than the AFR, and a related gift to defray all or part of the interest payable on the loan, may be the economic equivalent of an interest-free loan with a principal amount equal to the sum of the actual stated amount of the loan and the amount of the gift. The conferees anticipated that under regulations, such a transaction would be treated in accordance with its economic substance. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1021 (1984) 1984-3 (Vol. 2) C.B. 275."[28]

VII. SPECIAL PLANNING CONSIDERATIONS FOR GRATS.

A. Significance. The GRAT is a strategy to transfer future appreciation without making a current significant taxable gift. Furthermore, discounting arbitrage may be available if a discounted asset is contributed to a GRAT but the annuity payments can be funded with cash payments. Thus, particularly for longer term GRATS, the optimal planning goal is to fund the GRAT with discountable, income-producing assets, and to pay the annuity with cash or assets not subject to a discount. The outline assumes that the read has a basic knowledge of the requirements for creating a valid GRAT.

B. Factors Affecting Valuation. The primary factors affecting the value of a remainder interest for a GRAT are (1) the length of the term, (2) the amount of the retained annuity or unitrust percentage amount, and (3) the § 7520 rate. For example, the value of the remainder interest of a GRAT decreases if:

   1. The term of the retained annuity is increased,

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[26] Reg. § 1.6662-4(d)(3)(iii)(types of authority considered in determining whether substantial authority exists for avoiding taxpayer penalty); Reg. §§ 1.6694-2(b)(1) & 1.6694-2(d)(2)(incorporating standards under §6662 regulations for determining whether substantial authority or reasonable basis standard is met to avoid preparer penalties).

[27] T.C. Memo 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997).

[28] NSAR 08777, Vaughn # 8777 (June 24, 1991) (response of IRS Regional Technical Coordinator responding to submission from practitioner requesting amendment or clarification of §7872).

2. The annuity amount is increased, or

3. The § 7520 rate decreases.

Each of these factors must be studied carefully in planning any GRAT. For example, a planner might face potential liability if a GRAT were created late in the month, when a lower § 7520 rate has been announced for the next month. A valuation advantage could be obtained by merely waiting several days until the following month to create the GRAT. Alternatively, accelerating the implementation and funding of a GRAT may be advantageous if the rates will be going up the next month.

C. <u>Trustee Selection; Voting Rights Over Closely Held Stock</u>. The grantor may serve as trustee of the GRAT during the annuity payment period. The IRS's position is that most or all of the trust corpus would be included in the grantor's estate in any event if the grantor dies during the trust term, so there may be little added estate tax risk by having the grantor as the trustee.

If the grantor is the trustee, and if any voting stock of a closely held company is contributed to the GRAT and if the grantor as trustee retains the right to vote the stock, under § 2036(b) estate inclusion may continue for three years after the end of the annuity term, or whenever the grantor relinquishes the voting rights. Solutions: (1) recapitalize so the stock is no longer voting stock; (2) have the grantor resign as trustee; (3) have the grantor purchase such stock back from the trust; (4) if the grantor is not the trustee, eliminate the grantor's power to remove and replace the trustee; or (5) structure the trust to have a third party trustee who will hold the voting rights over such stock. Each of those steps (other than a purchase of the stock from the trust for full value) will likely result in application of the special three-year rule under § 2036(b)(2).

In addition, if the grantor has a nonfiduciary substitution power over stock of a controlled corporation, that may also trigger § 2036(b). If the grantor has a swap power and there is concern about the three-year rule, the grantor may substitute other assets into the GRAT and take back the § 2036(b) stock. If there is no swap power and there is concern about the three-year rule, the trustee might sell the controlled corporation stock back to the grantor.

Following the end of the annuity term, if the assets will remain in trust for the benefit of the grantor's children, the grantor generally should not continue as trustee. Having the grantor as trustee could risk estate inclusion, depending on the terms of the trust. The grantor, however, can retain the right to fire and replace the trustee under Revenue Ruling 95-58.

D. <u>Use Formula Annuity—Savings Clause Recognized by Regulations</u>. The regulations specify that the annuity amount may be a fixed dollar amount or may be defined by reference to a percentage of the value of the originally contributed property. This has the effect of <u>substantially</u> reducing the risks of significant gift tax adjustment in a gift tax audit. A determination that the property was undervalued will operate to increase the amount of the annuity payments, and will not significantly increase the amount of the taxable gift. Because of this advantage, the annuity amount should not be expressed as a dollar amount, particularly for hard-to-value assets. This is a very important advantage of using GRATs over other techniques, in which the use of valuation adjustment clauses has been scrutinized by the IRS.

Another possible formula approach is to describe the annuity in a way that will produce a specified remainder value. For example, the annuity might be described in terms of the "minimum percentage necessary to produce a remainder interest as close as possible to, but not greater than, $___." (This can guard against mistakenly listing wrong annuity factors, or having the client sign the trust agreement in a month after the trust agreement is drafted with annuity factors based on the § 7520 in the month the trust was drafted.)

E. Use Escalating Payments Approach—Keep Appreciating Assets in Trust As Long As Possible. If an asset is expected to have substantial start-up costs in the early years, but to produce higher cash flow in later years, consider using the option of having the annuity or unitrust payments increase by up to 120% per year. This flexibility, allowed by a change in the final regulations, can be very significant for transfers of interests in start-up entities to a GRAT. In addition, if the planner contemplates that in-kind distributions of appreciating trust assets (such as closely held stock) will be required to satisfy the annuity payments, "back-loading" the payments will substantially delay the timing of distributing payment of the appreciating trust assets back to the grantor. Using the escalating payments approach will produce a superior GRAT, by allowing the presumably high-yielding assets to remain in the GRAT longer.

Contrasted with using escalated payments is the opposite approach of "front-loading" the GRAT by scheduling a large annuity payment (for example, 90% of the annuity payments) at the end of the first year. This has the effect of largely making the trust a one-year GRAT. (Under the legislative proposal to impose a ten-year minimum term, "front-loading" is not allowed for the first ten years.) See Section VII.K of this outline for a further discussion of front-loading the GRAT annuity payments.

F. Minimizing Gift Resulting from GRAT Creation and Marital Deduction Issues. If an asset has extremely high appreciation potential, the client may consider transferring the asset to a GRAT with a high enough stated annuity interest (and for a long enough term of years) that the gift value of the remainder interest will be "zeroed out". (More precisely, GRATs are typically planned to result in a nominal value [such as $100] rather than a literal zero value. The nominal remainder value will be reported on a gift tax return.)

It is important to qualify for the marital deduction in case the grantor dies before the end of the GRAT term. Best practice steps include the following.

a. The annuity should be converted at the grantor's death to the greater of the stated annuity amount or fiduciary accounting income of the trust. (One attorney has reported an audit where the IRS questioned the availability of a marital deduction where the instrument did not include that provision.)

b. The annuity should be paid to the grantor's estate, to qualify under the Walton case and the Walton regulation.

c. The grantor's will or codicil should be revised to bequeath the annuity (greater of specified amount or income) to the surviving spouse, and there should be a direction that the amount be paid immediately to the spouse (to be sure that the "paid annually" requirement is satisfied.)

d. Do not have the remainder interest in the GRAT also revert to the grantor's estate. That would raise questions as to whether the entire interest following the spouse's death is a reversionary interest that must be valued at zero under the § 2702 regulations. See generally U.S. Trust, Practical Drafting 6768 (Covey ed. Jan. 2002). For example, the remaining annuity payments could be left to the donor's estate under the instrument, and the donor could be given a general testamentary power of appointment over the remainder interest if the donor dies before the end of the initial GRAT term.

e. If the remainder interest will pass to a QTIP trust, there is a difference of opinion among experienced planners as to whether the annuity amount that is paid to the estate should be left from the estate outright to the surviving spouse, or to the QTIP trust where the remainder interest also ends up. [For example, the annuity interest would pass to the estate, and the grantor's will could bequeath the annuity interest to a QTIP. The remainder interest would pass directly under the GRAT instrument to that QTIP, or the grantor might be given a general power of appointment that could be exercised to leave the remainder to the QTIP trust. In neither situation would the annuity interest and remainder interest both be left to the grantor's estate.] Some commentators have suggested that if the annuity interest is not married up with the remainder interest in the same QTIP, the IRS might question whether the annuity interest is a nondeductible terminable interest that does not qualify for the marital deduction.

f. An advantage of leaving the entire interest ultimately into a QTIP is to have the flexibility to make a partial QTIP election in the event the assets have appreciated so much that all trust assets would not be included in the grantor's gross estate under § 2036. That flexibility would not be available if the annuity and remainder interest both ended up passing outright to the surviving spouse.

G. <u>Use Separate GRAT for Each Asset</u>. If a particular asset transferred to a GRAT does not produce sufficient cash flow, together with the principal of the asset in order to make all of the specified annuity payments, when there is no further value left in the GRAT, it would simply terminate for lack of any trust corpus. If other assets had been gifted to the same GRAT, the other assets would have to be used to make up the deficiencies. In order to avoid this result, it would be desirable to use a separate GRAT for each individual asset so that poor performance results of one asset will not adversely affect the trust with respect to other assets.

H. <u>GRAT Inter Vivos Bypass Trust Continuing for Spouse</u>. A client may wish to create a "bypass trust" for the benefit of his or her spouse during lifetime rather than waiting to create a standard bypass trust by will. This would have the advantage of removing future appreciation from the date of the creation of the trust from the transferor's estate. This technique can be used in conjunction with a GRAT, because there is no limitation on the spouse being a beneficiary after the initial retained term interest. Various cases have held that a transfer of a residence to a spouse is not treated as a transfer subject to § 2036(a)(1) even though the transferor-spouse may expect to continue living with the spouse (and, therefore, live in the transferred residence). <u>E.g.</u>, <u>Estate of Gutchess v. Commissioner</u>, 46 T.C. 554 (1966), <u>acq</u>. 1967-2 C.B. 1; Rev. Rul. 70-155, 1970-1 C.B. 189. Using a "floating spouse" concept might be desirable, by defining "spouse" to be the grantor's current spouse at the relevant time.

<u>Example</u>: Husband could transfer substantial separate property into a GRAT, retaining the right to receive annuity payments for ten years. The payout rate and term could be structured so that the value of the remainder interest at the end of the ten-year term would be minimal. At the end of the ten-year term, the assets would remain in trust for the benefit of Wife and children (it could be a spray trust). At Wife's death, the remaining assets will pass to the children. Husband could give Wife a testamentary limited power of appointment, including the authority to appoint the assets to a trust with Husband as a discretionary beneficiary, as long as there is no express or implied agreement as to how Wife will exercise the power of appointment. Husband would be

able to leverage the amount of assets that could initially be placed into the trust, based on the value of his retained annuity interest.

If the grantor's spouse is a beneficiary of the trust, the trust will be a grantor trust for income tax purposes (unless an adverse party must consent to the distributions to the spouse). Grantor trust status to the grantor would continue even if there was subsequently a divorce. I.R.C. § 672(e).

I. Use Continuing Grantor Trust. The GRAT assets might remain in trust following the end of the annuity term. If the continuing trust is structured as a grantor trust, there may be increased flexibility for the grantor to enter into further estate freezing transactions with the grantor trust without having to recognize taxable gains upon sales to the trust. Furthermore, the grantor would be liable for income taxes produced by the trust, thus depleting the grantor's estate and permitting the trust value to grow at a higher rate. Rev. Rul. 2004-64, 2004-2 C.B. 7.

Using a GRAT in connection with a sale to grantor trust can be an outstanding combined strategy. A downside to the sale to grantor trust strategy is that an initial gift must be made to the grantor trust, or in some other manner the grantor trust must have acquired significant value in order to "seed" the sale transaction. See Section VIII.A.1 of this outline. An initial two-year GRAT hopefully would provide significant value at the end of the GRAT term. This value could serve as the seeding for a subsequent sale transaction to a grantor trust that would continue following the end of the GRAT term (although the trust would not be a GST exempt trust unless GST exemption is allocated to the trust at the end of the GRAT term.)

J. Excess Value Over Prescribed Amount May Be Returned to Grantor. A parent may own assets that might explode in value (such as stock in a company that may go public in the near future). The parent may be willing to transfer a substantial part of the increase in value, but be leery of transferring "too much value" to his or her children. The GRAT could be structured to provide that the first $X of value at the end of the GRAT term would pass to a continuing grantor trust for children, and that any excess value in excess of $X would be returned to the grantor.

The right to participate in future distributions will likely result in some (perhaps all—this is unclear) of the GRAT assets being included in the grantor's estate under § 2036(a)(1) if the grantor dies during the GRAT term. There may be more estate inclusion than if there is no right to participate in future distributions. See Part Three, Section III.B.1 of this outline. For a charitable remainder annuity trust, Revenue Ruling 82-105, 1982-1 C.B. 133, addresses the amount included in the grantor's gross estate under § 2036(a)(1) if the grantor retains a life interest in the trust. In that case, the amount includible in the gross estate under § 2036(a)(1) is that portion of the trust property that would generate the income necessary to produce the annuity amount, using the Treasury actuarial table rate in effect at the transferor's death. The IRS approved this approach of determining the amount includible for GRATs under § 2036 in Technical Advice Memorandum 200210009. Regulation § 20.2036-1(c)(2) adopts that same position for GRATs, effective for decedents dying after July 14, 2008.

If the trust assets have appreciated many times their original value, this approach might cause inclusion of less than the full value of trust assets under § 2036. But this is unlikely for short-term GRATs. For example, if a $1.0 million GRAT had an annuity payout percentage of 20% (which might apply for a six or seven year GRAT) and if the § 7520 rate is 6.0% at the grantor's death, the amount includible under § 2036 would be $200,000 (the annual annuity amount) divided by 0.06 (yielding $3.33 million), or the actual amount in the trust, whichever is lower. For a short- term GRAT, where the annuity payout percentage is much higher, the GRAT assets would have to appreciate to many times their original value before § 2036 would result in less than all of the trust assets being includible in the estate if the donor dies before the end of the GRAT term.

Even if the GRAT assets appreciate so much that not all of the assets would be brought back into the estate under § 2036 if the grantor dies during the GRAT term, the IRS previously maintained that § 2039 would cause all of the trust assets to be included in the grantor's estate. E.g., Tech. Adv. Mem. 200210009. Regulation § 20.2036-1(c)(2)(iii) Ex. 2 provides that the IRS will no longer take that position.

An example in the regulations makes clear that the annuitant may retain a contingent reversionary interest although such a contingent reversionary interest will be valued at zero for purposes of determining the amount of the gift. Treas. Reg. § 25.2702-3(e) Ex. 1.

In light of the ability to "zero-out" a GRAT under the *Walton* case, the donor has not used any gift exemption by reason of creating the GRAT. Accordingly, there is no particular tax "inefficiency" by having excess value over a specified target amount being returned to the grantor.

This added flexibility is even more apparent if a GRAT is compared to a sale to grantor trust transaction. Assume that parent owns an asset that may realize very large appreciation in future years (such as with an IPO or sale of a company). An inherent uncertainty with the sale approach is knowing how much to sell to the grantor trust in order to transfer a targeted desired amount to trusts for younger generations—because the result depends in large part on how much appreciation will occur in the transferred asset.

For example, assume that parent's goal is to transfer up to $10 million to trusts for children. If the sale transaction were structured to leave $10 million to trusts within five years assuming a growth rate of X%, but the stock that is sold to the trust grows at 3X%, the trusts for the children would end up owning far more than parent intended.

In addition, using a GRAT may allow the owner to be more aggressive in transferring a substantial part of a highly appreciating asset to the GRAT, because the grantor can retain the right to receive a certain amount of the trust assets at the end of the GRAT term. For example, parent might transfer almost all of her closely held stock to a GRAT. The GRAT would require substantial payments to parent (equal to the current value of the stock contributed to the GRAT plus a factor to reflect discounting the payments to present value using the § 7520 rate as the discount factor.) In addition, the GRAT could provide that at the end of the trust term, some of the remaining trust assets would also be returned to parent, depending on the value of the assets at that time. For example, the GRAT could provide that up to $10 million of value would pass to the new trust for descendants, but any excess over that would be returned to parent. [Alternatively, the GRAT could provide that after the annuity payments are paid, the next $5.0 million of value would also pass to parent, and only the excess above that would pass to the trusts for descendants.] There is more flexibility in defining how much would be returned to parent—thus allowing parent to be much more aggressive in determining how much to transfer.

K. Front-End Loaded GRAT. There is no clear authority for using a one-year GRAT. See I.R.C. § 2702(b)(1) (referring to qualified annuity interests as amounts payable not less often than annually; the underlined terms suggest a possible minimum term of two years). See also Walton v. Commissioner, 115 T.C. 589 (2000), acq. Notice 2003-72, 2003-2 C.B. 964 (approving 2-year GRAT); Kerr v. Commissioner, 113 T.C. 449

(1999), aff'd, 292 F.3d 490 (5th Cir. 2002) (IRS did not contest validity of 367-day GRAT). A multi-year GRAT may achieve much the same effect as a one-year GRAT if the agreement calls for a substantial payment at the end of year one, and a payment equal to 0.01% of the initial contribution in later years. If the grantor were to die after year one, it appears that the amount to be included in the grantor's estate may be the amount that would be required to produce the annuity of 0.01%—which would be a very small amount. While Treasury Regulation § 25.2702-3(e) Ex. 3 clearly allows the amount of the GRAT payment to decrease without limit, no rulings have addressed extreme front-loaded GRATs. Some planners have structured these transactions to have about 90% of the initial value distributed after the first year, leaving a significant payment the second year, in case the IRS were to argue that a de minimis payment in year two is essentially the same as a one-year GRAT.

L. Use Revised Spendthrift Clause. In a totally separate and independent transaction from the creation of the GRAT (to avoid step transaction arguments), the owner of the remainder interest of the GRAT may desire to transfer the remainder interest to his or her descendants (or a long-term trust for their benefit) at a time when the remainder interest has a relatively low value. Doing so may be prohibited if the GRAT contains a typical spendthrift clause. If a limited form of a spendthrift clause is desired, consider requiring the written consent of "independent trustees" to any anticipation, alienation, or other assignment of a beneficiary's interest in the trust. Alternatively, consider specifying that no beneficiary can assign or anticipate his or her interest except a voluntary transfer to one of more of the Grantor's descendants (other than to the beneficiary himself or herself). However, observe that § 502(a) of the Uniform Trust Code, adopted in August 2000, provides that "a spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest."

