XVII. LEVERAGING THE LIFETIME TRANSFER OF ASSETS

A. Introduction

Under the Internal Revenue Code (the "Code"), the Internal Revenue Service (the "IRS") prescribes certain interest rates to be used to value annuities, life estates, interests for a term of years, remainder interests, and reversionary interests for federal transfer tax purposes. The IRS also publishes base interest rates to be used for various sale and loan transactions. There are a number of estate planning techniques that take advantage of the spread between these growth rates assumed by the IRS and the actual rate of return that is realized on the asset transferred to transfer wealth to clients' descendants. The amount by which the rate of return on the asset transferred, whether by gift or sale, exceeds the applicable interest rate for the transaction is transferred to descendants free of transfer taxes. If the asset actually produces in income and appreciation a yield equal to the assumed interest rate, the asset will have been valued correctly. If the asset outperforms the assumed interest rate, however, the asset will have been undervalued. As a result, these techniques allow the client to "leverage" the difference between the assumed rate of return and the actual rate of return, meaning that the client can give away property with a value in excess of the value that the IRS places on the property.

The following are the primary techniques that will be discussed in this Chapter:

- Grantor retained annuity trusts and the changes in the law that have made such trusts even more attractive;
- Sales and loans to grantor trusts, including how they compare to grantor retained annuity trusts;
- Private annuities and self-canceling installment notes, which are techniques that involve the sale of property and allow the seller to defer capital gain;
- Grantor retained income trusts and how they may be used in certain limited circumstances to make a discounted gift to the beneficiaries; and
- The requirements, advantages and disadvantages of qualified personal residence trusts, which can transfer residences to descendants while substantially decreasing transfer taxes.
- The sale of a remainder interest in a marital trust and how it avoids a taxable gift to the spouse yet escapes estate tax at the spouse's death.
- The leveraging opportunities for charitable lead annuity trusts.

B. General Principles

Following is an explanation of several principles and Code sections that apply to the techniques discussed in this Chapter and to which several of the sections will refer.

1. Present Value

Suppose an individual would like to save $100,000 in ten years to send his or her children to school. He or she would like to know how much to set aside today to have $100,000 in ten

years. This is the concept of present value. The fact that the asset will not be received for ten years makes the asset worth much less today.

The present value depends on the "discount rate," which is the interest rate assumed throughout the time period. The higher the discount rate, the lower the present value of a given future amount. That is, an individual would have to invest less today to reach a future sum if interest rates are high rather than low.

> **EXAMPLE:** If the discount rate is 8%, the present value of the right to receive $1,000,000 15 years from now is $315,242. If, however, the discount rate is 4%, the present value is $555,265.

The techniques discussed in this Chapter are based on the concept of present value. That is, the value of the asset transferred, whether for purposes of determining the amount of the taxable gift or the sales price, will be the present value of the right of the beneficiaries to receive the asset at a future date or the present value of the right to receive a stream of payments over time.

> **EXAMPLE:** Grantor, age 55, transfers an asset valued at $1,000,000 to an irrevocable trust for the benefit of his nieces and nephews. The applicable interest rate is 5.4%, and the trust will terminate in 10 years. The value of the remainder interest for gift tax purposes is $591,009, which is the present value of the right of the nieces and nephews to receive $1,000,000 in 10 years at a discount rate of 5.4%.

2. Applicable Federal Rates

The success of the techniques discussed in this Chapter depends upon whether the rate of return on the assets transferred, whether by gift or sale, exceeds the applicable interest rate for the transaction. The applicable interest rate for techniques discussed in this Chapter generally will be determined by reference to either the applicable federal rate (the "AFR") under Internal Revenue Code ("IRC") § 1274(d) or the rate determined under IRC § 7520.

a. IRC §§ 1274 and 7872. Each month, the IRS publishes base interest rates known as the applicable federal rates. These interest rates are used for various purposes under the Code. IRC § 1274 provides rules for interest on debt instruments issued in consideration for the sale of property, and IRC § 7872 provides rules for the imputation of interest in the case of loans where the stated interest is less than the AFR (known as "below-market loans").

The AFR changes monthly and varies depending upon the term of the loan and how frequently interest compounds (*e.g.*, annually, semi-annually, quarterly or monthly). There are three AFRs that vary based on the term of the loan: 1) the short-term rate, which applies for instruments having a term of three years or less; 2) the mid-term rate, which applies to instruments having a term greater than three years and nine years or less; and 3) the long-term rate, which applies to instruments having a term greater than nine years.

b. IRC § 7520. Under IRC § 7520, the value of any annuity, life interest, term interest, remainder interest or reversionary interest is determined by use of certain tables and an

interest rate that is equal to 120% of the federal mid-term rate in effect under IRC § 1274(d)(1) for the month in which the transfer occurs. The actuarial factors contained in the tables for interests that depend on life expectancy include a mortality component based on life expectancy and an interest rate component that is the growth rate assumed by the IRS for the purpose of valuing such interests, while the factors in the tables that are not dependent on life expectancy include only the interest rate component.

The IRC § 7520 rate cannot be used if the individual who is the measuring life is terminally ill. An individual who is known to have an incurable illness or other deteriorating physical condition is considered to be terminally ill if there is at least a 50% probability of death within one year of the transaction. If the individual survives for eighteen months or longer after the date of the transaction, however, he or she is presumed not to have been terminally ill at the time of the transaction, unless the contrary is established by clear and convincing evidence. Treas. Reg. § 25.7520-3(b)(3).

Additionally, the IRC § 7520 rate cannot be used if the trust instrument does not "provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time." Treas. Reg. § 25.7520-3(b)(2)(ii). Thus, for example, if stock is transferred to a trust in which the grantor has retained an income interest and the stock historically pays dividends equal to one percent of fair market value, and the valuation tables assume an eight percent return, the income interest should not be valued using the IRC § 7520 tables. Examples 1 and 2 in Treas. Reg. § 25.7520-3(b)(2)(v) make it clear that the income beneficiary should be given the power to direct the trustee to "make the trust corpus productive consistent with income yield standards for trusts under applicable state law," and specifically contemplate that the minimum rate of income that a productive trust may produce may be substantially below the IRC § 7520 interest rate on the valuation date. Moreover, Example 2 of these regulations shows that, so long as the beneficiary has the power to make the trust property productive of income, the fact that it actually does not produce income will not preclude use of the IRC § 7520 income factors.

3. IRC § 2702

IRC § 2702 provides special valuation rules to determine the amount of a gift when an individual transfers property to a trust (or trust equivalent) to or for the benefit of a "member of the transferor's family," and immediately after the transfer the transferor or an "applicable family member" retains an interest in the trust (or trust equivalent). IRC § 2702(a)(1); Treas. Reg. § 25.2702-1(a). Under IRC § 2702, if such a transfer is made, the value of the interest retained by the transferor or applicable family member is valued at zero unless it is a "qualified interest" or the interest falls within an exception to IRC § 2702. IRC § 2702(a)(2) and (3). If the retained interest is valued at zero, the gift is a gift of the entire value of the property transferred. In contrast, if an exception to IRC § 2702 applies, or if the retained interest is a "qualified interest," the gift tax value of the transferred interest is determined by subtracting the value of the retained interest determined under IRC § 7520 from the value of the property that is the subject of the transfer.

<u>**EXAMPLE**</u>**:** Grantor transfers $1,000,000 to a trust and retains an

annuity, which is a qualified interest. If the value of the retained annuity interest is $419,430, then the value of the gift is $1,000,000 less the value of the retained annuity interest, or $580,570. If the grantor's retained interest were not a qualified interest, it would be valued at zero, and the value of the gift would be $1,000,000.

a. **Member of the Transferor's Family**. For IRC § 2702 to apply, the transfer in trust must be to or for the benefit of a "member of the transferor's family." A "member of the family" includes (i) the transferor's spouse, (ii) ancestors or descendants of the transferor or the transferor's spouse, (iii) siblings of the transferor, or (iv) the spouse of any of the foregoing. IRC §§ 2702(e); 2704(c)(2). A transfer to a relative that does not fall within this group (*e.g.*, a niece or nephew) is not subject to IRC § 2702's special valuation rules.

b. **Applicable Family Member**. For IRC § 2702 to apply, the transferor or an "applicable family member" must have retained an interest in the trust. An "applicable family member" includes (i) the transferor's spouse, (ii) ancestors of the transferor or the transferor's spouse, and (iii) spouses of any such ancestor. IRC §§ 2702(a)(1); 2701(e)(2).

➔ **Planning Point:** The transferor or the applicable family member must have retained an interest in the trust, which means that such individual has an interest in the trust both before and after the transfer. Thus, if an individual transfers property in trust and retains the right to income for 5 years, after which time the property is payable to the individual's child, the individual has retained an interest in the trust. If, however, an individual creates a trust that provides that income is to be paid to the individual's spouse for life, after which time the property will be distributed to the individual's child, the individual has not retained an interest in the trust, nor has the individual's spouse retained an interest in the trust. Therefore, IRC § 2702 does not apply. See Treas. Reg. § 25.2702-2(d)(1), Ex. 3.

c. **Qualified Interest**. If IRC § 2702 applies, and if an exception to IRC § 2702 does not apply, then in order for the transferor's retained interest to be valued under IRC § 7520 rather than being valued at zero, the transferor's retained interest must be in the form of a "qualified interest." Two types of qualified interests, a "qualified annuity interest" and a "qualified unitrust interest," will be discussed in this Chapter.

EXAMPLE 1: Grantor creates a trust, retaining the right to receive an annual annuity equal to 8% of the initial fair market value of the trust property for 5 years. When the 5-year term ends, the trust property will be distributed to the grantor's daughter. Grantor's retained annuity is a qualified annuity interest. The amount of the gift will equal the fair market value of the property transferred to the trust less the value of the retained qualified annuity interest determined under IRC § 7520.

EXAMPLE 2: The facts are the same as in Example 1, except that the grantor receives the right to all of the income of the trust property,

payable annually. Grantor's retained interest is not a qualified interest and is, therefore, valued at zero for purposes of determining the value of the gift of the remainder to the daughter. The amount of the gift equals the fair market value of the property transferred to the trust.

4. Grantor Trust Status

Under the grantor trust provisions of the federal income tax law (IRC §§ 671-679), if the creator of a trust (known as the "grantor") retains certain powers over or benefits in a trust, the trust will be deemed to be owned by the grantor for federal income tax purposes. Such a trust is known as a "grantor trust." The grantor will be taxed individually on the grantor trust's income rather than the trust or its beneficiaries being taxed on the income. The grantor trust rules can be violated in certain ways so that the grantor retains sufficient controls over the trust property to be the owner of the trust for federal income tax purposes but not for gift, estate or generation- skipping transfer ("GST") tax purposes. The result of grantor trust status is that the trust is ignored for federal income tax purposes and, therefore, transactions between the grantor and the trust will be ignored for federal income tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184. Thus, the following benefits result:

- The grantor will not recognize gain or loss on the sale of assets to a grantor trust.
- The grantor is not taxed on annuity payments or interest payments he or she receives from the trust.
- Because the grantor is treated for income tax purposes as if he or she still owns the trust assets, the grantor will report, for income tax purposes, all items of income, deduction and credit generated by the trust on his or her individual income tax return. Such items will not be taxable to the trust as a separate entity. Thus, if interest or dividends are received or capital gains are recognized by the trust, the grantor continues to be taxed on such items as though he or she had never sold the assets to the trust, regardless of whether the income actually is distributed to the grantor.

a. **Additional Gifts**. The grantor's payment of income tax on assets that eventually pass to the trust beneficiaries is effectively a tax-free gift to such beneficiaries (*i.e.*, it reduces the grantor's estate without any transfer tax consequences and leaves intact the trust assets, which eventually pass to the beneficiaries of the trust). In PLR 9444033, the IRS took the position that the grantor's payment of income tax was an additional gift to the remainder beneficiaries. The language in that ruling was deleted, however, when the ruling was modified by PLR 9543049. In Rev. Rul. 2004-64, 2004-2 C.B. 7, the IRS concluded that the grantor's payment of the tax on the income of a grantor trust does not constitute a taxable gift.

b. **Reimbursement Rights**. If the grantor does not wish to pay the income taxes, the trust instrument can contain a provision allowing the trustee to reimburse the grantor for the income taxes. The planner should consider who has the right to reimburse the grantor for income taxes. In Rev. Rul. 2004-64, the IRS ruled that a provision that requires the trustee to reimburse the grantor for income taxes paid by the grantor on trust income, or that gives the trustee

the discretion to determine whether to reimburse the grantor, does not constitute a taxable gift. A provision that gives the trustee the discretion to determine whether to reimburse the grantor, however, does cause inclusion of the trust property in the grantor's gross estate under IRC § 2036(a)(1).

The facts of Rev. Rul. 2004-64 stated that the trustee was a person not related or subordinate to the grantor within the meaning of IRC § 672(c). Whether the IRS would consider this ruling inapplicable to a trust under which the trustee could be related or subordinate to the grantor under IRC § 672(c) is unclear.

C. Grantor Retained Annuity Trusts

A grantor retained annuity trust ("GRAT") provides the grantor with a "qualified annuity interest," which is the right to receive a fixed amount, payable at least annually. IRC § 2702(b)(1). Because the annuity is a "qualified interest," the value of the grantor's retained interest is valued under IRC § 7520, and the value of the gift will be the fair market value of the property transferred less the present value of the retained annuity interest determined under IRC § 7520.

1. Overview of Grantor Retained Annuity Trusts

A GRAT is an irrevocable trust that pays the grantor an annuity, at least annually, for a fixed term of years. The annuity interest generally is described as a percentage of the initial value of the assets transferred to the GRAT. If the grantor is living at the end of the term, any property remaining in the GRAT after the last annuity payment is made will pass to the remainder beneficiaries (usually the grantor's children), either outright or in trust for their benefit. If the expected return on the GRAT assets is less than the applicable IRC § 7520 rate, all of the trust property will be distributed to the grantor as part of the annuity payments during the trust term and nothing will be left for distribution to the remainder beneficiaries. The grantor will be no worse off than if the grantor had not created the GRAT, except for the cost of creating the GRAT and any gift tax paid upon funding the GRAT. If the return exceeds the applicable IRC § 7520 rate, however, then the remaining trust property will be distributed tax free to the remainder beneficiaries. If the GRAT is appropriately designed and the assets appreciate significantly, substantial wealth can be transferred to the grantor's children free of both gift tax and estate tax.

EXAMPLE 1: Grantor, age 50, transfers $1,000,000 to a 5-year GRAT. The IRC § 7520 rate is 5.4%. The annual annuity payment to Grantor is $233,535.60. If the assets grow at the rate of 5%, all of the assets will be distributed to Grantor to satisfy the annuity, and no property will be left in the GRAT at the end of the term.

Year	Beginning Principal	5.00% Growth	Annual Payment	Remainder

1	$1,000,000.00	$50,000.00	$233,535.60	$816,464.40
2	$ 816,464.40	$40,823.22	$233,535.60	$623,752.02
3	$ 623,752.02	$31,187.60	$233,535.60	$421,404.02
4	$ 421,404.02	$21,070.20	$233,535.60	$208,938.62
5	$ 208,938.62	$10,446.93	$219,385.55	$ 0.00
	$1,000,000.00	$153,527.95	$1,153,527.95	$ 0.00

<u>EXAMPLE 2</u>: The facts are the same as in Example 1, except that the assets grow at the rate of 8%. Because the return on the assets exceeds the IRC § 7520 rate, there will be assets in the GRAT at the end of the term to be distributed to the beneficiaries. At an 8% return, $99,267.90 will be left for the beneficiaries.

Year	Beginning Principal	8.00% Growth	Annual Payment	Remainder
1	$1,000,000.00	$80,000.00	$233,535.60	$846,464.40
2	$ 846,464.40	$67,717.15	$233,535.60	$680,645.95
3	$ 680,645.95	$54,451.68	$233,535.60	$501,562.03
4	$ 501,562.03	$40,124.96	$233,535.60	$308,151.39
5	$ 308,151.39	$24,652.11	$233,535.60	$ 99,267.90
	$1,000,000.00	$266,945.90	$1,167,678.00	$ 99,267.90

Generally, any assets with appreciation potential or total return in excess of the IRC § 7520 rate are appropriate assets for a GRAT. Assets that can be valued at a discount, such as a minority interest in a closely held corporation, a limited partnership interest or a large block in a publicly traded company, can produce significant savings because the amount of the annuity will be based on the discounted value of the asset, rather than on the full value. In this situation, the grantor's annuity payments (which are potentially includable in the grantor's estate) will be smaller than if the annuity payments were based on assets that were not discounted. This will be particularly beneficial if the asset has a high yield because the effective yield will be made even higher by the discount. Additional benefits can be obtained if the asset can be valued at its full value (rather than its discounted value) when distributed as part of the annuity payment or to the remainder beneficiaries at the end of the GRAT term. The latter circumstance can occur, for example, when a GRAT holds limited partnership interests and distributes such interests tax-free to the remainder beneficiaries upon the end of the GRAT term. If the remainder beneficiaries can then terminate the limited partnership, they will receive the undiscounted assets from the limited partnership with no tax consequences.

➔ **<u>Planning Point</u>:** If the assets in the GRAT have significant appreciation, the grantor may be able to substitute other assets to "lock-in" the profit of the GRAT. This may be appropriate when the highly-appreciated assets currently held by the GRAT are nonetheless volatile, and the assets substituted will still appreciate but with less volatility. This substitution

may be prohibited, however, by Treas. Reg. § 25.2702-3(b)(5), which requires the GRAT instrument to prohibit additional contributions after the initial funding. A number of private letter rulings have approved GRAT instruments containing a power of substitution without mentioning this issue. <u>See, e.g.</u>, PLR 200220014; PLR 200030010; PLR 9352007.

a. **<u>The Annuity</u>**. The annuity must be a fixed amount, that is, a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the assets transferred to the GRAT. Treas. Reg. § 25.2702-3(b)(1)(ii).

> **<u>EXAMPLE</u>:** A payment of $50,000 each year would constitute a fixed amount, as would a payment of 10% of the initial fair market value of the property contributed to the trust.

➔ **<u>Planning Point</u>:** It is generally more desirable to define the annuity amount as a percentage or fraction of the value of the initial trust assets in the event that the fair market value of the assets contributed to the GRAT is uncertain. If the value of the assets transferred to the GRAT is increased on audit, the taxable gift will increase. If the annuity amount is expressed as a percentage of the fair market value of the assets transferred to the GRAT, however, an increase in the value of the assets results in an increase in the annuity payable to the grantor, thus reducing or nearly eliminating the increase in the taxable gift.

The annuity amount may increase annually by up to 120% of the preceding year's annuity amount. *Id.*

➔ **<u>Planning Point</u>:** For example, the annuity could be 10% in the first year, 12% in the second year, 14.4% in the third year, and so on. The advantage of an increasing annuity is that less property is distributed to the grantor in the beginning, and, therefore, property grows within the trust for a longer period of time. An increasing annuity is particularly useful for assets that are not expected to achieve a high return in the early years but that are expected to achieve an increasing return in the future.

The trust also may provide that income in excess of the annuity amount may be paid to the grantor. The right to receive the excess income is not, however, a qualified interest, and, therefore, it will not reduce the value of the transferor's retained interest. Treas. Reg. § 25.2702-3(b)(1)(iii). No distributions can be made to anyone other than the holder of the annuity interest during the term of the annuity interest. Treas. Reg. § 25.2702-3(d)(2).

b. **<u>Payment of the Annuity</u>**. The annuity can be paid from income, and, if income is insufficient, from principal.

(1) **<u>Payment in Kind</u>**. If the income generated by the GRAT assets is insufficient to pay the annuity, the trustee can transfer trust principal in kind to the grantor to pay the annuity. This is a common practice when highly appreciating assets with low cash flow are

contributed to a GRAT.

(2) **Payment of the Annuity With a Note**. The trustee cannot make the annuity payment with a note from the trustee to the grantor. Treas. Reg. § 25.2702- 3(b)(1)(i). In fact, the governing instrument must expressly prohibit the use of notes or similar financial arrangements to make the annuity payments. The trustee can, however, borrow from an unrelated third party, such as a bank, to satisfy the annuity payments. 65 Fed. Reg. 53587, 53588 (September 5, 2000).

c. **Timing of Payments**. The annuity payments can be made on a calendar year or anniversary year basis and can be made annually or more frequently. If the payment is for a short taxable year, the payment must be prorated. Treas. Reg. § 25.2702-3(b)(3).

d. **Term of the GRAT**. The term can be for any length. Generally, the longer the term (a) the smaller the amount of each annuity payment, and (b) the greater the possibility that the grantor will die during the term (in which case there will be no, or minimal, estate tax savings).

➔ **Planning Point:** It is accepted practice to create GRATs for a term as short as 2 years. The IRS approved a 2-year GRAT in PLR 9239015.

➔ **Planning Point:** If the grantor desires to have most or all of the trust principal remain in the GRAT, the grantor can reduce the size of the required annuity payment by creating a GRAT with a longer term (*i.e.,* as the term of the GRAT is increased, the required annual annuity payment will decrease, thereby making it easier to satisfy the annual annuity from the cash flow generated by the GRAT assets).

2. **Gift, Estate and Income Tax Consequences**

a. **Gift Tax**. The transfer of assets to a GRAT is a taxable gift. The amount of the gift will equal the excess of (a) the value of the property transferred to the GRAT over (b) the value of the interest retained by the grantor, determined under the actuarial tables in IRC § 7520.

EXAMPLE: Grantor, age 50, transfers $5,000,000 to a GRAT with a 5-year term. The GRAT assets increase in value at a rate of 15% per year during the GRAT term. The IRC § 7520 rate in effect at the creation of the GRAT is 6%.

The trust provides that Grantor will receive $1,186,972 from the GRAT each year during the 5-year term. The value of the annuity is $4,935,071. The amount of the taxable gift equals $64,929, which is $5,000,000 less $4,935,071, the value of the retained annuity. The assets remaining in the GRAT at the end of the 5-year term will, based on the stated assumptions, equal $2,053,772 and are distributable to children free of gift or estate tax. Thus, Grantor has transferred over $2,000,000 of assets to his children with a taxable gift of only $64,929.

➔ **<u>Planning Point</u>:** The gift made on the creation of a GRAT is a gift of a future interest. Therefore, it will not qualify for the gift tax annual exclusion. Gift tax will not be due, however, if the gift is sheltered by the grantor's applicable exclusion amount.

➔ **<u>Planning Point</u>:** The annuity rate and the length of the term can be adjusted so that the value of the initial gift is close to zero, so that no gift will result upon funding the GRAT. This type of GRAT is known as a "zeroed-out GRAT" and is accomplished by making the annuity large enough to have the value of the retained annuity interest equal the value of the property transferred, thereby reducing the value of the gift to zero. With a zeroed-out GRAT, the grantor will receive back all of the original assets transferred to the trust and some appreciation in the value of the trust assets, while shifting the appreciation in excess of the IRC § 7520 rate during the term of the GRAT to the beneficiaries. Zeroed-out GRATs will be discussed in detail below.

b. **<u>Estate Tax</u>**. If the grantor is living at the end of the trust term, any property remaining in the GRAT (which will be the case if the total return on the trust assets is greater than the IRC § 7520 rate in effect when the GRAT is created) will pass to the named beneficiaries and avoid gift and estate tax. If the grantor dies during the trust term, however, some portion of the trust property will be included in the grantor's gross estate for federal estate tax purposes. In such a case, there will be no estate tax savings. Nevertheless, the grantor will be no worse off than if he or she had not created the GRAT, except for the cost of creating the GRAT and any gift tax paid upon funding the GRAT.

The IRS has released proposed regulations providing guidance on the inclusion of trust property in a grantor's gross estate under IRC § 2036. 72 Fed. Reg. 31487-01; 2007-28 I.R.B. 74 (June 6, 2007). Generally, IRC § 2036 brings back into a decedent's gross estate the entire value of property gifted by the decedent if the decedent retained for life or for a period that does not in fact end before the decedent's death: (1) the possession or enjoyment of the property; (2) the right to the income from the property; or (3) the right, either alone or in conjunction with another person, to determine who would possess or enjoy the property or the property's income.

Under the proposed regulations, the portion of the principal includible in the decedent's gross estate is that portion of the principal, "valued as of the decedent's death (or the alternate valuation date, if applicable) necessary to yield that annual payment (or use) using the appropriate IRC § 7520 interest rate." Prop. Reg. § 20.2036-1(c)(2). The applicable IRC § 7520 rate is the rate in effect on the decedent's date of death (or the alternate valuation date, if applicable). The proposed regulations operate under the premise that, if the annuity distributes enough trust income so as to carry out all of the trust income, then IRC § 2036 will include all the trust property in the grantor's gross estate. Conversely, if the annuity is unable to carry out all of the trust income, *i.e.*, the annuity rate is less than the IRC § 7520 rate, only a portion of the trust property will be includible under IRC § 2036.

<u>EXAMPLE</u>: D transferred $100,000 to a GRAT in which D's annuity is a qualified interest described in IRC § 2702(b). The trust agreement

provides for an annuity of $12,000 per year to be paid to D for a term of 10 years or until D's earlier death. The annuity amount is payable at the end of each month in twelve equal installments. At the expiration of the term of years or on D's earlier death, the remainder is to be distributed to C, D's child. D dies before the expiration of the 10-year term. On the date of D's death, the value of the trust assets was $300,000 and the IRC § 7520 interest rate was 6%.

The amount of principal with respect to which D retained the right to the income, and thus the amount includible in D's gross estate under IRC § 2036, is that amount of principal necessary to yield the annual annuity payment to D. In this case, the formula for determining the amount of principal necessary to yield the annual annuity payment to D is: annual annuity (adjusted for monthly payments) / IRC § 7520 interest rate = amount includible under IRC § 2036. The Table K adjustment factor for monthly annuity payments in this case is 1.0272. Thus, the amount of principal necessary to yield the annual annuity is ($12,000 x 1.0272) / .06 = $205,440. Therefore, $205,440 is includible in D's gross estate under IRC § 2036(a)(1).

