TRANSFER PLANNING, INCLUDING USE OF GRATS, INSTALLMENT SALES TO GRANTOR TRUSTS, AND DEFINED VALUE CLAUSES TO LIMIT GIFT EXPOSURE

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September 28, 2007

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PART ONE—SPECIAL PLANNING CONSIDERATIONS FOR GRATS, INSTALLMENT SALES TO GRANTOR TRUSTS, AND CLATS

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 $12,000 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 percent 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, were as the gift tax rate is multiplied just times 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.

II. GRAT DESCRIPTION AND BASIC REQUIREMENTS.

A. Significance.

The GRAT technique allows transfer of substantial value to trust with low immediate gift consequences, because under §2702 the donor's retained value of a "qualified annuity interest" is subtracted from the value transferred in determining the gift. The GRAT is an outstanding planning technique for a wildly appreciating business -- appreciation in excess of §7520 rate is removed from the grantor's estate if the grantor survives the period of the annuity payments.

B. Example and Description of GRAT Operation.

The donor transfers assets to a GRAT. The trust instrument provides that "annuity payments" will be made to the grantor for several years. The annuity payments are fixed in amount (but they do not necessarily have to be made in cash.) This can be designed to produce in a very low gift for gift tax purposes. The annuity payments are set high enough so that the present value of the payments almost equals the value of assets contributed to the GRAT. (The resulting gift is often less than $100.) The trust is designed so that the donor pays income taxes on the trust's income, allowing the trust assets to grow more rapidly inside the trust. At the end of the GRAT term (often two years), any remaining assets in the GRAT can pass to the individual's children (or better yet, to a trust for the benefit of the individual's family which can be, and often is an income tax "defective" trust as to the grantor) without any additional gift taxes, no matter how large the GRAT assets are at that time. In the unlikely event that the donor dies before the end of the GRAT term, the trust assets will probably be included in the individual's estate for estate tax purposes, but the individual is no worse off than if the trust had not been created.

Generally speaking, there will be assets at the end of the GRAT term to pass to the individual's family free of gift taxes if the assets in the GRAT have experienced combined income/appreciation in excess of the "hurdle rate" that is used to determine the present value of the annuity payments. This rate is reset monthly according to a procedure described in Section 7520 of the Internal Revenue Code. This "hurdle rate" is based on market interest rates, and is currently very low. (This rate reached an all-time low of 3.0% in July 2003.) The rate in effect in the month in which the GRAT is created applies for the entire term of the GRAT. Therefore, this strategy does not literally transfer all future appreciation free of gift or estate tax—but only future income/appreciation above this very low "hurdle rate."

Overall Purposes That The GRAT Achieves

In light of this description of how the GRAT operates, observe the important purposes that the GRAT achieves.

- The GRAT transfers most of the future income and appreciation of assets that are given to the trust—the transferred appreciation passes without gift or estate tax.
- There is a very small current gift ($100 or less) for gift tax purposes.
- The trust can grow free of income taxes because the donor pays income taxes on the trust's income.
- The bottom line is that the combined income and appreciation in excess of the very low "hurdle rate" passes without gift or estate taxes if the donor lives to the end of the GRAT term.

- Weighing Upside and Downside: If the GRAT assets grow at more than the hurdle rate, the excess passes without gift or estate taxes. If the GRAT assets do not have combined income and appreciation at least equal to the low hurdle rate, all of the trust assets are merely returned to the donor. Except for the transactional costs and the negligible use of the unified credit (the later of which is restored if the grantor does not survive the term, a GRAT is virtually a "cost free bet."

C. Basic Statutory Requirements for GRATs. The key driving force behind GRATs is that section 2702 authorizes placing a value on the donor's retained interest, so that only the value of the remainder interest is a gift for gift tax purposes. Section 2702 contains various requirements to constitute a "qualified annuity interest". Some of these requirements are as follows.

1. Annual Payments. Payments must be made not less frequently than annually. I.R.C. § 2702(b)(1).

2. Annuity Must Be Fixed Amount or a Fraction of Initial Value, and May Increase By No More Than 20% Annually. The annuity amount may either be a stated dollar amount or a fixed fractional percentage of the initial fair market value. Treas. Reg. §25.2702-3(b)(1)(ii). (Using the fixed fractional percentage of initial value approach basically constitutes a valuation savings clause on the value of assets contributed to a GRAT.) The stated amount may increase or decrease in any year, but any increase is limited to a 20 percent increase over the amount in the prior year. I.R.C. § 25.2702-3(e) Ex.2.

3. Income in Excess of Annuity Amount May be Retained. Income in excess of the annuity amount may be paid to the annuitant. However, "the right to receive the excess income is not a qualified annuity amount and is not taken into account" in valuing the gift. Treas. Reg. 25.2702-3(b)(iii).

4. No Additional Contributions. The governing instrument must prohibit additional contributions. Treas. Reg. § 25.2702-3(b)(4).

5. Prohibit Commutation. The governing instrument must prohibit commutation of the annuity interest at its actuarial value at the date of prepayment. Treas. Reg. §25.2702-3(d)(4).

D. Estate Tax Actuarial Risk. There is an inherent actuarial risk with a GRAT. If the grantor dies during the term of the GRAT term, a substantial portion, if not all, of the trust assets will be included in the grantor's estate. See Part One, Section IV.B.1. of this outline for a more detailed discussion of the estate tax effects if the grantor dies before the end of the GRAT term.

E. No Allocation of GST Exemption Until End of GRAT Term. GST exemption cannot be allocated by the grantor until the end of the "estate tax inclusion period." Accordingly, the grantor cannot allocate GST exemption until the end of the GRAT term. (This is way to utilize all $2.5 million of a person's GST exemption without making a gift that exceeds the $1.0 million gift exemption.)

III. SPECIAL PLANNING CONSIDERATIONS FOR GRATS.

A. Significance.

As discussed above, 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.

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 section 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 section 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 section 7520 rates were available for the next month indicating that the rates would be decreasing in 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.

The grantor may serve as trustee of the GRAT during the annuity payment period. The IRS's position is that the entire trust corpus would be included in the grantor's estate in any event if the grantor dies during the trust term, so there is no 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, the grantor should relinquish any voting rights at least three years prior to the end of the annuity term. (Otherwise, estate inclusion may continue for three years after the end of the annuity term, or whenever the grantor relinquishes the voting rights, under §2036(b).)

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. See generally McCaffrey & Kalik, Using Valuation Clauses to Avoid Gift Taxes, 125 TR. & EST. 47 (Oct. 1986).

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, "backloading" 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.

F. Minimize Initial Gift.

The IRS will not issue a private letter ruling for a GRAT unless the remainder interest has a 10% value. However, there is nothing in the statute or regulations requiring a minimum remainder value. To the extent that the client is willing to make taxable gifts (keep in mind that the gift produced with a GRAT is not a present interest and does not qualify for the annual exclusion), outright gifts achieve the same goal of shifting future appreciation without any risk of inclusion of the appreciation in the estate if the donor dies early. Accordingly, GRATs are typically designed to produce only a negligible gift value of the remainder interest.

Interestingly, the same amount will be shifted to the donee with (1) a GRAT structured to produce a substantial gift, or (2) a GRAT that produces a nominal gift combined with an outright gift (to produce the same overall gift)—but only if the GRAT assets produce a total return over the life of the GRAT at least equal to the section 7520 rate. However, the primary advantage of using a nominal gift with the GRAT occurs if the assets produce less than the section 7520 rate. In that case, the donee would have received more with the combination of (1) a nominal gift GRAT, and (2) an outright gift.

G. Minimizing Gift Resulting from GRAT Creation.

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 can be reported on a gift tax return.)

1. Historical Difficulty of Zeroing Out the GRAT Under "Example 5 Approach".

   There has previously been uncertainty regarding the manner in which the transferor's retained annuity interest should be valued. Example 5 in the Regulations takes 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. 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 section 2702. Walton v. Comm'r, 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 is 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).

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 & Silvan, The Walton GRAT and Marital Deduction Planning, TAXES 35, 38-41 (July 2001). If the grantor should die before the end of the GRAT term, the IRS's position is that all of the GRAT assets will be included in the grantor's estate. Therefore, 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 One, Section II.G.4 of this outline.

3. Revocable Spousal Annuity Not Recognized by IRS and Unneeded in Light of Walton.

   a. General Description of Spousal Revocable Contingent Annuity. An alternate approach to reduce the potential gift exposure is to provide that if the transferor dies during the annuity term, the annuity would be paid to the surviving spouse, and that the transferor would have the right to revoke this interest. The spouse's contingent right to receive annuity payments arguably was a "qualified interest" that could be given value. See Treas. Reg. §§ 25.2702-2(a)(5), §25.2702-2(d)(1) Ex. 7.

   b. Revocable Spousal Annuity Not Recognized by IRS and Unneeded in Light of Walton.

      After initially issuing favorable letter rulings, the IRS now takes the position that the revocable contingent spousal annuity is not effective in reducing the gift amount upon the creation of a GRAT. The Tax Court and Seventh Circuit Court of Appeals agrees with the IRS analysis. Cook v. Comm'r, 115 T.C. 15 (2000), aff'd 269 F.3d 854 (7th Cir. 2001); Schott v. Comm'r, 80 TCM 1600 (2001), rev'd 319 F.3d 1203 (9th Cir. 2003); Focardi v. Comm'r, T.C. Memo 2006-56.

      The Tax Court confirmed that the Walton case did not change its position on contingent spousal annuities in Schott v. Comm'r, 80 TCM 1600 (2001). The Tax Court continued with its reasoning that "[a] qualified annuity interest cannot be a contingent interest that may in fact never take effect." The Ninth Circuit Court of Appeals reversed (and remanded) the Schott case, recognizing the validity of the revocable contingent spousal annuity. In that case, the GRAT agreement provided that "[i]f the grantor died prior to the end of the fifteen-year term, the annuity was to be paid to the spouse for the balance of the term, unless the right had been previously revoked by the grantor."

      The Ninth Circuit in Schott distinguished the Cook case, by pointing out that the spousal annuity in the Cook case was contingent on a factor other than just life expectancies—it was also contingent on the grantor and spouse being married at the time the spouse's annuity began. "This contingency is different from the contingency necessarily built into interests dependent on a life." The Ninth Circuit observed that the Tax Court had invalidated Example 5 in the Walton case. The Ninth Circuit noted that it did not need to invalidate a regulation in reaching its decision; it merely held that the IRS's interpretation of Example 7 was unreasonable.

      Regulations now clearly take the position that a revocable spousal interest is not a "qualified interest" that can reduce the gift value of the GRAT if the spouse will not receive any payments if the transferor to the GRAT survives the initial fixed term of the GRAT. Treas. Reg. §§ 25.2702-2 (a)(6) & 25.2702-3 (e)(Exs. 6 & 8).

      Under Walton and the revised Example 5 in the regulations, the gift to a GRAT can be "zeroed out" by designing the present value of the retained annuity to equal the value

contributed to the GRAT, so there would be no necessity of using a contingent spousal annuity to minimize the gift upon the creation of a GRAT. If the revocable contingent spousal annuity approach is used, it is important, in light of the Schott case's distinguishing of the Cook case, not to make the spouse's interest contingent on the spouse being married to the grantor at the time the spouse's interest begins.

4. 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 Covey, Practical Drafting 6768 (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. Another 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.

H. Payment of Annuity Amounts; Structure Trust as Grantor Trust for Income Tax Purposes.

1. Cash.

If the GRAT has sufficient cash to make the annuity payments, the planning is easy. This may be possible with assets that are high income producing, especially if contributed to the GRAT in a minority interest. Cash may also be available if the clients plan to have the GRAT

assets sold (or redeemed if the contributed assets are stock) in the relatively near future. Furthermore, substantial cash can be contributed to the GRAT, along with appreciating (hopefully) assets to facilitate making at least some of the annuity payments with cash. Backloading the GRAT (i.e., using annuity payments that increase by 20% each year) can assist in being able to make the annuity payments in early years from cash. See Part One, Section III.GG. of this outline.

2. Fractional Interests of In-Kind Assets.

   If the asset does not in fact produce enough income to pay the annuity amount, fractional interests in the asset could be distributed in partial payment of the annuity amount each year. If the trust is a grantor trust as to all trust assets for income tax purposes, such distributions should not result in taxable income to the trust for the beneficiary. See Rev. Rul. 85-13, 1985-1 C.B. 184 (in which the IRS refused to follow Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984)); see e.g., Ltr. Rul. 9239015 (donor is treated as owner of entire GRAT for income tax purposes; neither donor nor trust will recognize gain or loss as a result of (1) contribution of stock to GRAT, (2) transfer of stock to donor in satisfaction of annuity payments, or (3) donor's exchange of cash for stock held by the GRAT); Ltr. Rul. 9352017 (neither donor nor trust will recognize gain or loss as a result of contribution of stock to the trust or the distribution of in-kind assets in satisfaction of annuity payments). Observe that appropriate minority and marketability discounts will have to be applied in valuing the in-kind distributions and appraisals will often be needed.

3. Loan from Grantor.

   Alternatively, the grantor might consider lending the trust sufficient assets to allow payment of the annuity or unitrust amount. However, the IRS expressed its disapproval of this approach in Tech. Adv. Memo. 9604005 (discussed in subparagraph 5 below). Final regulations, discussed in paragraph 5 below, address the issuance of notes to satisfy annuity payments. The preamble to the final regulations makes clear that borrowings by the GRAT to make annuity payments will be scrutinized under the step transaction doctrine if there has been an indirect borrowing from the grantor.

4. Loan from Third Party.

   A preferable approach might be for the remainderman or another third party to loan funds to the trust for payment of the annuity amounts. If the GRAT borrows from a third party, will the interest be deductible by the grantor? The underlying theory for why transactions between a grantor and his or her grantor trust are not gain recognition events (see Rev. Rul 85-13) is that the grantor is considered to own all the assets in the grantor trust for income tax purposes. Thus, the grantor could be treated as having borrowed the money that was in fact borrowed from a third party by the GRAT. Because the funds were used by the grantor to make investments, the tracing rules of Regulation §1.163-8T would appear to cause the interest expense generated on the loan from the third party to be deductible as investment interest to the extent of investment income. Cf. IRS Notice 89-35, 1989-1 C.B. 675 (application of interest tracing rules to passthrough entities).

   Final regulations, discussed below, make clear that the loan of funds to the GRAT by a third party (such as a bank) do not cause concerns to the IRS.

5. Regulations Prohibiting Issuance of Notes by GRAT to Satisfy Annuity Payments.

   The IRS issued a regulation in 2000 that address the use of notes by GRATs to satisfy annuity payments. The regulations provide that the issuance of notes, other debt instruments, options, or similar financial arrangements, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount. Reg. § 25.2702-3(b)(1)(i). The preamble, states that the annual annuity payment "must be made with either cash or other assets held by the trust."

The preamble to the final regulations makes clear that the trustee of a GRAT may borrow the required funds for a GRAT payment from an unrelated third party. However, the step transaction will be applied where a series of transactions is used to achieve a result that in inconsistent with the regulations. For example, if the trustee borrows from a bank to make the annuity payment, and then borrows from the grantor to repay the bank, the payment would be treated as an indirect issuance of a note from the GRAT to the grantor in payment of the annuity payment. The final regulations add that issuance of a note "directly or indirectly" in satisfaction of the annuity amount does not constitute payment of the annuity amount.

The regulation requires that the prohibition on giving notes in satisfaction of annuity payments must be in GRATs established on or after September 20, 1999. The regulations include a transitional rule for trusts created before September 20, 1999. If a GRAT created before September 20, 1999 does not include the express prohibition, the retained annuity interest will still be treated as a qualified interest if (1) notes, other debt instruments, or similar financial arrangements are not used after September 20, 1999, to satisfy the annuity obligation, and (2) "[a]ny note or notes or other debt instruments issued on or prior to September 20, 1999 to satisfy the annual payment obligation are paid in full by December 31, 1999, and any option or similar financial arrangement is terminated by December 31, 1999, such that the grantor actually receives cash or other trust assets in satisfaction of the payment obligation." Reg. §25.2702-3(d)(5). The regulation states that an <u>option</u> will be considered terminated only if the grantor receives cash or other trust assets equal in value to the greater of the required annuity payment plus interest computed under §7520 [rather than the lower rate that would apply under § 7872] or the fair market value of the option. Reg. §25.2702-3(d)(5)(B). The proposed regulation does not address what interest rate must be payable on <u>notes</u> (which had to be paid by December 31, 1999).

A situation that arises fairly often is that a GRAT provides for annual annuity payments, but the grantor must pay income taxes with respect to the GRAT's income throughout the year. The GRAT may advance cash to the grantor throughout the year, so the grantor can make required estimated income tax payments. The GRAT could transfer those notes (given by the grantor) to the grantor at the end of the year in partial satisfaction of the required annuity payment.

6. <u>Property Distribution Followed by Substitution of Note</u>.

Another alternative would be for the GRAT to distribute in-kind property to the grantor, and have the grantor exercise a substitution power to substitute a note from the GRAT for the property. The initial distribution by the GRAT would seem to satisfy the payment requirement under the regulations. The subsequent exchange would appear to clearly be permitted under the substitution power. Interestingly, the actual exercise of the substitution power may strengthen the taxpayer's position that the section 675(4)(c) power is indeed held in a nonfiduciary capacity.

The final regulation (discussed in subparagraph 5 above) prohibits the use of notes "directly or indirectly" by a GRAT for making annuity payments. The IRS would likely take the position that a property distribution followed by a substitution of a note by the grantor would violate the regulation.

7. <u>Property Distribution Followed by Re-GRAT</u>.

An alternative would be to distribute in-kind assets from the trust and to "re-GRAT" the assets under a rolling GRAT approach.

8. <u>Structure as Grantor Trust</u>.

In order to make sure that there is the flexibility to satisfy annuity payments with in-kind distributions without causing a realization of income, it is important to structure the GRAT as a grantor trust for income tax purposes.

9. Consider Valuation Discounts.

If the annuity payments are satisfied with in-kind distributions, realize that valuation discounts may be appropriate in valuing the small fractional interests distributed with respect to each particular payment. (In that case, a larger percentage interest in-kind interest would have to be distributed back to the grantor than if there were no valuation discount.) This could be especially problematic if a majority interest is contributed to a GRAT (so that little or no valuation discount is appropriate, thus requiring relatively large annuity payments), but small minority interests are distributed, which must be discounted. See Estate of Chenowith, 88 T.C. 1577 (1987) (bequest of 51% of stock of family company to surviving widow entitled to premium "control element" to increase marital deduction); Estate of Mellinger v. Comm'r, 112 T.C. 26 (1999), acq. 1999-2 C.B. 763 ("[t]he proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest"); Estate of Disanto v. Comm'r, T.C. Memo 1999-421 (surviving wife signed disclaimers so that only a minority interest in closely held stock passed to the wife; court held that the stock passing to the wife must be valued as a minority interest for purposes of determining the amount of the marital deduction).

I. Structure as Grantor Trust.

The GRAT should be designed to be a grantor trust for federal income tax purposes, at least during the term of the retained annuity payments. If the annuity payments cannot be satisfied entirely with cash, the trust may need to distribute appreciated assets in satisfaction of the annuity payments. Generally, this would generate taxable gain to the extent that the value of the asset exceeded the grantor's basis. However, no gain is recognized because the transaction is between a grantor trust and the grantor. In addition, because the GRAT is a grantor trust, the grantor will owe income taxes with respect to the income earned by the GRAT.

In order to obtain a ruling on the GRAT, the IRS at one time insisted that the trust contain a provision that reimburses the grantor borne by the grantor for income taxes borne by the grantor with respect to income in excess of the annuity amount. There is no statutory or regulatory requirement that a reimbursement provision be included. Presumably, the IRS no longer has that requirement in light of Revenue Ruling 2004-64, 2004-27 IRB 7, which provides that the inclusion of a reimbursement clause would risk inclusion of the estate assets under §2036.

In order to achieve grantor trust status, the grantor may retain a general power of appointment if the grantor dies during the initial term and the trust may provide that the grantor would have the right to receive the greater of the income produced by the GRAT or the annuity amount. The combination of these two rights and powers should result in a wholly owned grantor trust under Sections 674 and 677. (See Private Letter Ruling 9625021.) In addition, the instrument may give the grantor a non-fiduciary power to reacquire assets from the GRAT by substituting other property of equal value to resulting grantor trust treatment under Section 675(4). (However, the IRS refuses to issue rulings as to whether the substitution power results in grantor trust treatment, under the argument that whether the power is actually held in a non-fiduciary capacity is inherently a factual issue.) Another alternative would be to provide that a non-adverse party trustee has the authority to make loans to the grantor for less than adequate interest and security. This would result in grantor trust treatment under Section 675(2) of the Internal Revenue Code.

J. Time Period for Making Annual Payments; Late Payments; Early Payments.

The statute requires that annuity payments be made annually. A technical amendment to the §2702 regulations adopted on May 4, 1994, suggested that the annuity payments did not have to be made within the trust's first taxable year. However, the regulation itself was vague on this point, and reference to the preamble was required to understand the IRS's intent. Letter rulings indicated that payments could be made annually based on the trust's anniversary date rather than having to be made in each taxable year. E.g., Ltr. Ruls. 200001013 & 200001015 (the payment of the annuity amount on the anniversary date of the trust without proration during the

first taxable year of the trust, will not affect the status of taxpayer's interest as a qualified annuity interest).

Final regulations issued effective September 5, 2000, explain that the annuity payment does not have to be based on the trust's taxable year. Rather, the annuity payment may be made annually based on the anniversary date of the trust's creation. If the payment is made based on the anniversary date, the preamble to the final regulations have an example suggesting that the annuity payment should be made each year on the day preceding the anniversary date of the trust. However, the substantive regulation (before corrected, as discussed below) merely stated that the annuity amount must be paid by the "anniversary date". Reg. §25.2702-3(b)(4).

The section 2702 regulations that were issued in 1992 provided that the annuity payment could be made after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the federal income tax return of the trust for the taxable year (without regard to extensions). (If the trust does not file a return, but is a grantor trust and meets the requirements of Regulation § 1.671-(4)(b) so that the trust income is just reported directly on the grantor's return, the payment must be made by the date the trust's return would have been due if the trust were filing a return.) Reg. §25.2702-3(b)(i)(i). A final regulation issued on September 5, 2000, provided that only annuity payments made based on the taxable year of the trust could be paid after the close of the taxable year, but by the due date of the trust income tax return. Payments based on the anniversary date of the trust had to be paid by the anniversary date. Reg. §25.2702-3(b)(4). This final regulation was corrected to state that if the payment is being made annually based on the anniversary date of the trust, the payment must be paid no later than 105 days after the anniversary date. T.D. 8899, issued November 28, 2000. The regulations do not address whether interest should be paid on any late annuity payment that is made within the allowed grace period.

If the value of assets in the GRAT appear to be temporarily high, can the trustee make an early in-kind payment to the grantor in satisfaction of that year's annuity payment? Alternatively, if the value of the trust assets have dropped substantially, to the point that there likely will be no remainder following the end of the GRAT term, can the current year's payment be made early so that the grantor could re-GRAT the asset with its depressed value into a new GRAT? (Other strategies for dealing with this issue are addressed in Part One, Section III.EE of this outline.) A regulation requires that a GRAT prohibit "commutation (prepayment) of the interest of the term holder." Treas. Reg. § 25.2702-3(d)(4). Arguably, a prepayment without commuting the payment to present value for the early payment would be permitted. [Treasury Regulation §25.2702-3(b)(1)(ii) merely requires that the annuity payment be "payable periodically, but not less frequently than annually." This does not appear to require that the payment be made at the end of the period. However, no discount can be applied because the payment is being made early, for fear that the discounted payment would be treated as a prohibited commutation. Treas. Reg. § 25.2702-3(d)(4). The trust instrument would have to permit the trustee to make a prepayment. Furthermore, the word "commute" generally carries the connotation that the interests of the respective holders are discounted to present value. For example, a Revenue Ruling takes the position that a charitable lead trust would not be a qualified trust if it permits commuting (i.e., discounting to present value and prepaying) the charitable interest. Rev. Rul. 88-27, 1988-1 C.B. 311. The ruling reasoned that "the amount of any prepayment is determined on a commuted basis at a date subsequent to the date of transfer. Under these circumstances, the interest does not represent the right to receive periodic payments over a specified period of time because the number of payments will be a function of whether, and to what extent, the trustee decides to prepay the charitable annuity. Similarly, the exact amount payable cannot be determined as of the date of the gift because the amount of each payment will be dependent on whether the trustee decides to prepay. Therefore, *A*'s transfer to charity is not a guaranteed annuity interest within the meaning of section 2522(c)(2)(B) because the charity does not have the right to receive periodic payments over a specified term and the periodic payments that the charity is entitled to receive are not determinable in amount as of the date of the gift." That reasoning would similarly suggest that there would be no problem with prepaying payments during a particular year as long as the prepayment did not change the amount of the payment that is due during that year.] However, there is assurance that early payments are allowed.

K. 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.

L. 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 section 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., Gutchess Estate v. Comm'r, 46 T.C. 554 (1966), acq. 1967-1 C.B. 2 and 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, at least as to the trust income (unless an adverse party must consent to the distributions to the spouse).

M. 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 permitting the trust value to grow at a higher rate. Rev. Rul 2003-64, 2004-27 I.R.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 One, Section V.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.)

N. 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 the GRAT assets being included in the grantor's estate under Section 2036(a)(1) if the grantor dies during the GRAT term—but the assets would likely be included in the grantor's estate anyway if the grantor dies during the GRAT term. (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 Section 2036(a)(1) if the grantor retains a life interest in the trust. In that case, the amount includible in the gross estate under Section 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 Section 2036 in Technical Advice Memorandum 200210009. Proposed Regulation §20.2036-1(c)(2) adopts that same position for GRATs, effective for decedents dying after the regulation is finalized.

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 Section 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 Section 7520 rate is 6.0% at the grantor's death, the amount includible under Section 2036 would be $200,000 (the annual annuity amount)/0.06, or $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 Section 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 Section 2036 if the grantor dies during the GRAT term, the IRS previously maintained that Section 2039 would cause all of the trust assets to be included in the grantor's estate. E.g., Technical Advice Memorandum 200210009. Proposed regulation §20.2036-1(c)(2)(ii)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 Section 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.