There are two reasons that it may be helpful for the remainder beneficiary to be able to assign its interest in the GRAT. 1. In several recent cases, the IRS was forced to value lottery annuity payments using a lower value than the §7520 value because the annuity payments are nontransferable. Could the IRS argue that the existence of the spendthrift clause means the annuity payments are nontransferable, so that the grantor could not rely on §7520 in placing a high value on the retained annuity payments? 2. It may be helpful for remainder beneficiaries to transfer their interests in the trust (for example, to a GST exempt trust or to the grantor).

M. Funding GRAT with S Stock or Interest in Partnership.

1. Particular Advantage. A particular advantage of funding a GRAT or GRUT with S corporation stock is that the grantor will be taxable on a pro rata share of all income of the S corporation, thus reducing, to some extent, the amount brought back into the grantor's estate by the annuity or unitrust payments. In addition, as with a partnership, cash can be distributed from the S corporation to its shareholders (including the GRAT) without dividend treatment. However, a longer term GRAT will likely be needed so that the annuity payments are low enough that they can be funded with available cash flow. Otherwise, interests in the S corporation or partnership that are used to make the annuity payments will have to be valued, and there could be serious gain recognition issues in funding annuity payments with in-kind assets following the death of the settlor.

2. Trusts as Qualified Shareholders. Only certain types of trusts can qualify as shareholders of S Corporations. I.R.C. § 1361(c)(2). One of these types of trusts is a "grantor trust", all of which is treated under sub-part E of part I of subchapter J of Chapter 1, as owned by an individual or resident of the United States. Section

1361(c)(2)(A)(i) requires that all of the trust be treated as owned by an individual under the grantor trust rules. Therefore, the individual must be treated as the owner of both income and principal of the trust under the grantor trust rules.

3. GRAT as a Qualified Shareholder. If the taxpayer wishes to fund a GRAT with S Stock, the planner must be careful to assure that the trust will be treated as a grantor trust as to income and principal for income tax purposes. Some commentators have suggested that a GRAT would necessarily be treated as owned by the grantor under § 677, because the trustee may use undistributed income or principal to pay the annuity or unitrust interest in later years. See Aucutt & Zaritsky, "S Corporation Freezing Techniques After Chapter 14", 3 J.S Corp. Tax'n 3, 25 (Summer 1991); Ltr. Rul. 9501004 (once CRUT loses its status as a charitable remainder unitrust it would be a wholly grantor trust because of the possibility that income allocable to principal could be used to satisfy the unitrust payment).

   To be more cautious in assuring grantor trust treatment, the planner may consider having the grantor retain a contingent reversionary interest or power of appointment (in each case with an actuarial value in excess of 5%.) I.R.C. § 673(a); see Ltr. Rul. 9152034 (12% annuity GRAT with § 673 reversion if grantor dies during term of trust qualifies as S corporation shareholder). Another possible planning alternative to cause grantor trust treatment would be to give the grantor a right to amend the trust agreement to create a non-fiduciary power of administration in another person. See I.R.C. § 675. Another possible technique is to give the grantor a nonfiduciary power to reacquire the S corporation stock by substituting assets of equivalent value. See Ltr. Ruls. 9248016 (GRAT with § 675(4)(C) retention of power to substitute assets can qualify as S corporation shareholder); 9037011.

N. Effect of Insider Trading Restrictions. Section 16(b) of the Securities Exchange Act of 1934 permits recovery to a corporation of insider trading profits made within a 6-month period. Under the § 16(b) "short-swing profits" rule, profits must be disgorged if any sales and purchases occur within six months of each other. A contribution to a GRAT is arguably a "sale," and a distribution of insider stock in satisfaction of the annuity payment is arguably a "purchase" by the grantor. If a corporate insider funds a GRAT with the corporation's stock, will the return of some of the stock to the grantor (in satisfaction of an annuity payment) trigger a 6-month insider trading test period? A 1997 SEC No-Action Letter held that the creation of a GRAT and subsequent return of stock to the grantor in satisfaction of annuity payments will "effect only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities." Accordingly, such a transaction would be ignored for § 16(b) purposes under that No-Action Letter. Peter J. Kight, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,403 (October 16, 1997). However, cases (discussed below) have held that the substitution of insider stock and an unauthorized transfer from a GRAT of insider stock for the benefit of insiders constituted purchases for purposes of § 16(b).

   If the grantor/corporate insider exercises a power to substitute property of equal value for some of the stock in a GRAT during its term, one court held that the substitution constitutes a "purchase" for § 16(b) purposes, thus creating a six-month period during which any profits from subsequent sales of such stock would have to be disgorged to the corporation. Morales v. Quintiles Transnational Corp., 25 F. Supp. 2d 369 (S.D.N.Y. 1998). In Morales, the taxpayer sold the shares within 6 months from the date of the reacquisition under the substitution power for more than $1 million. The District Court ordered the taxpayer to surrender the $1 million profit to the corporation. The case was appealed to the Second Circuit Court of Appeals, but was settled prior to hearing, and the appeal was withdrawn.

In Dreiling v. Kellett, 281 F. Supp.2d 1215, 1244 (W.D. Wash. 2003), the court imposed a $247 million damage award, as a result of determining that distributions from a GRAT constituted a "sale." See generally Harrison, "Case Studies – Implementing Bright Ideas," 38th Annual Heckerling Institute on Estate Planning ¶ 1902.5 (2003).

O. Income Tax Payment by Grantor; Danger of Reimbursement Provisions. The IRS at one time required that the grantor be reimbursed for income taxes borne by the grantor with respect to income in excess of the annuity amount in order to get a private ruling approving a GRAT. In PLR 9444033, the IRS stated in dicta that the failure to reimburse the grantor for income taxes would be considered a gift by the grantor to the remaindermen. The IRS subsequently reissued the ruling without the dicta in PLR 9543049 and has yet to challenge taxpayers on this issue. Rulings have approved various types of reimbursement provisions. See Ltr. Ruls. 9415012, 9416009, 9352004, and 9352007.

In light of this position, some planners have drafted GRAT instruments to require the trustee to reimburse the grantor for income taxes, but only to the extent necessary for the trust to create a "qualified annuity interest" under § 7520. [However, that approach would no longer be advisable following the issuance of Revenue Ruling 2004-64, as discussed below.]

The IRS's position created a dichotomy, because including an income tax reimbursement provision would seem to create some risk that the trust would be included in the grantor's estate under § 2036 (by providing for payment of legal obligations of the grantor.) See Treas. Reg. § 20.2036-1(b)(2). Various IRS private rulings previously held that there would be no inclusion under § 2036(a). See Ltr. Ruls. 200120021, 199922062, 9710006, 9709001, & 9413045. However, the IRS changed its position in Revenue Ruling 2004-64, 2004-2 C.B. 7.

Revenue Ruling 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1) Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause "the full value of the Trust's assets" at the grantor's death to be included in the grantor's gross estate under § 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor's legal obligation. (Situation 2) [The statement that the "full value of the trust assets" would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor's benefit at his or her death.] Observe that if a reimbursement is mandatory and it is not paid, the grantor will be treated as making a gift. That would have disastrous effect on a GRAT because it would violate the prohibition against any additions to the GRAT.

In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. (Situation 3) The Ruling provides that the IRS will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before October 4, 2004. Some planners suggest allowing a third person to authorize the trustee to reimburse or to allow an independent trustee to reimburse the grantor for payment of income taxes attributable to the trust. Other planners suggest drafting the reimbursement clause to provide that the discretionary reimbursement power does not exist to the extent that it exposes the trust assets to claims of the grantor's creditors.

Some planners suggest including a discretionary reimbursement power during the initial term of a GRAT, under the theory that the trust assets will likely be included in the grantor's estate if the grantor dies during the term of the trust even without the reimbursement power. A possible concern is that the IRS might attempt to argue that an additional 3-year inclusion period would arise under § 2035 when the creditors' rights terminate. That would not seem appropriate, because creditors' rights terminate because of a lapse of rights under the agreement (i.e., the discretionary reimbursement right would exist only during the initial term of the GRAT), not because of anything that the grantor does volitionally to give up powers or interests.

Some states are amending their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. See Tex. Property Code Ann. § 112.035(d) (Vernon 2004); N.H. Stat. Ann. § 564-B:5-505(a)(2) (2006). Where a discretionary reimbursement provision is used, the planner should select a state which has such a law to govern the trust.

P. Re-Purchase of GRAT Assets by Grantor. The grantor may re-purchase assets from the GRAT/grantor trust, either prior to or following the end of the initial GRAT term. If the trust is a grantor trust at the time of the re-purchase by the grantor, the purchase transaction should not be a taxable event for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184. The advantage of a re-purchase is that the low-basis asset in the GRAT would then be in the grantor's estate and would receive a step-up in basis at the grantor's death. The GRAT remaindermen would have the cash paid to the GRAT for the low-basis asset, which cash obviously would not have any built-in capital gains tax liability.

Q. Locking In Gains or "Cutting Your Losses". If the assets in a GRAT have appreciated substantially, the grantor may wish to take steps to lock in the gain of the GRAT, and not risk that subsequent depreciation would leave the GRAT with no assets to pass to the remaindermen. One way of doing this would be for the grantor to exercise the substitution power by substituting cash for the in-kind asset in the GRAT. The cash will earn interest for the balance of the GRAT term, which hopefully will be close to the § 7520 "hurdle" rate for the GRAT. If the in-kind asset subsequently depreciates in value, the depreciation would be borne by the grantor, not the GRAT.

A further refinement would be for the grantor to contribute the in-kind asset that has been "purchased" from the initial GRAT to a new GRAT. Future appreciation would then be transferred, but future losses would not reduce the amount of assets that can pass to remaindermen from the initial GRAT.

Another possibility of accomplishing the same effect would be for the GRAT to hedge its assets by classic hedging techniques based on the values after the appreciation has occurred. There may be the possibility of entering into a private hedge transaction with the grantor. See Paragraph FF below.

On the other hand, if the GRAT assets have declined in value substantially, the grantor might similarly exercise the substitution power to substitute cash for the in-kind assets.

At the end of the GRAT term, there would not be sufficient assets to pay fully the last annuity payment, and all of the GRAT assets would be returned to the grantor. The initial GRAT would have failed to transfer assets to remaindermen. However, the grantor could contribute the in-kind assets to a new GRAT, so that appreciation above the GRAT hurdle rate from that point on could be transferred. The advantage of this approach is that the grantor would not have to wait until the first GRAT ends to transfer future appreciation from the in-kind asset. In addition, if the original GRAT were kept intact, the "catch-up amount" plus the shortfall on the amount of the AFR would have to be made up before any wealth shift would occur. With a new GRAT, that amount would inure to the benefit of the GRAT remaindermen rather than the original grantor.

An alternate approach (suggested by Edward Manigault) might be to have the grantor contribute the annuity from an underwater GRAT to a new GRAT. Presumably, the annuity would be valued at approximately the remaining value in the GRAT. Any subsequent appreciation would inure to the benefit of the new GRAT.

R. Contribute Cash with Discounted Asset to Facilitate Keeping Appreciating Asset in GRAT as Long as Possible. The Walton case and Notice 2003-72 assure that a GRAT can be created that will result in a nominal gift. There is no downside to putting a portion of the client's fixed income portfolio in a GRAT, together with a discounted appreciating (hopefully) asset. The cash/fixed income assets could be used in the early years of the GRAT to make the annuity payments, leaving the appreciating asset in the GRAT as long as possible. This strategy can be particularly useful if the grantor anticipates that there may be an "exit strategy" available for the asset during the GRAT term. The cash could be used to make annuity payments (hopefully) until the appreciating asset is liquidated. This would result in transferring not only the appreciation (above the § 7520 "hurdle rate") in the underlying asset, but also the amount of the discount when the asset was initially contributed to the GRAT. A disadvantage of this approach is that the fixed income portion of the GRAT assets may not have combined income/appreciation equal to the § 7520 "hurdle rate." If not, the fixed income assets would produce some "drag" on the overall amount of income/appreciation of the GRAT over the § 7520 rate.

S. Identify Remainder Beneficiaries in a Separate Trust Instrument. Do not put the trust for remaindermen in the same GRAT document. If there is not a separate current trust, there is no ability for the grantor to engage in transactions with the remainder beneficiary. Name a separate trust funded with $10 as the remainder beneficiary. Make sure it is a grantor trust to avoid income taxes on future transactions with the grantor. For example, the grantor may consider purchasing the remainder interest if the grantor becomes seriously ill before the end of the GRAT term. If the grantor dies during the term of the GRAT, all assets in the GRAT will be included in the estate. But if the grantor purchases the remainder interest, the amount the grantor paid for the remainder interest to the remainder beneficiary trust is excluded from the grantor's estate. See Section VII.V of this outline, below.

Consider including the grantor's spouse as a potential discretionary beneficiary of the trust that receives the remainder interest. That provides rainy day money if needed to support the spouse (and indirectly the grantor).

Include individuals who are not skip persons as remainder beneficiaries. If only skip persons are beneficiaries at the end of the GRAT term, there would be a taxable termination for GST purposes when the GRAT terminates.

T. IRS Looking At Annuity Payments. There may be a trend of the IRS looking to see if annuity payments are made timely and how annuity payments are valued. One speaker called 6 GRAT clients who had family members as trustee to ask when the annuity payments were made. One of the six made the annuity payments on a timely basis. One of the clients said that he never made a payment and GRAT term had ended. (The client said "if IRS comes after me, I will sue you-you had a duty to make sure the trustee did his job right.")

One possible response is to do an assignment of each annuity payment at the creation of the GRAT, taking effect at the payment date UNLESS the trustee changes it before that time. This solves possible problem that the trustee will not cut the check on the payment date (or 105 days later). There should be an ordering rule of what GRAT assets to use first in satisfying the assignment (i.e. cash first, then lowest basis assets, etc.) [If there is a securities law §16b problem with stock, that would be the last asset to be paid.] A similar approach would be to provide I the trust agreement that payments would vest in the grantor on the annuity payment date even if not paid and the trustee would act as agent for the grantor with respect to such vested amounts.

U. Revocable GRAT. Mil Hatcher and Ed Manigault have suggested making a GRAT revocable until all funds have been retitled in the name of the GRAT. At that time the grantor would release the revocation right. That would avoid a possible argument by the IRS that additional contributions are being made to the trust (which is prohibited) if all assets are not funded into the GRAT on the date that it is signed. Manigault & Hatcher, "Revocable GRATs," 145 Trusts & Estates 30 (Nov. 2006). Observe that this might create an unintended gift if the annuity amounts are based on the AFR when the trust agreement is signed and if the AFR changes before the time the funding is completed and the revocation right is released. Under the approach, the annuity payments would be due on the anniversary of the release of the revocation right.

V. Purchase of Remainder Interest by Grantor. If there is a really successful GRAT and there is a worry that client might die before the end of the GRAT term, the grantor might consider purchasing the remainder interest from the remainder beneficiary for its present value. If the grantor dies during the term of the GRAT, all assets in the GRAT will be included in the estate. But now, the remainder beneficiary trust has the dollars paid for the remainder interest that is excluded from the grantor's estate. The grantor has no interest in it and has no control over it, so it is excluded from the grantor's estate for estate tax purposes.

A potential risk is that the IRS might argue that this is in effect a prohibited commutation. Presumably that might raise the risk of an argument that the GRAT does not create qualified interests under § 2702, so the entire initial transfer to the GRAT would be treated as a gift. To avoid that possible argument, wait to purchase the remainder interest until after the statute of limitations has run on the gift tax return for the year the GRAT was created.

One attorney has reported doing this in a transaction where the grantor of the GRAT was about to die and the grantor purchased the remainder interest from the grantor trust that owned the remainder interest. That sale was audited. In that case, there were different trustees of the grantor trust remainder owner and the GRAT itself (to help show no merger). The attorney even had the grantor trusts file a Form 1041 when initially created, reporting them as grantor trusts. The grantor borrowed money from a bank to pay for the remainder interest. The IRS agent didn't like it, but it passed the audit.

VIII. INSTALLMENT SALE TO GRANTOR TRUST.

A. Description. A very effective method of freezing an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member. The traditional disadvantage of an installment sale is that the donor has to recognize a substantial income tax gain as the installment payments are made. The gains would typically be taxed at 15% (without considering state income taxes), and the interest would be taxed or ordinary income tax rates. [The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the long-term capital gains rate from 20% to 15% and from 10% to 5% (0% for years after 2007) for low- bracket taxpayers. The capital gains rate reduction is effective for sales and exchanges (and installment payments received) on or after May 6, 2003 and before January 1, 2010.] If the sale is made to a trust that is treated as a grantor trust for income tax purposes, but which will not be included in the settlor's estate for federal estate tax purposes, the estate freezing advantage can be achieved without the income tax costs usually associated with a sale. In addition, care must be taken to select a "defect" that would cause the grantor to be treated as the "owner" of trust income as to both ordinary income and capital gains.

Briefly, the steps of planning an installment sale to a grantor trust are as follows:

1. Step 1: Create and "Seed" Grantor Trust. The individual should create a trust that is treated as a grantor trust for federal income tax purposes (meaning that the grantor is the owner of the trust for income tax purposes). The trust will be structured as a grantor trust for income tax purposes, but will be structured so that the grantor is not deemed to own the trust for estate tax purposes. This type of trust (which is treated as owned by the grantor for income but not estate tax purposes) is sometimes called a "defective trust". [In order to assure that the trust is treated as wholly-owned by the grantor for income tax purposes, the most conservative approach is not to use Crummey withdrawal powers in the trust. However, the IRS has issued numerous private rulings saying that using Crummey withdrawal powers does not destroy grantor trust status as to the original grantor, and it is highly unlikely that the IRS will raise the issue. See Section VIII.B.2. of this outline.]

   The grantor trust should be "seeded" with meaningful assets prior to a sale. There is lore that the value of equity inside the grantor trust must be 10% of the total value in order for the sale to be respected. In Letter Ruling 9535026, the IRS required the applicants to contribute trust equity of at least 10% of the installment purchase price in order to avoid association status for income tax purposes and to have the trust be treated as a trust.

   Various planners have suggested that is not required absolutely, and some respected national speakers said that the equity amount could be as low as 1%--depending on the situation. One planner (who considers himself a conservative planner) has used less than 10% sometimes, and on occasions he is concerned whether 10% is enough. The legal issue is whether there is debt or equity. [For example, if it is debt, it is permissible to use the AFR as the interest rate.] The issue is whether there is comfort that the "debt" will be repaid.

   Under the 10% rule of thumb, the trust should hold approximately 10% in value of the eventual trust assets after a purchase occurs in step 2. As an example, if a $900,000 asset will be sold to the trust, the settlor might make a gift of $100,000 to the trust. After the trust purchases the asset, it would own assets of $1,000,000, and it would have a net worth of $100,000, or 10% of the total trust assets. [This is analogous to the 10% cushion requirement in § 2701(a)(4).] Stated differently, if the 10% seeding is based on analogy to the initial seeding gift should be 11.1% of the amount of the later sale to the trust (if values remain constant.) If the grantor transfers $11.10 to the trust, and later sells an asset for a $100.00 note, the "$11.10 "seeding" would be 10% of the total $111.10 assets in the trust following the sale. That means there would be a 9:1 debt equity ratio.

