ESTATE PLANNING LEGISLATIVE DEVELOPMENTS, TRANSFER PLANNING IN THE SHADOW OF TRANSFER TAX REFORM EFFORTS, AND UPDATE REGARDING USE OF FLPS AND LLCS IN TRANSFER PLANNING

Estate Planning Council of Birmingham

STEVE R. AKERS
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
(214) 981-9407
akers@bessemer.com

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Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas
(214) 981 9407
akers@bessemer.com

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PART ONE—LEGISLATIVE DEVELOPMENTS

I. RERESENTATIVE BILLS UNDER CONSIDERATION. The wide differences in opinion as to the structure of future estate and gift tax legislation are reflected in some of the bills that have been introduced in 2009. These include:

H.R. 3905 – Proposal for $5.0 million exemption (indexed after 2019) and 35% rate. The exemption increase and rate decrease is phased in over 10 years through 2019. The state death tax deduction is phased out over the same period. The bill is sponsored by Representative Shelley Berkley (D-NV) with 47 bipartisan co-sponsors. (For decedents in states with a state estate tax, this bill might result in an increased federal exemption and lower federal rates—but a similar or even higher overall combined federal and state tax for some estates.)

"Lincoln-Kyl Amendment" to 2009 Budget – Room in the budget for $5 million estate tax exemption, indexed for inflation, and 35% rate, with unification of the gift tax and portability of the estate exemption between spouses. This amendment passed the Senate 51-48, but it applied only if the "legislation would not increase the deficit" over a five or ten year period.

S. 2784 - $3.5 million indexed estate and GST exemption; unification of the gift and estate tax exemptions; 45% rate; and portability of the estate and gift exemptions. (Introduced November 17, 2009; almost identical to the transfer tax provisions of S. 722 introduced in March 2009 by Senators Baucus, Rockefeller and Schumer.)

S. 3533 – introduced June 24, 2010 by Senators Sanders (I-VT), Harkin (D-IA) and Whitehouse (D-RI), who a Forbes article describes as "three of the Senate's most liberal members;"

- $3.5 million (not indexed) estate and GST exemption;

- Progressive rates (45% up to $ 10 million, 50% from $10-$50 million, 55& above $50 million, additional 10% "Billionaire's Surtax" (total rate of 65%) on estate above $500 million;

- "Loophole closers" (consistent valuation for basis and estate tax purposes, valuation discount restrictions [no discount for nonbusiness assets in an entity except for reasonable working capital, no "tiered discounts" for 10% or greater subsidiaries no lack of control discount if transferee and family have control], GRAT 10-year minimum term);

- Additional relief for special use valuation (allowing value to be reduced by up to $3 million) and conservation easements;

- Retroactive to January 1, 2010. (A Forbes.com article on June 24 gives the following insight: A letter from the three senators describing the bill "pointed out that the estate tax lapse is allowing the family of the late Dan L. Duncan, the Texan who died in March with a net worth Forbes estimates at $9.8 billion to inherit his wealth estate tax free. 'At a time when we have a record-breaking $13 trillion national debt and an unsustainable federal deficit,

people who inherit multimillion- and billion-dollar estates must pay their fair share in estate taxes….' The three senators' proposal would be retroactive to the start of 2010, which would *likely* face a court challenge from Duncan's heirs as well as others." (emphasis added)

II. RETROACTIVE LEGISLATION? There have been varying indications as to whether legislation would be retroactive to January 1. Retroactivity could be viewed as very unfair to people who have died in the interim (and even more unfair for people who make gifts thinking they are subject to a 35% gift tax rate rather than a 45% or even higher gift tax rate) and could be politically difficult to get through Congress in an election year. The longer it takes to pass legislation, the more likely it is that the legislation will not be retroactive.

If the legislation is imposed retroactively, there will probably be constitutional attacks, but it is likely that the restorative legislation would be upheld. U.S. v. Carlton, 512 U.S. 26 (1994) (upheld validity of retroactive legislation regarding an § 2057 estate tax deduction); Quarty v. United States, 83 AFTR2d ¶ 99-597 (9th Cir. 1999)(increase in gift and estate tax rates from 50% to 53% and 55% in OBRA, signed on August 10, 1993, retroactive to January 1, 1993, was constitutional where the decedent died on January 12, 1993 having made taxable gifts earlier in that year).

Whether retroactive legislation would ultimately be held constitutional is not the point. The real point is that it would take six, seven or eight years of uncertainty before we have an answer.

There would seem to be very little risk of retroactive legislation in 2011 that would be retroactive back into 2010. (Republicans will likely be even more powerful next year. They will not say "we delivered on repealing the estate tax, but now we are reinstating it retroactively.")

An approach that has been discussed in informal discussions with some legislative staffers is to continue the 2009 system retroactively, with the right to elect which regime (estate tax or modified carryover basis) would apply. An election system may place difficult burdens on fiduciaries if each election favors a different set of beneficiaries of the estate. A similar election would likely not be extended to persons who make gifts before the legislation is passed.

Representative Levin (current Chair of the House Ways and Means Committee) indicates that he favors a retroactive approach to provide uniformity but acknowledges that an elective approach will also be considered. He has indicated that he has requested a study of the revenue impact per-day that would result from a retroactive reinstatement of the estate tax.)

III. INFORMAL DISCUSSIONS WITH SENATE FINANCE COMMITTEE STAFFER. An informal discussion with a staffer for the Senate Finance Committee in early May provides several insights, at least from that staffer's perspective.

A. Cost Projections. Extending the 2009 system for two years has a cost of $18 billion (compared with doing nothing, in which event there would be a $1 million exemption and a 55% rate with a 5% surtax beginning in 2011). Extending the 2009 system has a 10-year cost of $253 billion, and having an indexed 2009 system has a 10-year cost of $270 billion.

B. PAY-GO Approach. As a practical matter, there is no way to offset the revenue costs of extending the 2009 system with other revenue offsets. The general understanding that is emerging is that extending the 2009 system will not have to be "paid for" (meaning that 60 votes in the Senate will be required), but any relief beyond the 2009 system would have to be offset with other revenue increases or spending cuts.

C. Negotiations. Negotiations center around the exemption and rate. Those who favor increased exemptions are generally not determined on a partisan basis, but based on rural vs. non-rural states (with rural states favoring increased exemptions). There are some indications that negotiations are continuing with respect to an approach for a 10-year phase in of increased exemptions and lower rates (reminiscent of the "Berkley bill," H.R. 3905).

There has been no discussion so far of a separate standalone bill merely to remove carryover basis retroactively for 2010 decedents. [Not coming from the staffer: Some have suggested that a

possible compromise if carryover basis is retained is to increase the $1.3 million basis adjustment amount to $3.5 million.]

Negotiations about retroactivity are not based on a partisan split.

Unification of the gift and estate tax exemption and portability of the estate tax exemption with a surviving spouse have both been favorably received; the issue is just the revenue cost and whether the cost of unification and portability can be offset with other revenue increases or spending cuts.

D. GRAT 10-Year Minimum Term. H.R. 4849 includes the 10-year minimum GRAT term provision (discussed below). The staffer indicates that there is great concern with including estate and gift tax offset items in other legislation. It will be hard enough to find offsets for estate and gift tax relief even keeping all the possible offset measures in the estate tax bill. The Senate will probably NOT include the GRAT provision in any legislation other than estate and gift tax legislation.

E. Section 2704. The President's Budget proposal to revise §2704 has been met with a great deal of resistance. There is a strong preference that valuation not be touched. As difficult as it is to find offsets for estate tax legislation, this staffer's perception is that it is very unlikely that the §2704 proposal will be included as an offset item.

F. Awareness of Planning Complexities. The staffer indicates that the Senators have been bombarded with comments making them aware of the estate planning complexities that the uncertainty raises for their constituents (although it does not hurt to keep impressing upon them the importance of getting some resolution and certainty). I was also impressed with the technical knowledge of the staffer with respect to the difficult planning issues that are raised by the 2010 uncertainty and the sunset rule.

G. Timing. The staffer indicated that there would be work trying to achieve a "roadmap" of a compromise in the early summer of 2010. The perception is that other important actions that the Senate needs to address may be more contentious if there is no agreement on an approach for estate and gift tax legislation (although there have been no overt statements to that effect). (As an example, an independent source indicates that Senator Kyl told reporters on May 11 that an agreement on estate tax must be reached before the Senate Finance Committee can move forward on small business legislation.)

H. House Action. Even if the Senate is able to garner 60 votes for a compromise package, there is no assurance that the House will go along. Speaker Pelosi and Chairman Levin (Chairman of the House Ways and Means Committee) have both stated repeatedly that they will not go beyond a $3.5 million exemption and 45% rate system.

IV. UPDATE ON NEGOTIATIONS. A small group focusing on the estate tax issue includes Senators Baucus, Grassley, Kyl and Lincoln. Apparently, the discussions have centered around having a top rate of 35% with a $5 million exemption. The discussions have addressed whether there will be a phase-in and whether the changes will be indexed for inflation. Offset have been a big part of the discussions and apparently, the assumption is that offsets would be needed only for relief beyond a permanent extension of the 2009 system. As indicated above, merely indexing the 2009 system has an additional 10-year cost of $17 billion. Increasing the exemption to $5 million and reducing the rate to 35% apparently has an additional 10-year cost of $60 billion. (Portability and unification of the gift exemption would add even more to the cost.)

Very little has leaked about revenue offsets that are being considered. One rumor is that "prepayment trusts" have been considered — apparently allowing taxable gifts to a trust allowing the donor to retain the right to beneficial enjoyment and control without estate inclusion under §§2036 or 2038. However, that apparently has been controversial, with some staffers saying that is a "non-starter." Other likely possibilities are eliminating the state death tax deduction (and the credit as well) and the 10-year minimum GRAT proposal.

There were reports in the second week of May 2010 that the parties were very close to an agreement on the exemption, rates and "many of the offsets" but they were still working on the last offsets that would be needed. The preference is not to have phase-ins, but that depends on the amount of offsets. However, Senator Kyl said on May 18 that he believed there was an agreement a week ago, subject only to certain offset limitations, but "that may not be the case anymore." Senator Baucus agreed, saying, "There is no agreement on the estate tax in either substance of process. None whatsoever."

Even if the bipartisan negotiators agree and even if the Senate Finance Committee agrees, many believe that there will not be 60 senators that will support the proposal (and 60 votes would be required because the PAYGO rule only has an exception for extending the 2009 system for two years.). A discussion of estate tax legislation at a policy luncheon of Democrats the week of May 17 reflected divergent opinions. Senator Bernie Sanders (I-VT) reported said "I will do everything I can to stop" a $5 million exemption/35% rate system. Senator Bob Casey (D-PA) said following the meetings that a majority of Senate Democrats oppose the $5 million/35% plan, estimating the split at "80 percent, 20 percent" against. Even if the Senate were to agree on a $5 million 35% bracket, various House leaders (including Speaker Pelosi and House Ways and Means Chairman Levin) have stated that they will not agree to a higher exemption than $3.5 million or a rate lower than 35%.

Senator Conrad (Senate Budget Chairman) has suggested that all of this year's tax legislation be bundled into one mega tax package. A primary issue apart from the estate tax is extension of the "Bush tax cuts" for taxpayers with income under $200,000 ($250,000 joint), and that has an estimated 10-year cost of $2.5 *trillion* dollars (which has an exemption under the PAYGO rules). A significant faction proposes that the Bush tax cuts also be extended for persons with income over those threshold amounts for some limited period of time (one or two years).

The staffers are dealing with a myriad of technical issues regarding tax matters, including the issues related to extension of some of the "Bush tax cuts." Now that there appears to be an impasse in the negotiations, the Senate Finance Committee staffers may focus on other issues than the estate tax (bearing in mind that these issues only impact about 2%, or less, of taxpayers). Furthermore, Congressmen may want to talk about the estate tax in campaigns leading up to the November elections, and there may be little motivation to act before the elections. Even after the elections, particularly if there is a change of control in the House or Senate, very little may happen during the lame duck session.

There have been some reports that the Lincon-Kyl proposal ($5 million exemption, 35% rate with slow phase-in) is still being considered in settlement discussions. Discussions will likely include the number of years over which the new policy is phase in and whether different rates will apply to estates of different sizes. Furthermore, there have been indications from some Senators and Representatives that the estate tax is the "linchpin" to resolving the rest of the tax policy squabbles.

There is no doubt a significant (some would even say likely) possibility that there will be no estate and gift tax legislation this year. However, as Ron Aucutt points out, legislative action can come together quickly and unexpectedly. Reminiscent of Yogi Berraisms, Ron observes: "It will happen quickly no matter how long it takes."

V. GRAT 10-YEAR MINIMUM TERM PROPOSAL. The Administration's Budget Proposal includes various legislative proposals, including restrictions on valuation discounts (by revisions to §2704) and a required minimum 10-year term for GRATs. The 10-year minimum terms for GRATs proposal has found its way into H.R. 4849, "Small Business and Infrastructure Jobs Tax Act of 2010", passed by the House on March 24, 2010 by a vote of 246-178 (generally along party lines, with only four Republicans voting Aye and only seven7 Democrats voting No). The last section of the bill adopts the proposal in the President's Budget Proposal to impose a ten-year minimum term on GRATs. It imposes a ten-year minimum term, stipulates that frontloading is not permitted (the annuity payments cannot decrease during the first ten years) and requiring that the remainder value must have a value greater than zero, with an effective date being for transfers made after the date of enactment.

The additional requirements for GRATs are detailed as follows:

"ADDITIONAL REQUIREMENTS WITH RESPECT TO GRANTOR RETAINED ANNUITIES. –For purposes of subsection (a), in the case of an interest described in paragraph (1)(A) (determined without regard to this paragraph) which is retained by the transferor, such interest shall be treated as described in such paragraph only if —

(A) the right to receive the fixed amounts referred to in such paragraph is for a term of not less than 10 years,

(B) such fixed amounts, when determined on an annual basis, do not decrease relative to any prior year during the first 10 years of the term referred to in subparagraph (A), and

(C) the remainder interest has a value greater than zero determined as of the time of the transfer."

Footnote 173 of the House Report gives this explanation for the "greater than zero" provision and the prohibition on frontloading the annuity payments: "The proposal also requires that the remainder interest of a GRAT have a term greater than zero and prohibits a reduction in the annuity during the GRAT term. These requirements are designed to prohibit circumvention of the ten-year minimum term requirement of the proposal." H.R. Rep. No. 111-447, at 55 n.173 (2010). Staffers have indicated informally that the "greater than zero" requirement is not an invitation to impose a *de minimis* remainder value by regulations, but so that the remainder (which would not constitute a present interest qualifying for the annual exclusion) would have to be reported on a gift tax return, putting the IRS on notice of the GRAT. Professor Jeff Pennell has theorized that the purpose of the "greater than zero requirement" is so that the "adequate and full consideration" exception to §2036 would not apply to the GRAT if the grantor died before the end of the GRAT term. The bill is effective "after date of enactment." (Ron Aucutt points out that means it is effective midnight the date that it is signed by the President and "midnight" would likely be based on the domicile of the donor.)

The House passed H.R. 5486, the "Small Business Jobs Relief Tax Act of 2010" on June 15, 2010. That bill contains the 10-year minimum term GRAT provisions. Interestingly, the GRAT provision is the primary revenue offset in this bill, and the anticipated 10-year revenue increased from $4.45 billion in the March bill to $5.3 billion in the June bill. (How can anyone really estimate this at all?) The bill was subsequently combined into H.R. 5297, the "Small Business Lending Fund Act of 2010." A cloture vote passed the Senate on June 29, 2010, cutting off filibuster possibilities. Various Senate versions have appeared, including a substitute amendment submitted by Senators Baucus (Chair of the Senate Finance Committee) and Landrieu (Chair of the Small Business and Entrepreneurship Committee), which includes a revenue raiser by allowing Roth rollovers from §457 plans (for government and tax-exempt organizations) but does NOT contain the 10-year minimum GRAT provision.

The GRAT legislative proposal has appeared (as of the time of printing of this outline) in 6 different bills:

- H.R. 4849, "Small Business and Infrastructure Jobs Tax Act of 2010," passed House 3/24/2010;
- H.R. 5297, "Small Business Jobs Relief Act of 2010," passed House 6/15/2010 (but not included in the Senate counterpart to this House bill);
- H.R. 4899, "Supplemental Appropriations Act of 2010," passed House 7/1/2010;
- S.B. 3533, "Responsible Estate Tax Act of 2010," introduced in Senate 6/24/2010;
- S.B. 3548, "Extend COBRA Premium Assistance Program Act of 2010," introduced in Senate 6/29/2010; and
- H.R. 5764, "Responsible Estate Tax Act," (very similar to S.B. 3533) introduced in House 7/15/2010.

Based on my conversation with the Senate Finance Committee staffer (see Part One, Section III of this outline) we would expect that the Senate version of the Small Business Jobs bill will probably not include the GRAT provision. There is a strong preference for retaining estate tax revenue raising proposals to be included as revenue offsets in future estate tax legislation. If the Senate and House versions of any legislation differ by the GRAT provision (or other provisions), differences will then be negotiated at the Conference Committee.

The 10-year minimum GRAT term proposal has not met significant criticism and likely will appear in future estate tax legislation as a revenue offset item.

VI. PROPOSAL FOR TWO-GENERATION LIMIT ON GST EXEMPTION.

Four highly respected academics and attorneys have recently sent letters to the Treasury Department urging a proposal to limit the GST exemption to trusts for two generations. Letters have been sent by Professors Gregory S. Alexander (Cornell University Law School), John H. Langbein (Yale Law School), and Lawrence W. Waggoner (University of Michigan Law School), and by attorney Raymond H. Young.

Several years ago the Staff of the Joint Committee on Taxation foresaw the tax-revenue leakage and made a similar proposal. Their proposal prohibits allocating GST exemption to a “perpetual dynasty trust,” which would include trusts permitting distributions to beneficiaries in the generations below the transferor's grandchildren’s generation.

The approach proposed by the Staff of the Joint Committee on Taxation might be referred to an “invalidation approach” — invalidating the allocation of any GST exemption to trusts that might last beyond the prescribed term. Another approach, which might be referred to as an “expiration approach,” would merely cause the exemption to expire at the end of the prescribed period. Professor Waggoner’s letter describes the alternatives in urging that these provisions be considered *in the current estate and gift tax legislation discussions*:

> “The 111th Congress now has an opportunity to close the loophole in the GST Exemption. The 2010 tax bill is not yet finalized. Congress should adopt a generation limit that is calibrated to the generations-based policy of the GST Tax. The Staff of the Joint Committee on Taxation wisely proposed a two-generation limit. A trust would not qualify for the exemption if it can continue beyond the death of the youngest beneficiary who is no more than two generations younger than the trust settlor. A softer approach would be to provide that a trust initially qualifies for the exemption but loses its exemption once the youngest beneficiary who is no more than two generations younger than the trust settlor passes away. Either approach would put a halt to the ill-advised perpetual or near-perpetual trust movement and the unwarranted loss of tax revenue that is now occurring.”

PART TWO—TRANSFER PLANNING IN 2010 IN LIGHT OF THE ONE-YEAR “REPEAL” OF THE ESTATE AND GST TAX

I. GENERAL GIFT TAX EFFECTS OF GIFTS IN 2010. Clients who plan to make large gifts anyway should consider doing it early in 2010, when there is a chance that they may pay a 35% gift tax rate rather than the 45% top rate that might be reinstated and the 55% top rate that will apply beginning in 2011.

There is a concern that Congress may retroactively impose a 45% rate after a gift is made. One strategy to reduce the impact of such a change is to make net gifts, so that the additional tax would itself reduce the gift amount. Another approach is to make a gift by formula, limited to amounts for which a 35% gift tax rate is applicable. Another concern is that a client may make a large gift in 2010 and pay gift tax, only to find that the gift tax exemption is increased substantially in 2011 or some future year by unifying the gift and estate exemptions.

The main concern that will arise from the 2010 system is for clients who die in 2010. However there are also concerns about missed opportunities especially if the gap remains for some time and it appears less likely that there will be a retroactive change. This is what concerns Bruce Stone the

most — missing an opportunity that is available during a very limited period of time. It is probably not a liability issue for the attorney, but there is a concern that clients may lose out on the opportunity.