O. 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. Comm'r, 115 T.C. 589, acq. 2003-44 IRB 964 (2000) (approving 2-year GRAT); Kerr v. Comm'r, 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. Using them would be unnecessary for healthy and younger donors, where the probability of death within the GRAT term is small.

P. Two-Year Rolling "GRATs".

Some planners have suggested using a series of "rolling" two-year GRATS. For example, the Grantor could create a two-year GRAT. Annuity payments within the two-year period would be repaid to the Grantor equal to most of the value contributed to the GRAT. Any appreciation in the assets over the §7520 rate would remain in the GRAT at the end of the two-year term. At the end of each year, the Grantor could contribute any annuity payments that had been made to him during that year into a new two-year GRAT. Therefore, all of the funds would constantly be in a GRAT. The primary advantage to this approach is that the risk of the Grantor dying early would be greatly minimized. Only the appreciation above the §7520 rate in the last two-year GRAT in existence would be brought back into the Grantor's estate. The appreciation build up in the GRATs that had terminated would be removed from the Grantor's estate. A second advantage of using a short-term GRAT is to minimize the possibility that a year of poor yield (or even losses) would require that high yields in other years be returned to the grantor in annuity payments. If a series of short-term GRATs were used, the high yields would be trapped in the GRAT to pass to the remaindermen, and in low-yield years the grantor would not be able to receive back the full annuity payment from the trust. One disadvantage of this approach is that future legislation may disallow the use of GRATs. In that case, the Grantor would have given up the benefit of a long-term GRAT. In addition, in low interest periods, using a short-term GRAT carries a risk that the section 7520 rate will increase significantly before the assets can be "re-GRATed".

If the primary advantage of using a GRAT in a particular situation is to get the benefit of transferring the asset with a valuation discount without producing a gift or a taxable sale, using a short-term GRAT allows taking advantage of the valuation discount while minimizing the actuarial risk of dying during the term of the GRAT.

The IRS has expressed some reluctance to approve short-term GRATs (with no apparent technical reason for doing so). For example, the IRS reportedly has refused to give favorable rulings for a two-year GRAT and for a four-year GRAT. Letter Ruling 9707001 recognized the validity of a 5-year GRAT. The Tax Court, in a unanimous opinion, approved a 2-year GRAT in

Walton v. Comm'r, 115 T.C. 15 (2000). A 367 day GRAT was used in Kerr v. Commissioner, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002), and the IRS never contested the validity of the GRAT.

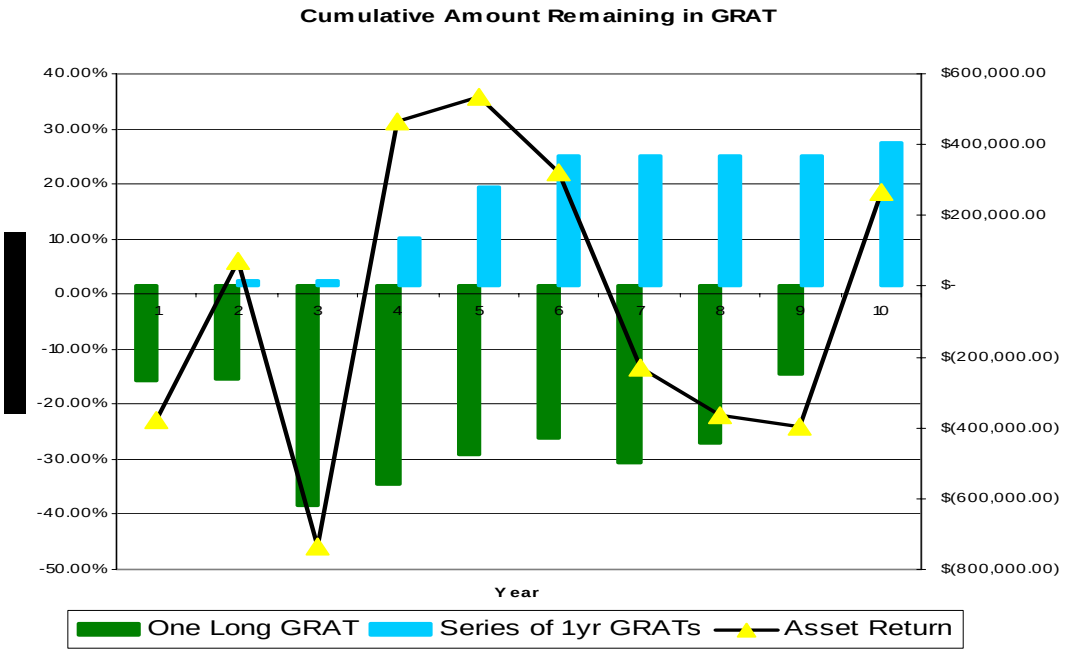
Q. Short Term Vs. Long Term GRATS Taking Volatility Into Consideration.

Should a GRAT be structured to last for a long term (say 10 years) in order to lock in the very low current rates for the long term because interest rates may rise in the future? On the one hand, locking in an extremely low "hurdle rate" over a long period of time would be advantageous, particularly if interest rates rise to the 7%-8% range of just three years ago. On the other hand, losses in one (or several) years of a long-term GRAT could "wipe out" the gains in other years of the GRAT. If a series of short term GRATs are used, losses in one year would not offset the gains in other years. Furthermore, there is the added actuarial risk of the grantor's dying before the end of a long term GRAT, which might result in all appreciation in the GRAT assets being included in the grantor's estate for estate tax purposes. Which of these factors is more important? **The answer is not intuitively obvious**.

The benefits of a long-term structure are twofold. First, with this Section 7520 "hurdle rate" so low, it is possible to lock in a very low threshold over time. Secondly, with the long-term GRAT structured so that the payments to the grantor are back ended (i.e., so that the annual annuity payments increase by 20% per year), there is a significant benefit from the compounding returns within the GRAT. Because relatively low payments are made in the early years, the appreciating asset can stay in the GRAT longer, and the GRAT is "getting appreciation on the appreciation." In fact, the "gut feel" of many estate planning professionals would be that this long-term structure is optimal—particularly at a time when the Section 7520 rate is so low.

That said, a series of 1-year GRATs (if that were permissible) would have the benefit of capturing interim volatility. Stated differently, gains in one year would not be offset by losses or "break even" performance in another year. The question is which of these two factors has a more profound economic effect?

With the steady increase in computing power, it is now possible to simulate the behavior of assets over time, taking into account the volatility of the assets. Using a technique known as a "Monte-Carlo" simulation whereby the computer generates thousands of random trials, it is possible to get a probabilistic sense of different portfolio strategies. A Monte Carlo simulation is a statistical technique that runs a large number of simulations (10,000 in this analysis). The following analysis compares a single ten-year GRAT versus a series of ten one-year GRATs. One simulation follows:

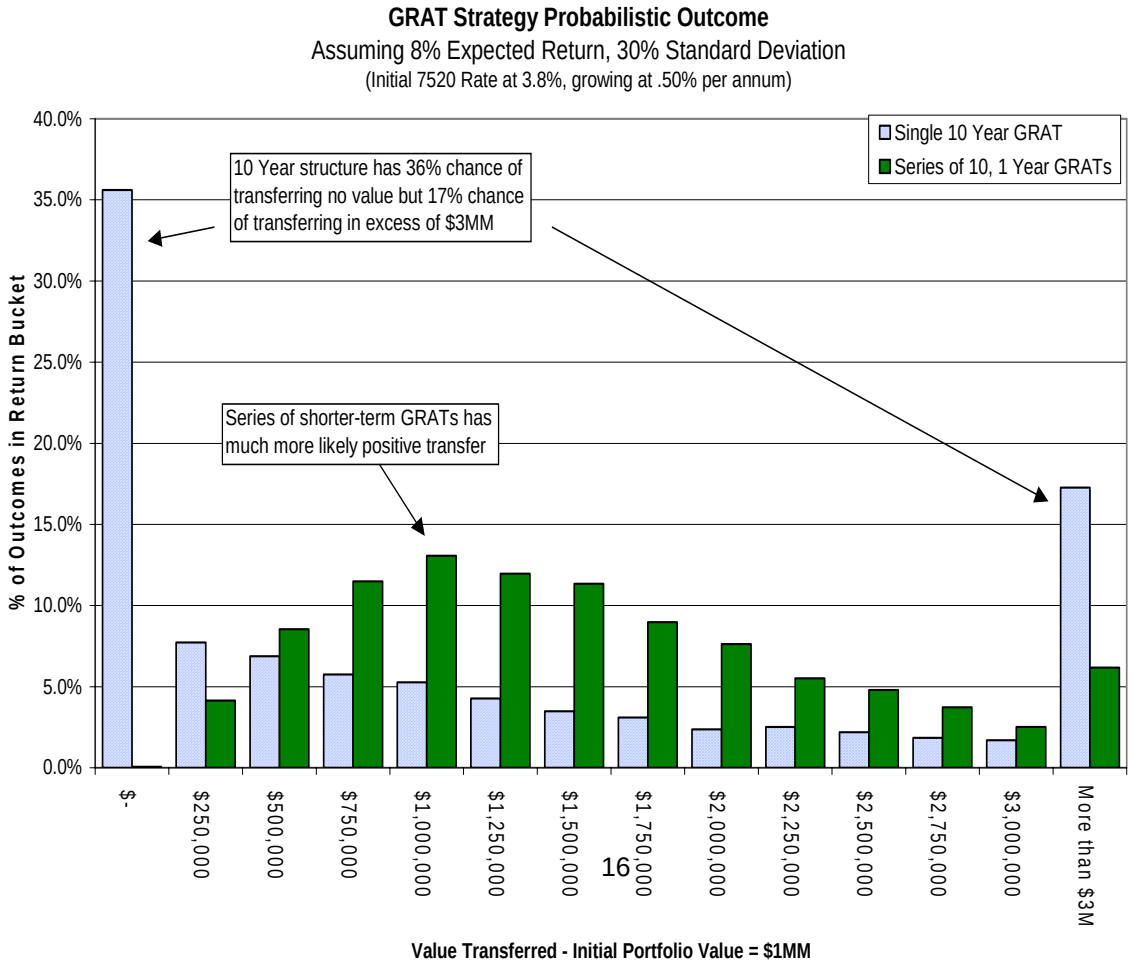


The analysis compares a 10-year GRAT to a series of one-year GRATS. (Many planners are reluctant to use one-year GRATs, and use a minimum of two-years. But see Kerr v. Comm'r, 113 T.C. 449 (1999) (GRAT lasted one year and one day; IRS did not contest validity of GRAT because of the short term). Furthermore, even with two-year GRATs, a loss in year one of a two-year GRAT can be isolated if the grantor purchases the asset from the initial two-year GRAT for cash, and contributes the asset to a new two-year GRAT along with the first year's distribution. At the end of the initial two-year period, the initial GRAT would distribute its cash to the grantor, and any appreciation in year two in the asset that is transferred to the new GRAT would hopefully result in assets remaining at the end of the new two-year GRAT.)

This simulation is part of a Monte Carlo analysis addressing a transfer to a "zeroed-out" GRAT of an asset that is initially worth $1.0 million and that has an expected return of 8% per year with a standard deviation of 30%, which is typical of individual stocks. To further handicap the results, the analysis assumes that the Section 7520 rate begins at 3.8% but increases each year by .5% thus ending the 10 year period at 8.8%. The simulation randomly runs 10,000 scenarios, using a random generator in each scenario based on the anticipated long-term expected return of 8% per year, but with a standard deviation in each year of 30%.

In this individual simulation, in Year 1 the asset return is –23%. In this particular simulation, the ten-year GRAT never regains the original loss and transfers no value. However, since there are indeed a few positive years during the full period, the series of short-term GRATs transfers roughly $400,000.

The next illustration reflects the full simulation results of comparing a single ten-year GRAT to a series of ten one-year GRATs. (The single ten-year GRAT starts with a first year annuity of 4.96%, which rises by 20% per year; the tenth year annuity is 25.61%.)



The results are surprising. In fact, the ten-year GRAT structure has a 17% chance of transferring more than $3MM from an initial contribution of $1MM. However, this same ten-year structure has a **36% chance of transferring nothing** and a 48% chance of transferring $500,000 or less.

On the other hand, the series of one-year GRATs has a very low chance of both extreme outcomes. In fact, it has a very high probability of transferring $500,000 to $2,000,000 to the next generation. Very similar to the arcade at the county fair, there are only a few men strong enough to ring the bell. Yet the average contestant willing to swing the sledgehammer ten times would win – even if they hadn't "rung the bell."

In conclusion, while this analysis is relatively straightforward in nature, the result really indicates that the significance of interim asset volatility (such as marketable securities) can easily overwhelm the impact of the Section 7520 rate. Furthermore, the choice to use short term GRATs becomes even more compelling if the added actuarial risk of the grantor's dying during the term of the GRAT is considered. That said, for very high-return assets, long-term GRAT structures do indeed provide an opportunity to truly "ring the bell." (Both factors that favor long term GRATs would contribute to this result. A very low Section 7520 rate is locked in for the entire term. Also, very low annuity payments are made in the early years, so that the highly appreciating asset remains longer in the GRAT, thus magnifying the compounding effect of "appreciation on appreciation" in the GRAT.) A long-term GRAT structure may also be helpful if using the longer term allows the anticipated cash flow from the asset to make the annuity payments without requiring that any of the appreciating asset be returned to the grantor in annuity payments. This can be facilitated by transferring cash or fixed income assets to the GRAT in addition to assets with high appreciation potential. See Paragraph GG below. Discounting arbitrage may be maximized with long term GRATs, by contributing a discounted interest in an entity, and making annuity payments with cash flow from the entity. Long term GRATs may be needed to reduce the annuity payments to an amount that can be serviced from cash flow. Long term GRATs also permit locking in the strategy against tax law changes.

R. <u>Use Revised Spendthrift Clause</u>.

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 section 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."

S. <u>Funding GRAT with S Stock or Interest in Partnership</u>.

1. <u>Particular Advantage</u>.

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(e)(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 section 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. Rul. 9248016 (GRAT with §675(4)(c) retention of power to substitute assets can qualify as S corporation shareholder); Ltr. Rul. 9037011.

T. Effect of Insider Trading Restrictions.

Section 16(b) of the Securities Exchange Act of 1934 permits recovery to a corporate issuer of insider trading profits made within a 6-month period. 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 section 16(b) purposes under that No-Action Letter. Peter J. Knight, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶77,403 (October 16, 1997). However, in Dreiling v. Jain, 2003 WL 22128787 (W.D. Was. 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, Implementing Bright Ideas, 38th ANNUAL HECKERLING INST. ON EST. PL. at 8 (2003).

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, the substitution constitutes a "purchase" for section 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.

U. Using Fiscal Year.

Generally, trusts must use a calendar year. However, Rev. Rul. 90-55 appears to permit a grantor trust to adopt a fiscal year. Private letter rulings have authorized GRATs to use a fiscal year. Using a fiscal year could permit the annuity payment to be payable on the last day of the taxable year of the GRAT if the GRAT is created on the first day of a month. (The fiscal year must end on the last day of a month and cannot exceed 12 months.) Unfortunately, using the first day of a month may not be desirable if the planner knows that the section 7520 rate will be increasing the next month. Using a fiscal year is no longer critical in light the clarification specifying that the first annuity payment need not be prorated but can be paid entirely in the second taxable year of the trust. See Part One, Section III.J. of this outline.

V. 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. PLRs 9415012, 9416009, 9353004, and 9353007.

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 section 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 section 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 Section 2036(a). See Ltr. Ruls. 200120021; 199922062; 199919039; 9710006; 9709001; 9413045. However, the IRS changed its position in Revenue Ruling 2004-64, 2004-27 IRB 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 Trusts's assets" at the grantor's death to be included in the grantor's gross estate under section 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.) 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 rust created before October 4, 2004.

W. Tax Reporting.

1. Income Tax.

The GRAT, as a grantor trust, either must file a Form 1041, or follow the alternate reporting procedures described in Treas. Reg. §1.671-4(b)(2).

If the trust files a Form 1041, the form is left blank, and a statement is attached indicating the income and deduction information that has been communicated to the grantor for inclusion on the grantor's Form 1040. The grantor trust box on the Form 1041 should be checked.

In some circumstances, no Form 1041 need be filed (and the trustee of the GRAT does not need to obtain a taxpayer identification number). Under Regulation § 1.671-4(b), if the trust (1) is a grantor trust, all of which is treated as owned by one grantor or one other person (2) if the grantor or other person who is treated as the owner of the trust provides to the trustee a complete Form W-9, and if (3) the trustee gives the grantor's (or other person's) name and taxpayer identification number to all payors to the trust during the taxable year, the trust need not file a Form 1041, and the items of income will be reported directly to the grantor. Reg. §1.671-4(b)(1), 4(b)(2)(i), and 4(b)(2)(ii)(B). Furthermore, if the grantor is also the trustee or co-trustee, the trust is not required to give a reporting information statement to the grantor. Reg. § 1.671-4(b)(2)(ii). If the conditions described above are satisfied, the grantor trust does not need to obtain a taxpayer identification number until either the first taxable year of the trust in which all of the trust is no longer owned by the grantor or another person, or until the first taxable year of the trust for which the trustee no longer reports pursuant to Regulation § 1.671-4(b)(2)(i)(A). Reg. § 301.6109-1(a)(2)(i).

2. Gift Tax.

The gift tax return of the grantor for the year of contribution should report the remainder interest as actuarially determined. (Keep in mind that the interest is not a present interest and does not qualify for the annual exclusion.) A statement must be filed with the return listing the information described in Treas. Reg. §301.6501(c)-1(e)(2). In addition, the manner in which the remainder interest is calculated should be described.

X. Joint Purchase with Client Purchasing Qualified Annuity Interest.

Section 2702 generally removes the estate and gift tax advantages of joint purchase transactions. The purchaser of the term interest is treated as initially purchasing the entire property and then transferring the remainder interest while retaining the income interest. The retained income interest is valued at zero because it is not a qualified annuity or unitrust interest.

If the retained interest is a qualified annuity (or unitrust) interest, it would seem that the actuarial value of the qualified interest could be subtracted in determining the amount of the gift made by reason of the deemed transfer of the remainder interest. See Treas. Reg. §25.2702-4(d), Ex.1 (retained interest in a joint purchase transaction is valued at zero "because it is not a qualified interest"). This raises the possibility of a joint purchase transaction in which the client would purchase a qualified annuity (or unitrust) interest payable from the acquired property. See Blattmachr & Painter, When Should Planners Consider Using Split Interest Transfers?, 21 EST. PL. 20 (1994); Practical Drafting 2482 (Covey ed. 1991). The joint purchase approach would have an advantage as compared to a grantor contributing property to a GRAT, because with a GRAT the grantor must survive the term of the annuity interest to avoid having the trust assets (or most of the trust assets—see Part One, Section IV.B.1.b. of this outline) included in the grantor's estate. Under the joint purchase approach, the value paid by the grantor for the qualified annuity interest would be excluded from the gross estate, assuming the payment equaled the actuarial value of the retained annuity interest, regardless of whether the grantor survived the term of the annuity interest. (Indeed, an annuity for the grantor's life could be used.)

Several rulings have cast doubt on the ability to use this technique, suggesting that the parent (who contributes an amount equal to the present value of the retained qualified annuity interest) would receive inadequate consideration, citing the reasoning of Estate of Gradow, 11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990). Letter Rulings 9515039, 9412036. However, a variety of recent cases have recognized sales of remainder interests, and have held that "adequate and full consideration" need only equal the value of the remainder interest transferred

by the decedent. E.g., Estate of Magnin, 184 F.3d 1074 (9th Cir. 1999); D'Ambrosio, 101 F.3d 309 (3rd Cir. 1996); Wheeler, 116 F.3d 749 (5th Cir. 1997). See generally Jensen, Estate and Gift Tax Effects of Selling a Remainder: Have D'Ambrosio, Wheeler and Magnin Changed the Rules?, 4 Fla. Tax Review 537 (1999); Pennell, Cases Addressing Sale of Remainder Wrongly Decided, 22 EST. PL.. 305 (Sept/Oct 1995).

Even if the rationale of the Gradow and Pittman (95-1 U.S.T.C. ¶60,186 (E.D. N.C. 1994)) cases do not apply, if the grantor dies during the term of the retained annuity interest, the IRS may attempt to apply the pre-Chapter 14 cases involving private annuity transactions with trusts. Some of those cases suggest that the transferor will be treated as making a transfer with a retained life estate under section 2036(a)(1) if the trust consists of little more than the transferred property and if the annuity payments approximate the amount of anticipated trust income. E.g., Ray v. Comm'r, 762 F.2d 1361, 1364 (9th Cir. 1985); Ltr. Rul. 9515039; but see Fabric Estate v. Comm'r, 83 T.C. 932 (1984).

Y. Lifetime GRAT with Trust Purchasing Remainder Interest.

The trend of recent cases supporting the sale of remainder interests under pre-§2702 facts suggests the possibility of using a GRAT that would last for the lifetime of the grantor, with the remainder passing to the grantor's estate. The annuity payments would be based on the grantor's life expectancy (which would result in much lower payments than the annuity payments under more typical 2-5 year GRATs). An entity for the benefit of lower generations (i.e., an irrevocable trust or partnership) would purchase the remainder interest from the grantor at the time the GRAT is created. Even though section 2702 applies to sales of remainder interests, here the retained interest is a qualified interest under section 2702, so it should not be valued at zero. Example 5 should not apply, because a life estate by definition takes mortality into account. (Example 5 is no longer important if the GRAT is structured as a Walton GRAT. See Part One, Section III.G.2. of this outline.)

The section 7520 regulations state that the annuity tables can be used where an annuity is paid from a trust only if there are sufficient trust assets to fund the annuity payments assuming the annuitant lives to age 110. An alternate valuation approach is provided in the section 7520 regulations, which would end up leaving some substantial value in the remainder interest.

If the annuity is set at an amount that does not exceed the section 7520 rate, the annuity could not possibly exhaust the fund (because the tables assume that the asset produces income each year equal to that amount). Accordingly, Reg. 25.7520-3(b)(2) says that "the corpus is assumed to be sufficient to make all payments" in that situation. However, using the section 7520 rate as the annuity amount will not "zero out" the remainder interest. For a 60 year old individual transferring $1.0 million, if the section 7520 rate is 8.0% and a $80,000 annuity is used, the value of the remainder interest is $267,944.

The regulations provide that the highest that the annuity rate can be set without having to adjust the value of the remainder interest under 25.7520-3(b)(2) is the annuity rate that would apply for a fixed number of years equal to 110 minus the person's age. Therefore, for a 60 year old donor, the fixed term of years would be 110 - 60, or 50 years. The annuity rate at an 8% section 7520 rate for a 50-year term is 8.174% (i.e., an annuity of 81,740 for 50 years would have a present value of $1.0 million). However, if an annuity rate of 8.174% is used for a 60 year old, the present value of the annuity is only 74.80%, and the remainder interest value is 25.20%. Therefore, a $252,022 gift would result from using the highest annuity possible without requiring an adjusted value under the last sentence of 25.7520-3(b)(2).

If the payout rate were increased to 10% (or $100,000 per year), the calculation is adjusted to determine the present value of the payment stream that could be made if the trust assets had an 8% return. The trust would produce payments of $100,000 per year for 20 years (having a present value of $851,580) and a payment of $91,545 in the 21st year, which would exhaust the trust (having a present value of $9,694). The present value of the payment stream would be $851,580 plus 9,694, or $861,274.

Therefore, this approach needs children (or another entity for the grantor's children or more remote descendants) who have sufficient wealth to buy the remainder interest at a significant value.

Consider having the children give a note for the remainder interest. (If an irrevocable trust or other entity is purchasing the remainder interest for a note, the entity should have a net equity value of at least about 10% of the amount of the note.) Under this approach, the children would be paying the grantor directly for the remainder interest, so a taxable sale could result as to that transfer (unless the remainder interest is purchased by a grantor trust). (If the children contribute the value of the remainder interest to the GRAT directly, there would be multiple grantors to the GRAT, so it would no longer be a wholly grantor trust, and satisfaction of the annuity payments could result in taxable transfers.)

If an existing trust does not already have sufficient assets to justify the purchase of the remainder interest for a note, the parent could fund a trust with assets, which the trust could then use as the "seed equity interest" to justify the purchase for a note. However, the IRS has previously taken the position that the purchaser of a remainder interest should not have acquired the funds to buy the interest from the holder of the life estate. See Tech. Adv. Memo. 9206006. One commentator suggests that "some lapse of time between the gift and the purchase (e.g., six months) is thus advisable to 'cleanse' the gift." Handler & Dunn, "Guaranteed GRATs": GRATs Without Mortality Risk, TR. &. EST. 30 (Dec. 1999) (article discusses creating a GRAT for the shorter of a term of years or death of the grantor, with a subsequent sale of the contingent reversionary interest).

This approach has substantial advantages over a typical GRAT in an appropriate fact scenario: (1) there would no longer be a mortality risk, (2) the economics are still good for a highly appreciating asset, (3) the transaction can be accomplished without a large gift.

Z. Private Annuities, Installment Sales, Self-Canceling Installment Notes.

The use of private annuities, installment sales, and self-canceling installment notes all appear to be unaffected by Chapter 14. The Joint Committee on Taxation Staff Description (JSC-13-90) of the Federal Transfer Tax Consequences of Estate Freezes (that was issued with the initial discussion draft of Chapter14) states (on page 30) that "the discussion draft generally does not apply to an installment note or private annuity for which an individual is the obligor." See Practical Drafting 2481 (private annuity comparison to GRAT), 2579 (self-canceling installment note), 2796 (private annuities and installment sales) (R. Covey ed. 1991-1992).

A GRAT is typically preferable to a private annuity, because the private annuity creates additional net income to the family under the annuity income tax rules of section 72. See Rye v. U.S., 92-1 U.S.T.C. ¶50,186 (Ct. Cl. 1992) (no part of private annuity payments can be deducted as interest on indebtedness pursuant to section 163). However, a private annuity has the advantage over a GRAT of removing the transferred property out of the estate without having to survive a specified term. For an excellent summary of the uses of private annuities and self-canceling notes in light of section 2702, see Leimberg, Kurlowicz & Doyle, GRATs, GRUTs, and GRITs After the Final Regulations - Part II, J. AMER. SOCY CLU & ChFC 74 (March 1993); Massey & Englebrecht, Self-Canceling Installment Notes and Private Annuities: An Analysis, 72 TAXES 27 (1994).