The seed money can be accomplished either through gifts to the trust, or through transfers to the trust from other vehicles, such as a GRAT.

In Petter v. Commissioner, T.C. Memo. 2009-280, footnote 8 notes that the estate tax attorney involved in structuring the transaction "said he believed there was a rule of thumb that a trust capitalized with a gift of at least 10 percent of its assets would be viewed by the IRS as a legitimate, arm's length purchaser in the later sale." At least this is a reference to the 10% rule of thumb in a reported case.

McDermott v. Commissioner, 13 T.C. 468 (1949), acq. 1950-1 C.B. 3, had a 19.6 to 1 debt equity ratio (which translates to a 5.6% equity amount). The IRS acquiesced in McDermott. One attorney uses that as a base point – he never uses less than 5.6% seeding. On the other hand, there is a published ruling involving a 20% contribution, and the IRS ruled it was debt. (That was not a sale to grantor trust situation.)

In determining whether the note represents debt or equity, one must consider a variety of factors, including the nature (and volatility) of assets in the trust, and the risk profile of the clients. If there is experience of assets actually increasing in value after sales to the trust and payments actually being made, when the next grantor trust sale is considered, the grantor would seem to have good reason to be more comfortable using a lower equity cushion.

Some commentators have suggested that initial seeding should not be required as long as the taxpayer can demonstrate that the purchaser will have access to the necessary funds to meet its obligations as they become due. Hesch & Manning, "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 34th Annual Heckerling Institute on Estate Planning ¶ 1601.1 (2000). Even those authors, however, observe that the § 2036 issue is an intensely factual one, and that "only those who are willing to take substantial risks should use a trust with no other significant assets." Id.

Guarantee. Can the "seeding" be provided by a guarantee? A guarantee by a beneficiary or a third party may possibly provide the appropriate seeding, sufficient to give the note economic viability. Beware that if the trust does not pay a fair price for the guarantee, the person giving the guaranty may be treated as making an indirect contribution to the trust, which might possibly result in the trust not being treated as owned wholly by the original grantor. Some commentators argue, however, that a beneficiary who guarantees an indebtedness of the trust is not making a gift until such time, if at all, that the guarantor must "make good" on the guarantee. [Otherwise, the beneficiary would be treated as making a gift to himself or herself.] See Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 J. Tax'n 152 (2000). Thus, the safest course is to pay for the guarantee and the safer alternative if that is not done is to have the guarantee be made by a beneficiary rather than a third party.

If the beneficiary has a real interest in the trust, and the beneficiary gives a guarantee to protect his or her own investment, the guarantee arguably is not a gift to the trust. The leading case is Bradford v. Commissioner, 34 T.C. 1059 (1960), in which the IRS acquiesced. [If the beneficiary is making a gift to the trust, the beneficiary is a grantor to that extent, and the trust is no longer a wholly grantor trust as to the original grantor, so there could be adverse income tax consequences.] The best analogy supporting that the beneficiary does not make a gift is in the life insurance area. There are various cases and acquiescences that if a beneficiary pays premiums to maintain the policy that is owned by a trust, that is not a gift to the trust. Indeed, that is an actual transfer, not just a guarantee.

If the planner is squeamish about guarantees by beneficiaries, the trustee could pay an annual fee to the beneficiary in return for the guarantee. Some planners report using a fee between 1-2%. Other planners suggest that the fee would typically be higher (about 3%). The 1-2% (or lower) fee for a typical bank letter of credit is based on having a pre-existing relationship with a person who has substantial assets. The difficulty with paying a guaranty fee is determining what the correct amount of the fee. There may be a gift if no fee or if an insufficient fee is paid for the guarantee. [Some planners have reported using Empire Financial to value these guaranties.] One planning alternative is to file a non-transfer gift tax return reporting the guarantee transaction.

Making “Equity Portion” an Incomplete Gift. Some commentators have suggested the intriguing strategy of making the “equity” portion of the trust an incomplete gift by retaining a limited power of appointment. Dunn, Such & Park, “The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts,” 34 Est. Pl. 39 (Feb. 2007). They argue that this is a way of increasing the equity of the trust without triggering gift tax. The approach is to provide that there would be two separate shares of the trust. Both would be administered under the same terms, except that the grantor would have a retained testamentary limited power of appointment over one share (the “LPA share”) and not the other (the “non-LPA share”). The portion allocated to the LPA share would be treated as an incomplete gift, and that share would be subject to estate tax at the grantor’s death. The authors maintain that the entire trust (even the incomplete gift portion) should be taken into account for purposes of any “seeding” requirement, because the transfer to the trust is complete for property law and trust law purposes. Creditors of the trust could reach the entire trust, including the LPA share. It is just a tax fiction that the transfer to the LPA share is incomplete for gift tax purposes—but it is a completed transfer for all other purposes. The grantor has simply retained the power to change the beneficiary of that share at the grantor’s death, but the grantor has no ability to take back the assets in that share or to prevent the trust’s creditors from reaching the asset. The authors suggest funding the LPA share with assets that are not expected to realize substantial growth (in order to minimize the amount included in the grantor’s estate with respect to the LPA share), but observe that the LPA share alternatively could consist of a percentage of the total trust property, in which case the LPA share would participate equally in all future trust growth. In any event, the grantor would likely want to execute a new will exercising the power of appointment to appoint the assets in the LPA share to a marital trust if the grantor’s spouse survives the grantor, in order to defer payment of estate taxes on that share until the surviving spouse’s subsequent death.

Spouses as Joint Grantors. Most planners do not use joint trusts with both spouses as grantors. There is the theoretical concern of whether one spouse might be treated as selling of the assets, which are eventually sold to the trust, to the portion of the trust treated as a grantor trust as to the spouse. If so, there would be no gain recognition on the sale (under § 1041), but interest on the note would be taxable.

Furthermore, there is significant uncertainty regarding the effect of a subsequent divorce or death of a spouse.

2. Step 2: Sale for Installment Note; Appropriate Interest Rate. The individual will sell property to the grantor trust in return for an installment note for the full value of the property (taking into account appropriate valuation discounts). The note is typically secured by the sold asset, but it is a full recourse note. The note is often structured to provide interest only annual payments with a balloon payment at the end of the note term. The interest is typically structured to be equal to the § 7872 rate (which is even lower than the § 7520 rate which is used for structuring GRATs). Often a 9-year note will be used, in which case the federal mid-term rate would apply. For March 2012 (when the § 7520 rate is 1.4%), the annual short-term (0-3 years) rate is 0.19%, the annual mid-term (over 3, up to 9 years) rate is 1.08%, and the long-term (over 9 years) rate is 2.65%. Typically, the note would permit prepayment of the note at any time without penalty. The note should be shorter than the seller's life expectancy in order to minimize risks that the IRS would attempt to apply § 2036 to the assets transferred in return for the note payments.

   In light of the relatively low interest rates for longer term notes, planners typically are using 9-year rather than 3-year notes. Furthermore, many planners are using long-term notes (over 9 years) because the interest rate is still relatively low; but use a note term shorter than the seller's life expectancy. [The buyer could prepay the note if desired, but there would be the flexibility to use the low long-term rate over the longer period.]

   Some planners structure the transaction to leave some time between the time of the seed gift and the subsequent sale, by analogy to the "real economic risk of a change in value" analysis in Holman v. Commissioner, 130 T.C. 170 (2008), aff'd on other grounds, 601 F.3d 763 (8th Cir. 2010) (avoiding step transaction argument with respect to funding and gifts of interests in a family limited partnership).

   Some planners have suggested taking the position that the lowest AFR in the month of a sale or the prior two months can be used in a sale to defective trust situation, relying on § 1274(d). Section 1274(d) says that for any sale or exchange, the lowest AFR for the month of the sale or the prior two months can be used. However, relying on § 1274(d) is problematic for a sale to a defective trust--because such a transaction, which is a "non-event" for income tax purposes, may not constitute a "sale or exchange" for purposes of § 1274(d). The apparently unqualified incorporation of § 1274(d) in § 7872(f)(2) arguably gives some credibility to this technique. However, relying on a feature that depends on the existence of a "sale" as that word is used in § 1274(d)(2) (in the income tax subtitle) in the context of a transaction that is intended not to be a "sale" for income tax purposes seems unwise.

   Most planners use the applicable federal rate, under the auspices of § 7872, as the interest rate on notes for intrafamily installment sales. Section 7872 addresses the gift tax effects of "below-market" loans, and § 7872(f)(1) defines "present value" with reference to the "applicable Federal rate." Using § 7872 rates would seem to be supported by the position of the IRS in a Tax Court case and in several private rulings.

   In Frazee v. Commissioner, 98 T.C. 554 (1992), the IRS urged, as its primary position, that the interest rate under § 7872 (rather than the interest rate under § 483 or any other approach), should apply for purposes of determining the gift tax value of a promissory note in the context of a sale transaction. In several separate private letter rulings (E.g., Ltr. Ruls. 9535026 & 9408018), the IRS summarized the Tax Court's analysis of this issue in Frazee as follows:

> [T]he Tax Court addressed the issue of whether, for gift tax purposes, the fair market value of a promissory note issued by children to their parents in exchange for real property must be determined by use of a discount rate prescribed under § 7872 of the Code, or the safe-harbor rate provided under § 483(e). The court also considered the application of the rates prescribed under § 1274. The court concluded that § 7872 applied in determining the gift tax treatment of below-market loans regardless of whether the transaction involved a sale of property or a cash loan. The court reaffirmed its earlier position in Krabbenhoft v. Commissioner, 94 T.C. 887 (1990), aff'd, 939 F.2d 529 (8th Cir. 1991), that § 483 of the Code does not apply for gift tax purposes. In concluding that § 1274 also was not applicable in valuing the note for gift tax purposes, the court stated that § 1274 characterizes installment payments as principal or interest and, where stated interest is inadequate, it imputes interest. On the other hand, the court noted that § 7872 was enacted specifically to address the gift tax treatment of below-market loans. Thus, the court concluded that the application of § 7872 is not limited to loans of cash. Rather, the term "loan" under § 7872 is broadly interpreted to include any extension of credit.

Whether the § 7520 rate or some other market rate should apply was not strictly before the court, because the IRS proposed using the lower § 7872 rate. However, the court analyzed § 7872 and concluded that it applied for purposes of valuing a note given in a seller financed sale transaction:

> Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted.

98 T.C. at 588. The opinion concluded with an acknowledgement that this approach was conceded by the IRS in its position that § 7872 applied rather than valuing the note under a market rate approach: "We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept." Id. at 590.

Private Letter Ruling 9535026 involved an installment sale of assets to a grantor trust in return for a note that paid interest annually at the § 7872 rate, with a balloon payment of principal at the end of 20 years. The ruling summarizes the provisions of § 7872 (which governs the gift tax effects of "below-market" loans), and discusses the Frazee case (which it summarizes as concluding that § 7872 is not limited to loans of cash but is broadly interpreted to include any extension of credit). The ruling observes that the stated interest rate on the notes in question equals the § 7872 rate. "Thus, we conclude that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the [trust's] ability to pay the notes is not otherwise in doubt." Private Letter Ruling 9408018 addressed whether a redemption of a mother's stock from a corporation, where her son was the remaining shareholder, constituted a gift. The note had an interest rate equal to the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with "adequate stated interest" under § 1274(c)(2) (which is tied to the applicable federal rate). The ruling employed reasoning similar Private Letter Ruling 9535026, and concluded that because the interest rate on the note will be at least equal to the applicable federal rate for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note. [That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.]

3. Step 3: Operation During Term of Note. Hopefully the trust will have sufficient cash to make the interest payments on the note. If not, the trust could distribute in-kind assets of the trust in satisfaction of the interest payments. Payment of the interest, whether in cash or with appreciated property, should not generate any gain to the trust or to the grantor, because the grantor is deemed to be the owner of the trust for income tax purposes in any event.

   Because the trust is a grantor trust, the grantor will owe income taxes with respect to income earned by the trust. Payment of those income taxes by the grantor is not an additional gift to the trust. Rev. Rul. 2004-64, 2004-2 C.B. 7. To the extent that the entity owned by the trust is making distributions to assist the owners in making income tax payments, the cash distributions to the trust could be used by the trust to make note payments to the grantor/seller, so that the grantor/seller will have sufficient cash to make the income tax payments.

   Consider having the seller elect out of installment reporting. The theory is that the gain would then be recognized, if at all, in the first year, but there should be no income recognition in that year under Rev. Rul. 85-13. Death during a subsequent year of the note arguably would be a non-event for tax purposes. Some commentators believe that installment reporting is not even available for sales to a grantor trust, because the transaction is a non-event for income tax purposes.

4. Step 4: Pay Note During Seller's Lifetime. Plan to repay the note entirely during the seller's lifetime. Income tax effects may result if the note has not been paid fully by the time of the seller's death. Income tax issues with having unpaid note payments due at the grantor's death and planning alternatives to avoid those issues are discussed in Section VIII.B.4 of this outline.

   The installment note could be structured as a self-canceling installment note ("SCIN") that is payable until the expiration of the stated term of the note or until the maker's death, whichever first occurs. However, there is an additional valuation uncertainty with the SCIN, because the amount of interest or principal premium to compensate for the self cancelling feature cannot be determined objectively under procedures that have been blessed by the IRS. If a SCIN is used, the principal and interest payment should be made in level payments (or in roughly level payments). See generally Hesch & Manning, "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 34th Annual Heckerling Institute on Estate Planning ch. 16 (2000).

For an excellent discussion of the issues involved with sales to grantor trusts, see Mulligan, "Sale to Defective Grantor Trust: An Alternative to a GRAT," 23 Est. Pl. 3-10 (Jan. 1996); Mezzullo, Freezing Techniques: Installment Sales to Grantor Trusts, Prob. & Prop. 17-23 (Jan./Feb. 2000); Aucutt, "Installment Sales to Grantor Trusts," <u>ALI-ABA Planning Techniques for Large Estates</u> 2121 (Nov. 2009).

B. <u>Selected Special Planning Considerations for Installment Sales to Grantor Trusts</u>. The outline does not discuss the basic requirements of grantor trusts or the basic estate, gift, GST and income tax effects of grantor trusts.

1. <u>Interest Payments Do Not Create Taxable Income</u>.

   Because the grantor is treated as the owner of the trust, interest payments from the trust to the grantor should also be a non-event for income tax purposes. [On the other hand, if there are sales between spouses, while there is no gain recognition on the sale under § 1041, interest payments would constitute taxable income. <u>See</u> <u>Gibbs v. Comm'r</u>, T.C. Memo 1997-196.]

2 <u>IRS Has Reconfirmed Informal Rulings That Using Crummey Trust Does Not Invalidate "Wholly Owned" Status of Grantor</u>.

   In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. Theoretically, this may be endangered if the trust contains a Crummey withdrawal clause. However, recent private letter rulings reconfirm the IRS's position that using a Crummey clause does not endanger the grantor trust status as to the original grantor.

   <u>The Potential Problem</u>. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under § 678(a)(1) while the power exists and under § 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. <u>See</u> Ltr. Ruls. 20011058, 200011054 through 20011056, 199942037, & 199935046.

   The IRS's position under § 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere <u>lapse</u> of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. [Sections 2041b)(2) and the 2514(e) provide that "the lapse of a power … shall be considered a release of a power."] Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

   Section 678(b) generally provides that if grantor trust status is conferred on the grantor under §§ 673-677 and on a beneficiary under § 678, the grantor trust status on the original grantor will prevail. However, § 678(b) literally applies only as to "a power over <u>income</u>" and a withdrawal power is typically a power to withdraw <u>corpus</u>. However, the 1954 Committee Reports make apparent that the language of § 678(b) contains a drafting error and that it was intended to apply to a power over income and corpus, similar to § 678(a)(1).

   Despite arguments from the literal statutory language (the exception in § 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will "trump" a § 678 power attributable to a person holding a Crummey withdrawal right that lapses. <u>E.g.</u>, Ltr. Ruls. 200011054, 9309023, & 9321050. [<u>See also</u> Ltr.

Rul. 9141027, but in that ruling the spouse also had an inter vivos power of appointment of principal.] This issue was raised in a PLR request that was discussed by Jonathan Blattmachr at the 2005 Heckerling Institute and the IRS said (during discussions in 2004) that this issue was "in a state of flux." A recent PLR held that where a Crummey withdrawal power was held by the grantor's spouse, the trust was still a grantor trust as to the grantor "notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under § 678." Ltr. Ruls. 200603040 & 200606006. Jonathan Blattmachr indicates that the IRS has informally confirmed that this issue is no longer "in a state of flux" with the IRS.

This has been confirmed by a number of recently issued private letter rulings, which all concluded that the original grantor continued to be treated as the "owner" of the all of the trust under the grantor trust rules despite the existence of a Crummey clause in the trust. See Ltr. Ruls. 200729005, 200729007 through 200729011, 200729013 through 200729016, & 200730011.

In any event, the IRS can change its position from that taken in prior PLRs. If grantor trust treatment for the entire trust is really important, at least consider this issue in determining whether to use a Crummey withdrawal power. A message dated February 17, 2007 has been published that was sent from David Handler to Catherine Hughes (U.S. Department of Treasury) describing the problem of using a Crummey provision in a grantor trust and concluding that the issuance of private letter rulings does not solve the problem:

> However, we cannot rely on private letter rulings, as you know. This uncertainty has caused great headaches or inconvenience for many practitioners and their clients. Guidance confirming what the letter rulings have concluded would be most helpful.

Unfortunately, the IRS and Treasury Department has not acted on that request. IRS Priority Guidance Plans do not list this issue as one of the projects after the request by Mr. Handler.

Even if the trust does continue as a grantor trust as to the original grantor, it is not clear what happens at the grantor's death. Does the trust then become a grantor trust as to the Crummey beneficiaries under § 678(a)? Just reading the statute says the lapsed powers come roaring back to life — and the trust is treated as owned by the Crummey power holders. There have been only two private rulings (and they arose out of one ruling: Ltr. Rul. 9321050, revoking Ltr. Rul. 9026036 on the § 678 issue). The IRS initially ruled that the beneficiary would be treated as the owner. Several years later, the IRS revoked that position and said the beneficiary would not be treated as the owner—with no further discussion. Perhaps the IRS was saying that no one could figure this out. Practically, the IRS apparently does not want to treat all of the Crummey powerholders as the owners, but cannot justify that position under the statute.

