MENDING WAYWARD WEALTH TRANSFER STRATEGIES

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ABA SECTION OF TAXATION – FALL MEETING

October 22, 2011

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MENDING WAYWARD WEALTH TRANSFER STRATEGIES[1]

I. Introduction

A. In General.

To paraphrase the poet Robert Burns, the best laid plans of clients and their estate planning lawyers sometimes go astray.[2] Such is the case with wealth shifting strategies like GRATs, installment sales, and QPRTs. Sometimes we devise the ideal plan for our client but, due to the occurrence of unforeseeable circumstances or unanticipated factors, the plan no longer is appropriate and our client is left, in Burns's phrase, with "nought but grief an' pain." Sometimes the plan we devise and implement for the client works fine but unanticipated factors afford the opportunity to shift additional wealth for the client by modifying the plan in some respect.

B. Five Ways for Plans to Go Awry.

This paper focuses on the three wealth-shifting strategies mentioned above: GRATs, installment sales, and QPRTs. For each of them, this paper examines some or all of the following five things that can adversely affect a client's plan or that can create additional wealth-shifting opportunities by altering an existing plan:

- Bad design. The chosen planning technique is appropriate for the client, but there are problems in drafting the transaction documents, choosing the assets to use in the technique, structuring the transaction, etc.
- Economic changes. The economics of the transaction suggest a need for change; for example, the assets involved in the transaction have failed to appreciate or have appreciated more than expected, or due to interest rate changes the transaction is no longer optimal and its performance could be improved by the incorporation of current interest rates.
- Mortality changes. Someone's life expectancy (e.g., the grantor or a beneficiary) changes after the transaction is implemented, threatening the anticipated wealth shift.
- Client's wishes change. The client no longer wants the wealth shift that the transaction was intended to achieve or promises to provide (e.g., due to family changes from marriage, divorce, births, deaths, etc., lifestyle changes such as acquiring a new residence, a change in financial position, etc.).
- Bad administration. The client or his advisers have failed to administer the transaction appropriately, threatening the wealth shift or creating other problems.

C. Purposes of this Paper.

The purposes of this paper are to discuss some of the ways in which wealth-shifting transactions may go astray or may need to be modified to enhance their performance, to suggest potential solutions and planning considerations that may help when they do, and to suggest drafting strategies that may reduce, eliminate, or otherwise cope with problems and take advantage of opportunities. Many of the potential solutions and planning considerations discussed in this paper implicate various fiduciary duties of a trustee, such as the duty to act prudently, to treat beneficiaries impartially, and to refrain from self-dealing. Obviously, the trustee should take into account those fiduciary duties and all others in deciding whether to employ any strategy mentioned in this paper.

D. Disclaimer.

This paper is not intended to be, and should not be construed as constituting, the author's opinion with regard to any specific case or transaction or the author's legal or tax advice with respect to any specific case or transaction. The forms included in this paper are for illustrative purposes only and may not be appropriate for any particular client or for use in any particular case or transaction. These forms should be used only by competent counsel and only as illustrations.

II. Grantor Retained Annuity Trusts

A. In General.

1. Overview of GRATs.

Section 2702 of the Internal Revenue Code[3] specifically authorizes the grantor retained annuity trust, or "GRAT". A GRAT is a trust in which the grantor contributes assets to the trust and retains the right to receive an annuity for a term of years. The annuity interest can be expressed either as a dollar amount or as a specified percentage of the initial fair market value of the trust assets. When the retained term interest ends, the GRAT terminates and any remaining assets are distributed to the remainder beneficiaries. If the trust satisfies all of the requirements for a GRAT,[4] the grantor's retained annuity interest will be a "qualified interest" and, for purposes of determining the amount of the grantor's gift to the remainder beneficiaries, the value of the grantor's retained annuity interest will be determined under Section 7520.[5] If the trust does not satisfy the requirements for a GRAT, the grantor's retained annuity interest will not be a qualified interest and it will be valued at zero.[6] This means that the grantor will have made a gift to the remainder beneficiaries equal to the value of the property transferred to the trust, undiminished by the grantor's retained interest.[7] Generally, if the property transferred to a GRAT has an overall annual investment performance that exceeds the Section 7520 rate in effect at the time of the creation of the GRAT,[8] value will be shifted to the remainder beneficiaries free of gift tax. If the investment performance of the GRAT assets does not exceed the Section 7520 rate, all of the GRAT assets will be returned to the grantor in satisfaction (or partial satisfaction) of the grantor's retained annuity interest, and the grantor will be in the same position economically and tax-wise as if the GRAT had never been established.

If the grantor dies during the term of the GRAT, some or all of the GRAT assets will be included in the grantor's gross estate.[9]

A GRAT does not facilitate a leveraged use of a client's exemption from the generation-skipping transfer tax due to the "ETIP" rules under Section 2642(f).

Section 2702 and the regulations promulgated under it describe the various requirements for a "qualified annuity interest." Many of these requirements are as follows:

a. Annual annuity payments.

Payments must be made from the GRAT to the annuitant at least annually.[10]

b. Annuity amounts.

The annuity must be a fixed amount which may either be a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the asset transferred to the GRAT. The annuity amount may increase or decrease in a given year, but any increase cannot exceed 120% of the stated dollar amount or fixed fraction or percentage payable in the preceding year.[11]

c. **Income exceeding annuity amount**.

The trust may permit income in excess of the amount required to satisfy the annuity to be paid to the grantor or the holder of the annuity interest.[12] The excess income, however, is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

d. **Incorrect valuations**.

If the annuity amount is stated in terms of a fraction or percentage of the initial fair market value of the assets transferred to the GRAT, the governing instrument must contain provisions relating to adjustments for any incorrect determination of fair market value of the transferred asset.[13]

e. **Period for payment of annuity amount**.

The annuity amount may be payable based on either the anniversary date of the GRAT's creation or the taxable year of the trust, and may be paid more frequently than annually. The governing instrument should provide for proration of the annuity amount in certain situations.[14] If payable based on the anniversary date, the annuity must be paid no later than 105 days after the anniversary date. If payable based on the trust's taxable year, the annuity must be paid no later than the date the trustee is required to file the trust's Federal income tax return (without regard to extensions).[15]

f. **No additional contributions**.

The governing instrument must prohibit additional contributions to the trust once the trust is initially funded.[16]

g. **Prohibit payment to others**.

The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the annuitant during the term of the GRAT.[17]

h. **Term fixed**.

The governing instrument must fix the term of the annuity interest and the term must be ascertainable at the creation of the trust.[18]

i. **Prohibit commutation**.

The governing instrument must prohibit commutation (prepayment) of the annuity amounts.[19]

j. **Prohibit payment by debt instrument**.

The governing instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity amount.[20]

2. **Example**.

Grantor creates a GRAT with a 2-year term and funds it with $1,000,000 of marketable securities during a month when the Section 7520 rate is 3.2%. The GRAT provides that the first year's annuity payment equals 47.71675% of the initial fair market value of the assets contributed to the GRAT. The second year's annuity payment will be 20% greater than the payment in the first year (which is 57.2601% of the initial fair market value of the assets contributed to the GRAT). The GRAT contains all of the requirements under Section 2702 and its regulations. Based on the grantor's qualified retained interest in the GRAT, the grantor will make a taxable gift of $0.07 upon creation of the GRAT. Assume that the grantor survives the two-year term of the GRAT and the GRAT assets produce an annual return of 25%, the GRAT will have $393,440 of assets at the end of its two-year term, which will pass free of gift tax to the remainder beneficiaries. Thus, the grantor will have transferred $393,440 to the remainder beneficiaries for a taxable gift of $0.07.

B. Problems Relating to Bad Design.

1. Trust agreement states an incorrect annuity percentage.

a. Nature.

In order for a trust to qualify as a GRAT, the grantor must retain a "qualified annuity interest." This is an "irrevocable right to receive a fixed amount" from the trust.[21] A "fixed amount" can be either a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the trust property.[22]

Most practitioners define the annuity amount as a percentage of the initial fair market value of the trust property. This prevents a significant taxable gift if, upon audit, the Internal Revenue Service ("IRS") successfully argues that the grantor undervalued the assets initially contributed to the trust. Under those circumstances, the dollar amounts of the annuities payable to the grantor increase in response to the increased value of the GRAT assets. The value of the grantor's retained annuity interest increases and the taxable gift to the remainder beneficiary remains nominal.

Most practitioners will also use a computer program (*e.g.*, NumberCruncher, Tiger Tables, z-Calc, etc.) to compute the GRAT annuity percentages. The annuity percentages are generally set so that the grantor's retained annuity interest is worth nearly as much as the value of the assets transferred to the GRAT, ensuring that the value of the taxable gift (the remainder interest) is a nominal amount. The practitioner must then transfer those annuity percentages from the computer program to the trust agreement.

Minor errors in transferring the annuity percentages can create big problems. For example, assume the grantor funds a 3-year GRAT with $10 million, the retained annuity payments increase by 20% per year, the initial annuity payment is to be fixed at an amount that will zero-out the GRAT,[23] and the Section 7520 rate is 3.2% (the rate in effect for December 2009). Here are the required annuity percentages that will yield a taxable gift of zero:

Payment No.	**Annuity Percentage**
1	29.360810%
2	35.232972%
3	42.279566%

Suppose that, in transferring these annuity percentages from the computer program to the trust agreement, the typist transposes two figures in the first annuity payment, changing it from 2***9.3***6081% to 2***3.9***6081%. The reduction of the first-year annuity payment reduces the value of the grantor's retained annuity interest by over $1,800,000 and, therefore, produces a taxable gift over $1,800,000. This drafting error may also cause the trust agreement to violate the requirement that annuity payments cannot increase more than 120% from the prior year.[24] This should not disqualify the grantor's retained interest and result in a taxable gift of $10 million. However, the grantor's retained interest would be valued as if each year's annuity payment were no more than 120% of the prior year's.[25] This could result in the grantor having made a larger taxable gift than he anticipated. See further discussion of this issue at II.B.2 below.

b. Potential Solutions and Planning Considerations.

(1) Be careful.

There is no substitute for being careful. Practitioners should take extra precautions to ensure that the annuity percentages stated in the trust agreement are exactly those produced by the computer program.

(2) **Rely on a savings clause**.

If the trust agreement contains a savings clause (see the sample language at II.B.1.c(2), below), this may be enough to solve the problem.

Generally, the IRS will not respect a savings clause to negate a trustee power or direction that, apart from the savings clause, is unambiguously conferred upon the trustee.[26] It will, however, give effect to a savings clause to resolve an ambiguity about whether the power or direction has been conferred.[27]

(3) **Judicial modification or construction of trust**.