The preamble to these proposed regulations explains that, in many cases, both IRC § 2036 and IRC § 2039 may be applicable to the annuity interest, along with other payments retained by a deceased grantor, that are the subject of these proposed regulations. IRC § 2039 includes in the gross estate any payment made by an annuity and receivable by any beneficiary under any form of contract or agreement under which a payment was to be made to the decedent during his or her lifetime. The IRS states, however, that in most cases, IRC § 2036 (and, consequently, IRC § 2035 when applicable) will apply in the future to these interests. Prop. Reg. § 20.2039-1(a); -1(e)(1).

c. **Income Tax**. The GRAT will be a grantor trust for income tax purposes. As a result of the grantor trust status, the following favorable income tax results are achieved:

- No gain or loss is recognized on the creation of the GRAT when the grantor transfers assets to fund the trust because the grantor is deemed to have transferred the assets to himself or herself for income tax purposes;
- The payment of the annual annuity by the GRAT to the grantor is ignored for income tax purposes, as the grantor is deemed to have paid it to himself or herself; and
- The income and capital gains generated by the GRAT assets are taxable to the grantor whether or not distributed to him or her.

➔ **Planning Point:** Thus, if the grantor funds the trust with appreciated property, the distribution of such property in satisfaction of the annuity will not cause the grantor to recognize gain.

3. Valuation of the Gift

The value of the retained annuity interest generally depends on the value of the property transferred to the GRAT, the annuity rate, the IRC § 7520 rate in effect for the month in which the GRAT is created, the age of the grantor at the creation of the GRAT and the length of the term for which the grantor is retaining the annuity.

a. <u>Valuing the Reversion and Example 5</u>. In addition to the annuity interest that the grantor retains, the grantor also can retain a contingent reversion in the property transferred to the GRAT. A reversion is the possibility that the trust property will revert to the grantor's estate if the grantor dies before the end of the term of the GRAT. Thus, if a GRAT provides that the trust property will be paid to the grantor's estate if the grantor dies before the end of the term, the grantor has retained a reversion in the trust property.

➔ **<u>Planning Point</u>:** Because a portion or all of the trust property will be includable in the grantor's gross estate for federal estate tax purposes if the grantor dies before the end of the annuity term, it is common for the trust to provide that, upon the grantor's death, assets will revert to the grantor's estate. In such a case, the GRAT property will be disposed of according to the grantor's will or revocable trust. If the grantor dies survived by a spouse and the grantor's estate plan contains a marital deduction formula, the reversion allows the grantor to obtain a marital deduction for the GRAT property. Additionally, because the GRAT assets are paid to the grantor's estate, they are available to pay estate tax. Because less than all of the trust assets may be included in the grantor's gross estate, the trust instrument may provide that only the portion of the assets includable in the grantor's gross estate will be paid to the grantor's estate.

If the grantor retains a reversion in the GRAT property, three interests are created in the GRAT: (1) the grantor's right to the annuity interest for the shorter of the GRAT term or the grantor's life; (2) the remainder, which is paid to the remainder beneficiaries of the GRAT if the grantor survives the GRAT term; and (3) the reversion, which is paid to the grantor's estate if the grantor does not survive the GRAT term. The older the grantor, the less likely he or she is to survive the term of the GRAT, and, therefore, the more valuable the reversion.

A reversion is not a qualified interest, and, therefore, it is valued at zero for purposes of determining the taxable gift. <u>See</u> Treas. Reg. § 25.2702-3(e), Ex. 1. As such, a reversion does not reduce the value of the gift, and only the annuity interest is subtracted from the value of the property transferred to the GRAT in calculating the gift. If the GRAT is optimized to reduce the taxable gift to the smallest number possible, then in effect, the grantor makes a gift to the remainder beneficiaries equal to the value of the reversion, as illustrated below.

<u>EXAMPLE 1</u>: Grantor, age 50, transfers $5,000,000 to a 10-year GRAT. The GRAT pays Grantor an annuity of $660,162 for the shorter of 10 years or Grantor's life. If Grantor dies before the end of the term, the balance of the property will be distributed to his estate (*i.e.*, he retains a reversion). The IRC § 7520 rate is 5.4%.

The value of the annuity interest is $4,856,082.
The value of the reversion is $143,915.
The value of the remainder interest is $3.
The value of the taxable gift is $143,918 ($5,000,000 - $4,856,082 (annuity)) or ($143,915 (reversion) + $3 (remainder)).

If the grantor retains an annuity for a fixed term, however, so that the annuity payments are made regardless of whether the grantor is living, two interests are created in the GRAT: (1) the annuity interest for the fixed term, which is payable to the grantor if living, otherwise to the grantor's estate; and (2) the remainder, which is paid to the remainder beneficiaries at the end of the GRAT term. In this case, because there is no reversion, the value of the gift includes only the value of the remainder interest, which is zero or almost zero.

EXAMPLE 2: The facts are the same as in Example 1, except that if Grantor dies before the end of the term, the remaining annuity payments will be made to his estate (*i.e.*, he does not retain a reversion).

The value of the annuity interest is $4,999,997.
The value of the remainder interest is $3.
The value of the taxable gift is $3 ($5,000,000-$4,999,997).

The difference in the value of the taxable gift in Examples 1 and 2 is the value of the reversion in Example 1.

The IRS's former position under Example 5 of Treas. Reg. § 25.2702-3(e) ("Example 5") was that, even if the grantor retains an annuity for a fixed term, an annuity for a fixed term must be valued as if the grantor's right to the annuity terminates at death, regardless of whether payments are made to the grantor's estate after death. Example 5 provided that an annuity for a term of years must be valued as if it were an annuity for the shorter of the term or the grantor's life because the possibility that the grantor may die during the term must be considered. Thus, under the prior version of Example 5, even if the grantor does not retain a reversion, the annuity must be valued as if the grantor had retained one.

Because the IRS considered the term of a fixed-term GRAT to be shorter than its term (because the possibility of the grantor's death during the term must be considered), the grantor was not expected to receive all of the annuity payments. Consequently, under Example 5, the present value of the annuity decreased and created a remainder subject to gift tax. However, as discussed further below, Example 5 has been invalidated by the *Walton* case, the IRS has acquiesced in *Walton* and revised its regulations in this regard.

b. Zeroed-Out GRATs and the *Walton* Case. A zeroed-out GRAT is a GRAT in which the value of the grantor's retained annuity interest equals the value of the property transferred to the GRAT, resulting in a remainder (and value of the taxable gift) of zero. As discussed above, under the former interpretation of Example 5, zeroing-out a GRAT was not possible because the possibility of the grantor's death during the term, which reduces the value of the retained interest, had to be considered.

The IRS's position that because of Example 5 zeroed-out GRATs were not possible was

rejected by the Tax Court in *Walton v. Comm'r*, 115 T.C. 589 (2000); *acq*., Notice 2003-72. In *Walton*, the grantor established two substantially identical GRATs, each for a two-year term, and transferred shares of stock in Wal-Mart to the GRATs. The grantor was to receive an annuity amount from each trust equal to 49.35% of the initial trust value for the first year of the trust, and 59.22% of the initial value for the second year of the trust. If the grantor died during the two- year term, the remaining GRAT payments would be made to her estate, with the balance of the GRAT property being paid to the remainder beneficiaries at the end of the two-year term.

The GRAT payments were designed to result in no gift on creation of the GRAT under the position that the grantor's mortality need not be considered in valuing the remainder (a position contrary to the IRS and Example 5). Therefore, the grantor reported the gift of the remainder interest on a gift tax return at a value of zero. The Wal-Mart stock did not perform as expected, and all of the property was distributed to the grantor to satisfy the annuity. As such, there was nothing left for the remainder beneficiaries. The IRS sought to impose gift taxes on the transfer.

The Tax Court held that Example 5 was an invalid interpretation of IRC § 2702 and that the grantor's retained annuity interest was to be valued as an annuity for a term of years rather than as an annuity for the shorter of a term of years or the grantor's life.

As a result of *Walton*, practitioners can create GRATs with an annuity that equals the value of the transferred property, which means that all of the property and income and appreciation thereon at the assumed rate of return (that is, the IRC § 7520 rate) is returned to the grantor in the form of an annuity. The result is a gift (and a remainder interest) in the amount of zero. Any income and appreciation in excess of the IRC § 7520 rate will pass to the remainder beneficiaries of the GRAT free of any gift or estate tax.

> **EXAMPLE:** Grantor, age 50, transfers $10,000,000 worth of stock in a closely-held business to a zeroed-out GRAT with a 10-year term. The GRAT assets grow in value at a rate of 15% per year during the GRAT term. The GRAT instrument provides that, if Grantor dies during the 10-year term, the remaining annuity payments will be paid to his estate for the balance of the term. The IRC § 7520 rate in effect at the creation of the GRAT is 5%.
>
> The trust instrument provides that Grantor will receive $1,295,051 from the GRAT each year during the 10-year term. Because the GRAT annuity payments received by Grantor have a present value equal to the value of the stock transferred to the GRAT, there is no gift when Grantor creates the GRAT. The stock remaining in the GRAT at the end of the 10-year term will, based on the stated assumptions, have a value equal to $14,161,227 and that stock will be distributable to Grantor's children free of gift and estate tax. Thus, by use of a zeroed- out GRAT, Grantor can transfer over $14,100,000 of stock to his children free of any transfer tax consequences.

➔ **Planning Point:** In light of *Walton*, practitioners should consider structuring GRATs for a fixed term with payments to be made to the grantor or, if the grantor dies during the fixed term, to the grantor's estate (hereinafter referred to as a "*Walton* GRAT"). If minimizing gift tax on creation of a GRAT is a primary goal, a GRAT should not be structured to terminate at the grantor's death and then to pay any remaining assets to the remainder beneficiaries or to the grantor's estate. Such a structure would result in the value of the annuity interest being valued as the lesser of the fixed term or the grantor's life, and, therefore, would not benefit from the holding in *Walton*. The value of the retained interest for the shorter of term or life will be less than the value of the retained interest for a term, resulting in a taxable gift.

➔ **Planning Point:** It may be appropriate to make a modest taxable gift in establishing the GRAT so that the Grantor can file a gift tax return, disclose the gift and start the running of the statute of limitations.

On February 25, 2005, the IRS finalized regulations that conform the regulations under Section 2702 to *Walton*. T.D. 9181. Example 5 now provides that the grantor's interest in that example will be a qualified interest for the entire term of the interest, whether the grantor survives the term or dies before the end of the term causing the remaining payments to be made to the grantor's estate. Thus, the example no longer treats the term of a fixed-term GRAT that continues making payments to the grantor's estate in the event of the grantor's death before the end of the fixed term as the shorter of the fixed term or the grantor's life. These regulations are effective as of July 26, 2004.

(1) Estate Tax Inclusion. If a GRAT is structured as a *Walton* GRAT, then the fact that the annuity payments will continue, rather than the remaining GRAT property being paid to the estate, must be considered in determining how estate taxes, if applicable, will be paid in the event that the grantor does not survive the term of the GRAT and some portion or all of the GRAT property is includable in the grantor's gross estate. Because the GRAT property will not be distributed to the estate, there may be insufficient assets with which to pay estate taxes. Therefore, it is important to consider the source of funds from which to pay estate taxes by reason of the inclusion of the GRAT in the grantor's gross estate for federal estate tax purposes.

One approach would be for the GRAT grantor to establish and fund an irrevocable trust which, in turn, would purchase insurance on the grantor's life. The amount of the death benefit could be structured to equal the anticipated federal and state estate taxes that would be incurred if the grantor failed to survive the term of the GRAT. At the grantor's death, the insurance proceeds could be used to provide liquidity to the grantor's estate (assuming the grantor's estate had sufficient assets to be purchased) or could be distributed to the GRAT's remainder beneficiaries (which, as practical matter, would enable them to pay the estate tax generated by inclusion of the value of the GRAT property in the grantor's gross estate if the burden of that tax were apportioned to them).

➔ **Planning Point:** If the GRAT is a short-term GRAT, the annuity payment

is very high, so payment of estate taxes may not be an issue because the annuity payments, which continue to be made to the grantor's estate, may be sufficient to cover the tax liability.

(2) **Marital Deduction Planning**. When the grantor retains a reversionary interest in a GRAT, which is generally the case with a GRAT that is not structured as a *Walton* GRAT, and dies before the end of the GRAT term, the GRAT usually provides that some portion (that portion that is included in the grantor's gross estate) or all of the remaining GRAT property will be distributed to the grantor's estate. Such planning allows the GRAT property to be disposed of in accordance with the grantor's will or revocable trust and often will allow the GRAT property to qualify for the marital deduction if the estate tax is in effect. With a *Walton* GRAT, however, the remaining GRAT property is not paid to the grantor's estate, to be disposed of according to his or her will or revocable trust. Rather, the annuity payments continue to the grantor's estate. Therefore, if the grantor wants to ensure that the entire GRAT, including both the remainder interest and the grantor's right to continuing annuity payments for the balance of the term, qualifies for the marital deduction, some additional planning will be required. Two alternatives follow.[1]

(a) **Direction in Will that Payments Be Made to the Surviving Spouse**. The grantor's will can direct that a portion of the continuing annuity payments equal to the portion of the GRAT property that is included in the grantor's gross estate, once they are paid to the estate, will be distributed outright to the surviving spouse and that the remainder will be paid directly to the surviving spouse when the GRAT term ends.

(b) **Distribution to a Marital Trust**. The GRAT instrument can provide that, if the grantor dies during the fixed term and is survived by a spouse, the remaining annuity payments and the GRAT remainder will be distributed to a marital trust for the surviving spouse's benefit. To ensure that the surviving spouse receives all of the income earned by the GRAT (which is a requirement to qualify the trust for the marital deduction), the GRAT must distribute any income in excess of the annuity amount to the marital trust. The GRAT itself could establish the marital trust as a remainder trust, or a separate irrevocable marital trust could be established. The latter alternative may be preferable if more than one GRAT has been created, in which case all of the GRATs could be payable to the separate irrevocable marital trust.

c. **Valuation Discounts.** A GRAT can be more beneficial if assets such as closely-held business interests, as opposed to readily marketable securities, are transferred to the GRAT. If closely-held business interests are used to fund the GRAT, the value of the gift to the remainder beneficiaries will be discounted to reflect not only the present value of the remainder beneficiaries' interests (as with any GRAT) but also the lack of marketability and/or lack of control inherent in the transferred business interests. However, when engaging in this sort of planning, it is important to consider whether the GRAT's assets will generate sufficient cash flow with which to make annuity payments or whether it will be practical or even possible to make annuity payments in kind.

➔ **Planning Point:** Taking advantage of lack of marketability and lack of control discounts (thereby minimizing the amount of the taxable gift

without at the same time increasing the value of the Grantor's retained annuity interest) when business interests are transferred to a GRAT may be important because the Grantor and the Grantor's spouse should not ordinarily utilize IRC § 2513 to split the Grantor's gift to the GRAT. If the Grantor dies before the expiration of the GRAT term, some or all of the GRAT's value will be includable in his or her gross estate for federal estate tax purposes. The Grantor's applicable gift tax exclusion amount will be restored with respect to his or her one-half of the gift. However, generally, the consenting spouse may not obtain a restoration or recovery of his or her gift tax applicable exclusion amount. IRC § 2001(e). Thus, the consenting spouse's gift tax applicable exclusion amount used in these circumstances is completely squandered.

d. Revocable Spousal Annuity Interest. One way that practitioners have sought to minimize the value of the gift on the creation of a GRAT was to provide that the grantor's spouse had an annuity interest that would take effect if the grantor died during the term of the GRAT and the spouse survived. In such a case, the remaining annuity amount would be paid to the surviving spouse for the balance of the term, unless the grantor revoked the spouse's interest. Because the grantor has the right to revoke the spouse's annuity interest, the grantor has not made a completed gift to the spouse. The possibility of either the grantor or the grantor's spouse surviving the GRAT term is greater than the possibility of only the grantor surviving, and, therefore, the value of the reversion (and, therefore, the gift) decreases.

EXAMPLE 1: Grantor, age 50, transfers $5,000,000 to a 10-year GRAT. The IRC § 7520 rate is 5.4%. The annual annuity is $660,162, which will be paid to Grantor until the end of the 10-year term or Grantor's prior death. The value of the reversion, and thus the gift, is $143,918.

EXAMPLE 2: The facts are the same as in Example 1, except that, if Grantor dies before the end of the 10-year term, the remaining annuity payments will be made to his spouse, also age 50. Because of the two-life annuity and the possibility that either Grantor or his spouse will survive the GRAT term, the value of the reversion decreases to $6,340, with a corresponding decrease in the value of the taxable gift.

Previously, the IRS's position was that the spouse's revocable annuity interest was a qualified interest so that, in determining the value of the gift, the value of both the grantor's annuity interest and the spouse's annuity interest could be deducted. The result was a significant reduction in the value of the gift, as evidenced by Examples 1 and 2 above. See PLR 9451056; and PLR 9449013.

Later, the IRS reversed its position, however, concluding that a revocable annuity in the surviving spouse is not a qualified interest that reduces the value of the gift. See TAM 9848004; TAM 9717008; TAM 9741001; and TAM 9707001. The IRS's position was upheld by the Tax Court and the Seventh Circuit in *Cook v. Comm'r*, 115 T.C. 15 (2000), *aff'd*, 269 F.3d 854 (7th Cir.

2001). In *Cook*, a husband and wife each created two separate GRATs in 1993 and in 1995. Both of the 1993 GRATs provided for annual payments to the grantor of 23.999% of the initial fair market value of the trust principal, for a period of five years. If the grantor survived the five- year term, the remainder would pass to a trust for the benefit of the grantor's son. If the grantor died before the expiration of the five-year term, a revocable spousal annuity was created for the spouse, whereby the spouse would receive the same annual payments for the remainder of the

deceased grantor's five-year annuity term. The 1995 GRATs were structured in the same manner, except they had different terms and annuity payments.

In reporting the taxable value of their respective GRATs, both the husband and wife reported that the value of the dual-life annuities were exempt from gift tax liability. The IRS, on the other hand, claimed that the spousal interests created in each GRAT were not qualified interests, and, as a result, must be valued at zero for gift tax purposes (thereby creating a taxable gift). The Tax Court and the U.S. Court of Appeals for the Seventh Circuit agreed with the IRS, finding that the spousal interests were not qualified interests, and, therefore, they could not be considered in valuing the retained annuity interests. Accordingly, the IRS could value the retained interest as a one-life, not a two-life, annuity.

In *Schott v. Comm'r*, 319 F.3d 1203 (9th Cir. 2003), *rev'g* T.C. Memo. 2001-110, Patricia and Stephen Schott each created a GRAT with a two-life annuity. Both GRATs provided the grantor with an annuity for 15 years or until the grantor's death, whichever occurred first. If the grantor did not survive the 15-year term, the annuity payments would be made to the spouse if living unless the grantor revoked the spouse's annuity interest. If the grantor died before the end of the 15-year term, and if the spouse did not survive the grantor or if the grantor had revoked the spouse's interest, the annuity would end, and the property would be distributed to a trust for the benefit of the surviving spouse or for the grantor's descendants. If Stephen survived the term of his GRAT, the remaining assets would be held in trust for Patricia if living, or otherwise for Stephen's descendants. If Patricia survived the term of her GRAT, the assets would be held in trust for Patricia's descendants. The IRS found that the two-life annuities were not a qualified interest under Section 2702(b) and assessed a tax deficiency. The Tax Court, confirming its decision in *Cook*, upheld the IRS's assessment, finding that the two-life annuities were unqualified because the annuities could extend beyond the life of the term holder.

At issue on appeal was whether Treas. Reg. § 25.2702-2(d)(1), Ex. 7, allows a contingent spousal annuity interest to be a qualified interest under Section § 2702(b). The example states that a two-life annuity in which both interests are qualified annuity or unitrust interests and in which the grantor has the power to revoke the spouse's annuity or unitrust interest will be a qualified interest under Section 2702(b). Treas. Reg. § 25.2702-2(a)(5) provided that the retention of a power to revoke a qualified interest of the transferor's spouse is the retention of a qualified interest.

The Ninth Circuit, reversing and remanding the Tax Court's decision, concluded that the Schotts' GRATs fell within Example 7. The Ninth Circuit noted that the amounts payable are a fixed percentage of the trust property under Section 2702(b) with a fixed termination after 15 years if the grantor and spouse live that long. Furthermore, the Ninth Circuit stated, the value of the two-life annuity is ascertainable under the annuity tables, and the value of each grantor's power to revoke is treated as the retention of a qualified interest under Treas. Reg. § 25.2702- 2(a)(5).

The Ninth Circuit distinguished *Cook*, stating that, in that case, an additional contingency existed: the grantor and spouse had to be married at the time the spouse's annuity began. This interest was thus unascertainable by the annuity tables.

IRS regulations clarify that a spouse's revocable successor annuity interest will be treated as a qualified interest only if the spouse's annuity or unitrust interest, standing alone, would meet

the requirements for a qualified annuity or unitrust interest under Treas. Reg. § 25.2702-3(d)(3) but for the grantor's revocation power. Treas. Reg. § 2702-2(a)(6); -3(d)(2). Furthermore, Treas. Reg. § 25.2702-2(d)(1), Ex. 7, which was at issue in *Schott*, has been removed.

4. Rolling GRATs

By creating a series of GRATs, often called rolling GRATs, rather than a single long- term GRAT, a grantor can take advantage of the benefits of short-term GRATs.

> **EXAMPLE:** Rolling GRATs work as follows: the grantor creates a GRAT for a short term, such as 2 years. The annuity payment in year 1 from the first GRAT is used to fund the second GRAT, also for a 2- year term. The annuity payments in year 2 of GRAT 1 and year 1 of GRAT 2 would be used to create the third GRAT. Annuity payments from GRAT 2 and GRAT 3 would be used to create the fourth GRAT.

a. Advantages of Short-Term GRATs. Short-term GRATs have the following advantages:

- The risk of death during the term of the GRAT is minimized. For example, if a grantor creates a six-year GRAT and dies in year five, the GRAT fails. If, however, the grantor creates three two-year GRATs, only the third GRAT will fail, and GRATs one and two (assuming the return on the property exceeds the IRC § 7520 rate) will have succeeded in transferring assets to the beneficiaries; and
- The risk that a year or two of poor performance during the term of the GRAT will adversely affect the overall benefit of the GRAT is minimized. The failure of one GRAT because of poor investment performance will not affect the success of the future GRATs in the series. Thus, a series of short-term GRATs may result in a larger gift to the remainder beneficiary.

b. Disadvantages of Short-Term GRATs. Short-term GRATs have the following disadvantages:

- The risk of the IRC § 7520 rate increasing is an issue. With a long-term GRAT, the grantor can lock in the benefits of a low IRC § 7520 rate;
- A change in the tax law may prohibit later GRATs; and
- There will be additional transaction costs in doing a series of short-term GRATs, including fees to prepare trust instruments and, possibly, the revaluation of the trust property.

5. Allocation of GST Exemption to a GRAT

If the grantor survives the retained term and the trust property is distributed to grandchildren or trusts from which distributions can be made to grandchildren, GST tax may be imposed if it is in effect at the time of the grantor's death.[2] Under IRC § 2642(f)(1), the grantor of a trust cannot allocate his or her GST exemption to property transferred during an estate tax

inclusion period ("ETIP"). The ETIP is the period of time after the transfer during which the value of the trust property would be includable in the grantor's gross estate. Because some portion or all of the GRAT will be includable in the grantor's gross estate if he or she does not survive the term of the GRAT, GST exemption cannot be allocated to the GRAT until the end of the GRAT term. If the GRAT is successful (the total return on the trust property exceeds the IRC § 7520 rate, so that there is property left for the beneficiaries), allocating GST exemption at the end of the term, when the trust property has appreciated, does not leverage the GST exemption. As such, a GRAT generally is not considered to be an effective technique to transfer assets to grandchildren.

> **EXAMPLE:** Grantor, age 50, transfers $10,000,000 to a 10-year GRAT when the IRC § 7520 rate is 5.4%. The GRAT will pay him an annuity of $1,320,323 each year for the shorter of Grantor's life or the 10-year term. The taxable gift is $287,836. Without the ETIP rules, Grantor could allocate $287,836 of his GST exemption to the transfer. As a result, the trust remainder, which would be almost $5,000,000 at a 10% rate of return, could be distributed to a trust for grandchildren without any GST tax consequences. Because of the ETIP rules, however, Grantor must wait until the end of the GRAT term and allocate GST exemption to the higher amount, thus using all of his GST exemption, which would not shelter the entire remainder in this example.

➔ **Planning Point:** If GST exemption is not allocated to a GRAT, it is important to be sure that the GRAT terminates in favor of non-skip persons, *e.g.*, children. If a child is not then living, then his or her share should be distributed to the other then living children. Because the deceased child's descendants will not receive a share of the GRAT, it is necessary to consider whether adjustments must be made in the grantor's other estate planning documents to compensate the family of a deceased child.

6. Sale of Remainder Interest in a GRAT

Having the grantor's children sell their remainder interests in the GRAT to a GST exempt trust for the benefit of the grantor's grandchildren may be a way to avoid the problem caused by the ETIP rules. The effect is to create a generation-skipping GRAT.

a. Structure of the Transaction. When the GRAT is created, the remainder beneficiaries, generally the grantor's children, sell their remainder interests to an existing GST exempt trust previously created by the grantor for the benefit of the grantor's grandchildren. When the GRAT terminates, the remaining trust property will be distributed to the trust for the grantor's grandchildren from which distributions can be made to grandchildren and more remote descendants free of transfer taxes. As a result, the benefits of the GRAT are shifted to the GST trust. The purchase price is the fair market value of the remainder interest, which has little or no value when the GRAT is created. If a *Walton* GRAT is used, so that the gift has a value of zero, a nominal amount, such as $1, should be paid for the remainder.