While this issue can raise various administrative complexities, it also affords a planning opportunity. At the grantor's death, the trust may become a grantor trust as to the beneficiary, creating an extremely advantageous planning vehicle if the beneficiary also wishes to maximize transfer planning opportunities while still remaining a potential discretionary beneficiary of the trust (as discussed in Section VIII.D of this outline).

3. Grantor's Liability for Ongoing Income Taxes of Trust; Income Tax Reimbursement Provisions.

The grantor will be liable for ongoing income taxes for the trust income. This can further reduce the grantor's estate for estate tax purposes and allow the trust to grow faster. However, the grantor must be willing to accept this liability. A possible alternative for the sale to grantor trust strategy is that if the grantor's spouse is a discretionary beneficiary of the trust, the trust could make a distribution to the spouse that would be sufficient to pay the income taxes that would be payable on the joint return of the grantor and the grantor's spouse.

Another possible alternative is to use an income tax reimbursement provision.Revenue Ruling 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1) Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause "the full value of the Trust's assets" at the grantor's death to be included in the grantor's gross estate under § 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor's legal obligation. (Situation 2) [The statement that the "full value of the trust assets" would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor's benefit at his or her death.] Observe that if a reimbursement is mandatory and it is not paid, the grantor will be treated as making a gift. That would have disastrous effect on a GRAT because it would violate the prohibition against any additions to the GRAT.

In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. (Situation 3) The Ruling provides that the IRS will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before October 4, 2004. Some planners suggest allowing a third person to authorize the trustee to reimburse or to allow an independent trustee to reimburse the grantor for payment of income taxes attributable to the trust. Other planners suggest drafting the reimbursement clause to provide that the discretionary reimbursement power does not exist to the extent that it exposes the trust assets to claims of the grantor's creditors.

Some planners suggest including a discretionary reimbursement power during the initial term of a GRAT, under the theory that the trust assets will likely be included in the grantor's estate if the grantor dies during the term of the trust even without the reimbursement power. A possible concern is that the IRS might attempt to argue that an additional 3-year inclusion period would arise under § 2035 when the creditors' rights terminate. That would not seem appropriate, because creditors' rights terminate because of a lapse of rights under the agreement (i.e., the discretionary reimbursement right would exist only during the initial term of the GRAT), not because of anything that the grantor does volitionally to give up powers or interests.

Some states are amending their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. See Tex. Property Code Ann. § 112.035(d) (Vernon 2004); N.H. Stat. Ann. § 564-B:5-505(a)(2) (2006).

Where a discretionary reimbursement provision is used, the planner should select a state which has such a law to govern the trust.

4. Seller Dies Before Note Paid in Full. If the seller dies before the note is paid off, the IRS may argue that gain recognition is triggered at the client's death. The better view would seem to be that gain recognition is deferred under § 453 until the obligation is satisfied after the seller's death. The recipient of installment payments would treat the payments as income in respect of decedent. Presumably, the trustee would increase the trust's basis in a portion of the business interest to reflect any gain actually recognized. The income tax effect on the trust if the grantor dies before the note is paid in full has been hotly debated among commentators. Compare Dunn & Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," 95 J. Tax'n 49 (July 2001) and Cantrell, Gain Is Realized at Death, TRUSTS & ESTATES 20 (Aug. 2010) with Gans & Blattmachr, No Gain at Death, TRUSTS & ESTATES 34 (Aug. 2010); Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 Tax Mgmt. Est. Gifts & Tr. J. 3 (1999); Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 J. Tax'n 152, 161-64 (2000); Blattmachr, Gans & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 J. Tax'n 149 (Sept. 2002).

   The Manning and Hesch article provides a detailed analysis for the authors' position that income should not be realized as payments are made on the note after the grantor's death. Their arguments include the following.

   - No transfer to the trust occurs for income tax purposes until the grantor's death (because transactions between the grantor and the trust are ignored for income tax purposes.)
   - There is no rule that treats a transfer at death as a realization event for income tax purposes, even if the transferred property is subject to an encumbrance such as an unpaid installment note. See Rev. Rul. 73-183, 1973-1 C.B. 364. However, the property does not receive a step up in basis because the property itself is not included in the decedent's estate.
   - The note itself is included in the decedent's estate, and Manning and Hesch argue that the note should be entitled to a step up the basis. A step up in basis is precluded only if the note constitutes income in respect to the decedent ("IRD") under § 691. They argue that the note should not be treated as IRD because the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount." I.R.C. § 691(a)(3). The decedent would not have recognized income if the note were paid during life (under Rev. Rul. 85-13), so the note should not be IRD.
   - This position is supported by the provisions of § 691(a)(4) & (5), which provide rules for obligations "reportable by the decedent on the installment method under section 453." The installment sale to the grantor trust was a nonevent for income tax purposes, and therefore there was nothing to report under § 453.
   - This position does not contradict the policy behind § 691, because the income tax result is exactly the same as if the note had been paid before the grantor's death – no realization in either event.

- If the unpaid portion of the note were subject to income tax following the grantor's death, double taxation would result. The sold property, which is excluded from the grantor's estate, does not receive a stepped-up basis—so ultimately there will be an income tax payable when that property is sold.

One possible planning approach where the grantor does not expect to survive the note term is for the grantor to make a loan to the trust and use the loan proceeds to pay the installment note before the grantor's death. [A step transaction argument presumably could be avoided by having the trust borrow funds from someone other than the grantor to be able to pay off the note.]

Some authors have suggested a strategy they identify as "basis boosting." Dunn & Park, "Basis Boosting," 146 Tr. & Est. 22 (Feb. 2007). If an individual sells assets to a grantor trust and the individual dies, most planners think gain should not be realized at death. But the answer is unclear. Authors suggest contributing other property to the grantor trust with basis sufficient to eliminate gains. Example: An individual sells an asset with a basis of 10 for note for 50. The asset appreciates to 100 before the grantor dies. The potential gain would be 50 minus 10 (40) when the trust is no longer a grantor trust. If the grantor contributes additional assets to the grantor trust with a basis of 40, that basis could be applied and offset the gain. However, it is not yet clear that this will work. The amount realized from the relief of liability (50 in the example) might have to be allocated between the two assets. If one must allocate the amount deemed realized between the two assets, the gain would not be totally eliminated.

The result might be better if the two assets are contributed to a partnership or LLC, which would require having another partner or member to avoid being treated as a disregarded entity. There would seem to be a stronger argument that there would be no apportionment of the amount realized between the two classes of assets in that situation.

<u>Conversion From Nongrantor to Grantor Trust Status Not a Taxable Event; CCA 200923024</u>. In Chief Counsel Advice 200923024, the Chief Counsel's office addressed what seems to be an abusive transaction. The basic (way oversimplified) facts are that a nongrantor trust sold appreciated property for a private annuity, so that the gain would be recognized ratably over the duration of the annuity. The purchaser sold the asset, recognizing no gain because the sale proceeds did not exceed its cost basis (i.e., the value of the annuity). [Actually, the purchaser was a partnership with a § 754 election in effect and the partnership sold the assets for a price about equal to its inside basis as a result of the § 754 election.] The nongrantor trust later converted to grantor trust status (by a change in the trustee to someone who was a "related or subordinate person"), with the result that the grantor would not realize gain on any subsequent annuity payments received from his grantor trust. An IRS agent argued that the conversion from nongrantor to grantor trust status was a taxable event, and that the transferee grantor trust would recognize gain. The CCA disagreed. It recognized that the transaction appears to be abusive, and observed that it was not addressing the possible applicability of the step transaction, economic substance or other judicial doctrines. However, it observed that treating the conversion as a taxable transaction would have an impact on non-abusive transactions, noting that nongrantor trusts may be converted to grantor trusts by various ways, including a change of trustees, borrowing of the trust corpus, or payment of the grantor's legal obligation. It noted that Rev. Rul. 85-13, which held that the conversion of a nongrantor trust to a grantor trust (by

reason of the trust's purchase of assets from the grantor for a note, which constituted an indirect borrowing by the grantor) did not result in taxable income to the grantor.

An interesting statement in the CCA is relevant to the commonly asked question of whether there is gain recognition on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of "Example 5" (Reg. § §1.1001-2(c) Ex. 5), Madorin, and Rev. Rul. 77-402, the CCA observed:

> "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner ***which is generally not treated as an income tax event."*** (emphasis added)

5. Risk of Treatment of Note as Retained Equity Interest, Thus Causing Estate Inclusion of Transferred Asset. Under extreme circumstances, it is possible that the IRS may take the position that the note is treated as a retained equity interest in the trust rather than as a mere note from the trust. If so, this would raise potential questions of whether some of the trust assets should be included in the grantor's estate under § 2036 and § 2702. It would seem that § 2036 (which generally causes estate inclusion where the grantor has made a gift of an asset and retained the right to the income from that asset) should not apply to the extent that the grantor has sold (rather than gifted) the asset for full market value. See Ltr. Ruls. 9436006 (stock contributed to grantor trust and other stock sold to trust for 25-year note; held that § 2702 does not apply); 9535026 (property sold to grantor trust for note, interest-only AFR rate for 20 years with a balloon payment at end of 20 years; held that the note is treated as debt and "debt instrument is not a 'term interest' within the meaning of § 2702(c)(3)"; specifically refrained from ruling on § 2036 issue).

   One Technical Advice Memorandum concluded that § 2036 did apply to property sold to a grantor trust in return for a note, based on the facts in that situation. See Tech. Adv. Mem. 9251004 (transfer of $5.0 million of stock to trust in return for $1.5 million note in "sale/gift" transaction; ruling held that § 2036 applies to retained right to payments under note, reasoning that note payments would constitute a major share, if not all, of the trust income, thus causing inclusion of trust property in estate).

   Analogy to private annuity cases would suggest that § 2036 should not typically apply to sale transactions. For example, the Supreme Court refused to apply the predecessor of § 2036 to the assignment of life insurance policies coupled with the retention of annuity contracts, because the annuity payments were not dependent on income from the transferred policies and the obligation was not specifically charged to those policies. Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274, 277 (1958). Various cases have followed that approach, in both income and estate tax cases. For a listing of cases that have addressed the application of § 2036 in the context of private annuity transactions where are the grantor is retaining the right to receive substantial payments from a trust, see Hesch & Manning, "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 34th Annual Heckerling Institute on Estate Planning ¶ 1601.1 n. 55 (2000).

   One commentator has suggested that there is a significant risk of § 2036(a)(1) being argued by the IRS if "the annual trust income does not exceed the accrued annual interest on the note." U.S. Trust, Practical Drafting 4365-4370, at 4367

(Covey ed. Apr. 1996). Much of the risk of estate inclusion seems tied to the failure to have sufficient "seeding" of equity in the trust prior to the sale.

Various cases have addressed when promissory notes will be respected for general tax purposes. Deal v. Commissioner, 29 T.C. 730 (1958) (intent to forgive notes at time they were received cause gift treatment at outset); Estate of Holland v. Commissioner, T.C. Memo 1997-302 (loan owed by estate not treated as valid loan qualifying for estate tax debt deduction; "The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances including whether: (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax is consistent with a loan."); FSA 1999-837 (if intent to forgive loan as part of prearranged plan, loan will not be treated as consideration and donor makes gift to the full extent of the loan). The same nine objective factors listed in Estate of Holland were also described in Miller v. Commissioner, 71 T.C.M. 1674 (1996), aff'd, 113 F.3d 1241 (9th Cir. 1997). See also Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104.

If the note that is received from the trust is treated as debt rather than equity, the trust assets should not be included in the grantor/seller's gross estate under §2036.

A recent case reiterated some of these same factors in determining that advances from an family limited partnership should be treated as equity distributions rather than being recognized as advances in return for a note. Estate of Rosen v. Commissioner, T.C. Memo 2006-115 (decedent never intended to repay the advances, demand note with no fixed maturity date, no written repayment schedule, no provision requiring periodic payments of principal or interest, no stated collateral, no repayments by decedent during lifetime, no demand for repayment, only one note was prepared during lifetime even though numerous "advances" were made, decedent had no ability to honor a demand for repayment, no interest payments on the note, repayment of the note depended solely on the FLP's success, transfers were made to meet the decedent's daily needs, adequacy of interest on the note was questioned). For an excellent discussion of the impact of the Rosen case on potential estate inclusion, see Blattmachr & Zeydel, "Comparing GRATs and Installment Sales," 41st Annual Heckerling Institute on Estate Planning ¶ 202.3[C][2] (2007).

John Porter reports that he has several cases in which the IRS is taking the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the "economic realities of the arrangement … do not support a part sale," and that the full value of the partnership interest was a gift not reduced by any portion of the notes. (This position conflicts with Treas. Reg. § 25.2512-8(a), which provides that transfers are treated as gifts "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor.") Porter, "Current Valuation Issues," AICPA Advanced Estate Planning Conference ch. 42 at 51 (2004).

If the note term is longer than the seller's life expectancy, the IRS would have a stronger argument that § 2036 applies.

The IRS has questioned the validity of a sale of limited partnership interests to a grantor trust in the Karmazin case, which was settled in a manner that recognized the sale. See Part One, Section V.G.7.

Practical Planning Pointers: One respected commentator summarizes planning structures to minimize the estate tax risk.

> "The reasoning in *Fidelity-Philadelphia Trust* suggests that the estate tax case is strongest when the following features are carefully observed:
>
> a. The note should be payable from the entire corpus of the trust, not just the sold property, and the entire trust corpus should be at risk.
>
> b. The note yield and payments should not be tied to the performance of the sold asset.
>
> c. The grantor should retain no control over the trust.
>
> d. The grantor should enforce all available rights as a creditor."
>
> Aucutt, "Installment Sales to Grantor Trusts," ALI-ABA Planning Techniques for Large Estates 1539, 1577 (April 2007).

6. Valuation Risk. If the IRS determines that the transferred assets exceed the note amount, the difference is a gift. There is no regulatory safe harbor of a "savings clause" as there is with a GRAT. One way that might reduce the gift tax exposure risk is to use a defined value clause—defining the amount transferred by way of a fractional allocation between an (1) irrevocable trust and (2) the spouse (or a QTIP Trust or a GRAT or a charity). The fractional allocation would be analogous to a typical marital deduction formula clause, based on the values as finally determined for federal gift tax purposes, with any value exceeding the note amount to be allocated to the spouse (or a QTIP Trust or a GRAT).

   One "defined value" approach to avoid (or minimize) the gift risk is to provide in the trust agreement that any gift before Date 1 passes to a gift trust. The initial "seed gift" to the trust would be made before that date. The trust would say that any gift after that date goes 10% to a completed gift trust and 90% to incomplete gift trust.

   Another possibility is to use a disclaimer even for a sale to grantor trust. The trust would specifically permit a trust beneficiary to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula: "To the extent any gift made by father to me, I disclaim 99% of the gift."

   The IRS maintains that defined value clauses should not be recognized, primarily on public policy grounds because they tend to discourage tax audits. The IRS has lost that argument in three cases. Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009) (formula disclaimer; "excess value" portion passed to a charity and other persons would have a fiduciary duty and incentive to enforce the clause); Petter v. Commissioner, T.C. Memo. 2009-280 (formula gifts and sales' "excess portion" passed to charity), aff'd, 653 F.3d 1012 (9th Cir. 2011)(IRS did not make broad-based public policy argument on appeal); Hendrix v. Commissioner, T.C. Memo 2011-133. A fourth case approved inter vivos defined value transfers, but the IRS did not make the public policy argument on appeal. Estate of McCord, 461 F.3d 614 (5th Cir. 2006). See Sections X.B.1 & X.B.6 of this outline, below.

7. Volatility Risk. If the asset that is sold to the trust declines in value, the trust still owes the full amount of the note to the grantor. Thus, any equity that had been gifted to the trust prior to the sale could be returned to the donor or included in the donor's estate. Furthermore, if beneficiaries or others give guaranties to provide the 10% "seeding," the guarantors will have to pay the guaranteed amount to the trust if the trust is otherwise unable to pay the note.

   Realize that equity contributed to a grantor trust is really at risk. Also, appreciation in the grantor trust is at risk if there is a subsequent reversal before the note is repaid. If you continue to use the trust for new purchases, that can have great benefit – but it also has risks.

8. Risks Regarding Timing of Sale Transaction. If the gift to the trust and the subsequent sale occur close to each other, the IRS might conceivably attempt to collapse the two steps and treat the transaction as a part-sale and part-gift. Some planners structure the transaction to leave some time between the time of the seed gift and the subsequent sale, by analogy to the "real economic risk of a change in value" analysis in Holman v. Commissioner, 130 T.C. 170 (2008), aff'd on other grounds, 601 F.3d 763 (8th Cir. 2010) (avoiding step transaction argument with respect to funding and gifts of interests in a family limited partnership). [Conceivably, the IRS might argue that the combined transaction is a transfer with retained interest that is not covered by the bona fide sale for full consideration exception in § 2036 because of the gift element of the combined transaction. However, there are no reported cases where the IRS has taken that position based on gifts and sales within a short period of time of each other.] The application of the step transaction doctrine in the "Pierre II" case raises similar issues.

9. Defined Value Clause.

   a. Sale to Grantor Trust With Defined Value Approach. If the value of the transferred assets exceeds the value of the note, a gift results. One possible "defined value" approach to avoid (or minimize) the gift risk is to provide in the trust agreement that any gift before Date 1 passes to a gift trust. The initial "seed gift" to the trust would be made before that date. The trust would say that any gift after that date goes 10% to a completed gift trust and 90% to incomplete gift trust. If a court ultimately determines that the note does not equal the full value of the asset that is sold to the trust, 90% of the gift element would pass to an incomplete gift trust, and there would be no immediate gift taxation on that portion.

   b. Sale With Disclaimer of Any Gift Element . Another possibility is to use a disclaimer even for a sale to grantor trust. The trust would specifically permit a trust beneficiary to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula: "To the extent any gift made by father to me, I disclaim 99% of the gift."

   c. Sale to Grantor Trust Created for Client By Spouse. If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor 's estate, but the client would have achieved the goal of transferring as much as possible as the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. Gibbs v. Commissioner, T.C. Memo 1997-196. Jonathan Blattmachr observes that the IRS will not audit these types of transactions; "the IRS is only in it for the money."

d. Public Policy Issue. The IRS does not recognize defined value clauses, on public policy grounds but various courts have now rejected that argument. Defined value clauses (and the McCord, Christiansen, Petter, and Hendrix, cases) are discussed in more detail in Section X of this outline.