State law generally permits a court to judicially modify a trust agreement to correct a scrivener's error. Some states also permit courts to reform a trust in order to correct problematic provisions that did not result from a scrivener's error. For example, Texas law permits a court to reform a trust if the reformation is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intent.[28] Such an order may have retroactive effect.[29]

However, a judicial modification or reformation may not be sufficient to cure the federal tax problem. Unless the IRS is a party to the state court action, the IRS and federal courts generally are bound only by state court decisions from the highest court in the state.[30] In most cases, a petition seeking judicial modification or reformation of a trust will not be opposed. Hence, in most states (including Texas) there is no way to secure a decision from the highest state court because there is no procedure for seeking review of the trial court's decision.

Some states (such as Massachusetts) have a procedure under which the state's highest court can certify the decision of a lower court modifying a trust, even though no error in the lower court's judgment is claimed. If the trust agreement permits, consider changing the situs of the trust to such a jurisdiction, appointing a local trustee (if necessary), and pursuing the judicial modification in that state.

The IRS generally has been reluctant to give retroactive effect to modifications of trust agreements that seek to cure tax defects.[31] In contrast, a "construction" of an ambiguous provision of a trust agreement may apply retroactively, provided that the document is ambiguous and the construction is consistent with state law.

Despite the general reluctance of the IRS and federal courts to grant retroactive effect to state court modifications of trust agreements, they have shown some willingness to allow retroactive effect when the reformation has been obtained to correct a scrivener's error.[32] While a state trial court decision reforming a trust is not, per se, binding on the IRS and federal courts, it still can significantly impact federal tax treatment. In a federal tax controversy, the federal court must independently determine whether the state court properly applied applicable state law in reforming the trust instrument to correct a scrivener's error.[33] If the federal court determines that the state court properly applied state law, the reformation to correct the scrivener's error can apply retroactively for tax purposes as well.[34] The result compares to the treatment of a construction suit, in that the reformation restores the trust instrument to the settlor's original intent.[35] Anyone pursuing a retroactive reformation to correct a scrivener's error should strongly consider seeking a private letter ruling as to the tax implication of the proposed reformation proceeding.

c. **Drafting Suggestions**.

(1) **Proofread carefully**.

Take extra care in proofreading annuity percentages. An even safer practice would be for a second professional to review the trust agreement and confirm that the percentages are accurate.

(2) **Include a savings clause**.

Consider including a savings clause that automatically overrides erroneous annuity percentages. Example:

"*Notwithstanding the annuity percentages stated in the table above, the annuity percentage for each year during the trust term shall be the minimum percentage necessary to produce a remainder interest as close as possible to, but not greater than, $_______, assuming that the annuity percentage for each year after the first year is 20% greater than the annuity percentage for the previous year*."

2. **Annuities increase by more than the permissible amount**.

a. **Nature**.

The annuity amounts payable to the grantor may, but need not, be equal during each year of the GRAT term. However, regardless of whether the annuity amount is defined as a stated dollar amount or a fixed fraction or percentage of the initial fair market value of the trust property, the annuity amount in the second and subsequent years of the GRAT term cannot be more than 120% of the annuity amount for the prior year.[36] Many practitioners prefer "back-end loaded" GRATs—that is, GRATs whose annuity amounts start out low and increase by the maximum amount each year over the term of the trust. In many cases, a back-end loaded GRAT will shift more wealth to the remainder beneficiaries than a level annuity amount that has the same actuarial value. However, practitioners must exercise caution to ensure that the 120% limitation is observed. Exceeding the 120% limitation should not disqualify the grantor's retained interest. However, the grantor's retained interest would be valued as if each year's annuity payment were no more than 120% of the prior year's.[37] This could result in the grantor having made a larger taxable gift than he anticipated.

b. **Potential Solutions and Planning Considerations**.

The solutions for this problem are the same as those for an incorrect annuity percentage.

(1) **Be careful**.

Again, caution and attention to detail are the first line of defense in avoiding an impermissible increase in annuity percentages.

(2) **Rely on a savings clause**.

The trust agreement's savings clause (see the sample language at II.B.2.c(2), below) may be enough to solve the problem if the trust agreement presents an ambiguity. See the discussion at II.B.1.b(2) above.

(3) **Judicial modification or construction of trust**.

Judicial modification of the annuity percentages through a state law proceeding might not solve the problem. The IRS usually does not respect retroactive modifications, particularly when the IRS is not a party to the proceeding. However, it has shown some willingness to respect a retroactive modification that attempts to correct a scrivener's error, if the modification was consistent with applicable state law. If the issue can somehow be characterized as an ambiguity in trust agreement that requires construction, a favorable judicial construction might solve the problem. See II.B.1.b(3), above.

c. **Drafting Suggestions**.

(1) **Proofread carefully**.

Again, take extra care in proofreading annuity amounts or percentages or, alternatively, ask a second professional to review the trust agreement and confirm that the 120% limitation has not been exceeded.

(2) **Include a savings clause**.

Consider including a savings clause that prohibits an impermissible increase in the annuity amount. Example:

"*Notwithstanding the annuity percentages stated in the table above, the Annuity Amount payable in each year after the first year of the Initial Trust Term shall not exceed 120% of the Annuity Amount payable during the preceding year.*"

3. **Trust agreement omits a necessary GRAT provision**.

a. **Nature**.

Treasury regulations require that GRATs contain certain provisions, such as provisions prohibiting commutation of an annuity interest or payment of an annuity with a note or other debt obligation.[38] Failure to include a required provision could disqualify the GRAT and result in the grantor having made a gift equal to the value of the entire trust property, without reduction for the grantor's retained interest.

b. **Potential Solutions and Planning Considerations**.

(1) **Rely on a savings clause**.

If the trust agreement contains a savings clause (see the sample language at II.B.3.c(2), below), this may solve the problem if the trust agreement presents an ambiguity. See the discussion at II.B.1.b(2) above.

(2) **Use limited power to amend**.

If the trust agreement contains a limited power to amend (see II.B.3.c(3), below), rely on that power to amend the trust agreement and include the necessary power. As discussed in II.B.1.b(2) above, the IRS will generally not give effect to a savings clause to negate a disqualifying power. The IRS has utilized similar arguments to negate the effectiveness of a limited power of amendment.[39]

(3) **Judicial modification**.

Judicial modification to add the omitted provision through a state law proceeding may not solve the problem, because the IRS usually does not respect retroactive modifications, particularly when the IRS is not a party to the proceeding. It has shown some willingness to respect a retroactive modification that attempts to correct a scrivener's error, if the modification was consistent with applicable state law. If the issue can somehow be characterized as an ambiguity in trust agreement that requires construction, a favorable judicial construction might solve the problem. Regarding the efficacy of such a solution, see the discussion at II.B.1.b(3), above.

c. **Drafting Suggestions**.

(1) **Scrutinize GRAT forms**.

Most estate planning attorneys maintain their own forms. A GRAT form should be reviewed periodically to ensure that it contains all required provisions. Counsel who rely on published forms should compare those forms to the applicable regulations and be certain that they contain all required provisions.

(2) **Include a savings clause**.

Consider including a savings clause that automatically incorporates required provisions. Example:

"*Notwithstanding any provision of this Trust Agreement to the contrary, all provisions of this Trust Agreement shall be construed and applied so the trust administered under this Trust Agreement qualifies as a retained annuity trust whereby a 'qualified interest' is retained within the meaning of*

Section 2702(b)(1) of the Code. The Trustee (1) shall not take any action or have any power that would disqualify, and (2) shall have all additional powers necessary to qualify, the trust as a retained annuity trust whereby a "qualified interest" is retained within the meaning of Section 2702(b)(1) of the Code."

(3) **Include limited power to amend**.

Consider expressly giving the trustee the power to amend the GRAT to include any necessary provisions. Example:

"*The Trustee shall have the power to amend this Trust Agreement but only for the limited purpose of ensuring that the trust qualifies as a retained annuity trust whereby a 'qualified interest' is retained within the meaning of Section 2702(b)(1) of the Code. In this connection, the Trustee may amend this Trust Agreement in order to (1) delete any provision that would disqualify the trust as such a retained annuity trust, and (2) add any provision necessary to qualify the trust as such a retained annuity trust. Any such amendment shall be retroactive to the date the trust was created unless the Trustee expressly provides otherwise.*"

(4) **Other helpful tools**.

Consider preparing a checklist enumerating all of the required provisions of a GRAT and comparing each GRAT against that checklist. Alternatively, do a "redline" comparison of each GRAT against a trusted GRAT form to ensure that all required provisions are included.

4. **GRAT is funded with problem assets**.

Funding a GRAT with certain kinds of assets can cause problems. Examples are discussed in this section.

a. **An interest valued under Section 2701.**

(1) **Nature**.

Normally, for gift tax purposes the value of transferred property is its fair market value at the time of the transfer.[40] However, Section 2701 provides different valuation rules if the donor transfers an interest in a corporation or partnership to a member of his family and retains certain kinds of interests in the corporation or partnership.[41] Under those circumstances, the value of the transferred property for gift tax purposes may be significantly in excess of its fair market value. Suppose the grantor funds a GRAT with an interest in a corporation or partnership whose value is to be determined under Section 2701, but the trust agreement, in compliance with Section 2702,[42] computes the grantor's retained annuity payment by referring to the "fair market value" of the transferred interest. The result could be that the grantor has made a significant gift to the remainder beneficiary. For example, suppose the grantor holds both preferred and common stock in a family corporation, the grantor transfers common stock to a GRAT, the common stock has a fair market value of $1 million, but the value of the common stock determined under the Section 2701 special valuation rules is $3 million. The grantor's retained annuity interest will be determined by reference to the initial fair market value of the common stock—*i.e.*, $1 million. If the grantor's retained annuity is fixed at that amount which will zero out the GRAT, it too will have a value of $1 million. The grantor will have made a gift of $2 million simply because the value of what the grantor transferred is valued under Section 2701 but the value of what he retained is not.

(2) **Potential Solutions and Planning Considerations**.

(a) **Avoid Section 2701 interests**.

Do not fund GRATs with interests in corporations or partnerships that will be valued under Section 2701 unless the grantor obtains an appraisal in advance showing that the Section 2701 value of the interest to be transferred does not exceed its fair market value by more than an acceptable amount (*i.e.*, an amount that the grantor is willing to treat as a taxable gift).

(b) **Make Section 2701 elections**.

If the GRAT is funded with an interest valued under Section 2701, be sure to make any elections under Section 2701 that are necessary to give the seller's retained interest the highest possible value and, consequently, produce the lowest value for the transferred interest. If an election would not be timely, consider asking the IRS for an extension of time to make the election.[43]

(c) **Transfer a "vertical slice"**.