The 35% rate does not create an opportunity to "game the system" when the post-1976 gifts are included in the estate of the decedent as adjusted taxable gifts for purposes of calculating the estate tax. The tentative tax on the taxable estate plus adjusted taxable gifts is calculated at the current rate at the date of death and the tax on the adjusted taxable gifts alone, using the same rate, is subtracted. The effect is just to tax at the highest estate tax bracket, taking into consideration prior gifts. (It is not totally clear what gift exemption will be applied in calculating the amount of the tax on the adjusted taxable gifts, because of the "had never been enacted rule.") A possible estate tax advantage of making gifts with a 35% gift tax rate is that if the client dies within three years of the gift, the actual amount of gift tax paid is grossed up. There is an opportunity to lock in a 35% possible gross up amount if the client dies within three years.

II. EFFECT OF PRIOR GIFTS OVER $500,000 AND EFFECT OF 2010 GIFTS ON GIFTS IN LATER YEARS. While we think of having a gift "exemption" of $1.0 million, we actually have a gift tax credit of an amount that covers $1.0 million of gifts. Having a credit rather than an exemption system has an interesting impact this year when the gift tax rate has lowered to 35%. The unified gift tax credit in 2009 was $345,800. The credit in 2010 is $330,800 (that is the tentative tax on a $1.0 million gift, with the brackets above $500,000 taxed at 35%.) An individual who has made taxable gifts before 2010 of more than $500,000 will not be able to make gifts in 2010 of the difference between $1.0 million and the prior taxable gifts. This is because the prior taxable gifts over $500,000 utilized the gift tax credit at greater than the 35% rate that applies in 2010. For example a donor who has made taxable gifts before 2010 of $961,538.46 will not be able to make additional gifts in 2010 without paying gift tax.

This same concept works in reverse. A donor who has made no taxable gifts in prior years and makes a $1.0 million gift in 2010 can make about $36,000 of additional gifts after 2010 that will be sheltered by the gift tax credit (assuming the maximum rate returns to 45%).

III. INTER VIVOS QTIP TRUSTS. Using an inter vivos QTIP trust may allow a person to make a transfer and postpone the time of deciding whether to treat the transfer as a completed gift (for example, to take advantage of the 35% gift tax rate if the gift tax rate is not increased retroacti vely, especially if the assets appreciate substantially in value after the time of the transfer). While this planning strategy is not new, it takes on new importance in light of the favorable low 35% gift tax rate, which translates to 25.9% tax inclusive equivalent rate, and the possibility of retroactive legislation taking away the benefit of that low rate. The decision of whether to make the gift tax QTIP election can be delayed until October 15, 2011 (assuming the income and gift tax returns are extended to October 15). Alternatively, the spouse could disclaim within the first nine months if the parties decided that paying gift tax on the transfer would be desirable.

IV. DISCLAIMERS. Disclaimers may also afford a way to hedge against a retroactive rate change. A disclaimer of an outright gift generally reverts to the donor, but there is the question of how to make delivery of an outright gift without constituting acceptance that would bar a disclaimer. A way to make a completed gift but avoid the acceptance issue is to make the gift to a trust. There could be a delivery to the trust, but provide in the trust agreement that if the beneficiary renounces his interest in the trust, the property would pass back to the donor. Make sure that no distributions were made out of the trust before the end of the nine-month disclaimer period. Also, the trust should authorize the trustee to disclaim and provide that the trustee has no liability if it disclaims.

V. RESCISSION. Neal v. United States, 187 F.3d 626 (3rd Cir. 1999) addressed the tax effect of a rescission allowed under Pennsylvania law in the case of a unilateral mistake where there was no consideration. The issue is whether there was a unilateral mistake if the law subsequently was changed retroactively. The case involved old section 2036(c), and the donor kept a retained power to comply with a Notice about the old section 2036(c). The section was later repealed retroactively. The taxpayer had the local probate court approve a rescission of the retained power based on unilateral mistake. The IRS challenged that the rescission was not binding for tax purposes and lost. The case said further that an actual rescission was not even needed, because the gift was not complete because it could have been rescinded under Pennsylvania law. See also Berger v. United States, 487 F. Supp 49 (Pa. 1980) (rescinded gift not taxed); cf. Rev. Rul. 80-58, 1980-1 C.B. 181; Ltr. Ruls. 200613027, 200701019, 200911004 (income rulings relying on rescissions to undo transactions).

Another recent rescission case involves an invalid disclaimer rather than a retroactive law change. Breakiron v. Guidonis, ___ F. Supp. __, 2010 WL 3191794 (D. Mass. August 10, 2010). That case involved QPRTs that terminated in 2005, and a remainder beneficiary wished to disclaim his interest when the QPRT terminated so that his sister, the other remainder beneficiary, would receive the trust assets. His lawyer advised him, *incorrectly*, that the disclaimer would be valid as long as it was made within 9 months of when the QPRT terminated. The beneficiary acted on that advice and disclaimed his interest so that the $2.3 million residence passed to his sister and it was retitled in her name. The IRS said that the disclaimer was invalid and assessed gift taxes. Howard Zaritsky (an attorney and prolific author in Rapidan, Virginia) summarizes the court's reasoning in invalidating the disclaimer, for both state and federal tax law purposes:

> "The U.S. District Court for Massachusetts (Judge Zobel) held that the disclaimers were made in error and were, therefore, ineffective for both state law purposes and federal tax purposes, and that no taxable gift occurred. The court noted that Massachusetts law permitted the retroactive reformation of a written instrument, including a disclaimer, to correct an error that caused the instrument not to reflect the intent of the parties. Simches v. Simches, 423 Mass. 683, 687-688 (1996); Kaufman v. Richard, 442 Mass. 1010, 1011 (2004) (reforming disclaimer where intent of disclaimant was to minimize tax consequences for disclaimant's children). The court found there to be ample evidence that the taxpayer intended to do a disclaimer only if it did not result in a taxable gift, and that, therefore, the disclaimer should be deemed revocable until such time as it was reformed or rescinded. The court also noted that there was a split among the courts regarding the tax effects of such a rescission or reformation. One line of cases holds that state law reformation of the original transfer does not change the tax result of the initial transfer, because the IRS is not a party to the reformation and the parties to it have no interest in preserving the disadvantageous federal tax treatment. Van Den Wymelenberg v. United States, 397 F.2d 443, 445 (7th Cir. 1968); M.T. Straight's Trust v. Comm'r, 245 F.2d 327, 329 (8th Cir. 1957); Emerson Institute v. United States, 356 F.2d 824, 826 (D.C. Cir. 1966); American Nurseryman Publishing Co. v. Comm'r, 75 T.C. 271 (1980). Another line of cases holds that where a state court permits reformation on account of mistake, the original transaction was revocable until the order reforming it, and thus was not complete for tax purposes. Dodge v. United States, 413 F.2d 1239, 1243 (5th Cir. 1969); Berger v. United States, 487 F. Supp. 49, 52 (W.D. Pa. 1980); Touche v. Comm'r, 58 T.C. 565, 569 (1972); Bergeron v. Comm'r, T.C. Memo 1986-587; Holland v. Comm'r, T.C. Memo 1997-302. In this case, the court noted, the reformation is being ordered by a federal court in a case in which the IRS is a party, and so under either line of cases, it should be given retroactive effect.
>
> Note. Massachusetts has a history of being one of the most permissive states for retroactive trust reformation, but the key element in this case was probably the fact that the suit was brought in Federal court and the IRS was named a party to the litigation."

Howard concludes: "Mulligans in tax law are few and far between, and this case should get put in a special file marked 'EMERGENCY' for future use."

VI. DEFINED VALUE CLAUSE. Using a defined value clause has the effect of adjusting values based on retroactive law changes (for example that might disallow valuation discounts.)

VII. CONTINGENT GIFTS. Consider making gifts contingent on the fact that laws that now apply a certain maximum rate or that allow discounts remain effective as of the date of the gift. That does not make the gift incomplete because the condition is outside the control of the donor. However, if the law does change, the gift would be reversed.

VIII. GST PLANNING CONSIDERATIONS.

A. Uncertainty. There is a great deal of uncertainty regarding various GST issues. Some of the uncertainty revolves around possible Congressional action including (1) no action in 2010, (2) retroactive reenactment, or (3) prospective legislation. How the "had never been enacted" sunset rule will be applied is very uncertain. Even if we knew how it would be applied, there is the uncertainty of whether there will be legislation changing the sunset rule. There is the danger that Congress does something to change the sunset rule but does not directly address many of the peripheral impacts such as the various GST issues.

B. Direct Skip Gifts. Direct skip gifts in 2010 will be subject to the gift, but will not be subject to the GST tax (unless, of course, the tax is imposed retroactively). Direct skip gifts generally should be made outright to grandchildren (or other skip persons). If gifts are made in trust, distributions

from the trust in later years may be taxable distributions or taxable terminations subject to the GST tax. The "move-down" rule in §2653(a) ordinarily prevents that from happening, but that section is in Chapter 13 and Chapter 13 does not apply to GST transfers (including direct skips) in 2010. However, in 2011, the "had never been enacted" rule may mean that §2664 is ignored so Chapter 13 did apply to the direct skip in 2010, not to cause the imposition of a GST tax in 2010, but for all other purposes. Carol Harrington likes that answer and thinks it is correct because it is bad policy to punish transfers to a trust so harshly as compared to an outright transfer to a grandchild. Not only would the taxable distributions be subject to tax, they would be taxed more harshly. The GST tax on a taxable distribution is "tax inclusive" (the rate is applied to the total amount transferred, including the GST tax itself) while the tax paid under direct skip is tax exclusive (the rate is applied to the amount actually received by the grandchild). It would make no sense for the move down rule not to apply.

The same issue applies for annual exclusion gifts to a single beneficiary-vested trust. The zero inclusion rule under §2642(c) arguably would not apply for direct skip transfers in 2010. However, it may be deemed to have applied under the "had never been enacted rule" after 2010, for the same reasons discussed above. Carol does not think the IRS would want to go after these types of transfers and treat them more harshly than if a GST tax applied.

Transfers to custodianships are subject to the same issues because the regulations treat custodianships as trust equivalents.

Are gifts to 529 Plans for grandchildren subject to these same concerns? There is no clear answer. Transfers to 529 Plans are treated as present interest gifts that qualify for the annual exclusion, but it is not clear whether they are treated as outright gifts or as gifts in trust. The proposed regulations (now about 12 years old) have some indications that the IRS viewed transfers to 529 accounts as transfers to a trust that qualify for the annual exclusion.

An alternative is to make gifts of LLC or FLP interests directly to the grandchildren, and the LLC/FLPs would provide management and restrictions on the ability of the grandchild to squander the gift.)

However, panelists said that as a practical matter, annual exclusion gifts will still be made to custodianships and to some "annual exclusion vested GST exempt" trusts. We hope that §901(b) will operate to treat the trust as having a zero inclusion ratio after this year. (The argument is that if the 2001 Tax Act "had never been enacted," §2664 would not apply in 2010 to provide that Chapter 13 does not apply to GSTs.) It is better for a client to run that risk than to lose the ability to make annual exclusion gifts to the grandchild.

For large direct skip gifts, though, avoid gifts to trusts or custodianships. In golf terms, "if you're going to lay up, lay-up," meaning to be sure that you are successful in the conservative approach. If the client is going to make **large gifts** to avoid GST tax in this gap period, use an LLC for management capability. But for annual exclusion gifts, it does not make sense to set up an LLC for the smaller gifts.

Howard Zaritsky, who quips that he is "renowned for his tact with clients," gives this recommendation for advising a client who wants to use a trust for a gift to a grandchild this year:

> *"I would write the plainest, simplest, most understandable letter I could saying that the current law is unclear and no one knows whether the later distributions will be taxable, whether your client will be able to make a late allocation of GST exemption to the transfer, and whether there might be other adverse tax consequences not yet foreseen regarding the sunset provisions of the EGTRRA. I would stress that the better approach is to use an FLP, though there may be issues relating to whether a minor grandchild can receive the interest.*
>
> *Then reaffirm that your recommendation is to wait a while longer to see if the law clears up.*
>
> *Have the client sign a statement saying that he understands these things and **that he is a fool**, but is willing to go ahead anyway."* (emphasis added)

Another strategy is to makes large transfers to a "HEET" trust that includes non-skip beneficiaries. Because there are non-skip persons in the trust, there will not be GST issues even if there is retroactive legislation.

Some attorneys are using a formula approach for these types of transfers. The transfer is made to a trust, but the assignment provides that the transfer will be outright if putting the asset in trust will cause distributions in 2011 or later to be subject to GST tax.

In 2011, under the sunset rule, perhaps the automatic allocation rule under pre-2001 law would apply to direct skip gifts made in 2010, even though the transfers are not subject to the GST tax. To provide certainty that does not happen, a Form 709 could be filed for 2010 electing out of automatic allocation. However, if the gift asset will remain in trust, the donor may want automatic allocation to apply.

C. Gifts to Long Term Trusts. A downside to making gifts to long-term trusts this year is that there is no GST exemption available in 2010. (The GST exemption is equal to the estate tax applicable credit amount and in § 2010(c), the table for the applicable credit amount ends with 2009; there is nothing listed for 2010 or beyond.) In 2011, depending on how the "had never been enacted" rule is applied, there may be a GST exemption equal to $1.0 million, indexed for inflation since 1997. That amount in 2010 is $1.34 million (although the GST exemption amount in 2010 is zero). Therefore, there would likely be at least $1.34 million of GST exemption in 2011 to allocate on late returns. (It is not clear whether the exemption could be filed on a timely return in 2011 for a 2010 transfer.) If the trust is a skip person trust (only for second generation or more remote beneficiaries), the automatic allocation rule that applied for direct skips before the 2001 Act may apply to cause automatic allocation to have occurred in 2010.

The inclusion ratio must be recomputed for gifts to trusts in 2010 when there is no GST exemption to allocate to the gift. Chapter 13 continues to apply generally, it just does not apply to GST transfers. A gift to a trust is not a GST transfer. However, GST exemption could be allocated in 2011 (as discussed above).

D. Additional Premium Payments to ILITs. The concern is that no GST exemption allocation can be made in 2010. If the plan is to make late allocations, that should not be a problem. (Observe that no late allocations can be made in 2010 for transfers to ILITs in prior years.)

If the client has used less than $1,340,000 of GST exemption previously, and it is a GST trust, the "as if had never been enacted rule" may allow allocation of GST exemption up to that amount (or whatever the indexed GST exemption amount is for 2011). The safest approach is not to waste the ability to use annual exclusion amounts, but to make the gifts in a way so that when the uncertainty over, the gifts can be added to the insurance trout. Step 1. Create a new ILIT, the beneficiary of which is the old ILIT. Step 2. To pay the premiums, client lends money to the original ILIT trust to make the payments. Step 3. Once the legislative uncertainty is over, if there is available GST exemption, the trustee of the new trust can contribute the assets to old trust, and it can then repay the debt.

If loans are made to the trust in 2010 so that the trust can pay premium payments, be aware that split dollar principles may apply if the loan is to be repaid from the policy (or there is a presumption to that effect). In that case, be aware that (1) payment ordering rules apply so that loans must be repaid in the order in which the loans were made, and (2) if the loan is nonrecourse, a statement must be filed with the income tax returns of the lender and borrower, signed by both parties, representing that a reasonable person would expect that all payments under the loan will be made, and if that is not done, the complicated "contingent obligation" rules of §7872 would apply. Reg. §1.7872-15(d).

E. Planning Opportunities for Existing Non-Exempt Trusts. No GST tax will be imposed on taxable distributions or taxable terminations from non-exempt trusts in 2010. However, making transfers or terminations of these trusts in 2010 could accelerate payment of the GST tax if the GST tax system is imposed retroactively, so this strategy might be appropriate only for non-exempt trusts that will likely terminate in the next several years in any event. Many planners are waiting to see what happens in Congress with legislative discussions, and whether a decision to have a retroactive reenactment of the GST appears to be emerging. (A possible concern with that approach is the risk that legislation may be introduced reinstating the GST tax in 2010 with an effective date of the date of introduction of the bill or the date that it is passed by a legislative Committee. There has been no discussion of such an effective date and that risk would appear to be small.)

F. Formula Clause. Formula clauses may be used to make the transfers described above only to the extent they do not generate a GST tax, taking into consideration any retroactive legislation.

For example, the assignment might transfer the maximum amount possible, perhaps up to cap, as long as it will not be subject to GST tax. (Theoretically, it is possible that such an assignment does not result in zero distribution to the trust if the GST tax is retroactively reenacted, but is a conditional transfer based on the odds of a retroactive reenactment.)

Various commentators have said that such clauses should not be subject to a public policy attack under Procter because they are based on Congressional action, not IRS action and are not designed to discourage IRS audits.

The argument is that the clause is not merely intended to reduce the IRS's incentive to audit returns. "[I]n the circumstance where formulas are necessitated by the uncertain state of the tax law, the use of a formula would not appear to constitute 'trifling with the judicial process' as proscribed by *Procter."* See Blattmachr, Gans, Zaritsky & Zeydel, The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010, 112 J. TAX'N (February 2010).

Another approach is to use a "formula allocation" type of transfer, similar to the defined value clause addressed in Petter v. Comm'r, T.C. Memo 2009-280 (2009). As an example, a distribution from a non-GST exempt trust might be allocated to a grandchild to the extent that the distribution would not be subject to any GST tax, but would be allocated to another person (for example, a child or a trust having a child has a potential beneficiary) if any GST tax liability would otherwise be incurred. By its nature, such a clause would take into account any retroactive legislation (even if it did not specifically reference retroactive legislation.) Another example use of such a clause would be for an individual who wants to make a large gift to grandchildren, but wants to hedge against the possibility of retroactive legislation that would subject the transfer to the GST tax. See Hatcher & Koren, Formula Clauses: Hedging Value and Legislative Risks, TAX NOTES (March 15, 2010). Their thesis is that such a formula allocation clause provides the strongest argument against a Procter argument, which the Petter case summarized as a clause that results in the transferor receiving some property back.

G. Formula Disclaimers. Disclaimers by "child-level" beneficiaries to more remote generations may also be considered by testamentary transfers to child-level beneficiaries. A concern is the possibility of retroactive reinstatement of the applicability of the GST tax to GST transfers in 2010. A formula disclaimer may be possible to address that concern. Consider the following possible disclaimer clause:

> "NOW, THEREFORE, the Disclaimant, by execution of this instrument, does hereby irrevocably and unqualifiedly renounce, disclaim, and refuse to accept any and all of the rights, title, and interest which the Disclaimant would otherwise have in and to the GST-Exempt Fractional Share (as defined hereinbelow) of the Residuary Gift by reason of the Decedent's death. For all purposes of this Disclaimer, the "GST-Exempt Fractional Share" shall be defined as follows:
>
> > That certain fractional share derived by multiplying the Residuary Gift by a fraction,
> >
> > the numerator of which is the largest pecuniary amount of the Residuary Gift, if any, which may be distributed to or for the benefit of a grandchild of the Decedent without incurring federal generation-skipping transfer tax (now or in the future), whether by reason of the repeal of Chapter 13 of the Code for decedents dying after December 31, 2009 (and without retroactive reinstatement to decedents dying on [DATE OF DEATH]), by reason of the allocation of the Decedent's generation-skipping transfer tax exemption to a portion or all of the Residuary Gift, or otherwise,
> >
> > and the denominator of which is the value of the Residuary Gift, as finally determined for federal estate tax purposes."

Zeydel, Davis, Fisher & Harrison, Practicing in Interesting Times: Administering Estates in 2010 and the Increasing Importance of Formula Clauses, ACTEC Summer Meeting Seminar at 17-18 of 95 (June 19, 2010).

The disclaimer regulations allow formula disclaimers and an example in the regulations recognizes a formula disclaimer to the surviving spouse of "the smallest amount which will allow A's estate to pass free of Federal estate tax." Treas. Reg. §25.2518-3(d) Ex. (20).