10. Whether to Report Sale Transactions on Gift Tax Returns. Various planners typically have not reported sales on gift tax returns. However, they must rethink that position in light of the Question 12(e) on Form 706 about whether the decedent ever sold an interest in an entity to certain types of trusts. The trend is now toward reporting sale transactions in most circumstances. If the planner decides to report the transaction, how much should be disclosed? Many planners attach copies of all of the sale documents, including any sales agreement, transfer documents, notes, security agreements, deeds of trust, UCC filings, etc. Disclosing all of that information illustrates that the transaction was treated and documented as an arms' length commercial transaction. Some attorneys also report adding to the disclosure a statement that the return and all attachments, taken together, are intended to satisfy the requirements of the adequate disclosure regulations. The intent is to communicate that the planner is ready in case the case is selected for audit.

11. Underwater Sales.

Alternative approaches include:

(a) renegotiating the interest rate if the AFR has become lower;

(b) renegotiating the principal amount of the note (but why would the grantor renegotiate for a lower principal payment?; there seems to be no advantage to the grantor unlike the typical bank renegotiation in which the bank may renegotiate in order to receive some upfront payment or more favored position; the trust has nothing "extra" to grant to the grantor in a renegotiation; this approach seems risky);

(c) have the grantor sell the note from the original grantor trust that purchased the asset to a new grantor trust (the note would presumably have a lower value than its face value; any appreciation above that value would inure to the benefit of Trust 2 even though Trust 1 ends up having to pay all of its assets on the note payments; a big disadvantage is that the new trust would have to be "seeded" and the value of the underlying asset could decrease even further so that the seeding to Trust 2 would be lost as well); or

(d) the grantor could contribute the note from the grantor trust to a new GRAT (future appreciation would inure to the benefit of the GRAT remaindermen but there would be no new "seeding" requirement which could be lost as well if there were more deprecation in the value of the underlying assets). See Hatcher, "Underwater GRATs and ISGTs," ACTEC 2008 Summer Meeting.

12. Structure to Give Beneficiary Power of Withdrawal Rather Than Having Stated Termination Date During Grantor's Lifetime. Letter Ruling 200840025 concluded that the power of the nonadverse trustee to make loans to the grantor, with or without security, caused the trust to be a grantor trust under § 675(2) so long as the

grantor is alive and the nonadverse trustee has not released the power with respect to a particular trust.

Under the trust instrument, a beneficiary could withdraw assets upon reaching a specified age. The ruling concluded that the grantor would continue to be treated as the sole owner of the trust, even after the beneficiaries reach those specified ages, so long as the grantor is alive and the nonadverse trustee has not released the lending power. The ruling acknowledged that the withdrawal powers held by the beneficiaries would otherwise cause them to be treated as the owners of the trust under § 678 after they reach the age for making withdrawals.

Practical Planning Pointer: Instead of requiring terminating distributions as the beneficiary reaches specified ages, instead give the beneficiary a power of withdrawal. This gives the beneficiary the flexibility to keep the assets in trust to maintain the grantor trust treatment.

13. <u>Example With Key Best Practices for Sale to Grantor Trust Transaction</u>. The following is based on comments from a panel presentation at the 2012 Heckerling Institute by Ann Burns, John Bergner and David Handler.

    a. <u>Business Interest -- Gift and Sale to Grantor Trust</u>.

    - A starting point is to create voting and non-voting units. One planner typically creates 999 non-voting shares for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business.
    - Gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt.
    - The installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests.
    - Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.) Make the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year). John Porter suggests transferring an initial gift of cash to the trust—something other than the illiquid asset that will be sold to the trust—so that the cash is available to help fund note payments.
    - The key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, the real estate could be transferred to the trust because it does have cash flow. (See the following subparagraph.)
    - Cash flow from the business may be sufficient to assist making payments on the promissory note.
    - Model anticipated cash flow from the business in structuring the note.
    - For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This “tax distribution cash flow” may be enough to fund a substantial part of the note payments.
    - The goal is to be able to pay off a note during lifetime.
    - Lack of control and lack of marketability discounts would apply.

- Best practices for avoiding §2036, 2038 argument: Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments)(John Porter suggestion). Be as certain as possible that consideration paid in the sale transaction is "adequate and full consideration" so that the full consideration exception to §§2036 and 2038 applies.
- Cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. (This couple has the assets to make that happen.)
- Use a defined value clause to protect against gift consequents of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value" typically a donor advised fund from a Communities Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)
- The interest rate is very low. For example, in January 2012 a nine-year note would have an interest rate of 1.17%. If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is 0.8%, so if the business has earnings/growth above that, there is a wealth shift each year.
- This approach takes advantage of things available today that could be eliminated in the future – discounts, $5 million gift and GST exemptions, and extremely low interest rates.

b. <u>Real Estate Used In Business</u>.

- If the business does not produce excess cash flow, consider first transferring (by gift and sale if appropriate) the real estate to the trust. The lease of the real estate from the business will produce consistent cash flow. The trust can use some or all of the lease payments to pay down the note. After nine years when the note has been paid, the continued cash flow from the lease payments could be used to purchase some of the closely held business interests.
- Reverse planning strategy (depending on client's objectives): transfer the closely held business interest into the trust, and have the client retain the real estate. The client may want to retain the cash flow coming from the real estate.
- If the client is considering selling the business at some point, inquire whether the real estate would also likely be sold. If not, the real estate could provide continuing cash flow. (The third-party buyer of the business may or may not allow that.)
- When the ownership of the business and real estate are not the same, determining and structuring appropriate fair market rental rates becomes very important.
- Document the lease with commercially reasonable terms.

c. <u>Timing of Gift and Sale Transactions</u>. Do not make the gift and sale on the same day. The *Pierre* case aggregated assets that were given and sold on the same day for valuation purposes, to reduce the lack of control discount of the respective blocks that were given and sold. In addition, if the gift and sale is made the same day, that would open up a potential argument from the IRS that §2036 applies to the sale transaction, because the aggregate transfer is a transfer that does not come within the bona fide sale for full consideration exception in §2036 (i.e., it involves a gift element).

14. Summary of Trust Provisions That Cause Grantor Trust Status. Observe: Many planners use more than one grantor trust trigger provision in case the IRS attacks one as a "sham" or is not otherwise effective.

    a. Summary of Trust Provisions to Trigger Grantor Trust Status Under Section 674. Navigating all of the exceptions based on a dispositive power of the trustee requires very careful planning. A nonadverse party must serve as trustee with a power of disposition over trust assets (§ 674(a)). The instrument must not have reasonably definite external standards for distributions (to avoid § 674(d)), and more than half of the trustees must be related or subordinate parties (to avoid § 674(c)). In addition, the trustee should have a spray power over corpus distributions and not have to charge any distributions of corpus against the beneficiary's proportionate share of corpus (to avoid § 674(b)(5)). Also, the trust should permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries (to avoid § 674(b)(6)). [Alternatively, to avoid § 674(b)(6), if the grantor wishes to provide for "separate shares" for each beneficiary to accumulated income, provide that the trust will last for the lifetime of the beneficiary and do not distribute accumulated income to the beneficiary's estate or give the beneficiary a testamentary power of appointment.]

       Another possible of causing grantor trust treatment under § 674 would be to give the grantor's spouse the power to distribute income or corpus to third parties without including a "reasonably definite external standard". As long as the spouse did not make any contributions to the trust, this power should not result in estate inclusion for the spouse (as long as the spouse cannot distribute to himself or herself or in satisfaction of his or her legal obligations). Observe that this would result in grantor trust treatment even following a divorce if the prior spouse continued to serve as trustee (although the grantor may not want that person to continue to serve as trustee for other reasons). The trust instrument should carefully plan who the successor trustees would be in the event the spouse ceases to serve, to assure that more than half of the trustees would be related or subordinate parties. To guard against the possibility of a divorce, the trust might give the grantor the power to remove and replace a divorced spouse in a manner that complies with Rev. Rul. 95-58.

    b. Power of a Nonadverse Person to Distribute to or Accumulate Income for the Grantor or the Grantor's Spouse, § 677(a)(1) or (2). Including the grantor or the grantor's spouse as a discretionary beneficiary may trigger grantor trust treatment under § 677.

       An obvious advantage of including the spouse as a discretionary beneficiary, the trustee would be able to access the trust for the benefit of the spouse in the unlikely event that the spouse ever needed distributions from the trust. However, the parties should be aware that including this provision will cause the trust to be a grantor trust as to the income under § 677, including after a divorce.

       If the spouse is included as a potential beneficiary, shedding grantor trust status may be difficult. If the spouse relinquishes his or her rights as a discretionary beneficiary, a taxable gift from the spouse may result (unless the relinquishment is a qualified disclaimer within nine months of the creation of the interest.) One possible planning strategy would be to give an independent party the power to remove the spouse as a discretionary beneficiary. Another alternative is to use a "floating spouse" defined as the person the settlor is married to and living with at the time of the settlor's death (or at the time of distribution if the settler is still alive).

If § 677 is being utilized to confer grantor trust status by including the grantor's spouse as a potential beneficiary, the death of the spouse would result in the trust no longer being a grantor trust (unless one of the other grantor trust provisions applies.)

If the grantor, rather than the grantor's spouse, is a discretionary beneficiary, there is a likelihood that the trust assts would be included in the grantor's estate under § 2036 unless the trust is formed in a state which has adopted a Domestic Asset Protection Trust statute (where a settlor can be a discretionary without subjecting the trust assets to the settlor's creditors.) Even in such a "self-settled trust" state, however, if the trustee actually makes distributions to the grantor, a concern may arise under § 2036 as to whether there was an implied agreement about distributions to the grantor, which could trigger § 2036 inclusion even apart from creditors rights. (Some attorneys respond to that concern by noting that the donor would only receive trust distributions if he has lost all of his other assets, in which case he may not care about estate taxes.) Some attorneys suggest that if the grantor is included as a discretionary beneficiary (in a self-settled trust state), a third party should be provided the power to eliminate the grantor as a potential beneficiary; the 3-year rule under § 2035 should not apply if the removal is exercised, even shortly before the grantor's death, because there is no transfer (or relinquishment) by the grantor.

Letter Ruling 200944002 recognizes that transfers to the trust (apparently under Alaska law) are completed gifts, even though the grantor is a discretionary beneficiary, because he cannot revest beneficial title or change the beneficiaries. [Various cases have held that there is no completed gift if the settlor's creditors can reach the trust, but this Alaska trust was protected from the settlor's creditors.] In addition, the ruling addressed the application of § 2036, noting that the "trustee's authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036" as long as state laws provide that including the grantor as a discretionary beneficiary does not cause the trust to be subject to claims of the grantor's creditors. However, the ruling expressly declined to give an unqualified ruling and noted that the discretionary authority to make distributions to the grantor "combined with other facts (such as, but not limited to an understanding or pre-existing arrangement between grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." For a general discussion of this ruling, see Shaftel, "IRS Letter Ruling Approves Estate Tax Planning Using Domestic Asset Protection Trusts," 112 J. Tax'n 213 (April 2010); Rothschild, Blattmachr, Gans & Blattmachr, "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Est. Pl. 3 (Jan. 2010).

c. <u>Actual Borrowing of Trust Funds by Grantor or Grantor's Spouse Without Adequate Interest Or Security, § 675(3)</u>. Under § 675(3), if the grantor has (directly or indirectly) <u>actually</u> borrowed corpus or income from the trust and has not completely repaid the loan with interest before the beginning of the taxable year, the trust will be treated a grantor trust. Grantor trust treatment will not result if the loan provides for adequate interest or security and if the loan is made by a trustee other than a related or subordinate party. Under the statute, actual borrowing is required; the mere power to borrow is not sufficient to cause grantor trust status.

The statutory language suggests that grantor trust status depends upon whether a loan is outstanding at the beginning of a taxable year. Under that interpretation, if borrowing occurs during year one, but is repaid before year two, grantor trust status would not exist in either year one or year two. However, the IRS interprets § 675(3) as imposing grantor trust status if the loan to the grantor has been outstanding <u>any</u> time during the year. Rev. Rul. 86-82, 1986-1 C.B. 253, following <u>Mau v. United States</u>, 355 F. Supp. 909 (D. Hawaii 1973). For example, if a loan is outstanding on 12/31/2007 and repaid on 1/2/2008, the grantor would be treated as owning the trust for all of 2007 and 2008 under Revenue Ruling 86-82. There is the intriguing possibility of just making a loan on December 30 of a year to make the trust a grantor trust for the entire year. That may be used in year-end planning, (but there is the possibility that the IRS might take the position at some point that this is an abusive strategy, despite the outstanding Revenue Ruling and case support.)

It is not clear whether grantor trust status relates only to amounts actually borrowed and not repaid before the end of the taxable year, or whether it applies to all income or corpus which could have been borrowed if some borrowing occurs. <u>Compare Bennett v. Commissioner</u>, 79 T.C. 470 (1982) (grantor borrowed less than all of the income; held that grantor was taxable on portion of current year's income which the principal of the loan at the beginning of the year bears to the total trust income from the trust inception) <u>with</u> <u>Benson v. Commissioner</u>, 76 T.C. 1040 (1981) (grantor borrowed all income of trust owning real estate; held that grantor should be taxed on all trust income). Unless the grantor borrows the entire corpus, there can be no assurance that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

Because grantor trust status is predicated on actual borrowing, it would be possible to toggle grantor trust status on and off. If the grantor wanted to achieve grantor trust status in any particular year, the grantor could borrow all of the trust funds for some period of time during the year (if the trustee is not a related or subordinate party, the borrowing should not provide for adequate interest or security. However, if the trustee is a related or subordinate party, the borrowing could provide for adequate interest and security and still result in grantor trust status.) The grantor would need to repay the entire amount of the loan before the end of the taxable year, so that the grantor could make an independent decision in the following year whether the grantor trust status was desired in the following year.

d. <u>Power Exercisable in a Nonfiduciary Capacity to Reacquire Assets By Substituting Assets of Equivalent Value, § 675(4)(C)</u>.

(1) <u>Statutory Provision</u>. Section 675 provides that the existence of various administrative powers will cause a trust to be a grantor trust for income tax purposes. Section 675(4) lists several general powers of administration, which if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment.

One of those powers, listed in § 675(4)(C), is "a power to reacquire the trust corpus by substituting other property of an equivalent value."

(2) Grantor Trust as to Both Corpus and Income. Even though § 675(4)C) refers to a power to reacquire "trust corpus," this power causes the grantor to be treated as the owner of trust corpus and income (including ordinary income not allocable to corpus). Treas. Reg. § 1.671-3(b)(3).

(3) Nonfiduciary Capacity Determination. The regulations provide that "the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." Treas. Reg. §1.675-1(b)(4). The IRS has taken the position in several rulings that whether the grantor holds the power in a nonfiduciary capacity for purposes of § 675 is a question of fact to be determined by the district director after returns have been filed. Ltr. Ruls. 199942017, 9645013, 9525032, 9407014, 9352007, 9352004, 9337011, 9335028, 9248016, & 9253010. Other letter rulings have not applied the facts and circumstances requirement, but have held that the substitution power caused the trust to be a grantor trust. Ltr. Ruls. 9451056, 9352017, 9351005, 9345035. Some rulings have applied a compromise approach, stating that the grantor trust determination depends on the facts and circumstances but that, assuming exercise of a § 675(4)(C) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. E.g., Ltr. Rul. 9810019 (charitable lead trust).

(4) Trustee or Adverse Party Should Not Hold Power. Because grantor trust status depends upon the power being held in a "non fiduciary" capacity, the power of substitution should not be held by the trustee. Regulation §1.675-1(b)(4) provides that if a power is exercisable by a person "as trustee," there is a rebuttable presumption that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Similarly, a trustee's approval or consent should not be required (or else the requirement in the initial sentence of § 675(4) will not be satisfied.)

The power should not be held by an adverse party. Even though several clauses of § 675 require that a power be exercisable by a nonadverse party (§ 675(1) & (2)), § 675(4), which deals with general powers of administration, merely refers to powers held "by any person" without requiring that the power be held by a nonadverse party. However, Regulation § 1.675-1(b)(4) refers to powers of administration held in a nonfiduciary capacity "by any nonadverse party." [While it is difficult to understand how a beneficiary could possibly be adverse as to the decision of whether to exercise a substitution power, the general concept of an adverse party typically includes beneficiaries.] Despite the clear contradiction of the statute, it is possible that the regulation might be upheld under the broad deference standard announced in Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984). Accordingly, to be safe, the substitution power should not be held by a trust beneficiary.

(5) Grantor Substitution Power Generally Does Not Trigger §§ 2036, 2038; Revenue Ruling 2008-22. Revenue Ruling 2008-22, 2008-16 I.R.B. 796, provides very helpful guidance, indicating that a grantor non-fiduciary substitution generally will not trigger estate inclusion under §§ 2036 or 2038. The Ruling cites Jordahl, but says that it did not apply § 2038 because the decedent was bound by fiduciary standards. Even if the grantor is not bound

by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, it says that if the trustee thinks the assets being substituted have a lower value than the assets being reacquired, "the trustee has a fiduciary duty to prevent the exercise of the power." The ruling reasons that (1) the trustee "has a fiduciary obligation to ensure that the assets exchanged are of equivalent value," and (2) the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result from the substitution in view of the trustee's power to reinvest assets and the trustee's duty of impartiality regarding the beneficiaries.

The precise holding of the ruling states (the indentions and words in ALL CAPS are added for clarity):

> A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantors gross estate under §2036 or 2038, provided
>
> the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, AND
>
> further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. *[The Ruling does not suggest how that might occur,(perhaps an example would be swapping raw land for income producing property in a trust that provides mandatory income distributions) but it does provide some safe harbors against the possible shifting of benefits in the next sentence.]*
>
> A substitution power cannot be exercised in a manner that can shift benefits if:
>
> (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus AND a duty of impartiality with respect to the trust beneficiaries *[Observe, state law would generally impose both of these duties unless the trust instrument negates these duties]*; OR
>
> (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

Attorneys have differed as to drafting approaches to assure that the trustee must satisfy itself that assets of equivalent value are substituted and that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries. Some attorneys recommend relying on state law and general fiduciary principles. Other attorneys have suggested drafting those requirements into the trust instrument. In an initial reaction to the ruling, Jonathan Blattmachr and Michael Graham suggested the following:

> Without reducing or eliminating the fiduciary duties imposed upon the Trustee acting hereunder under the terms of this instrument or applicable law, the Trustee shall ensure the Substitutor's compliance with the terms of this power by being satisfied that the properties acquired and substituted by the Substitutor are in fact of equivalent value within the meaning of Rev. Rul. 2008-22; further, this power to substitute property shall not be exercised in a manner that may shift benefits among the trust beneficiaries within the meaning of Rev. Rul. 2008-22; without limiting the foregoing prohibition upon shifting benefits among trust beneficiates, the Trustee shall have the power to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries at all times while this power of substitution is in effect, within the meaning of Rev. Rul. 2008-22.