If Section 2701 would otherwise apply, consider funding the GRAT with a "vertical slice" of the grantor's interest in the corporation or partnership—that is, a proportionate part of each class of equity interest held by the grantor and not just the subordinate interest that carries the expectation of significant appreciation. This should prevent Section 2701 from applying to the transfer.[44]

(3) **Drafting Suggestions**.

Consider including a provision stating that, for purposes of computing the amount of the annuity payments to the grantor, if the gift tax value of the GRAT assets is greater than the fair market value, the annuity percentages will be applied to the gift tax value rather than the fair market value. The goal would be to increase the annuity payments due to the grantor and, thereby, increase the value of the grantor's annuity interest and reduce the amount of the remainder interest, if Section 2701 produced a greater value than fair market value. Caution: Before employing this suggestion, consider whether the so-called "exhaustion test" would prevent it from succeeding. Treasury regulations[45] provide that, if an annuity is payable solely from a trust or other limited fund, the standard Section 7520 annuity factor may not be used to compute the value of the annuity interest if the annuity is expected to exhaust the fund prior to the last annuity payment. Instead, the value of the annuity interest will be determined based on the number of annuity payments the fund is expected to satisfy. Query: Would the exhaustion test be applied by using, as the value of the fund, the fair market value or the Section 2701 value of the GRAT assets? If it is the former, then computing annuities based on the Section 2701 value would cause the GRAT to fail the exhaustion test. Hence, the grantor's annuity interest could never achieve a value in excess of the fair market value of the GRAT assets and this potential solution will not work.

b. **Insider stock**.

(1) **Nature**.

If the grantor is an insider (*i.e.*, a director, officer, or 10% stockholder) in a publicly-held company, the grantor will be subject to the "short-swing profits" rule under Section 16(b) of the Securities Exchange Act. If the grantor contributes stock in the company to a GRAT, the stock held in the GRAT will be subject to this rule just as though the grantor retained the stock individually. Similarly, if at the end of the GRAT term, the stock is transferred from the GRAT to the grantor as trustee of a remainder trust, the stock will continue to be subject to this rule. Generally speaking, the short-swing profits rule provides that any profits realized by an insider from the purchase and sale of stock within a six-month period is recoverable by the company. In enforcing this rule, the SEC will match all purchases and sales that occur within the six-month period before and after the purchase or sale regardless of whether those transactions were based on "inside information" and regardless of which transaction occurred first (*i.e.*, the purchase or the sale). In that regard, a purchase or sale transaction is not limited to a transaction effected through the open market. Instead, it can also encompass private transactions, including those between family members and trusts for their benefit. As a result, it is important to properly structure the powers reserved by the grantor under a GRAT in a way that will not unintentionally trigger the short-swing profits rule. Those powers may include the discretionary power to use insider stock to satisfy an annuity payment and the grantor's power to substitute other assets for the insider stock.[46] In a No-Action Letter, the Securities Exchange Commission concluded that the transfer of securities by an insider to a GRAT and the transfer of the securities back to the grantor in satisfaction of the annuity payments are only a change in the form of ownership and would not be subject to Section 16(b).[47] However, two court decisions indicate practitioners should use caution in funding GRATs with insider stock.[48]

(2) **Potential Solutions and Planning Considerations**.

The grantor should be able to use insider stock to fund a GRAT if the grantor refrains from entering into any other insider stock transactions within 6 months before and after a potential "triggering" transaction with the GRAT's insider stock. The GRAT instrument should include the protective provisions discussed in II.B.4.b(3) below.

(3) **Drafting Suggestions**.

If the grantor intends to use insider stock to fund a GRAT, the GRAT should include provisions designed to limit the grantor's discretion over the insider stock and to avoid a "deemed" purchase or sale transaction between the grantor and the GRAT. Those provisions include:

(a) **Omit swap power**.

Omit a swap power or, alternatively, provide that it does not apply to insider stock.

(b) **Include alternate grantor trust trigger**.

If full grantor trust status is desired, consider adding a provision stating that the grantor is entitled to receive each year the greater of the annuity amount or all income of the GRAT. Such a provision is permissible under the Treasury regulations, although the right to receive excess income is not a qualifying income interest and is not taken into account in valuing the qualified annuity interest.[49] This should ensure that the GRAT is a grantor trust under Section 677(a), even if the swap power is deleted[50] and no other grantor trust provision applies. This probably will not affect the amount distributable to the grantor from a short-term GRAT since the annuity payments retained in such a GRAT are so large that the possibility of trust income being greater is remote. However, in a long-term GRAT, trust income may exceed the annuity payments (especially in the early years of a back-end loaded GRAT), so the addition of this provision would have an economic effect on the amount distributable to the grantor.

(c) **Include ordering rule**.

Include an ordering rule that requires the trustee to satisfy the annuity payments with specific GRAT assets (*e.g.*, first with insider stock, then with cash, then with other assets) and give no discretion to the trustee to choose assets to satisfy the annuity payment until all insider stock has been distributed or sold.

(d) **Prohibit use of grace period**.

Require the trustee to satisfy the annuity payment on the anniversary date of the GRAT, and prohibit the trustee from taking advantage of the 105 day grace period that would otherwise apply.[51]

c. **Stock options**.

(1) **Nature**.

Funding a GRAT with nonqualified stock options ("NQSO") can leverage the GRAT's wealth-shifting potential. If a client decides to contribute NQSO to a GRAT, the client must decide whether to contribute vested options, nonvested options, or a combination of the two. Since vested options are more likely to have a higher gift tax value, many clients would prefer to transfer nonvested options.

However, the IRS takes the position that the transfer of a nonvested NQSO to a family member (or a trust for a family member) is only complete upon the later of: (i) the date of transfer or (ii) the date vesting occurs (*i.e.*, the date the right to exercise the NQSO is no longer conditioned on the performance of services).[52] The rationale behind the ruling is that prior to the time of vesting, the NQSO does not possess "the character of enforceable property rights susceptible of transfer" for federal transfer tax purposes. Furthermore, the ruling provides that if the NQSOs are subject to an incremental vesting schedule, the taxpayer will be deemed to have made a series of completed gifts as the options vest.

The IRS's position that a nonvested NQSO is a non-transferable expectancy right has been criticized by many practitioners on the basis that state law recognizes nonvested options or nonvested retirement benefits as property rights subject to transfer and division.[53]

In addition to the issue surrounding when a transfer of a nonvested NQSO is complete, clients should also be mindful of the tax strategy patent issued in connection with the transfer of a NQSO to a GRAT. On May 20, 2003, the U.S. Patent and Trademark Office granted Mr. Robert C. Slane of Wealth Transfer Group, LLC, a patent for the technique of funding a GRAT with nonqualified stock options.[54] The patent holder has sued individuals for infringement of this patent. Tax patents such as this one have been subject to much criticism and Congress is considering legislation to limit such patents.

(2) **Potential Solutions and Planning Considerations**.

(a) **Avoid funding GRATs with options**.

Consider using other assets to fund a GRAT.

(b) **Pay the patent holder a licensing fee**.

If stock options are the client's only asset appropriate for funding a GRAT and the client is adverse to litigation, the client should consider obtaining a license from the patent holder.

(c) **Gift tax reporting**.

If the client elects to fund the GRAT with nonvested NQSOs, the client must file a gift tax return reporting the transfer and indicating that the client is taking a reporting position contrary to a published Revenue Ruling. This additional disclosure is made by completing IRS Form 8275 (Disclosure Statement) and including it with the client's gift tax return.

(3) **Drafting Suggestions**.

(a) **Consider funding GRAT with an interest in a limited partnership or LLC that owns stock options and other significant assets**.

Some practitioners have suggested that this structure does not violate the patent since the asset transferred to the GRAT is an interest in an entity – not stock options. Consider consulting with an intellectual property attorney before pursuing this structure. Query: Does the contribution of nonvested options to a partnership or LLC followed by the transfer of partnership or membership interests enable the client to avoid the application of Revenue Ruling 98-21?

(b) **Utilize an installment sale of stock options to a grantor trust.**

This estate planning technique may be more effective to transfer wealth generated by NQSOs, and the author is not aware of an existing patent of this technique.

d. **Stock subject to Section 2036(b)**.

(1) **Nature**.

If a decedent has transferred property for less than adequate and full consideration and has retained the enjoyment of the transferred property for his life, the transferred property will be included in the decedent's gross estate under Section 2036(a). Section 2036(b) provides that the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation is considered a retention of the enjoyment of the stock. For this purpose, a "controlled corporation" is one in which, at any time after the transfer and within 3 years of the decedent's death, the decedent and certain members of his family owned or had the right to vote stock possessing at least 20% of the total combined voting power of all classes of stock. If the grantor funds a GRAT with Section 2036(b) stock and names himself as trustee, then the stock will be included in his gross estate. This probably adds little to the estate tax problems of the grantor of a "short-term GRAT" who dies during the GRAT term, since the GRAT assets will likely be included in his gross estate anyway.[55] However, Section 2036(b) may cause inclusion of the stock in the grantor's estate after the GRAT terminates, defeating the GRAT's wealth-shifting objective. For example, if the stock passes to a remainder trust of which the grantor is the trustee, Section 2036(b) will continue to apply. Furthermore, even if the stock passes to others when the GRAT terminates, the cessation of the grantor's voting rights is treated as a transfer of the stock for purposes of Section 2035. If the grantor dies within 3 years of the termination of the GRAT, the stock will still be included in his gross estate under Section 2035(a).

(2) **Potential Solutions and Planning Considerations**.

If the grantor has transferred voting stock in a controlled corporation to the GRAT, then consider the following actions:

(a) **Recapitalize**.

Recapitalize the voting stock in the GRAT to turn it into non-voting stock being sensitive to fiduciary concerns relating to any potential change in value of the GRAT's stock relative to stock owned outside the GRAT. Alternatively, if valuation is a concern, consider having all shares of the corporation subject to the recapitalization, exchanging each share of voting stock for 1% voting and 99% non-voting. Then only 1% of the GRAT's stock should be exposed to 2036(b) inclusion, and this exposure can be reduced by satisfying the annuities first with the voting stock. Query: Would Section 2035(a) only apply to the 1% voting stock during the 3-year period following either distribution of the voting stock in satisfaction of the annuity or termination of the GRAT, or would it also apply to the non-voting stock received in the recapitalization during the 3-year period following the recapitalization? It appears that Section 2035(a) would also apply to the non-voting stock in this situation, as a cessation of voting rights is treated as a transfer for purposes of applying Section 2035.[56] The recapitalization would, however, start the running of the 3-year period for inclusion under Section 2035.