AA. Purchase of Remainder Interest Prior to End of Trust Term.

A GRAT and a qualified personal residence trust must prohibit commutation (or prepayment) of the interest of the term holder. Treas. Reg. §25.2702-3(d)(4) (GRAT and GRUT), 25.2702-5(c)(6) (qualified personal residence trust). Query whether a purchase by the term holder of the remainder interest prior to the end of the trust term will be recognized for estate tax purposes. For example, prior to the end of the retained term interest, the transferor might pay cash for the actuarial value of the remainder interest (which would be equal to almost the entire value of the trust.) The total value of the trust property would then be included in the transferor's estate, but the cash that was used to purchase the remainder interest would not be includible in the gross estate under section 2033. However, the unified credit that was used when the trust was

created will probably not be restored even though the assets are includible in the gross estate. See Practical Drafting 2577 (R. Covey ed. 1991). Query whether the IRS might attempt to apply any of the "string statutes" to bring the dollars paid as consideration back into the estate. There are no regulations or cases addressing the effect of this planning alternative, and it should be considered an aggressive planning technique. However, particularly if the transferor discovers that he or she has a terminal illness and is not expected to survive the end of the trust term, this alternative might be considered.

An analogous strategy is the purchase of a remainder interest in a QTIP by the surviving spouse. The IRS gave its response to this plan in Revenue Ruling 98-8, 1998-1 C.B. 541 by concluding that the spouse makes a taxable gift when the remainder interest is purchased. Revenue Ruling 98-8 takes the position that the gift occurs under section 2519, which treats a spouse as making a gift of the remainder interest in QTIP property if she disposes of any part of the qualifying income interest. The ruling examines the legislative history and concludes that the term "dispositions" includes sales or commutations of a surviving spouse's qualifying income interest. The ruling concludes that the purchase by the surviving spouse of the remainder interest is a sale or commutation of her income interest, which in turn constitutes a "disposition" of her qualifying income interest. Accordingly, the ruling concludes that a gift will result equal to the greater of (1) the value of the remainder interest, or (2) the value of the property or cash transferred to the holder of the remainder interest. The IRS's rationale for concluding that the amount of the gift may depend on the value of the remainder interest is difficult to understand. Where the spouse acquires the entire remainder interest, it would seem that the amount of the gift would be equal to the amount of the note. The value of the remainder interest would seem to have nothing to do with determining the amount of the gift. The government's position in Rev. Rul. 98-8 does not negate a gift by the remainder beneficiaries who consent to having a QTIP terminate and pass to the surviving spouse. Ltr. Rul. 199908033. A Tax Court case where there was a purchase of a remainder interest in a marital trust was resolved by a stipulated decision on May 22, 2002. Blumberg Family Investment Partnership L.P., Transferee, et al. v. Comm'r, Tax Ct. No. 000694-02, 000693-02, 000692-02, 000690-02.

BB. Sale of Remainder Interest to Dynasty Trust.

GST exemption cannot be allocated to a GRAT until the end of the GRAT term. One possible planning strategy is to have the remaindermen under a GRAT sell their remainder interest (assuming the GRAT does not have a spendthrift clause that prohibits such transfers) to younger generations or to a GST-exempt trust. See generally Handler & Oshins, The GRAT Remainder Sale, TR. & EST. 33 (Dec. 2002). If the sale is made soon after the GRAT is created and before there has been any substantial appreciation in the GRAT assets, the remainder interest should have a low value. A concern is that the IRS may argue substance over form and recast the series of transfers as the creation of a GST-exempt GRAT (which is not permitted). The subsequent sale transaction by the GRAT remaindermen should be independent of the initial creation of the GRAT. (For this purpose, it would be best if the GST-exempt trust that purchases the remainder interest is created far in advance of the creation of the GRAT.) Observe that if the remaindermen of the GRAT and the GST-exempt trust that purchases the remainder interest are both grantor trusts for income tax purposes, there should not be any gain recognized as a result of the sale transaction.

Under a strict reading of the Code, the IRS might argue that a taxable termination occurs under §2612(a) upon the distribution of the GRAT remainder to the GST-exempt trust at the end of the GRAT term. Section 2611(a) provides that a "taxable termination" occurs upon the termination of an interest in property held in trust unless immediately after the termination a non-skip person has an interest in the property or no distribution may ever be made to a skip person. If the GST-exempt trust is a skip person (i.e., there are no beneficiaries in the first generation below the transferor), a taxable termination may occur upon the termination of the GRAT because the settlor's interest in the property terminates, and the property is distributed to a skip person from a trust (the GRAT) with an inclusion ratio of one. Under this strict reading of the statute, the result is not changed by the fact that the GRAT remainder interest has been purchased by a GST-exempt trust. See Handler & Oshins, The GRAT Remainder Sale, TR. & EST. 33 (December 2002). A planning feature may be to have the children as potential beneficiaries of the GST

exempt trust, so that it is not a skip person when the grantor's retained annuity interest terminates. Another way to avoid the argument is to have the grantor purchase the remainder interest from the GST-exempt trust before the end of the GRAT term. The consideration given for the remainder interest would be an asset of the GST-exempt trust. Id.

The IRS has informally indicated its position that it will treat the sale of the remainder interest as a contribution to the trust by the seller so that the trust has two grantors for GST purposes. The portion owned by the seller of the remainder interest is just the small amount paid for the remainder interest. The original grantor is deemed to be the grantor of the balance of the trust (which is almost all of the trust) for GST purposes. Ltr. Rul. 200107015; Cf. Treas. Reg. §26.2652-1(a)(1) Example 4 (trust is created for child for life with remainder to grandchild; a transfer by child of his or her income interest will not change the transferor, and parent is still treated as the transferor "with respect to the trust" for GST purposes).

The IRS's approach is to consider the original donor who created the GRAT as a transferor along with the children who assigned their remainder interests to the grandchildren or to a dynasty trust. Ellen Harrison points out this argument is analogous to the one the IRS lost in D'Ambrosio v. Comm'r, 101 F.3d 309 (3d Cir. 1996) and Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997). In those cases, the IRS argued that "full and adequate consideration" for the sale of a remainder interest was much more than the actuarial value of the remainder interest. The courts disagreed. Similarly, the gift of a remainder interest by the donor's children should not be treated as something other than a gift solely by the children. See Harrison, Ten Best Ideas I Am Willing To Share, 2002 ACTEC Annual Meeting, at S2-7-EKH (2002).

An additional twist on this planning strategy is that the children (or preferably a trust that is the remainderman of the GRAT) might buy back the remainder interest from the GST exempt trust before the end of the GRAT term. This strategy gets additional CASH to the GST trust (the difference between the amount paid by the grantor in the repurchase and the amount received by the grantor in the sale of the remainder interest soon after the GRAT is created.) At the end of the GRAT term (i.e., at end of the ETIP), nothing is passing to grandchildren—children own the remainder interest, so there is no GST effect at that time.

CC. Reciprocal GRATs.

GRATs could be designed based on the provision in the regulations for revocable spousal annuities in Regulation §25.2702-2(d)(1) Ex. 7. In that example, A retained an annuity for 10 years, and, upon the expiration of 10 years, A's spouse receives an annuity for 10 years if living. The example indicated that A's interest and the interest of A's spouse could be subtracted in determining the value of the gift to the GRAT.

Reciprocal GRATs by spouses would be designed as follows. H would create a GRAT, retaining an annuity interest for 2 years, followed by a revocable annuity interest of W for the earliest of 30 years or W's death. W would create a similar GRAT, with a revocable annuity for H. If H and W both were to die during the initial 2-year term, nothing would be transferred to family members. If H and W were both to survive the entire 32-year term, both GRATs would be removed from their estates. The more likely occurrence is that at least one of the grantors would survive at least two years, but one of them would fail to survive the entire 32-year term. In that event, the GRAT created by the surviving spouse would be removed from the estate for estate tax purposes. For example, If H died during the initial 2-year term, his GRAT would terminate and be distributed to his estate (to be paid to W in a manner that would qualify for the marital deduction), but W's GRAT would continue. If she survived the full 2-year term, her GRAT would then pass to her children—because H was not living to receive his revocable annuity. Assume that H lives the full initial 2-year term, but dies in year 3. H's GRAT is still included in H's estate because of his power of revocation over the annuity interest. His will would revoke the spousal annuity interest, and the remaining trust assets would pass to a marital trust for W (or pass outright to W.) However, W's GRAT would terminate at that time, because H is no longer living and his spousal annuity interest in W's GRAT would terminate at this death. The remaining assets in W's GRAT would pass to the trust remaindermen without further estate or gift taxation. (Perhaps the assets would pass to a trust that is a grantor trust as to W.)

The overall effect of the transaction is that (1) the GRAT annuity payments could be set at a low amount because of the long payment period, (2) the spouses would be assured of receiving the annuity as to at least one of the trusts for the extended term of the GRAT (or receiving the assets of one of the two trusts if one spouse dies before the extended terms of the trusts), and (3) the strong actuarial likelihood is that one-half of the assets contributed to the GRATs would pass free of estate taxes. For an excellent summary of this technique, see Baird, A Potpourri of Leveraged Transfers Using Defective Grantor Trusts, ALI-ABA Estate Planning for the Family Business Owner, at 888-892 (August 2000).

DD. 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.

EE. 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.

FF. Use of Options or Derivatives With GRATs.

Using derivatives with GRATs may be advantageous in a variety of possible planning alternatives.

For example, the parent-grantor might purchase an option from the trust to purchase the GRAT assets at an appreciated price. Assume parent transfers a publicly traded stock having a current

value of $10 per share to a GRAT. Parent might purchase a two-year option from the GRAT to purchase the stock, with a strike price of $12.5 (which is 25% higher than the current value). Depending on the volatility of the stock, the two-year option under a Black Scholes approach might have a value of about $3.29 per share. Accordingly, parent would pay the GRAT $3.29 per share to purchase the option.

The economic effect of this arrangement is as follows. If the stock increases in value above 25 percent during the two-year term of the option, the parent would get the benefit of all increase in value above 25 percent and the GRAT would have a 25% return over two years, plus the 32.9% amount paid to the trust for the option; therefore there would be substantial value to pass to the GRAT remainder beneficiaries. If the stock does not increase in value but remains constant in value, the option would not be exercised, the GRAT would keep the $10/ share stock, and would have the $3.29 per share that parent paid to the GRAT for the option. Thus, the GRAT would have $13.29 (reflecting a 32.9% return). Therefore, substantial value would remain at the termination of the GRAT to pass to the GRAT remainder beneficiaries. The GRAT would fail only if the $10 / share stock fell in value substantially, to more than offset the $3.29 / share that parent paid to the GRAT for the option. Thus, the effect is that the GRAT would trade away some upside potential (i.e., above 25% in the example described above) in order to assure (almost) that there would be some value to pass to the GRAT remainder beneficiaries at the termination of the GRAT. See discussion by Carlyn McCaffrey at Question and Answer Session of the Thirty-Seventh Annual Institute on Estate Planning, 37TH ANNUAL HECKERLING INST. ON EST. PL. ¶ 1007.3 (2003). Furthermore, if the grantor wants to transfer the upside potential in the purchased option, the grantor could contribute the option to a new GRAT.

The appreciation above the option strike price can also pass to the next generation if the call option that is purchased by the grantor or grantor's spouse is transferred to a 2nd GRAT. Be careful that the two GRATs have differences so that the reciprocal trust doctrine does not apply. A business purpose for this arrangement is that the amount of the appreciation that will inure to GRAT 1 could be capped so that GRAT 1 would not exceed the grantor's remaining GST exemption at the termination of the GRAT.

The safest way to do these techniques often involves using the grantor's spouse. A potential problem with having the donor buy the option is that implicit in the pricing of a call option is that the seller of the option owns the beginning value of stock—and will receive that initial value. But an argument can be made for a GRAT that the donor already owns the implicit value of the stock through the retained annuity payments. So it may be preferable for the GRAT to sell the option to the grantor's spouse and not to the grantor. There is an income tax advantage to the GRAT selling the option to the grantor's spouse rather than to a third party. Under §1041, sales between spouses are income tax free, and similarly sales between a grantor trust and the other spouse are also tax-free. PLRs 8644012 & 200120007.

An advantage of using intra-family options is that all of the economics with the options stay in the family and do not pass to a brokerage firm who sold the option.

Another example strategy would be to acquire a call option that would have the effect of doubling any gain in the underlying stock value up to 20%, but would give up any gain in excess of 20% of the underlying stock value. This could be helpful with a stock position that the planner expects may have modest gains over the GRAT term. For example, the GRAT could enter into a "1 x 2 call spread." See Goldsbury, Increasing a GRAT's Effectiveness With Derivatives, 30 EST. PL. (June 2003). Assume that a GRAT owns 100 shares of a single publicly traded stock that currently trades at $100 per share. (1) The GRAT would purchase a call option on 100 shares of the stock with a strike price of $100 per share (giving the GRAT the right to any future appreciation on 100 shares). Therefore, if the stock increases in value, the GRAT would receive the increased value on the 100 shares that it owns directly and in the 100 shares subject to the purchased call. (2) The GRAT would also sell call options on 200 shares with a strike price of $120. (This assumes that the cost of the purchased call option on 100 shares equals the sale proceeds on the sold call option for 200 shares. The number of shares for the purchased call option [or the exercise price on the sold call options] would be adjusted so that the cost of the purchased call options equals the amount that would be received for the sold call options, thus

resulting in no net cost outlay by the GRAT.) If the stock price increases above $120 per share, the purchaser of the option would exercise the option. The GRAT would have to pay the excess value above $120 per share on 200 shares—which would be funded by the excess value above $120 per share in the 100 shares owned directly by the GRAT and by the value in the purchased call option for $100 shares. Therefore, if the stock increases in value above $120 per share, the GRAT would keep all of the appreciation up to $120 per share on the 100 shares that it owns directly and in the 100 shares under the purchased call option. The excess value above $120 in the 100 shares directly owned and in the 100 shares under the purchase call option would be given up. (3) The net effect is that the GRAT receives double the return on appreciation between $100 and $120 per share and gives up all appreciation above $120 per share. This increases the likelihood of a successful GRAT that has assets remaining at termination to pass to younger generations—but at the cost of giving up returns in excess of 20% over the GRAT term.

GG. 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.

HH. Using Life Expectancy Term for GRAT in Special Situations.

Carlyn McCaffrey suggests that if the client or client's spouse has a short life expectancy (but not so short that the tables cannot be used) consider using the "shortened" life to measure the gift. McCaffrey, "The Care and Feeding of GRATs—Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring," 39th ANNUAL HECKERLING INST. ON EST. PL, ch. 6 (2005).

If the grantor's spouse has a short life expectancy, use the spouse's life expectancy and give the spouse a revocable spousal annuity. (Design it to satisfy the Schott regulation, as discussed in Part One, Section III.G.3 of this outline.) The grantor can revoke the spousal annuity at any time, so there is an incomplete gift to the extent of the actuarial value of the spousal annuity, leaving a small value for the value of the remainder interest. If spouse dies "early," the value of the remainder interest will actually be much higher than the low calculated actuarial value of the gift when the GRAT was created.

If the grantor has a short life expectancy, use the grantor's life. Normally there would be estate inclusion under §2036 at the grantor's death. However, the grantor would create a GRAT in which she retained an annuity for life and simultaneously sold the remainder interest for its full actuarial value. (The Magnin, Wheeler, and D'Ambrosio cases would respect the sale of remainder interest as being within the transfer for full consideration exception in §2036. See Part One, Section III.BB of this outline.)

II. 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 dollars that the grantor paid for the remainder interest to the remainder beneficiary trust are 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.

JJ. <u>Extend Substitution Power Past Stated Termination Date</u>. It may be helpful to be able to substitute assets even after the stated termination date so that the assets that the grantor really wants to pass to the children can be substituted into the GRAT even after the end of the initial GRAT term.

Drafting Tip: The grantor trust trigger (whether it is a substitution power or any other trigger power) should continue until all annuity payments have been made back to the grantor.

KK. <u>Deferred Payment GRAT</u>. Assume that an asset will have no cash flow for 2 or 3 years, but will have great appreciation potential after that time. One way around this problem is to use a long GRAT. For example, a 20 year GRAT with an annuity that increases 20% per year would have very low annuity payments in the first two years. The early annuity payments could be paid from cash funded into the GRAT up front. Another way is using a "Deferred Payment GRAT." The GRAT would provide that annuity payments would not begin for 3 years. For example, with a 6 year GRAT, with payments beginning in the 4th year, the initial annuity payment would be about 36%. This seems consistent with the statute and the regulations. Section 2702(b) says that fixed payments are required, payable not less frequently than annually. That does not say when the payments must start. [Query: Since payments must be paid annually, does that imply that a payment must be made in year one?] The regulations dealing with that section also seems to allow deferred payments. Reg. 25.2702-3(d)(2) is titled "Contingencies." It says that the payment cannot be subject to any contingency other than the right to revoke the qualified interest of the transferor's spouse or "the survival of the holder until the *commencement*, or throughout the term, of that holder's interest." That seems to sanction deferred payment GRATs; however there are no cases, rulings (or apparently even audits) that address a deferred payment GRAT.

LL. <u>IRS Looking At Annuity Payments</u>. 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.

MM.Revocable GRAT. Mil Hatcher and Ed Manigault suggested in a recent Probate & Property article 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, Trusts & Estates 30 (Nov. 2006).

NN.Spendthrift Clause. Do not include a spendthrift clause because it may not do much good anyway, and more importantly, it prevents the remainder beneficiary from assigning its interest in the GRAT. There are two reasons this may be important: 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).

OO.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.

PP. Loan to Grantor's Spouse. If the grantor or the grantor's spouse needs access to value in the GRAT before an annuity payment is made, may the trustee loan assets to the grantor's spouse? This should be permissible. The reason for the borrowing should not matter—as long as the loan is a legitimate loan and not a disguised distribution to the spouse. The trustee should be able to use the §7872 rates. A potential concern is that if the loan is too favorable to the spouse, it could be treated as an impermissible distribution to someone other than the grantor, and if the loan is too favorable to the trust, it could be treated as a prohibited additional contribution to the trust.

QQ.GST Exemption Allocation at End of GRAT Term. Using a GRAT is a good way to utilize the exemption during the client's lifetime without making a taxable gift. Potential concern: At the termination of the GRAT, if the GRAT document says to transfer the portion of the remaining assets that do not exceed the grantor's remaining GST exemption to a GST exempt trust and the balance to the grantor's children outright, does it create an argument that the grantor has retained the right to designate how the assets pass? An alternative is not to define the transfer in terms of the grantor's remaining GST exemption, but to leave the GRAT assts to a trust and use a qualified severance to sever out the portion of the trust that can be covered by allocation of the grantor's GST exemption.

RR. Possibility That GRAT Does Not Trigger an ETIP Period; If So, Risk of Automatic GST Exemption Allocation at Creation of GRAT Unless Election Out of Automatic Allocation.

1. Does the ETIP Rule Apply Before the Termination of the GRAT? GST exemption cannot be allocated to a trust during the "estate tax inclusion period" (or ETIP). The traditional thinking is that there is an ETIP during the term of a GRAT, because the assets would be included in the gross estate of the donor if the donor dies during the trust term. However, there is a strange regulation saying that the ETIP rules do not apply "if the possibility that the property will be included [in the gross estate of the grantor or the grantor's spouse] is so remote as to be negligible." Treas. Reg. §26.2632-1(c)(2)(ii)(A). The regulation says that the risk of inclusion "is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate." There is probably less than a 5% chance that the grantor will die within two years (unless the grantor is older than about age 68). The regulation might suggest that the GRAT is therefore not subject to the ETIP rules. (Various attorneys pointed out this potential problem when this regulation was proposed, but the regulation was finalized without any change.)

   However, the context of the definition of an ETIP in the regulation before the "so remote as to be negligible" clause may suggest that the intent is to inquire whether there is a 5% chance that the value would be included in the grantor's estate if the grantor were to die within the GRAT term. But, the regulation does not literally say that. As a practical matter, attorneys are not relying on this possible interpretation to allocate GST exemption at the creation of GRATs.

2. If the ETIP Rule Does Not Apply to GRATs, How Much GST Exemption Would Have to Be Allocated To Achieve an Inclusion Ratio of Zero? If $10 million is contributed to a GRAT with a $10 gift, can the grantor just allocate $10 of GST exemption to cover all of the remainder interest? Probably not. IRC §2642(a)(2)(B) says that the denominator of the applicable fraction is "the value of the property transferred to the trust" (reduced by taxes and the charitable deduction). The statute and regulations do not refer to reducing the denominator by the amount of the grantor's retained interest.

   The counter argument is that if there is a part gift, part sale, the donor should not have to allocate GST exemption to the sale portion. Under this approach, the "value of the property transferred" is impliedly the net value of the property. Some GRATs with highly speculative assets are expected to result in a zero transfer or a huge transfer. In that situation, a planner may want to consider allocating GST exemption to the initial transfer equal to the "net value" of the transfer [i.e., the value of the remainder interest] when the GRAT is created. For example, a formula allocation could be made of "so much as is necessary to achieve a zero inclusion ratio, but not more than the value of the remainder." In light of the uncertainty over the amount of GST exemption needed in this circumstance, if GST exemption is allocated at the creation of a GRAT, it is essential to put a cap on the amount allocated.

   An outline and article in 1987 had a long discussion of this issue, before the 1988 revisions that brought the ETIP rules. Before the ETIP rules were passed, planners thought that this kind of leveraging with the GST exemption was available for trusts like GRATs (although they weren't typically referred to as "GRATs" back then). If GST exemption had to be allocated based on the full amount transferred to the trust, why were the ETIP rules needed in the first place?

   There is an excellent discussion of this issue in Manigault & Hatcher, GRATs and GST Planning: Potential Pitfall and Possible Planning Opportunity, 20 Probate & Property 28 (Nov./Dec. 2006). The authors suggest the following approach:

   - Make a formula GST exemption allocation, with a cap (perhaps $100) when the GRAT is created.
   - Allocate GST exemption on the gift tax return on which the GRAT is first reported.

- As a "belt and suspenders" approach, at the end of the annuity period, the grantor would make a protective formula GST allocation (again, perhaps with a cap depending on the circumstances) on a gift tax return.

3. Risk of Automatic Allocation of GST Exemption. If the GRAT remainder will pass in a manner that could potentially have distributions to skip persons, and IF the ETIP rule does not apply, there would be automatic GST exemption allocation when the GRAT is created. It is likely that the amount allocated would be the entire value of the property transferred to the trust, even though all of that current value (and more) will be distributed back to the donor—thus likely wasting GST exemption. To be sure of preventing this result, an election against automatic allocation of GST exemption could be filed when the GRAT is created. (However, some of the nationally respected attorneys who have been aware of this particular potential concern for years have not been electing out of automatic allocation upon the creation of the GRAT, although I spoke with one such attorney who may start doing so out of an abundance of caution.)

   A separate issue, of which most planners are aware, is that the gift tax return that is filed for the GRAT when it is created can elect out of automatic allocation at the end of the ETIP—to avoid automatically allocating an undetermined amount of GST exemption when the GRAT terminates. See Treas. Reg. §26.2632-1(b)(2)(iii)(A)(1).

SS. Distributions From or Redemptions of Interests in Entities Transferred to GRATs. What if a discounted limited partnership interest is transferred to a GRAT, and large distributions are made from the partnership to the GRAT in order that the GRAT could make cash payments (undiscounted) to the grantor in making the annuity payments? To avoid an argument that the legal entity is just a sham for tax purposes, consider using a 5 or 6 year GRAT, and funding the GRAT with liquid assets (that could be used to make the annuity payments during the first three years and) as well as discounted interests in partnerships or other entities. After the statute of limitations has run on the gift value passing to the GRAT, distributions from or redemptions of interests in the partnership would not run the risk of a revaluation of the interest transferred to the GRAT under a sham analysis.

TT. Assets Subject to Blockage Discount. If a large block of stock that is subject to a blockage discount is contributed to a GRAT, there may be a large discount on the value going into the GRAT (which would lower the annuity payments). If smaller blocks are distributed each year, the blockage discount may not apply to those payments, thus allowing a discount arbitrage advantage that could result in a successful GRAT even if the combined appreciation and income of the assets do not beat the §7520 rate.

UU. Rolling GRATs With Single Instrument. The GRAT trust instrument could provide that annuity payments would be automatically transferred back into a new GRAT under the terms of the original instrument, unless the grantor directed the trust at the time of the termination to make the annuity payment distribution directly to the grantor. This would avoid the necessity of drafting a new GRAT instrument each year when an annuity payment is received. [Query whether this might give rise to an IRS argument that the intent is to create a continuing GRAT (and retained interest) until the grantor's death, and that all appreciation in the terminated GRATs that presumably passed to other trusts should be brought back into the grantor's gross estate.]

IV. 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 for 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 Notice 2003-72. See Part One, Section III.G.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.

a. Section 2036(a)(1). Proposed 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 (the regulation says "annual yield" equal to the annual annuity, 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. 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. Prop. Reg. §20.2036-1(c)(ii) Ex. (2). The proposed regulation is effective for decedents dying after the regulation is finalized. (The proposed 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.)

For a charitable remainder annuity trust, Revenue Ruling 82-105, 1982-1 C.B. 133 addressed the amount included in the grantor's gross estate under section 2036(a)(1) if the grantor retains a life interest in the trust. In that case, the amount includible in the gross estate under section 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 using that same approach for determining the amount includible for GRATs under Section 2036 in Technical Advice Memorandum 200210009.)

Revenue Ruling 82-105 addressed a situation in which the transferor retains an interest for life. If the transferor merely retains a term interest rather than an interest for life, the Tax Court has, in at least in one case, ruled that there would be no difference in the amount includible in the estate. Estate of Pardee v. Commissioner, 49 T.C. 140, 150 (1967), acq., 1973-2 C.B. 3. Under this approach, a very large amount of trust assets may be includible in the gross estate even if there is only one or two years of remaining payments to be made to the grantor. One case has held that no part of a trust is includible in the estate of a transferor to a trust who retains an annuity for life. Estate of Becklenberg, 273 F.2d 297 (7th Cir. 1959), rev'g, 31 T.C. 402 (1959). Reliance on the Becklenberg case appears inappropriate, particularly in light of the proposed regulation.