PART THREE—SPECIAL PLANNING CONSIDERATIONS FOR GRATS, INSTALLMENT SALES TO GRANTOR TRUSTS, AND FINANCED NET GIFTS

I. OVERVIEW OF TRANSFER PLANNING STRATEGIES.

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

1. Annual Exclusion and Medical/Tuition Exclusion Gifts. The first level of gifting is to make gifts within the $13,000 annual exclusion amount. I.R.C. § 2503(b)(1). Furthermore, clients may make gifts for medical expenses or tuition expenses directly to the medical care or education provider, without gift or GST tax consequences. I.R.C. § 2503(e). Annual exclusion gifts are the first level of gifting strategy because if gifts are not made in a particular calendar year to fully utilize the annual exclusion for that year, it is lost forever.

2. Applicable Exclusion Amount Gifts. Gifts in excess of the annual exclusion amounts or medical/tuition exclusion for any particular year first "use up" part of the donor's lifetime "applicable exclusion amount". Beginning in 2002, the applicable exclusion amount for gift tax purposes is $1 million. This amount is fixed for gift tax purposes, and does not increase as the estate tax applicable exclusion amount increases to $3.5 million by 2009. Aggregate lifetime gifts up to the "gift exemption amount" can be made without generating current federal gift tax.

3. Excess Gifts. Gifts in a year that are not covered by annual exclusions and that exceed the aggregate lifetime gift exemption amount will be subject to current federal gift taxes, beginning at a 41% rate. Even though such excess gifts are subject to the payment of a current gift tax, the overall taxes may be significantly reduced by making transfers subject to the gift tax than by retaining the assets and having them subject to the estate tax. The estate tax is calculated based on the entire estate, including the amount paid as estate taxes, whereas the gift tax rate is applied only to the assets actually passing to donees. In order to get this benefit, the donor must live at least three years after making the gift; otherwise the gift tax is brought back into the estate. I.R.C. § 2035(b). However, in light of the specter of possible estate tax repeal, most clients want to avoid paying current gift taxes.

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

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

II. SPECIAL PLANNING CONSIDERATIONS FOR GRATS.

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

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

1. The term of the retained annuity is increased,

2. The annuity amount is increased, or
3. The § 7520 rate decreases.

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

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

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

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

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

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

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

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

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

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

1. Historical Difficulty of Zeroing Out the GRAT Under "Example 5 Approach". There had previously been uncertainty regarding the manner in which the transferor's retained annuity interest should be valued. Example 5 in the Regulations took the position that if remaining annuity payments following the transferor's death during the trust term terminate or are to be paid to the transferor's estate, the retained interest must be valued as the value of the right to receive the stated annuity amount for the trust term or until the transferor's prior death. Treas. Reg. § 25.2702-3(e) Ex. 5. Depending on the age of the transferor, this could be a substantial decrease in the value of the retained interest.

2. Walton—Rejection of Example 5 By Tax Court, and By IRS. In a unanimous decision, the Tax Court rejected Example 5 as being an unreasonable and invalid interpretation of and an invalid extension of § 2702. Walton v. Commissioner, 115 T.C. 589 (2000). In that case, Audrey Walton transferred about $100 million worth of Wal-Mart stock to each of two GRATs for her two daughters. The GRATs provided for two years of retained annuity payments. If the grantor did not survive to receive all of the annuity payments, the remaining annuity amounts were to be paid to her estate. Upon completion of the two-year term, the remaining assets, if any, were to be distributed to the respective daughter for whom the GRAT was created. The taxpayer filed a gift tax return reporting the gift at zero value. [On brief, the taxpayer conceded that the gift to each GRAT should be valued at $6,195.10.] The IRS took the position that the amount of the gift to each of the GRATs was over $3.8 million. The reason for the disparity is the IRS's application of Example 5, valuing the retained annuity as the value of the annuity for the shorter of 2 years or the period ending upon the taxpayer's death.

   After considering the legislative history and purpose of § 2702, the Tax Court rejected the IRS's position and held that Example 5 was an unreasonable interpretation and invalid extension of § 2702.

   The IRS did not appeal the Walton case, and has now issued regulations that change the result in Example 5 and make clear that annuity payments to the grantor's estate can offset the gift tax value of the transfer. Treas. Reg. §§ 25.2702-2(a)(5), 25.2702-3(e) Ex. 5.

   To clearly satisfy the Walton case, if the grantor dies before the end of the GRAT term, any remaining annuity payments should be made to the grantor's estate as they come due. The remainder interest in the GRAT should not also pass to the estate, or else the IRS might take the position that the grantor has retained a "reversionary interest," and the regulations indicate that reversionary interests are valued at zero.

   Careful planning is required to navigate the requirements of the Walton case and to qualify the GRAT assets for the marital deduction if the grantor dies before the end of the GRAT term. For an excellent discussion of the issues, see Lee & Silvian, "The Walton GRAT and Marital Deduction Planning," 79 Taxes 35, 38-41 (July 2001). If the grantor should die before the end of the GRAT term, the IRS's position is that most or all of the GRAT assets will be included in the grantor's estate. See Part Three, Section II.B.1 of this outline. The GRAT is typically structured to provide that the GRAT assets will pass in a manner that will qualify for the marital deduction if a married grantor dies before the end of the GRAT term. For example, the GRAT could provide that remaining annuity payments be paid to the grantor's estate and that the trust remainder interest (after paying the annuity payments) would be paid to a QTIP trust created in the GRAT instrument or in another trust agreement. The grantor's

will would bequeath the right to the annuity payments to the QTIP trust, which could provide that an amount equal to the greater of the trust income or any annual annuity payments would be distributed annually to the surviving spouse. For a further discussion of marital deduction planning issues, see Part Three, Section II.F.3 of this outline.

3. Planning Issues For Married Grantors. It is important to qualify for the marital deduction in case the grantor dies before the end of the GRAT term.

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

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

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

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

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

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

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

H GRAT Inter Vivos Bypass Trust Continuing for Spouse. A client may wish to create a "bypass trust" for the benefit of his or her spouse during lifetime rather than waiting to create a standard bypass trust by will. This would have the advantage of removing future appreciation from the date of the creation of the trust from the transferor's estate. This technique can be used in conjunction with a GRAT, because there is no limitation on the spouse being a beneficiary after the initial retained term interest. Various cases have held that a transfer of a residence to a spouse is not treated as a transfer subject to § 2036(a)(1) even though the transferor-spouse may expect to continue living with the spouse (and, therefore, live in the transferred residence).

E.g., Estate of Gutchess v. Commissioner, 46 T.C. 554 (1966), acq. 1967-2 C.B. 1; Rev. Rul. 70-155, 1970-1 C.B. 189. Using a "floating spouse" concept might be desirable, by defining "spouse" to be the grantor's current spouse at the relevant time.

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

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

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

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

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

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

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

to appreciate to many times their original value before § 2036 would result in less than all of the trust assets being includible in the estate if the donor dies before the end of the GRAT term.

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

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

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

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

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

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

K. Front-End Loaded GRAT. There is no clear authority for using a one-year GRAT. See I.R.C. § 2702(b)(1) (referring to qualified annuity interests as amounts payable not less often than annually; the underlined terms suggest a possible minimum term of two years). See also Walton v. Commissioner, 115 T.C. 589 (2000), acq. Notice 2003-72, 2003-2 C.B. 964 (approving 2-year GRAT); Kerr v. Commissioner, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002) (IRS did not contest validity of 367-day GRAT). A multi-year GRAT may achieve much the same effect as a one-year GRAT if the agreement calls for a substantial payment at the end of year one, and a payment equal to 0.01% of the initial contribution in later years. If the grantor were to die after year one, it appears that the amount to be included in the grantor's estate may be the amount that would be required to produce the annuity of 0.01%—which would be a very small amount. While Treasury Regulation § 25.2702-3(e) Ex. 3 clearly allows the amount of the GRAT payment to decrease without limit, no rulings have addressed extreme front-loaded GRATs. Some planners have structured these transactions to have about 90% of the initial value distributed after the first year, leaving a significant payment the second year, in case the IRS were to argue that a de minimis payment in year two is essentially the same as a one-year GRAT.

L. Use Revised Spendthrift Clause. In a totally separate and independent transaction from the creation of the GRAT (to avoid step transaction arguments), the owner of the remainder interest of the GRAT may desire to transfer the remainder interest to his or her descendants (or a long-term trust for their benefit) at a time when the remainder interest has a relatively low value. Doing

so may be prohibited if the GRAT contains a typical spendthrift clause. If a limited form of a spendthrift clause is desired, consider requiring the written consent of "independent trustees" to any anticipation, alienation, or other assignment of a beneficiary's interest in the trust. Alternatively, consider specifying that no beneficiary can assign or anticipate his or her interest except a voluntary transfer to one of more of the Grantor's descendants (other than to the beneficiary himself or herself). However, observe that § 502(a) of the Uniform Trust Code, adopted in August 2000, provides that "a spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest."

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

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

1. Particular Advantage. A particular advantage of funding a GRAT or GRUT with S corporation stock is that the grantor will be taxable on a pro rata share of all income of the S corporation, thus reducing, to some extent, the amount brought back into the grantor's estate by the annuity or unitrust payments. In addition, as with a partnership, cash can be distributed from the S corporation to its shareholders (including the GRAT) without dividend treatment.

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

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

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

N. Effect of Insider Trading Restrictions. Section 16(b) of the Securities Exchange Act of 1934 permits recovery to a corporation of insider trading profits made within a 6-month period. Under the § 16(b) "short-swing profits" rule, profits must be disgorged if any sales and purchases occur within six months of each other. A contribution to a GRAT is arguably a "sale," and a distribution of insider stock in satisfaction of the annuity payment is arguably a "purchase" by the grantor. If a corporate insider funds a GRAT with the corporation's stock, will the return of some of the stock to the grantor (in satisfaction of an annuity payment) trigger a 6-month insider trading test period? A 1997 SEC No-Action Letter held that the creation of a GRAT and subsequent return of stock to the grantor in satisfaction of annuity payments will "effect only a change in the form of beneficial

ownership without changing a person's pecuniary interest in the subject equity securities." Accordingly, such a transaction would be ignored for § 16(b) purposes under that No-Action Letter. Peter J. Kight, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,403 (October 16, 1997). However, cases (discussed below) have held that the substitution of insider stock and an unauthorized transfer from a GRAT of insider stock for the benefit of insiders constituted purchases for purposes of § 16(b).

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

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

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

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

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

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

In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. (Situation 3) The Ruling provides that the IRS will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before October 4, 2004. Some planners suggest

allowing a third person to authorize the trustee to reimburse or to allow an independent trustee to reimburse the grantor for payment of income taxes attributable to the trust. Other planners suggest drafting the reimbursement clause to provide that the discretionary reimbursement power does not exist to the extent that it exposes the trust assets to claims of the grantor's creditors.

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

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

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

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

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

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

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

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

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

S. Identify Remainder Beneficiaries in a Separate Trust Instrument. Do not put the trust for remaindermen in the same GRAT document. If there is not a separate current trust, there is no ability for the grantor to engage in transactions with the remainder beneficiary. Name a separate trust funded with $10 as the remainder beneficiary. Make sure it is a grantor trust to avoid income taxes on future transactions with the grantor. For example, the grantor may consider purchasing the remainder interest if the grantor becomes seriously ill before the end of the GRAT term. If the grantor dies during the term of the GRAT, all assets in the GRAT will be included in the estate. But if the grantor purchases the remainder interest, the amount the grantor paid for the remainder interest to the remainder beneficiary trust is excluded from the grantor's estate. [One attorney reported doing this in a transaction where the grantor of the GRAT was about to die and the grantor purchased the remainder interest from the grantor trust that owned the remainder interest. That sale was audited. In that case, there were different trustees of the grantor trust remainder owner and the GRAT itself (to help show no merger). The attorney even had the grantor trusts file a Form 1041 when initially created, reporting them as grantor trusts. The grantor borrowed money from a bank to pay for the remainder interest. The IRS agent didn't like it, but it passed the audit.]

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

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

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

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

U. Revocable GRAT. Mil Hatcher and Ed Manigault have suggested making a GRAT revocable until all funds have been retitled in the name of the GRAT. At that time the grantor would release the revocation right. That would avoid a possible argument by the IRS that additional contributions are being made to the trust (which is prohibited) if all assets are not funded into the GRAT on the date that it is signed. Manigault & Hatcher, "Revocable GRATs," 145 Trusts &

Estates 30 (Nov. 2006). Observe that this might create an unintended gift if the annuity amounts are based on the AFR when the trust agreement is signed and if the AFR changes before the time the funding is completed and the revocation right is released. Under the approach, the annuity payments would be due on the anniversary of the release of the revocation right.

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

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

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

III. SUMMARY OF GIFT, ESTATE, AND GST TAX TREATMENT OF GRATS.

A. Gift Tax.

1. No Annual Exclusion. The gift of a remainder interest is a future interest and will not qualify for the gift tax annual exclusion. Treas. Reg. § 25.2503-3(a).

2. Gift Valuation of GRAT.The grantor's retained annuity or unitrust interest will generally be treated as a qualified interest that can be given value for purposes of determining the value of the gift of the remainder interest. The interest will be valued under the appropriate treasury actuarial tables, depending upon the term of the retained interest. No value can be assigned to any reversionary interest retained by the grantor of a GRAT.

   An annuity that is paid to the grantor or grantor's estate if the grantor dies during the term is valued as an annuity for the full term under Walton and Treas. Reg. §§ 25.2702-2(a)(5), 25.2702-3(e) Ex. 5. See Part Three, Section II.F.2 of this outline. Therefore, the annuity payments can be structured to "zero out" the GRAT so that the present value of the annuity payments equals the value contributed to the GRAT, and so that no gift results from the creation of the GRAT.

B. Estate Tax.

1. Grantor Dies During Term of Trust. Regulation § 20.2036-1(c)(2) adopts the position that the amount of a GRAT includible in the estate under § 2036 (if the grantor dies during the GRAT term) is the portion of the trust that would be required to produce income equal to the annual annuity (the regulation says "yield the annual annuity payment"), based on the § 7520 factor at the applicable valuation date for the decedent's estate. The regulation describes an example of a GRAT that has an annuity of $12,000 per year paid monthly, with a § 7520 rate of 6% at the grantor's death. If the decedent dies during the GRAT term, the amount included is "the amount of corpus necessary to yield the annual annuity payment . . . ." The formula is: "annual annuity (adjusted for monthly payments) / section 7520 interest rate." In this example, the Table K adjustment factor for monthly payments is 1.0272, and the amount includible is ($12,000 x 1.0272) / .06 = $205,440. Treas. Reg. § 20.2036-1(c)(2)(iii) Ex. 2. The regulation is effective for decedents dying on or after July 14, 2008. [The regulation also gives up on the IRS's argument that § 2039 would always cause inclusion of the GRAT assets, see paragraph B.1.c below.] The regulation reserves a section to address graduated annuity payments following further consideration. Treas. Reg. § 20.2036-1(c)(2)(ii). Proposed Reg. § 20.2036-1 addresses estate inclusion if the grantor dies during the term of the trust

and if the annuity amount will increase in years after the date of death. The general approach is, first, to include the amount that would be required to yield the annuity amount for the year of death based on the § 7520 factor, and then to add additional amounts that would be required to yield the *increase* in the annuity amounts in future years (for every subsequent year that there would be an increase), but to discount such additional amounts from the date of the future payment of the increased annuity to the date of death. See Prop. Treas. Reg. § 20.2036-1(c)(2)(ii), 2009-20 I.R.B. 1017.

2. Grantor Survives to End of Trust Term. If the grantor survives the end of the trust term, when the remaining trust assets pass to a designated beneficiary, none of trust assets will be included in the grantor's estate for estate tax purposes at his or her subsequent death. The grantor will not have to survive for an additional three years after the termination of the trust and § 2035 will not apply if the trust merely terminates pursuant to its terms. However, if the grantor serves as trustee, and if the grantor has the power as trustee to vote the stock of a "controlled corporation" for purposes of § 2036(b), the stock will be included in the decedent's estate unless the right to vote the stock was relinquished at least three years prior to the decedent's death.

C. Generation Skipping Transfer Tax.

1. GST Exemption Allocation.GST exemption cannot be allocated until the end of the "estate tax inclusion period." Treasury Regulation § 26.2632-1(c)(3)(ii) implies that exemption cannot be allocated to a trust as long as any part of the trust is included in the grantor's gross estate. The amount of GST exemption that will be needed with respect to a GRAT is uncertain at the time the GRAT is created, because the amount includible in the estate of the transferor may be unknown until the earlier of the end of the term or the transferor's death.

2. Taxable Termination Rather Than Direct Skip.If the remainder interest passes to second generation or more remote beneficiaries, the transfer at the end of the trust term will be a taxable termination rather than a direct skip. I.R.C. § 2612. This adversely affects qualification for the predeceased child exception, and causes the GST tax to be imposed at a higher effective rate.

IV. INSTALLMENT SALE TO GRANTOR TRUST.

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

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

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

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

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

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

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

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

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

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

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

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

and the safer alternative if that is not done is to have the guarantee be made by a beneficiary rather than a third party.

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

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

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

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

2. Step 2: Sale for Installment Note; Appropriate Interest Rate. The individual will sell property to the grantor trust in return for an installment note for the full value of the property (taking into account appropriate valuation discounts). The note is typically secured by the sold asset, but it is a full recourse note. The note is often structured to provide interest only annual payments with a balloon payment at the end of the note term. The interest is typically structured to be equal to the § 7872 rate (which is even lower than the § 7520 rate which is

used for structuring GRATs). Often a 9-year note will be used, in which case the federal mid-term rate would apply. For April 2010 (when the § 7520 rate is 3.2%), the annual short-term (0-3 years) rate is 0.67%, the annual mid-term (over 3, up to 9 years) rate is 2.70%, and the long-term (over 9 years) rate is 4.40%. Typically, the note would permit prepayment of the note at any time without penalty. The note should be shorter than the seller's life expectancy in order to minimize risks that the IRS would attempt to apply § 2036 to the assets transferred in return for the note payments.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

   1. Interest Payments Do Not Create Taxable Income.

      Because the grantor is treated as the owner of the trust, interest payments from the trust to the grantor should also be a non-event for income tax purposes. [On the other hand, if there are sales between spouses, while there is no gain recognition on the sale under § 1041, interest payments would constitute taxable income.]

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

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

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

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

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

Despite arguments from the literal statutory language (the exception in § 678(b) refers to a power over income, but a Crummey withdrawal power is a power over corpus), various rulings have indicated that the grantor trust provisions will "trump" a § 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., Ltr. Ruls. 200011054, 9309023, & 9321050. [See also Ltr. Rul. 9141027, but in that ruling the spouse also had an inter vivos power of appointment of principal.] This issue was raised in a PLR request that was discussed by Jonathan Blattmachr at the 2005 Heckerling Institute and the IRS said (during discussions in 2004) that this issue was "in a state of flux." A recent PLR held that where a Crummey withdrawal power was held by the grantor's spouse, the trust was still a grantor trust as to the grantor "notwithstanding the powers of withdrawal held by Spouse that would otherwise make her an owner under § 678." Ltr. Ruls. 200603040 & 200606006. Jonathan Blattmachr indicates that the IRS has informally confirmed that this issue is no longer "in a state of flux" with the IRS.

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

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

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

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

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

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

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

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

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

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

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

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

See Part Three, Section II.O. of this outline regarding the possibility of having an income tax reimbursement provision for the grantor.

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

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

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

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

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

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

Conversion From Nongrantor to Grantor Trust Status Not a Taxable Event; CCA 200923024. In Chief Counsel Advice 200923024, the Chief Counsel's office addressed what seems to be an abusive transaction. The basic (way oversimplified) facts are that a nongrantor trust sold appreciated property for a private annuity, so that the gain would be recognized ratably over the duration of the annuity. The purchaser sold the asset, recognizing no gain because the

sale proceeds did not exceed its cost basis (i.e., the value of the annuity). [Actually, the purchaser was a partnership with a § 754 election in effect and the partnership sold the assets for a price about equal to its inside basis as a result of the § 754 election.] The nongrantor trust later converted to grantor trust status (by a change in the trustee to someone who was a "related or subordinate person"), with the result that the grantor would not realize gain on any subsequent annuity payments received from his grantor trust. An IRS agent argued that the conversion from nongrantor to grantor trust status was a taxable event, and that the transferee grantor trust would recognize gain. The CCA disagreed. It recognized that the transaction appears to be abusive, and observed that it was not addressing the possible applicability of the step transaction, economic substance or other judicial doctrines. However, it observed that treating the conversion as a taxable transaction would have an impact on non-abusive transactions, noting that nongrantor trusts may be converted to grantor trusts by various ways, including a change of trustees, borrowing of the trust corpus, or payment of the grantor's legal obligation. It noted that Rev. Rul. 85-13, which held that the conversion of a nongrantor trust to a grantor trust (by reason of the trust's purchase of assets from the grantor for a note, which constituted an indirect borrowing by the grantor) did not result in taxable income to the grantor.