(b) **Eliminate grantor's voting power**.

Alternatively, consider having the grantor resign as trustee and limit powers that would allow the grantor to control the identity of the trustee who has voting power. The grantor's resignation and release should start the running of the 3 year period during which the stock will still be included in his gross estate under Section 2035(a).

(c) **Swap Section 2036(b) stock for other assets.**

Many GRATs include a "swap power" which permits the grantor, acting in a non-fiduciary capacity, to reacquire the GRAT assets by substituting assets of equivalent value.[57] The wisdom of including such a power is subject to some debate, as indicated in the Drafting Suggestions below. However, if the grantor has retained a swap power, the grantor can reacquire the voting stock by substituting cash, a promissory note, or other assets of equivalent value. In substituting assets, however, the grantor will want to be sensitive to the timing of the substitution in light of the reason that the corporate stock was deployed into a GRAT in the first place. Presumably, the grantor believed that the stock had significant appreciation potential. Therefore, if the substitution is to take place before the appreciation in the voting stock has occurred (and the grantor still wants to use the GRAT for a potential wealth-shift), the grantor will want to select other assets believed to have significant appreciation potential to substitute for the voting stock. On the other hand, if appreciation in the voting stock has already occurred, substituting cash, a promissory note or other assets may be desirable. In any event, the 3-year inclusion concern of Section 2035(a) should not apply to the GRAT's assets after the substitution provided that the exchange qualifies as a bona fide sale for adequate consideration in money or money's worth.[58] In such case, the end result should be inclusion of the voting stock, itself, in the grantor's gross estate under Section 2031 (assuming that it is still owned by the grantor at death), with the GRAT purged of its 2036(b) inclusion.

(d) **Sell Section 2036(b) stock.**

If the trust agreement does not contain a swap power and consistent with the trustee's fiduciary duty, the trustee can sell the voting stock to the grantor (or a third-party) at its current fair market value, in exchange for cash, a promissory note, or some other asset. The same issues discussed above pertaining to the timing of the purchase, as compared with whether or not the desired appreciation in the voting stock has already occurred, would be relevant to the GRAT's potential success as a wealth-shifting strategy.

(3) **Drafting Suggestions**.

When using stock of a closely-held corporation to fund a GRAT, avoid the elements that would cause Section 2036(b) to apply.

(a) **Transfer only non-voting stock**.

Consider recapitalizing the corporation to create both voting and non-voting shares and have the grantor transfer only non-voting shares to the GRAT.

(b) **Transfer voting stock and deprive grantor of voting power.**

Either designate someone other than the grantor as the trustee (or as a co-trustee with the power to vote the stock) and prohibit the grantor from exercising any power to vote the stock or to control the identity of the trustee or co-trustee who has voting power. Prohibit the grantor from removing and replacing the trustee with voting power, unless the grantor must appoint as successor trustee someone who is not "related or subordinate" to the grantor.[59]

(c) **Consider whether the grantor should have a swap power over Section 2036(b) stock**.

The concern is whether the inclusion of a swap power would cause attribution of voting rights to the grantor because the grantor could reacquire the stock at any time. If so, this would cause inclusion of the stock in the grantor's gross estate under Section 2036(b). In one letter ruling, the IRS ruled that a swap power held in a fiduciary capacity would not cause inclusion under Section 2036(b).[60] In Revenue Ruling 2008-22,[61] the IRS ruled that, if certain requirements are met, retention of a swap power held in a nonfiduciary capacity will not result in inclusion under Section 2036. Revenue Ruling 2008-22 does not specifically address Section 2036(b); rather, it deals generically with Section 2036. Of course, Section 2036(b) simply specifies one set of facts that, for purposes of Section 2036(a), constitutes the retention of enjoyment of transferred property. If Revenue Ruling 2008-22 really means what it says – that Section 2036 does not apply to a power of substitution – then this conclusion should apply to Section 2036(b) as well. Nevertheless, some commentators, out of an abundance of caution, have recommended that the grantor not retain a swap power over Section 2036(b) stock.[62]

e. **Community property**.

(1) **Nature**.

A GRAT should not be funded with community property. If the nominal grantor uses community property to fund a GRAT for his benefit, then the grantor's spouse is the transferor of one-half of the GRAT assets. This has a number of adverse consequences. First, the grantor's spouse will probably have made a gift equal to the value of his or her community property interest in the GRAT assets. Second, the grantor's annuity interest, since it is a terminable interest, will not qualify for the gift tax marital deduction.[63] Third, as to the spouse's community one-half interest, the grantor will not be deemed to be the owner of the GRAT assets for grantor trust purposes, complicating transactions between the grantor and the GRAT (such as a swap of other assets for GRAT assets or payment of an annuity by distributing GRAT assets to the grantor in kind). The terms of the GRAT may be such that the spouse is treated as the owner of one-half of the GRAT assets under the grantor trust rules. If so, such transactions may not result in recognition of gain or loss because they will be transactions between spouses.[64] However, if the spouse ceases to be treated as the owner of one-half of the GRAT assets for grantor trust purposes, those kinds of transactions may have income tax consequences to the grantor and the trust.

(2) **Potential Solutions and Planning Considerations**.

Avoid funding a GRAT with community property. If the grantor wants to fund a GRAT with an asset that is (or arguably is) community property, the grantor and his spouse should take steps under applicable state law to partition or exchange the community property to create separate property of the grantor before funding the GRAT.

(3) **Drafting Suggestions**.

Community property presents a variety of unique issues that arise in an estate planning context. Failure to be sensitive to these issues and recognize the appropriate planning strategies can lead to unanticipated transfer tax problems. Practitioners who do not practice in a community property state but represent clients who wish to implement estate planning strategies with community property should consult with separate counsel in the applicable community property state. If there is any doubt at all as to whether property to be contributed to a GRAT is community property, the grantor and grantor's spouse should partition the property so that the property contributed to the GRAT is clearly the grantor's separate property.

5. **Congress imposes minimum GRAT term**.

a. **Nature**.

In recent months, several bills have been introduced in Congress that would require GRATs to have a minimum term (*e.g.*, ten years). It is unlikely that such a change, if approved by Congress, would be retroactive, but it might be. Even if the change were prospective only, it is possible that Congress could impose a minimum term and that an inattentive practitioner could continue creating short-term GRATs without knowing of the new requirement.

b. **Potential Solutions and Planning Considerations**.

Until the Congressional intention on this issue is clarified, practitioners should consider planning for the possibility that Congress may impose a minimum GRAT term.

c. **Drafting Suggestions**.

(1) **Include a provision that incorporates any minimum GRAT term and adjusts annuity payments accordingly**.

For example, consider including the following provision:

"*Notwithstanding the foregoing, if the Initial Trust Term specified above is shorter than the minimum term required for grantor retained annuity trusts by Code section 2702, the Initial Trust Term shall instead be the minimum term required for grantor retained annuity trusts and the annuity percentage for each year during the Initial Trust Term shall be the minimum percentage necessary to produce a remainder interest as close as possible to, but not greater than, $10, assuming that the annuity percentage for each year after the first year is 20% greater than the annuity percentage for the previous year.*"

(2) **Make the GRAT revocable if it provides for less than the required minimum term**.

For example, consider including the following provision:

"*On or after the Effective Date, this Trust Agreement and each of its provisions may no longer be amended and the trust created hereunder shall become irrevocable, except as provided below. If, as of the Effective Date, Code section 2702 requires a minimum term for grantor retained annuity trusts that exceeds the period of time encompassed by the Initial Trust Term, this Trust Agreement shall be revocable and amendable and Settlor may amend or revoke this Trust Agreement in whole or in part.*"

C. Problems Relating to Economic Changes.

1. **GRAT assets perform poorly (the "burnt-out GRAT")**.

a. **Nature**.

Generally, a GRAT will effect a wealth transfer only if the combined income and appreciation of the GRAT's assets exceed the applicable Section 7520 rate. Sometimes a GRAT's assets fail to perform as well as hoped. The GRAT likely will not shift wealth to the remainder beneficiary, and may not even perform well enough to satisfy all of the prescribed annuity payments.

For example, suppose the grantor funds a 2-year GRAT with an asset worth $10 million in December of 2009, when the Section 7520 rate is 3.2%. The GRAT is "back-end loaded" and the annuity payment in the second year is 20% greater than the annuity payment in the first year. The trust agreement fixes the annuity percentages so that the grantor's retained interest will equal $10 million and there will be no taxable gift to the remainder beneficiaries. Here are the required annuity payments for each year:

Year	Annuity Percentage	Annuity Amount
1	47.71675%	$4,771,675
2	57.26010%	$5,726,010

Suppose that, by December of 2010, the value of the asset transferred to the trust has declined by 40%, to $6 million. After satisfying the first annuity payment, the GRAT will only own assets with a value of less than $1,229,000. This GRAT will almost certainly shift no wealth to the remainder beneficiaries. The Section 2702 regulations prevent early termination of the GRAT through commuting the grantor's annuity interest in the GRAT.[65]

b. **Potential Solutions and Planning Considerations**.

Several solutions are possible, depending upon whether the GRAT assets still have appreciation potential:

(1) **Swap and re-GRAT**.

Most practitioners include a "swap power" in their GRATs which permits the grantor, acting in a non-fiduciary capacity, to reacquire the GRAT assets by substituting assets of equivalent value.[66] A swap power not only bolsters the position that the GRAT is a grantor trust[67] but also gives the grantor flexibility to respond to problems or opportunities that arise in the administration of GRATs. If the GRAT assets still have appreciation potential and the grantor has retained a swap power, the grantor can reacquire the asset by substituting cash or other assets of equivalent value and transfer the asset to a new GRAT. The diminished value of the asset will yield lower annuity payments in the new GRAT, increasing the probability of a wealth shift in the new GRAT compared to the old GRAT. Obtaining reliable valuation information is essential. The trustee of the GRAT has a fiduciary duty to ensure that, if the grantor exercises his swap power, the assets he substitutes in the GRAT are equal in value to the asset he reacquired.[68] The grantor also has an interest in insuring that the assets he transfers to the GRAT are equal in value to those he receives. If he transfers too much to the GRAT, the IRS may contend that he has made a prohibited additional contribution to the GRAT. If he transfers too little to the GRAT, the IRS may argue that he has received an excess distribution from the GRAT. If the grantor does not wish to utilize existing assets (or does not have sufficient assets) to effectuate the swap, the grantor could consider swapping the assets for a promissory note. As long as the note bears interest at or above the AFR, the value of the note (for federal transfer tax purposes) should equal its face amount.[69]

(2) **Sale to grantor and re-GRAT.**

If the trust agreement does not contain a swap power, the trustee could sell the GRAT asset at its current fair market value for cash or a promissory note. As in paragraph (1) above, if the purchased asset still has appreciation potential, the grantor can transfer the asset to a new GRAT where there will be a fresh start toward the goal of achieving a wealth-shift. Again, reliable valuation and attention to the trustee's fiduciary duties are required.