The IRS approved this approach of determining the amount includible under section 2036 in Technical Advice Memorandum 200210009. 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 section 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 section 7520 rate is 6.0% at the grantor's death, the amount includible under section 2036 would be $200,000 (the annual annuity

amount)/0.06, or $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 section 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.

b. Section 2033. If the grantor's estate is entitled to receive remaining payments for the balance of the specified trust term (which is required to "zero out" the GRAT under Walton and Notice 2003-72), the actuarial value of the payments may be included in the gross estate under section 2033. (in addition to the amount includible under section 2036). See Practical Drafting 3380, 3442 (R. Covey ed. 1993).

If any part of the gifted property is brought back into the estate, part or all of the adjusted taxable gift (if any) resulting from the creation of the GRAT will not have to be added to the taxable estate under section 2001(b).

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

Technical Advice Memorandum 200210009 reasoned that section 2039(a) applies because (1) the annuity payments were made pursuant to the terms of the GRAT trust agreement, which constituted a "contract or agreement" for purposes of section 2039(a), (2) the annuity was paid to the grantor for a period that did not in fact in before his death, and (3) the annuity and other payments received by the grantor's estate and the GRAT remainder beneficiaries were receivable by reason of surviving the decedent. The estate argued that because the annuity payments were payable to the grantor's estate for the balance of the fixed term, section 2039 should not apply because the survivorship requirement of section 2039 would not be met. (Commentators had agreed with this position. See Practical Drafting, 5599 (R. Covey ed. 1999).) The IRS disagreed, reasoning that all post-death payments from the GRAT are receivable by reason of surviving the decedent. The Preamble to Prop. Reg. §20.2036-2 says that the language of §2039 is broad enough to support the IRS's prior position, but in the interest of ensuring similar tax treatment for similarly situation taxpayers, the IRS will no longer make the argument that §2039 applies to GRATs. It reasons that (1) §2039 appears to have been intended to address annuities purchased by or on behalf of the decedent and annuities provided by the decedent's employer, and (2) the interests retained in GRATs (as well as CRTs and Income Trusts and QPRTS) are more similar to interests addressed in §2036 than those addressed in §2039.

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 section 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 section 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.

V. 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% 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, 2009.) 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" opf 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. See Part One, Section V.D.3. of this outline.)

   The grantor trust should be "seeded" with meaningful assets prior to a sale. (For example, the trust should hold approximately 10% in value of the eventual trust assets after a purchase occurs in step 2. In Letter Ruling 9535026, the IRS required the applicants to contribute trust equity of at least 10 percent of the installment purchase price.) 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.

   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.

   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 PLR 9535026, the IRS insisted on a 10% floor. 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.

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.)

If the 10% seeding is based on analogy to §2701(a)(4), 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.

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, 34 UNIV. MIAMI INST. EST. PL., Beyond the Basic Freeze: Further Uses of Deferred Payment Sales, ¶ 1601.1 (2000). Even those authors, however, observe that the Section 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).

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 [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 bad 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. Typically, the fee would be between 1%-2%. The trust could even use a bank letter of credit. However, 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.

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 (2007). They argue that this is a way of increasing the equity of the trust without triggering gift tax.

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 September, 2007 (when the section 7520 rate is 5.8%), the annual short-term (0-3 years) rate is 4.82%, the annual mid-term (over 3, up to 9 years) rate is 4.79%, and the long-term (over 9 years) rate is 5.09%. Typically, the note would permit prepayment of the note at any time. The note should not 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 incredibly flat yield curve, planners typically are using 9 year rather than 3 year notes (indeed, as an example, the mid-term rate is even lower than the short term rate in September, 2007). Furthermore, many planners are using long term notes (over 9 years) when the long term rate is only marginally higher than the mid-term rate; 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 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 section 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 Section 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 Section 1274(d). The apparently unqualified incorporation of section 1274(d) in section 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 section 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 section 7872, as the interest rate on notes for intrafamily installment sales. Section 7872 addresses the gift tax effects of "below-market" loans, and section 7872(f)(1) defines "present value" with reference to the "applicable Federal rate." Using section 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 section 7872 (rather than the interest rate under section 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:

   > "The 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 section 7872 of the Code, or the safe-harbor rate provided under section 483(e). The court also considered the application of the rates prescribed under section 1274. The court concluded that section 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 section-483 of the Code does not apply for gift tax purposes. In concluding that section 1274 also was not applicable in valuing the note for gift tax purposes, the court stated that section 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 section 7872 was enacted specifically to address the gift tax treatment of below-market loans. Thus, the court concluded that the application of section 7872 is not limited to loans of cash. Rather, the term "loan" under section 7872 is broadly interpreted to include any extension of credit."

Whether the section 7520 rate or some other market rate should apply was not strictly before the court, because the IRS proposed using the lower section 7872 rate. However, the court analyzed section 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 section 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 section 7872 rate, with a balloon payment of principal at the end of 20 years. The ruling summarizes the provisions of section 7872 (which governs the gift tax effects of "below-market" loans), and discusses the Frazee case (which it summarizes as concluding that section 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 section 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 section 1274(c)(2) (which is tied to the applicable federal rate). The ruling employed reasoning similar Ltr. Rul. 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, 2004-27 I.R.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.

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.

   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 INST. ON EST. PL. 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, 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 1359 (April 2007).

B. Basic Estate Tax Effects.

1. Note Includible In Estate.

   The installment note (including any accumulated interest) will be included in the grantor/seller's estate.

2. Assets Sold to Trust Excluded from Estate.

   The asset that was sold to the trust will not be includible in the grantor's estate, regardless how long the grantor/seller survives. (There is some risk of estate inclusion if the note is not recognized as equity and if the grantor is deemed to have retained an interest in the underlying assets. See Part One, Section V.G.1 of this outline. The risk is exacerbated if a thinly capitalized trust is used – less than 10 percent equity. See Part One, Section V.G.2. of this outline.)

3. Grantor's Payment of Income Taxes.

   The grantor's payment of income taxes on income of the grantor trust further decreases the grantor's estate that remains at the grantor's death for estate tax purposes.

4. New Question 12(e) on Form 706. The new Form 706 (dated October 2006) has a new question in Part 4, Question 12e.

   Question 12a asks "Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?"

Question 12b asks: "Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest or trusteeship?"

Question 12e asks: "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?"

Interestingly, there seems to be a way around the question. The obvious way around this question, to stay "under the radar screen," would be to create the grantor trust, sell to the grantor trust, have the grantor trust pay off the note while it is still a grantor trust (so there is no income recognition) then terminate the trust before the decedent dies. The trust would not be described in Question 12a or b, so the answer to Question 12e would be no. That would seem to work if the client wants the trust to terminate during his or her lifetime. (But that is not practical in many situations.) Query whether having the trustee “decant” the assets to a new trust created by the trustee under a decanting power would avoid answering Question 12a in the affirmative?

Be careful in looking for technical ways to avoid this question. If the planner is “too clever,” the IRS may say the planner is being misleading and allege a Circular 230 violation. Furthermore, even if the planner could avoid the current question, the IRS can change the form in the future in reaction to clever plans to avoid the question.

This question underscores the desirability of reporting sales of discounted interests in closely-held entities on a gift tax return. Eventually the IRS will learn about this transaction. This new question applies retroactively to all transfers made by decedents filing the new Form 706.

Recognize that the question only applies to transfers to trusts and not to transfers to individuals.

C. Basic Gift Tax Effects.

1. Initial Seed Gift.

   The grantor should “seed” the trust with approximately 10% of the overall value to be transferred to the trust by a combination of gift and sale. This could be accomplished with an outright gift when the grantor trust is created. Alternatively, the grantor trust could receive the remaining amount in a GRAT at the termination of the GRAT to provide seeding for a further installment sale.

2. No Gift From Sale.

   The sale to the trust will not be treated as a gift (assuming the values are correct, and assuming that there is sufficient equity in the trust to support valuing the note at its full face value.) There is no clear authority for using a valuation adjustment clause as exists under the regulations for GRATs.

D. Basic Income Tax Effects.

1. Initial Sale.

   The initial sale to the trust does not cause immediate gain recognition, because the grantor is treated as the owner of the trust for income tax purposes. Regulation §1.1001-2(c) Ex.5: Rev. Rul. 85-13, 1985-1 C.B. 184.

2. 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.

3. 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 Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. See Ltr. Ruls. 200011058, 200011054-056, 199942037 & 199935046.

The IRS's position under Section 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 Section's 673-677 and on a beneficiary under Section 678, the grantor trust status on the original grantor will prevail. However, Section 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 section 678(b) contains a drafting error and that it was intended to apply to a power over income and corpus, similar to Section 678(a)(1).

Despite arguments from the literal statutory language (the exception in section 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 section 678 power attributable to a person holding a Crummey withdrawal right that lapses. E.g., PLRs 200011054; 9309023; 9321050. (See also PLR 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." PLR 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. Ltr. Ruls. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 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.

4. Grantor's Liability for Ongoing Income Taxes of Trust.

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. See Part One, Section III.V. of this outline regarding the possibility of having an income tax reimbursement provision for the grantor.

5. 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 Section 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 (July 2001) with 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 section 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 Sections 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 section 453.

- This position does not contradict the policy behind section 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.

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 or 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.

6. Gift Tax Basis Adjustment.

If a donor makes a gift to the grantor trust in order to "seed" an installment sale, and if the donor has to pay gift tax with respect to the initial gift, can the trust claim a basis adjustment under Section 1015(d) for the gift tax paid? There is no definitive authority as to whether the basis adjustment is authorized, but there would seem to be a good-faith argument that the gift-tax paid basis adjustment should be permitted even though the gift was to a grantor trust.

E. Generation-Skipping Transfer Tax Effects.

Once the trust has been seeded, and GST exemption has been allocated to cover that gift, no further GST exemption need be allocated to the trust with respect to the sale (assuming that it is for full value).

A potential risk, in extreme situations, is that if the sold asset is included in the transferor's estate under Section 2036, no GST exemption could be allocated during the ETIP.

F. Advantages of Sale to Grantor Trust Technique.

1. No Survival Requirement.

The estate freeze is completed without the requirement for survival for a designated period.

2. Low Interest Rate.

The interest rate on the note can probably be used on the §7872 rate, which is significantly lower than the §7520 rate which must be used for structuring the annuity payments from GRATs. For example, for September, 2007 (when the section 7520 rate is 5.8%), the annual short-term (0-3 years) rate is 4.82%, the annual mid-term (over 3, up to 9 years) rate is 4.79%, and the long-term (over 9 years) rate is 5.09%. Typically, the note would permit prepayment of the note at any time. .

Section 7872 deals with the income and gift tax consequences of below market interest loans, and provides that comparison of the interest rate on a note to the "applicable federal

rate" will determine if there is a gift and the amount of the gift in intra-family loan transactions. There is, at least arguably, some question as to whether a deferred payment sale should be subject to §7872, since §7872(f)(8) provides that the section in general does not apply to any loan to which §483, 643(i), or 1274 applies. However, in Frazee v. Comm'r, 98 T.C. 554 (1992) the Tax Court accepted the IRS's contention that §483 and §1274 (the reference to §643(i) was added in 1995) are not valuation provisions, and, therefore, that §7872 must control for gift tax purposes. See Ltr. Ruls. 9535026 & 9408018.

3. GST Exempt.

The sale can be made to a GST exempt trust, or a trust for grandchildren, so that all future appreciation following the sale will be in an exempt trust with no need for further GST exemption allocation. For a GRAT, no GST exemption can be allocated during the period of the retained term (because it is an ETIP, I.R.C. §2642(f)(3)).

4. Interest-Only Balloon Note.

The installment note can be structured as an interest only-balloon note. With a GRAT, the annuity payments cannot increase more than 120% in any year, requiring that substantial annuity payments be paid in each year. However, the planner must judge, in the particular situation, if using an interest-only balloon note might raise the risk of a §2036 challenge by the IRS. It would seem that a §2036 challenge is much less likely if the transaction looks like a traditional commercial transaction. While there is no requirement that even the interest be paid currently, it "may be most commercially reasonable to require the payment of interest at least annually … even if all principal balloons at the end." Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1572 (April 2007).

5. Income Tax Advantages.

The estate freeze is completed without having to recognize any income tax on the sale of the assets as long as the note is repaid during the seller's lifetime. In addition, the interest payments will not have to be reported by the seller as income.

G. Risks.

1. 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 Letter Rulings 9436006 (stock contributed to grantor trust and other stock sold to trust for 25-year note; ruling holds §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 retained interest" for purposes of §2702; specifically refrained from ruling on § 2036 issue).

One letter ruling concluded that Section 2036 did apply to property sold to a grantor trust in return for a note, based on the facts in that situation. Letter Ruling 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 section 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, 34 UNIV. MIAMI INST. EST. PL. ¶ 1601.1 n. 55 (2000).

One commentator has suggested that there is a significant risk of section 2036(a)(1) being argued by the IRS if "the annual trust income does not exceed the accrued annual interest on the note." Covey, Practical Drafting 4365-4370, at 4367. 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. Estate of Deal v. Comm'r, 29 T.C. 730 (1958) (intent to forgive notes at time they were received cause gift treatment at outset); Estate of Holland v. Comm'r, 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).

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. Miller v. Commissioner, 71 T.C.M. 1975 (1996), aff'd, 113 F.3d 1241 (9th Cir. 1997) identified nine objective factors to determine if the transfer was made with a real expectation of repayment and an intention to enforce the debt. See also Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104.

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. Comm'r, 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).

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-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 therefore.") Porter, Current Valuation Issues, AICPA ADV. EST. PL. CONF. 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).

2. Risks of Thin Capitalization.

One commentator summarizes the possible risks of thin capitalization as follows--"includibility of the gross estate under section 2036, a gift upon the cessation of section 2036 exposure, applicability of section 2702 to such a gift, the creation of a second class of equity in the underlying property with possible consequences under section 2701 and possible loss of eligibility of the trust to be an S Corporation, continued estate tax exposure for three years after cessation of section 2036 exposure under section 2035, and inability to allocate GST exemption during the ensuing ETIP. The section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain." Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1578 (April 2007).

In Karmazin, (T.C. Docket No. 2127-03, filed Feb. 10, 2003) the IRS made a number of arguments to avoid respected a sale of limited partnership units to a grantor trust, including §2701 and 2702. That case was ultimately settled (favorably to the taxpayer). In the Dallas case this year, the IRS agent made arguments under §2701 and 2702 in the audit negotiations to disregard a sale to grantor trust transaction, but the IRS dropped that argument before trial and tried the case as a valuation dispute. In Dallas, the IRS respected the note as debt.

3. Potential Gain Recognition if Seller Dies Before Note Paid.

There is potential gain recognition if the seller dies before all of the note payments are made. The IRS may argue that the gain is accelerated to the moment of death. It would seem more likely that the gain should not be recognized until payments are actually made on the note. Credible arguments can be made for no income realization either during or after the grantor's death, as discussed in Part One, Section V.D.5. of this outline.

4. 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). 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 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."

Defined value clauses are discussed in detail in Part Two of this outline.

5. 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.

6. Recognition of SCIN Sale as Bona Fide Transaction.

In Estate of Costanza v. Comm'r, T.C. Memo. 2001-128, the court ruled that a transfer of real estate to a son in return for a self-cancelling installment note was a taxable gift because the conveyance was not a bona fide transaction for full consideration. The court pointed out that the son's inconsistency in making note payments failed to establish that an arm's length sale occurred. Also, the court concluded that there was no showing that either the decedent or the son intended to enforce the note's payment provisions.

The Sixth Circuit Court of Appeals reversed and remanded the case. 91 AFTR 2d 2003-988 (6th Cir. 2003). The court stated the general rule that intrafamily transactions are subject to strict scrutiny, but a presumption that it is not bona fide and results in a gift may be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The court rejected the Tax Court's reasons for finding that the transaction was not bona fide. (1) The fact that the documents were signed on different dates than the date of the transaction is because the attorney needed to pick a date on which to base an amortization schedule, and the documents were circulated for signature and signed within several weeks. (2) The parties orally agreed to make payments quarterly rather than monthly for convenience to decrease the number of bank transactions and the necessity of bank deposits. (3) The fact that payments were not made for the last two months is not surprising because the end of the quarter had not occurred. The IRS also argued that the parties assumed that the seller would die before full satisfaction of the note, or else why would they have included the self-canceling provision. The court observed that this circular analysis questions the validity of any SCIN, "an argument that the tax court has long since rejected" (citing Estate of Moss v. Comm'r, 74 T.C. 1239 (1981)). The fact that the seller died within months of the transaction

was not determinative because the seller died very unexpectedly and medical experts testified that he was expected to live somewhere between 5 and 13.9 years at the time of the transaction (and an 11 year term was used on the note.) Furthermore, the court observed that the note was fully secured by a mortgage on the properties that were sold to the son. The court remanded for a determination of whether the value of the note equaled the value of the properties that were sold, or whether the transaction constituted a bargain sale.

7. Karmazin Settlement (T.C.Docket No. 2127-03, filed Feb. 10, 2003).

Taxpayer created an FLP owning marketable securities. Taxpayer made a gift of 10% of the LP interests and sold 90% of the LP interests to two family trusts. The sales agreements contained "defined value clauses." The sales to each of the trusts were made in exchange for secured promissory notes bearing interest equal to the AFR at the time of the sale, and providing for a balloon payment in 20 years. Jerry Deener represented the taxpayer and has reported that the IRS "threw the book" at a gift/sale to grantor trust transaction. The IRS sent a 75-page Agent's Determination Letter in which the entire transaction was disallowed. The partnership was determined to be a sham, with no substantial economic effect, and the note attributable to the sale was reclassified as equity and not debt. The result was a determination that a gift had been made of the entire undiscounted amount of assets subject to the sale. The agent's argument included: (1) the partnership was a sham; (2) Section 2703 applies to disregard the partnership; (3) the defined value adjustment clause is invalid; (4) the note is treated as equity and not debt because (i) the only assets owned by the trust are the limited partnership interests, (ii) the debt is non-recourse, (iii) commercial lenders would not enter this sale transaction without personal guaranties or a larger down payment, (iv) a nine-to-one debt equity ratio is too high, (v) insufficient partnership income exists to support the debt, and (vi) PLR 9535026 left open the question of whether the note was a valid debt; and (5) because the debt is recharacterized as equity, section 2701 applies (the note is treated as a retention of non-periodic payments) and 2702 applies (rights to payments under the note do not constitute a qualified interest).

The parties reached a settlement, under the following major terms.

a. Sale of units to grantor trust was respected as a bona fide sale. (The transaction was not treated as a retained annuity; neither §2701 nor §2702 applied.)

b. Defined value clause in the sales agreement ("that number of units equal to a value of 'x'") was not given effect.

c. Original deficiency of $2,500,000 asserted by the IRS was reduced by 95% to $134,000. (MPI appraisers had valued the limited partnership interests using a 42% combined discount for minority interest and lack of marketability. The IRS agreed to a 37% discount as a part of the settlement.)

d. Reasons discussed for conclusion that §2702 did not apply (and that the Note was respected as debt and not retained equity interests):

(1) Substantial economic reality to the transaction

(2) Reliable income stream to fund the obligation

(3) Note payments were independent of whether the transferred property produced income

(4) Seller provided financing did not exceed the value of the asset purchased, and the Purchaser was able to meet the financial obligations as they became due

(5) Gifted and sole partnership units were pledged to secure payments under the Note

(6) Income generated by the underlying property transferred by gift and sale exceeded the obligation on the Note, so the Note obligation is not tied into the income of the trust

(7) IRS argument that payments from the trust are in effect derived from the donor ignored the existence of the partnership

(8) Note is a negotiable instrument that could be sold or transferred to a third party.

H. Summary of Note Structure Issues

1. Term of Note.

The term of the note usually does not exceed 15-20 years, to ensure treatment of the note as debt rather than a retained equity interest. The term of the note should be less than the grantor's life expectancy (whether or not a SCIN is used).

2. Interest Rate.

The Section 7872 rate is typically used.

3. Timing of Payments.

The note typically calls for at least having the interest paid currently (annually or semi-annually). While there is no absolute requirement to have interest paid currently, doing so makes the note appear to have more "commercial-like" terms than if interest merely accrues over a long term.

4. Security.

Is permissible to use a secured note. In fact, having security of the note helps ensure that the value of the note equals the value of the transferred property.

5. 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. However, that would not seem to change the overall result.

6. Defined Value Clause.

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.

Another possibility is to use a disclaimer even for 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."

See Part Three of this outline addresses defined value clauses in detail.

7. Crummey Clause.

To be totally conservative and assure that the trust is treated as a grantor trust as to the original grantor, consider not using a Crummey clause. However, the IRS has ruled numerous times that using a Crummey clause does not convert the trust to being partially a grantor trust as to the beneficiary rather than as to the owner. See Part One, Section V.D.3. of this outline.

8. Entire Corpus Liable for Note.

   The entire corpus of the trust should be liable for the note, not just the property sold in return for the note.

9. Payments Not Based on Performance of Sold Asset.

   The amount and timing of payments should in no way be tied to the performance of the sold asset—or else the note has the appearance of being a retained equity interest in the property itself.

10. No Retained Control Over Sold Asset

    The grantor should retain no control over the sold asset. The risk of inclusion under section 2036, in a situation where the grantor is retaining payments from the transferred property, is exacerbated if the grantor also has any control over the transferred property.

11. Payments Less Than Income From Sold Asset.

    Preferably, the required ongoing note payments would be less than the income produced by the sold assets. Furthermore, the trust should not routinely make prepayments to distribute all trust income to the grantor as note payments.

12. Ability to Make Payments

    The trust should have sufficient assets to make principal and interest payments as they become due.

13. Reporting

    The existence of the notes should be reflected on financial statements and interest income and expenses must be property reported.

14. 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 new Question 12(e) on the new Form 706. (See Part One, Section V.B.4 of this outline.)

15. Downpayment. Some attorneys prefer giving cash to comprise the "10% gift element" in order to stay under the IRS's radar screen. If a partnership interest is given to the trust, the box must be checked on the gift tax return indicating that the asset was valued with a discount. [That may have been what triggered the audit that resulted in the Karmazin lawsuit.]

16. One Planner's Suggested Approach.
    - Cash gift of 10%
    - Sale of assets, so that the sale portion and gift portion are in a 90/10 ratio.
    - Do not report the sale on an income tax return. Generally do not get a separate tax ID number for the grantor trust, but follow the procedures of Regulation §1.671-4(b).
    - If the plan is to keep the trust in existence until the grantor's death (for example if it is a GST exempt trust), report the sale on a gift tax return. There are much lower odds of a gift tax audit than of an estate tax audit.

- The general preference is to use sale to grantor trusts rather than GRATs for business interests, because a longer term is needed to make the payments out of the business's cash flow. (That planner tends to use 2-year GRATs for publicly traded securities.)

I. Detailed Analysis of Trust Provisions That Cause Grantor Trust Status.

1. Power of Disposition by Related or Subordinate Parties Not Governed by Reasonably Definite External Standard.

   a. Overview. A power in trustees, more than half of whom are related or subordinate parties, to sprinkle or accumulate income or corpus of the trusts without a "reasonably definite standard" will not qualify for any of the exceptions from grantor trust treatment under Section 674(c)-(d). Furthermore, the trust can be planned to avoid the exceptions in Section 674(b)—generally by giving the trustee "spray" powers without having separate shares for the beneficiaries. Therefore, the trust would be a grantor trust under the general rule of Section 674(a).

   b. Section 674(a) General Rule. Section 674(a) triggers grantor trust treatment if the grantor or a non-adverse party holds a power of disposition over trust assets. Various exceptions in Sections 674(b), 674(c), and 674(d) can negate grantor trust treatment. Therefore, to rely on a trustee's general power of disposition to trigger grantor trust status requires very careful navigating of all of those exceptions.

   c. Section 674(b)(5) Exception for Corpus. Section 674(b)(5) is an exception from grantor trust treatment as to corpus if there is a reasonably definite standard (§674(b)(5)(A)) or if separate shares are created for the respective beneficiaries (§674(b)(5)(B)). Therefore, to avoid this exception, there should be no "reasonably definite standard" for the distributions, and the trustee should have a spray power and not have to charge any distributions of corpus against the beneficiary's proportionate share of corpus.

   d. Section 674(b)(6) Exception for Income. Section 674(b)(6) is an exception from grantor trust treatment as to income if any of the following apply:

      (1) Income accumulated for a beneficiary must ultimately be payable to that beneficiary, to his estate, or to his appointees including anyone other than his estate, his creditors, or the creditors of his estate, §674(b)(6)(A),

      (2) Income accumulated for a beneficiary must ultimately be payable on termination of the trust or in conjunction with a distribution of corpus that includes accumulated income to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, §674(b)(6)(B), or

      (3) Income accumulated for a beneficiary is payable to the beneficiary's appointees or to one or more designated alternate takers (other than the grantor or grantor's estate) if the beneficiary dies before a distribution date that could reasonably be expected to occur within the beneficiary's lifetime, §674(b)(6)(second paragraph).

      The regulations provide that these rules generally mean that the exception from grantor trust treatment will not apply "if the power is in substance one to shift ordinary income from one beneficiary to another." Treas. Reg. §1.674(b)-1(b)(6)(i)(c). An exception from this general summary of the income exception applies if the grantor or a nonadverse party has the power to shift income from one beneficiary to another by accumulating income with a provision that at a later distribution date the accumulated income will be distributed to current income beneficiaries in shares that are irrevocably specified. For example, an instrument might provide for payment of income in equal shares to two daughters but permit withholding the distribution from either daughter. When the youngest daughter reaches age 30, the remaining trust would be distributed equally between the two. If income is withheld from a daughter, this has the effect of ultimately shifting one-half of the accumulated income from one daughter to the other. However,

this shift would not negate the exception from grantor trust treatment. Treas. Reg. §1.674(b)-1(b)(6)(ii)(Ex. 1).