EXAMPLE: Grantor, age 55, transfers $5,000,000 to a 10-year GRAT of which his children are the remainder beneficiaries. The IRC § 7520 rate is 5.4%. The GRAT will pay Grantor an annuity in the amount of $660,162 for the shorter of 10 years or Grantor's life. The resulting gift is approximately $223,732. Shortly after the creation of the GRAT, the children sell their remainder interest to an existing GST exempt trust for $223,732. At the end of the 10 years, assuming that the GRAT assets grow at a rate of 8%, $1,231,154 will be remaining in the GRAT, to be distributed to the GST exempt trust, free of any transfer taxes.

➔ **Planning Point:** The GRAT instrument can provide that, at the end of the term, the remainder is payable to a trust for the benefit of the grantor's children, in which case the trustee of such trust is the owner of the remainder interest, and the trustee can sell the remainder interest to the GST trust. Alternatively, the grantor's children themselves can be the beneficiaries, and they will sell their remainder interests. The GRAT should not, however, terminate in favor of the grantor's descendants, *per stirpes*, because of the likelihood of needing the consent of unborn beneficiaries to the transaction.

➔ **Planning Point:** The planner must be sure that the spendthrift clause in the GRAT does not prohibit the transfer of the remainder interest.

b. Value of the Remainder. If the children sell the remainder interest for its value under IRC § 7520, the sale should be for full and adequate consideration, so there should be no gift tax consequences upon the sale or GST tax consequences when the GRAT remainder is distributed to the GST trust.[3]

Whether the payment of the actuarial value of the remainder interest in a trust as the purchase price for such interest constitutes adequate and full consideration has been the subject of a line of cases, the leading case on such issue being *Gradow v. U.S.*, 897 F.2d 516 (Fed. Cir. 1990). See also *U.S. v. Past*, 347 F.2d 7 (9th Cir. 1965); *Parker v. U.S.*, 894 F. Supp. 445 (N.D. Ga. 1995); and *Pittman v. U.S.*, 878 F. Supp. 833 (E.D.N.C. 1994). In *Gradow*, the IRS argued, and the court held, that the purchase of a remainder interest is deemed to be for full and adequate consideration for purposes of IRC § 2036's estate inclusion provisions only if the price paid for the remainder is equal to the full value of the property and not just the value of the remainder interest. The IRS could attempt to extend *Gradow*'s rationale by arguing that unless the children pay the grantor an amount equal to the full value of the GRAT property, as opposed to the actuarial value of the remainder interest, they will not have paid adequate and full consideration for the interest. Three Courts of Appeal have, however, held that consideration equal to the fair market value of the remainder interest is adequate for purposes of IRC § 2036. See *Magnin v. Comm'r*, 184 F.3d 1074 (9th Cir. 1999); *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997); and *D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996). More importantly, the IRS has conceded that this line of cases does not apply for purposes of the gift tax. *Wheeler v. U.S.*, 116 F.3d at 755 ("[b]oth parties [*i.e.*, the government and the taxpayer] agree that, for the purposes of the gift tax (IRC § 2512), consideration equal to the actuarial value of the remainder interest constitutes adequate

consideration").

c. **Severance of Trusts**. IRC § 2642(a)(3) provides another alternative to allow a GRAT to take advantage of the GST exemption. Under IRC § 2642(a)(3), if certain requirements are met, an existing trust can be severed for GST tax purposes into two trusts, and GST exemption can be allocated to one of the trusts so that it is completely exempt from GST tax. The other trust would not be exempt from GST tax.

Under this Section, therefore, if a grantor wishes to allocate GST exemption to a GRAT but the value of the GRAT property at the end of the term exceeds the grantor's available GST exemption, the grantor can structure the GRAT so that the remainder is held in a continuing trust for the remainder beneficiaries, at least one of whom should be a child of the grantor (*i.e.*, a non-skip person). The remainder trust will then be severed to create a trust for the benefit of grandchildren and more remote descendants, and the trustee can allocate the grantor's remaining GST exemption to that portion of the remainder trust. The balance of the GRAT property will be held in a non-exempt trust from which distributions can be made to children.

➔ **Planning Point:** Although severing a trust as discussed above is a method for allocating a grantor's GST exemption to a GRAT, the basic problem with allocating GST exemption to a GRAT is that the GST exemption cannot be allocated until the end of the term of the GRAT. The fact that the GST exemption is not effectively leveraged must still be considered.

7. GRATs Without Mortality Risk[4]

The primary disadvantage of a GRAT is that, if the grantor dies during the term of the annuity, a portion or all of the property is includable in his or her gross estate for federal estate tax purposes. As a result, the GRAT fails to achieve the goal of transferring property to the beneficiaries at no, or a reduced, gift tax cost. Additionally, the grantor may have paid gift tax or used part of his or her applicable exclusion amount. One technique, called a "guaranteed GRAT,"[5] has been suggested to eliminate the mortality risk inherent in a GRAT.

a. **Structure of the Transaction**. A grantor creates a GRAT, retaining a contingent reversion in the GRAT property, so that such property will be paid to the grantor's estate if he or she does not survive the GRAT term. The grantor's children are the remainder beneficiaries and will receive the remaining property in the GRAT if the grantor survives the term.

Shortly after the creation of the GRAT, the grantor and his or her children enter into an agreement whereby the children purchase the equivalent of the grantor's contingent reversion for its fair market value. Pursuant to the agreement, the grantor agrees that his or her estate will pay the children the value of any amount it receives from the GRAT because of the contingent reversion, and the children pay the grantor an amount equal to the current actuarial value of the contingent reversion (hereinafter the "reversion equivalent") determined under IRC § 7520. Note that the agreement does not obligate the estate to pay the actual GRAT property that reverts to the grantor's estate to the children, but rather to pay the children an amount equal to the value of such property.

If the grantor dies during the GRAT term, the GRAT will terminate and distribute the remaining trust property to the grantor's estate. Pursuant to the terms of the agreement, the grantor's estate must pay the children an amount equal in value to the property distributed to the grantor's estate from the GRAT upon the grantor's death (*i.e.*, the contingent reversion interest). As explained in more detail below, the grantor's estate should be entitled to an estate tax deduction for the amount it pays to the children. Thus, although the GRAT property is included in the grantor's estate, the estate receives a deduction that offsets the value of the GRAT property included in the gross estate. Such a transaction eliminates the mortality risk because, as a result of the deduction, the GRAT property is effectively not included in the grantor's gross estate for federal estate tax purposes. Thus, the children receive the value of the GRAT property free of estate tax.

Additionally, there is a possible windfall to the children. If the grantor dies during the GRAT term before all of the annuity payments have been made to the grantor, more property will remain in the GRAT than there would have been if the grantor had survived the GRAT term and received all of the annuity payments. This additional amount remaining in the GRAT (which the children receive from the grantor's estate pursuant to the agreement) will represent a windfall to the children.

b. <u>Why the Guaranteed GRAT Works</u>. Although the GRAT property is includable in the grantor's gross estate for federal estate tax purposes, the estate should be entitled to a deduction under IRC § 2053(a) for the value of the GRAT property that is paid to the children. IRC § 2053(a) provides for an estate tax deduction for claims against the estate, to the extent the claims were contracted for an adequate and full consideration in money or money's worth. The purchase price of the reversion equivalent will constitute adequate and full consideration because the purchase price will equal the actuarial value of the reversion, as determined under IRC § 7520. Thus, the requirements of IRC § 2053(a) should be satisfied. In contrast, a deduction would not be allowed under IRC § 2053(a) if the children received the reversionary interest by gift.

c. <u>Funding the Purchase Price</u>. The children will need funds to purchase the reversion equivalent from the grantor. If the children have sufficient wealth to purchase the reversion equivalent from the grantor but do not have sufficient liquid assets, they could give the grantor a promissory note, although the children should have sufficient other assets to ensure they have the ability to make payments on the note. If not, their payment may be deemed illusory, and the IRS could recharacterize the transaction as a gift of the reversion equivalent. Interest payments made by the children to the grantor will be taxed as interest income to the grantor. If the reversion equivalent is purchased by a trust for the benefit of the children that is a grantor trust as to the grantor, however, any interest payments made by the trust will not be taxable interest income to the grantor. This is because with a grantor trust, as discussed above, transactions between the grantor and the trust are ignored for federal income tax purposes.

If the children do not have sufficient funds to purchase the reversion equivalent or to make payments on a note, the grantor could make a gift to the children, which they may use to pay the purchase price. Unless such a gift qualifies for the gift tax annual exclusion or is sheltered by the applicable exclusion amount, a gift tax will be due. The timing of the gift and the purchase of the

reversion equivalent should be irrelevant. The IRS has held, however, that the purchaser of a remainder interest must not have acquired the funds to buy such interest from the holder of the life estate. See TAM 9206006. It is reasonable to assume that the IRS would take a similar position with respect to the purchase of a reversion interest. Therefore, a lapse of time between the gift and the purchase (*e.g.*, six months) is preferable.

d. IRC § 2702 Does Not Apply. IRC § 2702, which applies to a "transfer of an interest in trust," should not apply to the reversion purchase. The grantor's sale of the reversion equivalent should not be deemed to be a transfer of an interest in trust. Under the purchase agreement, the children are entitled only to receive an amount equal in value to the property received by the grantor's estate by reason of his or her reversion, but they are not entitled to receive the specific property paid to the grantor's estate from the GRAT. Thus, there is no transfer with respect to the GRAT property. Accordingly, IRC § 2702 should not apply, and the reversion should be valued under IRC § 7520.

e. The *Gradow* Issue. As discussed above, the children must pay adequate and full consideration for the reversion equivalent for the estate's obligation to pay the children an amount equal to the reversion to be deductible under IRC § 2053(a). In *Gradow v. U.S.*, 897 F.2d 516 (Fed. Cir. 1990), the court held that the purchase of a remainder interest is deemed to be for full and adequate consideration for purposes of IRC § 2036's estate inclusion provisions only if the price paid for the remainder is equal to the full value of the property and not just the value of the remainder interest.

The IRS could attempt to extend *Gradow*'s rationale by arguing that, unless the children pay the grantor an amount equal to the full value of the GRAT property, as opposed to the actuarial value of the reversion interest, they will not have paid full and adequate consideration for purposes of IRC § 2053. Consequently, the grantor's estate would not receive a deduction under IRC § 2053. As noted above in the discussion of the sale of a remainder interest in a GRAT, three Courts of Appeal have held that consideration equal to the fair market value of the remainder interest is adequate for purposes of IRC § 2036. See *Magnin v. Comm'r*, 184 F.3d 1074 (9th Cir. 1999); *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997); *D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996). As recognized by the court in *Wheeler*, the sale of a remainder interest for its actuarial value does not result in the circumvention of the estate tax because the consideration received for the remainder interest, reinvested at the IRC § 7520 rate for the applicable life expectancy or term, will equal the value of the property in which the remainder interest is sold.

f. Cost of a Guaranteed GRAT. Even if the IRS were to succeed in arguing that an IRC § 2053 deduction is not allowed for the grantor's estate's obligation to pay the children under the purchase agreement, the children will be no worse off than if the guaranteed GRAT had been a traditional GRAT (in which the grantor retains the reversion) and the grantor died during the annuity term. This comes with two exceptions: first, the children will have incurred an additional "cost" associated with a guaranteed GRAT, discussed below; and, second, a shorter term might have been used with a traditional GRAT, and the grantor may have survived the shorter term.

The purchase price that the children pay for the reversion equivalent becomes part of the grantor's estate, and it, and any appreciation thereon, will be subject to estate tax at the grantor's death. Thus, the additional "cost" of a guaranteed GRAT compared to a traditional GRAT is the estate tax on the amount the children pay the grantor for the contingent reversion (and on the appreciation thereof). The children place this amount into the grantor's estate, to be subject to estate tax before passing back to them.

If the GRAT assets grow at a rate that is less than the IRC § 7520 rate, or if the assets decline in value, the loss is greater with a guaranteed GRAT than with a traditional GRAT. In the case of a traditional GRAT, all that is lost is the grantor's use of the funds used to pay the gift tax. With the guaranteed GRAT, however, the purchase price paid by the children for their reversion equivalent will be subject to estate tax in the grantor's estate. Thus, in 2011, the children would lose 55% of the reversion equivalent purchase price (plus 55% of any appreciation thereon). This loss is in addition to the loss in the case of a traditional GRAT, *i.e.*, the use of the gift tax funds.

EXAMPLE 1: 10-Year Guaranteed GRAT. When the IRC § 7520 rate is equal to 5.4%, the grantor, who is 50 years old, transfers $10,000,000 to a 10-year GRAT that will pay her an annuity of $1,320,323 per year. The grantor also retains a contingent reversion in the event she does not survive the GRAT term. Her children are the remainder beneficiaries of the GRAT. The value of the gift (the contingent reversion) upon creation of the GRAT is $287,836. Assuming a 45% gift tax rate, the grantor will be required to pay $129,526 in gift tax (before application of any unified credit). Shortly after the creation of the GRAT, the grantor and her children enter into an agreement whereby the children purchase the reversion equivalent from the grantor for $287,836. The grantor then dies just before the end of the GRAT term.

If the GRAT's rate of return on its investments is 10%, the children will receive about $4,900,000 from the GRAT property. The children also will receive the $287,836 that the grantor received from the children as payment for the reversion, reduced by estate tax. However, the estate will be able to take a deduction for $287,836 under Section 2053. Assuming the grantor reinvested the purchase price at 10%, it will have grown to about $746,572. After estate taxes, the children will receive $410,615 + $4,900,000, which equals $5,310,615.

EXAMPLE 2: Traditional 10-Year GRAT. If the grantor creates a traditional 10-year GRAT with identical terms and the grantor survives the 10-year term but dies immediately thereafter, the children will receive the same $4,900,000 from the GRAT at the end of 10 years. The children will have retained their $287,836 (not used to purchase the reversion equivalent), which will have grown to $746,572. The children will have $4,900,000 + $746,572, which equals $5,646,572. The difference between what they receive from the guaranteed GRAT and

what they receive from the traditional GRAT, $335,957, results because the children kept their $287,836, which grew to $746,572 over 10 years and was not subject to estate tax at the grantor's death. The "cost" of the guaranteed GRAT is the amount of estate tax saved on the $746,572.

If the grantor dies in year 5, however, the traditional GRAT would have failed to save any estate tax, while the guaranteed GRAT shifted all of the GRAT property at that time to the children free of estate tax.

g. <u>Factors Offsetting the Additional Cost</u>. The additional cost of a guaranteed GRAT is reduced or offset by three factors:

(1) <u>Economic Benefits of GRAT Increase With Longer Term</u>. The economic benefit produced by any type of GRAT (traditional or guaranteed) is that the amount by which the investments in the GRAT outperform the IRC § 7520 rate passes to the remainder beneficiaries free of gift or estate tax other than any gift tax paid when the GRAT is initially funded. Because the guaranteed GRAT does not have the mortality risk associated with a traditional GRAT, however, the GRAT term can be longer than one might otherwise use in a traditional GRAT. The economic benefit produced by the GRAT is increased because more property remains in GRAT for a longer period of time, thereby shifting to the children the spread between the actual rate of return and the IRC § 7520 rate on more property for a longer period.

As the GRAT term is increased, however, the value of the contingent reversion (and thus the amount of the gift tax triggered upon creation of the GRAT and the purchase price of the reversion equivalent) will also increase. This is because the longer the GRAT term, the greater the likelihood that the grantor will not survive the entire term, and, therefore, the more valuable the reversion equivalent (and the greater the purchase price of the reversion equivalent).

<u>EXAMPLE 1</u>: Grantor, age 50, transfers $10,000,000 to a 5-year GRAT and retains a contingent reversion. The IRC § 7520 rate is 5.4%. The GRAT will pay Grantor an annuity of $2,335,357 for the shorter of his life or the 5-year term. If the assets grow at 8%, at the end of the 5-year term, $992,673 will be available for the beneficiaries. The value of the grantor's reversion, and the value of the taxable gift, is $130,548.

<u>EXAMPLE 2</u>: The facts are the same as in Example 1, except that the GRAT is for a 10-year term. In that case, the annuity payment is $1,320,323. At the end of 10 years, $2,462,308 will be available for the beneficiaries. The value of the grantor's reversion, and the value of the taxable gift, is $287,836.

➔ **<u>Planning Point</u>:** If a *Walton* GRAT is used, however, there is no reversion, and, therefore, no gift. Accordingly, a longer-term, traditional (non-guaranteed) GRAT can be used without the corresponding increase in the gift tax.

(2) Windfall Upon Premature Death. If the grantor dies during the term of a guaranteed GRAT, the children will receive a "windfall" because they will receive the property in the GRAT before all of the annuity payments are made to the grantor. (With a traditional (non-guaranteed) GRAT, such property returns to the grantor's estate and is subject to estate tax before passing to the children.) Thus, unlike a traditional (non-guaranteed) GRAT, a practitioner can consider a guaranteed GRAT for those clients who do not have a normal life expectancy but nevertheless are not terminally ill within the meaning of the regulations under IRC § 7520. (Recall that, if the grantor is terminally ill, the IRC § 7520 rate cannot be used to value the reversion. Treas. Reg. § 1.7520-3(b).) A guaranteed GRAT thus can function as a "bet to die" technique, providing a greater benefit when the grantor dies prematurely.

(3) Less Investment Risk. A longer GRAT term reduces the investment risk, *i.e.*, the risk that the GRAT's investment return will not exceed the IRC § 7520 rate over the GRAT term.

8. GRAT v. Direct Gift

The success of a GRAT must be compared with the alternative of making an outright gift. Whether a GRAT should be used depends on whether, at the end of the term of the GRAT, the remainder beneficiaries will receive more than they would have if the grantor had made an outright gift.

As discussed above, a GRAT serves to transfer property at a reduced gift tax cost to the remainder beneficiaries only if the GRAT assets achieve a rate of return in excess of the IRC § 7520 rate. If the grantor dies during the term of the GRAT, the remainder beneficiaries will not receive anything. Had the grantor made a direct gift to them, however, they would have received something. A GRAT may decrease the transfer tax cost of a gift, but a direct gift of an amount equal to the amount of the gift upon creation of the GRAT may result in more property being available for the beneficiaries because they receive the property immediately and are entitled to all of the income and appreciation on it.

> **EXAMPLE:** Grantor, age 55, transfers $5,000,000 to a 5-year GRAT for Son. The IRC § 7520 rate is 5.4%, and the annuity payment is $1,167,679. Based on the value of the annuity for the shorter of 5 years or Grantor's life, the taxable gift is $102,406.
>
> If the GRAT property grows at 5.0% (less than the IRC § 7520 rate), nothing will be passed to Son. If, instead, Grantor had given Son $102,406 directly, which also grew at 5%, Son would have $130,699 after 5 years. Thus, the direct gift produces a better result than the GRAT.
>
> If the property in the GRAT grows at 8%, however, upon termination $496,337 will be distributed to Son. Had Grantor given Son $102,406 directly, which grew at 8%, Son would have $150,468, a less favorable result than with the GRAT.

Although it is said that a GRAT is successful if it outperforms the IRC § 7520 rate, it may not be as successful as an outright gift. At a 6% rate of return, the GRAT will result in $108,816 available for Son, while an outright gift of $102,406 will result in $137,042.

D. Grantor Retained Unitrusts

A grantor retained unitrust ("GRUT") is similar to a GRAT, except that it provides the grantor with a "qualified unitrust interest," which is another type of qualified interest under IRC § 2702. A "qualified unitrust interest" is the right to receive, at least annually, a fixed percentage of the fair market value of the property in the GRUT, determined annually. IRC § 2702(b)(2). Thus, a grantor transfers property to an irrevocable trust and, instead of paying an annuity as with a GRAT, the trust pays the grantor a fixed percentage of the fair market value of the property, determined annually. Trust distributions under a GRUT vary from year to year, depending on the value of the trust property. That is, because the payment is a percentage of the value of the trust property, as the value of the trust property increases (or decreases), so does the annual payment. This, of course, differs from a GRAT, where the distributions do not change from year to year.

A GRUT is more difficult to administer than a GRAT because the trust assets must be revalued each year in order to determine the annual payment. The revaluation is especially burdensome if the GRUT holds hard to value assets, such as closely held stock.

1. Gift and Estate Tax Consequences

As with a GRAT, the transfer of property to a GRUT constitutes a taxable gift equal to the value of the property transferred to the GRUT less the value of the retained unitrust interest. Because the unitrust interest is a "qualified interest," it will be valued under IRC § 7520. As with a GRAT, the GRUT property will be included in the grantor's gross estate if the grantor dies during the term of the GRUT.

2. Why GRUTs Are Rarely Used

In general, practitioners do not use GRUTs because the unitrust payment returns more property to the grantor, which is contrary to the usual goal of removing property from the grantor's estate. That is, if the rate of return on the GRUT assets exceeds the IRC § 7520 rate, the unitrust payment will increase, so that the grantor shares in the excess, thereby eliminating any transfer tax savings from the high returns. In contrast, with a GRAT, the excess benefits the remainder beneficiaries exclusively.

The GRUT generally provides little benefit over a direct gift, regardless of whether the GRUT assets exceed or fall short of the IRC § 7520 rate, and a direct gift may be preferable because it eliminates the mortality risk associated with a GRUT.

EXAMPLE: Grantor, age 60, transfers $1,000,000 to a 5-year GRUT. The IRC § 7520 rate is 5.4%. The unitrust payment is 10% of the value of the trust. The taxable gift is $619,470.

If the assets grow at a rate of 10%, then, at the end of the GRUT term, the beneficiaries will receive $1,000,000. Had the grantor made a direct gift of $619,470, after 5 years at 10% growth, the beneficiaries would have $997,663, or $2,337 less than with a GRUT.

If the assets grow at a rate of 6%, the beneficiaries will receive $815,373 at the end of the term. Had the grantor made an outright gift of $619,470, the beneficiaries would have received $828,991, or $13,618 more than with the GRUT.

In either case, although the rate of return exceeds the IRC § 7520 rate, very little additional property, if any, is transferred to the remainder beneficiaries using a GRUT versus what they would receive from a direct gift.

E. Sale to an Intentionally Defective Grantor Trust

A sale to an intentionally defective grantor trust ("IDGT") is often proposed as an alternative to a GRAT, as it is a similar technique to transfer property to beneficiaries at no, or a reduced, transfer tax cost. As with a GRAT, the success of this technique depends upon the assets that are the subject of the transaction achieving a rate of return in excess of the IRS' assumed interest rate.

1. Structure of the Transaction

The grantor sells property at its fair market value to the IDGT in return for an installment note. There are two keys to the transaction: (a) the trust must be structured as a grantor trust so that it will be disregarded for income tax purposes; and (b) the transaction must be recognized as a bona-fide sale for adequate and full consideration to avoid the imposition of estate and gift taxes. At the end of the note's term, any income and appreciation on the trust assets that exceed the payments required to satisfy the promissory note pass to the beneficiaries of the trust (usually the grantor's children and/or grandchildren) free of estate, gift and, if appropriately structured, GST transfer taxes.

If the trust assets appreciate at a rate that is less than the interest rate used to determine the interest payments on the promissory note, or if the assets decline in value, the grantor will receive back (as promissory note payments) the value of the original property sold to the trust, and nothing will be left to distribute to the remainder beneficiaries. Thus, if the trust assets underperform, some of the grantor's assets could be subject to double taxation: assets that are gifted to the trust to fund the note payments will be subject to gift tax upon funding the trust and subject to estate tax at the grantor's death). Assets transferred to the grantor as payment on the note are eligible for a stepped-up basis at the grantor's death.

If the trust's total return exceeds the applicable interest rate but the income generated by the trust assets is insufficient to pay the interest on the note (*i.e.*, the assets have a high growth rate, but a low income yield), the trustee can transfer trust principal back to the grantor in order to make the annual interest payment. This method of payment is common where the assets sold to the trust are highly appreciating assets with low cash flow.

Generally, any assets with appreciation potential or yield in excess of the applicable interest rate are appropriate assets to sell to an IDGT. Assets that can be valued at a discount, such as a minority interest in a closely held corporation or limited partnership interests, can produce significant savings because the face amount of the note will be based on the discounted value of the assets sold, rather than on the full value.

a. **The Grantor Trust**. A sale to an IDGT involves the creation of an irrevocable trust that is a grantor trust for income tax purposes. A grantor trust is ignored for federal income tax purposes and, as a result, the trust's income, deductions, and credits are passed through the trust to the grantor and reported on the grantor's individual income tax return rather than to the trust as a separate entity. Although the trust is a grantor trust for federal income tax purposes, the trust is structured so that the trust assets are not includable in the grantor's gross estate for federal estate tax purposes. The basis of the assets sold to the IDGT is equal to the grantor's basis in such assets (*i.e.*, a carryover basis). Because the value of the IDGT will not be included in the grantor's gross estate, the trust assets will not receive a stepped- up basis at the grantor's death. The loss of the step-up in basis for the assets sold to the IDGT must be considered in determining the tax consequences of the sale transaction.

➔ **Planning Point:** One alternative to avoid the adverse income tax consequences of selling highly appreciated assets to an IDGT and losing the step-up in basis is to pay the note in kind before the grantor's death with appreciated assets. Because the trust is a grantor trust, no gain or loss would be recognized on the payment, and the appreciated property used to pay the note would be included in the grantor's gross estate and, therefore, would get a step-up in basis at the grantor's death.

Rather than creating a new trust to which the assets will be sold, the assets could be sold to an irrevocable grantor trust that already exists. Doing so will avoid the need to fund the trust with cash or other assets in order to support the assertion that the eventual sale is a bona-fide sale. The reasons for funding the trust with other assets will be discussed below.

b. **Terms of the Sale**. After creating the trust, the grantor sells assets to the trust at their fair market value in return for a promissory note that bears interest at the interest rate sanctioned by the Code.