(3) **Sale to a grantor trust**.

If the underperforming asset still has appreciation potential, and if the grantor has created another trust for the same beneficiaries and the second trust is a grantor trust, the GRAT could sell the underperforming asset to the second trust without income tax consequences. Any future appreciation would enhance the value of the second trust. The benefits are further enhanced if the second trust is a generation-skipping trust.

(4) **Re-GRAT the annuity interest**.

If the trust agreement permits (see II.C.1.c(2), below), the grantor could create a second GRAT and fund it with the grantor's annuity interest in the first GRAT (funded with the underperforming asset). Since the first GRAT should not be able to fully fund all of its annuity payments, that should be taken into account in valuing the annuity interest in the first GRAT that is being transferred to the second GRAT. The second GRAT will then pay the grantor a new, lower annuity based on the discounted value of the annuity interest in the first GRAT.[70]

(5) **Pay remaining annuities early and terminate GRAT**.

If the underperforming asset has no significant appreciation potential, can the GRAT simply make the remaining annuity payments early (to the extent of the GRAT assets) and terminate? This would eliminate the administrative burden of continuing the GRAT until its normal termination date. The regulations require that the trust agreement prohibit "commutation (prepayment) of the interest of the holder."[71] This may include any prepayment of the grantor's annuity interest, although "commutation" is generally understood to mean prepayment at a discounted amount based on the actuarially-determined present value of the annuity interest.[72]

(6) **Do nothing**.

If the underperforming asset has no further appreciation potential, the best solution may be to do nothing and let the GRAT run its course. This will likely lead to the ultimate distribution of all GRAT assets to the grantor in satisfaction, or partial satisfaction, of the annuity payments due him and the GRAT will simply terminate.

c. **Drafting Suggestions**.

(1) **Include a swap power in all GRATs**.

Unless there are specific reasons not to do so (for example, see II.B.4.b(3)(a), above), always include a swap power in a GRAT to permit the grantor to reacquire the GRAT assets.

(2) **Omit or modify spendthrift clause**.

The typical spendthrift clause would prevent the grantor from transferring his annuity interest in a GRAT to another GRAT. To permit the solution discussed in II.C.1.b(4) above, do not include a spendthrift clause in the GRAT or modify the spendthrift clause to permit the grantor to transfer his annuity interest.

(3) **Omit prohibitions against self-dealing**.

Make sure the GRAT does not include provisions that would prohibit the sale of GRAT assets to the grantor or to another trust with the same trustee, or other self-dealing provisions that would interfere with the sale of a depreciated asset to a desirable purchaser.

2. **GRAT assets perform well (the "home run")**.

a. **Nature**.

Sometimes a GRAT's assets will realize significant early appreciation, suggesting that the GRAT will not only satisfy all annuity payments but also transfer significant wealth to the remainder beneficiary. However, today's appreciation could be lost to tomorrow's declining market. Retaining the appreciated assets in the GRAT subjects the potential wealth shift to market risk. Locking in the appreciation and avoiding market risk for the GRAT may be appropriate.

b. **Potential Solutions and Planning Considerations**.

(1) **Swap for a less risky asset**.

If the grantor has retained a swap power, the grantor can simply substitute assets with less market risk for the appreciated asset. If the appreciated asset has further appreciation potential, the grantor can transfer it to a new GRAT. The easiest asset to substitute in the GRAT is, of course, cash. However, there may be times when the grantor cannot, or prefers not to, transfer cash to the GRAT. In this case, the grantor could substitute a promissory note for the appreciated asset, so long as the promissory note has a value equal to the asset reacquired from the GRAT.

(2) **Sell the appreciated asset**.

If consistent with the trustee's fiduciary duty, the trustee can sell the appreciated asset at its current fair market value, in exchange for cash, a promissory note, or some other asset that is not susceptible to market risk. The trustee could sell to the grantor; this would be an option if the trust agreement omitted a swap power. The trustee could also sell to another trust. If the purchaser is either the

GRAT grantor or a trust that is a grantor trust as to the GRAT grantor, this transaction should not have income tax consequences.

(3) **Purchase a collar on publicly-traded security**.

If the GRATs holds marketable securities, the trustee could hedge against market risk (and retain some upside investment potential in the underlying securities) by purchasing puts, calls and collars on the open market.

(4) **Pay annuity amounts as early as possible**.

If the Trustee believes that the GRATs assets may decline in value, the Trustee should consider satisfying the required annuity payments as early as possible via an in-kind distribution of trust assets. This would ensure that the annuity payment is satisfied at a time when the assets have an appreciated value. Any subsequent decline in the fair market value of those distributed assets would occur in the hands of the grantor. It should be noted, however, that if the distributed assets continue to appreciate, such appreciation would occur in the grantor's estate.

c. **Drafting Suggestions**.

(1) **Include a swap power**.

Always include a swap power in a GRAT unless there are specific reasons not to do so (for example, see II.B.4.b(3)(a), above).

(2) **Omit prohibitions against self-dealing**.

Make sure the GRAT does not include provisions that would prohibit the sale of GRAT assets to the grantor or to another trust with the same trustee, or other self-dealing provisions that would interfere with the sale of the appreciated asset to a desirable purchaser.

3. **GRAT assets perform too well (the "grand slam home run")**.

a. **Nature**.

Sometimes a GRAT's assets will appreciate to the point that the GRAT promises to shift more wealth to the remainder beneficiaries than the grantor intended.

b. **Potential Solutions and Planning Considerations**.

Assuming the grantor has not otherwise drafted in anticipation of this issue (see II.C.3.c, below), when the desired level of appreciation has been reached, the grantor may have several options:

(1) **Exercise a swap power**.

If the grantor has retained a swap power, the grantor can exercise that power, recover the appreciating asset in exchange for an asset with less appreciation potential, and limit any additional appreciation that may be shifted to the remainder beneficiaries. Any additional appreciation in the swapped asset will benefit the grantor. Alternatively, the grantor can deploy the swapped asset in another estate planning strategy, such as another GRAT with different remainder beneficiaries. For the reasons discussed previously (see II.C.1.b(1), above), both the trustee and the grantor should ensure that the assets the grantor transfers to the GRAT have a value equal to those he recovers from the GRAT.

(2) **Purchase appreciating asset**.

If consistent with the trustee's fiduciary duty, the trustee can sell the appreciating asset to the grantor (an option if the trust agreement omitted a swap power) or to another trust at its current fair market value and thereby shift post-transfer appreciation away from the beneficiaries of the GRAT and to the beneficiaries of the second trust. If the purchasing trust is also a grantor trust, this transaction should not have income tax consequences.

(3) **Add or change beneficiaries**.

If the trust agreement permits (see II.C.3.c(4), below), a powerholder can add other remainder beneficiaries to the GRAT or other beneficiaries to the remainder trust, such as members of the grantor's family or friends of the grantor. This may prevent the original GRAT remainder beneficiaries from receiving more than the grantor intended.

(4) **Turn off grantor trust status**.

If the remainder of the GRAT is payable to a separate grantor trust, the grantor can ameliorate the wealth shift by taking action (such as changing the trustee or releasing powers) that will terminate grantor trust status and cause the remainder trust to be taxed on its own income. Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.[73]

(5) **Pay annuity amounts as early as possible**.

If the Trustee believes that the GRATs assets may continue to appreciate in value, the Trustee could satisfy the required annuity payment as early as possible via an in-kind distribution of trust assets. Doing so would ensure that any future growth occurs outside of the GRAT. The obvious issue in pursuing this course of action (rather than deferring the payment of the annuity payment for as long as permitted by the trust agreement) is the Trustee's fiduciary duties to the remainder beneficiaries.

c. **Drafting Suggestions**.

(1) **Include a swap power**.

See II.C.1.c(1), above.

(2) **Omit prohibitions against self-dealing**.

Make sure the GRAT does not include provisions that would prohibit the sale of GRAT assets to the grantor or to another trust with the same trustee, or other self-dealing provisions that would interfere with the sale of an appreciated asset to a desirable purchaser.

(3) **Include a "waterfall" provision**.

If the grantor knows in advance how much wealth he wants to shift to the remainder beneficiaries, he can include a provision in the GRAT stating that, upon termination, assets up to that amount will be distributed to the remainder beneficiaries and assets in excess of that amount will be distributed to another remainder beneficiary (*e.g.*, to another family member, another remainder trust, a charity, or back to the grantor). Example:

"*Termination of Initial Trust Term. Upon the expiration of the Initial Trust Term, the Trust shall terminate and the Trustee shall distribute all of the remaining trust estate (other than any amount due to Grantor) as follows:*

"*(a) To First Beneficiary. The Trustee shall distribute to First Beneficiary assets having a value, on the date of distribution, equal to one million dollars ($1,000,000.00). If the assets of the remaining trust estate have a value, on the date of distribution, of less than one million dollars ($1,000,000.00), the Trustee shall distribute the entire remaining trust estate to First Beneficiary.*

"*(b) To Second Beneficiary. The Trustee shall distribute the balance of the trust estate to Second Beneficiary.*"

(4) **Permit changes in beneficiaries**

Consider appointing a third party trustee or independent powerholder and conferring on that trustee or powerholder the power to add to or change the remainder beneficiaries of the GRAT or the beneficiaries of the remainder trust. This should not result in adverse gift or estate tax consequences for the grantor. However, while this power exists it would be difficult for the grantor to avoid grantor trust status.[74] Also, if this power is conferred on a trustee, consider whether the trustee's fiduciary duties to other beneficiaries would interfere with the trustee's exercise of the power. Consider expressly providing that the exercise or non-exercise of this power will not be a breach of the trustee's fiduciary duty and expressly exonerating the trustee from any liability for exercising or not exercising the power.

4. **GRAT assets available to make the annuity payments are illiquid (the "illiquid GRAT")**.

a. **Nature**.