Accordingly, provisions that would flunk this exception include the following. Permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries. See Treas. Reg. §1.674(b)-1(b)(6)(ii)(Ex. 2). Alternatively, 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 does not distribute accumulated income to the beneficiary's estate or give the beneficiary a testamentary power of appointment.

e. Section 674(c), Independent Trustees. Section 674(c) provides that the general rule triggering grantor trust treatment under Section 674(a) will not apply if no more than half of the trustees are related or subordinate parties and they have the power to distribute or accumulate income or corpus for a class of beneficiaries. To avoid this exception, more than half of the trustees would have to be "related or subordinate parties who are subservient to the wishes of the grantor." The term "related or subordinate party" is defined in Section 672(c).

f. Section 674(c), "Subservient to the Wishes of the Grantor." The Section 674(c) exception from grantor trust treatment provides that no more than half of the trustees can be related or subordinate parties "who are subservient to the wishes of the grantor". Section 672(c) creates a presumption that a related or subordinate party is subservient to the grantor. This presumption is difficult to overcome, and would require a finding that the trustee is not acting in "accordance with the grantor's wishes." S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954).

The requirement that the trustee be "subservient to the wishes of the grantor" to cause grantor trust treatment raises an interesting estate tax question. If the person who holds the power to make distributions without a standard is in fact subservient to the wishes of the grantor, does a potential estate inclusion issue arise under Sections 2036 and 2038? See Estate of Goodwyn v. Comm'r, 32 T.C.M. 740 (1973) (de facto control of trustee was insufficient to cause inclusion in grantor's estate under §2036).

g. Section 674(d), Reasonably Definite External Standard. Section 674(d) provides that the general rule triggering grantor trust treatment under Section 674(a) will not apply if the trustees (other than the grantor or grantor's spouse) have the power to make or withhold distributions of income or corpus, if the power is limited by a reasonably definite external standard.

h. 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 non-adverse party must serve as trustee with a power of disposition over trust assets (Section 674(a)). The instrument must not have reasonably definite external standards for distributions (to avoid Section 674(d)), and more than half of the trustees must be related or subordinate parties (to avoid Section 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 Section 674(b)(5)). Also, the trust should permit totally discretionary distributions of current and accumulated income to be sprayed among beneficiaries (to avoid Section 674(b)(6)). (Alternatively, to avoid Section 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.)

i. Does Not Have the Appearance of Just Being a "Grantor Trust" Provision. An advantage of qualifying for grantor trust treatment under this approach is that it does not have the appearance of merely being a provision added to confer grantor trust status. The provision has real-life economic consequences that are of major importance to trustors--the decision of who has the power to control distributions.

j. Giving Grantor's Spouse Power to Control Distributions Without a Reasonably Definite Standard. One possible method of using this approach to cause grantor trust status 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). 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.

2. Power of a Non Adverse Person to Distribute to or Accumulate Income for the Grantor or the Grantor's Spouse, §677(a)(1) or (2).

a. May Result in Grantor Trust Treatment Only as to Income. The literal language of Section 677(a) would suggest that income and corpus of the trust would be treated as a grantor trust. I.R.C. Section 677(a) ("the owner of any portion of a trust…whose income…is, or…maybe" distributed or accumulated for distribution to the grantor or the grantor's spouse). However, an example in the Regulations very specifically indicates that the Section 677 power only results in the grantor being treated as the owner of the income portion of the trust and not the corpus. Treas. Reg. §1.677(a)-1(g), Ex. 1.

Despite the very clear example in the regulations, the IRS has issued several private letter rulings holding that both the income and corpus portion of a GRAT would be treated as owned by the grantor under the grantor trust rules because the annuity amount would be payable from principal to the extent that income was insufficient. Letter Rulings 9504021, 9451056, 9449012, 9444033, and 9415012. See also Ltr. Rul. 9501004 (CRUT treated as grantor trust as to income and corpus under §677(a) because of the possibility that income allocable to principal could be used to satisfy the unitrust payment). However, the IRS has taken the position that a retained annuity alone does not confer grantor trust status as to both the income and corpus portion of a GRAT. Letter Ruling 9625021.

b. Grantor or Grantor's Spouse as Discretionary Beneficiary Plus Power of Appointment May Cause Grantor Trust Status As to Income and Corpus. Various rulings have indicated that a combination of Sections 677 and 674(b)(3) can be used to confer grantor trust status as to income and corpus for a GRAT. The authority to make distributions of the annuity payments would result in grantor trust treatment as to the income under Section 677. If the grantor retains a testamentary power of appointment to appoint the trust assets (in the event the grantor dies before the stated termination of the GRAT), this power will result in grantor trust treatment as to the corpus under Sections 674(a) and 674(b)(3). See Treas. Reg. §1.674(b)-1(b)(3) ("if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion"); Letter Rulings 200001013 & 200001015 (grantor trust treatment as to income because trustee had discretion to pay all of GRAT's income—if any is remaining after payment of the annuity payments—to the grantor; grantor trust treatment as to corpus under section 674(a) because capital gains are accumulated and added to corpus and grantor held general testamentary power of appointment over the accumulated amounts); 9707005 (GRAT is a grantor trust as to income and corpus under §674(a) and §677(a) because grantor will either receive all the trust income or be able to appoint it by will, and qualifies as an S corporation shareholder); 9625021.

c. Grantor Trust Status May be Unintended. Additional economic flexibility can be created for the parents engaged in transfer planning if one of the parents transfers his or her separate property into a trust that would include the spouse as a discretionary beneficiary. The trust should specifically restrict the use of trust income to discharge the grantor's obligation of support. Treas. Reg. §20.2036-1(b)(2). (Each spouse cannot name the other as beneficiary or the reciprocal trust doctrine may apply.) By 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 Section 677.

d. Difficult to Relinquish Grantor Trust Status if Spouse is Discretionary Beneficiary. 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.

e. Grantor Status Would Be Terminated at Spouse's Death. If Section 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.)

f. No Estate Tax Inclusion For Spouse Even if Split Gift Election is Made. As long as the spouse does not make any contribution to the trust, merely including the spouse as a potential discretionary beneficiary will not cause inclusion in the spouse's estate for estate tax purposes (as long as the spouse does not have a general power of appointment under §2041). For purposes of applying §§2036 and 2038, the spouse is not a grantor to the trust, so those sections would not apply. This is true even if the split gift election is made, because the split gift election applies just for gift tax and GST exemption allocation purposes. I.R.C. §2513(a)(1) & 2652(a)(2); there is no analogous estate tax provision. E.g., Rev. Rul. 74-556, 1974-2 C.B. 300 (no §2038 inclusion).

3. Power of Non-Adverse Person to Use Income to Pay Life Insurance Premiums on Life of Grantor or Grantor's Spouse, §677(a)(3).

a. Statutory Provision. The grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse. I.R.C. §677(a)(3). This statutory provision appears to be very broad. Literally, giving a trustee the power to pay life insurance premiums on income of a trust would conceivably cause all of the income and corpus of the trust to be a grantor trust.

b. Grantor Trust Treatment May Apply Only as to Actual Payment of Life Insurance Premiums. The grantor clearly is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse. Treas. Reg. §1.677(a)-1(b)(2). However, cases have imposed restrictions on grantor trust status merely because of the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status. Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939) (trust owned no policy on grantor's life). Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums. Weil v. Comm'r, 3 T.C. 579 (1944), acq. 1944 C.B. 29: Iversen v. Comm'r, 3 T.C. 756 (1944); Rand v. Comm'r, 40 B.T.A. 233 (1939), acq. 1939-2 C.B. 30, aff'd., 116 F.2d 929 (8th Cir. 1940), cert. denied, 313 U.S. 594 (1941); Moore v. Comm'r, 39 B.T.A. 808, 812 (1939), acq., 1939-2 C.B. 25; Letter Ruling 6406221750A (June 22, 1964). But see Letter Ruling 8852003 (power to pay premiums causes entire trust to be grantor trust). See also Letter Ruling 8839008 (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income). See generally Zaritzky, Drafting and Planning Life Insurance Trust for Policies Both Traditional and Unusual, UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶403.2.D.2.a. (1994).

A troubling concept is that the IRS might extend this reasoning to more of the grantor trust triggers. This would suggest the wisdom of using a power of disposition in a non-adverse party as described in Item I.1. above.

c. Not Useful to Assure Grantor Trust Status. Due to the case law limitations discussed above, the power is not useful as a tool to assure that a trust will be treated as a grantor trust. However, if the draftsman wishes to use this as one of multiple grantor trust triggers, provide in the trust agreement that the trustee may pay insurance premiums from income or principal, to build the best possible argument that the trust is a grantor trust as to both income and principal.

4. Actual Borrowing of Trust Funds by Grantor or Grantor's Spouse Without Adequate Interest Or Security, §675(3).

a. Actual Borrowing Required. Under §675(3), if the grantor has (directly or indirectly) actually 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.

b. Grantor Trust Status if Loan Outstanding Any Time During the Year. 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. 109 (D. Hawaii 1973). For example, if a loan is outstanding on 12/31/98 and repaid on 1/2/99, the grantor would be treated as owning the trust for all of 1998 and 1999 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.)

Repurchase of Asset For a Note. Most attorneys overlook that Revenue 85-13 (which concluded that transactions between grantor and grantor trusts do not result in gain recognition) says that a non-grantor trust can be converted into a grantor trust by having the grantor just buy back the trust asset for a note, and the grantor trust treatment is effective even as to that sale. Rev. Rul 85-13 stands for more than just no gain recognition. It is unresolved whether the amount of the borrowing impacts the portion of the trust that is treated as a grantor trust. (See the following paragraph.))

c. Unclear as To Portion of Trust Treated as Grantor Trust. 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. Comm'r, 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. Comm'r, 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.

d. Permits Toggling, But Close Supervision Required. 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.

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

   a. 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 section 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, 9248016. 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 Section 675(4)(c) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. E.g., Letter Ruling 9810019 (charitable lead trust).

   b. Trustee 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. Similarly, a trustee's approval or consent should not be required.

   c. Retention of Power by Grantor. Can the grantor retain a nonfiduciary power to substitute assets of equivalent value without causing inclusion in the grantor's estate for estate tax purposes? A 1975 Tax Court case is often cited for the proposition that a substitution power will not cause estate tax inclusion. Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975). Interestingly, the facts in Jordahl involved a situation in which the grantor held the substitution power in a fiduciary capacity. Is this difference critical? The reasoning in the Jordahl case would suggest that the same result would have been reached if the substitution power had been held in a nonfiduciary capacity:

      "Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of 'equal value' indicates that the power was held in trust...We do not believe that decedent could have used his power to shift benefits in [a manner to deprived the remainder of benefits or to deprive an income beneficiary of property.] Substitutions resulting in shifted benefits would not be substitutions of property 'of equal value.'"

      Commentators have generally concurred that the Jordahl result should apply even where the substitution power is held in a nonfiduciary capacity. See Practical Drafting 3753-3757 (R. Covey ed. 1994). In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion. Ltr. Ruls. 200001015 & 200001013 (ruled that if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor's gross estate under section 2036(a); did not specifically address grantor's nonfiduciary substitution power in the analysis), 199922007 (charitable lead trust contained substitution clause, and IRS held trust assets not includible in estate, but no specific discussion of effect of substitution clause on estate inclusion issue), 9642039 (substitution clause in charitable lead trust, which causes charitable lead trust to be a grantor trust for income tax purposes, does not cause estate inclusion under §§2033, 2035-38, or 2041), 9548013 (grantor trust holding S corporation stock), 9413045 (no estate inclusion under sections 2036, 2038, or 2042, with discussion of Jordahl): 9227013, and 9037011. But see Ltr. Rul. 9318019 (declined to rule on whether amending GST grandfathered trust to give

grantor power to exchange assets of equal value would cause loss of GST grandfathered status or whether it would create estate tax exposure to the grantor).

PLR 200603040, issued on 1-20-2006, addresses a trust with a substitution power where "the instrument provides that Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity." The PLR concluded that the substitution power would not cause estate inclusion under §§2033, 2036(a), 2036(b), 2038 or 2039. The PLR focused on the fact that the instrument said that the substitution power could only be exercised in a fiduciary capacity. In Jordahl, the decedent was a co-trustee so one might infer that all powers held by the grantor in that case were held in a fiduciary capacity. However, the PLR interpreted Jordahl as follows: "Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries." Under this reasoning, would any substitution power be exercisable only in a fiduciary capacity? That reasoning might suggest why the IRS refuses to rule in PLRs whether a substitution power is held in a nonfiduciary capacity (to be a grantor trust trigger under §675(4)) even though the instrument specifically says the power is not held in a fiduciary capacity.

Similarly, PLR 200606006 said that §2036 would not apply in a situation where the substitution power was held in a fiduciary capacity. Without changing the trust under state law so that the trustee would hold the substitution power in a fiduciary capacity, the IRS would not give a favorable ruling on §2036. (In the facts of that ruling, there were other grantor trust triggers, so the trust was a grantor trust even without a nonfiduciary substitution power. The substitution power was important to the grantor in that ruling, because the grantor planned to transfer closely held business interests to the trusts, and the grantor wanted a substitution power to be able to substitute cash for those interests.) Despite the existence of dozens of previous private letter rulings saying that §2036 does not apply to a substitution power even if it is held in a nonfiduciary capacity, the IRS is no longer willing to grant favorable §2036 rulings to nonfiduciary substitution powers.

d. 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). In addition, allowing a third party to hold the substitution power could create additional flexibility to "turn off" or to "toggle" grantor trust status (as discussed below).

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 non adverse 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 that 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).

e. 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. This should avoid any risk of estate inclusion in the event that the Jordahl result is overturned. 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 Section 672(e).

f. Power of Substitution Held by Insured Not an Incident of Ownership. A power of substitution held by an insured should not constitute an incident of ownership over a policy owned by an irrevocable life insurance trust. Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975), Letter Ruling 9413045 (citing and relying on Jordahl case).

6. Power of Non-Adverse Trustee to Make Loans to the Grantor and/or Grantor's Spouse Without Adequate Security, §675(2).

a. Mere Existence of Power Sufficient. The mere existence of the power exercisable by the grantor or a non adverse 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). The mere existence of the power is sufficient to cause grantor trust status regardless whether the power is actually exercised. (Contrast this provision with Section 675(3), discussed below, which requires an actual borrowing of trust funds by the grantor to confer grantor trust status.)

b. Grantor Treated as Owner of Entire Trust. As long as the power extends to borrowing corpus or income from the trust, grantor trust status will result as to the entire trust. (Some of the other grantor trust powers will result only in partial grantor trust treatment.)

c. Power to Borrow Without Adequate Security is Sufficient. 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. Letter Rulings 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. See Ltr. Ruls. 9645013 (non-adverse party authorized to lend to the grantor without security) and 9525032 (grantor's power to borrow without security causes GRAT to be grantor trust). However, in Letter Ruling 199942017, the IRS issued a ruling that the trust would be a grantor trust where the grantor retained the power to borrow all or any portion of the corpus or income of the trust "without adequate security". (Presumably, the result would be the same if the trustee merely had the power to lend without adequate security as opposed to the grantor having the power to borrow without adequate security.) Interestingly, in that ruling, the S corporation and the grantor who were seeking the grantor trust ruling represented that their intention was "that this section allows Settlor to exercise this power unconditionally, without the approval of the trustees, or any other party".

d. Non Adverse Party Other Than Grantor Should Hold the Power. A provision giving the grantor the power to make loans to himself or herself without adequate security would cause grantor trust treatment under Section 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 non-adverse 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 Sections 2036 or 2038 as long as the replacement trustee must be someone who is not a related or subordinate party within the meaning of Section 672(c).

7. Power of Non-Adverse Party to Add Beneficiaries, §674(b), §674(c), 674(d).

   a. Statutory Provisions. 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 Sections 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), 674(b)(6), 674(b)(7), 674(c), 674(d). If such a power to add beneficiaries exists, the exceptions provided in Section 674(b), (c), and (d) will not apply, so the general rule in Section 674(a) provided for grantor trust treatment would apply.

   b. Who Should Hold the Power? The exception to the exceptions in Sections 674(b), (c), and (d) applies if "any person" holds the power to add beneficiaries. Therefore, there is no limitation on who can hold the power as far as whether the power will result in grantor trust status. The general rule of Section 674(a), which triggers grantor trust treatment where there is a power of disposition over trust property, applies only if the power of disposition is exercisable "by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." However, as long as a non-adverse party holds a power over dispositions, there is no requirement that the person who holds the power to add beneficiaries be a non-adverse party. However, a beneficiary should not hold the power to add non-charitable beneficiaries, or else gift consequences might result from its exercise.

      (1) Grantor. 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 Sections 2036(a)(2) or 2038.

      (2) Grantor's Spouse. 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.)

      (3) Beneficiary. The power to add beneficiaries should not be held by a beneficiary. An exercise of the power by a beneficiary might result in a deemed gift. Perhaps a gift would not result if the beneficiary merely has the power to add to the class of permissible beneficiaries but another trustee holds the power to make discretionary distributions to the added beneficiary.

      (4) Trustee. The power to add beneficiaries is sometimes granted to the trustee of the trust. See Letter Rulings 199936031 (trustee who was a non-adverse party held power to add one or more charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date), 9709001 & 9010065 (independent trustee holds power to add charities as beneficiaries). Query whether fiduciary principles would place any constraint on the ability of the trustee to add a beneficiary. One commentator summarizes this fiduciary problem:

         "One must face the dilemma that a trustee ordinarily would have no reason consistent with fiduciary duty to voluntarily relinquish powers that might be exercised in the future in the best interests of the trust beneficiaries. This is

> particularly true when an obvious result of such relinquishment would be to subject the trust or its beneficiaries to an income tax that they otherwise would avoid. Broad discretion in the trust instrument might not be sufficient to authorize the trustee to relinquish a power when there is no reason to do so. **Mere accommodation of the grantor does not appear to ever by a proper reason. Recent family limited partnership cases under section 2036(a) should give us pause."** Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1555 (April 2007).

(Ron Aucutt suggests that one possible solution to this dilemma is to provide that the trustee acquires a desirable power by relinquishing the power that makes the trust a grantor trust. For example, the Trustee might acquire the power to vary the shares of family members or to broaden the standard for distributions by relinquishing the power to add charitable beneficiaries. Id.)

If the client would really like the prospect of adding charitable beneficiaries of the trust in certain circumstances, perhaps the instrument could give guidance to the trustee regarding the situations in which the trustee should particularly consider adding charitable beneficiaries. However, the instrument should not add objective standards that may likely never be satisfied before a charitable beneficiary could be added. A court might determine in that situation that no real ability to add charitable beneficiaries existed.

c. Classes of Beneficiaries That May Be Added. The statute provides that the power to add beneficiaries "to provide for after-born or after-adopted children" would not cause grantor trust status. There appears to be no other limitations on the permissible class of added beneficiaries.

(1) Charities. Various cases and rulings have recognized grantor trust status where there is a power to add charities as beneficiaries. Eg. See Madorin v. Comm'r, 84 T.C. 667 (1985) (power of trustee to add charitable organizations causes grantor trust treatment); Ltr. Rulings 199936031 and 9709001. Another permissible way of limiting the types of charities that could be added would be to permit only the addition of charitable remainder trusts or charitable lead trusts with the grantor's issue as the noncharitable beneficiaries.

(2) Specified Classes of Individuals. The power could be granted so broadly as to permit adding any person as a permissible additional beneficiary. However, most grantors would be uncomfortable granting that broad of discretion to any individual. The permissible classes of additional beneficiaries could be limited in any manner desired by the grantor. For example, the power could be given to add members of a specific group, such as nieces and nephews, spouses of children, or more remote relatives. However, it is not clear that a power to "add" persons who are already contingent remote beneficiaries would be treated as a power to "add" beneficiaries that would trigger grantor trust treatment. "Adding" beneficiaries in that situation arguably just elevates their beneficiary status, but really does not "add" them as beneficiaries.

d. Special Power of Appointment. A special power of appointment granted to an individual to appoint trust assets to non-beneficiaries should constitute a power to add beneficiaries that would confer grantor trust status. See Letter Ruling 9643013 (trustee for one trust and grantor's spouse for another trust held special power of appointment currently exercisable in favor of spouses and former spouses of the grantor's descendants; held that the power of appointment was the equivalent of the power to add beneficiaries, which meant that the §674(c) exception did not apply).

e. Checks and Balances. Because of the very broad power granted to an individual to add beneficiaries, the grantor may feel more comfortable with a "checks and balances" system to assure that various individuals concur with the addition. (However, the consent of beneficiaries should not be required (because the actual grant of consent by beneficiaries may be a deemed gift)).

An approach used by some planners to provide "checks and balances" is to give someone other than the trustee the power to add beneficiaries, but to provide that the trustee would make the decision of when to make distributions to the new beneficiaries, the same as for all trust beneficiaries. However, one commentator has suggested that under section 674(a), the same person who has the power to add beneficiaries must "also have the power, without the approval or consent of an adverse party, to direct a distribution to such added beneficiaries." Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1553 (April 2007).

8. Foreign Grantor. Section 672(f) provides that the grantor trust rules will not apply if they would cause someone other than a U.S. citizen or resident or domestic corporation to be treated as the owner of the income. Therefore, if a foreign person is the grantor of a trust, the grantor trust rules will not apply as to that person. For example, a foreign person could create a trust for a U.S. beneficiary, who might be the trustee of the trust, and who might also be treated as the owner of the income of the trust under section 678 if the beneficiary has a Crummey withdrawal power over all contributions to the trust. Broad dispositive powers could be granted without fear of causing the foreign person to be treated as the owner of the trust under the grantor trust rules.

9. 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.)

   Grantor Trust 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.

10. 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 Section 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 Section 674—generally, more than one-half of the trustees are related or subordinate parties and there is no reasonably definite external standard for distributions. (2) Give a non-adverse

party the power to add beneficiaries. (3) Give a non-adverse trustee the power to make a loan to the grantor and not have to require adequate security for the loan. (4) Give the grantor 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.)

J. Grantor Trust—Toggle Provisions.

1. Desirability of Flexibility. A grantor may be concerned with being liable for what could potentially be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Being able to "turn off" the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a trust that would initially be treated as a grantor trust. Furthermore, planning flexibility could be increased if the power to "toggle" grantor trust status could be achieved. For an excellent discussion of these issues, see Van Hoften, Planning With Intentionally Defective Grantor Trusts, ALI-ABA Video Law Review 207 (March 26, 1997).

2. General Guidelines to Maximize Flexibility.

   (a) Use Different Persons to Trigger Power Verses Right to Relinquish or Reacquire Power. If the grantor has the right to relinquish a power that causes grantor trust status but has the right to reacquire that power, the relinquishment would not be given effect. The regulations provide specifically that if the grantor has a power broad enough to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under Section 675, he will be treated as the owner of the portion from the trust's inception. Treas. Reg. §1.675-1(a). Therefore, at a minimum, if the grantor has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute that power (to toggle back "on" the grantor trust status.) Furthermore, the grantor's retention of the right to toggle grantor trust status might arguably constitute a Section 2036(a)(2) estate inclusion power or arguably result in an incomplete gift.

   (b) Adverse or Non-Adverse Party Could Hold Power to Relinquish and Reinstate The Grantor Trust Power. Many of the grantor trust powers must be exercisable by a non adverse party in order to result in grantor trust status. However, the power to relinquish or reinstate a grantor trust power could be held by either an adverse party or a non-adverse party. (Non-adverse party status is only important for the person who holds the grantor trust power, and has no relevance to a person who has the authority to relinquish or reinstate that power.) An example of this is Letter Ruling 9010065, where the grantor's descendants (who were beneficiaries of the trust and, therefore, adverse parties) held the power to terminate the trustee's grantor trust power.

   (c) Spouse Holding Power to Relinquish or Reacquire Grantor Trust Powers. The grantor's spouse could have the power to exercise the grantor trust power directly, or could be authorized to relinquish the grantor trust power. (This may be helpful in some circumstances, because powers that could not be held by the grantor without risking estate inclusion could generally be held by the grantor's spouse.) However, beware of Section 672(e), which indicates that any powers held by the spouse will be deemed to be held by the grantor for income tax purposes. Accordingly, if the grantor's spouse is given the power to relinquish and to reacquire the grantor trust power, the grantor would be treated as holding the power to reacquire the grantor trust power and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status.

   (d) Using Different Persons May Provide Helpful Checks and Balances. The powers used to result in grantor trust status may be very "powerful" powers. Giving different persons the authority to exercise those powers, to relinquish them, or to reacquire them, may provide useful checks and balances of the ability to misuse those powers. Letter Ruling 9010065 illustrates an intricate checks and balances system. An unrelated trustee could add a qualified charity (which would cause grantor trust status). However, the designation of a charity as an additional beneficiary could not be made without the approval of the taxpayer's spouse (but if the spouse were not living, with the approval of the taxpayer's brother). Other parties (a majority of the taxpayer's

adult descendants) were given the power to cut off grantor trust status by terminating the trustee's authority to designate additional beneficiaries.

(e) Relinquishment Should Address Whether it Binds Successors; Only Permit Reinstatement in Subsequent Year. The relinquishment of a grantor trust power should specifically indicate whether it is binding on successor trustees or successor persons holding the relinquishment power. Maximum flexibility could be retained by not having the relinquishment binding on all successors, so that a third party could reinstate the power. In that case, perhaps provide that the reinstatement power could only be exercised in a subsequent taxable year, to help clarify that the trust is not a grantor trust in the year in which the relevant power is relinquished.

3. Examples of Toggle Arrangements.

(a) Removal and Replacement Power of Trustees Where Power to Make Discretionary Distributions by Trustee Who is Not "Related or Subordinate" is Used to Cause Grantor Trust Status. The power of a trustee, more than half of whom are related or subordinate parties, to make discretionary distributions not covered by a reasonably external standard will result in grantor trust treatment as to the entire corpus and income of the trust. See section II.C.3.a. of this outline. A third party could be given the power to remove and replace the trustees. This power could be exercised in a manner that would cause more than half of the co-trustees to be related or subordinate parties (if grantor trust status was desired) or that would cause no more than one-half of the trustees as being related or subordinate parties (if grantor trust status was not desired.) The grantor should not hold the power to remove and replace successor trustees unless any such successor must be someone who is not a related or subordinate party in order to meet the "safe harbor" provided in Revenue Ruling 95-58, 1995-2 C.B. 191.

Using this mechanism may be mechanically cumbersome unless the grantor is willing to give the party who has the removal power (or perhaps another party) a power to replace the removed trustee. If the grantor wishes to include a list of specified successor trustees in the event that a trustee fails to serve, it would be difficult to determine whether the next successor should be a related or subordinate party or not at the time that the trust agreement was prepared.