(1) **The Interest Rate**. The interest rate on the note is determined by reference to IRC § 7872(f)(2)(A). This Section states that the AFR for a term loan is the AFR in effect under IRC § 1274(d) for the period represented by the loan, compounded semi-annually. The AFR changes monthly and varies depending upon the term of the note. The short term rate applies for terms of three years or less, the mid-term rate applies to terms greater than three years and nine years or less, and the long-term rate applies to terms greater than nine years.

(2) **The Note**. The promissory note will bear interest at the interest rate determined by reference to the applicable federal rate ("AFR") under IRC § 7872(f)(2)(A). Ideally, the note will be structured as a balloon note, where repayment of the principal is deferred until the end of the note term. Therefore, the trust will make only annual interest payments to the grantor.

By using a balloon note, a larger percentage of the assets remains in the trust during the note term, thereby allowing the greatest compounding of appreciation inside the trust.

➔ **Planning Point:** The term of the promissory note can be for any length. Generally, the longer the term, the larger the required interest payment because the AFR will be higher. Because the death of the grantor during the note term only will result in the unpaid balance of the note being included in the grantor's estate (as opposed to the full value of the note), the grantor's survival of the term is not necessary to achieve transfer tax savings. In general, the length of the term will depend on interest rates at the time of the transaction (*e.g.*, if the AFR is low, the grantor may want to lock in this rate by using a longer term; alternatively, if the AFR is high, the grantor may want to use a shorter term and then enter into another sale transaction when rates are more favorable).

➔ **Planning Point:** The sale should be documented in the same way in which a sale to an unrelated party would be. Thus, there should be a sales contract, an assignment, a promissory note, an appraisal of the property, if necessary, and a security document, if applicable.

> **EXAMPLE:** Grantor, age 50, transfers $500,000 to an irrevocable grantor trust. The income and principal of the trust are to be paid, in the trustee's discretion, for his daughter's health, education, support and maintenance. At his daughter's death, the trust assets will be held in the trust for the benefit of his grandchildren. Grantor files a gift tax return to report the $500,000 gift to the trust (which is sheltered from tax by his applicable exclusion amount) and allocates GST exemption to the transfer. After funding the trust, Grantor sells $5,000,000 worth of assets to the trust in exchange for a 5-year, $5,000,000 promissory note. The promissory note is structured so that interest is paid annually at the mid-term AFR of 4.65%, and a balloon payment of principal is due at the end of the 5-year note.
>
> As discussed, the initial funding of the trust with $500,000 results in a taxable gift. Nevertheless, if Grantor's applicable exclusion amount is available, the initial transfer can be sheltered from gift tax. No gain or loss is recognized on the sale of $5,000,000 of assets to the trust, and the annual interest payments of $232,500 ($5,000,000 x 4.65%) will not be taxable as income to Grantor. Assuming a 15% annual growth rate, at the end of the note term, the trust will pay Grantor a balloon payment of $5,000,000, which also will not be taxable income to Grantor. After the payment of the note, $3,489,183 will be left in the trust and will pass to the trust beneficiaries free of gift, estate and GST taxes.
>
> If the assets were sold to an existing trust, however, Grantor would avoid the $500,000 gift.

2. Tax Consequences of a Sale to an Intentionally Defective Grantor Trust

a. **<u>Gift Tax</u>**. A promissory note bearing interest at the AFR is deemed to have a fair market value equal to its face amount. Therefore, the sale of assets to the IDGT in return for a promissory note will not be a gift as long as the promissory note equals the value of the property transferred and bears interest at the AFR. An accurate appraisal is essential to support the fair market value claimed in the transaction.

If the assets are not sold to an existing trust, the initial funding of the IDGT will be a taxable gift. The grantor can use, if available, a portion of his or her applicable exclusion amount to shelter the gift from tax.

(1) <u>Avoiding the Undervaluation of Assets</u>. Gift tax concerns may arise if the property that is the subject of the sale is a hard-to-value asset, such as closely held stock. A taxable gift will occur if the value of the property transferred is later determined to be greater than the sale price. This section discusses the most common methods used to minimize the risk that the IRS will increase the value of the property transferred.

(a) <u>General Rule</u>. The seminal case in this area is *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). *Procter* involved a transfer by gift to a trust. The trust provided that if a federal court of last resort held that any part of the transfer was a taxable gift, that portion of the property subject to gift tax would be excluded from the transfer. The court held that this was a condition subsequent and it violated public policy. The court stated that there were three reasons for declaring the condition subsequent void:

- It would deter the IRS from auditing returns because there would be no possibility to collect tax,
- The donees would not be parties to the tax litigation and might later try to enforce the gift and
- This type of provision would obstruct the administration of justice because as soon as a court rules that the value of the gift should be increased, the trust instrument revokes the gift and makes the court's ruling moot.

(b) <u>Valuation Formulas</u>. The IRS and the courts have continued to confirm *Procter*. See, e.g., *Estate of McClendon v. Comm'r*, T.C. Memo. 1993- 459, *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995); *Ward v. Comm'r*, 87 T.C. 78 (1986); Rev. Rul. 86-41, 1986-1 C.B. 300. Practitioners have responded by creating valuation formulas (also called "valuation definition clauses" or "defined value gifts") that attempt to avoid the risk of revaluation. One valuation formula specifies the dollar amount of the gift and then calculates what portion of the property would be needed to satisfy the amount of the gift. The valuation formula arguably avoids the creation of a condition subsequent and the transferring of property back to the grantor. In other words, the donee never has a right to the portion of property that exceeds the specified dollar amount. While the IRS appeared at first to favor these valuation formulas (see, e.g., TAM 8611004, in which the IRS granted the ruling requests of a taxpayer who transferred "such interest in X partnership as has a fair market value of $13,000," although neither one of the issues at stake concerned the validity of this formula), the IRS has subsequently ruled that these

clauses are invalid. In TAM 200337012, the taxpayer transferred "that fraction of Assignor's Limited Partnership Interest . . . which has a fair market value . . . of
$a." The taxpayer reported the transfer on a federal gift tax return as a gift of a specific percentage partnership interest with a value of $5,000 less than the figure mentioned in the deed of gift. Relying on the above-cited cases and ruling, the IRS stated that the formula gift clause was ineffective for gift tax purposes because it violated public policy. The IRS saw no difference between a valuation clause such as the one at issue in this TAM and the revaluation clauses in *Procter* and its progeny.

Other valuation formulas have not been any more successful. In TAM 200245053, the taxpayer, as trustee of a revocable trust, sold a fractional share of a 98.9% limited partnership interest to his irrevocable trust. The fraction used to determine the share of the limited partnership interest had a numerator equal to the stated purchase price and a denominator equal to the fair market value of a 98.9% interest in the limited partnership interest. The sale agreement stated that the fair market value of the limited partnership interest "shall be such value as finally determined for federal gift tax purposes." The sale agreement stated that the parties
reached a tentative agreement that the percentage interest transferred was the revocable trust's entire interest. The sale agreement also stated that the agreement may be modified if the IRS determines that the sale actually conveyed a different percentage than 98.9%. Upon such a determination by the IRS, the ownership interests and prior distributions would be adjusted. The IRS stated that this clause was against public policy, relying on *Ward* and Rev. Rul. 86-41. The IRS stated that the formula was an "attempt to ameliorate any adverse consequences if the Service challenged the transaction and thereby to discourage any such challenge," and that the clause "does not serve a legitimate purpose."

While the IRS may disfavor valuation formulas, the Fifth Circuit may have given some hope for the validity of these formulas. In *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), the taxpayers formed a limited partnership to hold various investment assets, including stocks, bonds, real estate and other limited partnership interests. The taxpayers then gave partnership interests to their children and certain charities under a formula clause that purported to give (a)
$6,910,933 worth of partnership interests to the taxpayers' children and trusts for their benefit; (b) $134,000 worth of partnership interests to the Shreveport Symphony (but not more than the difference between the value of the total gift and the amount allocated to the children and their trusts) and (c) the balance to a second charity (later determined to be $324,345). The donees were required, without any involvement by the taxpayers, to determine the value of the partnership interests and to allocate the gift among themselves using gift tax valuation methods. The IRS valued the total gift at $12,426,086, and declined to recognize the validity of the formula clause, upholding its position in FSA 200122011, which dealt with a similar formula.

The Tax Court determined the value of the total gift to be $9,883,832. The gifts were calculated on the basis of the fair market value determined by the Tax Court and the percentage interests transferred as independently determined by the donees. The court then stated that the specific formula clause might be valid to limit the amount given to the children and their trusts, but that it did not create a charitable deduction for the entire additional amount passing to the charity because it relied on the valuation fixed by the donees, rather than one fixed by the courts. The court stated that it did not, therefore, have to reach the question of whether such a formula

clause would be enforced if it was tied directly to the gift tax values set by the court. The court stated, however, that it might have allowed the larger charitable deduction had the agreement given each donee the "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 taxpayers could, therefore, deduct as the gift to the second charity for gift tax purposes only the amount actually allocated to the second charity by the donees' agreement, rather than the difference between the court's valuation of the gift and the amount allocated to the children and the Shreveport Symphony, thus creating a $2,514,554 net additional taxable gift. ($9,883,832 - $7,044,933 - $324,345).

On appeal, the Fifth Circuit was very critical of the Tax Court's analysis and dismissed any positive language concerning the validity of valuation formulas that one may have taken from the Tax Court's opinion. However, the Fifth Circuit, in reversing the Tax Court, still indicated that valuation formulas may be generally valid. The Fifth Circuit stated that the Tax Court should have not considered events after the date of the gift, such as the donees' agreement, especially when the taxpayers were not parties to such agreement. The Fifth Circuit also found the transaction was not abusive.

Because the Tax Court rejected the IRS's expert's valuation, and because of the Fifth Circuit's finding that the Tax Court erred in its own valuation, the Fifth Circuit found that the only usable valuation for the transferred interests is the taxpayer's appraisal, which led to the value of the gifts reported on the taxpayer's gift tax return.

➔ **Planning Point:** Although *McCord* was a very taxpayer-friendly decision, its reliability may be severely limited because the IRS did not discuss in its brief the traditional policy arguments against defined value formulas discussed above. The IRS has attempted to use these arguments in at least one case post-*McCord*. See *Dallas v. Comm'r*, T.C. Memo. 2006-212, n.19.

(2) IRC § 2702 Should Not Apply. A gift could result if IRC § 2702 applies to the IDGT promissory note sale. Under IRC § 2702, the value of a retained interest in a trust that is not a "qualified interest" is valued at zero for purposes of determining the value of the gift. With a sale to an IDGT, only the interest payments on the note would constitute qualified interests. Thus, if IRC § 2702 were applicable, the balloon note payment at the end of the term would be deemed to be a gift.

Nevertheless, IRC § 2702 should not apply because the promissory note issued by the IDGT is not a retained interest of the grantor. A promissory note, unlike a retained beneficial interest in a trust, is governed by its own terms and is independent of the trust instrument. The note can be pledged or otherwise disposed of even if the trust from which it is issued contains a spendthrift provision. See PLR 9535026 and PLR 9436006 (concluding that IRC § 2702 does not apply to promissory notes issued to a trust to pay for assets sold to the trust).

b. Estate Tax. If the grantor dies before the note is fully paid, then the balance due on the note will be included in the grantor's gross estate. Post-sale appreciation on the trust

assets, however, will not be subject to estate tax.

(1) Inclusion in the Gross Estate Generally. The trust must be designed so that the trust assets will be excluded from the grantor's gross estate for federal estate tax purposes. Accordingly, the grantor must not retain any interests in or powers over the property transferred to the trust that would cause the trust property to be includable in his or her gross estate for federal estate tax purposes.

➔ **Planning Point:** To avoid inclusion of the IDGT property in the grantor's gross estate, the grantor should not be a beneficiary of the trust. Generally, state law allows a grantor's creditors to reach a grantor's retained beneficial interests in a trust. If state law allows a grantor's creditors to reach an irrevocable trust created by the grantor to satisfy claims against the grantor, the trust is included in the grantor's gross estate. See Rev. Rul. 77-378, 1977-2 C.B. 347; Rev. Rul. 76-103, 1976-1 C.B. 293.

The grantor can be a trustee if his or her powers are appropriately limited. For example, if the grantor is acting as trustee, the grantor cannot have the power to distribute the trust property to discharge his or her legal obligations, including support obligations. If the grantor has such a power, the grantor's creditors can reach the trust property, and in that case, the trust property may be included in the grantor's gross estate. See *Estate of McTighe*, 36 T.C.M. 1655 (1977). In practice, the grantor generally is not the trustee of the grantor trust.

➔ **Planning Point:** The grantor's spouse can, however, be a beneficiary of the IDGT, which, in effect, allows the grantor to obtain benefits from the transferred property. If the spouse is a beneficiary, the spouse must not transfer property to the IDGT, as doing so could have adverse estate tax consequences for the spouse. Even if the spouse is a beneficiary, the spouse can split gifts with the grantor so that gifts by the grantor to the trust are treated as having been made one-half by each of them without causing inclusion of the trust property in the spouse's gross estate. Splitting gifts also is effective for GST tax purposes, so that both the grantor and the spouse will be deemed to be the transferor of one-half of the property that the grantor gifts to the IDGT. Depending on the terms of the trust, however, the spouse's ability to split gifts to such a trust could be limited. Treas. Reg. § 25.2513-1(b)(3), (4).

EXAMPLE: Grantor contributes $1,000,000 to an IDGT of which spouse is a discretionary beneficiary. Grantor and spouse elect to split gifts. Each of Grantor and spouse is deemed to have transferred $500,000 to the trust, so that each uses $500,000 of his or her respective applicable exclusion amount. Each also is deemed to be the transferor for GST tax purposes with respect to $500,000, so that each uses

$500,000 of his or her respective GST exemption.

(2) **Inclusion Under IRC § 2036(a)(1)**. If the sale is structured correctly as a bona fide sale, then the grantor's sale of assets to the IDGT should not be characterized as a transfer with a retained interest under IRC § 2036(a)(1). The argument for inclusion is that the right to annual interest payments on the note constitutes a right to receive the income from the transferred property. The concern is one of "coverage" or "thin capitalization," i.e., if the only assets held by the trust are the assets the trust received in exchange for the note, then the grantor is relying on the income from the transferred property to make interest payments on the note. The result of thin capitalization would be that the trust assets would be included in the grantor's gross estate at their date of death value, including the appreciation and accumulated income.

➔ **Planning Point:** A number of commentators have stated that the obligation should not be secured by the property held in trust. Their concern is that using the trust property to secure the note might be deemed a retained interest, causing the assets to be included in the grantor's estate under IRC § 2036(a)(1). Others believe, however, that using the trust property to secure the assets in the trust will lend credence to the fact that the sale is a "bona fide sale" that is outside the purview of IRC § 2036.

The result in a number of cases illustrates how a sale to an IDGT should be structured to avoid inclusion of the property in the IDGT in the grantor's gross estate under IRC § 2036(a)(1). See, e.g., *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958); *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1985); *Estate of Fabric v. Comm'r*, 83 T.C. 932 (1984); see also Rev. Rul. 77- 193, 1977-1 C.B. 273. The cases set forth the following factors to determine whether inclusion under IRC § 2036 can be avoided.

(a) **No Tie Between Trust Income and Interest Payments**. The note should be structured so that the rate of interest is not tied to the income generated by the assets sold to the trust. This is accomplished by using the AFR.

(b) **Note is Obligation of Trustee**. The note should be the personal obligation of the trustee. It is unlikely, however, that the trustee would accept personal liability.

(c) **Note Not Charged to Trust Property**. The obligation on the note should not be charged to the transferred property. That is, the trust assets should not be the sole source of the debt repayment. This factor, as well as the previous factor ((b) above), should be satisfied if the IDGT is funded with assets other than those sold to the trust, which can be used to meet the trust's obligation under the note. One solution is to sell the assets to a preexisting, funded trust. If that is not possible, the following alternatives can be used to provide the necessary coverage.

1. Ten Percent Funding. The prevailing view is that the trust should be funded with assets equal to ten percent of the face amount of the note. This ten percent funding is often called "seed money" or a "downpayment." The contribution of seed

money to the IDGT will be a gift and will generate a gift tax unless it is sheltered by the grantor's applicable exclusion amount. Funding the trust with assets other than those sold to the trust lends credence to the fact that the sale is a "bona fide sale." For the view that pre-sale funding is unnecessary, see Elliott Manning and Jerome M. Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Est., Gifts & Tr. J*. 3 (Jan. 1999) (hereinafter "Manning and Hesch").

2. Beneficiary Guarantees. As an alternative to a gift of seed money, coverage can be afforded by the personal guarantees of the beneficiaries. Guaranteeing payment of the note, however, might constitute a gift by the guarantors if it is possible that the guarantors might be required to make payments on the note.

The mere giving of a guarantee should not be a gift, especially if the remainder beneficiaries are the guarantors, who would be making a guarantee for their own benefit. Additionally, there should be no gift if the guarantee is a bona fide obligation of the beneficiary making the guarantee and the beneficiary has sufficient net worth to make payments in the event of default by the trust. See PLR 9515039; Milford B. Hatcher, Jr. and Edward M. Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 *J. Tax'n* 152 (Mar. 2000) (hereinafter "Hatcher and Manigault"). Hatcher and Manigault suggest that as long as the trust assets are expected to be sufficient to repay the note at the end of the term, and as long as there is no evidence that the parties do not expect or intend for the beneficiaries to honor their guarantees, the guarantee should be bona fide and should not cause the guarantors to have made taxable gifts. But see *Dickman v. Comm'r*, 465 U.S. 330 (1984) (while concluding that an interest-free loan was a taxable gift, the Court defined the term "gift" very broadly, stating that the gift tax applied to all transfers of property and property rights having significant value).

Payment of a commercially reasonable guarantee fee by the IDGT to the guarantors should avoid the argument that such a guarantee is itself a gift by the guarantor to the trust or the grantor. If the trust does not pay a fee for the guarantee, or if the fee is inadequate, however, the guarantors could become contributors to the trust and thus grantors, with the result that the IDGT would not be wholly owned by the original grantor. In such a case, interest payments and any in- kind payments to the grantor would be taxable events to the grantor to the extent that the grantor is not treated as the owner of the trust.

The timing of the gift, if one is made, is uncertain. First, there could be an annual gift as long as the guarantee is outstanding. Second, there could be a one-time taxable gift when the guarantee is made. Finally, no gift might occur until the beneficiary actually makes a payment under the guarantee.

➔ **Planning Point:** The client may wish to use a combination of seed money and guarantees, such as by contributing seed money equal to 5% of the value of the note and obtaining a beneficiary's guarantee of 5% of the value of the note to reach the desired 10% interest.

c. Generation-Skipping Transfer Tax. The IDGT can be designed so that the trust assets are exempt from GST tax. As discussed above in connection with GRATs, the grantor of a trust cannot allocate his or her GST exemption to property transferred during an estate tax inclusion period, which is the period of time after the transfer during which the value of the trust property would be includable in the grantor's gross estate. Because the IDGT will not be includable in the grantor's gross estate, the grantor can allocate a portion of his or her GST exemption to the assets used to fund the trust immediately upon the creation of the trust and thereby shelter the entire trust from the GST tax.

d. Income Tax. As discussed above, the trust is designed to be a grantor trust for income tax purposes. This means that transactions between the grantor and the trust have no income tax consequences (because the grantor is treated for income tax purposes as if he or she still owns the trust assets). The transaction has the following income tax ramifications:

- The grantor will not recognize gain or loss on the sale of assets to the trust in return for the promissory note. As the sale is ignored for income tax purposes, the income tax basis of the assets sold to the trust will not change as a result of the sale;
- The grantor is not taxed on interest payments he or she receives from the trust on the promissory note; and
- Because the grantor is treated for income tax purposes as if he or she still owns the trust assets, the grantor will report, for income tax purposes, all items of income, deduction and credit generated by the trust on his or her individual income tax return. Such items will not be taxable to the trust as a separate entity. Thus, if interest or dividends are received or capital gains are recognized in the trust, the grantor continues to be taxed on such items as though he or she had never sold the assets to the trust. The net effect of this income tax treatment is that the grantor is effectively able to make a tax-free gift to the beneficiaries of the trust, as the grantor's payment of income taxes reduces his or her estate without any transfer tax consequences while enhancing the assets that ultimately pass to the remainder beneficiaries by leaving the trust assets intact.

(1) **Achieving Grantor Trust Status**. Grantor trust status can be achieved by intentionally violating one of the grantor trust rules specified in IRC §§ 671-679. Some of the typical provisions used to cause grantor trust status are as follows:

- Naming the grantor's spouse as a beneficiary of the IDGT. IRC § 677(a).
- Granting the grantor the power to borrow the income or principal of the IDGT without adequate interest or security. IRC § 675(2). There is concern, however, that the grantor's retention of the power to borrow income or principal without adequate interest may cause inclusion in the grantor's estate as a retained right to the possession or enjoyment of, or the right to income from, the trust property under IRC § 2036(a)(1).
- Granting the grantor the power, in a nonfiduciary capacity, to reacquire the trust corpus by substituting property of equivalent value. IRC § 675(4). The IRS, in an apparent attempt to discourage the use of this provision as a means of achieving grantor trust status, has declined to rule on whether or not this provision will cause grantor trust status. Instead, the IRS has stated that the determination as to whether the grantor is acting in a nonfiduciary capacity is a factual issue that must await the filing of the fiduciary income tax return.
- Granting a person other than the grantor or an existing beneficiary the power to add beneficiaries. IRC § 674(c). See PLR 200030019; and PLR 199936031.

➔ **Planning Point:** The trust should provide for the ability to change from a grantor trust to a nongrantor trust if the law changes or other circumstances dictate such a change. For example, if the grantor's payment of income

taxes is determined to be a gift, grantor trust status may result in unwanted gift, estate and GST tax consequences.

(2) Basis of Property Sold to IDGT. The basis of the assets sold to the IDGT is equal to the grantor's basis in such assets. That is, the assets have a carryover basis. Because the IDGT will not be included in the grantor's gross estate, the assets in the trust will not receive an increased basis, as is the case with assets held by the grantor at death (the basis is "stepped up" to equal the fair market value at death). If highly appreciated assets are sold to the IDGT and the assets do not continue to appreciate as expected, the grantor may have been better off had the sale not taken place, in which case the assets would be included in his or her gross estate, but they also would receive a stepped-up basis.

➔ **Planning Point:** One alternative to avoid the adverse income tax consequences of selling highly appreciated assets to an IDGT is to pay the note in kind prior to the grantor's death with appreciated assets. Because the trust is a grantor trust, no gain or loss would be recognized on the payment, and the appreciated property used to pay the note would be included in the grantor's gross estate and, therefore, would get a step-up in basis at the grantor's death.

(3) Death of the Grantor During the Note Term. If the grantor dies before the note is paid in full, the IDGT will lose its status as a grantor trust and become a separate entity for income tax purposes. When grantor trust status terminates, the grantor is treated as transferring assets to the IDGT for income tax purposes. Treas. Reg. § 1.1001-2(c), Ex. 5; *Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222. Practitioners disagree, however, about whether the deemed transfer to the trust, usually presumed to be in exchange for the note, occurs before or after the grantor's death. The different views follow.[6]

(a) Sale at Death With Tax Consequences. Under Madorin, the loss of grantor trust status during the grantor's lifetime was treated as a transfer (sale) of property to a newly formed non-grantor trust causing the grantor to recognize income to the extent that the liability (i.e., unpaid balance of note) exceeded the basis of the transferred property. The Madorin case, however, involved a situation where the grantor renounced certain powers, causing grantor trust status to terminate. In the IDGT situation, the grantor's death causes the loss of grantor trust status.A Sale Occurred Immediately Before Death. Under the view that a sale occurred immediately before death, gain would be recognized by the grantor to the extent the balance due on the note exceeds the grantor's basis in the assets sold to the IDGT. The assets

purchased would acquire a new income tax basis in the hands of the IDGT equal to the balance due on the note.

If the sale did not qualify for installment treatment under IRC § 453 because, for example, it involved marketable securities for which installment treatment is not available, the gain would be reportable on the grantor's final return. The additional income taxes generated by the gain would be deductible for estate tax purposes under IRC § 2053 as a claim against the estate.

If the sale qualifies for installment treatment, the gain would not be reported on the grantor's final return, but payments received by the grantor's estate after death would be income to the estate or a beneficiary of the estate.

2. <u>A Sale Occurred Immediately After Death</u>. Under the view that a sale occurred immediately after death, the property deemed sold would be considered owned by the grantor at death and, therefore, should acquire a new income tax basis under IRC § 1014 with no gain resulting. Manning and Hesch disagree with this conclusion, noting that the assets are owned by the trust, not the grantor, at death for transfer tax purposes. Therefore, the property cannot receive a step-up in basis at the grantor's death because it does not pass from the grantor at death. <u>See</u> Manning and Hesch, *supra*.

(b) **<u>Sale at Death With No Recognition of Income</u>**. Under the view that a sale occurs at death without any recognition of gain, the basis of the trust assets is the amount the IDGT paid for the assets, *i.e.*, the amount of the note. The note is included in the grantor's gross estate and receives a stepped-up basis to its fair market value at death. In this case, neither the grantor nor the grantor's estate will recognize gain. For a comprehensive discussion of this alternative, see Manning and Hesch, *supra*.

(c) **<u>Repaying the Note Prior to the Grantor's Death</u>**. Given the uncertainty as to which of the above views would prevail, every effort should be made to pay the note off with appreciated assets during the grantor's lifetime (thereby causing the appreciated assets to be included in the grantor's gross estate, where they will receive a stepped-up basis). Because the trust is a grantor trust, the grantor would not recognize gain or loss on the payment. Assuming the trust property has appreciated since the original transfer, the note could be satisfied with a return of only part of the original trust property, with sufficient assets remaining in the trust for the benefit of the trust beneficiaries. The property remaining in the trust would retain the grantor's original basis. Satisfying the note in kind is preferable to the trust's selling property to satisfy the note because the trust would incur income tax upon the sale of the property, which could decrease the overall tax savings of the transaction.