A somewhat more detailed example form clause is provided by Diana Zeydel, Miami, Florida, and Jonathan Blattmachr, New York, New York:

> During the settlor's lifetime, the settlor shall have the power, exercisable at any time in a nonfiduciary capacity (within the meaning of § 675(4) of the Internal Revenue Code), without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire the trust estate (other than any direct or indirect interest in stock described in § 2036(b) of the Internal Revenue Code or any policy insuring the life of the settlor) by substituting other property of an equivalent value, determined as of the date of such substitution.
>
> This power to substitute property is not assignable, and any attempted assignment will render this power void. Without reducing or eliminating the fiduciary duties imposed on the trustees under this agreement or applicable law, the settlor shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value and the trustees shall have a fiduciary obligation to ensure the settlor's compliance with the terms of this power to substitute property buy being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact or equivalent value, within the meaning of Revenue Ruling 2008-22.
>
> This power to substitute property shall not be exercised in a manner that can shift benefits among the trust beneficiaries within the meaning of Revenue Ruling 2008-22. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the trustees shall have the power to reinvest the principal of the trust and, except in the case of an Marital Trust, the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect, unless the trustees shall have absolute discretion in making distributions of principal and income among the trust beneficiaries so that the power to reinvest the principal of the trust and the duty of impartiality are not required in order to avoid this power of substitution potentially

causing a shift of benefits among trust beneficiaries, all with the meaning of Revenue Ruling 2008-22.

(6) Grantor Substitution Power Generally Does Not Trigger §§ 2036, 2038; Revenue Ruling 2011-28. There are concerns (and inherent uncertainty) as to whether a nonfiduciary substitution power will be treated as an incident of ownership if held by the insured over a policy on his or her life under § 2042.

(7) Grantor Retained Substitution Power Over Voting Stock. Many planners suggest providing that the power could not be exercised to acquire to any voting stock of a "controlled corporation" for purposes of § 2036(b). Rev. Rul. 2008-22 literally says that a grantor substitution power does not trigger §2036, which includes §2036(b). However, the discussion in Rev. Rul. 2008-22 does not specifically address voting stock of §2036(b).

(8) Substitution Power Held By Third Party. Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes. E.g., Ltr. Rul. 199908002 (grantor's brother held substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate). That concern is greatly diminished, in light of the issuance of Revenue Ruling 2008-22. However, if a planner is concerned about the potential application of §§ 2036(b) or 2042 (as discussed in paragraph (g), above), a third party substitution power might be used with respect to life insurance on the grantor's life of stock of a controlled corporation. In addition, allowing a third party to hold the substitution power could create additional flexibility to "turn off" or to "toggle" grantor trust status.

The statute and regulations would both literally suggest that the power of substitution can be held by a third party. I.R.C. § 675(4) (power "exercisable in a nonfiduciary capacity by any person"); Treas. Reg. § 1.675-1(b)(4) (referring to existence of powers of administration exercisable in a nonfiduciary capacity by "any nonadverse party"). However, the statute refers to the power to "reacquire" trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property.

Letter Rulings 199908002, 9810019, and 9713017 ruled that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. [If the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under § 4941(d).] Letter Ruling 9037011 gave one of the trustees a power to "acquire any property then held in trust by substituting property." The IRS similarly held that power caused grantor trust status. Those rulings did not address the statutory requirement of a power to "reacquire" trust assets.

Observe that the "reacquire" possible IRS argument does not exist if the grantor's spouse holds the substitution power, because any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules. I.R.C. § 672(e). However, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under § 672(e).

The IRS issued Rev. Proc. 2007-45 (inter vivos trusts) and 2007-46 (testamentary trusts) describing sample forms for charitable lead annuity trusts. Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status. Similarly, Rev. Proc 2008-45 uses the same approach for the sample inter vivos CLUT grantor trust form.

(9) Substitution Power Held by Grantor's Spouse. If someone other than the grantor can hold the substitution power (as discussed above), the grantor's spouse could be given the substitution power. For example, a spousal substitution power might be used for life insurance or voting stock of a controlled corporation. However, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under § 672(e). The "reacquire" possible IRS argument does not exist if the grantor's spouse holds the substitution power, because any power or interest held by the grantor's spouse is deemed to be held by the grantor for purposes of the grantor trust rules. I.R.C. § 672(e).

e. Power of Nonadverse Trustee to Make Loans to the Grantor and/or Grantor's Spouse Without Adequate Security, § 675(2). The mere existence of the power exercisable by the grantor or a nonadverse party that enables the grantor to borrow corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security, will confer grantor trust status. I.R.C. § 675(2).

If the grantor has the power to borrow funds either without adequate security or without adequate interest, the trust will be treated as a grantor trust. Grantor trust status can be achieved if the trustee has the power to lend unsecured, even if the loan provides for adequate interest. See Ltr. Ruls. 199942017 (grantor has authority to borrow all or any of the corpus or income "without adequate security"), 9645013, and 9525032. To avoid an argument that the grantor has retained a discretionary beneficial interest in the trust that would cause estate tax inclusion, the lending power should be limited to the authority to make loans without security, and should not include the authority to make loans to the grantor without adequate interest. Furthermore, in order to assure that the "adequate" requirement is satisfied, the power is typically drafted in a manner that would explicitly permit making loans without any security to the grantor.

A provision giving the grantor the power to make loans to himself or herself without adequate security would cause grantor trust treatment under § 675(2), but could risk estate inclusion for estate purposes if the IRS were to determine that the power gave the grantor the authority to receive trust assets for less than full and adequate consideration. To minimize this estate inclusion risk, the power should be held by a nonadverse party other than the grantor. The safest course would be to use someone who is not a "related or subordinate party" to the grantor, by analogy to Revenue Ruling 95-58, 1995-2 C.B. 191, which permits a grantor to remove a trustee without risking estate inclusion under §§ 2036 or 2038 as long as the replacement trustee must be someone who is not a related or subordinate party within the meaning of § 672(c).

f. Power of Nonadverse Party to Add Beneficiaries, § 674(b), § 674(c), § 674(d). Section 674(a) states the general rule that a grantor is treated as the owner of the trust the beneficial enjoyment of which is subject to a power of disposition. Exceptions are provided in §§ 674(b), 674(c), and 674(d). The provisions for many of those exceptions provide that the exceptions will not apply if "any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children". E.g., I.R.C.§ 674(b)(5)-(7), (c), (d). If such a power to add beneficiaries exists, the exceptions provided in § 674(b), (c), and (d) will not apply, so the general rule in § 674(a) provided for grantor trust treatment would apply.

There is no requirement that the person who holds the power to add beneficiaries be a nonadverse party. However, a beneficiary should not hold the power to add non-charitable beneficiaries, or else gift consequences might result from its exercise. The grantor should not hold the power to add beneficiaries because that retained power would cause the transfer to result in an incomplete gift. Treas. Reg. § 25.2511-2(c), (f). In addition, the assets may be included in the grantor's estate under §§ 2036(a)(2) or 2038. The power could be held by the grantor's spouse without risking estate inclusion as long as no property is contributed to the trust by the spouse and as long as the spouse is not controlled by the grantor. (However, a successor holder of the power should be provided or else the death of the spouse could cause a termination of grantor trust status.)

Document that the person who holds the power is aware of its existence, to show that the power is not "illusory." Consider actually exercising the power at some point, to show that it is not "illusory" such as by adding the spouse of a particular beneficiary as a potential discretionary beneficiary. Typically, the power to add beneficiaries is discontinued following the grantor's death. A possible planning strategy might be to provide that the person who has the power to add beneficiaries also has the power to remove any beneficiary that was added as a potential beneficiary by that same person. Another possibility if there is a desire to keep as much flexibility as possible would be to give someone the power to add a beneficiary for that particular calendar year.

g. Inter Vivos Power of Appointment. Carlyn McCaffrey suggests giving a third party (who is not a trustee and is not a beneficiary) a presently exercisable power of appointment, at least during the grantor's lifetime. The third party must be a nonadverse party (so a beneficiary cannot hold the power). Because the person is not a trustee, the exception in § 674(c) would not apply. [Consider using a related or subordinate party if there is any concern that the power may be deemed to be held in a fiduciary capacity; in that event, § 674(c) still would not apply.] Because there is no standard, the exception in § 674(d) would not apply. The testamentary power of appointment exception in § 674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in § 674 would apply, so the general rule of § 674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the asset. Provide a succession of power holders during the grantor's lifetime—so that the trust will continue as a grantor trust if the initial power holder dies before the grantor.

h. Converting Non-Grantor Trust to Grantor Trust. Possible ways of converting a non-grantor trust to a grantor trust include the following:

- If the trust allows distributions without an ascertainable standard, change trustees so that more than half of the trustees are related or subordinate parties (§ 674(c)). [This strategy can also be used to toggle between grantor trust and non-grantor trust status.]
- Turn the trust into a foreign trust (§ 679) [but many other complexities arise with being a foreign trust].
- Actual borrowing of assets from the trust by the grantor without giving adequate security (§ 675(3)). (See Section VIII.B.14.c of this outline for a more detailed discussion of this alternative.)
- Court modification or modification by consent of the grantor and all beneficiaries that is recognized by state law to reform the trust in a manner so that it becomes a grantor trust [Letter Ruling 200848017 held that a reformation recognized under state law to add a grantor nonfiduciary substitution power would result in a trust being treated as a grantor trust; the ruling expressed no opinion as to whether the modification or any future substitution of assets would have federal gift tax consequences gift tax consequences.]
- "Decant" to a trust that is a grantor trust (if decanting is permitted under the instrument or local law).

Grantor Trust Conversion During a Year. If a non grantor trust is converted into a grantor trust, as of what date does it become a grantor trust? Generally, the trust does not become a grantor trust for the entire year, but only for a fraction of the year. However, for some triggers (such as borrowing from the trust), the trust would become a grantor trust for the entire year.

i. Summary of Selection of Trustee Issues With Respect to Grantor Trust Rules. The trust will be a grantor trust if the trust may make distributions to the grantor or grantor's spouse (probably only as to trust income) or if premium payments may be made on life insurance on the life of the grantor or grantor's spouse (probably only as to the amount of premiums actually paid during the year.)

If the planner wants to avoid grantor trust status, use one of the following exceptions: (1) Use an independent trustee (no more than half of whom are related or subordinate parties) and give them the authority to distribute assets among a designated class of beneficiaries; (2) Use a trustee other than the grantor or grantor's spouse, whose distribution powers are limited by a reasonably definite external standard; (3) With no limitation on who is the trustee—as to corpus use a reasonably definite distribution standard (or have separate shares for the beneficiaries), and as to income, either have (i) a vested trust for a single beneficiary, (ii) provide that the income must ultimately pass to current income beneficiaries in irrevocably specified shares, or (iii) provide that on termination the assets may be appointed to appointees (other than the grantor or grantor's estate) if the trust is reasonably expected to terminate during the current beneficiary's lifetime; (4) Use an adverse party as trustee. Even if one of those exceptions is satisfied, also make sure the trust is not a foreign trust and that none of the proscribed administrative powers in § 675 are present.

If the planner wants to trigger grantor trust status, use one (or more to be safe) of the following: (1) Select trustees and dispositive powers to flunk all of the exceptions in § 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions and distributions are charged against the trust as a whole, not against a beneficiary's share; one method is to name the grantor's spouse as trustee with those trust provisions (as long as the spouse does not have a legal obligation to support any beneficiary and the spouse is not a beneficiary); (2) Give the grantor or some other nonadverse party a substitution power in a nonfiduciary capacity (realizing that the IRS takes the position that whether it is exercisable in a nonfiduciary capacity is a fact question, to be determined in every case); (3) Give a nonadverse party the power to add beneficiaries who are not after-born or after-adopted children (with another nonadverse person serving as trustee); (4) Give a nonadverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan; (5) Give a non-beneficiary/non-trustee person an inter vivos limited power of appointment over both principal and income of the trust.

C, <u>Grantor Trust Issues With Life Insurance Trusts</u>.

1. <u>Transfer to Grantor Trust Does Not Violate Transfer for Value Rule; Rev. Rul. 2007-13</u>. The IRS has ruled privately in various rulings that transfers of a life insurance policy among grantor trusts do not trigger the transfer for value rule. Letter Rulings 200514001, 200514002, 200518061, and 200606027 all held that an exchange of a policy between grantor trusts was not a taxable event and did not trigger the transfer for value rule because the grantor was the treated as the owner of both trusts for income tax purposes. Some of the rulings have also relied on the "same basis" exception in the transfer for value rule [§ 101(a)(2)(A)].

   Life insurance proceeds are generally excludable from income under § 101(a)(1), but if the policy has been transferred for consideration, the death proceeds are taxable income to the extent the proceeds exceed the consideration paid for the policy and premiums or other amounts later paid by the purchaser of the policy. I.R.C. § 101(a)(2). There is an exception to the transfer for value rule if the policy is transferred to the insured, a partner of the insured, a partnership of which the insured is a partner, or a corporation in which the insured is a shareholder or officer. I.R.C. § 101(a)(2)(B).

   Rev. Rul. 2007-13, 2007-1 C.B. 684, addresses a transfer of a policy between grantor trusts and from a non grantor trust to a grantor trust. Rev. Rul. 2007-13 covers two situations. In Situation 1, the ruling reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts. The "wholly-owned" term apparently means that the trust is a grantor trust as to both income and principal of the trust, and that the grantor is the only grantor of the trust. <u>Cf</u>. <u>Swanson v. Commissioner</u>, 518 F.2d 59 (8th Cir. 1975) (transfer of policy to a grantor trust did not constitute a transfer for value, but only to the extent of the grantor's 91% of contributions to the trust).

   In Situation 2, the ruling reasons that the sale of the policy from a non-grantor trust to a grantor trust is a "transfer" for income tax purposes. [Accordingly, the sale could generate taxable gain if the consideration paid exceeds the owner's basis in the policy. While the ruling does not specifically address the gain issue, other private letter rulings have addressed that transfers between two grantor trusts do not result in gain recognition. <u>E.g.</u>, Ltr. Rul. 200606027.] However, the ruling concludes that the transaction is treated as a transfer to the grantor, so the "transferred to the insured" exception to the transfer for value rule applies if the policy insures the grantor's life. We've been waiting since Swanson for the IRS to rule that "grantor trust equals the insured" for transfer for value purposes. This was particularly important in Situation 2, because the ruling could not rely on the "same basis" exception to §101, but had to conclude that the transfer was treated as a transfer to the insured-grantor.

2. Reconfirming Position That Grantor Is Treated as Owner of Trust Assets For Income Tax Purposes. The IRS officially restates its often cited 20-year-old position in Rev. Rul. 85-13, 1985-1 C.B. 184, which treats the grantor as the owner of the trust assets of a grantor trust for income tax purposes. [Some commentators have suggested that the grantor trust rules are now being used proactively by taxpayers and that the IRS may seek to retreat from that position at some point. This ruling reiterates that the IRS is not changing its position anytime soon.] Therefore, transfers between grantors and grantor trusts do not trigger gain for income tax purposes.

3. Advantages of Transferring Policies Between Trusts. Transfers of policies to or between grantor trusts are very helpful for two reasons. First, sales of policies may help avoid the three-year rule of § 2035 that generally applies if an insured gives a life insurance policy on his life within three years of his subsequent death (and the ruling makes clear that a sale can be made to a grantor trust without violating the transfer for value rule.) There is an exception from the three-year rule under § 2035(a)(2) if the transfer is for full consideration. [This may be more than the gift tax value, and should take into consideration the value of the policy in the secondary market for insurance policies.] Furthermore, the IRS might argue, based on the old Allen case, that the full consideration exception to § 2035 only applies if the amount of the consideration is the amount that would otherwise have been included in the grantor's gross estate. See United States v. Allen, 293 F.2d 916 (10th Cir. 1961). However, the IRS has ruled privately that sales of policies for their gift value would not require inclusion in the gross estate under § 2035 if the insured died within three years of the sales. E.g., Ltr. Rul. 9413045 (sale of policies for interpolated terminal reserve value plus the value of any unexpired premiums). Interestingly, the ruling did not cite Allen. A difference with Allen is that a transfer of a life insurance policy requires future investment to bring it to fruition. Even if Allen does not apply, what is the value of the policy for purposes of the full consideration rule in § 2035? The interpolated terminal reserve value was developed when the only cash value life insurance was whole life. However, for a universal policy, it is not clear that additional premiums will be paid. So, it is safest if the policy is issued directly to the trust; but if that is not done, a sale may avoid the three year rule and a sale is permitted without violating the transfer for value rule if the transfer is to a grantor trust.

   Second, a transfer to a new grantor trust may provide helpful flexibility if the insured decides that he or she becomes unhappy with the terms of the original irrevocable trust (and may be unwilling to contribute additional gifts for paying future premiums.) The existing trust might sell the policy to a new grantor trust having acceptable trust terms. [The trustee of the selling trust would have to exercise diligence to assure that the trust is receiving full value for the policy.] The transfer to the new wholly-owned grantor trust would not trigger the transfer for value rule.

4. Planning Concerns With Transfers Between Trusts. There are several reasons to be cautious with these kinds of transfers between trusts:

   1. The sale should be at fair market values, and the life settlement industry might suggest higher prices than just the cash surrender value. [The regulations under §2042 refer to the cost of a comparable policy.]

   2. If a beneficiary thinks the trust sold the policy for too low a price, there are fiduciary liability possibilities.

   3. Make sure that the trusts are grantor trusts or else the transfer for value rule may cause the proceeds to become taxable.

   4. A typical plan is to move a policy from an old "bad" trust to a new "good" trust. If the "good" trust is better because it cuts out certain beneficiaries or restricts the rights of beneficiaries, there may be fiduciary liability concerns that individual trustees often totally overlook.

5. Using Partnership to Assure Transfer for Value Rule Not Violated. Some attorneys like to have a partnership in which the trust and grantor are partners. In case it is not a grantor trust for some reason, the transfer is still protected from transfer for value rule under the partnership exception in § 101(a)(2)(B). There have been several private rulings where the partnership was formed moments before the transfer for that purpose—and IRS still held it worked. (But reliance on that position would not seem appropriate in the planning stage.) A simpler solution would be for the grantor trust and the insured to buy units of a master limited partnership. However, that may not work. The legislative history to § 101 suggests that § 101 refers to a true partnership of partners joining together and not an investment vehicle.

6. Transfer to Insured (or Grantor Trust) Cleanses Prior Transfer for Value Problems. The regulations under § 101 say that if a policy is transferred to the insured, that cleanses all prior transfers for value. Treas. Reg. §§ 1.101-1(b)(3)(ii) & 1.101-1(b)(5) Ex. 7. So if there has been a transfer for value "hiccup' somewhere in the history of the policy, the problem can be cleansed by a transfer to a grantor trust.