The person being given the authority to remove and replace trustees should be protected by broad exculpatory provisions so that decisions regarding the grantor trust tax status of the trust will not be challenged by the grantor or by the beneficiaries.

(b) Third Party Having Authority to Cancel and Reinstate Substitution Power. Grantor trust status could be toggled by giving someone other than the grantor the right to cancel and reinstate a power of substitution under Section 675(4)(C).

(c) Power to Loan to Grantor Without Adequate Security. Either the trustee or the grantor could be given the authority to relinquish the trustee's power to make loans to the grantor without requiring adequate security. Someone other than the grantor could be given the power to reinstate the power to loan without adequate security. To provide additional checks and balances, different persons could be given the authority to terminate and reinstitute the power to lend without adequate security. However, if desired, a single person, who is not related or subordinate to the grantor (to put the grantor in the best position to argue that the power to lend without adequate security does not cause estate inclusion) could be given the power to both terminate and reinstate the lending power.

(d) Power to Add Beneficiaries. The person who is given the authority to add beneficiaries could also be given the authority to relinquish the right to add beneficiaries. If a potential toggle is desired, another party should be given the authority to reinstitute the power to add beneficiaries. (If the original party has the power to reinstitute the authority to add beneficiaries, he or she would be treated as never having relinquished the authority to add beneficiaries.) Even if different persons are used, some commentators are concerned that the IRS may view the two persons together as still holding the power. Aucutt, Installment Sales to Grantor Trusts, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1359 (April 2007) ("The ability to reacquire the power may be viewed as tantamount to having the

power itself. Even if the power is held by someone other than the trustee (such as a 'protector'), that probably only means that the trustee and the protector together still have the power.").

K. Grantor Trusts With Split Purchase Transactions

A transaction may be structured as split purchase transactions where the "retained income interest" that is purchased by the parent is in the form of a qualified interest under section 2702 (either a qualified interest in a residence or a qualified annuity interest). An old ruling said that the parties would be treated as an association rather than a trust if there are successive interests. To avoid any possible such income tax consequences, some planners structure split purchase transactions so that the grantor or a grantor trust are on all sides of the transaction.

L. 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. PLRs 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. §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. §101(a)(2)(B).

   Rev. Rul. 2007-13 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. Pvt. 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. 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., Pvt. 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.

M. Charitable Lead Trusts.

1. General Description.

A charitable lead trust ("CLT") pays a specified amount (either a fixed annuity amount or a unitrust amount) to charity annually. At the end of a fixed term (which can either a term of years or for the life or lives of an individual or individuals), the assets typically pass to younger family members. The trust is a qualified split interest trust, and a charitable gift and estate tax deduction is allowed for the present value of the payments to charity. The trust is typically structured as an annuity trust ("CLAT"), so that the payments to charity are fixed and all appreciation in the assets that are not needed to pay the fixed annuity amounts will pass to younger generations free of gift or estate tax. In this manner, the CLAT is very much like a GRAT, except that the annuity payments are made to charity instead of being made to the grantor. (Indeed, the regulations for GRATs were drafted based on the charitable lead trust regulations.)

2. Alternatives for Describing Charitable Amount.

A annuity trust format (i.e., for a CLAT) provides that a fixed or determinable amount must be payable at least annually throughout the charitable term. The amount may either be a fixed dollar amount or a fixed percentage of the net fair market value of the initial trust corpus. Treas. Reg. §§ 1.170A-6(c)(2)(i), 20.2055-2(e)(2)(vi)(a), 25.2522(c-3(c)(2)(vi)(a). The annuity payments do not have to be level, but may vary as described in the trust instrument so long as the amounts are determinable on the date of transfer. Id.; Ltr. Rul. 9112009. If the annuity payments are very low in the early years of the GRAT (to leave property expected to appreciate substantially in the trust as long as possible), the low early payments may leave the CLAT with taxable income. (The CLT is not a tax-exempt entity, but generally receives a deduction for the annual payments as they are made to charity.)

A unitrust format (for a CLUT) must provide for a payment at least annually of a fixed percentage of the net fair market value of the trust's assets, determined annually. The agreement may specify a particular annual valuation date, or specify a valuation method based upon the average of several specified dates during the year. Treas. Reg. §§ 1.170A-6(c)(2)(ii), 20.2055-2(e)(2)(vii), 25.2522(c)-3(c)(2)(vii).

3. Permissible Term of Charitable Interest.

The charity's interest must last for a fixed number of years, for the life or lives of an individual or individuals each of whom is alive at the date of transfer, or for the life of an individual plus a term of years. Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a) (annuity trusts); 20.2055-2(e)(2)(vii)(a) and 25.2522(c)-3(c)(2)(vii)(a) (unitrusts). The charity's lead interest can continue for the lesser of a term of years or a period of lives in being plus a term of years. Rev. Rul. 85-49, 1985-1 C.B. 330.

4. Grantor CLT.

The CLT may be designed so that it would violate the grantor trust rules in §671-677, and the grantor would be treated as owning the trust assets for income tax purposes. The grantor would

then receive an income tax charitable deduction upon the formation of the CLT, but he or she would be taxed on the CLT's income during the term of the trust. I.R.C. §170(f)(2)(B). Any charitable deduction claimed is subject to recapture if the grantor trust status is terminated before the end of the trust term. Id. (The income tax charitable deduction is subject to the 30% of AGI limitation because it is "for the use of" and not "to" the charity. I.R.C. §170(b)(1)(B) & Treas. Reg. § 1.170A-8(a)(2).) The grantor does not receive a charitable deduction when the payments that are made to charity, even if those payments exceed the amount of charitable deduction that the grantor received on creating the trust.

5. Non-Grantor CLT.

If the CLT does not violate the grantor trust rules, the trust is not a grantor trust. The grantor does not receive an upfront income tax charitable deduction, but the trust's income is excluded from his or her taxable income during each year of the trust. I.R.C. §170(f)(2)(B). The non-grantor CLT is not a tax-exempt entity and is taxed on its income each year. The trust receives an unlimited income tax charitable deduction for amounts paid to charity during the year. I.R.C. §642(c)(1). The CLT does not have to pay income tax in any year if the payments to charity exceed the taxable income of the trust in that year.

6. Gift Tax Considerations in Structure of CLT.

If the CLT is formed during the grantor's life, the grantor receives a gift tax charitable deduction for the present value of the stream of payments to charity. The gift will not qualify for the gift tax annual exclusion, because the remainder interest is not a gift of a present interest. By using the right combination of annuity rate and trust term, the gift can be reduced to zero. A CLUT will never result in a zero gift because no matter how high the unitrust rate is set, there will be something to pass to remaindermen at the end of the trust term. A CLAT is generally preferable to a CLUT for maximizing the amount that could be transferred to younger generations at the end of the CLT term.

7. GST Tax Considerations.

GST exemption can be allocated to a CLAT when it is created, but the inclusion ratio is not determined until the lead interest ends. I.R.C. §2642(e). The "adjusted GST exemption, for purposes of determining the inclusion ratio when the trust ends, is the amount of the initial GST exemption compounded by the §7520 rate that is used to value the annuity interest for gift tax purposes. For this reason, it is difficult to allocate the proper amount of a taxpayer's GST exemption when it is created, to be a sufficient amount that will cover (but not exceed—so GST exemption is not wasted) the full value of the trust at its termination.

The inclusion ratio of a CLUT is determined when the trust is established. For this reason, CLUTs are often the preferred type of CLT when a donor wishes to benefit grandchildren at the termination of the trust.

8. Replacement of Grantor's Charitable Contributions.

One situation in which a CLT would make sense is if the grantor is making substantial regular charitable contributions. The CLT could be designed to make the charitable contributions that the grantor would otherwise make. While the grantor will not receive an income tax deduction for those payments, the grantor is also not taxed on the income of the trust that would have otherwise been owned by the grantor. In addition, the grantor may be able to transfer substantial value to younger generations at the end of the CLT term without any gift or estate tax.

9. Applicability of Private Foundation Rules.

A CLT is treated as a private foundation for certain purposes, thus subjecting the trust to limitations on self-dealing (I.R.C. §4941), excess business holdings (I.R.C. §4943), jeopardizing investments (I.R.C. §4944), and certain "taxable expenditures" (I.R.C. §4945).

The limitation on excess business holdings is particularly important in the situation of a client who wishes to utilize the charitable lead trust for transfers of stock in the client's closely held business. However, the excess business holdings limitation (and also the jeopardy investments limitation) will not be applicable if the initial value of the charitable interest in the trust constitutes 60% or less of the aggregate fair market value of the amount in the trust. I.R.C. §4947(b)(3)(A); see Treas. Reg. §25.2522(c)-3(c)(2)(vi)(e). Of course, this would require incurring a gift tax (or estate tax for CLTs created at the death of an individual) on at least 40% of the value of the amount initially contributed to the trust.

PART TWO—FORMULA VALUATION AND DEFINED VALUE CLAUSES

I. PROBLEMATIC VALUATION ISSUES.

A. Gift Issues.

Determining the correct value of the donated item is obviously important for purposes of determining the amount of the gift tax (or the amount of the "applicable exclusion amount" that would be utilized by the gift.) An example of a gift situation where difficult valuation problems arise is in funding with in-kind property pecuniary annuity payments that are due under GRATs.

B. GST Transfers.

If gifts to grandchildren exceed the donor's available GST exemption, GST taxes (as well as gift taxes) may be due. Even if "direct skip" gifts are not involved, valuation issues are vitally important. Planning flexibility is increased and administrative complexities are reduced dramatically if a trust is either fully subject to the GST tax or fully exempt from the GST tax. If a gift to a purported GST-exempt trust exceeds the donor's remaining GST exemption amount, a partially GST-exempt trust can result.

C. Sales.

Proper valuation of assets that are sold as well as consideration received in the sale (i.e., an installment note or annuity payment) is vitally important to assure that an indirect gift does not result from the sale. These problems apply to both direct sales as well as transfers in return for private annuities.

D. Testamentary Transfers.

A classic problem is to make sure that the amount passing to a bypass trust at the first spouse's death is maximized, without generating estate taxes at the first spouse's death. Valuation problems can also arise in the funding of pecuniary bequests.

II. DEFINED VALUE CLAUSES ARE COMMON IN TESTMENTARY PLANNING.

Defined value clauses are routinely used in various traditional planning strategies, including formula marital deduction bequests, bequests with "pick and choose" funding provisions, fractional share bequests, formula GST exemption allocations, and disclaimers.

III. HISTORICAL BACKGROUND SUMMARY OF CASE LAW AND RULINGS REGARDING VALUATION ADJUSTMENT CLAUSES BEFORE THE FIFTH CIRCUIT SPOKE IN MCCORD

A. 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 Frederic W. Procter free from the trust hereby created." 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:

- It tended to discourage tax collection by public officials since enforcement would defeat the gift;
- It obstructed justice by requiring the court to decide a moot case; and
- If the adjustment clause were given effect, a final judgment of the court would be for naught.

Miscellaneous other cases and rulings have followed the Procter analysis. Ward v. Comm'r, 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. Comm'r, 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"); TAMs 9309001, 9246007, 9133001, 8549005, & 8531003.

B. Favorable Decision-King v. US.

In King v. US, 545 F.2d 700 (10th Cir. 1976), the transferor agreed to sell corporate stock, with a provision requiring an adjustment to the sale price in the promissory note if the IRS determined that the stock was sold for less than fair market value. The Tenth Circuit relied upon the existence of the price adjustment clause to support a factual determination that the transferor had intended to make an arms-length sale. The facts did not involve any reconveyance of property.

C. Recent Case-Estate of McLendon.

A more recent valuation adjustment clause case is Estate of McLendon v. Comm'r, T.C. Memo 1993-459, rev'd, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause). In that case, the transferor sold assets in exchange for an annuity. The annuity agreement included the following paragraph in light of the difficulty of valuing the assets transferred:

> "The parties hereto recognize that the valuation of many of the assets set out on the attached Exhibit A are, by their nature, as determined by the best judgment of the parties and independent consultants engaged to assist in the valuation process and maybe subject to differing opinions. Therefore, the parties agree, to the extent that any of the values on the attached Exhibit A are changed through a settlement process with the Internal Revenue Service, or a final decision of the United States Tax Court, the purchase price hereunder shall be adjusted accordingly, with interest on said adjustment at the rate of ten percent (10%) from the date hereof until said final determination of value, and the annuity payments due and payable hereunder shall likewise be adjusted to reflect any change in valuation."

The Tax Court ignored the adjustment clause, based on Procter and Ward. The court concluded 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."

D. Revenue Ruling 86-41.

Revenue Ruling 86-41, 1986-1 T.C. 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 a transfer subject to a condition subsequent. Their ruling suggested that a different result might occur if the adjustment resulted from an independent appraisal.

E. TAM That Recognized a Defined Value Clause.

In Technical Advice Memorandum 8611004, the decedent had assigned "such interest in x partnership…as has a fair market value of $_____." The Service determined that the portion of the partnership that the decedent owned for estate tax purposes could only be determined by valuing the partnership as of the date of gift and then dividing the stated dollar amount of the gift by the value of the partnership. The Service concluded that no gift tax liability would result from an assumption that the donees had received a larger fractional interest than ultimately determined by the IRS or from partnership distributions that were made in reliance on the erroneous assumption, so long as the decedent had not waived rights under local law to assert a claim for the excess partnership interest and the excess distributions and as long as the claims were not barred by the statute of limitations.

The IRS has subsequently ruled that this type of clause is not recognized, as discussed below.

F. IRS Objection to Formula Allocation to GST-Exempt and Non-Exempt Trusts, East v. Commissioner.

In a case docketed in Tax Court, the IRS refused to allow the taxpayer's use of a formula clause to determine the respective amounts of property gifted to children and grandchildren. Evelyn East v. Comm'r, Tax Court Docket No. 12019-98 (the lead attorney on the taxpayer's petition filed with the Tax Court on July 6, 1998, is Donald F. Wood, Vinson & Elkins, LLP, Austin, Texas). The donor made gifts of her interest in a general partnership to trusts for the benefit of her grandchildren and children using a formula clause to define the value of the partnership interest initially transferred in terms of the value of such interest as finally determined for federal transfer tax purposes. The IRS took the position that the percentage interest determined for the transfer to each of the grandchildren's trusts based on the assumed value of the partnership assets (i.e., 9.6618 %) would continue to apply. Each grandchild's trust was deemed to have been transferred that partnership percentage times the appropriate value of the partnership for gift tax purposes.

The IRS's approach points out the logical disconnect of refusing to give any effect to the formula allocations because the defined value clause itself defines the amount transferred, and one cannot determine the amount transferred except by reference to the formula. There seems to be no logical reason to use 9.6618% as the partnership interest transferred when the conveyance instrument never specified that particular percentage amount. However, if the percentage amount (based on the gift tax return) is not used, there is a "chicken or the egg" problem in determining what is the amount of the excess gift. It would seem difficult to distinguish the IRS's position in East with marital deduction/GST formula clauses that are very commonly used in wills.

Court records reflect that the East case was eventually settled. The settlement provided for a very sizable reduction in the gift tax, compared to the $1,294,406 assessed by the IRS, and provided for no GST tax. In effect, the settlement recognized the GST exempt nature of the defined value transfer to the grandchildren.

G. Tax Court Refuses to Recognize Defined Value Clause in Gift Transaction Because Parties Did Not Respect the Clause-Knight v. Commissioner.

In Knight v. Commissioner, 115. T.C. 506 (2000), parents made gifts of limited partnership interests to their two children by the following conveyance: "Transferor irrevocably transfers and assigns to each Transferee above identified, as a gift, that number of limited partnership units in Herbert D. Knight Limited Partnership which is equal in value, on the effective date of this transfer, to $600,000." The intent of the conveyance was to transfer limited partnership interests worth $300,000 to each of the two children. The IRS argued that the transfer document made a formula gift that is void as against public policy, citing Commissioner v. Proctor, 142 F.2d 824 (4th Cir. 1944), and Ward v. Comm'r, 87 T.C. 78, 109-116 (1986). The court observed that in Proctor, the excess value would revert to the donor, and the Fourth Circuit Court of Appeals described this as a condition subsequent that was void as against public policy.

The Tax Court in Knight stated that it did not have to decide whether Proctor and Ward control the conveyance of a limited partnership equal to a stated value because the parties in that case did not respect the clause. (1) The gift tax return reported a gift of 22.3% limited partnership interest rather than a gift of limited partnership interests worth $300,000 (which the court thought shows the parties' disregard for the transfer document), and (2) the taxpayer in litigation argued that the gift was worth less than $300,000 (which the court found to be inconsistent with the conveyance document). The court concluded: "We treat petitioners' contention and offer of evidence that the gifts were worth less than $300,000 as opening the door to our consideration of respondent's argument that the gifts were worth more than $300,000." In a footnote, the court also mentioned that the appraisal at the time of the transfer said that a 22.22222% limited partnership interest was worth $300,000, but the parties treated the transfer as a 22.3% limited partnership interest. [Editorial comment: Picky, Picky!] The court seemed to go out of its way to refuse giving effect to the defined value clause without having to hold that it was a savings clause that is prohibited under Proctor.

H. IRS Refuses to Recognize Defined Value Clause in Field Service Advice Memorandum; McCord.

The IRS has addressed a defined value clause-type situation in Field Service Advice Memorandum 200122011. In that FSA, a transfer was made to a children's trust of a percentage interest in a partnership equal to $x, and the balance of the partnership interest was transferred to a charity. The charity obtained an appraisal and sold its partnership interest back to the partnership, in redemption of its interest. The IRS viewed this as a Procter-type clause that would not be respected. The underlying case addressed in that FSA is McCord v. Commissioner, (discussed below). In McCord, the taxpayers made gifts of limited partnership interests under a formula clause: (a) The first amount passed to trusts for grandchildren; (b) Next, an amount passed to children; and (c) The remaining portion passed to specified charities. About three months after the gifts, the general partners negotiated with the charities to redeem their interests in the partnership. The transfers were made using two net gift approaches: First, the gift tax was netted, and second, the actuarially determined value of the obligation to pay estate tax on the inclusion of the gift tax if the donors died within three years of the gift was netted from the gifts.

For a detailed discussion of this FSA and the McCord case, see Hood, Defined Value Gifts: Does IRS Have It All Wrong?, EST. PL. (Dec. 2001); "Charitable Lid" Formula Used in Connection With FLP Disregarded, J. TAX'N (Aug. 2001).

Another docketed case involving a price adjustment clause is Estate of Marshall v. Comm'r, Tax Court Docket No. 1076-00 (using price adjustment clauses in redemption from a GRAT, an installment sale to the decedent's son, and a private annuity).

I. TAM 200245053—IRS Refuses to Recognize Defined Value Clause in Sale Transaction.

The IRS determined that "formula sale" provisions in a purchase agreement were not effective for gift tax purposes. The IRS concluded that the savings clause was void for gift tax purposes, citing Procter, Ward, and Rev. Rul. 86-41. The IRS reasoned that if the clause were given effect, the IRS would have no incentive to challenge the value of the partnership interest because any adjustment would be rendered moot. The IRS also observed that, as in Ward, there is no assurance that the agreement would be enforced. Tech. Adv. Memo. 200245053.

In Technical Advice Memorandum 200245053 the taxpayer's revocable trust gave a 0.1% limited partnership interest to a new irrevocable trust for her lineal descendants. In addition, the revocable trust sold to the new irrevocable trust a fractional portion of a 98.5% limited partnership interest owned by the revocable trust in the same partnership.

The Sale Agreement describes the fractional share that is being sold as follows: "The numerator of such fraction shall be the Purchase Price, and the denominator of such fraction shall be the fair market value all of [the 98.9 percent limited partnership interest]. The fair market value of [the 98.9 percent limited partnership interest] shall be such value as finally determined for federal gift

tax purposes based upon other transfers of limited partnership interests in the Partnership by Seller as of [Date 2], in accordance with valuation principles set forth in Regulation Section 25.2512-1 as promulgated by the United States Treasury under Section 2512 of the Internal Revenue Code of 1986, as amended." The "Purchase Price" was defined as a value to determined by appraisal as soon as practicable after Date 2. The trustees of the revocable paid for the Purchase Price by giving a promissory note.

The taxpayers argued that the case was distinguishable from Procter because the assets subject to the sale would not be adjusted based upon a final determination of the gift tax value of the property subject to the sale, but rather based on the gift tax value of the 0.1 percent limited partnership interest that was transferred by gift to the new irrevocable trust. Furthermore, the IRS's action would not be moot, because it would impact the gift tax value of the 0.1 percent limited partnership interest. The IRS rejected that distinction: "The Taxpayer has placed an insignificant portion of the transaction at issued in order to circumvent well-established case law that has developed regarding savings clauses. We do not believe the courts would permit these decisions to be so easily avoided."

The taxpayer also argued that this type of clause is similar to valuation formula clauses sanctioned by the IRS in other situations, such as testamentary marital deduction formula clauses, and GRATs. The IRS responded that marital funding formula clauses are distinguishable, reasoning that making full utilization of the credit shelter amount requires the use of formula clauses because a testator cannot anticipate when he or she will die or the value of the property of the time of death. Furthermore, the values of certain assets are inherently uncertain, and it is not feasible to continuously redraft testamentary instruments each time asset values change. "Thus, utilization of a testamentary marital deduction or credit shelter valuation formula clause is the only practical way a testator can take full advantage of these Congressionally authorized benefits." The IRS distinguished the GRAT situation because it is specifically sanctioned by regulation and because the preamble to the GRAT regulations expresses concern regarding the use of a formula to "zero-out" a gift under a GRAT.

The IRS, in no uncertain terms, concluded that the use of the defined value clause in the sale transaction was abusive: "The creation of the partnership and the use of the valuation formula clause in the sale of the partnership interests are all part of an integrated transaction the primary purpose of which is to transfer assets to the natural objects of Taxpayer's bounty at a discounted value, while foreclosing any realistic opportunity to challenge the transaction. The Taxpayer created and funded the limited partnership primarily, if not solely, to generate valuation discounts, with the goal of enabling her irrevocable trust to acquire the interests at a reduced purchase price. The Taxpayer employed the formula clause as part of the transaction in an attempt to ameliorate any adverse consequences if the Service challenged the transaction and thereby to discourage any such challenge. The clause does not serve a legitimate purpose, such as ensuring that the purchase price accurately reflects fair market value. Rather, the clause recharacterizes the nature of the transaction in the event of a future adjustment to the value the partnership interests by the Service. Under these circumstances the adjustment clause should not be effective for gift tax purposes."

J. TAM 200337012—IRS Refuses To Recognize Transfer of Fractional Interest Having A Specified Value.

The taxpayer transferred to a trust "that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $A." The IRS ruled that this is not recognized because it is similar to the clauses in Ward v. Comm'r, and Rev. Rul. 86-41, 1986-1 C.B. 300, and is void as contrary to public policy. The taxpayer argued that this clause is distinguishable from the clauses in Procter because the donor never receives anything back. The IRS did not agree: "However, pursuant to the assignment, Trust received an X% interest in Partnership from Taxpayer. If Paragraph B is given effect and the value of the X% interest, as finally determined by the Service, is greater than $A, a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in Procter and Ward conclude are void as contrary to public policy."

K. Tax Court Refuses to Give Effect to Defined Value Clause Under Interpretation Analysis McCord v. Commissioner.

On January 12, 1996, parents assigned their Class B limited partnership interests (actually assignee interests) by a formula clause: "Under the terms of a 'formula clause' contained in the assignment agreement (the formula clause), the children and the trusts were to receive portions of the gifted interest having an aggregate fair market value of $6,910,933; if the fair market value of the gifted interest exceeded $6,910,933, then the symphony was to receive a portion of the gifted interest having a fair market value equal to such excess, up to $134,000; and, if any portion of the gifted interest remained after the allocations to the children, trusts, and symphony, then CFT [Communities Foundation of Texas] was to receive that portion (i.e., the portion representing any residual value in excess of $7,044,933)."

The majority opinion interpreted the assignment agreement to leave to the assignees the task of allocating the gifted interest among themselves. McCord v. Comm'r, 120 T.C. 358 (2003). The agreement contains the following instruction concerning valuation: "For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this Assignment Agreements between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Any dispute with respect to the allocation of the Assigned Partnership Interests as among Assignees shall be resolved by arbitration as provided in the Partnership Agreement."

After the assignment, the various assignees agreed (in a "Confirmation Agreement") to specific percentage amounts that would pass to the various assignees. The charities (and their outside counsel) reviewed an appraisal report that was the basis of the allocation, and determined that it was not necessary for them to obtain their own appraisals.

The court held that the specific clause was not "self-effectuating" because the formula was based on the "fair market value" of the transferred interest, rather than being based on the "fair market value as finally determined for Federal gift tax purposes." The Court, in effect, ignored the Defined Value Clause, and gave effect to the percentages recognized by the parties in the Confirmation Agreement—despite the fact that the percentages agreed to in the Confirmation Agreement were based on appraised values that were far different than the finally determined gift tax values.

The 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 interst 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."

A concurring opinion stated that the clause should also be disregarded because of the "long-standing 'reasonable probability' and 'public policy' doctrines applicable generally to gifts…" The opinion cited Hamm v. Commissioner, T.C. Memo 1961-347, aff'd, 325 F.2d 934 (8th Cir. 1963) (applying reasonable probability standard to the question of whether a charitable donee will ever receive gifted property) and Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944) (applying public policy principles to question of whether abusive valuation or adjustment clauses are to be respected). In the opinion of Judge Swift, "these doctrines live and breathe and have a life that should be broad and flexible enough to apply to contemporary and overly aggressive gift and estate tax planning (such as that involved herein)—particularly where charity is involved." Judge Swift also said that the rules disallowing deductions for gifts to charity of partial interests should apply to gifts of assignee interests (had the IRS made that argument).

Interestingly, a dissent by Judge Chiechi points out that the formula clause was based on "fair market value" as defined in the Agreement, and the majority opinion acknowledged that the definition of "fair market value" in the Agreement is the same definition of that term as applies for Federal gift tax purposes. She points out that in essence, "the majority opinion concludes that the donees of the gifted interest made a mistake in determining the fair market value of that interest and that petitioners are stuck with that mistaken value solely for purposes of determining the respective assignee percentage interests transferred to the donees under that agreement."