For various reasons, a GRAT may find itself without the liquidity to make annuity payments that the grantor expected. For example, the grantor may have transferred a business interest to a GRAT, anticipating an early liquidity event that would convert the GRAT assets to cash and enable the GRAT to make its annuity payments in cash, but that liquidity event did not occur when expected. Or the grantor may have transferred to the GRAT assets that the grantor expected to generate significant cash flow (*e.g*., oil or gas interests) but the actual cash flow is less than anticipated (*e.g*., because gas prices dropped by 50% after the GRAT was funded). The GRAT assets are still valuable and they could be distributed in kind to satisfy the annuity payments. However, the GRAT assets are difficult to value (*i.e*., they are not marketable securities or other assets that can be valued without an appraisal) and they may be subject to valuation discounts (*e.g*., they are closely-held business interests). These considerations also make the exercise of the grantor's swap power or a sale of the illiquid assets to generate cash less than optimal as solutions. A loan from the grantor to the GRAT is not an available option. Treasury regulations forbid the GRAT from satisfying an annuity payment with a note or other debt obligation,[75] and a loan from the grantor would violate this prohibition.

b. **Potential Solutions and Planning Considerations**.

(1) **In-kind distribution**.

The trustee can always distribute GRAT assets in kind to the grantor in satisfaction of the annuity payment. For a number of reasons, this may not be a good solution. It may transfer assets with appreciation potential back to the grantor. If the assets were valued at a discount upon contribution to the GRAT, they will likely be subject to a discount for annuity payment purposes as well, requiring a larger share of the assets to be distributed than if no discount were involved. Finally, it may be necessary to obtain an appraisal of the assets to support the value used for annuity payment purposes, adding to the expense of administering the GRAT.

(2) **Loan from third party**.

The GRAT can borrow funds from a third party sufficient to permit it to make the annuity payment. Many practitioners believe that it is safe for the GRAT to borrow from a lender that is related to the grantor, such as another trust of which the grantor is the settlor or trustee, although some also feel that borrowing from the grantor's spouse may be risky.[76] Many practitioners also believe that it is safe for the grantor to guarantee a third-party loan, so long as the GRAT pays the grantor an adequate guarantee fee. Many practitioners believe that a guarantee fee of around 1% to 2% of the guaranteed amount per year is adequate. In this connection, note that the IRS once asserted in a letter ruling that a loan guarantee was a taxable gift from the guarantor to the debtor.[77] The IRS later withdrew that letter ruling.[78]

c. **Drafting suggestions**.

(1) **Use a long-term, back-end loaded GRAT**.

Use a long-term GRAT with annually-increasing annuity payments to minimize the amount of the annuity payments in early years. This will minimize the problem if the anticipated liquidity event is postponed.

(2) **Initially fund the GRAT with some liquid assets**.

In addition to the illiquid asset with appreciation potential, also contribute some cash, marketable securities, or other liquid assets to the GRAT to enable it to make early annuity payments without resorting to the illiquid asset.

D. Problems Relating to Mortality.

1. **Grantor's life expectancy changes**.

a. **Nature**.

If the grantor dies during the term of the GRAT, some or all of the GRAT assets will be included in his gross estate under Section 2036.[79] The grantor may have created a long-term GRAT based on the assumption that he had a certain life expectancy. However, illness or injury may have reduced that life expectancy after the GRAT was funded, increasing the likelihood that the GRAT assets will be brought back into the grantor's gross estate and the anticipated wealth shift to the remainder beneficiary will not occur. Prepayment of the annuity interest in this situation would not appear to be a viable solution. The regulations require that the trust agreement prohibit "commutation (prepayment) of the interest of the holder."[80] This may include any prepayment of the grantor's annuity interest, although "commutation" is generally understood to mean prepayment at a discounted amount based on the actuarially-determined present value of the annuity interest.[81] While it may be possible to prepay the current year's annuity, the prepayment of multiple annuity amounts would presumably violate the requirement for the annuity payment to be made annually.[82]

b. **Potential Solutions and Planning Considerations**.

There is no solution to the problem of dying earlier than expected. However, if the problem is the more specific one of reducing the potential estate tax imposed on the GRAT assets, there may be a solution.

(1) **Grantor purchases remainder interest.**

If the trust agreement permits (see II.D.1.c(1), below), the grantor could purchase the remainder interest from the remainder beneficiary for its actuarial value. Note that the Treasury regulations forbid only commutation of the annuity interest, and not of the remainder interest.[83] The grantor would then own the annuity interest and the remainder interest. This should cause a merger and a termination of the GRAT, putting the GRAT assets back into the hands of the grantor where tax can be deferred (through use of the marital deduction) or avoided (through use of the charitable deduction). The remainder beneficiary will be left with cash or other assets equal to the value of the remainder interest at the time of the transaction, undiminished by estate tax. If there are alternate contingent remainder beneficiaries (*e.g.*, a trust for children if the grantor survives the GRAT term but a marital deduction trust if he does not), all potential remainder beneficiaries would need to sell their interests to the grantor. The purchase price for the entire remainder interest would be divided between the alternate remainder beneficiaries in accordance with the actuarial values of their respective interests.

(2) **Separate grantor trust purchases GRAT assets for a private annuity or self-canceling installment note ("SCIN")**.

If the grantor's life expectancy is reduced but the grantor has a greater than fifty percent chance of surviving for at least a year,[84] the trustee of the GRAT could sell the GRAT assets to another grantor trust in exchange for a private annuity or a SCIN. The sale should be ignored for income tax purposes as long as both trusts are grantor trusts with respect to the same grantor. Of course, this transaction requires that the grantor have an existing irrevocable grantor trust with sufficient assets to support a purchase of the GRAT's assets. Additionally, if the beneficiaries of the GRAT remainder differ from those of the purchasing trust, the GRAT trustee must consider whether the private annuity transaction would constitute a breach of the trustee's fiduciary duties to the GRAT's remainder beneficiaries. In any case, the trustee of the GRAT must ensure that the fair market value of the private annuity or SCIN he receives equals the value of the GRAT assets he transfers.

(3) **Beneficiaries purchase assets from GRAT**.

If the GRAT assets have additional appreciation potential (*e.g.*, pre-IPO or pre-merger stock), the GRAT remainder beneficiaries could purchase the assets from the GRAT. The acquisition of the assets by the remainder beneficiary should minimize any fiduciary duty concerns the Trustee of the GRAT might otherwise have in selling the GRAT assets. If the remainder beneficiary is an individual or a non-grantor trust, the purchase could result in income tax liability for the grantor depending upon the current value of the assets and the grantor's income tax basis in those assets. Furthermore, it should be noted that if the GRAT assets fail to appreciate or worse, they depreciate in value, the sale would result in a reverse wealth shift.

c. **Drafting Suggestions**.

(1) **Omit or modify spendthrift clause**.

The typical spendthrift clause would prevent the remainder beneficiary from selling its beneficial interest to the grantor. To permit the solution discussed above, do not include a spendthrift clause in the GRAT or modify the spendthrift clause to permit a sale to the grantor.

(2) **Omit prohibitions on self-dealing**.

Be sure the remainder trust does not include self-dealing provisions that prohibit the trustee from selling the remainder interest in the GRAT to the grantor. Preferably, the remainder trust should specifically authorize purchase and sale transactions with the grantor.

(3) **Ensure grantor trust status**.

The GRAT and remainder beneficiary of the GRAT should be structured as grantor trusts so that there is no income tax caused by the potential solutions described above or, if tax is due, it is paid by the grantor.

2. **Grantor dies during GRAT term**.

a. **Nature**.

If the grantor dies during the GRAT term, some or all of the GRAT assets will be included in the grantor's gross estate.[85] Unless the GRAT assets qualify for the marital or charitable deduction, they will consume some or all of the grantor's applicable exclusion amount and perhaps cause the grantor's estate to incur estate tax.

b. **Potential Solutions and Planning Considerations**.

Consider adding contingent marital deduction provisions to the GRAT that will divert the GRAT assets to a deductible gift if the grantor dies during the GRAT term. The grantor's death will defeat the grantor's goal of securing a tax-free wealth shift to other beneficiaries, but it will at least defer estate tax until the grantor's spouse dies. Be sure to consider both of the interests that would lead to estate tax: the annuity interest and the remainder interest.

c. **Drafting Suggestions**.

(1) **Contingent marital deduction planning**.

If the grantor is married, consider including alternate dispositions of the annuity interest and the remainder interest if the grantor dies before the GRAT term expires. The alternate dispositions should qualify for the estate tax marital deduction so that, even if the GRAT assets are included in the grantor's gross estate, estate tax will be deferred until the surviving spouse dies. The disadvantage is that no wealth will be shifted to the remainder beneficiary.[86] The surviving spouse may be able to utilize various estate planning techniques to transfer these assets to family members at a reduced transfer tax cost.

3. **Beneficiary's life expectancy changes**.

a. **Nature**.

GRATs are not efficient for reducing GST tax on a leveraged basis. Under Section 2642(f), no effective allocation of the grantor's GST exemption can be made until the end of the GRAT term. Accordingly, GRATs are generally used for transfers to or for the benefit of children and other "non-skip" persons. Suppose the remainder beneficiary is a non-skip person for generation-skipping transfer tax ("GSTT") purposes (*e.g.*, a child of the grantor or a trust of which a child of the grantor is a beneficiary).[87] Suppose the child dies prematurely and, as a result, the remainder beneficiary is either the child's child (the grantor's grandchild) or a trust of which the grandchild is the only beneficiary. The "move-up" rule[88] will not apply because child died after the grantor's taxable gift, and therefore there will be a taxable termination when the GRAT terminates.[89] The GSTT attributable to a taxable termination will be paid by the GRAT[90] at the then maximum Federal estate tax rate.[91]

For example, suppose the GRAT has assets worth $1 million when the GRAT terminates in favor of a skip person. If the GRAT terminates in a year that the maximum estate tax rate is 45%, the GSTT will be $450,000 ($1 million x 45% x 1 [inclusion ratio]). This tax will be payable by the GRAT, diminishing the assets passing to the skip person (the grandchild or a trust of which the grandchild is the only beneficiary.).

b. **Potential Solutions and Planning Considerations**.

(1) **Sell remainder interest to a non-skip person**.

If not prohibited by a spendthrift provision, prior to termination of the GRAT the remainder beneficiary/skip person could sell the remainder interest to a non-skip person for its fair market value. When the GRAT terminates, the remaining trust property will be distributed to the non-skip person and there should not be a taxable termination of the GRAT.[92] If the buyer and seller are the same person for income tax purposes (*e.g.*, they are both grantor trusts with the same grantor), then the sale should not incur income tax. Otherwise, the transaction will be a sale or exchange with income tax consequences.

(2) **Add a non-skip person as a beneficiary**.

If the remainder trust provisions permit (see II.D.3.c(1), below) and it meets with the grantor's intentions, add a non-skip person as a beneficiary of the remainder trust to prevent a taxable termination when the GRAT terminates. This will not eliminate, but will instead defer, the GSTT event. When a distribution is eventually made from the remainder trust to a grandchild (a skip person) during the ongoing existence of the trust, it will then be a taxable distribution,[93] and the skip person will be responsible for paying the tax.[94] Or, if the eventual distribution is made upon termination of the trust caused by a triggering event, *e.g.* the skip person reaching a certain age, it will then be a taxable termination that was deferred for some period of time.