7. Achieving Grantor Trust Status for Life Insurance Trusts. If the trust does not prohibit paying premiums on life insurance policies on the life of the grantor, is that sufficient to make the trust a grantor trust? [One attorney has reported having an agent take the position that trust is a grantor trust if it does not expressly prohibit paying life insurance premiums of the life of the insured, because the trustee would have the authority to purchase a policy.] See I.R.C. §677(a)(3).

D. Section 678—Income Taxed to Beneficiary As Owner Under Grantor Trust Rule; "Beneficiary Controlled Trust". If the trust does not contain any provisions that would cause the original grantor to be treated as the owner of the trust for income tax purposes under the grantor trust rules, a beneficiary who has a withdrawal power over the trust may be treated as the owner of the trust for income tax purposes under § 678. The IRS generally treats the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under § 678(a)(1) while the power exists and under § 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. See Ltr. Ruls. 200011058, 200011054 through 200011056, 199942037, & 199935046.

   The IRS's position under § 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power. This arguably is not the same as the mere lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" is a result of a passive nonexercise of a power. Furthermore, the gift and estate tax statutes make a distinction between lapses and releases. [Sections 2041b)(2) and 2514(e) provide that "the lapse of a power … shall be considered a release of a power."] Despite this argument, the IRS clearly treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.

A further complication is that under § 678(a), grantor trust treatment applies to "any portion" of a trust as to which the power of withdrawal exists and has been released while reserving control that would cause §§ 671-677 to apply if such person were the grantor of the trust. The regulations discuss the "portion" issue in Treas. Reg. §1.671-2(e)(6) Ex. 4. In that example, the beneficiary holds an unrestricted power to withdraw "certain amounts contributed to the trust." The example concludes that the beneficiary is treated as an owner of "the portion of [the trust] that is subject to the withdrawal power." Some planners believe that the "portion" refers to a fractional interest rather than an amount, so that if all gifts are subject to withdrawal power by the beneficiary, the entire trust would be treated as owned by the beneficiary under § 678. However, the term "portion" might refer to as the amount that can be withdrawn by the beneficiary, which would exclude growth in the trust from the time of the contribution to the time of the release of the withdrawal right. Under that view, if the initial contribution of $20,000 is covered by a withdrawal power, but the trust is worth $100,000 at the beginning of year 2, only 20,000/100,000, or 20% of the trust would be treated as owned by the beneficiary in year 2. [Observe that under this approach, in all of the private letter rulings that have been issued treating the Crummey powerholder as the owner of a trust owning S stock, there would no longer be a wholly grantor trust if there were any growth in the assets before the withdrawal power lapsed, which would cause the trust no longer to be a qualified S shareholder under the grantor trust exception. None of the S stock/Crummey trust PLRs have even hinted at that limitation. Furthermore, this approach would require revaluing Crummey trusts each year in order to determine the portion of the trust hat is attributable to the powerholder and the portion that is attributable to the trust. It presents an administratively unworkable reporting requirement.]

For example, a client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The beneficiary would be treated as the owner of the entire trust for income tax purposes under § 678. Because the beneficiary never contributes anything to the trust, the trust assets would not be included in the beneficiary's estate, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary's creditors if it contains a spendthrift clause. Furthermore, the trust could give the client a broad limited testamentary power of appointment. In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client's estate for estate tax purposes and cannot be reached by the client's creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise result from the assets that were sold to the trust) to interest on the note. Furthermore, if the trust gives the client a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. [The trustee could then divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.] The trust can deplete the client's other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating "a freeze, a squeeze, and a burn." The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client's other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client's parents or other relatives, the planner may decide to use guarantees to support a large sale to the trust for a note and to have the trust pay fair value for the guarantees. For an excellent discussion of planning considerations, see Oshins, The Beneficiary Defective Inheritor's Trust ("BDIT") (2008).

IX. FINANCED NET GIFT STRATEGY AS ALTERNATIVE TO INSTALLMENT SALE TO GRANTOR TRUST OR OTHER PLANNING STRATEGIES.

At various seminars, David Handler has presented an intriguing idea of using net gifts in place of installment sales in appropriate circumstances. The general idea is that the donor makes a net gift and agrees to finance the donee's gift tax liability. The gift tax is about 31% of the gross value transferred (with a 45% rate), so the note back to the donor is 31% of the transferred value rather than 90% as it would be in the traditional gift/sale to grantor trust transaction. (Under the 35% gift tax rate that applies in 2010, the effective net gift tax rate is 26%.) The following discussion is a summary of David Handler's creative ideas. Handler, "Alternative Planning Strategies to Enhance GRATs and IDGTs: Decreasing Short-Term GRATs and Financed Net Gifts as an Alternative to Sales", 67th N.Y.U. Institute of Federal Taxation ch. 17 (2008); Handler, "Financed Net Gifts Compared to Sales to Grantor Trusts," 44th Annual Heckerling Institute on Estate Planning ch. 17 (2010).

A. Net Gift Basics. "Gift tax paid by the donee may be deducted from the value of transferred property where it is expressly shown or implied that payment of tax by the donee or from the property itself is a condition of the transfer." Rev. Rul. 75-72, 1975-1 C.B. 310. The donees agree to pay any gift tax, including gift tax resulting from a gift tax audit. The gift could be outright to donees or to a grantor trust (David typically uses grantor trusts as the donees).

The formula for determining the net gift tax rate is Tentative tax/(1 + Rate of tax). For a 45% gift tax rate, the effective net gift rate is .45/1.45, or .310344. (Check it: The gift is .689655, so the gift tax is .689655 x .45, or .310344.) For a 35% gift tax rate that applies in 2010 (unless the rate is changed retroactively), the effective net gift rate is .35/1.35, or .259259.

B. Financed Net Gift. The donor may agree to loan funds to the donee to pay the gift tax. The loan could be made at the AFR. For example, in February, 2010 the mid-term rate is 2.82%, so the note could be financed with a 9-year 2.82% note.

C. Installment Sale to Grantor Trust. Possible disadvantages of the sale to grantor trust approach include the following.

1. Seeding Required. The grantor trust must have a "sufficient" amount of equity under debt-to-equity concepts. Traditionally, 10% seeding is used. This may require a gift of the about 11.1% of the amount to be sold (so the debt to equity ratio will be 9 to 1).

2. Potential § 2036 Inclusion. Is the overall transaction really a transfer with a retained interest? The IRS has not been successful in making that argument. However, if the payment on the note is equal to the income, it may look like a transfer with a retained income interest.

3. Cash Flow. Most planners recommend that at least the interest be paid each year, and there may not be enough cash flow to make even the interest payment. If an FLP interest is sold, making an in-kind payment is difficult.

4. Leveraged Investment Risk. The biggest risk is the investment risk that is amplified by leverage. If there is 90% leverage, a decline of only 10% of the value of the transferred asset wipes out the trust. "In today's world, that can happen in a weekend." If the trust loses 10% in value, it must grow by 11.1% to get back to even. Leverage amplifies gains, but it also amplifies losses.

5. Rest of Estate; Large Note Still in Estate. An installment sale is a classic freezing transaction. The value at the time of the transfer is still in the estate. The large note value is still subject to estate tax. The sale does not shrink the estate.

D. Advantages of Financed Net Gift Compared to Sale.

1. Simplicity. The transaction can be as simple as giving stock to children and having them sign an agreement that they will pay the gift tax, and then having a simple note to document the loan from parent to children to pay the gift tax.

2. Tax Exclusive Gift Tax Rate. The effective gift tax rate is 31% (assuming a 45% federal gift tax rate) compared to the estate tax rate of 45%, if the donor lives at least three years after making the gift.

3. Shrinks Estate Value. The entire estate value of the transferred property is no longer subject to estate tax. ([he note from the donee is included in the estate, but that is offset by the decrease in value of the cash the donor transferred to the donee to pay the gift tax.] If the state does not have a state gift tax (most don't), the state tax is avoided entirely. Another way of stating this is that the net gift transaction shrinks the estate value; it does not just freeze the value. The value of transferred assets actually reduces the estate subject to estate tax by that amount — at a current gift tax cost to the family of a 31% rate. A sale transaction is simply a freezing transaction. The current value of the estate, represented by the note, is still in the estate.

4. Less Cash Flow Required. The note amount is only 31% of the value transferred, not 90% of the value transferred. The annual interest is obviously about a third as

much, making it more likely that cash flow from the asset will be sufficient to pay all interest as well principal on the note to the donor.

5. Principal Balance Much Lower. The principal balance of the note (which will be included in the donor's estate) is about a third of the principal balance of the note in a typical sale to grantor trust transaction.

6. Debt to Equity Ratio. If the gift is made outright to donees, there is no debt to equity limit. If the gift is made to a grantor trust, the trust will by the nature of the transaction have sufficient seeding; the debt will only be about 45% of the trust's equity value (i.e., for a financed net gift of $100, the trust will have $100 less $31 gift tax, or $69 of assets and will owe a note for $31.) This is far different than the sale to grantor trust transaction where the note amount is typically 90% of the value of assets in the trust.

7. Smaller §§ 2702 and 2036 Risks. Because the debt is much smaller, it is much harder for the IRS to argue this is a transfer with a retained interest. Indeed, nothing is retained. Any loan to pay gift tax would not be made until several months or possibly more than a year later.

8. Flexibility. Until the gift tax return is filed, the donor could decide to pay the gift tax.

9. Decreased Leverage Means Less Risk. It would take a huge decline in the asset value to wipe out the transfer, as compared to a mere 10% decline that wipes out a sale to grantor trust transaction.

10. Valuation Risk on Audit Is Reduced. With a sale to grantor trust, every dollar of increased value results in an additional $0.45 gift tax. For the net gift transaction, every dollar of increased value increases the gift tax by $0.31. (For gifts in 2010 the comparable amounts are $0.35 and $0.26, respectively.)

    The legal issue raised is whether the additional gift tax on audit can also be subject to net gift treatment. Estate of Armstrong v. United States, 277 F.3d 490 (4th Cir. 2001), suggests perhaps not. However, the facts in that case were unusual—the donees did not agree to pay all gift tax, but just the increased tax on audit. Furthermore, the donees did not actually pay the tax later, so the court understandably held that the arrangement was illusory. The McCord case addressed a case where the donees agreed to pay any additional gift tax and estate tax if the donor died within three years. The court agreed that was not speculative and reduced the gift value by the three year risk element.

11. Gift Tax Portion of Net Gift Can Be Discounted. "If all of the net gift consists of assets subject to valuation discounts, such as stock in a closely held company or limited partnership interests, the benefit of a net gift is even greater. The 31% of the assets transferred to cover the gift tax are valued at a discount and not subject to gift tax, although the trust will pay the tax using cash borrowed from the donor." Assume a transfer of LP units representing underlying value of $1,000,000, but valued with a 35% discount at $650,000. The net gift is $448,000 and the gift tax is $202,000. Therefore, 31% of the $650,000 is to cover the gift tax and is not a gift. The undiscounted value of 31% of the units, is $310,000, so the trust receives an additional $310,000 less $202,000, or $108,000, that is not subject to gift tax.

E. Disadvantages of Net Gift Approach.

1. The Obvious: Payment of Gift Tax. The gift tax must be paid in cash by April 15 of the following year.

2. Possible Income Tax. Unless the net gift is made to a grantor trust, the donor will recognize capital gain to the extent the gift tax liability exceeds the donor's adjusted basis in the property transferred. Diedrich v. Commissioner, 457 U.S. 191 (1982). This can be avoided with gifts to grantor trusts; David Handler usually does these transactions with grantor trusts.

3. Legislative Change. There is the risk that the estate tax will be repealed (either actually or effectively for the client if increased exemptions exceed the client's estate).

4. Three Year Rule. If the donor dies within three years of making the gift, the gift tax paid is brought back into the estate under § 2035(b). (This is not actually a disadvantage. This would just remove the advantage of being able to use the tax exclusive gift tax rate for the transfer.) The three-year rule applies even if the donees pay the tax — because they are merely paying the donor's gift tax liability. The Estate of Samuel and Estate of Sachs Tax Court cases confirm that result.

   Possible planning strategies to deal with the three-year risk: (1) buy a three-year term policy to insure against the risk; or (2) loan money to the trust in the form of a SCIN. (If the donor dies within three years, the note is cancelled. The gift tax is brought back in the estate, but the note in that same amount is cancelled; so there is a complete offset. The downside of a SCIN is having to pay a premium interest rate over the AFR. However, for a three-year note, the actuarial risk of dying within that short time frame is very low (unless the donor is very old), so the interest rate bump is small. Furthermore, the rate is currently so low (the short term AFR in February 2010 is 0.72%), that even if the rate is doubled or tripled it is still extremely low.

F. Trust Can Be ESBT. One of the requirements for an ESBT is that no interest in the trust can have been acquired by purchase. The regulations were clarified to say that if *beneficiaries* of the trust pay the gift tax, an interest in the trust has been acquired by purchase, but if the *trustee* pays the tax, no *interest in the trust* has been acquired by purchase.

G. Example Actual Client Situations.

1. Especially Suited for Surviving Spouses. This strategy is particularly persuasive to a surviving spouse. The estate tax is more imminent (because if both spouses are alive, the estate tax is not due until both spouses have died).

2. Client Who Has Had Sales "Fail" in Past. David Handler has a surviving spouse with $300 million who made a $100 million net gift. The couple had done sales in the past, but the spouse did not want to be "nowhere" in five years, having transferred nothing, if the values did not appreciate.

3. Hedge Fund Managers. Two 45-year-old partners ran a hedge fund and trading firm. After discussing GRATs, sales and net gifts, the clients did the math in their heads before David Handler could discuss it. They came to the conclusion this is the only strategy that makes sense. They are doing a $10 million net gift. By the time they die, there will likely be $80 million in their trusts. They believe they don't need to do anything else for their families; they can leave the rest of their estates to charity.

X. LIMITING GIFT TAX EXPOSURE BY USING DEFINED VALUE GIFTS AND SALES.

A. General Description of Defined Value Clauses. In making transfers of hard-to-value interests, such as limited partnership interests in an FLP, some planners have structured gifts or sales of a specified dollar amount of limited partnership interests. One attorney has analogized this to going to a gas station and asking for $10 worth of gasoline. While that seems straightforward enough (and is strikingly similar to marital deduction formula clauses that are commonly accepted in testamentary instruments), the IRS objects, largely on the grounds that the clause would make IRS gift tax audits meaningless.

There are two general types of defined value clauses, “formula transfer clauses” and “formula allocation clauses.”

1. Formula Transfer Clause. A “formula transfer clause” limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula). An example fractional formula transfer clause (with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes) is as follows:

> I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the “Gift Tax Value”) over $100,000. The denominator of the fraction is the Gift Tax Value of the property.

McCaffrey, “Tax Tuning The Estate Plan By Formula,” 33rd Annual Heckerling Institute on Estate Planning ¶ 402.4 (1999).

2. Formula Allocation Clause. A “formula allocation clause” allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, “incomplete gift trusts” (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and “zeroed-out” GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the McCord and Hendrix cases used the second type of clause with the allocation being based on a “confirmation agreement” among the transferees. The two recent cases have both involved clauses that were based on finally determined estate (Christiansen) or gift (Petter) tax values.

The IRS’s primary position is that these types of clauses should not be recognized for tax purposes on public policy grounds because they reduce the IRS’s incentive to audit returns.

B. Planning Observations.

1. Four Cases Recognizing Defined Value Clauses. Four cases have now recognized the validity of defined value clauses (or analogous formula disclaimers), McCord, Christiansen, Hendrix, and Petter. Three of those are courts of appeal cases, McCord (5th), Christiansen (8th), and Petter (9th). All four of these cases have involved situations in which the excess amount over a defined value passes to charity. At least in that circumstance, it would seem that the IRS would recognize the validity of defined value clauses, or risk the possible assessment of attorney's

fees for continuing to assert the same argument in the face of consistent contrary court decisions.

Christiansen, the Petter Tax Court case, and Hendrix all addressed the public policy issue. The 5th Circuit McCord Tax Court decision did not, although a majority of the Tax Court judges in the case seemed to have no problem with the public policy concerns in McCord. The McCord and Petter circuit level opinions did not address the public policy issue.

2. John Porter Victories. The taxpayers in all four of these cases have been represented by John Porter.

3. Basic Advantages/ Disadvantages of Using Defined Value Clauses. The basic advantage of using the defined value transfer is creating the ability to make lifetime transfers without risking having to pay current gift taxes. Disadvantages include: (1) whether the defined value clause is a red flag that triggers or intensifies a gift tax audit; (2) complexities of administering the defined value clause; and (3) if the IRS does not respect the clause, there may nevertheless be an adjustment of the amount of assets passing to the family trust (with more assets passing to a charity or other "pourover" party) even though no tax benefits result from the adjustment.

4. Jeff Pennell Observations (At 2012 Heckerling Institute).

    a. Prefers "As Finally Determined for Gift Tax Purposes" Approach. Jeff views the Petter approach as the cleaner and the more "arm's length-good faith" approach, as opposed to the McCord-Hendrix confirmation agreement approach. The Petter approach is very similar to the standard every day testamentary formula marital deduction clause.

    b. IRS May Regulate Against Defined Value Clauses. The IRS will likely issue regulations that generally will not respect inter vivos defined value transfers for gift tax valuation purposes. He thinks the IRS will follow up on the invitation by the 9th Circuit in Petter: "we expressly invite the Treasury Department to 'amend its regulations' if troubled by the consequences of the resolution of th[is] case [quoting the U.S. Supreme Court in Mayo Foundation, 131 S. Ct. 704, 713 (2011)]. (However, the 9th Circuit was specifically addressing the condition precedent charitable deduction regulation rather than the general public policy/Procter issue.) [Akers observation: It would seem that the IRS will have great difficulty in refusing to respect inter vivos defined value transfers in light of the fact that it has respected almost identical testamentary transfers for decades. Distinguishing those two situations seems very difficult.]

5. Dennis Belcher Observations (At 2012 Heckerling Institute).

    a. Also Prefers Petter Approach. Dennis also agrees that the Petter approach is the cleaner approach.

    b. Like "Taking Aspirin." Clients who want to make large gifts of hard to value assets, and who have charitable goals, should consider using defined value clauses. They should be viewed as a normal everyday alternative, like taking aspirin. Some are concerned that this creates a red flag for the IRS but Dennis does not believe so. "You're in the soup anyway." He thinks we should be using them for large transfers this year.

c. May Have Limited Shelf Life. These clauses may have a limited shelf life because the Service may come in — someway, somehow; "but it's going to be pretty hard for the Service to nail them."