Another dissent by Judge Foley points out that the IRS never made the "interpretation argument"—the Court came up with that theory on its own. The Foley dissent (which was agreed to by Judge Chiechi) also concluded that the clause did not violate public policy and is distinguished from the Procter case because no assets were to be returned to the donor based on the results of the gift tax determination. Judge Foley, who was the trial judge, obviously was most displeased that the majority of the full Tax Court did not agree with his conclusions. His dissent opens with this volley: "Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law." Is there any doubt how Judge Foley felt about the majority's result?

While the case did not give recognition to a defined value clause, 10 of the 12 judges apparently would have recognized the clause if it had been based on values as finally determined for federal gift tax purposes. Only two judges held that the clause should be rejected on public policy grounds.

The case was reversed by Fifth Circuit Court of Appeals, as discussed below.

L. Karmazin Settlement (T.C.Docket No. 2127-03, filed Feb. 10, 2003).

Taxpayer created an FLP owning marketable securities. Taxpayer made a gift of 10% of the LP interests and sold 90% of the LP interests to two family trusts. The sales agreements contained "defined value clauses." The sales to each of the trusts were made in exchange for secured promissory notes. The IRS refused to recognize the sale transaction, but the case ultimately settled. However, the IRS refused to give effect to the defined value clause in the settlement. See Part One, Section V.G.7. of this outline.

M. Specifically Sanctioned Defined Value Clauses.

1. Traditional Marital Deduction Formula Clauses.

   Revenue Procedure 64-19, 1964-1 C.B. 682 specifically sanctions the use of formula marital deduction bequests.

2. GRAT.

   The GRAT regulations specifically sanction defining the annuity amount in terms of a percentage of the finally determined fair market value of the assets transferred to the GRAT. Treas. Reg. §25.2702-3(b)(1)(ii)(B). The GRAT regulations also describe document requirements for dealing with an incorrect valuation (incorporating the charitable remainder annuity trust provisions). Treas. Reg. §25.2702-3(b).

3. Charitable Reminder Annuity Trusts.

   The CRAT regulations provide that "[t]he stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of property irrevocably passing in trust as finally determined for federal tax purposes." Treas. Reg. §1.664-2(a)(1)(iii). See Rev. Rul. 80-123, 1980-1 C.B. 205 & Rev. Rul. 82-128, 1982-2 C.B. 71 (allowing formula value clauses in charitable remainder trusts). The regulation also provides details as to how repayments or payment additions or other procedures are to be carried out if the market value is incorrectly determined initially. Treas. Reg. §1.664-3(a)(1)(iii).

4. Disclaimers.

The regulations and a large number of private letter rulings recognize that a formula disclaimer may be a qualified disclaimer. Treas. Reg. §§25.2518-3(c); 25.2518-3(d), Ex. 20. The specific recognition of formula disclaimers may be used creatively to create defined value transfers.

a. Marital Gift With Disclaimer. A taxpayer could make a gift to an inter vivos QTIP trust or outright to his or her spouse, with a provision that any disclaimed assets would pass to a trust for the taxpayer's children. The spouse could subsequently (within 9 months) disclaim a formula amount of the gift, based on values as finally determined for federal gift tax purposes. For example, the disclaimer could provide for a disclaimer of a fractional share of the gift, where the numerator of the fraction is $_____, and the denominator of the fraction is the value of the transferred property as finally determined for federal gift tax purposes.

b. Formula Disclaimer Where Disclaimed Amount Passes to Charity. A will could provide that disclaimed assets would pass to a charitable organization (perhaps to a donor-advised fund of a Communities Foundation). The beneficiaries could disclaim all of the estate over a specified dollar amount based on federal estate tax values. If the IRS asserted that the values on the estate tax return were too low, the excess value would pass to charity and would not generate additional estate tax. However, the IRS has (surprisingly) attacked this type of disclaimer as an invalid Procter type of transfer. see Part Two, Section VI.B.3. of this outline.

See Part Two, Section VI of this outline for a detailed discussion of formula disclaimers.

IV. THE FIFTH CIRCUIT WEIGHS IN--MCCORD

A. Basic Issue.

McCord involves a gift made by a formula giving a specified dollar amount of limited partnership interests. 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). 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.

B. Two Fundamental Types of Defined Value Clauses.

(1) Defined Value Clauses That Limit the Amount Transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula)
(2) Defined Value Clauses That Allocate Amount Among Transferees (i.e., transfer all of a particular asset, and allocating that asset among taxable and non-taxable transferees by a formula)
(The McCord case used the second type of clause.)

C. Basic Facts.

1. Assignment Under Defined Value Clause.

Parents assigned their Class B limited partnership interests by a formula clause, very simply summarized by the Fifth Circuit as follows:

"We have observed that these gifts divested the Taxpayers of their entire interest in MIL then remaining. It did so, however, *not* in *percentages* of interest in MIL, however, but in *dollar*

amounts of the net fair market value of MIL, according to a *sequentially* structured "defined value clause":

Donee	Gift
First, to the Generation Skipping Tax Trusts ("GST trusts")	A dollar amount of fair market value in interest of MIL equal to the dollar amount of Taxpayers' net remaining generation skipping tax exemption, *reduced by* the dollar value of any transfer tax obligation owed by these trusts by virtue of their assumption thereof.
Second, to the Sons	$6,910,932.52 worth of fair market value in interest of MIL, *reduced by* the dollar value of (1) the interests in MIL given to the GST trusts, and (2) any transfer tax obligation owed by the Sons by virtue of their assumption thereof.
Third, to the Symphony	$134,000.00 worth of such in interest of MIL.
Last, to [Communities Foundation of Texas]	The dollar amount of the interests of the Taxpayers in MIL, *if any*, that remained after satisfying the gifts to the GST trusts, the Sons, and the Symphony."

The assignment agreement contains the following instruction concerning valuation: "For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this Assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Any dispute with respect to the allocation of the Assigned Partnership Interests as among Assignees shall be resolved by arbitration as provided in the Partnership Agreement."

Observations regarding the basic facts surrounding the defined value gift

Apparently, the family was very charitably inclined. If the clause operated to leave more assets than originally contemplated to the donor advised fund at the Communities Foundation of Texas, the family would have simply substituted distributions from the donor advised fund for charitable contributions that the family would have made anyway in future years.

The $6,910,932.52 number is rather curious. Apparently, the taxpayers had a detailed appraisal prepared, and they wanted to leave a targeted significant interest to the "residual" gift to the Communities Foundation. They worked backwards in setting the dollar amount gift to the sons, in order to leave the anticipated targeted amount to the charity. In retrospect, the planners would probably use round figures in future transactions (for example, $7.0 million instead of $6,910,932.52).

2. Confirmation Agreement Among Donees. About two months after the assignment (in March 1996), the various assignees agreed (in a "Confirmation Agreement") to specific percentage amounts that would pass to the various assignees. The charities (and their outside counsel) reviewed an appraisal report that had been prepared by Howard Frazier Barker Elliott, Inc. (the "Frazier appraisal") after the gifts were made. The Frazier appraisal concluded that a 1% assignee interest was worth $89,505. The charities determined that it was not necessary for them to obtain their own appraisals. The donees agreed on the percentages passing to the various donees, using a value of $89,505 per 1% interest.

3. Exercise of Call Right to Acquire Charities' Interests. About three months later (in June 1996), the partnership exercised its call right to acquire the charitable interests. The appraiser updated his appraisal. The partnership and the charities reviewed it and agreed to

accept its $93,540 value of a 1% interest. (The Fifth Circuit concluded that the donors had nothing to do with the exercise of the call rights or the redemption prices.)

4. Gift Tax Returns. Gift tax returns were filed, calculating the taxable gifts for the gifts to the non-charitable donees as $89,505 per 1% interest, less the gift tax and actuarially determined contingent estate tax liability under §2035(b).

5. Notice of Deficiency. The IRS Notice of Deficiency claimed that the gifts should have been calculated based on $171,749 per 1% interest (almost double the donors' $89,505 figure).

D. Summary of Fifth Circuit Holdings.

Oral argument to the Fifth Circuit Court of Appeals was in May 2004. For some unknown reason, the three judge panel took almost 27 months to issue this unanimous opinion. (In light of the long delay, many had theorized that there must be a huge difference of opinion among the judges, which would suggest that there would have been a dissent. That was not the case.)

(1) The case involved, at most, a mixed question of law and fact, and because it turns on a legal conclusion, the court reviews the case de novo.

(2) 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, are 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).

(3) The contingent estate tax liability under §2035 that is assumed by the non-charitable donees if either donor died within three years of the gift is not so speculative that it cannot be considered in determining the net value of the gifts.

E. Brief Analysis of Fifth Circuit Opinion.

1. Burden of Proof. The parties had stipulated that the Commissioner had the burden of proof.

2. Commissioner's Theory on Appeal. The Commissioner did not argue in the body of its brief what many believed to be its strongest arguments in fighting the defined value clause (substance over form, public policy, etc.). However, it did note those arguments (citing the Procter, Ward, Gregory, and Court Holding cases) in footnote 18 of its brief, and requested the Fifth Circuit to remand the case to the Tax Court if the court determined not to accept the Tax Court's "interpretation argument" that refused to apply the defined value clause. The Fifth Circuit's position is that the Commissioner waived those arguments, and the Fifth Circuit did not consider them. The Commissioner just sought to uphold the various steps of the Tax Court majority, as summarized in Item 5 above regarding the Tax Court opinion. Similarly, the Commissioner did not include in its brief the argument that the transferred interests should be valued as full limited partnership interest rather than assignee interests.

3. Concluding Logic. The Fifth Circuit concluded that given the Tax Court Majority's non-erroneous rejection of the Commissioner's experts' values, its own legal error of refusing to discount the gift by the present value of the assumed liability for §2035 estate taxes, the fair market values "are, by a process of elimination, those determined by the Frazier report and used by the Taxpayers in preparing their gift tax returns for 1996." This logic reflects the organization of the gift tax return in reporting the gifts. The gift tax returns determined the taxable gifts by starting with the total value of the transferred interests (using the Frazier appraisal), subtracting the assumed gift tax liability and the actuarial present value of the assumed estate tax liability, and the charitable deductions for amounts passing to charity. While the court's logic follows the organization of the gift tax returns, it might seem that even

the Frazier appraised value is irrelevant to determining the amount of the gift to the non-charitable donees, which was merely stated as a dollar amount. That would seem to be the only basis for refusing to remand the case to the Tax Court to determine the factual value consistent with the court's opinion (or reviewing the Tax Court's determined value under a clear error standard).

4. Court's Logic is Confusing; Did Court Actually Recognize Defined Value Clause? Some commentators have concluded that the Fifth Circuit case merely held that the Commissioner did not meet its burden of proof, and that it was error to use the Confirmation Agreement to impact the determination of the gift tax. While the concluding logic is somewhat confusing, there are clear indications in the opinion that the court was doing more than just saying that the IRS did not meet its burden of proof and that gift values must be determined on the date of the gift without regard to post-gift acts of the donees.

   Richard Covey and Dan Hastings conclude: "Given the Fifth Circuit's recognition that this [defined value] issue was at the 'heart' of the case and 'fractionated' the Tax Court, one might have expected a direct discussion of whether such clauses work or do not work. No such discussion occurs. Instead the Fifth Circuit assumes they work…" Heckerling Institute on Estate Planning Current Developments (2007).

   John Porter (and others) respond that courts do not bless and broadly validate the use of general tax planning strategies. Instead, courts just decide based on the facts of a particular case before them—and that is what the Fifth Circuit did. Courts do not say, "Estate planners, start your engines—you can now safely use this new strategy."

   There are various places in the opinion where the Fifth Circuit specifically acknowledged that it was dealing with a defined value clause that made a gift of a particular dollar value:

   "At the heart of this case lies …a *sequentially* structured 'defined value clause'."

   "[T]he feature that most fractionated the Tax Court here is the Taxpayers' use of the dollar-formula, or "defined value," clause specified in the Assignment Agreement … to quantify the gifts to the various donees in *dollars* rather than in *percentages*…"

   "the Majority in essence suspended the valuation date of the property that the Taxpayers donated in January until the date in March on which the disparate donees acted, *post hoc*, to agree among themselves on the Class B limited partnership *percentages* that each would accept as equivalents of the *dollar values* irrevocably and unconditionally given by the Taxpayers months earlier."

   The "core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording."

   Various statements make clear that the court was basing its conclusion on the fact that the transfer was under a dollar formula. The case states in the last sentence of section II.C.3.a of the opinion that "the results of the Majority's independent appraisal of the donated interests in MIL and their values for gift tax purposes *become irrelevant* to the amount of the gift taxes owed by the Taxpayers." (emphasis added). The clearest indication of this is the court's opening sentence of its concluding paragraph of the section II.C.3 of the opinion dealing with the fair market value of interests in the partnerships transferred by the taxpayers:

   > *"In the end, whether the controlling values of the donated interests in MIL on the date of the gifts are those set forth in the Assignment Agreement based on Mr. Frazier's appraisal of $89,505 per one per cent or those reached by the Majority before it invoked the Confirmation Agreement (or even those used by the Commissioner in the deficiency*

notices or those reached by the Commissioner's expert witness for that matter), have no practical effect on the amount of gift taxes owed here."

The court specifically says that the appraisals and the Tax Court's determination of the value of a one percent interest in the partnership are irrelevant in determining the amount of gift taxes. What can be the basis for that statement unless the court is saying that the value of the gift is the dollar value stated in the Assignment Agreement where the agreement requires that the fair market of the assigned partnership interests be determined under a willing buyer willing seller test that is identical to the standard that is used in the gift tax regulations?

The court's logic that follows after that sentence seems questionable. The court seems to reason that (i) the Tax Court's rejection of the IRS's expert was non-erroneous, (ii) the government had the burden of proof, therefore (iii) the fair market value is the value used in the taxpayer's expert's report. (In the court's words, "the fair market values applicable in this case are, *by a process of elimination*, those determined by the Frazier report and used by the Taxpayers in preparing their gift tax returns for 1996." (emphasis added))

(As an aside: If that logic is correct, almost every Tax Court valuation case is incorrectly decided. The Tax Court rarely accepts the valuation of either side's expert and typically determines a value somewhere between the two experts' values. The McCord panel's logic seems to say that if the court does not accept the expert report from the side that has the burden of proof, the expert's report for the other side sets the fair market value.)

The panel at no place in the decision addresses the Tax Court Majority's determination of the value of a one percent interest under a clear error standard. If the value of a one percent interest was really critical to determining the gift amount, why did the court not review the Tax Court Majority's determination of the value of a one percent interest (i.e., $120,046 per one per cent interest) under a clear error standard of review? The answer seems to be the opening sentence of that tortured paragraph—stating that the values reached by the appraisers "or by the Majority before it invoked the Confirmation Agreement … have no practical effect on the amount of gift taxes owed here."

F. Significance of *McCord* in Whether Defined Value Clauses Will be Respected.

1. Important Taxpayer Victory. Although there are limits on the decision (read narrowly, it basically just rejects the Tax Court's reasoning that few could even understand let alone support), it is a seminal case of a federal court of appeals case recognizing and applying a defined value gift transfer. The Fifth Circuit DOES recognize that the transfer was of a dollar amount, and even states in its conclusion that the value of a 1% interest in the partnership would have "no practical effect on the amount of gift taxes." The Tax Court has apparently been troubled by these types of clauses, and has rejected several defined value transfers in the recent past, in each case on technical grounds without agreeing with the IRS's broad position that "dollar amount" gift transfers should not be recognized for public policy reasons. See Knight v. Commissioner, 115. T.C. 506 (2000) (court did not respect the clause because taxpayers did not); McCord, 120 T.C. 358 (2003). Tax Court judges referred pejoratively to the "sophistication of the tax planning before us." This federal court of appeals case at least turns the tide of some judges viewing these clauses as abusive and troublesome under a smell test.

2. Court Did Not Consider Public Policy or Substance Over Form Doctrines. The taxpayer's trial brief and brief to the Fifth Circuit summarized the response to the Commissioner's public policy and substance over form arguments: "The Commissioner erred in relying on such cases [Procter, Ward, and McClendon] because (i) the fixed-value clause in the Assignment Agreement was materially different from the 'savings arrangements' in *Procter, Ward,* and *McClendon*, (ii) similar formula clauses are used commonly and have been approved by the Commissioner, and (iii) the Commissioner's 'substance over form' argument ignores the independent character of both the Symphony and [Communities Foundation of Texas] as unrelated parties."

Interesting aside: In Procter, the 4th Circuit raised the public policy argument on its own. It was not argued by any of the parties.

The Court said that the Commissioner did not make the public policy or substance-over-form arguments in its brief, and that it waived those arguments to the Fifth Circuit. Some commentators have suggested that this opinion is not comforting at all because of that aspect of the opinion. Indeed, everyone has thought that the public policy arguments are the IRS's best arguments against these types of clauses (i.e., that they discourage audits because anything the examining agent does adds no additional gift tax).

Why did the Commissioner not make the public policy argument to the Fifth Circuit?

Only two of the Tax Court judges who participated in the McCord decision specifically agreed with the Commissioner's public policy argument. Some attorneys have suggested that the taxpayers' arguments in the trial brief responding to the public policy arguments and the arguments in Judge Foley's dissent were so strong that it is not surprising that the Commissioner did not make the argument again on appeal. (The Fifth Circuit's language may support this reasoning. After stating that the Commissioner did not advance several theories that it relied on in the Tax Court proceeding, including substance-over-form and violation-of-public-policy, the court said "Accordingly, the Commissioner has waived them, and has instead—not surprisingly—devoted his efforts on appeal solely to supporting the methodology and holdings of the Majority…") Did the Commissioner view the argument as such a loser that there was no point in making the argument? Or did the Commissioner specifically strategize not making the argument before the perceived taxpayer-friendly Fifth Circuit to preserve the argument in other more receptive courts?

Despite the fact that the Fifth Circuit said that the Commissioner did not make the argument in its brief and waived the argument, the Commissioner's brief DID restate the argument (albeit in a footnote—but are footnotes not still part of the brief?) and specifically requested the Fifth Circuit to remand the case to the Tax Court to consider the policy issues if the Fifth Circuit decided not to approve the Tax Court's "interpretation argument" about the defined value gift:

"In the Tax Court, the Commissioner argued that the estate planning device utilized here was akin to those in *Commissioner v. Procter*, 142 F.2d 824, 827 (4th Cir. 1944) and in *Ward v. Commissioner*, 87 T.C. 78, 110-14 (1986), which the courts rejected as contrary to public policy. The Commissioner had also argued that the series of transactions should be treated as a single integrated transaction pursuant to the substance-over-form doctrine. *See Gregory v. Helvering*, 293 U.S. 564 (1935); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). Although Judge Laro's dissent (Op. 109-117) is based on his view that the Court should have adopted the Commissioner's position on both matters, and Judge Foley's partial dissent (Op. 101-106) would have rejected it, the eight judges comprising the Tax Court majority specifically declined to deal with these arguments and made no finding with respect thereto. (Op. 64 n.47.) Therefore, if this Court disagrees with the Tax Court's conclusions with respect to the interpretation of the Assignment Agreement, it should remand the case to the Tax Court so that it can address these arguments in the first instance." Appellee Brief, n.18.

The Fifth Circuit opinion gives 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:

"Judge Foley's use of 'olfaction' is an obvious, collegially correct synonym for the less-elegant vernacular term, 'smell test,' commonly used to identify a decision made not on the basis of relevant facts and applicable law, but on the decision maker's 'gut' feelings or

intuition. The particular olfaction here is the anathema that Judge Swift identifies pejoratively in his concurring opinion as 'the sophistication of the tax planning before us.'"

If there had been concerns that the clause was abusive, would the judges not at least have expressed some concern about the policy concerns, to be decided another day? In sum, I have no doubt that this same three judge panel would have recognized a dollar amount assignment despite public policy or substance over form issues. As to the substance over form issue, the court went out of its way to emphasize the independence of the charitable donees and that there were no side understandings, which would seem important in a substance over form situation.

A fundamental difficulty with the public policy or substance over form argument for defined value clauses for gifts is that the clauses are practically identical to long recognized dollar amount clauses used in wills for marital or charitable bequests. For example, if there is a dollar amount (e.g., the remaining "exemption" amount) bequest to individuals in a will with the balance passing to a spouse, no one questions that this results in a zero estate tax situation, even though actual funding of percentage interests is based on later actions of the executor. The IRS tried (lamely, in this author's view) to identify why defined value clauses during lifetime were so different from testamentary marital deduction clauses from a policy viewpoint in TAM 200245053.

The taxpayer's trial court brief observed that these types of clauses are not abusive. "Petitioners simply were trying to determine and establish with certainty, through the use of a formula clause specifying a dollar value of the interst in MIL passing to each donee, the amount of gift tax that would result from such transfers." Transfers under clauses that fix the amount of estate taxes or GST taxes are routinely recognized. Why should it not be possible to make a transfer in a manner that established with certainty the dollar value that passes as a taxable gift, with any excess passing in a manner that does not result in a taxable gift?

3. IRS Reaction to These Clauses. The IRS did not request a rehearing or en banc review, or appeal to the Supreme Court. The IRS national office has informally reported to some attorneys that the Fifth Circuit had the opportunity to bless specifically the use of defined value clauses and declined to do so. However, some IRS agents (in the Fifth Circuit) have indicated that while they may not like the result, the Fifth Circuit has spoken and the agents will recognize defined value transfers that follow the format of the fact situation in McCord (including that the clause uses a "willing buyer-willing seller" valuation standard rather than using "values as finally determined for federal gift tax purposes," that the pourover transfer is to a charity that is independent of the donor, that there was no collusion with the independent charity over the value issue, and that the charity exercises reasonable due diligence in determining the interests that pass under the defined value clause.)

   Speakers and other attorneys at the seminar told me of a broad number of audit situations where they have used defined value clauses. Upon explaining to the auditing agent how the clause operates, the valuation issue was disposed of very quickly in the audit. (Another attorney has described an audit situation in which the existence of the clause complicated the audit because the agent somehow [inexplicably, in my view] took the position that the clause made the entire transfer an incomplete gift.)

V. CRAFTING THE DEFINED VALUE CLAUSE IN LIGHT OF MCCORD.

A. Overview of Issues.

An outstanding resource addressing the planning implications of various alternatives is Covey & Hastings, Current Developments, Recent Developments-2006, Heckerling Institute on Estate Planning (2007). Some of the issues to address include: (1) Define amount transferred or allocate transfer of all of a particular asset among donees? (2) If allocate among donees, who is alternate donee? (3) How to define value? (4) Leave some taxable gift?

B. Transfer and Allocate All of a Particular Block vs. Defining Amount Transferred.

One approach to using defined value clauses is to make a transfer of a particular block of assets, and the clause merely allocates who receives that block of assets according to dollar amounts or formula clauses. No part of the transferred block of assets will ever revert back to the donor. In this manner, the formulas will operate like the formula clauses in hundreds of thousands of wills that have been through federal estate tax audits. The goal is to mirror standard marital deduction clauses that dispose of all of a decedent's estate, leaving the largest amount possible without generating estate taxes to individuals (or a bypass trust) and leaving the balance to a surviving spouse.

An alternative approach used by some excellent planners is to transfer a fractional interest in an asset. The numerator of the fraction would be the desired dollar amount and the denominator would be the value as determined for federal gift tax purposes (or the value determined under a willing buyer/willing seller standard). 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 Trust a fractional share of the property described in the Schedule A. The numerator of the fraction is (a) $1,000,000 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 $1,000,000. The denominator of the fraction is the Gift Tax Value of the property." McCaffrey, Tax Tuning The Estate Plan By Formula, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. 3-14 (1999).

The "transfer of a fractional share" approach, however, may be somewhat more at risk to a Procter attack than the "allocation of amount transferred" approach, because whatever is not transferred with the fractional gift remains with the donor. For example, in TAM 200337012 the taxpayer transferred to a trust "that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $A." The IRS ruled that this is not recognized because it is similar to the clauses in Ward v. Comm'r, and Rev. Rul. 86-41, 1986-1 C.B. 300, and is void as contrary to public policy. The taxpayer argued that this clause is distinguishable from the clauses in Procter because the donor never receives anything back. The IRS did not agree: "However, pursuant to the assignment, Trust received an X% interest in Partnership from Taxpayer. If Paragraph B is given effect and the value of the X% interest, as finally determined by the Service, is greater than $A, a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in Procter and Ward conclude are void as contrary to public policy."

C. Should "Values as Finally Determined for Federal Gift Tax Purposes" Be Used?

There are various reasons why using a clause that refers to the same valuation standard that is used for gift tax purposes but not requiring the use of finally determined gift tax values may be preferable, as discussed below. However, there are also substantial gift risks with using a "willing buyer willing seller" standard unless the "residuary" party to the assignment is a charity or political party (or perhaps a GRAT).

If the "values as finally determined for Federal gift tax purposes" approach is used, realize that there are objective ways of determining those values. "Final determination" is now delineated in the Internal Revenue Code and regulations. The Code and Regulations address how gift tax values are "finally determined" in four different circumstances: (1) Uncontested return; (2) Unchallenged IRS audit determination, (3) Court determination, or (4) Settlement agreement. I.R.C.§2001(f)(2) (added by 1997 Act and amended by the 1998 Act); Treas. Reg. §20.2001-1. The formula allocation will likely make reference to those provisions.

1. Mechanical Difficulties. The difficulty in requiring the use of values "as finally determined for Federal gift tax purposes" is that the ownership percentages could be in abeyance for many years. Knowing the precise fractional interest owned by the various transferees will be uncertain until the gift tax value is "finally determined" in accordance with the principles of

section 2001(f)(2) of the Internal Revenue Code. Until that time, there may be questions regarding the distribution of income earned on the transferred property, the reporting of income from the transferred property for federal and state income tax purposes, and exercise of various ownership rights with respect to the property. In addition, there can be practical difficulties in re-registering shares, where the transfer agent will want to register a specified number of shares in each transferee's name.

The McCord children and their charities have had to wait over *10 years* to get a value as finally determined for Federal gift tax purposes. Instead of being required to use finally determined gift tax values (requiring a 10 year wait), they were allowed to reach agreement among themselves as to the percentages that each of the donees acquired under the assignment. If any of them had disagreed, that party could have brought an independent legal action (they were contractually bound to use an arbitration proceeding) to determine the amounts passing under the clause that assigned dollar amounts under the same valuation standard that is used for Federal gift tax purposes.