(3) **Consider allocating GST exemption**.

If all else fails, consider allocating the grantor's GST exemption to the remainder trust when the GRAT terminates and the estate tax inclusion period ("ETIP")[95] expires. While this may not leverage the grantor's GST exemption in the same way as an installment sale to a grantor trust, it does enable the grantor to utilize his GST exemption without incurring a taxable gift to do so. If the GRAT remainder creates lifetime trusts for its beneficiaries, the allocation of GST exemption upon the expiration of the ETIP may offer an effective, albeit unexpected, tool for utilizing the grantor's GST exemption, particularly at the current exemption level of $3.5 million. If the grantor elects not to allocate GST exemption at the expiration of the ETIP, the grantor could make a late allocation of GST exemption at some point in the future. In either case, the grantor should ensure that the trust agreement or applicable state law allows a severance of the remainder trust, if the allocation of GST exemption would result in a trust with a mixed inclusion ratio. The Code authorizes a qualified severance of a trust with a mixed inclusion ratio into two or more trusts with inclusion ratios of one or zero.[96]

c. **Drafting Suggestions**.

(1) **Add non-skip person as a beneficiary**.

Consider including a non-skip person (*e.g.*, a charity) as a beneficiary or potential beneficiary of the remainder trust. This will prevent the remainder trust from being a skip person and therefore prevent the termination of the GRAT from being a taxable termination resulting in immediate imposition of the GSTT transfer tax.[97] Of course, any distribution from the remainder trust to a skip person will be a taxable distribution resulting in GST tax.[98]

(2) **Include power to add new beneficiaries**.

Alternatively, give a third party the power to add a non-skip person as a beneficiary. If a beneficiary of the remainder trust dies before the GRAT terminates and this would otherwise cause the remainder trust to be a skip person, the powerholder could exercise this power and add a non-skip person as a beneficiary, thereby preventing a taxable termination when the GRAT terminates. See II.C.3.c(4), above.

(3) **Omit or modify spendthrift provision**.

The typical spendthrift clause would prevent a beneficiary from selling his or her beneficial interest. To permit the solution discussed above, do not include a spendthrift clause in the GRAT or modify the spendthrift clause to permit a sale to a non-skip person.

(4) **Ensure grantor trust status**.

The GRAT and remainder beneficiary of the GRAT should be structured as grantor trusts so that there is no income tax caused by the potential solutions described above or, if tax is due, it is paid by the grantor.

(5) **Authorize a qualified severance**.

Unless state law already does so, consider expressly authorizing the trustee of the remainder trust to effect a qualified severance of the trust[99] to more effectively use the grantor's GST exemption. This will allow the creation of two separate trusts, one of which has an inclusion ratio of zero and the other of which has an inclusion ratio of one. Distributions to non-skip persons can then be made out of the trust that is wholly subject to GST tax, preserving the assets of the GST-exempt trust for distribution to skip persons.

E. Problems Relating to Changes in Client Wishes.

1. Grantor desires to shift fewer assets to remainder beneficiaries.

a. Nature.

The GRAT assets are appreciating as originally hoped for, but the grantor no longer wishes to shift a significant amount of assets to the remainder beneficiaries. This is similar to the problem discussed in II.C.3 above (where the assets appreciate more than anticipated), and the solutions are the same.

b. Potential Solutions and Planning Considerations.

(1) **Exercise swap power**.

If the GRAT contains a swap power, the grantor can limit any additional wealth shift by substituting cash, a promissory note, or other assets of equivalent value for the appreciating GRAT assets. This may be particularly effective if the reacquired asset is valued at a discount and is swapped prior to realizing its full value. Exercise of the swap power should not be an income taxable event and is not reportable to the IRS if the GRAT is a fully grantor trust.

(2) **Purchase assets from the GRAT**.

If the GRAT does not contain a swap power, the grantor can still purchase appreciating assets from the GRAT if the trustee elects to sell. As with the swap power, this should enable the grantor to freeze the amount of wealth shifted to the remainder beneficiaries and shift future appreciation back to the grantor. Also, as with the swap power, this should not be an income taxable event.

(3) **Add or change beneficiaries**.

If the trust agreement permits (see II.E.1.c(3), below), a powerholder can add other remainder beneficiaries to the GRAT or other beneficiaries to the remainder trust, such as members of the grantor's family or friends of the grantor. The trustee can then distribute the excess wealth shift to these other beneficiaries. This may prevent the original GRAT remainder beneficiaries from receiving more than the grantor currently intends.

(4) **Turn off grantor trust status for remainder trust**.

If excess wealth has already shifted to the remainder trust and the remainder trust is a grantor trust, the grantor may be able to ameliorate the wealth shift by taking action (such as changing the trustee or releasing powers) that will terminate grantor trust status and cause the remainder trust to be taxed on its own income.[100]

c. Drafting Suggestions.

(1) **Include a swap power in the GRAT.**

See II.C.1.c(1), above.

(2) **Avoid prohibitions against self-dealing**.

Make sure the GRAT does not include provisions that would prohibit the sale of GRAT assets to the grantor and includes provisions that would specifically authorize such a sale.

(3) **Permit changes in beneficiaries**.

See II.C.3.c(4), above.

(4) **Permit grantor trust status to be "turned off"**.

Draft the remainder trust to facilitate termination of grantor trust status.[101] For example, do not include provisions that will result in grantor trust status and that cannot be altered. This would be the case if, for example, the remainder trust names the grantor's spouse as a beneficiary. The remainder trust will typically continue to be a grantor trust, and even a divorce will not terminate grantor trust status.[102] Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

(5) **Include power to lend to grantor**.

Consider authorizing the trustee of the remainder trust to lend trust funds to the grantor. This will enable the grantor to use the "excess" wealth shifted to the remainder trust. However, there are risks:

(a)

The loan must be consistent with the trustee's fiduciary duty, including the duty to invest trust assets prudently. A long term loan of trust funds to the grantor at the currently low applicable federal rate and with no required principal payments until the note matures may not be consistent with the trustee's duty.

(b)

If the grantor is the trustee and the power to lend is unfettered, the IRS may contend that the grantor has retained the right to enjoy the trust property and that Section 2036 causes the trust property to be includible in the grantor's gross estate. To avoid this, the power to lend must be limited by the trustee's fiduciary duty and, at a minimum, the note must provide for adequate interest. Also, to avoid potential Section 2036 inclusion of the trust assets in the grantor's estate, the loan should be administered in accordance with its terms, including the timely payment of interest and principal to the grantor.

2. **Grantor's liquidity needs change**.

a. **Nature**.

This is similar to the too-successful GRAT problem. However, this problem arises from the fact that the grantor has transferred liquid assets that, because of his changed financial situation, he wishes he still had. The solutions and drafting suggestions are similar.

b. **Potential Solutions and Planning Considerations**.

(1) **Exercise swap power**.

If the GRAT or remainder trust contains a swap power, the grantor can reacquire the liquid assets by substituting a promissory note or other illiquid assets of equivalent value for the trust's liquid assets.

(2) **Purchase GRAT or remainder trust assets**.

If the GRAT or remainder trust does not contain a swap power, the grantor may still purchase the trust's liquid assets if the trustee elects to sell. In this connection, see the discussion at II.E.1.b(2), above.

(3) **Borrow from the GRAT**.

If the trust agreement permits, the grantor could borrow from the GRAT to ease his liquidity problems. The promissory note should be properly structured and administered to avoid potential Section 2036 inclusion of the trust assets in the grantor's estate. See II.E.1.c(5), above.

(4) **Turn off grantor trust status for remainder trust**.

If the GRAT has already terminated, the grantor may be able to ease his future liquidity problems by taking action (such as changing the trustee or releasing powers) that will terminate grantor trust status and cause the remainder trust to be taxed on its own income.[103]

c. **Drafting Suggestions**.

(1) **Include a swap power in the GRAT**.

See II.C.1.c(1), above.

(2) **Avoid prohibitions against self-dealing**.

Make sure the GRAT does not include provisions that would prohibit the sale of GRAT assets to the grantor and includes provisions that would specifically authorize such a sale.

(3) **Include grantor's spouse as a beneficiary**.

Consider naming the grantor's spouse as a beneficiary of the remainder trust so that the assets of the remainder trust will be available to the grantor's family if needed. However, caution should be exercised in naming the spouse as a beneficiary. First, if both spouses are creating GRATs, care must be taken to avoid the reciprocal trust doctrine.[104] Second, if the grantor's spouse is a beneficiary, the grantor may not be able to turn off grantor trust status even if the grantor and the spouse later divorce.[105] Finally, if the grantor and his spouse later divorce, the fact that the grantor's (now former) spouse is a beneficiary will do little to solve the grantor's own liquidity problems.

(4) **Permit grantor trust status to be "turned off"**.

To relieve the grantor of the obligation to pay tax on the trust's income, draft the remainder trust to facilitate termination of grantor trust status.[106] For example, do not include provisions that will result in grantor trust status and that cannot be altered. In this connection, note the problem created by naming the grantor's spouse as a beneficiary. See II.E.2.c(3), above. Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

(5) **Permit the GRAT to make loans to the grantor**.

See II.E.1.c(5), above.

3. **The objects of the grantor's bounty change**.

a. **Nature**.

If the GRAT includes one or more remainder beneficiaries that the grantor no longer wants to provide for, or if the class of remainder beneficiaries excludes one or more persons that the grantor now wishes to benefit, the grantor may find that he is shifting wealth to people who are no longer objects of his bounty or who do not include all of his now intended objects. This predicament could occur under any number of circumstances: (i) the grantor's spouse and/or the spouse's children by a prior marriage are remainder beneficiaries and a divorce occurs and grantor no longer wishes to provide for them; (ii) the grantor has a falling-out with his own child who is a remainder beneficiary and now wishes to exclude the child; and (iii) the grantor has reconciled with a formerly excluded child who he now wants to share in the GRAT's wealth-shifting potential.

b. **Potential Solutions and Planning Considerations**.

(1) **Exercise swap power**.

If the GRAT contains a swap power, the grantor can freeze the amount of the wealth shifted to the now disfavored beneficiaries by substituting other assets of equivalent value for the appreciating

GRAT assets. Those other assets could be cash or a promissory note, so long as the value of the note equals the value of the appreciating assets at the time of the swap. If the grantor substitutes other assets, future appreciation in the reacquired assets will not benefit the disfavored beneficiaries. The grantor can either retain the appreciating asset himself, transfer them to another GRAT with different remainder beneficiaries who are the current objects of the grantor's bounty, or sell them to a grantor trust for the benefit of his now favored beneficiaries.