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

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

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

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

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

   One commentator has suggested that there is a significant risk of § 2036(a)(1) being argued by the IRS if "the annual trust income does not exceed the accrued annual interest on the

note." U.S. Trust, Practical Drafting 4365-4370, at 4367 (Covey ed. Apr. 1996). Much of the risk of estate inclusion seems tied to the failure to have sufficient "seeding" of equity in the trust prior to the sale.

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

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

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

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

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

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

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

> "The reasoning in *Fidelity-Philadelphia Trust* suggests that the estate tax case is strongest when the following features are carefully observed:
>
> a. The note should be payable from the entire corpus of the trust, not just the sold property, and the entire trust corpus should be at risk.

b. The note yield and payments should not be tied to the performance of the sold asset.

c. The grantor should retain no control over the trust.

d. The grantor should enforce all available rights as a creditor."

Aucutt, "Installment Sales to Grantor Trusts," ALI-ABA Planning Techniques for Large Estates 1539, 1577 (April 2007).

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

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

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

   The IRS maintains that defined value clauses should not be recognized, primarily on public policy grounds because they tend to discourage tax audits. The IRS has lost that argument in two cases. Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009) (formula disclaimer; "excess value" portion passed to a charity and other persons would have a fiduciary duty and incentive to enforce the clause); Petter v. Commissioner, T.C. Memo. 2009-280 (formula gifts and sales' "excess portion" passed to charity). See Part Four, Section II.D-E of this outline.

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

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

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

9. Defined Value Clause.

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

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

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

d. Public Policy Issue. The IRS does not recognize defined value clauses, on public policy grounds but tow court shave now rejected that argument. Defined value clauses (and the Christiansen and Petter cases) are discussed in more detail in Part Four, Section II.D-E of this outline.)

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

11. Underwater Sales.

Alternative approaches include:

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

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

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

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

12. Structure to Give Beneficiary Power of Withdrawal Rather Than Having Stated Termination Date During Grantor's Lifetime. Letter Ruling 200840025 concluded that the power of the nonadverse trustee to make loans to the grantor, with or without security, caused the trust to be a grantor trust under § 675(2) so long as the grantor is alive and the nonadverse trustee has not released the power with respect to a particular trust.

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

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

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

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

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

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

       An obvious advantage of including the spouse as a discretionary beneficiary, the trustee would be able to access the trust for the benefit of the spouse in the unlikely event that the spouse ever needed distributions from the trust. However, the parties should be aware that

including this provision will cause the trust to be a grantor trust as to the income under § 677, including after a divorce.

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

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

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

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

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

The statutory language suggests that grantor trust status depends upon whether a loan is outstanding at the beginning of a taxable year. Under that interpretation, if borrowing occurs during year one, but is repaid before year two, grantor trust status would not exist in either year one or year two. However, the IRS interprets § 675(3) as imposing grantor trust status if

the loan to the grantor has been outstanding any time during the year. Rev. Rul. 86-82, 1986-1 C.B. 253, following Mau v. United States, 355 F. Supp. 909 (D. Hawaii 1973). For example, if a loan is outstanding on 12/31/2007 and repaid on 1/2/2008, the grantor would be treated as owning the trust for all of 2007 and 2008 under Revenue Ruling 86-82. There is the intriguing possibility of just making a loan on December 30 of a year to make the trust a grantor trust for the entire year. That may be used in year-end planning, (but there is the possibility that the IRS might take the position at some point that this is an abusive strategy, despite the outstanding Revenue Ruling and case support.)

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

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

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

(1) Statutory Provision. Section 675 provides that the existence of various administrative powers will cause a trust to be a grantor trust for income tax purposes. Section 675(4) lists several general powers of administration, which if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment. One of those powers, listed in § 675(4)(C), is "a power to reacquire the trust corpus by substituting other property of an equivalent value."

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

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

(4) Trustee or Adverse Party Should Not Hold Power. Because grantor trust status depends upon the power being held in a "non fiduciary" capacity, the power of substitution should

not be held by the trustee. Regulation §1.675-1(b)(4) provides that if a power is exercisable by a person "as trustee," there is a rebuttable presumption that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Similarly, a trustee's approval or consent should not be required (or else the requirement in the initial sentence of § 675(4) will not be satisfied.)

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

(5) Revenue Ruling 2008-22. Revenue Ruling 2008-22, 2008-16 I.R.B. 796, provides very helpful guidance, indicating that a grantor non-fiduciary substitution generally will not trigger estate inclusion under §§ 2036 or 2038. The Ruling cites Jordahl, but says that it did not apply § 2038 because the decedent was bound by fiduciary standards. Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, it says that if the trustee thinks the assets being substituted have a lower value than the assets being reacquired, "the trustee has a fiduciary duty to prevent the exercise of the power." The ruling reasons that (1) the trustee "has a fiduciary obligation to ensure that the assets exchanged are of equivalent value," and (2) the trustee must prevent any shifting of benefits among beneficiaries that might otherwise result from the substitution in view of the trustee's power to reinvest assets and the trustee's duty of impartiality regarding the beneficiaries.

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

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

administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

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

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

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

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

(6) Possible Limitations? There are concerns (and inherent uncertainty) as to whether a nonfiduciary substitution power will be treated as an incident of ownership if held by the insured over a policy on his or her life under § 2042. Similarly, some planners suggest

providing that the power could not be exercised to acquire to any voting stock of a "controlled corporation" for purposes of § 2036(b).

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

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

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

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

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

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

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

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

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

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

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

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

g. Inter Vivos Power of Appointment. Carlyn McCaffrey suggests giving a third party (who is not a trustee and is not a beneficiary) a presently exercisable power of appointment, at least during the grantor's lifetime. The third party must be a nonadverse party (so a beneficiary cannot hold the power). Because the person is not a trustee, the exception in § 674(c) would not apply. [Consider using a related or subordinate party if there is any concern that the power may be deemed to be held in a fiduciary capacity; in that event, § 674(c) still would not apply.] Because there is no standard, the exception in § 674(d) would not apply. The

testamentary power of appointment exception in § 674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in § 674 would apply, so the general rule of § 674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the asset. Provide a succession of power holders during the grantor's lifetime—so that the trust will continue as a grantor trust if the initial power holder dies before the grantor.

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

- If the trust allows distributions without an ascertainable standard, change trustees so that more than half of the trustees are related or subordinate parties (§ 674(c)). [This strategy can also be used to toggle between grantor trust and non-grantor trust status.]
- Turn the trust into a foreign trust (§ 679) [but many other complexities arise with being a foreign trust].
- Actual borrowing of assets from the trust by the grantor without giving adequate security (§ 675(3)). (See Section V.I.4 of this Part for a more detailed discussion of this alternative.)
- Court modification or modification by consent of the grantor and all beneficiaries that is recognized by state law to reform the trust in a manner so that it becomes a grantor trust [Letter Ruling 200848017 held that a reformation recognized under state law to add a grantor nonfiduciary substitution power would result in a trust being treated as a grantor trust; the ruling expressed no opinion as to whether the modification or any future substitution of assets would have federal gift tax consequences gift tax consequences.]
- "Decant" to a trust that is a grantor trust (if decanting is permitted under the instrument or local law).

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

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

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

If the planner wants to trigger grantor trust status, use one (or more to be safe) of the following: (1) Select trustees and dispositive powers to flunk all of the exceptions in § 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions and distributions are

charged against the trust as a whole, not against a beneficiary's share; one method is to name the grantor's spouse as trustee with those trust provisions (as long as the spouse does not have a legal obligation to support any beneficiary and the spouse is not a beneficiary); (2) Give the grantor or some other nonadverse party a substitution power in a nonfiduciary capacity (realizing that the IRS takes the position that whether it is exercisable in a nonfiduciary capacity is a fact question, to be determined in every case); (3) Give a nonadverse party the power to add beneficiaries who are not after-born or after-adopted children (with another nonadverse person serving as trustee); (4) Give a nonadverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan; (5) Give a non-beneficiary/non-trustee person an inter vivos limited power of appointment over both principal and income of the trust.

C, Grantor Trust Issues With Life Insurance Trusts.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

7. Achieving Grantor Trust Status for Life Insurance Trusts. If the trust does not prohibit paying premiums on life insurance policies on the life of the grantor, is that sufficient to make the trust a grantor trust? [One attorney has reported having an agent take the position that trust is a grantor trust if it does not expressly prohibit paying life insurance premiums of the life of the insured, because the trustee would have the authority to purchase a policy.] For a detailed discussion of the power to pay life insurance premiums as a grantor trust trigger, see Section V.I.3 of this Part of the outline. For a discussion of the effects of a Crummey clause on the grantor trust status of a trust, see Section V.D.3 of this Part of the outline.

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

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

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

For example, a client's parents might create a trust for the client, and contribute $5,000 to the trust, with a Crummey power that would lapse after 30 days (before any growth occurred). The beneficiary would be treated as the owner of the entire trust for income tax purposes under § 678. Because the beneficiary never contributes anything to the trust, the trust assets would not be included in the beneficiary's estate, the beneficiary could serve as the trustee of the trust, and the trust should not be subject to the beneficiary's creditors if it contains a spendthrift clause. Furthermore, the trust could give the client a broad limited testamentary power of appointment. In many ways, this is a perfect estate planning vehicle for the client. If the client can build the value of the trust through special investment opportunities, for example, the client can build a source of funds that is available to the client (as a beneficiary) but that is not in the client's estate for estate

tax purposes and cannot be reached by the client's creditors. Such leveraging might occur through sales to the trust after the lapse of the Crummey power. In order to provide a 10% (or more) "seeding" of the trust to support the note given by the trust, persons other than the grantor (such as the grantor's spouse or a beneficiary) might give guarantees, paid for by the trust. (An advantage of having the grantor's spouse give the guarantees is that if there is any gift element in the guarantee, that would not prevent having a fully grantor trust during the life of both spouses.) Sales to the trust may be able to take advantage of valuation discounts, and can accomplish an estate freeze by limiting the build-up in the client's estate (that otherwise result from the assets that were sold to the trust) to interest on the note. Furthermore, if the trust gives the client a testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes. [The trustee could then divide the trust into "exempt" and "non-exempt" portions if the trust has a typical provision authorizing the trustee to divide the trust into identical separate trusts; the incomplete gift portion would be included in the client's estate at his or her subsequent death, but lifetime distributions to the client could first be made out of the non-exempt portion to minimize the estate tax liability.] The trust can deplete the client's other estate assets to the extent that the client pays income taxes on the trust income out of other assets. The depletion aspect is not as dangerous as other grantor trusts where the grantor may be subject to paying larger income taxes than anticipated; in this situation, the client is also a beneficiary of the trust, so distributions may be made to the client to assist in making the income tax payments after the client has "burned" as much of his or her other assets as desired through the income tax payments. Richard Oshins, of Las Vegas, Nevada, refers to this as incorporating "a freeze, a squeeze, and a burn." The freeze is the obvious freeze of future appreciation on assets acquired by the trust, the squeeze is taking advantage of valuation discounts, and the burn is depleting the client's other assets in making the income tax payments. In order to make a substantial sale to the trust that has been funded with a relatively small amount by the client's parents or other relatives, the planner may decide to use guarantees to support a large sale to the trust for a note and to have the trust pay fair value for the guarantees. For an excellent discussion of planning considerations, see Oshins, The Beneficiary Defective Inheritor's Trust ("BDIT") (2008).

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

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

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

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

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

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

1. Seeding Required. The grantor trust must have a "sufficient" amount of equity under debt-to-equity concepts. Traditionally, 10% seeding is used. This may require a gift of the about 11.1% of the amount to be sold (so the debt to equity ratio will be 9 to 1).
2. Potential § 2036 Inclusion. Is the overall transaction really a transfer with a retained interest? The IRS has not been successful in making that argument. However, if the payment on the note is equal to the income, it may look like a transfer with a retained income interest.
3. Cash Flow. Most planners recommend that at least the interest be paid each year, and there may not be enough cash flow to make even the interest payment. If an FLP interest is sold, making an in-kind payment is difficult.
4. Leveraged Investment Risk. The biggest risk is the investment risk that is amplified by leverage. If there is 90% leverage, a decline of only 10% of the value of the transferred asset wipes out the trust. "In today's world, that can happen in a weekend." If the trust loses 10% in value, it must grow by 11.1% to get back to even. Leverage amplifies gains, but it also amplifies losses.
5. Rest of Estate; Large Note Still in Estate. An installment sale is a classic freezing transaction. The value at the time of the transfer is still in the estate. The large note value is still subject to estate tax. The sale does not shrink the estate.

D. Advantages of Financed Net Gift Compared to Sale.

1. Simplicity. The transaction can be as simple as giving stock to children and having them sign an agreement that they will pay the gift tax, and then having a simple note to document the loan from parent to children to pay the gift tax.
2. Tax Exclusive Gift Tax Rate. The effective gift tax rate is 31% (assuming a 45% federal gift tax rate) compared to the estate tax rate of 45%, if the donor lives at least three years after making the gift.
3. Shrinks Estate Value. The entire estate value of the transferred property is no longer subject to estate tax. ([he note from the donee is included in the estate, but that is offset by the decrease in value of the cash the donor transferred to the donee to pay the gift tax.] If the state does not have a state gift tax (most don't), the state tax is avoided entirely. Another way of stating this is that the net gift transaction shrinks the estate value; it does not just freeze the value. The value of transferred assets actually reduces the estate subject to estate tax by that amount — at a current gift tax cost to the family of a 31% rate. A sale transaction is simply a freezing transaction. The current value of the estate, represented by the note, is still in the estate.
4. Less Cash Flow Required. The note amount is only 31% of the value transferred, not 90% of the value transferred. The annual interest is obviously about a third as much, making it more likely that cash flow from the asset will be sufficient to pay all interest as well principal on the note to the donor.
5. Principal Balance Much Lower. The principal balance of the note (which will be included in the donor's estate) is about a third of the principal balance of the note in a typical sale to grantor trust transaction.
6. Debt to Equity Ratio. If the gift is made outright to donees, there is no debt to equity limit. If the gift is made to a grantor trust, the trust will by the nature of the transaction have sufficient seeding; the debt will only be about 45% of the trust's equity value (i.e., for a financed net gift of $100, the trust will have $100 less $31 gift tax, or $69 of assets and will owe a note for $31.) This is far different than the sale to grantor trust transaction where the note amount is typically 90% of the value of assets in the trust.
7. Smaller §§ 2702 and 2036 Risks. Because the debt is much smaller, it is much harder for the IRS to argue this is a transfer with a retained interest. Indeed, nothing is retained. Any loan to pay gift tax would not be made until several months or possibly more than a year later.
8. Flexibility. Until the gift tax return is filed, the donor could decide to pay the gift tax.
9. Decreased Leverage Means Less Risk. It would take a huge decline in the asset value to wipe out the transfer, as compared to a mere 10% decline that wipes out a sale to grantor trust transaction.

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

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

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

E. Disadvantages of Net Gift Approach.

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

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

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

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

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

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

G. Example Actual Client Situations.

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

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

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

PART FOUR—DEFINED VALUE CLAUSES

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

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

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

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

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

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

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

II. BRIEF HISTORICAL BACKGROUND.

A. Commissioner v. Procter. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), a transfer instrument provided that if the federal court of last resort held that any part of the transfer was subject to gift tax, the gift portion of the property “shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the donor].” The Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and that the condition subsequent violated public policy for three reasons, discussed above in Item 2 of the Analysis portion of this summary.

Interesting aside: In Procter, the Fourth Circuit raised the public policy argument on its own. It was not argued by any of the parties.

Several lower court cases have relied on Procter in refusing to give effect to various types of clauses that reduce the IRS's incentive to audit returns. Indeed, prior to McCord and Estate of Christiansen, the trend of the cases has been to support the Procter result. E.g., Ward v. Commissioner, 87 T.C. 78 (1986) (gift with agreement that if finally determined gift tax value was different, the number of shares transferred would be increased or decreased; court construed agreement as power to revoke and expressed concern that if no challenge took place the "excess value" would pass without tax); Harwood v. Commissioner, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986) (transfer of limited partnership units with provision that if value finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"); Estate of McLendon v. Commissioner, T.C. Memo 1993-459, rev'd, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause; Tax Court ignored the adjustment clause, based on Procter and Ward, concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot").

One case that did not fall in line with this analysis was King v. United States, 545 F.2d 700, 703-04 (10th Cir. 1976), which gave effect to a "price-adjustment clause." Even in that case, though, the court emphasized that the stock that was sold was difficult to value and that the sale occurred in the ordinary course of business with no donative intent.

B. IRS Position; Revenue Ruling 86-41. Revenue Ruling 86-41, 1986-1 C.B. 300, refused to recognize two different types of valuation adjustment clauses contained in a deed of gift of real estate. The first clause provided that the transferee would reconvey to the transferor a sufficient portion of the real estate to reduce the value of the transferred interest to $1,000 as of the date of the gift. The second clause required that the transferee repay to the transferor an amount equal to the excess of the value of the property over $1,000, as determined by the IRS. The Service rejected both of those provisions as an invalid transfer subject to a condition subsequent.

C. McCord v. Commissioner; Fifth Circuit Gives Effect to Defined Value Clause But Does Not Address Public Policy Argument. McCord involves a gift made by a formula giving specified dollar amounts of limited partnership interests to trusts for children and to charities. 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). Under an assignment by parents, children and trusts for children were to receive limited partnership interests having an aggregate fair market value of $6,910,933 and the excess was to pass to various charities. The allocation was to be based on a "confirmation agreement" among the transferees. The Fifth Circuit held that the IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The values of the transferred interests, for purposes of calculating gift and GST taxes, were the values used by the taxpayers (i.e., $89,505 for a 1% interest). The Tax Court erred in using the confirmation agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Tax Court should have applied the defined value clause under its plain wording (although the Fifth Circuit stated that the Commissioner chose not to argue the public policy issue and the court did not explicitly consider that issue).

The Fifth Circuit opinion gave no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised "smell test" concerns. To the contrary, the court went out of its way to chide the Tax Court for ignoring the "plain wording" of the dollar value assignment on the basis of its perceived "olfaction." The Fifth Circuit concluded that the Tax Court majority's application of its "smell test" resulted in its failure to give effect to the dollar gifts in the assignment.

D. Christiansen v. Commissioner Recognizes Formula Disclaimer Over Public Policy Objections. The Eighth Circuit rejected the public policy argument against a formula disclaimer that had the effect of limiting the estate tax exposure of an estate regardless of what values the IRS used in the estate tax audit (as to a portion of the estate). The court gave three reasons: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. In addition, the court reasoned that "the Commissioner's role is not merely to maximize

tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009).

E. Petter v. Commissioner Recognizes Defined Allocation Gifts and Sales Over Public Policy Arguments. Petter v. Commissioner, T.C. Memo. 2009-280 (Dec. 7, 2009), involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue is whether the IRS is correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.

The decision document was filed in the Petter case in early March, so the 90-day period for the IRS to appeal the case is running from that time. The case is appealable to the Ninth Circuit Court of Appeals.

The court discusses four major reasons that the gift and sale transactions with the trusts and foundations by formula allocation do not violate public policy.

1. General Public Policy Encourages Charitable Gifts. The general public policy encourages gifts to charities. The court detailed the ways in which the charitable foundations were "sticking up for their interests and not just passively helping a putative donor reduced her tax bill":

   > Anne's gift made the charities equal members in the PFLLC, giving to charities power to protect their interests through suits for breach of the operating agreement or breach of a manager's fiduciary duties, as well as for the right to vote on questions such as amending the operating agreement and adding new members. These features leave us confident that this gift was made in good faith and in keeping with Congress's overall policy of encouraging gifts to charities.