2. Having an Arm's Length Transaction as Evidence of Value. The subsequent arm's length transaction among the donees is itself outstanding evidence of value—where the parties have some adverse interests. An arm's length transaction is typically viewed as the best evidence of value. In McCord, there were two different charities that had fiduciary obligations to ensure that they received no less than the appropriate percentage interests of the partnership to which they were entitled. They had independent counsel. Having this arm's length transaction close in time to the original transfer involving parties who had a direct economic stake in the outcome may be preferable to merely waiting for a court to make its determination of value years later.

3. Rebutting Policy Argument. The Procter and Ward public policy position is that a savings clause, returning a portion of transferred property to the donor that exceeds a specified value, is not respected where the event that triggers the readjustment was a determination by the IRS or a court. The cases reasoned that if such terms were given effect, there would be no way to determine the amount of the transfer until a court determined whether the transfer was subject to the gift tax. Using an approach that does not depend on final gift tax values removes some of the steam from that argument. An independent arm's length transaction determines the percentages rather than having the percentages set in a gift tax proceeding.

4. Court Precedent. The one opinion that rejected the defined value clause specifically because it did not require using finally determined gift tax values (i.e., the McCord Tax Court decision) has been reversed.

5. Gift Risk. There is an additional gift risk with using a "willing buyer willing seller" standard because the parties to the transaction must come to agreement on what is transferred since there will not be an objective determination as there would be under an "as finally determined for federal gift tax purposes" approach. If a "willing buyer willing seller" standard is used, the gift risk is shifted from the person making the initial transfer to the persons entering the agreement. For example, if the donor's spouse is the recipient of the "residue" after the dollar value transfers, the gift risk is shifted from the original donor to the donor's spouse (if he or she agrees to accept too little of the transferred assets in the agreement to allocate the ownership under the dollar value assignment.) That is not a problem if a charity or political party is the "residual" recipient. (While a charity cannot make taxable gifts, it would have to be concerned with potential intermediate sanction issues.) An "almost zeroed out" GRAT would also avoid a subsequent gift risk, but using a GRAT as the residual recipient may raise a somewhat stronger Procter argument, as discussed immediately below.

D. Concern With Using GRATs as Pourover Recipient.

A pourover to an "almost zeroed out" GRAT would represent a transfer that would not represent a significant taxable gift. It would not have the problem of just shifting any gift risk to the pourover recipient. A possible theoretical concern with using a GRAT approach is that it may give the IRS a somewhat stronger "Procter" argument, based on the Procter case that refused to give effect to

a transfer coupled with a return to the donor of any value over a specified dollar amount. The GRAT approach might be viewed as returning the present value of any transfer over the specified dollar amount back to the donor (through the annuity payments from the GRAT to the donor). The response of planners that use GRATs in this manner is that the tax savings clause feature of GRATs is specifically authorized in the GRAT regulations.

A mechanical problem with using GRATs, if an "as finally determined for federal gift tax purposes" valuation standard is used is how the late annuity payments would be handled when the additional amount passing to the GRAT is not determined for years after the initial transfer.

E. Building in Some Taxable Element to Refute Public Policy Argument.

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 described in subparagraph V.B above. A fractional portion of an asset is transferred, the numerator is the anticipated dollar amount to be transferred plus 1% of the excess, if any, of the gift tax value of the property over the specified dollar amount. The denominator is the gift tax value.

The "1% of the excess" provision is designed to result in some gift tax if the IRS audits the gift tax values of the assets. This will assist in avoiding the public policy argument that a contest by the IRS would be a moot issue because the clause would take away any gift consequences.

The McCord case does not specifically address the public policy issue. However, as discussed above, the judges certainly left the clear impression that they did not find the "dollar amount" assignment to be abusive. In light of the Tax Court's refusal to reject the defined value clause on policy grounds and in light of the impression from the Fifth Circuit that the clauses are not abusive, we may see fewer attorneys building in 1% (or greater) taxable amount clauses to rebut a public policy argument. That would seem particularly true in the Fifth Circuit.

F. Advantage of Using Grantor Trusts.

The uncertainty of ownership for a long period of time emphasizes the advantage, if at all possible, of making transfers to grantor trusts under defined value clauses. In that case, regardless of the percentages owned by the grantor and the various donees, all of the income is reported for federal income tax purposes on the grantor's income tax return. If there is any subsequent adjustment in the percentages passing under the formula, there would be no change in income tax liabilities of any person and there may be no necessity of amending income tax returns. (Of course, having all of the donees as grantor trusts diminishes the perceived arm's length character of the subsequent negotiation to determine the percentages that pass under the dollar amount clause. Having separate independent trustees of the trusts, each with fiduciary duties to maximize the amount passing to their respective trusts, would increase the appearance of the arm's length character of the negotiations.)

G. Allocation to Single Trust With Formula Subdivision Alleviates Mechanical Registration Difficulties.

If property is transferred to a single trust under which the trustee is required to allocate the assets among various subtrusts, the transferred property could be registered in the name of the trustee under the trust agreement until the gift tax values have been finally determined. At that time, the trustee can make allocations of shares among the various sub-trusts, and re-register the shares in the names of those particular trusts at that time. (However, using a single trustee for all family trusts that are donees will weaken the perceived arm's length nature of negotiations among the donees to determine the percentages passing under the dollar amount clause.)

H. Using Defined Value Clauses in Sales Transactions.

The same type of defined value clause that was used for a gift transfer in McCord could also be used in sales transactions to identify the donees of various blocks of assets that are being transferred. For example, the client could sell all of a particular block of assets to children and

either a spouse, a lifetime marital trust (if a lifetime QTIP is used, a Form 709 would have to be filed making the QTIP election and describing the assets of the QTIP), or a charity, or a zeroed out GRAT under an agreement allocating the transfers as follows: (a) the child purchases a fractional share of the assets, the numerator of which is the "intended value" and the denominator of which is the finally determined gift tax value; and (b) the remaining fractional interest in the assets will be allocated to the spouse, marital trust, charity, or GRAT (all of which would not be gift tax-free transfers). (Another alternative is to leave the excess to a trust in which the grantor has retained a sufficient interest/control to make the gift incomplete. Handler & Dunn, The LPA Lid: A New Way to "Contain" Gift Revaluations, 27 EST. PL. 206 (June 2000).)

As an example, assume that the liquidation value of a partnership is $10.0 million, and that the appraised value of the limited partnership interest is $6.0 million. The client might transfer all of the partnership interest, allocating the transfer into two different portions. The client might sell the first $5.9 million worth of the limited partnership interest to the client's children for a note. The sale document (i.e., the bill of sale) could indicate that if the value exceeds $5.9 million, the excess will pass to a Communities Foundation. The $5.9 million might be described as the value determined under U.S. gift tax principles (i.e., under a willing buyer willing seller test that is identical to the gift tax valuation standard).

In the past, IRS agents have viewed defined value cause as abusive, reasoning, "if your values are right, why do you need a defined value clause?" There has been a reluctance to use defined value clauses in some sale transactions, for fear the clause might invite greater IRS scrutiny. Some planners are concerned that using a defined value savings clause may be viewed by some IRS agents or some judges as evidence of a non-arms length transaction in and of itself. Does it look non-commercial and detract from it as a non arms length transaction at least from the prejudice of a judge? That concern is still present, though the existence of a circuit level case upholding the clause is at least some indication that the courts will not view the clauses as abusive. I anticipate that we will see more frequent use of defined value clauses in sales transactions but some planners who may use these clauses for gifts may be more circumspect about using them for sales.

I. Critical Importance of Avoiding "Wink-Wink" Side Understandings.

The Fifth Circuit opinion emphasized at various points that there were no understandings between the donor and the donees as to how the transferred assets would be divided among the donees in implementing the dollar amount transfers. The court emphasized that the facts before Judge Foley as the lone trial judge included "the absence of any probative evidence of collusion, side deals, understandings, expectations, or anything other than arm-length, unconditional completed gifts by the Taxpayers on January 12, 1996, and arm's-length conversions of dollars into percentages by the donees alone in March." Another place in the Fifth Circuit opinion observed that "[n]either the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement—not so much as an implicit, 'wink-wink' understanding…"

J. Formula Disclaimer Approach.

The IRS is currently litigating a somewhat similar post-mortem planning approach involving a formula disclaimer. One such case that settled was Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding "x" dollars (before payment of debts, expenses and taxes) in which the decedent's will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate's appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. The case was settled prior to trial. John Porter, who represented the taxpayer in Morfeld, reports that he is handling another case involving a similar formula disclaimer in which the IRS is again arguing that the disclaimer violates public policy under the Procter rationale.

K. Advisability of Post-Gift Cash Out?

If a defined value transfer involves a charity, it is likely that there will be significant pressure by the charity to "cash out" its interest under the "bird in a hand" theory, and under the theory that charities need cash for their special projects, not interests in closely held family entities. However, doing so raises the risk of the situation in the Tax Court opinion, where the court determined that the values of the interests are much greater than the amounts used by the parties, thus resulting in values of the residual percentage interests passing to charities that are much lower than the requested gift tax charitable deduction. Cashing out the charities soon after the transfer highlighted that the court ended up allowing a charitable deduction for a larger amount than what the charities actually received. There is obviously a smell test problem with allowing a charitable deduction for a greater amount than what the charity actually receives. That risk is minimized if the charity does not "cash out" before the gift tax proceeding is concluded.

Even so, charities and families will both want to get dollars to the charities and cash out the interests. If the individual donees and the charities all demand an early cash out, at the least take steps to help document the independence of the cashed out charities in the negotiations. In McCord, the court noted that the Communities Foundation of Texas retained experienced outside counsel (which trial briefs identify as Michael Graham, a very experienced Dallas attorney), and the president and director of development of the charity were both attorneys. They had the opportunity to retain their own outside appraiser, although they chose not to in this case because of their confidence in the appraisal, the appraiser and his firm's reputation. I suspect that the donor's attorneys would have liked for the Communities Foundation to have hired its own independent appraiser, but they obviously could not force the Foundation to spend its assets to do so.

VI. USING FORMULA DISCLAIMERS AS A DEFINED VALUE CLAUSE.

A. Formula Disclaimers Are Permitted.

The fundamental starting point is that the treasury regulations specifically permit using formula disclaimers. Treas. Reg. § 25.2518-3(d), Ex. (20) (disclaimer of property that would pass to surviving spouse; "The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate"). See Ltr. Rul. 200420007 (approved disclaimer of fractional share of residuary estate by child, with disclaimed assets passing to foundation; numerator of fraction is $X and denominator is value of residue determined on the basis of values, deductions, and other information reported on the federal estate tax return).

B. Planning Strategies.

1. Gift to Spouse Outright; Disclaimer to Grantor Trust.

One approach would be for a donor or to make a gift to his or her spouse outright. The conveyance instrument would specify that if the spouse disclaimed, the disclaimed assets would pass to an irrevocable grantor trust for descendants. The spouse might subsequently choose to make a formula disclaimer, with the disclaimed assets passing to the irrevocable grantor trust for descendants. An example of such a formula disclaimer would be the following: "I hereby disclaim that portion of the limited partnership units transferred to me by X that equals $__ in value as finally determined for federal gift tax purposes." The spouse could also be a beneficiary of the trust that would receive the disclaimed assets.

Advantages.

Advantages include:

a. Simplicity;
b. The spouse can disclaim and still be a beneficiary of the recipient trust;
c. The recipient trust can be a grantor trust, so that (1) the grantor pays income tax on trust income, and (2) the grantor can make future sales to the trust without recognizing income currently for income tax purposes;

d. The transfer can utilize the original grantor's gift exemption and GST exemption in a manner that will not exceed available exemption amounts; and
e. There is a stronger arguing position against a Procter attack than with a straight defined value gift. The disclaimer approach is stronger because (1) the statute and regulations allow formula disclaimers, and (2) the donor does not control the formula allocation.

Disadvantages.

Disadvantages include:
a. The spouse makes an independent decision of whether to disclaim; the spouse is not legally obligated to do so and there can be no prearranged agreement to do so;
b. The spouse continues to own any non-disclaimed assets in the event of a divorce or the original donor's prior death;
c. The disclaimant-spouse cannot retain a limited power of appointment over the disclaimed assets;
d. The disclaimant-spouse can serve as trustee only if there is an ascertainable standard on distributions; and
e. The IRS might make a "step transaction/integrated transaction" argument that there was an implied agreement between the donor-spouse and the donee-spouse to make the formula disclaimer, such that the original donor would be treated as the transferor of the entire transaction. See Griffin v. U.S., 2000-2 U.S.T.C. ¶ 60,380 (W.D. Tex. 2000) (unreported) (gift to spouse who soon thereafter makes second gift to initial donor's trust is ignored).

2. Gift to Inter Vivos QTIP and Disclaimer by Spouse.

The donor might make a gift to inter vivos QTIP trust, and the surviving spouse might subsequently decide to make a formula disclaimer. The trust instrument would specify that any disclaimed assets would pass to a separate trust. That trust could be a grantor trust, and could include the surviving spouse as a discretionary beneficiary (much like a typical testamentary "bypass trust").

Advantages.

Advantages include:
a. Generally the same advantages as for Approach No. 1, but using a QTIP trust rather than an outright gift is not as simple;
b. This approach might be used instead of Approach No. 1 because the grantor may not be comfortable making an outright gift to the spouse;
c. The donor may be a contingent remainder beneficiary of the QTIP trust;
d. Using a QTIP trust affords added flexibility through the QTIP election decision, including whether to make the "reverse QTIP" election for GST purposes to utilize the original donor's GST exemption; and
e. A possible planning flexibility would be that the surviving spouse might not make a disclaimer at all, but the trustee might make a formula QTIP election as to a "defined value" (an amount in excess of the gift exemption amount). (The Clayton regulation does not clearly apply to inter vivos QTIPs—because it is only in the estate tax regulation and not in the gift tax regulation. Accordingly, the non-elected portion of the QTIP should give the spouse a mandatory income interest and allow not beneficiaries other than the spouse during his or her lifetime—at least until the application of the Clayton regulation for gift tax purposes is clarified.)

Disadvantages.

Disadvantages include:
a. Same disadvantages as Approach No. 1, except that the surviving spouse would not own undisclaimed assets outright; and
b. Gives up some of the simplicity of the outright gift approach in Approach No. 1.

3. Bequest to Non-Spouse Beneficiaries; Formula Disclaimer With Disclaimed Amount Passing to Charity or Spouse.

This really is a post-mortem strategy. The decedent's will might make a bequest to beneficiaries other than the decedent's spouse. The will would provide that any disclaimed assets pass to a charity or to the surviving spouse (or in some manner that qualifies for an estate tax deduction.) If the original bequest for non-spouse beneficiaries is to a trust, the trust provisions must address mechanical details regarding the disclaimer. For example, what beneficiaries must disclaim in order for the assets to pass to charity or the spouse? Must all beneficiaries who are current possible discretionary beneficiaries disclaim? Can one person disclaim for all beneficiaries? The instrument must clarify where the disclaimed assets will pass.

Advantages.

Advantages include:

a. The intended beneficiaries are the persons choosing to make a disclaimer, not the original donor or donor's spouse; this would seem to make the IRS's possible "integrated transaction" Procter argument very weak; and
b. This transaction seems very similar to a variety of letter rulings that have authorized straightforward formula disclaimers based on a transfer tax exemption amount in a testamentary situation.

Disadvantages.

Disadvantages include:

a. The disclaimants (who are not the spouse of the donor) cannot be beneficiaries of the trust to which the disclaimed assets pass;
b. The disclaimants (typically children of the original transferor) cannot have any fiduciary power over the disclaimed assets that is not limited by an ascertainable standard;
c. If the bequest is to a trust with multiple beneficiaries, there are various mechanical issues regarding the disclaimer—such as which beneficiaries must sign disclaimers;
d. If there are minor beneficiaries, and if the law does not permit adult beneficiaries to disclaim on behalf of all trust beneficiaries, there could be considerable difficulties in obtaining appropriate disclaimers from all beneficiaries so that the disclaimed assets would pass to charity or to a spouse.
e. If there are multiple beneficiaries, and if one beneficiary cannot be authorized to disclaim on behalf of all beneficiaries, there is the possibility that one "rogue" beneficiary could thwart a well-designed plan desired by all of the other beneficiaries.
f. The IRS attacked this type of plan in Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding "x" dollars (before payment of debts, expenses and taxes) in which the decedent's will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate's appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. The case was settled prior to trial. John Porter, who represented the taxpayer in Morfeld, reports that he is handling another case involving a similar formula disclaimer in which the IRS is again arguing that the disclaimer violates public policy under the Procter rationale.

4. Gift of In-Kind Assets in Trust for Non-Spouse Beneficiaries; Disclaimed Assets Pass to Spouse or Charity.

This approach is very similar to Approach No. 3, but in a lifetime gift rather than testamentary bequest context. The same advantages/disadvantages would apply.

5. Gift of In-Kind Assets in Trust for Non-Spouse Beneficiaries; Disclaimed Assets are Returned to Donor.

This approach is similar to Approach No. 4, except that the disclaimed assets will be returned to the original donor or rather than passing to charity or to the donor's spouse. This would seem to be a more straightforward "defined value" approach. The amount that might otherwise be a "deemed gift" returns to the original donor and is treated as if it were never transferred.

Advantages.

Advantages include:

a. The IRS's potential Procter argument is weakened--the amount that is disclaimed and that is returned to the original donor is treated, under the disclaimer rules, as having never been transferred in the first place; there is no "condition subsequent" or even "condition precedent" argument about the transfers--the disclaimed amount is treated as if it were never transferred at all under Section 2518;
b. The IRS would be in a weak position to make a pre-arranged transfer argument, such as under the Griffin case described above, because a party who has an adverse interest in the transaction makes an independent decision to disclaim; and
c. No transfer to a third party as a result of the disclaimer occurs, which might be treated as an indirect transfer by the original donor.

Disadvantages.

Disadvantages include:

a. The planner must confirm that, under state law, disclaimed assets would in fact be returned to the donor.

6. Sale to Grantor Trust; Followed by Formula Disclaimer of Deemed Gift.

The transferor would sell assets to a grantor trust. Trust beneficiaries cannot disclaim investments made by the trustee. However, beneficiaries would disclaim any "deemed gift" as a result of the sale transaction. The instrument of conveyance would need to make clear that any disclaimed assets are returned to the original transferor.

Advantages.

Advantages include:

a. This approach opens the use of formula-based disclaimers by beneficiaries to sale transactions as well as straight gift transactions; and
b. Using formula disclaimers rather than a "defined value" clause in the sale transaction appears more closely tied to strategies that are specifically authorized by regulations (i.e. formula disclaimers).

Disadvantages.

Disadvantages include:

a. In many situations (such as where there are current minor beneficiaries of the trust to which assets are sold), obtaining appropriate disclaimers by the beneficiaries may be difficult;
b. Using disclaimers for "deemed gifts" in what are otherwise sale transactions pushes the use of disclaimers to the "next level." This might be deemed by the IRS to be outside the purview of formula disclaimers recognized by regulations.

C. Analysis of Formula Disclaimer Approach Under Procter.

An excellent analysis of using formula disclaimers under the rationale of the Procter case is detailed in Handler & Chen, Formula Disclaimers: *Procter*-Proofing Gifts Against Revaluations by IRS, 96 J. TAX'N 231 (April 2002). Following is a brief summary of the arguments posed by the article.

1. Disclaimed Interest Treated As If Assets Never Transferred to Original Recipient.

   Under Section 2518, the disclaimed interest is treated as if it had never been transferred to the original donor. Thus, the IRS should not be able to argue that the recipient or the amount of the gift is changed for gift tax purposes by a Procter-type savings clause.

2. Strategy Rooted in Concept That Donee Can Refuse to Accept Property.

   The statute (§ 2518) specifically sanctions a way for a donee to refuse to accept all or part of a gift. Recognizing formula disclaimers carries out this well recognized concept-- rather than being based on control by the original donor.

3. No Conditions on Transfer.

   The IRS cannot argue that there is a "condition subsequent" (or even "condition precedent") to the transferor under a Procter analysis. The original grantor retains no interest or control based on a condition subsequent (i.e., a subsequent action by the IRS or courts). An independent act of the beneficiary treats the original transferor as having never been made, rather than there being a condition (subsequent or precedent) "wired in" by the original grantor.

4. Statutory Support.

   Section 2518(c)(1) specifically allows a disclaimer "with respect to an undivided portion of an interest."

5. Explicit Regulatory Sanction of Formula Disclaimers.

   Treasury Regulation § 25.2518-3 (d.), Ex. 20 specifically recognizes a formula disclaimer, based on the maximum amount that can pass free of federal estate tax.

6. Actions Based on Statute and Regulations Cannot Be Contrary to Public Policy.

   Actions about beneficiaries that are specifically authorized in the statute and regulations should not be considered contrary to public policy -- unless the statute and regulations themselves are contrary to public policy.

7. Letter Rulings Have Approved Formula Disclaimers.

   A wide variety of letter rulings have approved a various post-mortem formula disclaimers -- designed to pass the maximum amount that can pass without estate tax or GST tax. For example, letter ruling 200130034 involves a disclaimer of closely held stock of a particular value "as finally determined for Federal estate tax purposes."

D. Detailed Planning and Structural Issues.

The Handler and Chen article analyzes various detailed planning issues regarding the use of formula disclaimers. These are summarized below.

1. Where Do the Disclaimed Assets Pass?

   Under most state laws, the disclaimed assets pass as if the disclaimant had predeceased, or pass pursuant to an explicit direction in the trust or instrument of conveyance specifying where a disclaimed asset will pass. The disclaimer must be effective to pass assets without direction on the part of the disclaimant. A disclaimer that is valid to leave the disclaimed assets to the desired recipient under state law meets this requirement. I.R.C. § 2518(b). In addition, even a disclaimer that is not valid under state law “will nevertheless qualify under section 2518 if the person entitled to the interest has not accepted the interest or any of its

benefits and timely transfers the interest to the person who would have otherwise received the property if any active disclaimer had been made." Rev. Rul. 90-110, 1990-2 C.B. 209 (citing legislative history to Section 2518(c)(3).

2. What Beneficiaries Must Disclaim?

The cleanest approach is to require that all current beneficiaries of the trust disclaim, and for the instrument to specify that the trust assets pass to the desired recipient if such current beneficiaries fail to survive or if they disclaim. "Unless *all* the current beneficiaries of a trust disclaim, however, the non-disclaiming beneficiaries could be treated as if they had received an interest in property. That is, the transferor would not be treated as if it never occurred under Section 2518 with respect to some of the beneficiaries, and there could still be a taxable gift." Handler & Chen, Formula Disclaimers: *Procter*-Proofing Gifts Against Revaluations by IRS, 96 J. TAX'N 231 (April 2002).

3. Can a Third Party Be Designated to Disclaim on Behalf of Beneficiaries?

Approach Nos. 4 and 5 above are based on transfers to a trust with multiple beneficiaries, as opposed to a strategy just relying on a disclaimer by the donor's spouse. This can be difficult if there are minors or other beneficiaries who are incapacitated. Furthermore, designating a single person to disclaim on behalf of all beneficiaries can prevent any one such individual beneficiary from thwarting the protection that the formula disclaimer can provide for transfers. The regulations provide that a disclaimer must be signed by the disclaimant or the disclaimant's "legal representative" without describing who is a "legal representative." "The question is whether the *donor* of a gift -- who does not have a statutory right to make a state law disclaimer of the gift on behalf of the donee -- can designate a person (e.g., under a trust instrument) who may disclaim the gift on behalf of the beneficiary for Section 2518 purposes. We believe the answer should be 'yes.' To qualify under Section 2518, the disclaimant or his legal representative simply must refuse to accept the property interest. As long as the legal result of the disclaimant's representative's refusal to accept the property interest is to cause the property to pass to another person (such as the grantor) in accordance with state law, it should be irrelevant whether such representative would have had the power to make a state law disclaimer on the beneficiary's behalf." Id.

This approach finds some support in Revenue Ruling 90-110, 1990-2 C.B. 209, in which the IRS suggested that a trust instrument could empower a person to disclaim a beneficiary's interest: "Under the law of most jurisdictions, a trustee cannot make a unilateral disclaimer of a fiduciary power that affects the rights of a beneficiary *unless the trust instrument expressly authorizes such a disclaimer* or the affected beneficiary consents to the disclaimer." Rev. Rul. 90-110 1990-2 C.B. 209 (emphasis added).

Concerns with authorizing a single beneficiary to disclaim on behalf of others: (1) There is no clear authority recognizing this approach; and (2) such a plan "smells" more as a prearrangement with one person -- rather than a mere refusal to accept property by beneficiaries who personally have "skin in the game."

4. Unreturned Property.

What if there is a long delay before the IRS revalues the gift and before the eventually determined amount passing under the formula disclaimer actually passes back to the donor (under Approach Nos. 5-6 above). Alternatively, if the disclaimed asset passes to a recipient transfer trust, what if an excess amount originally passes to the recipient trust before the ultimate amount passing under the formula disclaimer is resolved by gift tax audit? Various letter rulings approving formula disclaimers have not even raised the potential delay in the transfer as an issue. Nevertheless, Handler and Chen recommend that one of the following the considered:

> "(1) The trustee should not distribute any trust property to the beneficiary until the applicable statute of limitations has run.

(2) An amount of property that would safely "cover" the amount of a gift revaluation should be kept in a separate trust or account that would not be distributed to the beneficiary until the gift tax statute of limitations period has run with respect to the gift.
(3) Any distributions are made pursuant to a refunding agreement with the beneficiary."

5. Disclosure on Gift Tax Return.

There is no requirement to report the disclaimer or disclaimed assets on a gift tax return if the disclaimed assets are returned to the donor (as in Approach Nos. 5-6 above), because disclaimed property is treated as if it had never been transferred. However, disclosure of the disclaimer on the gift tax return would be required if the taxpayer wished to obtain finality under the gift tax statute of limitations.

6. Conclusion.

Handler and Chen strongly conclude that formula disclaimers should be recognized as an effective defined value strategy: "In fact, we believe that formula disclaimers have such a solid base in existing law that the Regulations themselves would first have to be amended before such disclaimers properly could be held invalid. Therefore, we believe that formula disclaimers offer donors and their families a viable way in which to *Procter*-proof gifts from subsequent revaluations by the Service and provide them with a level of peace of mind that could not be attained through prior strategies."