Alternatively, it has been suggested that to avoid the loss of basis step-up for all of the trust property when the note is satisfied with part of the trust property, the grantor could reacquire the remaining property in the trust during the grantor's life by substituting it for a high- basis asset. Again, there would be no income tax consequences on the substitution, and the substitution would bring low-basis assets back into the grantor's estate to get a step-up in basis. This method could avoid both the problems of gain recognition and loss of step-up in basis for all of the assets. <u>See</u> Frederic A. Nicholson, "Sale to a Grantor Controlled Trust: Better Than a GRAT?," *Tax Mgmt. Memo* (February 22, 1996).

3. Sale to an IDGT vs. Grantor Retained Annuity Trust

A GRAT offers similar transfer tax saving opportunities as a sale to an intentionally defective grantor trust, in that they both result in tax savings when the trust assets outperform (from an investment return perspective) the applicable interest rate. Following is a discussion of how GRATs and sales to an IDGT compare on several important issues.

a. Inclusion in the Grantor's Gross Estate. If the sale to an IDGT is structured correctly, no portion of the IDGT will be included in the grantor's gross estate for federal estate tax purposes. If the grantor dies before the promissory note is fully paid, only the unpaid balance of the note is included in his or her gross estate. Any appreciation in the value of the assets in the grantor trust escapes taxation. In contrast, if the grantor of a GRAT dies during the GRAT term, most or all of the GRAT property, including any appreciation in the value of the GRAT property, will be included in the grantor's gross estate for federal estate tax purposes. Therefore, there is a mortality risk with a GRAT that is not an issue with a sale to an IDGT. The mortality risk of a GRAT, however, can be eliminated by use of the guaranteed GRAT approach discussed above.

b. Annual Payments. The IRC § 7520 rate, which is used to value the retained annuity interest in a GRAT, equals 120% of the federal mid-term rate under IRC § 1274. As such, the IRC § 7520 rate is almost always higher than the interest rate on the note (the short-, mid-, or long-term AFR). Thus, the annual annuity payments under a GRAT almost always will be greater than interest payments required under the promissory note used in a sale to an intentionally defective grantor trust. In addition, the GRAT annuity payments often result in a portion of the underlying trust assets being returned to the grantor at a time that is often earlier than would be the case where a sale to an IDGT is used. As a result, with a GRAT, more property will be returned to the grantor in the form of an annuity payment (to be subject to estate tax if not consumed by the grantor), and less property will pass to the beneficiaries. Thus, more property usually will pass to trust beneficiaries free of transfer taxes under the sale technique than under a GRAT.

c. GST Exemption. The sale technique, unlike a GRAT, permits the leveraging of the grantor's GST exemption. This is because the ETIP rules, which prohibit the allocation of GST exemption to a GRAT before its term of years expires, do not apply to an irrevocable trust of the type used in connection with the sale technique. Thus, a grantor of an IDGT can allocate GST exemption to an IDGT immediately, and any appreciation after the sale will avoid GST tax. To achieve a similar result for generation-skipping transfer tax purposes with a GRAT, the family needs to consider employing the remainder sale technique discussed above.

d. Backloading Payments. By structuring the transaction as a sale to an intentionally defective grantor trust, it is possible to use a balloon note in which the repayment of principal is deferred until the end of the term of the note. Thus, it is possible to delay payments to the grantor, which has the effect of causing more growth to occur inside the irrevocable trust. With a GRAT, however, the extent to which annuity payments may be postponed is limited because the annuity for a given year cannot exceed 120% of the preceding year's annuity amount. Treas. Reg. § 25.2702-3(b)(1)(ii). Thus, a sale to an IDGT allows the greatest compounding of appreciation inside the trust.

e. Amount of the Gift. The sale of assets to an IDGT, if structured correctly, will not be a taxable gift. The only gift will be the gift upon contributing the "seed" money to the IDGT. As discussed above, a gift can be avoided entirely if the sale is to an existing funded grantor trust or if the beneficiaries guarantee payments on the note. In light of *Walton*, discussed in the section on GRATs above, a GRAT can be structured as a zeroed-out GRAT so that there is no gift upon creation. Before *Walton*, a sale to an IDGT was considered to have the advantage on this

point because it could be structured to avoid any gift.

➔ **Planning Point:** If the sale is not to an existing funded trust, the creation of a new trust will require the transfer of "seed" money to the trust. Such a transfer may result in the payment of gift tax. Thus, a sale to a newly created IDGT may not be as attractive as a gift tax-free *Walton* GRAT in light of the possibility of estate tax repeal. That is, clients may be less likely to pay gift tax now to save estate taxes later if there is a possibility that estate taxes may never be paid. Therefore, techniques that do not involve the payment of gift tax, such as a *Walton* GRAT, may be preferable.

f. Post-Sale Adjustment of Sale Price. As discussed above, if the value of the property sold to the IDGT is later increased on audit, the grantor will have made a taxable gift. Valuation concerns may be addressed by a price adjustment clause, but such provisions may be subject to attack by the IRS under the holding in *Procter*. With a GRAT, however, the regulations in effect sanction a post-transaction adjustment clause by permitting the annuity amount to be payable as a fraction or percentage of the fair market value of the GRAT assets. If the value of the assets increases, so will the amount of the annuity, which, in turn, results in no, or a minimal, increase in the taxable gift.

> **EXAMPLE:** Grantor transfers \$10,000,000 to a 10-year, zeroed-out GRAT when the IRC § 7520 rate is 5.4%. The annuity is expressed as 13.20323% of the initial value of the property transferred to the GRAT. As such, the annual annuity amount is \$1,320,323, and the taxable gift is \$6.00. If the value of the GRAT property is increased to \$13,000,000, then the amount of the annuity will increase to \$1,716,420. The value of the taxable gift will, however, only increase to \$7.00.

➔ **Planning Point:** Because of the possibility that the revaluation of the property sold to an IDGT could result in gift tax liability, and because the risk of revaluation of the property transferred to a GRAT is minimized if the annuity is expressed as a percentage of the value of the property, a sale to an IDGT may not be as attractive as a gift tax-free *Walton* GRAT in light of the possibility of estate tax repeal.

Although the sale technique has a number of advantages over the GRAT, the GRAT has one significant advantage over the sale technique in that it is a creature of statute. There is a provision of the Code, along with associated regulations, that explicitly states what a GRAT is, what the rules are for creating and operating a GRAT, and what the transfer tax consequences will be upon creating a GRAT. In contrast, no such certainty exists with respect to the sale to an intentionally defective grantor trust. The sale technique has been created based on a number of previously unconnected legal principles (*i.e.*, the technique was created based on logical connections and inferences that were drawn from court cases, published and private rulings by the IRS, Treasury Regulations and Code provisions). Thus, there is a risk that if the IRS, in litigation involving the viability of a sale to an intentionally defective grantor trust, is able to successfully

dislodge any of the key premises upon which the sale technique is built, the technique could lose its advantage (*e.g.*, the entire value of the trust property could be brought into the gross estate of the grantor for federal estate tax purposes). Despite this risk, the sale technique is a viable planning tool for attorneys and their clients who understand the benefits and potential pitfalls involved.

F. Low-Interest Loans to Grantor Trusts

1. Overview of the Transaction

A low-interest loan, which is a loan at an interest rate equal to the AFR, to an IDGT is one of the simplest estate planning techniques available, and its ability to transfer wealth to descendants is similar to that of a GRAT or sale to an IDGT. Generally, the lender loans money to the IDGT in return for an installment note that bears interest at the AFR in effect for the period represented by the loan, compounded semiannually. See IRC § 7872(f)(2)(A). The borrower (the IDGT) uses the funds to purchase an asset. The amount by which the borrower's rate of return on the funds loaned to the trust (or on the asset purchased by the trust with the funds) exceeds the interest rate on the note is, in effect, a gift tax-free transfer to the borrower.

➔ **Planning Point:** A sale to an IDGT is preferable to a loan where the client has an appreciating asset that he or she wants to remove from his or her estate by transferring it to an irrevocable trust. A loan to an IDGT, which has comparable results to a sale to an IDGT, is preferable where the client does not currently own the appreciating asset but is planning to acquire such an asset. In that case, the client lends the purchase price to the trustee of the IDGT, and the trust purchases the asset.

Ideally, the note will be structured as a balloon note, where repayment of the principal is deferred until the end of the note term. Therefore, the borrower will make only annual interest payments to the lender. By using a balloon note, a larger percentage of the assets remain in the trust during the note term, thereby allowing the greatest compounding of appreciation inside the trust.

EXAMPLE: Father lends $2,000,000 in cash to a grantor trust for the benefit of his children in exchange for a 5-year note with interest at the mid-term AFR of 4.65%. The annual interest payment will be $93,000. The trust uses the funds to purchase an appreciating asset. If the return on the investment of the asset is 10%, then at the end of 5 years, after the repayment of the $2,000,000 loan, the trust will have $653,246, which will pass estate tax-free and gift tax-free to the trust beneficiaries.

2. Estate Tax Consequences

If the lender dies with the note outstanding, the note will be included in the lender's gross estate. Depending on the interest rates prevailing at the time of the grantor's death, the value of the note may be more or less than the outstanding principal balance. If the AFR is higher than the interest rate on the note, the note will be worth less than the outstanding principal balance; but if the AFR is lower than the note's interest rate, the note may be worth more than the outstanding

principal balance, thus reducing the benefit of the strategy. The risk that the note will be worth more than its face if the note's interest rate is higher than the prevailing interest rate can be reduced by having the note prepayable at any time by the borrower.

Similar issues arise with a loan to an IDGT as with a sale to an IDGT with respect to the undercapitalization of the trust. That is, the IRS might argue that, in such a case, the note received by the grantor in exchange for the loan of cash or property to the trust should be recharacterized as a transfer with a retained life interest, with the result that the transferred property (*i.e.*, the property loaned to the trust) is includable in the grantor's gross estate under IRC § 2036.

As with a sale to an IDGT, these arguments should not succeed where the trust has other property, the income or principal of which can be used to service the debt, where the interest payments are not tied in to the income from the loaned property, and where the grantor has not retained any interests in the loaned property (such as, perhaps, a security interest). Thus, the loan should be made to an existing grantor trust, or the trust should be funded with cash or other property (*i.e.*, "seed" money) in an amount equal to ten percent of the value of the trust assets. For a more comprehensive discussion of the estate tax issues, see the section on sales to IDGTs above.

3. Gift Tax Consequences

The interest rate on the loan must be at least equal to the AFR in effect for the period represented by the loan, compounded semiannually, in order to avoid adverse income and gift tax consequences under IRC § 7872. See IRC § 7872(f)(2)(A). IRC § 7872 imputes interest in the case of below-market loans, which are loans where the stated interest is less than the AFR. Thus, if the stated interest on a loan to an IDGT is less than the appropriate AFR, the loan is subject to IRC § 7872.

IRC § 7872 recharacterizes a loan as a transaction in which the lender makes a loan to the borrower in exchange for a promissory note requiring interest to be paid at the AFR (rather than at the lower stated interest rate of the note). The deemed interest at the AFR in excess of the stated interest rate is called "imputed interest." Imputed interest generally is includable as taxable income to the lender. When loans are made to a grantor trust as to the lender, however, the imputed interest is not taxable interest to the lender.

The lender then is deemed to make a gift to the borrower (which the borrower is presumed to use to pay the imputed interest to the lender). The amount of the gift is equal to the amount loaned less the present value of the note determined using the AFR as the discount rate.

> **EXAMPLE:** Father makes an interest-free $1,000,000 loan to a grantor trust for 10 years. The AFR is 8%, compounded semiannually. The present value of $1,000,000 payable in 10 years at 8% interest compounded semiannually is $456,387. The amount of the deemed gift is $543,613 ($1,000,000 - $456,387).

If the aggregate outstanding loans (both market and below-market) between the lender and borrower are $100,000 or less, the imputed interest is limited to the borrower's net investment income for the year. IRC § 7872(d)(1). Whether the aggregate outstanding loans between the lender and borrower are $100,000 or less, however, does not limit the amount of the gift to the

borrower.

If accrued interest payable on the loan is waived, canceled, or forgiven by the lender, such interest is treated as if it were paid to the lender and then re-transferred by the lender to the borrower resulting in a taxable gift by the lender. Prop. Reg. § 1.7872-11(a).

4. Income Tax Consequences

Because the loan is made to a grantor trust as to the lender, the lender does not recognize interest income. That is, for income tax purposes, the loan is treated as between the lender and himself or herself.

The trust will cease to be a grantor trust upon the grantor's death. Pre-death accrued and unpaid interest should not be taxable income to the grantor or the grantor's estate for the following reasons.[7]

First, in the sale to an IDGT strategy, if the grantor dies with the note outstanding, a sale is deemed to have occurred. See Treas. Reg. § 1.1001-2(c), Ex. 5; *Madorin v. Comm'r.*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222. Practitioners disagree, however, about whether the deemed sale occurs before or after the grantor's death. If the sale occurs prior to the grantor's death, the capital gain will be reported on the grantor's final return or by the grantor's estate or a beneficiary of the estate, depending upon whether installment sale treatment applies.[8] If this theory is applied to the loan transaction, then if a loan is deemed to be made immediately prior to the grantor's death, no interest will have accrued during the grantor's lifetime that would be taxable. Post-death interest, however, will be taxable to the grantor's estate.

Second, the income would be taxable under the Code section and regulations that refer to "those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income" for the taxable year ending with his or her death (or any prior year). See Treas. Reg. § 1.691(a)-1(b). The pre-death interest was not gross income because interest payable by a grantor trust to the grantor is not income to the grantor.

In order to avoid the taxable income issues when the lender dies, the trust should pay all accrued interest or pay off the outstanding indebtedness prior to the lender's death. The trust could pay the note in kind with appreciated assets. Because the trust is a grantor trust, no gain or loss would be recognized on the payment, and the appreciated property used to pay the note would be included in the lender's gross estate and, therefore, would get a step-up in basis at the lender's death, thereby eliminating the capital gain.

5. Comparison to GRATs and Sales to IDGTs

As noted above, a loan to an IDGT is comparable to a GRAT and a sale to an IDGT, and, in fact, may have some advantages over these techniques.

a. GRAT. One difference between a loan to a grantor trust and a traditional GRAT is the mortality risk associated with the respective strategies. If the lender dies before the note is retired, the unpaid balance of the note will be included in his or her gross estate. In contrast, if the grantor of a GRAT dies during the term of a GRAT, the portion of the GRAT property

necessary to produce the annuity at the IRC § 7520 rate in effect at the grantor's death is subject to estate tax under IRC § 2036. Prop. Reg. § 20.2036-1(c)(2).

There is greater flexibility in structuring the note than the annuity payment. The note may be fully amortizing or bear interest only; the note may be refinanced; and the interest rate may vary. The GRAT payment, on the other hand, may change only in accordance with the regulations. If the client's death appears imminent while the note is outstanding, the borrower may accelerate the entire indebtedness if it is advisable to retire the note to avoid the possible income tax consequences discussed above. On the other hand, the annuitant's interest in a GRAT may not be commuted (indeed, if the governing instrument does not prohibit commutation, the annuity will fail to be a qualified interest under IRC § 2702 and the grantor will be deemed to make a gift of the entire trust property).

b. **Sale to IDGT**. The loan is a simpler strategy and provides the same benefit as the sale to an IDGT: the spread between the interest rate on the note and the rate of return on the trust's investments is transferred to the trust and its beneficiaries free of gift and estate taxes.

If the grantor dies with the note from the sale to the grantor trust outstanding, the prevailing view is that either the grantor or his or her estate will be liable for capital gain tax on the amount of the unpaid principal. With the loan strategy, however, no gain should be recognized on death if the note is outstanding.

The loan does not require an appraisal or subject the grantor to the risk that the IRS disagrees with the value of the property sold, which could result in gift tax liability.

G. Private Annuities

A private annuity is a sale of property by one individual (the annuitant) to another individual or entity (the buyer) (usually by one family member to a younger generation family member) in exchange for the latter's unsecured promise to make fixed annual payments to the annuitant for the annuitant's lifetime. A private annuity affords the annuitant an opportunity to defer recognition of capital gain, retain a steady stream of income, and remove the transferred property and the appreciation thereon from his or her gross estate without estate, gift or generation-skipping transfer tax.

➔ **Planning Point:** A private annuity is a good estate planning technique if the annuitant wishes to keep ownership of certain property within his or her family, yet shift management of the property to his or her children and have the security of a fixed income for life.

➔ **Planning Point:** The benefits of a private annuity will be maximized if the buyer has a lower marginal income tax rate than the annuitant. In such a case, the annuitant is able to shift the income tax burden on property to a family member with a lower tax rate.

The tax savings of a private annuity are greatest when the annuity is given in exchange for appreciating property, so that not only is the property removed from the annuitant's gross estate, but the appreciation also is removed from the annuitant's gross estate. This technique is

particularly effective when the actual life of the annuitant is significantly less than his or her life expectancy under the IRS actuarial tables. Because at the death of the annuitant the annuity payments cease, premature death allows the buyer to actually purchase the property for less than its full sales price, and because the total number of annuity payments is reduced, less property goes back into the annuitant's gross estate, where it will be subject to estate tax if not consumed by the annuitant.

➔ **Planning Point:** The property that is sold in exchange for the annuity should be expected to appreciate in value and should not be an asset that the buyer expects to sell in the short term. Additionally, the property should generate income, or the buyer must have another source of funds with which to make the annuity payments.

1. Gift Tax Consequences

A sale for a private annuity will not be subject to gift tax as long as the fair market value of the property transferred in exchange for the private annuity equals the present value of the annuity (that is, it is a sale for full and adequate consideration). The present value of the annuity payments must be computed using the IRC § 7520 actuarial tables for the month in which the sale occurs. The IRC § 7520 regulations prohibit the use of the actuarial tables if the transferor is terminally ill at the time of the transfer. If the individual survives for eighteen months or longer after the valuation date, however, he or she will be presumed not to have been terminally ill at the time of the transfer. Treas. Reg. § 25.7520-3(b)(3). Therefore, an individual whose health condition is likely to result in premature death, but not within eighteen months, can value the annuity payments under IRC § 7520, but will receive few of the annuity payments to increase his or her gross estate.

➔ **Planning Point:** The required annuity payments that the buyer must make in order to avoid gift taxes decrease as interest rates decline. Thus, lower annuity payments may make the transaction more feasible if the buyer is concerned about the ability to make payments.

There will be a taxable gift from the annuitant to the buyer to the extent that the present value of the annuity is less than the fair market value of the property sold. Thus, property that is difficult to value poses a risk of gift tax liability in the event of a later determination of a higher value for the property. Having a well documented appraisal significantly reduces (but does not completely eliminate) the gift tax exposure.

It may be possible to avoid the risk of gift tax liability with a valuation adjustment clause, which adjusts the payments to reflect the property value ultimately determined by court decision or by the IRS. The IRS does not, however, favor such clauses.[9] For example, PLR 9133001 involved a private annuity transaction where the agreement provided that the annuity payments and the purchase price would be adjusted to reflect any changes in valuation resulting from a settlement with the IRS or a final decision by the Tax Court. The IRS disregarded the provision for estate and gift tax purposes.

2. Estate Tax Consequences

Because the buyer's obligation to make annuity payments ceases upon the annuitant's death, a private annuity does not have any value for estate tax purposes, and the assets subject to the sale should not be included in the seller's taxable estate. To the extent that the annuitant does not consume the annuity payments, however, they will be included in the annuitant's gross estate and subject to estate tax. Thus, a private annuity is ideal when the asset sold is one that generates most of the annuitant's income because, in such a case, the annuitant will consume most of the payments.

a. **IRC § 2036**. In structuring a private annuity transaction, the parties must ensure that the IRS cannot claim that the annuitant has a retained life estate in the transferred property so that the property would be includable in the annuitant's gross estate under IRC § 2036. The IRS may make such an argument if the income from the transferred property equals the annual annuity payment. Therefore, annuity payments should never be tied to the income generated from the transferred property. Other ways to insulate the transaction from the application of IRC § 2036 are: (1) the buyer should not pay the annuity with a note; (2) the annuity agreement should impose personal liability on the buyer and make the buyer liable for annuity payments regardless of whether the property produces income; (3) the buyer should have sufficient other assets with which to make the annuity payments; (4) the buyer must make payments in a timely manner and the parties must respect the formalities of the transaction; (5) the annuitant should not take a security interest in the transferred property; and (6) the annuitant must not continue to possess or enjoy the transferred property.

b. **Trust as Buyer**. The buyer can be a trust, in which case it is particularly important to structure the transaction correctly, as the IRS has not favored private annuity arrangements where the trust is the purchaser. See *Ray, supra*; *Stern v. Comm'r*, 77 T.C. 614 (1981), *rev'd*, 747 F.2d 555 (9th Cir. 1984); *LaFargue v. Comm'r*, 73 T.C. 40 (1979), *aff'd in part and rev'd in part*, 689 F.2d 845 (9th Cir. 1982); and *Lazarus v. Comm'r*, 58 T.C. 854 (1972), *aff'd*, 513 F.2d 824 (9th Cir. 1975).

(1) **IRC § 2036**. Whether the annuitant has retained the right to income from the transferred property in exchange for the private annuity is generally the issue where the trust is the buyer. Because clients may feel more comfortable selling property to a trust rather than outright to descendants, practitioners can minimize the risk of an IRS challenge under IRC § 2036 by ensuring that there is no "tie-in" between the trust income and the annual annuity payment. In the absence of such a tie-in, the annuitant should not be considered to have retained a life estate in the transferred property. See *LaFargue*, *supra* (no tie-in); *Ray*, *supra* (tie-in); *Stern*, *supra* (no tie-in); and *Lazarus*, *supra* (tie-in).

For example, in *LaFargue*, the taxpayer funded a trust for the benefit of her daughter and herself with $100. Two days later, the taxpayer transferred assets with a fair market value equal to $335,000 to the trust and executed a private annuity agreement with the trust. The Tax Court characterized the annual payments as distributions of trust income, taxable to the taxpayer under the grantor trust rules. The Ninth Circuit reversed and remanded to the Tax Court, holding that there was no tie-in between the trust income and the amount of the annuity and, therefore, the transaction was a bona fide sale.

In addition to a tie-in between income and the annuity payment, the courts also may consider other factors in determining the validity of a private annuity with a trust as the buyer. These include: (a) the degree of control the annuitant exercises over the transferred property; (b) the nature and extent of the annuitant's continuing interest in the transferred property; (c) the source of the annuity payment; and (d) the arm's-length nature of the transaction. *Weigl v. Comm'r*, 84 T.C. 1192, 1225 (1985) (citing *LaFargue*, *Stern*, *Lazarus* and *Fabric*). The courts also may consider whether the parties disregarded the substance of the transaction. See *Lazarus*, *supra*. Finally, if the distributions to make the annuity payments are subject to the approval of an adverse party, then IRC § 2036 should not apply. *Lazarus*, 58 T.C. at 864 n.8.

(2) **IRC § 2702**. In a properly structured transaction, the annuitant does not retain any interest in the transferred property. Therefore, IRC § 2702 does not apply. The IRS might, however, use IRC § 2702 to reach an annuity transaction in which a trust is the buyer. IRC § 2702 should not apply unless it can be shown that a fixed annuity is being paid from the trust. Thus, there should be no tie-in between the income produced by the annuity property and the annuity payment. Even if there is a tie-in, the interest retained would likely qualify as a "qualified annuity interest" under IRC § 2702 and the regulations thereunder. See PLR 9253031.

3. Income Tax Consequences

The income tax consequences of a private annuity are governed by the annuity rules in IRC § 72. The annuity rules treat the annuity payments as having three elements for income tax purposes: a tax-free recovery of basis; a capital gain portion (to the extent the value of the transferred property exceeds the annuitant's basis in the property); and ordinary income (the annuity amount). If the private annuity is secured, however, the annuitant will recognize all capital gain in full at the time of the transfer rather than deferring it over his or her life expectancy. *212 Corp. v. Comm'r.*, 70 T.C. 788 (1978); *Estate of Bell*, 60 T.C. 469 (1973).

If a trust is the buyer and the annuitant is the grantor of the trust, and if the trust has no assets other than the property acquired in exchange for the annuity, the annuitant will be treated as the owner of the trust under the grantor trust rules. Rev. Rul. 68-183, 1968-1 C.B. 308. In such a case, the annuitant will be taxed on the entire trust income each year, which means that instead of a portion of each annuity payment being taxed as capital gain and a portion being excluded from income, the entire payment would be ordinary income.

a. **The Annuitant**. Rev. Rul. 69-74, 1969-1 C.B. 43 sets forth the following method for calculating the income tax components of a private annuity.

(1) **Tax-Free Portion**. A portion of each annuity payment will represent a tax-free recovery of basis until the annuitant has fully recovered his or her basis in the property. After the annuitant has fully recovered his or her basis, which occurs if the annuitant lives for his or her actuarial life expectancy, as determined under Table V of Treas. Reg. § 1.72-9, the balance of the payments received will be taxable as ordinary income. IRC § 72(b)(2). In the event that the annuitant dies before recovering his or her entire basis, the unrecovered amount can be taken as a deduction on his or her final income tax return. IRC § 72(b)(3).

The tax-free return of basis portion of each payment is determined by multiplying the

exclusion ratio by each annuity payment received. The exclusion ratio is the ratio of the annuitant's investment in the contract (the adjusted basis) to the expected return. The expected return is determined by multiplying each annuity payment to be made by the annuitant's life expectancy, as determined under IRC § 72. Treas. Reg. § 1.72-9.