2. Other "Potential Sources of Enforcement." The gifts were not as susceptible to abuse as the IRS maintains. The court points to various factors suggesting that the allocation clauses would be implemented fairly.

   a. The terms of the transfer documents made the LLC managers fiduciaries for the foundations, and they could police the trusts for "shady dealing." [The court did not fully explain this reason, particularly in light of the fact that the daughter and son were also the trustees of the trusts they would be "policing" as managers of the LLC. However, because the daughter and son were managers of their respective units and also trustees and beneficiaries of the trusts, they owed a high "duty of loyalty and duty of care" to the members (including the foundations), preventing them "from engaging in grossly negligent or reckless conduct, intentional misconduct, or knowing violations of the law."]

   b. The directors of the foundations "owed fiduciary duties to their organizations to make sure that the appraisal was acceptable before signing off on the gift — they also had a duty to bring a lawsuit if they later found out that the appraisal was wrong." [Observe: this is factually inconsistent under the facts of this case — the foundations signed the assignment documents before the appraisal was secured. However the facts are not clear, and perhaps the foundations were given the opportunity to "sign off" on the appraisal before the units were initially allocated.] The court acknowledged the issue of a recipient not wanting to alienate a donor. However, it observes that the transfers were irrevocable and that any lawsuits by a foundation would be against the trusts, not the donor.

c. The IRS Commissioner could revoke the foundations' 501(c)(3) exempt status "if he found they were acting in cahoots with a tax-dodging donor."

d. The state attorney general "is charged with enforcing charities' rights."

e. Taxpayers are not using these clauses just to avoid tax. [Indeed, the court observed that at the time of trial the taxpayer was in the process of reallocating units based on the agreed value.] Because of these enforcement mechanisms, "[w]e certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits. See Tellier, 383 U.S. at 694."

3. Mootness and Declaratory Judgment Concerns Rejected. The court reasoned that the second and third public policy reasons cited by Procter similarly do not rise to the level of a "severe and immediate" threat to public policy. This case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment.

4. Existence of Other Sanctioned Formula Clauses Suggests No General Public Policy Against Formula Clauses. The court pointed to various other formula clauses that have been sanctioned by regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts). Therefore, there cannot be a general public policy against formula provisions.

   The IRS tried to distinguish those other similar clauses because money passing under them will not escape taxation (if they result in assets remaining with the donor or assets passing to a spouse in which event they would be subject to estate tax in the donor's or spouse's estate). However, the court observed that is not always true, such as with formula provisions in charitable remainder trusts where the corpus of the trust will pass to charity tax-free. The IRS also tried to distinguish the other similar clauses as involving the assignment of a fixed percentage or fraction of value rather than an open ended amount exceeding a certain dollar amount. The court dismissed that as a mere semantics matter, and noted that the "children's gifts and sales were capped at the dollar amounts set in the transfer documents."

5. Summary of Public Policy Analysis. "In summary, Anne's transfers, when evaluated at the time she made them, amounted to gifts of an aggregate and set number of units, to be divided at a later date based on appraised values. The formulas used to effect these transfers were not void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place." [Observe: The statement that the units were to be divided at a later date based on appraised values is an oversimplification; under the documents, the units were to be divided at a later date based on values as finally determined for federal gift tax purposes.]

III. PLANNING ISSUES IN STRUCTURING DEFINED VALUE CLAUSES.

A. Formula Allocation Approach Favored. "Formula transfer clauses" are simpler to administer and do not require involving a third party. However, "formula allocation clauses" more squarely fall within the rationale of both Christiansen and Petter for rejecting the public policy argument, including having a third party with a fiduciary duty to police the valuation. Under Christiansen, the first reason for rejecting the public policy argument given by the Eighth Circuit (the "duty to enforce tax laws reason") applies to all defined value clauses, but the second and third reasons only apply to "formula allocation clauses" where there is a charity or someone with an interest that is adverse to a lower valuation can police the clause. The fiduciary duty rationale does not apply as strongly to a "formula transfer clause" even if the recipient is a trust, because the fiduciary has no duty to police that an excessive value is not being transferred to the trust. The sample "formula valuation clause" described in Item 5.a of this Observations section provides that the amount transferred will include 1% of any increased value from a gift tax audit. That provides one rationale for arguing that the public policy objection should not apply (because there is still some [albeit minimal] incentive to audit the return). However, the second and third reasons given by the Eighth Circuit in Estate of Christiansen for rejecting the public policy argument would not be applicable to that type of clause.

Similarly, Petter emphasizes that there are other "potential sources for enforcement" under the allocation clause with a third party having fiduciary duties to make sure that the clause is enforced. Furthermore, the Petter opinion has language that may be viewed as drawing distinctions with formula transfer clauses. The court observed that Christiansen involved a situation in which a "later audit did not change what the donor had given, but instead triggered final allocation of the shares that the donees received." The court spoke negatively of a transaction involving "a donor who tries to take property back." The effect of a formula transfer clause is that whatever does not pass under the formula is retained by the donor, and a court might view that as a donor "taking back" property after a value is finally determined for gift tax purposes.

B. Using Values "As Finally Determined for Federal Gift Tax Purposes." Formula transfer clauses can be designed to be implemented based on (1) values as finally determined for gift tax purposes, or (2) agreement of the various parties receiving the allocated assets.

In McCord, the Tax Court did not recognize a "formula allocation clause" that gave a dollar value to donees, with the excess passing to charities, and provided that the parties would agree on the number of units to be allocated to each of the parties. The formula allocation was to be implemented by agreement of the parties to the transaction, rather than being implemented based on values as finally determined for federal gift tax purposes. One advantage of the agreement approach is that actual sales or transactions are generally the best indicators of value, and that approach involves actual negotiated agreements among independent parties as to the amounts received. Another advantage is that the parties can reach finality rather quickly as to what the parties receive rather than having to wait for years for the finally determined gift tax value to determine how many units of the transferred asset each party receives.

The Tax Court held that the specific formula was not "self-effectuating." The Tax Court's reasoning is difficult to follow, but is based on the fact that the formula is not tied to values as finally determined for gift tax purposes, but fair market values as determined by the parties. Under the court's reasoning, the parties to the assignment documents were supposed to determine what interests passed to the various parties "based on the assignees' best estimation" of the value, and the court gave effect to the percentage interests agreed to by the parties. The court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes," the court "might have reached a different result." The Tax Court was reversed by the Fifth Circuit, because it viewed the Tax Court as impermissibly looking to events occurring after the sale date. The end result was that the Fifth Circuit did recognize a formula allocation clause that gave a dollar amount to donees even though it provided for funding based on the agreement of the parties. Even so, the Tax Court's rejection of that clause, suggesting that a different result may have been reached if the formula allocation was based on values as finally determined for gift tax purposes, causes planners to question whether that type of clause might be preferable.

Interestingly, both of the recent cases that have upheld the concept of defined value clauses against the IRS's public policy attack have involved clauses that based the allocation on values as finally determined for tax purposes. While the reasoning of the cases does not hinge on that fact, planners that want to most closely follow the approach of the favorable cases may tend toward using that approach.

C. Impact of Charity as "Pourover" Recipient. Christiansen and Petter both address formula clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. For example, Petter cites a general public policy favoring charitable gifts and some of the other enforcement mechanisms mentioned in Petter include the ability of the IRS Commissioner to revoke the 501(c)(3) exempt status of the charity and the state attorney general's possible involvement on behalf of charities. However, some of the other enforcement mechanisms mentioned in Petter could apply whenever a fiduciary is involved to make sure that its entity is receiving the appropriate amount under the formula clause. Accordingly, it is not critical that a charity be involved to come within the rationale of the cases, but using a charity follows the facts of the cases more closely, and all of the rationales given by those cases would apply, whereas some of the reasons given in those cases would not apply if charities are not involved. Of

course, the donor must have charitable intent and recognize that significant assets may pass to the charities under a formula allocation clause with the excess passing to charity.

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

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

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

G. Practical Planning Tips.

1. Active Negotiations. Involve all of the parties to the formula allocation assignment in the planning process. The court emphasized that the charities actively participated in the assignment transaction, and obtained several concessions in the process. (See Item 4.a of the Analysis section above.)

2. Provide That Transferees Become Substituted Members of Partners. The court expressly pointed out that the charities negotiated to become substituted members, which made clearer that the LLC managers owed them fiduciary duties. Furthermore, partners have high fiduciary duties to each other. If the family trust and charities are both partners, they would each owe fiduciary duties to the other to make sure that neither is being cheated.

3. Clarify Rights of Parties Following Reallocation. The opinion does not address whether the agreement specifically addressed the charities’ rights to income and dividends from the additional units that were allocated to them following the final determination of the gift tax value. Preferably, the agreement would clarify that upon reallocation of units under the formula allocation, any income and dividends received by the original transferee that are attributable to the transferred units would also have to be transferred in the reallocation.

4. Assignment vs. Trust Allocation. One approach of implementing a formula allocation approach would be to transfer all of a block of assets to a trust, and provide that the trustee would have to allocate those assets pursuant to formula provisions. That approach would have the advantage of requiring a fiduciary (hopefully an independent fiduciary) to implement the formula allocation. That approach was not used in Petter. Instead, the assignment document merely transferred the formula amount to the trust and the excess under the assignment document passed directly to the charity. (However, it is not clear how much additional protection that provides, because the trustee of the trust would not owe fiduciary duties to the beneficiary of the “excess” portion — perhaps unless the trust is also a fellow partner of the other beneficiary and owes a duty of fairness under partnership principles.)

5. Gift Tax Return Reporting. The donor fully disclosed the gift/sale transactions. In the court’s words, “she hid nothing.” The gift tax return obviously drew a gift tax audit and this court fight. The taxpayer was required to report the gift transaction, but voluntarily disclosed the sale

transaction (in order to get the gift tax statute of limitations running as to the sale transaction). There's no way of knowing of whether the additional disclosure of the sale transaction is what generated the gift tax audit.

For a client who wants to make full disclosure on a gift tax return, the Petter case gives a good roadmap of what to include on the return:

> She hid nothing: On that return, she listed gifts... For all of these gifts, her return indicated that the gifts were units in the PFLLC and 'the value of the limited liability company is based on the fair market value of the underlying assets with a 46% non-marketability discount and a 13.3% net asset value adjustment applied.' … She even attached to the return a disclosure statement that included the formula clauses from the transfer documents, a spreadsheet of the PFLLC unit allocation, the organizing documents for the PFLLC, the trust agreements and transfer documents, letters of intent to the Seattle Foundation and the Kitsap Community Foundation, the Moss Adams appraisal report, annual statements of account for the UPS stock, and Forms 8283, Noncash Charitable Contributions, disclosing her gifts to the Seattle Foundation and the Kitsap Community Foundation.

6. Consistent Reporting. In Knight v. Commissioner, 115 T.C. 506 (2000), the Tax Court refused to recognize a defined value transfer approach where the parties did not respect the formula transfer but treated the transfer as a transfer of a specific number of shares. For example, the gift tax return reported that the donors "gave two 22.3-percent interests in the partnership" rather than "the number of limited partnership units which equals $300,000 in value." Furthermore the taxpayers took position that the gift was actually less than $300,000, which is obviously inconsistent with a defined value of a transfer of units worth $300,000. The taxpayers in this case were careful to report the transaction consistently as a formula transfer. The transactions were described on the gift tax return as formula transfers, and the donor's letters to the foundations clearly described the donations to create the donor advised funds as formula transfers.

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

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

PART FIVE—PIERRE II CASE STEP TRANSACTION AND VALUATION IMPACTS IN STRUCTURING SALES TO GRANTOR TRUSTS

I. SYNOPSIS. In Pierre v. Commissioner, 133 T.C. No. 2 (Aug. 24, 2009) (Pierre I), the Tax Court (in a 10-6 decision) held that gifts and sales of interests in a single-member LLC to two trusts (12 days after the LLC was created) are treated for federal gift tax purposes as transfers of interests in the entity (with the possibility of discounts) rather than as transfers of proportionate shares of the underlying assets owned by the LLC, even though the single-member LLC is treated as a disregarded entity pursuant to the check-the-box regulations.

In this subsequent case (Pierre II) addressing two bifurcated issues, the court determines (1) that the step transaction doctrine applies to aggregate the gifts and sales made to each trust (50% combined interest transferred to each trust) for valuation purposes (although this determination had the negligible effect of merely reducing the lack of control discount from 10% to 8%), and (2) that a combined 35.6% lack of control and lack of marketability discount is appropriate in determining the value of the 50% combined interest transferred to each trust. See Pierre v. Commissioner, T.C. Memo. 2010-106 (May 13, 2010). The taxpayer had one appraisal for the gift tax return and a separate expert testifying at trial. The IRS did not produce any valuation expert, and apparently did not even contest the availability of a 30% lack of marketability discount.

The significance of the case is the potentially far-reaching nature of the court's step transaction analysis rather than the actual result of the case. The court gave four reasons for applying the step transaction doctrine in this case: (1) Same day transactions; (2) no lapse of time between gift and sale transactions; (3) intent of making transfers without gift taxes, and (4) poor documentation. The rationale that the taxpayer intended to transfer all of the LLC without paying gift taxes could potentially apply to a variety of structured estate planning transactions.

II. HOW TO STRUCTURE GIFT/SALE TRANSACTIONS TO AVOID AGGREGATION FOR VALUATION PURPOSES. To avoid aggregating gift and sale transactions for valuation purposes, the obvious response is to try to avoid the specific reasons that the court pointed to in reaching its conclusion in this case that the step transaction doctrine applied to aggregate the gift and sale assets for valuation purposes. The four factors were: (1) same-day transactions; (2) no time lapse at all in signing gift and sale documents; (3) taxpayer's intent; and (4) poor documentation.

The first two elements can certainly be addressed in planning gift/sale transactions. Ever since the Holman case, discussing that the delay of 6 days between the date of funding and the date of gifts of FLP interests prevented application of the step transaction doctrine to disregard the entity entirely for valuation purposes, planners have questioned whether a similar analysis might apply to separating the time between gift "seeding" of a grantor trust and a subsequent sale to that grantor trust. This case would suggest the wisdom of doing so. How long? Presumably the reasoning of the Holman and Gross cases would be relevant — wait long enough so that there is a real risk of a change in economic value. [However, that somehow seems to have less relevance for separating a gift and sale than for separating funding and transfers of interests in an entity —although the difference is hard to articulate, in light of the fact that it is difficult to discern the relevance of a "risk of change in economic value" in either situation.] The fourth element, poor documentation, can also be addressed in the planning stage.

The more difficult unknown is the "intent" factor stated by the court: "petitioner intended to transfer her entire interest in Pierre LLC to the trusts without paying any gift taxes." If that is enough to aggregate separate steps, perhaps most gift/sale transactions would be aggregated, because the transaction is typically planned to transfer assets without paying any gift taxes, and the sale transaction is used to transfer value with paying gift taxes. However, there can be reasons for making gifts and sales of interests in the same asset beyond just avoiding the payment of gift taxes. Parents may be willing to give a certain value but want payment in return for additional transfers. Perhaps that is why the court emphasized the actual implementation of the sale transaction during the eight years following the date of the sale. The court noted that the entity made distributions each year so that the trusts could make annual interest payments, and that no principal payments were made on the note. That could be interpreted as an indication that the taxpayer did not have any purpose for making a portion of the transfer by sale rather than gift for economic reasons beyond just avoiding gift taxes.

The particularly troubling aspect of the case is that the reasoning might seem to apply if the gift and sale transactions had been separated by weeks or months. The court's concluded that:

> "nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. We also find that the gift transactions and the sale transactions were planned as a single transaction and that the multiple steps were used solely for tax purposes."

The court's reasoning as to the intent factor is reminiscent of the district court's reasoning in Linton that the "end result test," based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result," is satisfied because the donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability." Similar reasoning appeared again in

Heckerman, in which the court observed that the donors "clearly had a subjective intent to convey property to their children while minimizing their tax liability, pursuant to which they crafted, with the help of their attorneys and advisors, a scheme consisting of 'pre-arranged parts of a single transaction[.]' *Penrod*, 88 T.C. at 1429. Such intent is evident in Mr. Heckerman's testimony that he and his wife 'wanted to fund the LLCs in such a way that would not trigger a gift tax.'"

In many situations, parents will have a goal of transferring all of a particular asset to children and decide to make the transfer partially by sale to avoid paying large gifts taxes. The court's language might seem to apply in many of those situations to conclude that the gift and sale transactions "were planned as a single transaction and that the multiple steps were used solely for tax purposes." Could this reasoning be extended to the common plan of making a "seed" 10% gift to a grantor trust, making a subsequent sale with a 9:1 debt equity ratio, and making additional sales as the equity value of the trusts increases over time and can support additional debt within the 9:1 debt-equity ratio goal? Could all of those transactions over time be aggregated for valuation purposes? [Perhaps it is best to stop referring to the gift as a "seed gift;" that may carry a connotation of a planned transaction involving both a gift and sale.]

III. POTENTIAL SECTION 2036 RISK. An even more significant risk for gift/sale transactions is if the IRS argues that the entire transaction should be collapsed into a single transaction for § 2036 purposes. (1) It might argue that the combined transfer is treated as a transfer for less than full and adequate consideration with a retained interest (i.e., the note payments), so that the sale portion of the transaction no longer qualifies for the "bona fide sale for full consideration" exceptions to §§ 2035 and 2036. (2) Alternatively, Professor Mitchell Gans points out that the step transaction doctrine might be used by the IRS to help bolster a "retained interest" argument. The U.S. Supreme Court considered the predecessor to § 2036 in Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274, 277 (1958). The case involved an annuity-life insurance combination, and the decedent had irrevocably transferred the life insurance policy while retaining the annuity. The Supreme Court concluded that this was not a transfer with a retained interest taxable under the predecessor to § 2036, observing in footnote 8 that the annuity payments were not linked to income produced by the transferred policies, and the obligation to make the annuity payments was not chargeable to the transferred property:

> "Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. [Citations omitted] In these cases the promise is a personal obligation of the transferee, the obligation is usually *not chargeable to the transferred property*, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made." (emphasis added).

That is a huge step from what the court did in Pierre II, and perhaps the IRS will never even make that § 2036 argument let alone find a court receptive to it. Query whether the risk is reduced if the initial gift is not the same asset that is being sold; it may be harder to collapse those separate transactions involving separate assets (perhaps unless the gift asset is used as downpayment for the sale transaction). However, the downside risk is so great, that it makes sense to take steps to avoid the argument, to the extent possible, by delaying the sale transaction for some "appropriate" period of time after the gift.

As a practical matter, the fact that the gift and sale transactions happened in Pierre within "moments" of each other (as noted in the court's conclusion) may have been an especially important factor in the court's decision. [Indeed, there was no hint that the court would have been receptive to applying the step transaction doctrine to the funding of the LLC and the subsequent gifts and sales made 12 days later even if the IRS had made that argument.]

IV. SUMMARY OF STRUCTURING SUGGESTIONS.

- Plan some time delay between the gift and sale transactions.
- If the client intends to limit the amount of gifts for economic reasons (i.e., the client is not willing to relinquish more value than a desired amount) and to make further transfers only as sales that will not deplete the client's assets, document that intent.
- To every extent possible, focus on the economics of the separate sale transaction, and implement the sale transaction in a way as to give credence to the sale transaction, including

making principal payments on the note over time, and not having the seller immediately turn around and make gifts of the note payments back to the purchaser (that did not happen in Pierre). The case indicates that the note was "payable in 10 annual installments." It did not say whether there were to be equal amortized payments or annual principal payments each year and the sellers failed to meet their payment obligations under the notes. In any event, the court went out of its way to observe that no principal payments were made on the notes over the eight years after the sale — suggesting that the taxpayer was not overly concerned with receiving payments from the sale transactions.

- Do not refer to the gift as a "seed" gift.
- If consistent with the client's intent, give and sell different assets. [Of course, there could be no aggregation if there are different assets, but more importantly, using different assets may help thwart a § 2036 argument by the IRS.]

PART SIX—TRANSFERS OF FRACTIONAL INTERESTS TO CO-OCCUPANT

I. SYNOPSIS OF STEWART V. COMMISSIONER. A recent Second Circuit court of appeals case does an excellent job in the majority and dissenting opinions of analyzing the issues involving the application of § 2036 to transfers of a fractional interest in property to a co-occupant. Stewart v. Comm'r, 106 AFTR 2d 2010-XXXX (2d Cir., August 9, 2010), vacating and remanding, T.C. Memo 2006-225(2006).