6. Public Policy Argument. In McCord, the IRS did not raise the public policy argument on appeal. In Petter, the IRS did not raise the "stand-alone" public policy argument under the Procter case on appeal. However, the IRS did make arguments that "numerous public policy concerns" should support the application of the gift tax regulation to deny a charitable deduction for additional units passing under the defined value clause. Indeed, the oral argument before the Ninth Circuit was filled almost totally with public policy arguments, and all three judges on the panel seemed to have fun in criticizing the government's position. (For a summary of the *Petter* oral argument before the Ninth Circuit, see http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Content/Akers%2520Insights/06_2011_Petter%2520Oral%2520Argument%2520Summary.html.)

   It is particularly interesting that in both inter vivos transfer defined value cases that have been appealed to federal courts of appeal, the IRS has opted not to make its general public policy argument. One wonders why the IRS is reluctant to raise this argument before appellate courts, and whether it will ever do so.

7. Defined Value Gift Transfer Should Not Disqualify Gift for Annual Exclusion. Is a gift of a formula determined amount a present interest qualifying for the annual exclusion? At the moment of the transfer, the precise final number of units that the donee is receiving under the formula is not determined. Nevertheless, Jeff Pennell does not think this is a problem.

8. McCord-Confirmation Agreement Approach vs. Petter-Finally Determined Gift Tax Value Approach. Two approaches have emerged for structuring these defined value clauses to allocate the block of transferred assets among the family trusts and the charity (or other donees that would not generate gift tax consequences). McCord and Hendrix used an approach allocating the shares based on a "confirmation agreement" among the transferees. Christiansen and Petter used an approach of allocating the block of transferred assets based on values as finally determined for estate (Christiansen) or gift (Petter) tax purposes.

   a. Agreement Approach. One advantage of the confirmation agreement approach is that actual sales or transactions are generally the best indicators of value, and that approach involves actual negotiated agreements among independent parties as to the amounts received. Another advantage is that the parties can reach finality rather quickly as to what the parties receive rather than having to wait for years for the finally determined gift tax value to determine how many units of the transferred asset each party receives.

      In McCord, the Tax Court did not recognize the agreement approach for purposes of determining the gift tax values of the shares involved. The Tax Court held that the specific formula was not "self-effectuating." The Tax Court's reasoning is difficult to follow, but is based on the fact that the formula is not tied to values as finally determined for gift tax purposes, but fair market values as determined by the parties. Under the court's reasoning, the parties to the assignment documents were supposed to determine what interests passed to the various parties "based on the assignees' best estimation" of the value. The Tax Court gave effect to the percentage interests agreed to by the parties but did not find those values to determine the gift tax value of the property transferred. The Tax Court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes," the court "might have reached a different result." The Tax Court was reversed by the 5th Circuit, because it viewed the Tax Court as impermissibly looking to events occurring after the sale date. The end result was that the 5th Circuit did recognize the effectiveness for gift tax purposes of a formula allocation clause that gave a dollar amount to donees even though it provided for funding based on the agreement of the parties. Hendrix relied on the 5th Circuit's decision in McCord to avoid that issue, but it still might be raised in cases appealable to other circuits. The Tax Court's initial rejection of the agreement approach, suggesting that a different result may have been reached if the formula allocation was based on values as finally determined for gift tax purposes, causes planners to question whether that latter type of clause might be preferable.

To some degree, this concern is illustrated by the Hendrix court's concluding paragraph, as discussed above. The Hendrix opinion does not directly address why the gift tax value passing to the family trusts should be based on $36.66 per share rather than some higher value, even though the formula allocation is respected for purposes of determining how many shares passed to each of the respective parties. That uncertainty does not exist with the "as finally determined for tax purposes" approach.

Furthermore, the taxpayer's public policy argument in some ways seems stronger with an approach allocating values based on values as finally determined for tax purposes. The Hendrix analysis of the public policy issue was extremely brief, omitting some of the reasons given in Christiansen and Petter. For example, Hendrix did not respond to the arguments from Procter that the clauses should be ignored on public policy grounds because they involve a moot issue and merely result in a declaratory judgment. Petter reasoned that those two reasons cited by Procter do not rise to the level of a "severe and immediate" threat to public policy. Petter reasoned that its case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment. That reasoning does not apply in a confirmation agreement-type approach.

b. "As Finally Determined for Gift Tax Purposes" Approach. While there may seem to be somewhat more certainty regarding the validity of these "as finally determined for gift tax purposes" types of clauses in light of the reasons discussed immediately above, be aware that there are potential disadvantages of this approach. The number of units passing under the formula transfer provision may not be resolved for years, until the final conclusion of a gift tax audit (and resulting litigation, if any). There could be underreporting and overreporting of income for income tax purposes by the respective transferees during the period of uncertainty. (This is a reason why all family trusts involved with the transaction should be grantor trusts so that all of the income is reported on the grantor's income tax return, regardless how shares are allocated to each party if all parties to the transaction are family trusts.) Furthermore, the gift tax audit itself will determine the number of shares passing to the charity (or other entity that does not result in the creation of a taxable gift). The family may feel more comfortable negotiating with the charity (or other "non-taxable" entity) in a real life context rather than using the values determined in a gift tax audit for that purpose.

9. Impact of Charity as "Pourover" Recipient. Is it essential that the "pourover" party be a charitable entity rather than a family "non-taxable" entity (such as the donor's spouse, a QTIP trust for the donor's spouse, a GRAT, or an "incomplete gift trust" that does not result in a current completed gift for gift tax purposes)? McCord, Christiansen, Petter and Hendrix all address formula clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. Hendrix gives only two reasons for its public policy analysis, that there is no condition subsequent and that public policy encourages charitable gifts. Christiansen and Petter each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved.

   From Christiansen: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. The court in Christensen reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009). In light of the other more robust discussion of the public policy issue in Christiansen, it is perhaps significant that Hendrix cited Christiansen with approval even if it did not repeat all of its public policy reasoning.

   From Petter: (1) There are other potential sources of enforcement (including references to fiduciary duties to assure that the parties were receiving the proper values); (2) the case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment; and (3) the existence of other formula clauses sanctioned in regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts) suggest there cannot be a general public policy against formula provisions.

   Even so, all four cases that have approved defined value clauses have cited various reasons that just apply to a charitable "pourover" entity to support their public policy analyses. Of course, the donor must have charitable intent and recognize that significant assets may pass to the charities under a formula allocation clause with the excess passing to charity. No court has yet addressed the validity of defined value clauses against the public policy issue where a charity is not the "pourover" party.

10. Structure Defined Value Clause to Require Fiduciary Review of Value Determination. The Christiansen and Petter opinions emphasize that there are other mechanisms to enforce the valuation determination, specifically emphasizing the fiduciary duties of the parties involved. To come within the scope of this rationale, a formula allocation clause should allocate the excess over the formula amount to a charitable foundation or to a trust where there are parties with fiduciary duties that have an obligation to assure that the entity is receiving its appropriate share under the formula transfer. Furthermore, someone other than the donor should serve as trustee of that entity. [For example, if a "zeroed-out" GRAT is the excess recipient, the donor should not serve as the trustee of that GRAT.] Furthermore, the trustee should be someone other than the beneficiary of a trust that is the recipient of the primary formula transfer, or else there would be a huge incentive to violate fiduciary duties and permit excess value to pass to the trust for the benefit of that individual. Indeed, a stronger rationale would exist if a professional fiduciary serves as the fiduciary.

11. Structure Transaction to Leave Significant Value to "Pourover" Party. A corollary to structuring the transaction to require fiduciary review of the value determination is leaving enough value to the "pourover" recipient to justify a detailed examination and due diligence review of the transaction by that party. A detailed review, with outside counsel and an outside independent appraisal review, will cost money. If the "pourover" party is not receiving significant value, it might reasonably conclude that the transaction does not warrant a significant expenditure of funds to conduct a detailed and independent review of the values and overall transaction. In Hendrix, the transaction was designed to leave $100,000 of stock value to the Foundation, based on the estimate of values provided by the donors' independent appraiser.

12. Use Trusts With Different Beneficiaries and Different Trustees. If the "pourover" entity is not a charity, but some kind of family trust (such as a QTIP trust or a GRAT), have different trustees of the two trusts, and to the extent possible have different beneficiaries of the trusts or at least significant differences in the dispositive provisions of the two trusts.

13. Arm's Length Requirement? Hendrix is the first court to address whether defined value clauses are recognized only if they are part of an arm's length transaction. Some planners have expressed chagrin that the court chose to validate the argument with a detailed analysis, suggesting that there is indeed such a requirement. Having an arm's length requirement is nonsensical in a pure gift transaction not involving a sale.

    The Hendrix court approached the issue in terms of whether "there is collusion, an understanding, a side deal, or another indicium that the transaction was not at arm's length." The court applied the arm's length requirement rather narrowly, stating directly that "a finding of negotiation or adverse interests [is not] an essential element of an arm's length transaction." After making that statement, the court went on to point out that in fact the clauses were subject to negotiation and that there were adverse interests even as to the daughters' trusts (apparently because of the purchase transaction).

As discussed above, having a "pourover" party with some degree of independence is essential in a confirmation agreement type of clause and is also important with an "as finally determined for gift tax purposes" type of agreement to establish the bona fides of the transaction and that it is not just a tax gimmick to facilitate "cheating" on values. Various courts have commented on due diligence actions taken by the "pourover" charity, including having independent counsel. The independence of the "pourover" party has been addressed by several other courts as part of the public policy issue — in terms of there being other mechanisms than just a gift tax audit to ensure appropriate enforcement of the clause.

14. Use Professional Appraiser. As in all four of the defined value cases (McCord, Christiansen, Petter, and Hendrix), use a reputable professional appraiser to prepare the appraisal for purposes of making the original allocation under the formula assignment. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in Petter) "shady dealing" by a "tax-dodging donor."

15. For Many, Defined Value Clauses Are Not as Important With $5 Million Gift Exemption. Many individuals may wish to make gifts in excess of the $1 million gift exemption allowed under prior law, but far less than the full $5 million allowed in 2011 and 2012. For those individuals, perhaps the most important effect of the $5 million gift exemption is that it provides a great deal of "cushion" before a gift tax audit would require the payment of current gift taxes. For example, an individual who wishes to make a $3 million gift will not be as concerned as in the past with having a way to structure the transaction in a manner that will transfer as much value as possible to an irrevocable trust for children without having to pay gift taxes. Even if the individual claims substantial valuation discounts on the gift tax return, the individual may feel comfortable that current gift taxes will not be due even if there is a gift tax audit.

C. Miscellaneous Planning Observations From McCaffrey/Porter. The following observations are a summary of comments by Carlyn McCaffrey and John Porter at the 2011 Heckerling Institute on Estate Planning. They make various outstanding suggestions of planning considerations for using defined value clauses.

1. Possible Methods of Reducing Gift Risk Due to Valuation of Hard to Value Assets. Possible approaches include using (1) a GRAT, (2) net gifts, (3) defined value formula clauses (either defining the transfer or defining the consideration received), or (4) an incomplete gift approach combined with a defined value transfer clause.

2. GRATs. The provision in the GRAT regulations recognizing that the annuity amount can be described in terms of a percentage of the initial value transferred to the trusts protects against unforeseen gift risk on the creation of the GRAT. The GRAT is the only "bullet proof" method. (However, John Porter describes an audit in which the business was sold for substantially more than the value when it was contributed to the GRAT. The examining agent, who is very knowledgeable about GRATs, stated that the IRS is considering taking the position that the donor so undervalued the property when contributed that she violated the spirit of §2702, so the donor's retained annuity was not a qualified annuity interest under §2702. The

valuation issue was ultimately resolved and the IRS dropped that "spiritual" argument.)

A problem with GRATs is that the cash flow may be insufficient to support the annuity payments without using a very long term (which increases the actuarial risk of dying during the GRAT term and causing estate inclusion). A shorter term could be used with in-kind distributions, but the valuation of assets used to satisfy the annual annuity payments is not protected by the GRAT "savings clause" feature in the regulations.

The following is a method of protecting against valuation risk and making the annual annuity payments from a GRAT. Make a gift using some of the $5 million gift exemption amount to a second trust (the "remainder trust") that is the pourover recipient of the GRAT at the end of the GRAT term. When an annuity payment is due after one year, the GRAT will borrow cash or other investment assets from the remainder trust and pay the annuity with those assets. After two years the GRAT terminates and passes to the remainder trust subject to the debt, and the debt would be extinguished. In this manner, the hard to value asset is moved to the remainder trust without any gift risk at all. (Disadvantages to that approach: (1) estate inclusion if the donor dies during the GRAT term; (2) GST exemption cannot be allocated until the end of the GRAT term; (3) a key advantage of the GRAT is the ability to shift much of the future appreciation/income of the contributed asset without using any gift exemption and this strategy will require using substantial gift exemption; and (4) the GRAT transaction has a built-in interest factor equal to the §7520 rate which is higher than the intrafamily short and mid-term loan rates.

3. Net Gifts. If the IRS re-values the gift, the net gift donees will have significantly reduced gift tax and penalties compared to what the donor would have owed without a net gift arrangement.

4. Defined Value Approaches Including Defined Consideration Approach. Clauses defining the amount transferred were used in McCord and Petter. It should also be possible to use a formula clause defining the consideration based on the value of a fixed property interest as finally determined for federal gift tax purposes. (As an example of a defined consideration approach, the parent might give $200,000 cash to a trust and loan an additional $2 million, which the trust would use to acquire a $2.0 million two-year Treasury Note. Parent might subsequently sell Blackacre to the trust in return for a fraction of the Treasury Note; the numerator of the fraction would be the value of Blackacre as finally determined for federal gift tax purposes and the denominator would equal $2.0 million.)

5. Structuring Defined Value Clauses.

   a. Spillover Arrangement Preferred. If there is any excess value, does the excess go to the transferor or to someone else? The successful reported cases have involved "spillover" type transactions. A properly structured defined value "transfer" clause should work, because property does not really "return" to the transferor but all that is transferred in the first place is a fraction of a larger piece of property. However, the more conservative approach is to use the "spillover" arrangement.

b. Who to Use as Spillover Recipient. The excess value would pass to some person or entity that would not have gift tax consequences. Possibilities are a charity, a GRAT, the donor's spouse, a QTIP trust for the donor's spouse, or an incomplete gift trust. The reported cases so far have used a charity as the spillover entity. John Porter prefers using the charity approach. Several cases have mentioned a public policy favoring charities. In addition, they are independent parties and owe duties to assure that they are receiving proper value under contractual arrangements. John Porter's next preferred spillover is a GRAT. Remainder beneficiaries of the GRAT should be different than the beneficiaries of the grantor trust that is the original donee of the defined value transfer. In addition, use an independent trustee who has a fiduciary duty to assure that the GRAT is receiving its appropriate number of units under the formula transferor. Using the spouse or a QTIP trust is not as favorable because the excess "spillover" value will be included in the spouse's gross estate and there are no independent parties reviewing the appropriate values under the formulas.

c. Some Property Should Pass To Spillover Transferee. Some significant property should pass to the spillover transferee even if the assets are not revalued by the IRS. The spillover transferee will not meaningfully participate in the negotiations regarding the proper number of units passing under the formula transferor unless it thinks that it will receive significant value. This is not essential but it provides a more comfortable arguing position.

d. Consider Leaving Some Percentage of "Excess Value" to Spillover Transferee. For example, the formula could be structured to leave 1% or 2% of any excess value upon a revaluation to the trust resulting in an additional taxable gift. This would help counter a "mootness" argument under Procter. However, there was no additional taxable gift produced by the operation of the formula in the successful McCord or Petter cases.

e. Method of Valuing Property For Purposes of Applying the Formula. If the property is valued by an appraiser, that does not eliminate any gift tax risk. One approach would be for the transferees to come to agreement as to the number of units passing under the formula (as in McCord). The other approach is to use values as finally determined for federal gift tax purposes. The first approach shifts the gift tax risk to a later time (if a family member agrees upon a value resulting in too few units passing to that person or trust). If a charity is involved there is no gift tax risk, but the charity runs into potential problems with the state attorney general or there could be self-dealing problems if it is a private foundation. Using values as finally determined for federal gift tax purposes protects both the transferor and transferee from gift taxes. This approach was used in Petter.

   John Porter likes both approaches. The McCord approach runs the risk of shifting units away from the family trust based on what the charity does. The Petter (as finally determined for federal gift tax purposes) approach runs the risk of shifting additional units away from the family trust based on what the IRS does.

f. Buying Out Charity's Interest. Is it permissible for the trust to purchase the charity's interest before the gift tax audit is completed? John Porter would prefer not. However, it should be permissible if the charity approaches the family rather than vice versa about selling its interest for a fixed sum rather than not knowing for sure what it owns until a gift tax audit is completed years later.

g. Income Tax Reporting. If the various transferees are all grantor trusts (for example, if a GRAT is the spillover transferee), income tax reporting is simplified – everything appears on the grantor's income tax return. If the income is reported by separate taxpayers, and one party is later determined to have reported excess income, there may not be the ability to amend a return and get a refund, even if the statute of limitations has not run. The taxpayer appeared to be entitled to the income at the time, and she had an obligation to report income on her return. Perhaps §1341 can help. If an item of income is included in gross income in a prior year because it appeared as if the taxpayer had a right to it but it is determined that she did not, there is a special way to calculate income tax in the subsequent year to provide relief. However, §1341 only applies if in the subsequent year she is entitled to a deduction for the obligation to return the income previously received under the claim of right, and it is not clear what that other section would be in this situation. John Porter said they are facing that issue in Petter.

h. Qualified Appraisal Important. It is important to obtain a qualified appraisal. It satisfies the adequate disclosure regulations, and helps rebut an IRS argument that the taxpayer is just trying to win the audit lottery with a defined value clause used in conjunction with a "low ball" appraisal.

6. Incomplete Gift Trust Approach. If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. Gain would not be recognized on the sale, but a downside to this is approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments. See Gibbs v. Comm'r, T.C. Memo 1997-196. A concern with this approach is that the full appreciation in the asset that is "sold/given" to the trust would be included in the grantor's gross estate, less a §2043 consideration offset for the value of the consideration (i.e., the note amount). A preferable approach would be to use a defined value transfer approach, to transfer a fraction of an asset in the sale transaction. For example, if the asset is believed to be worth $1 million, the formula could transfer a fraction of the asset with a numerator of $1 million and a denominator equal to the finally determined gift tax value the property. The combined defined value clause and incomplete gift trust gives protection against the gift tax and minimizes potential estate inclusion.