> **<u>EXAMPLE</u>:** Father, age 70, transfers stock with a fair market value of $1,000,000 and a basis of $500,000 to Daughter in exchange for a private annuity. The IRC § 7520 rate for the month of the sale is 5.4%. The annual annuity that Daughter must make to ensure that Father does not make a taxable gift is $112,726.
>
> Father's life expectancy under the life annuity tables in Treas. Reg. § 1.72-9 Table V is 16 years. Therefore, his expected return is $1,803,616 ($112,726 x 16).
>
> The exclusion ratio is 27.72% ($500,000 basis divided by $1,803,616 expected return). Therefore, $31,248 ($112,726 x 27.72%) of each annuity payment Father receives is treated as a tax-free return of investment.

(2) **<u>Capital Gain Portion</u>**. Because only a portion of each annuity payment is capital gain, a private annuity allows the annuitant to defer gain on the sale of the property by reporting it ratably over his or her life expectancy. If the annuitant lives at least as long as his or her life expectancy at the time of the transfer, the annuitant will eventually pay a tax on his or her entire realized gain.

The total capital gain recognized on the sale is the difference between the annuitant's basis in the property and the present value of the annuity. The total capital gain is then divided by the annuitant's life expectancy, and the resulting number is the capital gain portion of each annuity payment.

> **<u>EXAMPLE</u>:** Continuing the example above, the capital gain is $500,000 ($1,000,000 present value of the annuity less $500,000 adjusted basis). The gain is reported over Father's 16-year life expectancy, so that each year $31,250 is reported as capital gain ($500,000 divided by 16).

(3) **<u>Ordinary Income Portion</u>**. The ordinary income portion is the difference between the annuity payment and the sum of the return of basis portion and capital gain portion.

> **<u>EXAMPLE</u>:** Continuing the preceding examples, the balance of each annuity payment, $49,778 ($112,726 less $31,248 less $31,250), will be ordinary income.

b. **<u>The Buyer</u>**. Although part of each annuity payment is a payment of interest, the buyer will not be entitled to an interest deduction for any part of the annuity payments.

If the buyer sells the asset after the annuitant's death, the buyer's basis in the property purchased from the annuitant is the sum of all the annuity payments actually made under the contract. Rev. Rul. 55-119, 1955-1 C.B. 352. As such, in the event of the annuitant's premature death, the buyer will have made few payments and, therefore, will have a low basis in the property.

If the buyer sells the asset before the annuitant dies, the buyer's basis depends upon whether the transaction results in a gain or a loss. For gain purposes, the buyer's basis equals the total annuity payments actually made at the date of sale plus the present value of the future annuity payments yet to be made. The present value is determined using the annuitant's life expectancy and the IRC § 7520 rate on the date the buyer sells the property. For loss purposes, the buyer's basis is the sum of all annuity payments actually made to the date of sale.

> **EXAMPLE:** Building on the previous example, Daughter sells the stock in 6 years for $1,500,000. The IRC § 7520 rate has increased to 7.4%. Daughter's basis for gain will be determined as follows:
>
> $676,356 (total payments actually made), plus
> $726,158 (present value of future payments based on Father's age at the sale (76) and a 7.4% IRC § 7520 rate)
> $1,402,514 - Daughter's basis for gain
>
> Daughter's capital gain will be $1,500,000 less her adjusted basis of $1,402,514, for a capital gain of $97,486.
>
> Daughter's basis for loss is $676,356. Therefore, had she sold the property for $675,000, she would realize a loss of $1,356.

➔ **Planning Point:** Because of the possibility that a buyer may have a very low basis in the asset sold, the transferred property should be an asset that the buyer is not likely to sell, *e.g.*, an interest in the family business.

4. Advantages of a Private Annuity

Private annuities remove the transferred property from the annuitant's gross estate, and any appreciation on the transferred property subsequent to the sale avoids estate taxation in the annuitant's estate. Private annuities also serve to defer capital gain and to shift the taxation of income to individuals who are in a lower income tax bracket.

Private annuities have the greatest benefit for individuals who die prematurely because the value of the annuity will have been based on the assumption that the annuitant will receive all of the annuity payments. When the annuitant dies prematurely, the buyer will have paid less for the assets than what it is worth. Additionally, less annuity payments will be transferred to the annuitant to be included in his or her gross estate.

5. Disadvantages of a Private Annuity

Some of the disadvantages of a private annuity result from the uncertainty of death. The annuitant's children generally are in the awkward position of having an economic benefit if the

annuitant does not survive his or her life expectancy under the IRS tables. Also, because the buyer's adjusted basis in the property is, in general, the total annuity payments made to the date of the annuitant's death, the annuitant's premature death may result in a lower basis than the buyer would have received if he or she had inherited the property and received a basis equal to the property's fair market value (a "stepped-up basis") at the annuitant's death. If the annuitant outlives his or her actuarial life expectancy, the annuity payments made may cause the estate tax to exceed what it would have been if the asset were still in the annuitant's estate (unless the annuitant consumes the annuity payments).

There are a number of risks inherent in the use of a private annuity. For example, there is the risk to the annuitant of nonpayment of the annuity by the buyer. This risk may be exacerbated if the buyer predeceases the annuitant. Additionally, the annuity payments may place a significant economic burden on the buyer, which is a risk he or she bears, regardless of increase or decrease in the value of the property transferred. The buyer must be prepared to make continuous annuity payments to the annuitant even if the annuitant should outlive his or her life expectancy. In such a case, the annuity payments could exceed the original value of the property transferred by the annuitant to fund the private annuity.

6. Proposed Regulations Regarding Private Annuities

Proposed regulations (REG-141901-05, 2006-47 I.R.B. 947 (October 18, 2006)) provide that, if an annuity contract is received in exchange for property (other than money): (a) the amount realized attributable to the annuity contract is the fair market value (as determined under IRC § 7520) of the annuity contract at the time of the exchange; (b) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and (c) for purposes of determining the initial investment in the annuity contract under IRC § 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract). The preamble to the proposed regulations explain that "the proposed regulations provide a single set of rules that leave the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract." Rev. Rul 69-74 would be declared obsolete due to these proposed regulations.

In addition, the proposed regulations provide that charitable gift annuities are not affected by these proposed regulations because they are covered by Treas. Reg. § 1.1011-2. Also, the preamble to the proposed regulations provides that "[t]axpayers retain the ability to structure transactions as installment sales within the meaning of section 453(b), provided the other requirements of section 453 are met." Installment sales are discussed in the next Section.

H. Self-Canceling Installment Notes

A self-canceling installment note ("SCIN") is an installment note that is payable until the first to occur of the expiration of a stated term or the death of the seller. With a SCIN, property is sold in exchange for the buyer's promise to make periodic payments until a maximum sales price is received or the seller dies, whichever occurs first. A SCIN is generally viewed as an alternative to a private annuity. Like private annuities, SCINs provide estate tax savings, deferral of capital gain, and a stream of income to the seller.

For the SCIN to be a beneficial estate planning technique, the return on the asset that is sold must exceed the interest rate on the SCIN, or the seller must die before his or her life expectancy.

1. Estate Tax Consequences

SCINs remove the transferred property and any appreciation thereon in excess of the interest rate on the note from the seller's gross estate. The payments made on the note will, however, be included in the seller's gross estate to the extent that they are not consumed during the life of the seller, as is the case with the annuity payments in a private annuity. Because of the risk premium, discussed below, more money will be returned to the grantor's gross estate with a SCIN than with a private annuity.

➔ **Planning Point:** Because the term of a SCIN is less than the seller's life expectancy, the SCIN has an advantage over a private annuity in that the seller does not incur the risk of living beyond the installment term, thereby increasing his or her gross estate because of the continued annuity payments. The maximum term limits how much the buyer pays, but it also limits the seller's security because the seller may not receive payments for his or her life.

In addition to removing the transferred property from the seller's gross estate, the estate tax advantage of a SCIN is that because the buyer's obligation terminates at the seller's death, nothing is included in the seller's gross estate for federal estate tax purposes. *Estate of Moss v. Comm'r*, 74 T.C. 1239 (1980), *acq. in result* 1981-1 C.B. 2. The value of the remaining payments on the SCIN at death escapes estate tax.

2. Income Tax Consequences

A SCIN may be classified as either an installment sale or a private annuity for income tax purposes. Generally, it is structured so that it is treated as an installment sale, in which case the income tax consequences will be determined under the installment sale rules of IRC § 453.

➔ **Planning Point:** The sale of marketable securities is not eligible for installment reporting.

Gain is reported over the period during which payments are received, and each payment is divided into a return of basis portion, a capital gain portion, and interest income. Any gain remaining at the seller's death will be recognized by the seller's estate. *Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993); Rev. Rul. 86-72, 1986-1 C.B. 253. Commentators disagree with this result, however, arguing that the gain should be reported on the seller's final income tax return. See Jerome M. Hesch, "Installment Sale, SCIN and Private Annuity Sales to a Grantor Trust: Income Tax and Transfer Tax Elements," 23 *Tax Mgmt. Est., Gifts and Tr. J.* 114 (May 14, 1998).

Interest paid by the buyer on a SCIN is deductible by the buyer, although the extent to which it may be deducted depends on the type of property involved. GCM 39503 (May 7, 1986). In contrast, with a private annuity, the buyer cannot deduct interest paid.

If the SCIN is treated as an installment sale, it is generally believed that the buyer's basis in the property acquired in exchange for the installment note is the full face value of the note. Rev. Rul. 86-72, 1986-1 C.B. 253; GCM 39503 (May 7, 1986).

➔ **Planning Point:** The seller may take a security interest in the property sold without jeopardizing installment sale treatment. This is in contrast to a private annuity, under which the entire gain is taxable at the time of the sale if the seller has a security interest in the property sold.

3. Gift Tax Consequences

The note will never be paid if the seller dies before all installments have been paid. Therefore, to avoid a gift upon the sale, a risk premium must be added to the note to compensate the seller for the risk of cancellation. The premium may be reflected in either a higher interest rate or a greater sales price. As such, if the seller lives the full term, the amount payable to the seller under the SCIN (and, therefore, the increase in the seller's gross estate if the payments are not consumed) is greater than if a standard promissory note were used.

➔ **Planning Point:** A SCIN may be used in connection with a sale to an intentionally defective grantor trust. This strategy may be beneficial if the seller wants a stream of income greater than the amount required under a traditional promissory note (the AFR). Because of the risk premium, a higher interest rate may be paid on the SCIN, which results in more income to the seller.

I. Grantor Retained Income Trusts

A "grantor retained income trust" ("GRIT") is an irrevocable trust in which the grantor retains the right to receive all of the trust income for a specified number of years, after which time the remaining trust property is distributed to the remainder beneficiaries.

GRITs were practically eliminated when IRC § 2702 was enacted in 1990. As discussed in the section on general principles above, IRC § 2702 provides special valuation rules to determine the amount of a gift when an individual transfers property to a trust to or for the benefit of a "member of the transferor's family." A "member of the family" includes (i) the transferor's spouse, (ii) ancestors or descendants of the transferor or the transferor's spouse, (iii) siblings of the transferor, or (iv) the spouse of any of the foregoing. IRC §§ 2702(e); 2704(c)(2). A transfer to a relative that does not fall within this group (*e.g.*, a niece or nephew) is not subject to IRC § 2702's special valuation rules.

If such a transfer is made, the value of the interest retained by the transferor or applicable family member is valued at zero unless it is a "qualified interest" or the interest falls within an exception to IRC § 2702. The income interest in a GRIT is not a qualified interest under IRC § 2702. Therefore, in most cases, a transfer to a GRIT is treated for gift tax purposes the same as an outright gift to the remainder beneficiaries (because the retained income interest is valued at zero). There are three exceptions to IRC § 2702 that permit limited uses of GRITs: 1) a GRIT for an individual who is not a member of the grantor's family for purposes of IRC § 2702 (*e.g.*,

nieces and nephews); 2) a GRIT that holds certain tangible property; and 3) a GRIT that holds a personal residence of the grantor.

➔ **Planning Point:** GRITs can be used to transfer property to nieces and nephews and their descendants, to a partner in a non-marital relationship, or to an individual to whom one is engaged to be married. The fact that a premarital GRIT or other form of GRIT may eventually benefit a person who has become a member of the grantor's family but who was not a member of the grantor's family at the time the GRIT was created should not disqualify the GRIT. Thus, a GRIT for a future spouse could terminate in favor of the future spouse's children (who are the grantor's children), who would not have been members of the grantor's family when the GRIT was established.

1. Gift, Estate and Income Tax Consequences

a. **Gift Tax**. A GRIT for an individual who is not a member of the grantor's family will be valued under IRC § 7520. Thus, the amount of the taxable gift to the remainder beneficiaries upon the creation of a GRIT will equal the value of the property transferred to the GRIT less the value of the income interest retained by the grantor, determined under IRC § 7520. The IRC § 7520 valuation tables assume that: (1) the GRIT's rate of return on its investments will equal the IRC § 7520 rate; and (2) all of the growth in value of the GRIT will be allocable to income, all of which must be paid to the grantor annually.

➔ **Planning Point:** A GRIT will transfer property to the remainder beneficiaries if either or both of the following occur: (1) the GRIT's rate of return actually exceeds the IRC § 7520 rate, in which case the excess will be distributed to the remainder beneficiaries free of gift tax; and (2) if the income realized and paid by the GRIT (as opposed to the capital appreciation) is less than the IRC § 7520 rate, more property will remain in the GRIT than was presumed under the valuation tables to value the income interest, and such excess will have been transferred to the remainder beneficiaries free of gift tax.

A GRIT usually results in significant gift tax upon creation, although the gift can be sheltered from tax by the grantor's applicable exclusion amount. The taxable gift will equal the present value of the right to receive the property at the end of the term, valued under IRC § 7520.

> **EXAMPLE:** Grantor, age 50, transfers $1,000,000 to a 5-year GRIT. The IRC § 7520 rate is 5.4%. The taxable gift is $768,771, which is the present value of the right to receive $1,000,000 in 5 years at a 5.4% rate of return. As the term increases, the taxable gift decreases, so that if the GRIT lasts for 10 years, the taxable gift will be $591,009.

b. **Estate Tax**. If the grantor of a GRIT dies before the end of the term of the GRIT, the GRIT property is included in his or her gross estate under IRC § 2036. See Prop. Reg. Prop. Reg. § 20.2036-1(c)(2), discussed above.

c. **Income Tax**. The GRIT is a grantor trust for income tax purposes. Thus, all items of income, deduction and credit will be reported by the grantor on his or her personal income tax return rather than by the trust as a separate entity.

2. Tangible Property GRITs

IRC § 2702(c)(4) provides an exception to the IRC § 2702 gift tax valuation rules for the transfer of a term interest in tangible property where the nonexercise of rights with respect to the term interest would not have a substantial effect on the valuation of the remainder interest in such property. Where the special rule applies, the retained term interest will not be valued at zero. Rather, the value of the retained term interest will be the amount that the transferor establishes that an unrelated third party would pay for the term interest. IRC § 2702(c)(4). Note that IRC § 7520 is not used to value the term interest.

> **EXAMPLE:** Collector transfers a painting to her daughter, retaining the use of the painting for 10 years. The value of Collector's retained right to use the painting is the value that a third party would pay for the use of the painting for 10 years.

a. **Definition of Tangible Property**. As a general rule, the tangible property provision only applies to tangible property that cannot be depreciated or depleted. Treas. Reg. § 25.2702-2(c)(2)(i)(A). Such property includes works of art and undeveloped land (the value of which primarily reflects future development potential). Treas. Reg. § 25.2702-2(d)(2), Ex. 8; 136 Cong. Rec. S15682 (Oct. 18, 1990).

b. **Conversion of Tangible Property**. If the tangible property is converted into property that does not qualify for the exception, the conversion is treated for gift tax purposes as a transfer of the value of the unexpired portion of the term interest. Treas. Reg. § 25.2702-2(c)(4)(i). A conversion occurs not only when the tangible property is sold and the proceeds are reinvested in property that does not qualify for the exception, but also may occur when an addition or improvement is made to the tangible property. Treas. Reg. § 25.2702- 2(c)(5).

c. **Valuation**. If the transferor cannot reasonably establish the value of the term interest, the interest is valued at zero. Treas. Reg. § 25.2702-2(c)(1). To establish the value of the tangible property, the actual sales or rentals that are comparable both as to the nature and character of the property and the duration of the term interest are the best evidence of the value of the term interest. Treas. Reg. § 25.2702-2(c)(3). If the only evidence produced by the transferor is the amount paid by an organization for the use of a comparable painting for one year, such evidence does not indicate what the right to use the painting for ten years would be worth. Treas. Reg. § 25.2702(d)(2), Ex. 9. Appraisals are insufficient in the absence of comparable sales or rentals, and amounts determined under IRC § 7520 are not evidence of value. Treas. Reg. § 25.2702-2(c)(3). Given the difficulty in establishing the value of the term interest, tangible property GRITs are rarely feasible.

J. Personal Residence Trusts

IRC § 2702 does not apply to a transfer of an interest in a trust if the transferor or an

applicable family member retains the right to use the trust property as a personal residence for a term. IRC § 2702(a)(3)(A)(ii). As such, the value of the remainder will be the value of the transferred property less the value of the term interest, valued under IRC § 7520. The value of the term interest will not be deemed to be zero. The regulations provide that only two types of trusts can qualify for this statutory exception: a personal residence trust and a qualified personal residence trust ("QPRT").

1. Overview of Personal Residence Trusts

In general, IRC § 2702 allows a grantor to transfer title to a personal residence to the trustee of an irrevocable trust, retaining the right to live in the residence rent-free for the term of years specified in the trust agreement. The grantor continues to pay all ordinary expenses relating to the residence, such as utilities, maintenance, taxes and repairs.

If the grantor is living at the end of the retained term, the residence passes to the remainder beneficiaries (typically the grantor's children or trusts for their benefit) designated in the trust agreement. Thereafter, the grantor may wish to lease the residence from its new owners (*e.g.*, his or her children or trusts for their benefit). If the grantor dies prior to the end of the term, the residence is included in his or her gross estate for federal estate tax purposes. This is, however, essentially the same result that would occur if the grantor had not established the trust.

The value of the gift of the residence for gift tax purposes is based on the present value of the right of the beneficiaries of the personal residence trust to receive the residence at the end of the term of years. Because the beneficiaries must wait until the end of the term to receive the residence, the value of the gift of the residence is essentially "discounted." In other words, the value of the gift is substantially lower than the actual value of the residence at the time of transfer.

2. Definition of Personal Residence

The residence must be: (a) the principal residence of the term holder within the meaning of IRC § 1034 (relating to the rollover of capital gain on the sale of a principal residence); (b) one other residence of the term holder within the meaning of IRC § 280A (generally referring to a residence used by the term holder for personal purposes for the greater of fourteen days each year or ten percent of the number of days during the year that it is rented to others); or (c) an undivided fractional interest in either of the foregoing. Treas. Reg. §§ 25.2702-5(b)(2)(i), (c)(2)(i). Thus, each individual may transfer no more than two residences, and, therefore, can establish no more than two personal residence trusts. For this purpose, multiple trusts holding fractional interests in the same residence are treated as one trust. Treas. Reg. § 25.2702-5(a)(1).

➔ **Planning Point:** Because an individual can transfer an undivided interest in a residence, a grantor can reduce the mortality risk associated with a QPRT by transferring undivided interests in a residence to two or more QPRTs of varying terms, such as 10 and 15 years. Thus, the grantor could increase the chance that he or she would survive the term of at least one of the QPRTs. The property transferred to the shorter term QPRTs will, however, produce a larger gift than if all of the property were transferred to a single QPRT for the longer term. For example, if a grantor, age 50,

transfers a $1,000,000 residence to a 15-year QPRT when the IRC § 7520 rate is 5.4%, the taxable gift would be $391,140. If the grantor instead transferred $500,000 to a 10-year QPRT and $500,000 to a 15-year QPRT, the combined taxable gifts would be $469,215.

➔ **Planning Point:** While transferring a primary residence is permitted, vacation homes are often the preferred choice for several reasons. The primary reason is that when the personal residence trust term ends, the grantor must vacate the residence unless the instrument permits him or her to lease the residence from its new owners or they otherwise agree to do so.

Generally, the residence may not be used for any purpose other than the term holder's residence when occupied by the term holder. Treas. Reg. §§ 25.2702-5(b)(2)(iii), (c)(2)(iii). A residence will qualify as a personal residence, however, if a portion of it is used for a business use such that certain expenses are deductible business expenses for federal income tax purposes. Treas. Reg. §§ 25.2702-5(b)(2)(iii), (c)(2)(iii). A residence also may be rented during the portion of the year that it is not occupied by the term holder. Treas. Reg. § 25.2702-5(c)(2). See, e.g., PLR 200117021 (where the taxpayer's stay at the vacation property exceeded the minimum required under IRC § 280A(d), and the taxpayer rented the property for two months a year and provided no services in connection with the rental of the property, the IRS determined that such property qualified as a personal residence eligible for a QPRT).

a. **Additional Property**. A personal residence also includes appurtenant structures used for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes, considering the residence's size and location. Treas. Reg. §§ 25.2702-5(b)(2)(ii), (c)(2)(ii). There are numerous private letter rulings addressing the type of property and structures that will qualify as a personal residence, and the IRS has approved the treatment as a personal residence of:

- A parcel containing a residence, carport, pier, boat dock and guesthouse (PLR 199908032);
- A parcel containing a residence, two outbuildings, a swimming pool and land subject to a conservation easement (PLR 200039031); and
- A parcel containing a vacation home, detached garage with an apartment used by a maintenance person, a cabin, tennis court, Jacuzzi and land subject to a conservation easement (PLR 200109017).

b. **Furnishings**. The term personal residence does not include personal property, such as furnishings. Treas. Reg. §§ 25.2702-5(b)(2)(ii), (c)(2)(ii).

c. **Mortgaged Property**. Mortgaged property will qualify as a personal residence. *Id*. For purposes of determining the value of the gift, however, the mortgage must be considered, in which case the gift is the value of the property net of the mortgage. The view of some practitioners is, however, that if the grantor enters into an indemnification agreement with the trustee pursuant to which the grantor remains liable on the mortgage and the trustee has the right to enforce the debt against the grantor, then the gift is the full value of the property, not its net value. See Carlyn S. McCaffrey and Pam H. Schneider, "Planning for GRATs and QPRTs,"

301 *PLI/Est* 395 (Feb./Mar. 2001).

EXAMPLE: Grantor, age 50, transfers a residence worth $1,000,000 to a 15-year QPRT when the IRC § 7520 rate is 5.4%. The residence is subject to a $500,000 mortgage. If the transfer is not subject to the mortgage, the value for purposes of determining the gift is $1,000,000. Grantor's retained interest has a value of $608,860, and he makes a gift of $391,140. If Grantor transferred the house subject to the mortgage, however, its net value of $500,000 would be used in determining the amount of the gift. In that case, the value of Grantor's retained interest is $304,430, and he makes a gift of $195,570. As Grantor pays off the mortgage, he or she will be making an additional transfer to the trust in the amount of the principal portion of each mortgage payment, and a portion of the transfer will be treated as a taxable gift for which a gift tax return will need to be prepared and filed.

➔ **Planning Point:** If the residence is secured by a mortgage, the grantor should notify the bank of the transfer so the mortgage documents can be updated and to make sure the transfer does not accelerate the mortgage. The terms of the mortgage may prohibit a transfer to a QPRT or accelerate repayment if a transfer is made.

d. Joint Ownership by Spouses. Spouses who hold interests in the same residence may transfer their interests in the residence to the same trust, as long as the trust instrument prohibits any person other than one of the spouses from holding a term interest concurrent with the other spouse. Treas. Reg. §§ 25.2702-5(b)(2)(iv), (c)(2)(iv). Alternatively, each spouse may establish a personal residence trust and transfer his or her undivided interest to it.

➔ **Planning Point:** The transfer to separate trusts may result in fractional discounts, and it also may allow the spouses to take advantage of the longer life expectancy of one of the spouses by creating a trust with a longer term, thereby decreasing the taxable gift.

EXAMPLE 1: Wife, age 55, transfers a $1,000,000 residence to a 10-year QPRT when the IRC § 7520 rate is 5.4%. The value of the gift will be $524,000. If Wife and Husband, both of whom are 55 years old, hold their residence in joint tenancy and each of them transfers his or her respective one-half interest to a QPRT, the value of the residence can be discounted. Assuming a discount of 15%, the value of each one-half interest would be $425,000. Assuming the same IRC § 7520 rate, the value of each gift would be $223,000, for a total gift of $446,000, which is $78,000 less than had Wife transferred the entire residence.

EXAMPLE 2: If, in Example 1 above, Wife transferred her undivided one-half interest to a 15-year QPRT because of her longer life

expectancy, Wife would make a taxable gift of $154,000 rather than $223,000 (the amount of Husband's taxable gift). The total gift would be $377,000, which is $69,000 less than had Wife used a 10-year QPRT.

3. Personal Residence Trusts

A personal residence trust is a trust that must prohibit the trust from holding any asset other than one personal residence of the term holder and "qualified proceeds." Treas. Reg. § 25.2702-5(b)(1). "Qualified proceeds" are defined as proceeds payable as a result of damage, destruction or involuntary conversion of the personal residence if the proceeds are reinvested in a personal residence within two years of receipt of the proceeds. Treas. Reg. § 25.2702-5(b)(3). The trust instrument must prohibit the sale or transfer of the personal residence during the term of the trust. Treas. Reg. § 25.2702-5(b)(1).

The rules governing personal residence trusts are inflexible, and, therefore, such trusts are rarely used. Rather, QPRTs are used.

4. Qualified Personal Residence Trusts

In order for a trust to qualify as a QPRT, it must meet the requirements for a QPRT set forth in the regulations, and the governing instrument must contain several provisions, which are discussed below. For a sample governing instrument for a QPRT, along with annotations and optional provisions, see Rev. Proc. 2003-42, 2003-1 C.B. 993.

a. **Permissible Distributions**. All of the income must be distributed to the term holder at least annually, and no distributions of principal may be made to anyone other than the term holder prior to the end of the retained term. Treas. Reg. §§ 25.2702-5(c)(3), (c)(4).

b. **Permissible Trust Property**. The governing instrument must prohibit the trust from holding any asset other than one residence to be used as a personal residence by the term holder. Treas. Reg. § 25.2702-5(c)(5)(i). That said, the governing instrument also may permit the trust to hold the assets discussed below.