Five months after being diagnosed with pancreatic cancer, decedent transferred a 49% interest in a Manhattan brownstone to her son, who lived with her on two floors of the five-story residence. Decedent and son continued living on those two floors (she lived another six months) and the top three floors were leased to a commercial tenant. All income and expenses with respect to the rental portion were paid to and borne by decedent for the rest of her lifetime, although the son argued that there was an agreement to reconcile the income and expenses of the brownstone and another property that was co-owned by decedent and son. The Tax Court judge (Judge Foley) concluded that there was no such agreement, finding the son's testimony lacking credibility. The Tax Court found that there was an implied agreement of retained enjoyment, and included the transferred 49% interest in the gross estate under § 2036. (The major impact of that decision was to avoid applying any fractionalization discounts [stipulated by the parties to be 42.5%], because 100% of the property was included in decedent's estate.)

The Second Circuit vacated and remanded the lower court opinion, holding that even under a clear error standard, the trial court erred in finding that an implied agreement of retained enjoyment extended to *all* of the 49% interest transferred to the son.

Residence Property. For residence property, the court said that two factors are particularly significant in determining whether there is an implied agreement for retained possession or enjoyment of residential property: (1) continued exclusive possession by the donor; and (2) withholding of possession from the donee. If both factors are present, the taxpayer has lost every case (citing Estate of Maxwell; Estate of Reichardt; Estate of Kerdolff; Estate of Linderme; and Estate of Rapelje (donor's occupancy is "almost exclusive").) If neither factor applies (i.e., if there is joint occupancy by the donor and the transferee) the taxpayer has won every case "despite the great burden faced by the taxpayer in all these cases" (citing Union Planters Nat'l Bank v. U.S.; Estate of Binkley v. U.S.; Diehl v. U.S.; Stephenson v. U.S.; Estate of Roemer; Estate of Gutchess; Estate of Weir; and Estate of Burr). Most of these cases involved interspousal transfers where one spouse transferred the residence to the other spouse and continued to live in the residence with the transferee-spouse; the courts held that such occupancy with one's spouse is a merely a "natural use" and does not indicate an implied agreement of retained enjoyment. However, Diehl and Estate of Roemer involved familial transfers other than to a spouse where there was co-occupancy. Estate of Roemer explicitly rejected a "spouses only" reading of these cases.

The court stated that although the taxpayer has the burden to prove the absence of an implied agreement of retained enjoyment, "co-occupancy of... residential premises by the related donor and donee is highly probative of the absence of an implied agreement and has repeatedly been held to satisfy the taxpayer's burden."

Rental Property. The court concluded that it was clear error for the court to have found the existence of an implied agreement for decedent to retain full enjoyment of *all* of the 49% interest in the rental

portion of the property that she transferred to her son. The court gave guidance as to how to determine the extent to which the decedent retained enjoyment in the transferred interest, focusing on the net income received by the decedent.

Conclusion of Majority. The son "manifestly enjoyed, and Decedent did not, the benefits of the residential portion of the 49%," and even as to the rental portion, "it seems likely that Decedent retained the benefits of less than the total 49%." The case was remanded so the trial court can determine the *extent* to which there was an implied agreement of retained enjoyment in the 49% transferred interest.

Dissent. A dissenting opinion found no clear error for upsetting the trial court's finding of an implied agreement as to the entire transferred interest. The dissent pointed to the fact that decedent's relationship to the property changed "in not one significant respect" after the transfer. The dissent argues that the majority opinion misread cases and that mere co-occupancy should not be treated as "highly probative" of the absence of an implied agreement, observing that the majority opinion in effect shifts to the IRS the burden of proving the existence of an implied agreement, and that the majority's reasoning "makes it near impossible for the Commissioner to meet his new burden." The dissent believes the opinion "opens a new loophole that will vitiate to a considerable degree" § 2036 and invites "easy dodges by future tax avoiders."

Significance. From a numbers standpoint, this is a major victory for the taxpayer. The primary impact of finding that not all of the transferred interest is included in the estate under § 2036 is that substantial fractionalization discounts are allowed. The property appreciated relatively little over the six months after the transfer; therefore, very little will be added to the estate with respect to the portion of the 49% transferred interest that is included in the gross estate. It is conceivable that the parties will come to an agreement at this point rather than fight over an almost meaningless issue (from a dollars and cents standpoint) for another two years.

The opinion raises the practical planning scenario of making transfers of fractional interests in real estate to donees in order to take advantage of significant fractionalization discounts. If co-occupancy (or other co-uses, consistent with the rights of the co-tenants) of the property avoids § 2036, the transfer will result in a significant decrease in the value that is included in the gross estate.

II. PRACTICAL PLANNING CONSIDERATIONS REGARDING TRANSFERS OF FRACTIONAL INTERESTS.

A. Overview. Estate inclusion under Section 2036 has been argued in many cases involving continued use of a transferred residence by the donor. The cases have generally tended to require more than just continued possession of a residence in order to find that an agreement existed at the time of the transfer. See Stephens, Maxfield, Lind & Calfree, Federal Estate And Gift Taxation, ¶4.08[4][c] (2001). In fact, the IRS concedes that continued co-occupancy for interspousal transfers will not of itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 78-409, 1978-2 C.B. 234; Ltr. Rul. 200240020. However, the IRS is not as lenient where the residence is given to family members other than the spouse. E.g., Estate of Trotter v. Comm'r, T.C. Memo. 2001-250 (residence transferred to trust for children, decedent continued to pay all occupancy expenses and lived in residence without paying rent).

If only fractional interests are transferred, rather than the entire interest (as discussed in the preceding paragraph), it is more natural that the transferor would continue to use the property in some manner. The Stewart case deals with this fractional transfer situation.

B. Generally: Follow Formalities; Avoid Sloppiness in Recognizing Co-Owners. The § 2036 area has inherent factual and legal uncertainties. Do not compound the difficulty of the argument by sloppiness in following formalities. For example, in Stewart, the deed was not recorded until after decedent's death, income was received entirely by decedent and she paid all expenses. The trial court judge understandably had reservations about the bona fides of the transaction. The dissent pointed specifically to the decedent's receipt of all rental income and payment of most of the expenses as evidencing an implied agreement of retained enjoyment. Disbrow (discussed in Item 6 below) is another case where § 2036 was applied partly because of the parties' failure to respect formalities (frequent late payments, etc.)

C. Income Producing Property. This is the easiest situation to gather evidence demonstrating the absence of an implied agreement for the donor to continue receiving income from the transferred

fractional interest. Simply plan the transaction so that donor, in fact, does not receive income attributable to the transferred fractional interest. In light of the inherent uncertainty surrounding § 2036, it is MOST inadvisable for the donor to continue receiving all of the income and paying all of the expenses, as was done in the Stewart case.

Do not rely on using other transactions as an offset against decedent's retention of a disproportionate part of the income. The IRS made the argument that the effect of transactions involving other property could not be considered at all as a legal matter under § 2036. The court suggested that all of the facts and circumstances should be considered, but relying on using offsets from other transactions is not wise.

How is the income mechanically apportioned and paid among the co-owners? It would be burdensome (and in most cases totally unworkable) to have every receipt and every expense paid to and from separate accounts of the co-owners. Having a clear co-ownership agreement, reflecting the express agreement of the parties to share the income and expenses, should suffice (as long as the parties actually periodically split the income and expenses in accordance with that agreement). The receipts and disbursements could be paid from an account in the name of one of the co-owners, with an agreement to make net payments among the co-owners on a periodic basis. A nominee agreement could be filed with the income tax return of the account owner to document why all of the account income is not taxed to the account owner.

D. Occupancy Property. The much more difficult issue is how to plan for occupancy property. Whether there is an implied agreement for the donor to retain the right to use and enjoy the transferred fractional interest is a factual matter, to be determined from all the "fact and circumstances surrounding the transfer and subsequent use of the property." Therefore, there are no absolutes. What can be done to help build the best case for the absence of an implied agreement?

Both the majority and dissent agree that merely having co-occupancy among the various co-owners is not necessarily enough to establish the lack of an implied agreement. However, the majority opinion (as pointed out by the dissent with some disgust) suggests that co-occupancy by the various co-owners is "highly probative of the absence of an implied agreement and has repeatedly been held to satisfy the taxpayer's burden." The majority points out that where the donor does not have exclusive possession and does not exclude the transferees from occupying the property (i.e., where there is co-occupancy after the transfer), the cases have all found that no implied agreement of retained enjoyment existed, and that the donor's continued occupancy "is a natural use which does not diminish [the] transferee's enjoyment and possession and which grows out of a congenial and happy family relationship." The majority held that where the Tax Court made no specific findings regarding retained enjoyment and the IRS "points to nothing besides the mere co-occupancy between the donor and the donee, a conclusion based on an implied agreement concerning the residential portion cannot stand." The dissent strongly objects, noting that the majority's reasoning "in effect shifts the burden of proving the existence of an implied agreement" and "makes it near impossible for the Commissioner to meet his new burden with the astounding claim... that such residence is 'highly probative of the absence of an implied agreement.'"

The Wineman case (T.C. Memo. 2000-193) is discussed at some length by the dissent. That is the case that has been cited over the last ten years for the proposition that § 2036 does not apply to the transfer of a fractional interest as long as the donor merely retains proportionate use of the property consistent with the retained ownership. The dissent attempts to distinguish Wineman by pointing out that there were various structures on the homestead property in which she gave her children a 24% interest, and that she only used a limited number of those structures (including much of the larger house). The dissent points out that the court said (like the majority in Stewart) that limited personal use or using less than all of the property does not prove the absence of an implied agreement. Instead, like the majority in Stewart, the court said to look at all the circumstances surrounding the transfer and subsequent use of the property. The court looked at two factors, in particular, in finding the absence of an implied agreement. First, the court "heavily" relied on the decedent's son's testimony that there was no understanding between the decedent and her children. That will be key — whether the estate can convince the trial judge to believe the remaining co-tenants that they did not have an understanding allowing the donor to have full use of the transferred interest if he or she wanted it. (The Stewart estate beneficiary was not able to convince Judge Foley at the Tax Court that he was credible. The issue, then, is what can be

done in the planning stage to build evidence that will support the credibility of that testimony.) In addition, the Wineman court looked at the natural expectation of continued co-occupancy in these situations in strong language (that the dissent neglected to mention):

> Unlike the authority that has been cited in respondent's brief, this case involves a transfer of less than a fee simple interest in property. The majority owner's continued use and possession of real property, following transfer of a minority interest is not unusual [citing Gutchess]... In this case, decedent's continued use and possession of parcel 3, of which she owned a controlling interest, is natural in light of the children's minority ownership. It is not surprising that the children did not seek to partition the property, since they also used the property regularly and they had only a minority interest in the property.

Consider these planning possibilities:

- The clients must realize there are no guarantees. This is an inherently uncertain area of the law (except for interspousal transfers), and ultimately, the judge will decide whether to believe the estate beneficiaries that there was no understanding allowing the decedent to do anything he or she wished to do with the property, including interests transferred to them.
- Continue (or begin) co-occupancy so that the decedent is not the sole occupant. The majority points that there are two important factors, exclusive possession and withholding of possession from the donee. Satisfy both of those facts by having co-occupancy. (It should be possible, on the right facts, to avoid § 2036 even if the donor is the sole occupant, because he or she has the right as a co-tenant to occupy the property, as long as he or she does not deny occupancy rights to the other co-tenants. However, that would be a tougher argument to win; the estate would have to convince the court that the donor, at least by implied agreement, did not have an understanding that he or she could keep the other co-tenants from using the property.)

  A case illustrating the difficulty of retaining exclusive occupancy of a residence is Estate of Tehan, T.C. Memo 2005-128. In that case, the IRS included the value of the decedent's condominium ($275,000) in his gross estate under §2036 even though he had transferred the condo to his children in a series of three fractional gifts during three years prior to his death. The decedent had an agreement that as long as he owned any interest in the home, he would pay all of the expenses in return for the *exclusive* rights to use and occupy the property. However, that arrangement was continued for the two months after the decedent had transferred his entire interest up to his death. The IRS argued that the following facts proved the existence of a retained interest: The decedent retained possession of the condo, paid all expenses (even as the children's percentage ownership increased to 35%, then 72%, then to 100%), did not pay any rent, and at trial it was established that the children would not have evicted him even if he had not paid expenses.
- The question arises as to how much "co-occupancy" is needed. If both the decedent and co-tenant are living at the residence, that should be sufficient. However, except for the situation where children are living with their parents, it is likely that there will be less than full residential use of the property. For example, for a vacation home (and many fractional interest transfers of property are made in secondary homes rather than the taxpayer's primary residence), consider keeping track of use of the home by the various co-tenants. If the decedent used the secondary home frequently, and children only visited several times a year, there may be more of an implication that the decedent could use the home in any way desired. In that circumstance, consider having formal agreements laying out very clearly the children's right to use the secondary home whenever desired, perhaps with just the requirement of giving notice to the other co-owners of when they were going to use the property.
- Use a "co-ownership agreement" to spell out expressly each co-tenant's right to use the property (and pay the expenses of maintaining the property), and that no-co-tenant could be excluded from use of the property by any other co-tenant. (For an example of a "Tenancy in Common Agreement" for vacation property, see Wendy S. Goffe, *Keeping Vacation Property in the Family*, 41st U. MIAMI HECKERLING INST. ON EST. PL. ¶1811 (2007).) Give the co-ownership agreement to the accountant and other planners so they can assist in seeing that the operation of the property is consistent with the agreement. (In the Tax Court opinion, Judge Foley made note of the fact that there was no written agreement and that the

accountant did not know of a "reconciliation agreement" between decedent and her son regarding income and expenses from the property. Having a formal written agreement would seemingly have helped significantly in supporting the son's credibility.) The agreement could specify that there is no understanding among the co-tenants to the contrary. Such an agreement could help document that the transferees do not merely have the right to be a "houseguest" in decedent's house. Even the dissent in Stewart observed that "evidence demonstrating the existence of a genuine post-transfer tenancy in common" could rebut an implied agreement "that the transferor would continue to possess or enjoy the whole of a property."

- It would be best (but not absolutely required) if the donor's use of the property changed in some fashion after the transfer. The dissent suggests a test (not accepted by the majority) looking to whether the donor's relationship to the property changed in any way after the transfer, noting that decedent's "relationship to the property changed in *not one significant respect* from the period preceding transfer to the period after." The dissent noted "especially the lack of significant, objective changes in that relationship." The dissent cited Estate of Thompson, 382 F.3d at 376 (upholding inclusion of interest in gross estate where the "practical effect of . . . changes [imposed by the transfer] during decedent's life was minimal"). One significant change may be that the co-tenants begin sharing the maintenance expenses, including property taxes and insurance, proportionately rather than having all of those expenses paid by the older generation co-owners.
- Realize that avoiding § 2036 may be more difficult if the transfer is being made, with continued occupancy, by a terminally ill individual (as was likely the case in Stewart, where the decedent had been diagnosed with one of the deadliest cancers six months before the transfer, and died later that same year.) The transaction will have more of a testamentary feel and it may seem more likely to the judge that the transfer is just being made for tax avoidance purposes and that the decedent will continue to be able to do anything with the property that he or she wants during the terminal illness period.

E. Combined Rental and Occupancy Property (as in *Stewart)*. If the property involves both rental and occupancy aspects, follow the planning suggestions in both of the preceding sections, including a clear agreement to share the income and expenses proportionately. Just as the rental property case is easier than the occupancy property case, a situation involving both rental and occupancy may be easier to establish the absence of an implied agreement of retained use than with just occupancy property alone. The dissent takes the position that paying rent entirely to the decedent helps established an implied agreement of retained enjoyment even as to the occupancy portion of the property. Conversely, paying the rental income proportionately could help establish the understanding of the parties to recognize and respect each co-owner's rights as a co-tenant, including occupancy rights.

PART SEVEN—BUILT-IN GAINS TAX DISCOUNT FOR VALUING TRANSFERS OF C CORPORATIONS

I. SYNOPSIS OF JENSEN V. COMMISSIONER. In Jensen v. Comm'r, T.C. Memo. 2010-182 (August 10, 2010), the built-in gains tax discount was determined under a present value discounting approach. The case is appealable to the Second Circuit, and the court refused to speculate on whether the Second Circuit will use a "dollar for dollar" approach for determining the built-in gains tax discount that has been adopted by the Fifth and Eleventh Circuits. The court rejected the IRS appraiser's approach of analogizing to closed-end funds, which would have disallowed any built-in gains discount to the extent that the built-in gains tax was less than 41.5% of the corporation's net asset value. The court also rejected the IRS appraiser's analysis that built-in gains tax discounts should be limited because there are methods by which corporations can eliminate or reduce the tax. (The court concluded that it was "not convinced that a viable method for avoidance of the built-in LTCG exists for a hypothetical buyer" of the corporation's stock.

The court made its own present value analysis, assuming equal growth rates and discounts under two scenarios (5% in one and 7.5% in the other). Not surprisingly, the court's calculation was very similar to the dollar-for-dollar discount based on the amount of built-in gains tax at the date of death (because the assumed appreciation in the assets and the capital gains tax was offset by the assumed discount to present value when the factors were the same).

II. PRESENT VALUE APPROACH. There are two general approaches for calculating the built-in gains discount. First, a dollar-for-dollar approach is allowed in the Fifth and Eleventh Circuits. (Estate of Dunn, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke III, 507 F.3d 1317 (11th Cir. 2007), cert. denied (2008). (In Estate of Jelke, the court observed (in footnote 38) that in Simplot, 112 T.C. 130, 166 n.22 (1999) rev'd on other grounds, 249 F.3d 1191 (9th Cir. 2001), the IRS presented an expert witness who concluded that, when valuing a closely held corporation's interest in publicly traded stock, full recognition of built-in capital gains was appropriate.) Second, other courts have applied a present value analysis, considering when the corporation might sell appreciated assets and determining the present value of the additional corporate level capital gains costs. This case follows the trend of prior Tax Court cases of estimating the present value of the eventual built-in gains tax. The cases have made that present value determination in different ways, but the clear trend in the Tax Court, so far, is to use a present value approach rather than just allowing a dollar-for-dollar discount. (In Estate of Litchfield, the court specifically observed in footnote 10 that the expert did not apply a dollar-for-dollar discount and that the court did not need to decide if that approach "would be appropriate in another case where that argument is made.")

III. CONSIDERATION OF FUTURE APPRECIATION. There is no consistency in the cases as to whether future appreciation should be considered in the present value analysis. On one hand, the corporation is being valued as of a particular valuation date, and arguably neither increased liabilities nor increased asset values should be taken into account. On the other hand, a purchaser buying a corporation with appreciating assets will have to incur a second level capital gains tax on future appreciation that a purchaser of directly owned assets will not have to bear. As a result, prospective purchasers presumably will pay less for the corporate interest that would be subject to the additional tax on future appreciation, and an adjustment should be made in some manner with respect to the built-in gains tax attributable to future appreciation.

A. Cases Rejecting Consideration of Subsequent Appreciation.

In Estate of Bailey (T.C. Memo. 2002-152), the IRS expert made various assumptions in its present value analysis of the built-in gains tax, including an assumed growth rate of 2%, a discount-to-present value rate of 8%, and an assumed 5-year holding period. The court did not specifically comment about considering future appreciation, but just concluded that the expert "offered no explanation or support for any of the many assumptions that he utilized" and found the report unpersuasive.

The Tax Court in Estate of Jelke (T.C. Memo. 2005-131, Judge Gerber) specifically rejected the taxpayer's expert's argument that if a present value approach is used, there should a consideration of "a long term projection... that the stock will appreciate" and that "[i]f the stock appreciates, the capital gains tax liability will appreciate commensurate [sic]." The court responded:

> "If we were to adopt the estate's reasoning and consider future appreciation to arrive a subsequent tax liability, we would be considering tax (that is not "built in") as of the valuation date. Such an approach would establish an artificial liability. The estate's approach, if used in valuing a market-valued security with a basis equal to its fair market value, would, in effect, predict its future appreciation value and the tax liability and then reduce its current fair market value by the present value of a future tax liability."