(1) **Additions of Cash**. Additions of cash or the holding of cash in a separate account are permitted for the following purposes:

- For the payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be incurred within six months of the date on which the cash was contributed;
- For improvements to the residence to be paid for within six months of the date the cash was contributed; and
- For the purchase by the QPRT of the initial residence within three months of the date the trust is created, or for the purchase of a replacement residence within three months of the cash addition; provided that, in either case, the trustee has entered into a contract to purchase the residence. Treas. Reg. § 25.2702-5(c)(5)(ii)(A)(1).

➔ **Planning Point:** Additions of cash to a QPRT may be additional gifts to the QPRT. Items that the grantor, as the life tenant, is required to pay under applicable law, such as mortgage interest payments, taxes and utilities, however, should not be treated as additional gifts to the trust.

(2) Improvements. The trust may permit improvements to the residence to be added to the trust as long as the residence continues to meet the definition of a personal residence. Treas. Reg. § 25.2702-5(c)(5)(ii)(B).

➔ **Planning Point:** This exception appears to be limited to improvements paid for directly by the term holder, whereas under the exception for cash additions to pay for improvements, the trustee would pay for the cost of the improvements.

(3) Sale Proceeds. The governing instrument may allow the QPRT to hold the proceeds from the sale of the personal residence, in a separate account, for a period not to exceed two years from the date of sale if the trustee plans to use the proceeds within that period to purchase another personal residence for the term holder. Treas. Reg. §§ 25.2702- 5(c)(5)(ii)(C), (c)(7)(ii).

(4) Insurance Proceeds. The QPRT may hold insurance policies on the residence and the insurance proceeds payable to the trust as a result of damage to or destruction of the residence, if the proceeds are held in a separate account, for up to two years,

for the repair, improvement or replacement of the residence. Treas. Reg. § 25.2702-5(c)(5)(ii)(D).

➔ **Planning Point:** After the transfer of the residence to the QPRT, the grantor should notify his or her insurance agent so the homeowner's policy can be updated to reflect the trust as the new owner of the residence.

c. Commutation. The governing instrument must prohibit commutation (the prepayment of the income interest at its actuarial value at the date of prepayment). Treas. Reg. § 25.2702-5(c)(6).

d. Cessation of Use as a Personal Residence. The governing instrument must provide that the trust ceases to be a QPRT if the residence held by the QPRT ceases to be the personal residence of the term holder. Treas. Reg. § 25.2702-5(c)(7). A trust may cease to be a QPRT if the personal residence is sold, damaged or destroyed. Treas. Reg. §§ 25.2702- 5(c)(7)(ii), (c)(7)(iii).

(1) Sale of Residence. The sale of the personal residence is not a cessation of use if the sale proceeds are used to acquire a new residence within two years of the sale. Treas. Reg. § 25.2702-5(c)(7)(ii).

(2) Destruction of Residence. Damage to or destruction of the personal residence will not cause the trust to cease to be a QPRT if replacement of or repairs to the residence are completed, or the trust acquires a new residence, prior to the date that is two years after the

date of such damage or destruction. Treas. Reg. § 25.2702-5(c)(7)(iii)(A).

Within thirty days of the trust's ceasing to be a QPRT, either (i) the assets must be distributed outright to the term holder, or (ii) the trust must be converted to a GRAT. Treas. Reg. § 25.2702-5(c)(8)(i). The regulations set forth the manner in which a QPRT may be converted to a GRAT. Treas. Reg. § 25.2702-5(c)(8)(ii).

➔ **Planning Point:** The trustee may be given the discretion as to which of these results occurs. If the term holder is the trustee, however, such a provision may make the original transfer to the trust an incomplete gift. Requiring the trust to convert to a GRAT is the preferred option for this reason. Additionally, creating a GRAT allows at least a portion of the expected tax benefit of the QPRT to be preserved.

e. **Sale of Residence to Grantor**. The governing instrument must prohibit the trust from selling or transferring the residence to the grantor, the grantor's spouse, or a corporation or partnership controlled by the grantor or the grantor's spouse during the term of the trust or at any time after the retained term that the trust is a grantor trust. Treas. Reg. § 25.2702- 5(c)(9). For this purpose, a sale or transfer to a grantor trust of the grantor or the grantor's spouse is a sale or transfer to the grantor or the grantor's spouse. If the grantor dies before the expiration of the retained term, however, the residence can be distributed to anyone, including the grantor's estate and the grantor's spouse, pursuant to the terms of the trust or the grantor's exercise of a power of appointment. Id.

5. Gift, Estate and Income Tax Consequences

a. **Gift Tax**. A QPRT allows the grantor potentially to transfer his or her personal residence to others (*e.g.*, his or her children) at a reduced gift tax cost. For federal gift tax purposes, the original transfer of the residence to the QPRT will be treated as a taxable gift of the remainder interest to the remainder beneficiaries determined by subtracting from the value of the property transferred to the QPRT an amount equal to the value of the retained interest, determined under IRC § 7520.

The value of the gift to the QPRT for gift tax purposes is based on the present value of the right of the QPRT beneficiaries to receive the residence at the end of the term of years. In determining the value of the residence, a number of factors are considered, such as the grantor's age, the initial term of the QPRT, and the IRC § 7520 rate in effect for the month of the transfer. Because the QPRT beneficiaries must wait until the end of the term to receive the residence, the value of the gift is substantially lower than the actual value of the residence at the time of transfer. Therefore, the younger the donor or the longer the term of years, the lower the value of the gift.

EXAMPLE: Grantor, age 50, transfers a residence worth $300,000 to a QPRT when the IRC § 7520 rate is 6.2%. If the property grows at 4%, the following results will be achieved:

QPRT Term	Initial Value of Property	Value of Property at End of Term	Taxable Gift (Remainder Interest)	Estate Tax Savings @ 50% Estate Tax Rate
20 years	$300,000	$657,337	$69,588	$293,875
25 years	$300,000	$799,751	$43,638	$378,057
30 years	$300,000	$973,019	$25,161	$473,929

Not only is the initial transfer of the residence a gift to the QPRT, but also later contributions of cash to the trust and the direct payment by the grantor of certain expenses and improvements are gifts to the QPRT. When contributions of cash are made to the trust to pay for expenses or improvements, or payments are made by the grantor directly, the additional gift is valued using the factors (*i.e.*, term, age, IRC § 7520 rate) applicable to the date of contribution rather than those applicable on the date of the original transfer. Contributions of cash to pay for expenses that are allocable to income under applicable state law should not, however, be gifts to the trust because they are properly chargeable against the term holder. See PLR 9249014. Thus, in general, the grantor's payment of mortgage interest, taxes, maintenance charges, ordinary repairs and utilities will not result in a gift to the remainder beneficiaries. Similarly, the grantor's direct payment of such expenses will not constitute a gift. The payment of other expenses, such as principal on a mortgage loan, will be additional gifts.

b. Estate Tax. If the grantor survives the QPRT term, the full fair market value of the residence, including any appreciation in the value of the residence during the term of the trust, will not be included in the grantor's estate for federal estate tax purposes. Care must be taken to ensure that the grantor does not retain any interests in or powers over the trust after the retained term ends that would cause the trust property to be included in his or her gross estate. For example, although the grantor can act as trustee during the term of the retained use of the residence, he or she should cease to act at the end of the term to ensure that he or she does not retain any powers over the trust that would cause the trust property to be included in his or her gross estate.

(1) Gross Estate Inclusion. If the grantor dies during the term of the QPRT, the full value of the residence is included in his or her gross estate for federal estate tax purposes under IRC § 2036(a)(1). Prop. Reg. § 20.2036-1(c)(2). This Section includes in a grantor's gross estate the value of property transferred during life if the grantor retained for life the right to the income from or the right to possess or enjoy the transferred property. If the property is included in the grantor's gross estate, any of the grantor's applicable exclusion amount used to shelter the gift to the trust is restored. Consequently, the result for federal gift and estate tax purposes is the same as if the QPRT had never been established. The only "cost" if the grantor dies during the term of the QPRT is the expense of creating and operating the QPRT and the loss of the use of the funds used to pay any gift tax upon creating the GRAT. If the grantor paid gift tax, the grantor's estate will be entitled to an adjustment for the gift tax paid.

➔ **Planning Point:** Although the grantor's applicable exclusion will be restored, if the grantor's spouse consented to split the gift, the spouse's applicable exclusion will not be restored. Therefore, the grantor should not split gifts to a QPRT with his or her spouse because the spouse's applicable exclusion amount will be wasted if the grantor does not survive the term.

(2) Use of Residence After Retained Term. The QPRT instrument can include a "lease-back" provision. Pursuant to such a provision, if the grantor survives until the end of the term of the QPRT and the trust holds the residence at that time, the residence will continue to be held in trust for the benefit of the beneficiaries, subject to the grantor's right to lease the property for fair market value from the remainder beneficiaries. The grantor also could rent the residence from the children if the residence is distributed outright to them. If the trustee at any time decides to sell the residence, any sale would be subject to the grantor's continuing right to lease the property.

If the grantor or his or her spouse leases the residence from the remainder beneficiaries after the end of the QPRT term, the residence will not be subject to estate tax upon either spouse's death as long as the lease is at fair market value. See PLRs 199931028; 9723021. Although the rental payments will be taxable income to the beneficiaries, the income tax rate is less than the estate tax rate. Paying rent also will save estate tax on the rental payments that would otherwise be included in the grantor's estate at death and will move assets from the grantor to the new owners free of estate or gift tax.

➔ **Planning Point:** For a married individual, an alternative to renting the residence from the remainder beneficiaries is to provide that the residence will continue to be held in trust after the initial term with the grantor's spouse having the right to use and occupy the residence rent-free during the spouse's life. Thus, the grantor can continue to occupy the residence after the retained term without any adverse estate tax consequences.

In addition, the QPRT can provide that a continuing trust owns the residence after the expiration of the grantor's retained interest. If the continuing trust is structured as a grantor trust for income tax purposes and the grantor pays fair market rent for the use of the property, the rent payments will be out of the grantor's estate and will not be income to the continuing trust or its beneficiaries.

c. Generation-Skipping Transfer Tax. As discussed above in connection with the discussion on GRATs, the ETIP rule prevents the allocation of a grantor's GST exemption to a trust that will be included in the grantor's gross estate until such time as the grantor's interest has terminated. Under the ETIP rule, because the QPRT will be included in the grantor's gross estate if he or she dies during the retained term, the grantor cannot allocate GST exemption to a QPRT until the end of the retained term. Thus, it is preferable to designate the grantor's living children as the remainder beneficiaries of the QPRT.

d. Income Tax. A QPRT allows the grantor to take advantage of certain income tax savings normally available to individual taxpayers.

A QPRT is designed to be a grantor trust, which, as discussed above, means that the trust will be ignored for federal income tax purposes. Therefore, the grantor can deduct all real property tax payments on the residence in the QPRT and mortgage interest payments on his or her personal income tax return as long as the QPRT owns the residence. Further, if the home is the grantor's principal residence and is sold during the QPRT term, the grantor can take advantage of the capital

gain exclusion for the sale of a principal residence that is available to an individual under IRC § 121 ($250,000 for an individual, $500,000 for a married individual filing jointly).

If the property is sold after the term of the QPRT has expired, even though the grantor may be leasing the property, the capital gain will not be taxed to the grantor, but rather to the persons who received the property when the QPRT ended (*e.g.*, the grantor's children) unless the residence is held in a continuing trust that is treated as a grantor trust for federal income tax purposes.

It should be noted that a residence held in a QPRT that ends before the grantor dies does not get a step-up in basis at the grantor's death. Instead, the grantor's cost basis in the residence will carry over to the beneficiaries. Therefore, if the residence is eventually sold, the capital gains tax could be higher than if the grantor had owned the residence at his or her death. The beneficiary may still be able to use his or her own exclusion under IRC § 121, but only if the property is the beneficiary's principal residence for the required length of time.

K. Sale of Remainder Interest in a Marital Trust[10]

The sale of the remainder interest in a marital trust involves the grantor's transfer of property to an irrevocable trust for the benefit of the grantor's spouse, who receives an income interest or an annuity payment from the trust for life, and the grantor's simultaneous sale of the remainder interest in the trust to the grantor's children, a trust for the grantor's children or other non-spousal beneficiaries for its fair market value. The trust is designed to qualify for the gift tax marital deduction, but it will not be subject to estate tax at the spouse's death. As a result, the trust property passes to the grantor's children completely free of gift and estate taxes.

1. Gift Tax Marital Deduction

Generally, a lifetime transfer of property between a husband and a wife is not subject to gift tax because of the unlimited gift tax marital deduction provided in IRC § 2523.

a. **Terminable Interest Rule**. When a husband or wife transfers a "terminable interest" in property to his or her spouse, however, the transfer will not qualify for the marital deduction, except in limited circumstances. An example of a "terminable interest" is where a husband or wife transfers property in trust for the benefit of his or her spouse, and the spouse's right to receive payments from the trust will end at the spouse's death or at the end of a term of years, at which time the property passes to someone other than the spouse or the spouse's estate. Because the rights of the spouse or the spouse's estate terminate at some point, the spouse's interest is considered a terminable interest and may not qualify for the gift tax marital deduction.

b. **Exceptions to the Terminable Interest Rule**. IRC § 2523 contains exceptions to the "terminable interest" rule pursuant to which certain terminable interests will qualify for the gift tax marital deduction.

(1) **Certain Trusts**. Under the exceptions, certain types of marital trusts that contain requisite statutory provisions (so-called qualified terminable interest property ("QTIP") trusts and general power of appointment marital trusts) will qualify for the gift tax marital deduction. Each of these types of trusts, either by statute or as a result of required provisions, however, will be included in the spouse's gross estate for federal estate tax purposes at the spouse's death under either IRC § 2041 (by reason of the general power of appointment) or IRC § 2044 (by reason of the QTIP election), thereby merely deferring, but not eliminating, estate taxes.

(2) **Transfer for Full and Adequate Consideration**. Another exception to the terminable interest rule applies if the person receiving the remainder of a terminable interest paid full and adequate consideration for that remainder interest. IRC § 2523(b). It is this exception upon which the marital trust remainder sale strategy is built. The marital trust should not be subject to the terminable interest rule (and thus should qualify for the marital deduction) because the grantor sells the remainder interest for full and adequate consideration at the same time that he or she transfers the lifetime interest to his or her spouse. Because the marital trust remainder sale strategy relies on this exception, the trust agreement

need not contain any provisions that would cause the trust property to be included in the spouse-beneficiary's gross estate (the spouse will not have a general power of appointment, and a QTIP election will not have been made). As a result, transfer taxes should be eliminated, both on the initial transfer of property to the marital trust and on the transfer of the marital trust property to the remainder beneficiaries at the end of the marital trust term.

2. Marital Trust Remainder Sale Considerations

a. <u>Valuation of the Spouse's Interest</u>. In order to eliminate as many of the valuation issues as possible in determining the value of the remainder interest (and thus the purchase price to be paid by the remainder beneficiaries), the grantor's spouse should receive either only an income interest or an annuity in the trust; that is, an interest that requires that the spouse receive a fixed annuity or that all income be distributed to him or her. This structure makes the valuation of the spouse's interest a simple annuity or life estate calculation under IRC § 7520. The value of the remainder interest should be equal to the value of the property the grantor transfers less the value of the spouse's annuity interest or life estate, determined under IRC § 7520.

b. <u>Estate and Gift Tax Consequences</u>. As noted above, the spouse will not have a general power of appointment over the trust, and a QTIP election will not be made for the marital trust. Thus, the trust property should not be included in the spouse's gross estate at his or her death. Nonetheless, because the remainder beneficiaries pay the grantor adequate and full consideration for the remainder interest, the interest in the trust transferred to the grantor's spouse should qualify for the gift tax marital deduction. This is the case even though a person (*e.g.*, one or more of the grantor's children) will receive the trust property (*i.e.*, the remainder interest) after the termination of the spouse's interest.

The result of the transaction is that the property is removed from the grantor's estate, the grantor's spouse receives a benefit for life from the property in the trust, yet the trust property is not included in the spouse's gross estate for federal estate tax purposes. Thus, the property is not subject to estate tax or gift tax before reaching the children. Only the amount that the remainder beneficiaries pay to the grantor for the remainder interest and any appreciation thereon will be subject to estate tax in the grantor's gross estate.

The rationale for allowing the marital deduction in this case is that the remainder beneficiaries will have transferred to the grantor property having a value equal to the present value of what they will eventually receive from the marital trust. The property transferred to the grantor, as reinvested, will be subject to estate tax at his or her death, and thus, in theory, no circumvention of the estate tax will have occurred.

<u>See</u> PLR 200728018 (IRS concluded that a parcel constituted a personal residence within the meaning of the IRC and regulations and the transfer of the parcel to the trust followed by the sale of the remainder interest to a purchasing trust in exchange for cash or marketable securities will not constitute a taxable gift by either husband or wife for federal gift tax purposes under IRC § 2501)

c. <u>Income Tax Consequences</u>. Income tax consequences also must be

considered in determining the benefits of the transaction. If the asset being transferred to the trust has built-in appreciation, the grantor will recognize capital gain when he or she sells the remainder interest to the beneficiaries. The basis of the asset in the hands of the remainder beneficiaries will equal the purchase price, and the asset will not be entitled to a stepped-up basis at the grantor's death. Thus, when the remainder beneficiaries sell the asset, they will recognize more gain than if they had received the asset from the grantor by reason of the grantor's death.

3. Income Marital Trust

If the marital trust pays all of the trust income to the grantor's spouse for the shorter of a specified term or the spouse's life, and if the trust invests for growth rather than income, then, in effect, all of the appreciation on the trust property should be transferred to the children free of gift and estate tax. State law may require that the trust pay at least some income to the spouse, and may give the spouse the right to recover the minimum amount of income out of capital gains if the trust does not in fact earn that income. Even if the trust generates income at the rate of 1% or 2% per year, which amount is paid to the spouse as the income beneficiary, all growth in excess of that amount will pass to the remainder beneficiaries.

> **EXAMPLE:** Grantor transfers $2,000,000 of cash and marketable securities to an income marital trust for Spouse's benefit, from which she will receive all of the income for 15 years or until her death if sooner. Grantor simultaneously sells the remainder interest in the trust (the right to receive the remaining trust property after the 15-year term) to a trust for the benefit of Grantor's children (the "Children's Trust").
>
> Assume the transfer is made when Spouse is 55 and the IRC § 7520 rate is 7%. Given these facts, the value of the remainder interest is equal to $812,520. Thus, the Children's Trust pays Grantor $812,520 for such remainder. Because the Children's Trust purchases the remainder interest in the marital trust, the trust qualifies for the gift tax marital deduction. Thus, no gift tax is due as a result of the $2,000,000 transfer to the marital trust.
>
> If the trust property generates income of 1% per year and capital appreciation of 9% per year (10% total), at the end of 15 years, the trust assets would have a value of $7,280,000, as illustrated below, all of which would pass free of gift and estate taxes to the Children's Trust.

Year	Start of Year	Growth	Income Paid	End of Year
1	$ 2,000,000	$ 200,000	$ (20,000)	$ 2,180,000
2	$ 2,180,000	$ 218,000	$ (21,800)	$ 2,376,200
3	$ 2,376,200	$ 237,620	$ (23,762)	$ 2,590,058
4	$ 2,590,058	$ 259,006	$ (25,901)	$ 2,823,163

5	$ 2,823,163	$ 282,316	$ (28,232)	$ 3,077,248
6	$ 3,077,248	$ 307,725	$ (30,772)	$ 3,354,200
7	$ 3,354,200	$ 335,420	$ (33,542)	$ 3,656,078
8	$ 3,656,078	$ 365,608	$ (36,561)	$ 3,985,125
9	$ 3,985,125	$ 398,513	$ (39,851)	$ 4,343,787
10	$ 4,343,787	$ 434,379	$ (43,438)	$ 4,734,727
11	$ 4,734,727	$ 473,473	$ (47,347)	$ 5,160,853
12	$ 5,160,853	$ 516,085	$ (51,609)	$ 5,625,330
13	$ 5,625,330	$ 562,533	$ (56,253)	$ 6,131,609
14	$ 6,131,609	$ 613,161	$ (61,316)	$ 6,683,454
15	$ 6,683,454	$ 668,345	$ (66,835)	$ 7,284,965

If Spouse dies in year 8, however, the marital trust provides the Children's Trust with a "windfall" in that the property then held by the marital trust will pass to the Children's Trust several years earlier than anticipated. The marital trust would have $3,980,000 after 8 years, which would grow to $7,750,000 after an additional 7 years (*i.e.*, a total of 15 years).

The income Spouse receives from the marital trust and the $812,520 Grantor receives for the remainder interest can be reinvested and passed to their children after estate taxes (to the extent that they do not consume it). This provides their children with an additional $2,280,000 (assuming a 10% rate of return and a 50% estate tax rate) after estate taxes.

If Grantor had retained the $2,000,000 and the Children's Trust had kept its $812,520, in 15 years at a 10% rate of return, Grantor would have $8,350,000, only $4,175,000 of which would pass to his children after estate tax, and the Children's Trust would have $3,390,000. Thus, the total amount received by the children would be $7,565,000.

Accordingly, the marital trust remainder sale, taking into account (1) the value of the marital trust at the end of the 15-year term ($7,280,000), and (2) the $2,280,000 the children eventually inherit from Grantor's and Spouse's estates by reason of the payment for the remainder and the income Spouse received from the marital trust (a total of $9,560,000), increases the children's inheritance by almost $2,000,000.

a. **<u>Advantages Over Other Techniques</u>**. This result clearly is better than a GRAT or a sale to an IDGT, both of which transfer to the remainder beneficiaries only the growth in excess of the IRC § 7520 rate (on the GRAT) or the IRC § 1274 interest rate (on the note). Those rates could be several times higher than the 1% or 2% minimum income rate that may apply to the marital trust. In effect, the children receive the amount of the estate tax that would have been imposed on the property transferred into the trust, and give up the amount of

the estate tax on the property they transfer to the grantor to purchase the remainder interest.

b. **Use of IRC § 7520 Rate to Value the Income Interest**. The IRC § 7520 rate cannot be used if the trust instrument does not "provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time." Treas. Reg. § 25.7520-3(b)(2)(ii). Thus, for example, if stock is transferred to a trust in which the grantor has retained an income interest and the stock historically pays dividends equal to one percent of fair market value, and the valuation tables assume an eight percent return, the income interest should not be valued using the IRC § 7520 rate.

A trust with a mandatory income interest in favor of the grantor's spouse should satisfy the foregoing requirements. Examples 1 and 2 in Treas. Reg. § 25.7520-3(b)(2)(v) make it clear that the spouse should be given the power to direct the trustee to "make the trust corpus productive consistent with income yield standards for trusts under applicable state law," and specifically contemplate that the minimum rate of income that a productive trust may produce may be substantially below the IRC § 7520 interest rate on the valuation date. Moreover, Example 2 of these regulations shows that, as long as the beneficiary has the power to make the trust property productive of income, the fact that it actually does not produce income will not preclude use of the IRC § 7520 rate factors. (In this example, the trust owned non-dividend- paying stock, and the beneficiary had the right to compel the trustee to make the trust property productive of income.)

4. Annuity Marital Trust

Alternatively, the marital trust could pay the grantor's spouse an annuity for a fixed term of years. The annuity will be valued using the IRC § 7520 tables. The annuity could be structured so that the remainder value is minimized, thereby significantly reducing the purchase price to be paid by the remainder beneficiaries. In this case, only the growth of the trust property in excess of the IRC § 7520 rate will pass to the remainder beneficiaries. As the example below illustrates, less property is available for the remainder beneficiaries if an annuity marital trust is used than if an income marital trust is used because of the higher payout rate to the spouse.

> **EXAMPLE:** Grantor transfers $2,000,000 of cash and marketable securities to an annuity marital trust for Spouse's benefit, from which she (or her estate) will receive an annuity of approximately $202,000 for 15 years. Grantor simultaneously sells the remainder interest in the marital trust (the right to receive the remaining trust property after the 15-year term) to a trust for the benefit of Grantor's children (the "Children's Trust").
>
> Assuming an IRC § 7520 rate of 5.8%, the remainder is valued at $10,000. Thus, the Children's Trust pays Grantor $10,000 for the remainder. Because the Children's Trust purchases the remainder interest in the marital trust, the trust qualifies for the gift tax marital deduction. Thus, no gift tax is due as a result of the $2,000,000 transfer

to the trust.

Assuming a 10% rate of return on the trust property, at the end of 15 years, the trust assets would have a value of $1,900,000, as illustrated below, all of which would pass free of gift and estate taxes to the Children's Trust.

Year	Start of Year	Growth	Annuity	End of Year
1	$ 2,000,000	$ 200,000	$ (202,228)	$ 1,997,313
2	$ 1,997,313	$ 199,731	$ (202,228)	$ 1,994,358
3	$ 1,994,358	$ 199,436	$ (202,228)	$ 1,991,106
4	$ 1,991,106	$ 199,111	$ (202,228)	$ 1,987,530
5	$ 1,987,530	$ 198,753	$ (202,228)	$ 1,983,596
6	$ 1,983,596	$ 198,360	$ (202,228)	$ 1,979,269
7	$ 1,979,269	$ 197,927	$ (202,228)	$ 1,974,509
8	$ 1,974,509	$ 197,451	$ (202,228)	$ 1,969,273
9	$ 1,969,273	$ 196,927	$ (202,228)	$ 1,963,514
10	$ 1,963,514	$ 196,351	$ (202,228)	$ 1,957,178
11	$ 1,957,178	$ 195,718	$ (202,228)	$ 1,950,209
12	$ 1,950,209	$ 195,021	$ (202,228)	$ 1,942,543
13	$ 1,942,543	$ 194,254	$ (202,228)	$ 1,934,111
14	$ 1,934,111	$ 193,411	$ (202,228)	$ 1,924,835
15	$ 1,924,835	$ 192,483	$ (202,228)	$ 1,914,631

The $10,000 Grantor receives for the remainder interest and the annuity payments Spouse receives from the marital trust can be reinvested and passed to their children after estate taxes (to the extent they do not consume it). This provides their children with an additional $2,700,000 (assuming a 10% rate of return and a 50% estate tax rate) after estate taxes.