The taxpayer in Jelke pointed out that the IRS experts, in several other cases, have considered future appreciation in determining the present value of the built-in gains tax. In Estate of Borgatello, the IRS expert used assumed future appreciation in its determination of the built-in gains discount, and the court used a compromise between the positions of the IRS's and taxpayer's experts. In Estate of Bailey, the IRS expert similarly assumed future appreciation in its analysis, but the court rejected that expert's approach as being unpersuasive. The Tax Court in Jelke responded that it was not bound to follow the same approach used by experts in other cases, and that even in Borgatello, "the expert's approach does not represent the ratio decidendi of the case." [*Ratio decidendi? I'm impressed. Remember that term for cocktail party discussions.*] Of course, keep in mind that the Eleventh Circuit eventually reversed the Tax Court, holding that a dollar-for-dollar discount is appropriate. 507 F.3d 1317. The Eleventh Circuit took note of the taxpayer's concern about not taking into consideration future appreciation: "The estate attacks this approach on the basis that it is incomplete and inconsistent, as over this 16-year period, CCC's securities could appreciate in value, increasing tax payments and

obviating the need to reduce built-in capital gains by present value principles. The same could be true if the assets were to depreciate in value over the projected period." Id. n.9.

B. Cases Supportive of Considering Subsequent Appreciation.

In Estate of Borgatello (T.C. Memo 2000-264, Judge Wells), the IRS expert's approach of determining the built-in gains tax discount was to use a present value approach, assuming that the corporation's assets would have a 2% growth rate, that the assets would be held for 10 years before being sold, and that the resulting built-in gains tax at the end of 10 years would be discounted to present value at 8.3% (the long term applicable federal rate + 2% for added risk). This approach resulted in a 20.5% built-in gains tax discount (discount to net asset value). The taxpayer's expert used a dollar-for-dollar discount, resulting in a 32.3% discount to net asset value. The court concluded that there was not much support for the government's contention that a buyer would wait 10 years before liquidating the assets and reached a middle ground of using a 24% discount to net asset value. (This represented about 74.3% of the dollar-for-dollar built-in gains tax based on the amount of gain at the date of death.) The court did not have any discussion whatsoever of whether it was appropriate to assume a future growth of the assets in applying the present value analysis, but took into account the IRS's expert's conclusion (based on considering future growth of the assets) in reaching an eventual compromise amount of the appropriate discount.

In Estate of Dailey (T.C. Memo. 2001-263, Judge Foley), one of the IRS's experts acknowledged that he would take into account holding-period asset appreciation in calculating appropriate valuation discounts to net asset value (as cited in footnote 12 of Estate of Litchfield).

Estate of Litchfield (T.C. Memo. 2009-21, Judge Swift) is the first case in which the court has specifically criticized the IRS's expert for not assuming a growth rate during the holding period in making the present value computation. That case involved the valuation of a decedent's stock in two corporations that had elected S corporation status about one year before the decedent died (so still had nine years to run on the 10-year period of built-in gains after conversion from C corporation to S corporation status). The taxpayer's expert calculated the built-in gains discount by projecting holding periods and estimated sale dates after discussions with the officers and boards of directors of the corporations (5 and 8 years for the two separate corporations, vs. 54 and 29 years used by the IRS's expert), estimated appreciation of the assets up to the anticipated sale dates, calculated the estimated capital gains taxes on those sales dates (taking into account appreciation before the date of death as well as anticipated appreciation after the date of death up to the sale date for anticipated sale dates that were within ten years of the S conversion), and discounted the tax amounts to present values. The court agreed with the estate's appraiser as to the built-in gains discount. The opinion does not describe the assumed appreciation rates or the discount rates used by the estate's appraiser. (The IRS's expert used an 11.0% discount-to-present value factor.)

In Estate of Litchfield, the court was more persuaded by the taxpayer's expert as to the turnover estimates, including conversations with management and discovery that there were many elderly shareholders concerned with paying estate taxes, and that management had addressed selling assets to be able to provide liquidity to the shareholders' estates. A key distinction between the approaches of the parties is that the taxpayer's expert considered an amount of assumed appreciation in the assets during the holding period and took into consideration the additional capital gains taxes attributable to that appreciation in some manner.

The court agreed that an adjustment should be considered with respect to the additional level of capital gains taxes on future appreciation.

> "[R]espondent's expert does not take into account appreciation during the holding period that also likely will occur and that will be subject to taxes at the corporate level — what one expert has described as the tax-inefficient entity drag. See Johnson & Barber, 'Tax-Inefficient Entity Discount,' 6 Valuation Strategies 20, 46 (Mar./Apr. 2003). On the facts presented to us, we believe that, as of the valuation date, a hypothetical buyer of LRC and LSC stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in a built-in capital gains discount that would be negotiated between the hypothetical buyer and seller."

The built-in gains tax discounts allowed in Litchfield were not "dollar-for-dollar," (the estate did not request a "dollar-for-dollar" discount so the court did not have to address whether that is a proper approach to determine the discount), but the discounts were very substantial.

The Estate of Jensen opinion specifically criticized the IRS expert because the expert's report "did not account for the likelihood that the [the corporation's] assets would appreciate (and that concomitantly the built-in LTCG tax would increase) nor take into account time value of money concepts." The court cited Estate of Litchfield and Estate of Borgatello.

C. Summary Regarding Consideration of Future Appreciation. Courts have not yet resolved whether anticipated future appreciation of corporate assets should be considered in determining the present value of the built-in gains tax discount. However, the two most recent Tax Court cases to address the issue have criticized IRS experts for not taking into consideration anticipated future appreciation in making the present value analysis of the built-in gains tax. In Estate of Litchfield, the court specifically criticized the IRS's expert for not taking into account appreciation after the valuation date to the anticipated sale dates "that also likely will occur and that will be subject to taxes at the corporate level — what one expert has described as the tax-inefficient entity drag." Similarly, Estate of Jensen criticized the IRS expert for not taking into account "the likelihood that [the corporation's] assets would appreciate (and that concomitantly the built-in LTCG tax would increase)." The rationale for this approach is that if the asset were not in the corporation, future appreciation would not be subject to the double tax, so the analysis assumes that a hypothetical buyer would take this extra corporate level tax burden into account in negotiating a sales price. Jeff Pennell, at the 2010 Heckerling Institute, said this issue is unsettled and that commentators disagree on the proper approach as to whether future anticipated appreciation should be considered. Estate of Jensen, coming on the heels of Estate of Litchfield last year, suggests a trend toward considering future anticipated appreciation.

IV. CHOICE OF DISCOUNT-TO-PRESENT VALUE FACTOR (WHICH MAY RESULT IN DOLLAR-FOR-DOLLAR DISCOUNT).

In Estate of Litchfield, the court relied on the taxpayer's expert's present value analysis to determine the built-in gains tax discount. However, the opinion does not describe the assumed appreciation rates or the discount rates used by the estate's appraiser. (The IRS's expert used an 11.0% discount-to-present value factor.) The present value of the built-in gains tax was less than the date of death value, so the assumed appreciation rate must have been less than the assumed discount rate.

Several other cases have described some of the growth rates and/or discount rates used by appraisers in making the built-in gains tax present value computations. E.g., Estate of Jameson, 267 F.3d 366, 370 (10% annual growth to harvest rate of timber, 4% annual inflation rate in the value of harvest, and a 20% discount rate); Estate of Jelke (IRS expert used 13.2% discount rate "based on the average annual rate of return for large-cap stocks in the period for 1926-1998"); Estate of Bailey (IRS expert used 2% growth rate and 8% discount rate); Estate of Borgatello (2% growth rate and discount rate of 8.3%, based on long term AFR + 2% for added risk).

The recent Ludwick case had a discussion of growth and discount rates in the court's estimate of the discount for valuing 50% undivided interests in a residence. The court assumed a growth rate of 3% and a discount rate for the present value calculation of 10%.

In Estate of Jensen the court used a factor to discount the anticipated future built-in gains tax to the present value that was exactly equal to the assumed appreciation rate (i.e., 5% and 7.5% in the two scenarios considered by the court). Using the same number for the assumed rate of appreciation and the rate to discount the future capital gains taxes to present value results in an offset. In effect, the built-in gains tax is compounded by an assumed appreciation rate and then discounted back to present value by the same rate. If the appreciation rate and the discount-to-present value rate are the same, it makes no difference how long the assumed turnover period will be. Indeed, the court's calculation of the present value of the built-in gains tax over 17 years ($1.23 million and $1.26 million) was about the same as the estate's determination of the current "dollar-for-dollar" built-in gains tax ($1.13 million).

The math analysis is not quite that straightforward, because the value of the real estate is being compounded, but the income tax basis that is subtracted to determine the amount of the gain is static and does not compound. (That is why there is a slight difference in the court's calculation of the present value built-in gains tax for the 5% versus 7.5% assumed appreciation/discount rate

scenarios, and why the court's calculation is slightly different than the dollar-for-dollar discount amount.)

The assumed holding period, assumed growth rate, and "discount-to-present value" factor obviously greatly impact the calculation of the built-in gains discount. Courts should focus on specific discussion by experts of the reasons supporting the specific values for these factors used in their analyses.

V. PRACTICAL PLANNING GUIDANCE. In the Fifth and Eleventh Circuits, claim a dollar-for-dollar built-in capital gains discount. Outside of those circuits, there is no certainty. If the experts use a present value approach, the trend of the current cases suggests that future anticipated appreciation should be taken into consideration in determining the present value of the built-in gains tax. In determining the estimated holding period before assets are sold, consider historical data, recent data, and actual conversations with management about anticipated plans (which is what the taxpayer's expert did in Estate of Litchfield).

Is it possible to admit testimony that buyers typically reduce the purchase price because of the built-in gains tax liability when purchasing interests in corporations without having a detailed analysis of the precise amount of the built-in gains tax discount? The difficulty is that the built-in gains tax factor is merely one factor considered in the negotiation process, and it is hard to say how much discount is allowed specifically for that factor. Furthermore, some judges have refused to allow that kind of general testimony.

PART EIGHT—RECENT DEVELOPMENTS REGARDING FLP/LLC PLANNING CONSIDERATIONS

I. ADDITIONAL GUIDANCE UNDER 2704. The IRS Priority Business Plan for the last six years has included "Guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership" (first appearing in the 2003-2004 Priority Guidance Plan). This probably relates to the statutory authority to issue regulations regarding the effect of a restriction that has "the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." I.R.C. § 2704(b)(4). These regulations have been on the Priority Guidance Plan six years, leading Jeff Pennell to believe that the regulations may be more aggressive than §2704 currently permits, so the IRS is holding back on releasing the regulation until further legislation is passed revising §2704.

The Treasury on May 11, 2009 released the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals. Section 2704 would be revised to add a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. Disregarded restrictions would include limitations on a holder's right to liquidate that are more restrictive than a standard to be identified in regulations, and any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in an entity. For purposes of determining if restrictions can be removed, certain interests (to be identified in regulations) held by charities or others who are not family members would be ignored. (Kerr v. Commissioner held that requiring the approval of a small charitable interest before the partnership could liquidate was not an applicable restriction, and could be considered in valuing the limited partnership interests. 202 F.3d 490 (5th Cir. 2002).) Regulations could create "safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met." There would be "conforming clarifications" regarding the interaction of the valuation discount restrictions with transfer tax marital and charitable deductions. (This provision is estimated to raise $19 billion over 10 years.)

The President's Fiscal Year 2011 Budget Proposal contains the same proposal.

In light of the long delay in issuing the regulations, some commentators (including Prof. Jeffrey Pennell) speculate as to whether there may be uncertainty within the IRS as to whether the regulations could be upheld under the current statutory language of §2704.

II. HOLMAN 8TH CIRCUIT OPINION SYNOPSIS: SECTION 2703 AND MARKETABILITY DISCOUNT. A retired Dell employee and his wife created an FLP to hold some of their Dell stock, and made gifts of limited partnership interests in 1999, 2000, and 2001. The agreement contained commonly used transfer restrictions, restricting transfers of LP interests without approval of all partners, and giving the

partnership the right to purchase non-permitted assignments at the fair market value based on the right to share in distributions (i.e., considering discounts) of those assignee interests. The Tax Court rejected the IRS argument that the gift of LP interests six days after the partnership was created was an indirect gift of a proportionate part of the assets contributed to the partnership (i.e., without a discount), and the IRS did not appeal that decision. The 8th Circuit Court of Appeals (by a 2-1 split of the three-judge panel) affirmed the Tax Court's conclusion that transfer restrictions in the agreement must be ignored under §2703 in valuing the transfers. (The court reasoned that the transfer restrictions did not satisfy the "bona fide business arrangement" requirement in the §2703(b) safe harbor.) The Tax Court valued the transferred LP interests by applying combined lack of control and marketability discounts of 22.4%, 25%, and 16.25% in 1999, 2000, and 2001, respectively. The lack of marketability discount was only 12.5%, partly based on a consideration that the remaining partners would have an economic interest to purchase an interest for a value somewhere between the discounted price that a third party was willing to pay and a pro rata share of net asset value, thus placing a floor on the marketability discount. The 8th Circuit affirmed that approach and held that it did not violate the hypothetical willing buyer/willing seller valuation standard. 601 F.3d 763 (8th Cir. April 7, 2010) *aff'g* 130 T.C. 170 (2008).

There was a strong dissent as to both the §2703 and the marketability discount issue.

The case overall is still a taxpayer victory — gifts were made of a partnership interests holding only one marketable stock with a 22.4% discount for the most significant gift. The taxpayers were able to avoid losing all discounts by defeating the IRS's indirect gift/step transaction argument in the Tax Court. Some of the reasoning in the case, however, is quite troubling for planners if future courts follow the same approach of this Tax Court (regular opinion, not just a Memorandum decision) and 8th Circuit case:

- Section 2703 will likely not allow considering transfer restrictions in valuing FLP interests for most investment partnerships because of the strict test for meeting the "bona fide business arrangement" requirement of the §2703 safe harbor where there is not an operating business;
- The Tax Court's reasoning (which was not addressed by the 8th Circuit) for concluding that the "device" requirement of the §2703 safe harbor was not met (because of the "redistributive effect" of purchasing an interest in the entity at less than pro rata value of the entire entity) would suggest that many buy-sell agreements for even operating businesses with family members as owners would not be respected for transfer tax valuation purposes; and
- The reasoning suggests a major inroad on the hypothetical willing buyer/willing seller valuation standard by taking into consideration that remaining partners would likely purchase the interest of any exiting partner at a price higher than what a third party would pay; the 12.5% marketability discount is very low and IRS agents will likely be citing this case routinely in future audits to support a low marketability discount.

The court has denied the taxpayer's Petition for *En Banc* review.

III. SECTION 2036: ESTATE OF BLACK V. COMMISSIONER, 133 T.C. NO. 15 (DEC. 14, 2009); FLP TAXPAYER VICTORY: "BUY AND HOLD" INVESTMENT POLICY SATISFIES SECTION 2036 BONA FIDE SALE EXCEPTION. Estate of Black is illustrative of several § 2036 cases over the last year. In Estate of Black Husband and Wife died within five months of each other, after Husband was the second largest shareholder in a thinly traded public company. Husband had created an FLP eight years earlier. Husband had previously made gifts of some of the company's stock to his son and to revocable trusts for his two grandsons. Husband was concerned about the son or grandsons eventually disposing of the stock and planners advised that they all contribute their stock to an FLP in order to protect Husband's buy and hold investment philosophy with respect to the stock. (John Porter describes the stock as the "goose that laid the golden egg for the family" and that the block of stock was the swing vote between fighting factions of the founder's family.) The IRS argued that §2036 applied to the transfers by Husband to the FLP, causing a pro rata portion of the FLP assets to be included in Husband's gross estate. The IRS argued that the amount of marital deduction available in Husband's estate would be limited to the discounted fair market value of the FLP interests (which apparently were the only assets that could be used to fund the marital bequest). (This is sometimes referred to as the "marital deduction mismatch issue.") There were also disputes about the deemed funding date of the Marital Trust (which was not funded before Wife died), and the availability of administrative expense deductions in Wife's estate. John Porter represented the estates in the tax litigation.

- Trial. John Porter indicates that the case was tried in November 2007. The IRS attorney was the same attorney who tried and lost the similar Schutt case.

- Discounts Settled. John Porter indicates that valuation issues were settled, concluding there was a 12% blockage discount for the stock in the FLP (for thinly traded stock) and a 32% combined lack of control/marketability discount for the limited partnership interest.

- Buy and Hold Investment Philosophy. The Tax Court (in this "regular" Tax Court decision) held that the bona fide sale for adequate consideration exception to §2036 applied, primarily relying on the buy and hold investment philosophy as the nontax reason for creating the FLP.

- Divorce Protection. Another reason, in addition to preserving the family legacy asset, was the concern over divorce of the decedent's son. Some other courts have said that potential divorce concerns and the protection of an FLP in divorce is just theoretical. In this case, the son's divorce attorney testified that having the stock in the FLP helped in the divorce negotiation, and the parties realized they could not get to assets inside the FLP.

- Business Purpose Not Needed. Black (as well as Miller) emphasizes that having an investment purpose is sufficient, and it is not essential to have a "business purpose." (Mil Hatcher puts it: "Judge Laro is retired.") That has been a trend in recent years, and it is nice to see cases explicitly say so.

- Nontax Reason Is Predominant Reason. The IRS argues that the nontax reason must not only be a legitimate and significant reason, but must be the "predominant" reason for creating the partnership. The court explicitly agreed with that argument, stating directly that "[a] finding that the transferor sought to save estate taxes does not preclude a finding of a bona fide sale *so long as saving estate taxes is not the predominant motive.*" The case cites Mirowski and Schutt. (Neither of those cases directly stated that the tax reason must not be the predominant reason.) This suggests that if there are nontax reasons that represent 49% of the reasons for creating a partnership but tax reasons represent 51% of the reasons, the bona fide sale exception would not be satisfied. *This is a new development, and is an extension of the Tax Court's nontax reason test in Bongard and all prior §2036 cases.* While the court stated this as the test in its overview discussion of the bona fide sale exception, it did not address this "predominant motive" rationale in the application of the law to the facts of the case. (The Shurtz case repeated this exact same sentence. See Item 9.b.(vii) below.)

- Not Retaining Assets to Pay Estate Taxes Relevant to Retained Enjoyment Issue But Not A Factor For Bona Fide Sale Exception. Footnote 12 of Black makes clear that whether the decedent retained sufficient assets to pay estate taxes and fund bequests relates to whether there was a retained interest under §2036(a)(1) but is "inapposite to the bona fide sale question." Mil Hatcher views that as a "big takeaway" from Black.

- Marital Deduction Mismatch. Because §2036 did not apply to Husband's estate, the court did not have to address the marital deduction mismatch issue in Husband's estate. The issue is that the IRS argues that §2036 applies to cause the assets of the FLP or LLC to be included in the gross estate without a discount. However, for marital deduction purposes, the estate only owns a limited partnership or LLC interest and does not own the assets directly. All the estate can leave the spouse is a discounted entity interest. Thus, there would be estate inclusion at a high level (without a discount) but the marital deduction would be allowed at a much lower level (taking into account discounts). That difference would first reduce the amount passing to the bypass trust, but if that difference were more than the remaining estate tax exemption amount available to the estate, there would be estate taxes due at the first spouse's death. See generally Angkatavanich, Black Shirts (Black, Shurtz) and the Marital Deduction Mismatch, TRUSTS & ESTATES 37 (June 2010).

  The effect is exacerbated because the resulting estate tax itself would not qualify for the marital deduction. For example, under the facts of Black, the pro rata portion of the partnership assets includable under §2036 would have been about $250 million rather than the $165 million discounted value included in the estate. If §2036 applied, the additional $85 million in the gross

estate, according to the IRS position, would not have qualified for the marital deduction. This initially would produce an estate tax (at a 45% rate) of about $38 million. However, that $38 million also does not qualify for the marital deduction, producing still more tax. Ultimately, the estate tax liability at the first spouse's death would be about $70 million attributable to the additional $85 million in the gross estate (i.e., the combined $155 million times 45% equals about $70 million).

The IRS is continuing to make this argument. The IRS made this argument in the Shurtz case (discussed below). In addition, Charles Hodges, an attorney from Atlanta, Georgia, reports having tried a case recently (Estate of Clyde Turner v. Commissioner) in which the IRS made this same argument. The trial also addressed the amount of the valuation discount—even though there will be no additional estate tax if the IRS loses the § 2036 argument, regardless of the outcome of the valuation discount decision, because of the marital deduction.