If Grantor had retained the $2,000,000 and the Children's Trust had kept its $10,000, in 15 years at a 10% rate of return, Grantor would have $8,350,000, only $4,175,000 of which would pass to his children after estate tax, and the Children's Trust would have $42,000. Thus, the total amount received by the children would be $4,217,000.

Accordingly, the marital trust remainder sale, taking into account (1) the value of the marital trust at the end of the 15-year term ($1,900,000), and (2) the $2,700,000 the children eventually inherit from Grantor's and Spouse's estates by reason of the payment for the remainder and the income Spouse received from the marital trust (a total of $4,600,000), increases the children's inheritance by almost $400,000.

The marital trust remainder sale using an annuity marital trust has two advantages over a

GRAT. First, there is no mortality risk. That is, if the grantor's spouse dies during the annuity term, only the present value of the remaining annuity payments is included in the spouse's taxable estate. The amount of the marital trust property is not subject to estate tax. Second, there is no taxable gift upon creation of the marital trust, assuming the Children's Trust has sufficient assets with which to purchase the remainder.

5. Valuation Issues

The success of the marital trust remainder sale depends on a finding that the remainder beneficiaries paid full and adequate consideration for the remainder interest so that the grantor does not make a taxable gift to his or her spouse. Thus, the following valuation issues should be considered.

a. <u>Consequences of Incorrect Valuation of Remainder Interest</u>. If the property contributed to the marital trust was undervalued or overvalued for any reason, then the amount paid for the remainder interest would either be too great or too little. If the property contributed was overvalued, then the remainder beneficiaries will not have paid adequate and full consideration for the remainder interest. It is unclear how such a determination would affect the availability of the marital deduction. Two different results are possible, which are discussed below.

(1) <u>Spouse's Interest Does Not Qualify for the Marital Deduction</u>. It is possible that no portion of the spouse's interest in the marital trust would qualify for the gift tax marital deduction because the remainder beneficiaries did not pay adequate and full consideration, the result of which would be that the full value of the spouse's interest would be subject to gift tax. In that case, the value of the property transferred to the marital trust, less the amount paid by the remainder beneficiaries, would be subject to gift tax. Further, the grantor will have made a taxable gift to the remainder beneficiaries of the amount by which the value of the remainder interest exceeds the amount the remainder beneficiaries paid.

General Counsel Memorandum 38505 (September 19, 1980) supports this conclusion. In that memo, the taxpayer made a transfer to charity in a manner similar to the marital trust in a remainder sale only in that a third party paid for and would receive a future benefit. At issue was whether the gift to charity qualified for the gift tax charitable deduction under IRC § 2522. Like the marital deduction, IRC § 2522 permits a gift tax charitable deduction only for certain types of trusts that benefit both charity and individuals and that meet certain statutory requirements. If the individual paid full and adequate consideration for his or her interest, however, the trust has no formal requirements, and the charity's interest will qualify for the gift tax charitable deduction. This exception parallels, in concept and in language, the marital deduction exception upon which the marital trust remainder sale is based. In GCM 38505, the IRS determined that if the amount paid by the third party (remainder beneficiaries) was less than the value of his or her interest, the gift by the donor to charity failed to qualify for the gift tax charitable deduction in its entirety. Thus, no charitable deduction would be allowed -- not even an amount proportionate to the payment made by the remainder beneficiaries.

(2) <u>A Fraction of Spouse's Interest Qualifies for the Marital Deduction</u>. The more appropriate result is that a fraction of the spouse's interest in the marital

trust would qualify for the marital deduction. The numerator of the fraction is equal to the amount the remainder beneficiaries paid for the remainder interest, and the denominator is equal to the value of the remainder interest as determined by the IRS. The portion that does not qualify for the marital deduction is subject to gift tax. In addition, the remainder beneficiaries will have received a taxable gift from the grantor of the amount by which the value of the remainder interest exceeds the amount the remainder beneficiaries paid.

Technical Advice Memorandum 7605283200D supports this more favorable result. In this TAM, the IRS held that where the decedent's spouse received a terminable interest in an annuity from the decedent and only a portion of the interest passing to the remainder beneficiaries was paid for with full and adequate consideration, then the fraction that was so paid for will qualify for the marital deduction, and the balance will not. Thus, based on TAM 7605283200D, if the price paid by the remainder beneficiaries in a marital trust remainder sale is determined to be less than the fair market value of the remainder, only a fraction of the value of the spouse's interest in the marital trust will not qualify for the marital deduction.

Based on TAM 7605283200D and GCM 38505, it is unclear whether the IRS would disallow the entire marital deduction, or only a fraction of the deduction, if the remainder beneficiaries do not pay full and adequate consideration for the remainder. These two rulings have opposite results; neither is directly on point; and neither has precedential value. The TAM is more indicative of the IRS's anticipated position on the marital trust because the facts of TAM 7605283200D are more similar to a marital trust remainder sale than are the facts of GCM 38505, and the provision of IRC § 2523 that was at issue in TAM 7605283200D is the same provision on which the marital trust remainder sale technique is based.

Finally, the IRS might point to the "full and adequate consideration" language of IRC § 2523(b)(1) to deny the entire marital deduction if the remainder beneficiaries do not pay full and adequate consideration for the remainder interest. To bolster its argument, the IRS could argue that IRC § 2523 does not state that the deduction is allowed "to the extent" full and adequate consideration is received. On the other hand, the language of IRC § 2523 does not rule out that interpretation.

b. **Price Adjustment Clause to Avoid Gift Taxes**. To address the risk that the remainder beneficiaries will not have paid adequate and full consideration for the remainder interest, the marital trust could include a price adjustment clause if it is to be funded with property that is difficult to value (*e.g.*, limited partnership interests or closely held business stock). The purpose of a price adjustment clause is to adjust the price of the remainder interest if the value of the interest is increased on audit. If given effect, such an adjustment clause should eliminate the risk that an undervaluation would disqualify the trust entirely for the marital deduction. It is uncertain, however, whether any particular adjustment clause will be given effect. The subject of adjustment clauses is discussed above in greater detail in connection with the section on sales to intentionally defective grantor trusts.

6. IRC § 2702 and *Gradow*

As discussed above, it is necessary that the remainder beneficiaries pay full and adequate

consideration for the remainder interest in order to avoid a gift. It also is important that full and adequate consideration for the remainder be equal to the actuarial value of such interest as determined under IRC § 7520, and not to the value of the entire trust. Two potential areas of concern on this issue -- IRC § 2702 and the *Gradow* case -- should be irrelevant.

a. **IRC § 2702**. As discussed above, IRC § 2702(a)(1) provides that if property is transferred in trust for the benefit of a member of the transferor's family, and if the transferor retains (or certain family members retain) an interest in the trust, the value of any interest in the trust retained by the transferor (or by certain family members) will be valued at zero, resulting in a taxable gift of the entire amount to the remainder beneficiaries, unless the retained interest is a "qualified interest." In the case of a marital trust remainder sale, however, the transferor (*i.e.*, the creator of the trust) does not "retain" any interest in the trust; rather, he or she simultaneously transfers a life estate to his or her spouse and sells the remainder to his or her children. Treas. Reg. § 25.2702-2(a)(3) states that "[r]etained means held by the same individual both before and after the transfer in trust." Treas. Reg. § 25.2702-2(d)(1), Ex. 3 shows that if a grantor transfers property in trust that pays all of the income to his wife for life, remainder to children, IRC § 2702 does not apply because neither the grantor nor the spouse held an interest both before and after the transfer. With the marital trust remainder sale, the grantor will not hold an interest in the property both before and after the transfer, and thus IRC § 2702 would not apply. In addition, under Treas. Reg. § 25.2702-4(c), the spouse is treated as the grantor because the spouse has an income interest. The gift in this situation, however, is limited to the amount the spouse paid for his or her interest, which would equal zero.

b. ***Gradow* and the Meaning of Adequate and Full Consideration**. What constitutes full and adequate consideration for the sale of a remainder interest has been addressed in a series of cases arising under IRC § 2036. At issue in these cases was whether the transferor, who had a retained interest in the transferred property, had received adequate and full consideration for the sale of a remainder interest, thus avoiding estate tax inclusion under IRC § 2036. Some courts have held that, for purposes of the estate tax, full and adequate consideration for a remainder interest is not the actuarial value of the remainder interest but the full value of the property transferred. See, *e.g.*, *Gradow, supra*; *U.S. v. Past*, *supra*; *Parker v. U.S.*, *supra*; and *Pittman v. U.S.*, *supra*. If this authority applied to the marital trust remainder sale, the technique would not be viable. However, this authority should not apply to the marital trust remainder sale.

- First, as noted above, the grantor of the marital trust does not retain any interest in the property. Rather, the grantor makes a gift of a lifetime income or annuity interest to his or her spouse and sells the remainder interest. Thus, there is no basis for including any of the trust property in the grantor's estate under IRC § 2036.
- Second, the IRS has conceded that this line of cases does not apply for purposes of the gift tax. *Wheeler v. U.S.*, 116 F.3d 749, 755 (5th Cir. 1997) ("[b]oth parties [*i.e.*, the government and the taxpayer] agree that, for the purposes of the gift tax (IRC § 2512), consideration equal to the actuarial value of the remainder interest constitutes adequate consideration"). Thus, despite these cases, the remainder beneficiaries' payment of the actuarial value of the remainder interest should constitute adequate and full consideration.
- Finally, even if *Gradow* and its progeny apply to a marital trust remainder sale,

three Courts of Appeal have rejected its holding, recognizing that, in the context of the estate tax, adequate and full consideration for the sale of a remainder interest is equal to the actuarial value of such interest. *Magnin*, *supra; Wheeler*, *supra;* and *D'Ambrosio*, *supra*.

7. Funding The Purchase Price

The Children's Trust will need funds in order to purchase the remainder from the grantor. If the trust has sufficient wealth to purchase the remainder interest but not sufficient liquid assets, it could give the grantor a promissory note, although the trust should have sufficient other assets to ensure that it has the ability to service the note. Otherwise, the payment may be deemed illusory and the IRS could recharacterize the transaction as a gift of the remainder. Interest payments made by the Children's Trust to the grantor will be taxed as interest income to the grantor, unless the Children's Trust is a grantor trust as to the grantor, in which case interest payments made by the trust will not constitute taxable interest income.

If the Children's Trust does not have sufficient assets with which to purchase the remainder or to service a note, the grantor could make a gift to the trust, which the trust could then use to pay the purchase price. Unless such a gift qualifies for the gift tax annual exclusion or is sheltered by the applicable exclusion amount, a gift tax will be due. Technically, the timing of the gift and the purchase of the remainder should be irrelevant. The IRS has held, however, that the purchaser of a remainder interest must not have acquired the funds to buy such interest from the holder of the life estate. See TAM 9206006. Some lapse of time between the gift and the purchase (*e.g.*, six months) is thus advisable.

8. Timing of Transaction

The gift of the income or annuity interest to the grantor's spouse and the sale of the remainder interest to the remainder beneficiaries must be treated as occurring simultaneously. If the sale is deemed to occur after the gift, the gift will not qualify for the marital deduction because, at the time of the gift, the remainder beneficiaries will not have paid adequate and full consideration for their interest. If the sale is deemed to occur before the gift, the transaction would be treated as a transfer of property with an interest being retained by the grantor or an applicable family member, in which case IRC § 2702 would apply, causing the value of the remainder interest to be equal to the full value of the property for gift tax purposes.

➔ **Planning Point:** It should be possible to structure the gift and the sale as simultaneous transactions. For example, the remainder beneficiaries could sign the trust as purchasers of the remainder interest. If a parent transfers property to a child and the child then hands the parent a check for the fair market value of the property, the parent and child would not be deemed to have made successive gifts to one another. Rather, their actions would be viewed as a single transaction in which the parent sold property to the child.

9. Reporting the Marital Trust Remainder Sale

a. Gift Tax Return. The instructions to Form 709, the United States Gift (and

Generation-Skipping Transfer) Tax Return, require a taxpayer to report all gifts of terminable interests the taxpayer made to his or her spouse during the year unless the terminable interest qualifies as a life estate with a power of appointment. Thus, the marital trust remainder sale must be reported on a gift tax return.

Line 16 of the gift tax return states that if a gift (i) is listed on Schedule A, (ii) is claimed on line 8 as qualifying for the marital deduction and (iii) otherwise qualifies as QTIP property, then a QTIP election is deemed to have been made with respect to that property. There is no way to elect out when these requirements are met. The marital trust in a marital trust remainder sale will not qualify for QTIP treatment, however, because it does not provide the spouse with an income interest for life.

b. **Estate Tax Return**. The consideration the grantor receives from the remainder beneficiaries will be a part of the grantor's gross estate. Further, the instructions to line 12a of Form 706, the United States Estate (and Generation-Skipping Transfer) Tax Return, require the grantor's executor to attach to the estate tax return a copy of all trusts created by the grantor during his or her life (which would include the marital trust) and to complete Form 706, Schedule G. The instructions to Schedule G, however, require the executor to list only gift tax paid on gifts made within three years of death and property transferred during the grantor's life included under IRC §§ 2035(a), 2036, 2037 or 2038. Thus, the marital trust need not be listed on Schedule G, as the grantor will not have retained any interest in nor have any power that would cause inclusion of the trust property in his or her estate under any of the enumerated sections. The required attachment of the marital trust agreement to the estate tax return, however, would at least disclose the existence of the trust.

On the spouse's death, the instructions to line 12b of Form 706 require his or her executor to attach to the return a copy of all trusts of which the spouse is a beneficiary at his or her death (which would include the marital trust if the spouse's interest had not terminated before his or her death) and to complete Schedule F. Schedule F lists miscellaneous property that is included in the gross estate, however, and the marital trust will not be so included. Thus, the marital trust would not have to be listed on Schedule F (although a copy would have to be attached to the return).

L. Sale of Remainder Interest in a Charitable Trust

For a charitably-inclined client, the sale of the remainder interest in a charitable trust provides a way for the client to transfer property to his or her children completely free of gift and estate taxes (the same result as with a sale of a remainder interest in a marital trust), while enabling the client to make charitable contributions that the client would otherwise make.

The sale of the remainder interest in a charitable trust is a transaction that is similar to the sale of a remainder interest in a marital trust, but it involves charitable, rather than spousal, interests. The grantor transfers property to an irrevocable trust for the benefit of a charity, which receives an income interest from the trust for a period of time, and the grantor simultaneously sells the remainder interest in the trust to the remainder beneficiaries for its fair market value. The gift of the income interest to charity is designed to qualify for the gift tax charitable deduction. As a result, the trust property passes to the grantor's children completely free of gift and estate taxes.

EXAMPLE: Grantor, age 62, transfers $5,000,000 to a charitable trust that provides that all of the income will be distributed to charity for the shorter of 15 years or Grantor's life. Grantor simultaneously sells the remainder interest in the charitable trust (the right to receive the remaining trust property after Grantor's death or the 15-year term, whichever occurs first) to a trust for the benefit of Grantor's children (the "Children's Trust").

Based on Grantor's life expectancy, the term of the trust, and the IRC § 7520 rate of 5.6%, the remainder is valued at $2,550,000. Thus, the Children's Trust pays Grantor $2,550,000 for the remainder. Because the Children's Trust purchases the remainder interest in the charitable trust, the charitable income interest qualifies for the gift tax charitable deduction. Thus, no gift tax is due as a result of the $5,000,000 transfer to the trust.

Assuming a 2% rate of return on income and capital appreciation of 8% each year (a total of 10%), at the end of 15 years, the trust assets will have a value of $15,860,000, all of which would pass free of gift and estate taxes to the Children's Trust.

The charity will receive all of the income, which would be $100,000 in year 1, $136,000 by year 5, $200,000 by year 10, and $294,000 by year 15.

If Grantor dies in year 8, however, the charitable trust provides the Children's Trust with a "windfall" in that the property then held by the charitable trust will pass to the Children's Trust several years earlier than anticipated. The charitable trust would have $9,250,000 after 8 years, which would grow to $18,000,000 after an additional 7 years (*i.e.*, a total of 15 years).

Assuming a 2% rate of return on income and capital appreciation of 6% each year (a total of 8%), at the end of 15 years, the trust assets will have a value of $12,000,000, all of which would pass free of gift and estate taxes to the Children's Trust.

Assuming a 2% rate of return on income and capital appreciation of 10% each year (a total of 12%), at the end of 15 years, the trust assets will have a value of $20,900,000, all of which would pass free of gift and estate taxes to the Children's Trust.

Because the analysis of this technique is similar to that of the sale of a remainder interest in a marital trust, this section will highlight the differences in the techniques and aspects that apply only to the sale of a remainder interest in a charitable trust. The reader should refer to the previous section for a more in-depth discussion of the sale of a remainder interest and the issues that should be considered.

1. Gift Tax Charitable Deduction

IRC § 2522 provides an unlimited gift tax charitable deduction. If property is transferred to a trust that benefits both charitable and noncharitable beneficiaries, however, the charity's interest must be a specific type, and the trust must meet certain requirements. Like IRC § 2523 with respect to the marital deduction, however, if an individual pays full and adequate consideration for his or her interest, the trust has no formal requirements, and the charitable beneficiary's interest will qualify for the gift tax charitable deduction. IRC § 2522(c)(2). This exception parallels, in concept and in language, the marital deduction exception upon which the marital trust remainder sale is based.

2. Valuation Issues

One of the potential risks associated with the sale of a remainder interest in a charitable trust is that if the purchaser of the remainder interest does not pay full and adequate consideration for the remainder, the IRS could disallow the charitable deduction. This risk is discussed in detail with respect to the sale of a remainder interest in a marital trust immediately above, and a portion of that discussion bears repeating because it applies directly to the charitable trust. In GCM 38505 (September 19, 1980), the taxpayer made a transfer to charity, and a third party paid for and would receive a future benefit. At issue was whether the gift to charity qualified for the gift tax charitable deduction. The IRS determined that if the amount paid by the third party (remainder beneficiaries) was less than the value of his or her interest, the gift by the donor to charity failed to qualify for the gift tax charitable deduction in its entirety. Thus, no charitable deduction would be allowed -- not even an amount proportionate to the payment made by the remainder beneficiaries. In light of the holding in GCM 38505, therefore, the charitable trust should not be funded with any assets that are hard to value in order to avoid any possibility of undervaluation.

➔ **Planning Point:** It is important that the charitable trust be funded with income-producing assets so that the IRS will not challenge use of the IRC § 7520 valuation tables to value the remainder interest. See the discussion of this issue above in the section on the sale of a remainder interest in a marital trust.

3. Income Tax Charitable Deduction

The charitable trust can be structured as either a grantor trust or a nongrantor trust.

a. Nongrantor Trust. If the trust is structured as a nongrantor trust, the grantor will not be entitled to a charitable deduction for federal income tax purposes when property is transferred to the trust. The charitable trust, however, may deduct the income paid to charity each year. IRC § 642(c).

b. Grantor Trust. If the trust is structured as a grantor trust, all items of income, deduction and credit will be reported by the grantor on his or her income tax return rather than to the trust as a separate entity. The grantor will not receive a charitable deduction for federal income tax purposes in the year in which property is transferred to the trust. This is because in order for a transfer to a trust in which there are both charitable and noncharitable beneficiaries to

qualify for an income tax deduction, the charity's interest must take a specific form. The grantor will be entitled to an income tax deduction, however, when the trust makes annual distributions of income to charity. Treas. Reg. § 1.671-2(c). If the charitable beneficiary is a public charity, the amount of the grantor's charitable income tax deduction will be limited to 50% of the grantor's adjusted gross income, or 30% if long-term capital gain property is used to fund the charitable trust. If the charitable beneficiary is a private foundation, the deduction is limited to 30% of adjusted gross income, or 20% if the property is long-term capital gain property.

4. Reporting the Charitable Trust Remainder Sale

a. Gift Tax Return. The instructions to Form 709, the United States Gift (and Generation-Skipping Transfer) Tax Return, provide that if the taxpayer transfers a partial interest to charity, or transfers part of his or her interest to a person other than a charity, the taxpayer must file a gift tax return. Thus, the transfer of property to the charitable trust in a charitable trust remainder sale must be reported on a gift tax return.

b. Estate Tax Return. The consideration the grantor receives from the remainder beneficiaries will be a part of the grantor's gross estate. Further, the instructions to line 12a of Form 706, the United States Estate (and Generation-Skipping Transfer) Tax Return, require the grantor's executor to attach to the estate tax return a copy of all trusts created by the grantor during his or her life (which would include the charitable trust) and to complete Form 706, Schedule G. The instructions to Schedule G, however, require the executor to list only gift tax paid on gifts made within three years of death and property transferred during the grantor's life included under IRC §§ 2035(a), 2036, 2037 or 2038. Thus, the charitable trust need not be listed on Schedule G, as the grantor will not have retained any interest in nor have any power that would cause inclusion of the trust property in his or her estate under any of the enumerated sections. The required attachment of the charitable trust agreement to the estate tax return, however, would at least disclose the existence of the trust.

M. Charitable Lead Annuity Trusts

A charitable lead annuity trust ("CLAT") is a charitable vehicle that also serves to transfer assets to family members at a reduced transfer tax cost. Future appreciation in the value of the assets transferred to the CLAT is not subject to estate or gift tax. The purpose of the following brief discussion is to illustrate how CLATs can be used to leverage the difference between the assumed rate of return and the actual rate of return on the assets used to fund the CLAT.

1. Overview of Charitable Lead Annuity Trusts

A CLAT is a "split interest" gift, which means that both a charitable beneficiary and a noncharitable beneficiary receive interests in the same property. A CLAT allows an individual (the "donor") to donate a limited interest in specific assets to a charity. The donor transfers property to an irrevocable trust that pays the designated charity a fixed dollar amount (the "lead" interest) for a certain period of time, at least annually. At the expiration of this period of time, the grantor may reclaim his or her interest in the assets or provide for the assets to be transferred to noncharitable beneficiaries. Depending upon the type of CLAT the donor elects to establish, the donor may obtain an income tax charitable deduction, and/or a gift tax charitable deduction or an

estate tax charitable deduction for the present value of the charity's lead interest.

The CLAT works in a manner similar to a GRAT. The GRAT offers a potentially gift tax-free method of shifting future appreciation to beneficiaries, and the CLAT offers the same kind of benefit to individuals who want to make a gift to charity. If the rate of return on the CLAT assets exceeds the IRC § 7520 rate used to value the charitable gift, then the excess will be transferred to the noncharitable beneficiaries free of estate and gift tax. This is the same result that a GRAT has. The CLAT has an advantage over a GRAT because there is no mortality risk with a CLAT.

2. Estate and Gift Tax Consequences

The charitable deduction for income, estate and gift tax purposes is equal to the present value of the charity's interest determined under IRC § 7520. In determining the amount of the charitable deduction, the donor is allowed to use either the rate for the month in which the gift occurs, or either of the immediately preceding two months, whichever is the most favorable. In fact, because the IRC § 7520 rate is published on the 20th or 21st day of the preceding month, a donor may consider four months' rates when planning the date on which to establish a CRT.

➔ **Planning Point:** The lower the IRC § 7520 rate, the higher the charitable deduction will be for the charity's annuity interest in a CLAT. Thus, the donor will want to use the lowest of the four months' rates.

If the CLAT is established during the donor's life, the donor is entitled to a charitable gift tax deduction for the value of the charity's interest upon the creation of the trust. If the remainder beneficiaries are individuals other than the donor, then the value of the remainder interest is a gift that is subject to gift tax when the trust is created. The remainder interest passes to the beneficiaries free of additional gift tax or estate tax, however, at the expiration of the CLAT term. If the trust is designed so that the donor receives the trust assets back at the end of the term of the trust, however, then the donor has not made a gift, and there is no gift tax. In that event, the assets of the trust will be included in the donor's gross estate for federal estate tax purposes.[11]

It is possible to create a CLAT for a term of years with a charitable lead interest equal to the entire value of the property transferred to the trust. Thus, the value of the remainder interest, which is the interest gifted to the noncharitable beneficiaries, would equal zero (a "zeroed-out CLAT"). As a result, no gift will be made to the family remainder beneficiaries even though these individuals may receive a substantial amount at the termination of the trust.

EXAMPLE: Donor transfers $2,000,000 to a 20-year CLAT when the IRC § 7520 rate is 5.4%. The CLAT is zeroed-out, and the annual payment to the charity is $165,972. The present value of the annuity payments is $2,000,000, so the value of the remainder interest is $0. Therefore, Donor would receive a gift tax charitable deduction in the amount of $2,000,000 for the charity's lead interest, and if Donor designated his children as the remainder beneficiaries, Donor would not have made a taxable gift. If the assets had a total return of 8%, then at the end of 20 years, there will be $1,726,693 available for the remainder beneficiaries.

3. GST Tax Consequences

The creation of a CLAT is not subject to GST tax. If, at the end of the term of the CLAT, the trust will terminate in favor of grandchildren or more remote descendants, such distributions will be subject to GST tax. Special rules apply to the allocation of GST exemption to a CLAT, the effect of which is to discourage clients from using a CLAT for transfers to grandchildren.

➔ **Planning Point:** Because of the special GST rules, CLATs are not a good vehicle to transfer assets to grandchildren. Accordingly, to avoid the potential application of the GST tax, the trust assets should be distributed to the donor's then living children when the CLAT term ends.