One wonders if having this difficult marital deduction issue in the case makes it more likely that the court will find a way to determine that § 2036 does not apply, in order to avoid having to address the marital deduction mismatch issue.

- Gifts Made Within Three Years. The IRS did not raise the potential §2035 issue with respect to gifts of partnership interests within three years of Husband's death. The "bona fide sale for an adequate and full consideration" exception would not have applied to the gifts.

- Deemed Funding of Marital Trust. The stock (and therefore the FLP interest) increased in value in the five months between the two spouses' deaths, and the court agreed with the estate that the Marital Trust would be deemed to have been funded on the date of Wife's death. (Therefore, fewer units were allocated to the Marital Trust than if the trust had been deemed funded at Husband's death.)

- Graegin Note Interest Not Deductible. The $20.3 million of interest on the Graegin note was not deductible; the loan was not "necessary," primarily because it did not avoid having the company stock sold in any event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). See generally Liss, *Estate of Black:* When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds? 112 J. TAX'N 372 (June 2010).

- Administration Expenses for Estates in Quick Succession. Only the portion of the selling expenses attributable to funds needed by the estate for paying federal and state estate and income taxes was allowed as an estate tax deduction. Executor fees and legal fees were allocated equally to Husband's and Wife's estate and only the one-half allocated to Wife's estate could be deducted on her estate tax return to offset the substantial estate taxes payable from her estate.

Regarding the Graegin analysis, the court reasoned that the loan process was merely a recycling of value and that the partnership could have just made a distribution. Of course, had it done so, that might have been a factor suggesting the existence of a §2036 retained interest. This raises the issue of the tension that exists between using distributions or redemptions to get liquidity to the estate (raising potential §2036 concerns) or borrowing from the partnership (raising the interest deductibility issue).

IV. "SCORECARD" OF §2036 FLP CASES (11-19, WITH 2 ON BOTH SIDES). Of the various FLP cases that the IRS has chosen to litigate, eleven have held that at least most of the transfers to an FLP qualified for the bona fide sale exception — Church (preserve family ranching enterprise, consolidate undivided ranch interests); Stone (partnerships to settle family hostilities); Kimbell ("substantial business and other nontax reasons" including maintaining a single pool of investment assets, providing for management succession, and providing active management of oil and gas working interests); Bongard (placing ownership of closely held company in a single entity for purposes of shopping the company by a single seller rather than by multiple trusts); Schutt (maintaining buy and hold investment philosophy for family du Pont stock); Mirowski (joint management and keeping a single pool of assets for investment opportunities); Miller (continue investment philosophy and special

stock charting methodology); Keller (protect family assets from depletion in divorces); Murphy (centralized management and prevent dissipation of family "legacy assets"), Black (maintaining buy and hold investment philosophy for closely held stock), and Shurtz (asset protection and management of timberland following gifts of undivided interests). In every FLP case resulting in taxpayer successes against a §2036 attack the court relied on the bona fide sale exception to §2036.

Interestingly, four of those eleven cases have been decided by (or authored by) two Tax Court judges. Judge Goeke decided the Miller case and authored the Tax Court's opinion in Bongard. Judge Chiechi decided both Stone and Mirowski. (Judge Wherry decided Schutt Judge Halpern decided Black, Judge Jacobs decided Shurtz, and Church and Kimbell were federal district court opinions ultimately resolved by the 5th Circuit. Keller and Murphy are federal district court cases.)

Including the partial inclusion of FLP assets in Miller and Bongard, 19 cases have applied §2036 to FLP or LLC situations: Schauerhamer, Reichardt, Harper, Thompson, Strangi, Abraham, Hillgren, Bongard (as to an LLC but not as to a separate FLP), Bigelow, Edna Korby, Austin Korby, Rosen, Erickson, Gore, Rector, Hurford, Jorgenson, Miller (as to transfers made 13 days before death but not as to prior transfers) and Malkin. In addition, the district court applied §2036 in Kimbell, but the 5th Circuit reversed.

V. GROWING BODY OF CASES RELYING ON MAINTAINING BUY AND HOLD PHILOSOPHY FOR FAMILY ASSETS. Schutt based its determination that the bona fide sale exception applied based primarily on the intent of the donor of maintaining his buy and hold investment philosophy over family legacy assets (du Pont and Exxon stock). Two additional recent cases (Murphy and Black) have similarly treated the desire to maintain family legacy assets as a legitimate and significant nontax purpose that satisfied the bona fide sale exception to §2036. (Both Murphy and Black involved companies in which the family held a relatively high percentage ownership interest and in which the family had been intimately involved with the operation of the company.)

VI. POST-DEATH USE OF PARTNERSHIP ASSETS. Post-death use of partnership assets has become a hot item. In Erickson, the partnership purchased assets from the estate and redeemed some of the estate's interests in the partnership. Commentators argue that §2036 should not apply to post-death uses of partnership assets (John Porter points out that §2036 talks about retained interests by the "decedent," not the "decedent's estate"), but the clear trend of the cases is to consider post-death uses of partnership property for paying estate taxes for purposes of §2036. Seven cases have viewed the use of partnership assets to pay post-death obligations as triggering §2036(a)(1). Those cases are Rosen, Korby, Thompson, Erickson, Jorgensen, and Miller (Tax Court cases) and the Strangi Fifth Circuit Court of Appeals case. Miller and Erickson are two cases in which the court looked *primarily* to post-death distributions and redemptions to pay estate taxes as triggering §2036(a)(1). In Erickson, T.C. Memo. 2007-107, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Erickson (or the estate) could use the assets if needed."

Not all judges take the same view; Judge Chiechi was not troubled by post-death payments of estate taxes and other liabilities of the decedent's estate in Mirowski. However, many judges clearly now do take that position.

What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter's recommendations:

- It is best is to borrow from a third party, but a bank may be unwilling to make a loan using only the partnership interest as collateral. The bank may want a guarantee by the partnership. If so, partnerships should be paid a guarantee fee. There is a legitimate reason for the FLP giving a guarantee, because there will be an IRS lien against the partnership, and the partnership will not want the bank to foreclose on a partnership interest.

- Borrow from an insurance trust or a family entity, secured by the partnership interest.

- There are three options for utilizing partnership funds: redemption, distribution or loan. Erickson involved a purchase of assets and redemption but held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distributions for taxes are made all the time from partnerships, but usually income taxes. John prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arms' length transaction) Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John has used them successfully in a number of cases. (However, John says that he has cases in which the IRS argues that Graegin loans from an FLP to the estate evidences a retained enjoyment under §2036.)

Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses, so that the necessary cash never comes directly from the partnership.

VII. GRAEGIN LOANS FROM FLP.

A. 2009 Cases Allowing Interest Deduction. In Murphy and Keller, the court allowed interest deductions for amounts borrowed from partnerships (both 9-year notes). Both cases concluded that the borrowing was necessary for the estate administration.

B. Black Refused Interest Deduction. An interest deduction for a Graegin loan from the FLP was denied in Black. The court held that the loan was not "necessary," primarily because it did not avoid having the company stock sold in any event (i.e., the FLP sold stock and loaned sale proceeds to the estate instead of distributing stock to the estate and allowing it to sell the stock directly). The court reasoned that the loan process was merely a recycling of value and that the partnership could have just made a distribution.

C. Tension of §2036 vs. Interest Deduction. A distribution from an FLP to allow the estate to pay estate taxes may be a factor suggesting the existence of a §2036 retained interest. On the other hand, a loan from the partnership raises the issue of whether the interest is deductible. A Graegin loan from an FLP runs the risk of the estate not being able to deduct the interest and also the risk of flagging that there is a §2036 issue. Mil Hatcher has thought for years that this would be an issue, but it has only recently appeared in the cases. Lee Schwemer also confirms that a Graegin loan is a §2036 red flag for IRS agents.

D. Business Judgment. Cases generally have been lenient in not questioning the business judgment of executors as to whether borrowing by the estate is necessary. However, Black reasoned that the borrowing was unnecessary because there could have been a partial redemption of the estate's partnership interest. John Porter points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in Black substituted its business judgment for that of the executor.

VIII. IRS RED FLAGS REGARDING § 2036 AND FLP PLANNING. Lee Schwemer (Supervisory Attorney, Estate Tax, Internal Revenue Service) points out that the IRS is hiring additional estate tax agents. The IRS hired 14 new estate tax attorneys last year and plans to hire 10 more in March of this year. Lee listed factors that agents look at in determining whether an FLP is a "wounded animal" case with particularly bad §2036 facts. He emphasized that this is not an exclusive list of factors that agents look for, but it includes some of the "red flags."

- Near death creation of the FLP

- Decedent retained no assets for living expenses

- No contributions by other partners
- Nature of assets (personal use assets)
- Failure to observe partnership formalities (an advantage of near-death partnerships is they are not around long enough for failure to follow formalities to occur)
- Non pro rata distributions if the decedent is the only person receiving distributions
- Commingling of personal and partnership assets (worst case if the decedent is using the partnership bank account as a personal account)
- No real business or investment purpose or creditor protection purpose
- Post-death distributions or borrowing from the FLP (Graegin loans from the FLP are red flags of a §2036 issue)
- Achieving discounts seems to be the real reason for creating the FLP

IX. INDIRECT GIFT/STEP TRANSACTION CASES IN 2008-2009.

A. Holman, 130 T.C. No. 12 (2008). A retired Dell employee and his wife created an FLP to hold some of their Dell stock, intending to make gifts of limited partnership interests, and they made gifts of most of their limited partnership units six days later. The court's primary test was there is a "real economic risk of a change in value" of the Dell stock (and the value of the limited partnership interests) between the time of funding and the time of the transfer. This aspect of the case was not appealed. Other issues in the case were appealed. A discussion of the 8th Circuit case is at Items 9.b and 10.

B. Gross, T.C. Memo 2008-221. The same judge who wrote Holman again rejected the IRS's indirect gift argument where the gift was made at least 11 days after various publicly traded stocks were contributed to the partnership. The court concluded that was long enough where the contributions to the partnership consisted of a portfolio of "heavily traded, relatively volatile" stocks.

C. Linton v. U.S., 104 AFTR2d 2009-5176 (W.D. Washington July 1, 2009); Contributions of Property to LLC and Gifts of LLC Interests on the Same Day Treated as Indirect Gifts and as Step Transactions to Eliminate Any Discounts for Gift Tax Purposes. The court found factually that undeveloped real property, cash, and municipal bonds were contributed to an LLC on the same day that gifts of LLC interests were made to a trust (also created on that same day for the donor's children). (Despite factual testimony as to the intended dates of the gifts, the trust agreement itself stated that the gifts of LLC interests to the trust were made "[a]t the time of signing of this Agreement" and the trust agreement was signed on the same date as the date of the contributions.) In a gift tax refund action, the court upheld the government's motion for summary judgment, finding that no discount should be allowed with respect to the LLC interests. The gifts constituted indirect gifts of the underlying assets (the facts are particularly similar to those in Senda where the contribution and gift occurred on the same day and the facts did not make clear which occurred first).

The most significant impact of this case is its analysis of how the step transaction doctrine applies to gifts of partnership or LLC interests. Although not necessary to grant the government's motion for summary judgment, the court also added that the step transaction would apply. The court repeated all three of the alternative tests for the step transaction doctrine from income tax cases that were mentioned in Holman and Gross and concluded that all three tests would apply. The court's reasoning regarding especially the last two tests was very broad and might leave open an argument by the IRS in future cases that the step transaction doctrine could apply to gifts of partnership or LLC interests made long after the time that the entities are funded. (For example, the court concluded that the "end result test," based on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to

reach the ultimate result," is satisfied because the donors "undisputedly had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability.") The court distinguished Holman and Gross because those cases involved some delay (6 days and 11 days, respectively) between the date of funding of volatile stocks to the entities and the date of the gifts. The court specifically observed that the assets involved in this case (real property, cash, and municipal bonds) were not as volatile as the assets involved in Holman and Gross.

D. Heckerman v. U.S., 104 AFTR2d 2009-5551 (W.D. Washington July 27, 2009); Indirect Gifts and Step Transaction. This gift tax refund case is very similar to the Linton case decided in the same federal district court (though by a different judge). Not surprisingly, the Heckerman case reaches a very similar result, holding that the indirect gift and step transaction principles applied.

Non-Tax Purpose. The Heckerman case specifically addressed the importance of the non-tax purpose element to balance between "tax avoidance" and "tax evasion," depending on whether there is an "independent purpose or effect" in addition to the tax savings. While the §2036 cases invariably focus on whether there are "legitimate and significant non-tax purposes" for transferring assets to an FLP or LLC, that issue has not been applied previously to the gift tax arena.

E. Summary From Linton/Heckerman. Jeff Pennell concludes that Linton and Heckerman are merely articulating an equitable doctrine, and applying a sense of justice to reach the right result. He thinks that applying a detailed analysis of the three tests from the income tax step transaction cases is not helpful. As a planning matter, he says, it does not help to do thinking about how to avoid any of those three tests. What is important is that there be a delay between the creation/funding and transfers of ownership interests, and that a delay of as little as 15 days is probably safe. "That's all I take out of these cases." [I hope that is all that future courts take out of these cases as well, because the reasoning is outrageously overly broad.]

F. Planning Observations. Carefully document that assets are transferred to the entity before transferring interests in the entity. How long to wait? Mil Hatcher has always thought 30 days is appropriate. That may be more than is required for volatile stocks. He suggests that other things can be done besides just building in a delay. (1) Do not finalize what gifts will be made until after the partnership is funded. (2) Wait on drafting documents that will receive assignments of partnership interests until after the funding is completed. (3) John Porter suggests attaching a schedule of assets to the partnership agreement when it is signed. Those become partnership assets even before they are legally transferred, although John prefers to have all legal titles transferred before making transfers of partnership interests. Lee Schwemer (Supervisory Attorney, Estate Tax, Internal Revenue Service) believes that the IRS's focus on indirect gifts will be cases where there is no separation between the funding of the partnership and making gifts of interests. After that case law develops we will see cases where there is some separation.

X. ANNUAL EXCLUSION CASES; HACKL, PRICE AND FISHER.

A. Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003) ruled that gifts of LLC interests to 41 donees over a number of years did not qualify for the annual exclusion. Reasoning that the donees had neither the right to income from the property nor substantial present enjoyment of the property itself. The court held that the transfers did not constitute present interests that qualified for the gift tax annual exclusion. Two recent cases have followed this trend of refusing to allow the gift tax annual exclusion for gifts of limited partnership or LLC interests, based on the particular restrictions in those cases.

B. Price v. Commissioner, T.C. Memo. 2010-2. Gifts of limited partnership interests by parents to their three children did not constitute present interest gifts that will qualify for the gift tax annual exclusion. There was no immediate enjoyment of the donated property itself, because the donees had no ability to withdraw their capital accounts and because partners could not sell their interests without the written consent of all other partners. Furthermore, there was no immediate enjoyment of income from the donated property (which can also, by itself, confer present interest status) because (1) there was no steady flow of income, and (2) distribution of profits was in the discretion of the general partner and the partnership agreement specifically stated that distributions are secondary to the partnership's primary purpose of generating a long-term

reasonable rate of return. Perhaps most interesting is that the IRS pursued this annual exclusion argument in litigation even though there were limited donees (three, unlike the Hackl, case where there were 41 donees) and even though there were over $500,000 of actual distributions to the children from the partnership's creation in 1997 to 2002. Clearly, the annual exclusion issue is "in play" and the availability of the annual exclusion for limited partnership interest transfers cannot be assumed.

Several drafting suggestions will assist in countering the court's objections. Alternatives include:

(1) Do not include a prohibition on transfers but provide that any transferee will be subject to a right of first refusal, with reasonable time limits;

(2) Do not explicitly favor reinvestments over distributions in the partnership agreement;

(3) Make distributions every year and "regularize" distributions (although this may make §2036(a)(1) inclusion more likely if the parent retains interests in the partnership or LLC);

(4) Mandate distributions of "net cash flow" (although the IRS may also argue that this is an indication of an implied agreement of retained enjoyment under §2036(a)(1));

(5) Specify that the general partner/manager owes fiduciary duties to the other partners/members;

(6) Give donees a Crummey withdrawal power with respect to gifts of limited partnership interests that would enable the donees to withdraw the fair market value of their limited partnership interests for a limited period of time after each gift (this is obviously an unusual provision to be in a partnership agreement); and

(7) Give donee-partners a limited period of time to sell the interest to the partnership for its fair market value, determined without regard to the existence of the put right; this provision could be included in a conditional assignment that is subject to the transferee being allowed to require the donor or the partnership to substitute income producing property equal in value to the value of the donated partnership interest. If the put option is used, some panelists prefer giving the partnership the obligation to purchase the interest, but that would require that the partnership be a party to the assignment agreement if the put option is placed in the assignment. (The provision could also say that the partnership would have the first option to purchase the partnership interest but if it did not exercise the option, the donor would have to buy the interest.)

Jeff Pennell says that he once asked an IRS field agent why agents go after annual exclusions when truck loads of value pass out of estates through discounts. The response: "These are the cases we can win."

C. Fisher v. U.S., 105 AFTR 2d 2010-XXXX (S.D. Ind. March 11, 2010). Parents gave membership interests in an LLC to each of their seven children over three years (resulting in 42 annual exclusion gifts). The principal asset of the LLC was undeveloped beachfront property. The IRS contested the availability of annual exclusions, and the court rejected the donors' three arguments.

First, the donors argued that the children had the unrestricted right to receive distributions. The court rejected this argument because distributions "were subject to a number of contingencies, all within the exclusive discretion of the General Manager."

Second, the donors argued that the children possessed the unrestricted right to use the beachfront property. The court responded that the Operating Agreement did not convey this right to members. Somewhat confusingly, the court added that "the right to possess, use, and enjoy property, without more, is not a right to a 'substantial present economic benefit.' *Hackl*, 335 F.3d at 667. It is a right to a non-pecuniary benefit."

Finally, the donors argued that the children had the unrestricted right unilaterally to transfer their interests. Under the Operating Agreement, the children could transfer their "Interests" in the LLCs if certain conditions are satisfied. One of those conditions was that the LLC would have a right of first refusal over any such transfer. If the LLC exercises the right of first refusal it will pay "with non-negotiable promissory notes that are payable over a period of time not to exceed fifteen years" providing equal annual installments of principal and interest. The right of first refusal would not exist for transfers to the donors or to their descendants (but as noted below, the court said that other restrictions would apply, without explaining what those restrictions were). The Agreement defines "Interest" as a member's share of profits and losses and the right to receive distributions. The children could only transfer "Interests" rights as opposed to the rights of "Members" admitted by the LLC, which also include the right to inspect the Company's books and records and to "participate in the management of and vote on matters coming before the Company." (The rights that could be assigned seem analogous to "assignee" rights in the context of a partnership.) The court did not comment negatively on the fact that the children could merely transfer the right to share in profits, losses and distributions rather than a full membership right. However, the court reasoned that the right of first refusal "effectively prevents the Fisher Children from transferring their interests in exchange for immediate value." Even transfers to family members are "not without restrictions." "Therefore, due to the conditions restricting the Fisher Children's right to transfer their interests in Good Harbor, it is impossible for the Fisher Children to presently realize a substantial economic benefit."

The third argument is the one that most donors will use to support the availability of the annual exclusion for gifts of interests in partnerships or LLCs. If the donees had the immediate right to sell their interests for cash or other assets they could immediately enjoy, it would seem that the gifts would constitute present interests. The court did not explain its reasons that the right of first refusal kept the children from being able to transfer their interests for "immediate value." However, the court was probably correct in reaching this result because the LLC could pay with *non-negotiable* notes. This means that if the LLC exercised its right of first refusal, the children had no ability to sell the LLC's note for cash or other "immediate value." While the court did not explain its specific reasons, limiting the right to transfer the interest for only a non-negotiable note does seem to be a substantial impediment to being able to receive "immediate value." As discussed above in the discussion of Price, partnership or LLC agreements should not prohibit transfers. Fisher casts some doubt on whether subjecting transfers to a right of first refusal precludes annual exclusion treatment, but it would seem that the practical planning pointer from Fisher is that the partnership or LLC should not be able to exercise the right of first refusal by giving *non-negotiable* long term promissory notes.