(2) **Sell the appreciating asset to another trust with favored beneficiaries**.

The trustee of the GRAT can limit and perhaps eliminate the potential wealth shift to the now disfavored beneficiaries by selling the appreciating assets to another trust with favored beneficiaries. The purchase price could be paid with cash or a promissory note, provided the value of the promissory note equals the value of the acquired GRAT assets. As a result, future appreciation in the sold asset will not benefit the disfavored beneficiaries. However, this transaction must be consistent with the trustee's fiduciary duties. If both trusts are grantor trusts for income tax purposes, the transaction should not be a taxable event.

(3) **Change beneficiaries**.

If the trust agreement permits, change the remainder beneficiaries of the GRAT or the beneficiaries of the remainder trust. See II.E.1.c(3), above. Alternatively, if the trust agreement permits (for example, by conferring a termination power or a special power of appointment), the remainder trust could be terminated in favor of other beneficiaries designated by the powerholder.

(4) **Turn off grantor trust status**.

If the trust agreement permits, grantor trust status for the remainder trust could be turned off and at least require the remainder trust to pay its own income tax liability.[107] In this connection, note that turning off grantor trust status may be problematic if the grantor's former spouse is a beneficiary. The grantor will be deemed to hold the former spouse's interest in the remainder trust[108] and that interest may be sufficient to cause grantor trust status.[109]

c. **Drafting Suggestions**.

(1) **Include a swap power in the GRAT.**

See II.C.1.c(1), above.

(2) **Permit changes in beneficiaries**.

See II.C.3.c(4), above.

(3) **Permit grantor trust status to be "turned off".**

Draft the remainder trust to facilitate termination of grantor trust status. For example, do not include provisions that will result in grantor trust status and that cannot be altered. Also, permit the relinquishment of powers or interests that would result in grantor trust status. Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

(4) **Define "spouse"**.

If the remainder trust names the grantor's spouse as a beneficiary, protect against divorce by defining "spouse" to exclude the grantor's current spouse if a divorce occurs.

F. Problems Relating to Bad Administration.

1. Failure to timely make annuity payments.

a. Nature.

An annuity amount payable based on the anniversary date of the creation of the GRAT must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the GRAT must be paid no later than the due date for the trust's income tax return for that year (without regard to extensions).[110] If the trustee fails to make the annuity payment timely, the IRS may argue that the grantor's annuity interest is not a "qualified interest"[111] and that, for purposes of determining the amount of the grantor's gift, the annuity interest is valued at zero.[112] Presumably the risk of such an argument increases the longer the trustee delays payment or if the trustee persistently fails to make payments timely[113].

b. Potential Solutions and Planning Considerations.

Absent special provisions in the trust agreement, the best solution is for the trustee, upon realizing that an annuity payment is late, to pay the annuity amount plus interest. Query: Should interest run from the original due date or from the latest permissible date for payment under the grace provision? What is the appropriate interest rate?

c. Drafting Suggestions.

(1) Include agency provision.

Consider including a provision in the GRAT stating that, if an annuity payment is not timely made, the GRAT terminates as to assets having a value equal to the annuity amount and that the trustee thereafter holds those assets as the grantor's agent rather than as trustee. The purpose of such a provision is to deem an annuity payment to have been made when it has not actually been made. Example:[114]

"<u>*Unpaid Annuity Amounts*</u>. *If any portion of an Annuity Amount is not fully paid within the time prescribed (the "payment period"), the following provisions shall apply to a portion of the trust estate designated as the "Annuity Property*":

"*(a) The "Annuity Property" shall consist of property of the trust estate having a fair market value as finally determined for Federal gift tax purposes equal to the lesser of (i) all property held in the trust estate at the end of the payment period, or (ii) the unpaid portion of the Annuity Amount.*

"*(b) If the fair market value of the property held in the trust estate at the end of the payment period is greater than the unpaid portion of the Annuity Amount, the Annuity Property shall be funded with those assets then held in the trust estate having the lowest income tax basis as finally determined for Federal income tax purposes compared to their current fair market values as finally determined for Federal income tax purposes. If more than one asset has the lowest basis for Federal income tax purposes, the Annuity Property shall be funded with a proportionate share of each such asset. The Annuity Property shall include all income, appreciation and depreciation on such assets and all other incidents of ownership attributed thereto.*

"*(c) At the end of the payment period, the trust shall immediately terminate as to the Annuity Property and ownership of the Annuity Property shall vest absolutely in Grantor or Grantor's estate, as the case may be. The Trustee, in the capacity of Trustee under this Trust Agreement, shall have no further duties, power, authority, or discretion to administer the Annuity Property notwithstanding any provision of applicable law or this Trust Agreement to the contrary.*

"*(d) If the Annuity Property remains in the hands of the Trustee after the payment period, the Trustee shall hold such property exclusively as nominee and agent for Grantor or Grantor's estate, as* *the case may be. Grantor hereby authorizes the Trustee, but only as nominee and agent for Grantor or Grantor's estate, as the case may be, to invest the Annuity Property on Grantor's behalf or on behalf of Grantor's estate, as the case may be, with the same authority as Grantor or Grantor's estate, as the case may be, could do so individually. The Trustee, both as Trustee and as such nominee and agent, is hereby relieved of any liability for commingling assets that have vested absolutely in Grantor or Grantor's estate, as the case may be, with assets that remain part of the trust estate administered under this Trust Agreement.*

"*(e) Any Annuity Property that has vested in Grantor as provided above shall, upon Grantor's subsequent death, vest in Grantor's estate.*"

2. **GRAT is funded on multiple dates**.

a. **Nature**.

A GRAT may be funded only once and the trust agreement must prohibit additional contributions to the GRAT.[115] The grantor may intend to fund the GRAT primarily with one asset (*e.g.*, corporate stock or a limited partnership interest) but may also wish to transfer cash to the GRAT in order to have funds with which to make early annuity payments in anticipation of a later liquidity event or in order to avoid the necessity of distributing fractional shares of stock or other securities when the annuity amount is not evenly divisible by the share or unit value. Due to logistical issues or inadvertence, the assets may actually be contributed to the GRAT a few days apart. If this is construed as the creation of a GRAT (funded with the first asset transferred) followed by a later addition to the same GRAT, the IRS may contend that the GRAT is disqualified and the grantor's annuity interest is not a "qualified interest," resulting in a gift by the grantor of the full value of the assets transferred to the GRAT with no reduction for the value of the grantor's retained annuity interest.

b. **Potential Solutions and Planning Considerations**.

(1) **Treat as two GRATs**.

If the trust agreement complies with the Treasury regulations and prohibits additional contributions, the grantor could argue that the effect of funding on separate days is to create two separate GRATs. Indeed, the result could not be otherwise since the trustee is not permitted to receive additional contributions to the initial GRAT. This is not an ideal solution, because the grantor may have had a reason for transferring both assets to the same GRAT (*e.g.*, to provide cash for early annuity payments so that annuity amounts need not be satisfied by distributing illiquid assets in kind or to avoid distributing fractional shares of stock) or because the Section 7520 rate may have changed between the first transfer to the GRAT and the second. However, it is better than the grantor making a large taxable gift as a result of his GRAT being disqualified.

(2) **Return all contributions other than the first to the grantor**.

The trustee could return the second and subsequent contributions to the grantor on the theory that the trustee has no authority to accept them. This will prevent accomplishment of the grantor's goal in transferring multiple assets to the GRAT, but this is better than disqualifying the GRAT for favorable treatment under Section 2702.

(3) **Treat cash as a loan**.

Alternatively, the grantor might treat cash transferred to the GRAT as a loan rather than a contribution. If successful, this would avoid the grantor being deemed to have made two separate contributions to the GRAT.

c. **Drafting Suggestions**.

(1) **Include a revocation provision**.

Consider adding a provision to the GRAT stating that the grantor may revoke the GRAT until such time as all assets listed in the trust agreement as the initial trust property have been transferred to the GRAT. Such a provision should prevent the grantor's gift from being complete until the trustee receives the last asset and should cause a taxable transfer of all assets on that date. Example:

"*The grantor may revoke this trust at any time prior to the earliest time when all assets described in Exhibit A have been effectively transferred to the trustee. When all assets described in Exhibit A have been effectively transferred to the trust, this trust will be irrevocable.*"

This solution carries its own risk. The grantor may have specified the annuity payments or percentages based on the assumption that the GRAT would be effective in a particular month, but the provision quoted above may postpone the effectiveness of the GRAT to a subsequent month in which the Section 7520 rate is different and, consequently, the required annuity payments or percentages are different. In this connection, see the discussion at II.F.3, below.

(2) **Include a recharacterization provision**.

Consider adding a provision in the GRAT stating that if, after the initial funding of the GRAT, the grantor transfers any additional asset to the GRAT, the trustee will (i) treat the additional asset as a loan, to be repaid to the grantor, or (ii) hold the additional asset as the trust property of a second GRAT on the same terms that apply to the first GRAT.

3. **Funding of the GRAT occurs after a Section 7520 rate change**.

a. **Nature**.

Sometimes, through inadvertence or logistical difficulties, the GRAT may actually be funded several days or weeks after the grantor signs the trust agreement. In general, a trust is created when it is funded and not when the trust agreement is signed.[116] If the trust agreement, as signed, computes annuity payments or percentages based on the Section 7520 rate in effect at signing and the Section 7520 rate changes prior to the time the GRAT is actually funded, the GRAT may produce an annuity interest that is either greater or smaller than the grantor intended. If the value of the annuity interest increases, this should present no tax problem; the amount of the taxable gift will decrease, perhaps even to zero. However, the annuity percentages will be greater than necessary, resulting in larger annuity payments to the grantor and a correspondingly smaller wealth shift to the remainder beneficiaries. Alternatively, if the value of the annuity interest decreases, the grantor will make a larger taxable gift than anticipated.

b. **Potential Solutions and Planning Considerations**.

While there is no viable solution, specific provisions in the GRAT can minimize adverse consequences. Report the funding of the GRAT the way it occurred and suffer the results of any change in the Section 7520 rate.

c. **Drafting Suggestions**.

(1) **Savings clause**.

Consider adding a savings clause such as that described in II.B.1.c(2), above, which would adjust the annuity percentages as necessary to achieve the desired remainder interest.

(2) **Specify alternate annuity percentages**.

Alternatively, the grantor might include more specific provisions contemplating a postponement in the effective date and a change in the Section 7520 rate, if the next month's Section 7520 rate is known. Example:

"*The annuity percentage for each year during the trust term shall be the percentage corresponding to that year that appears in the table below under the column for the month in which the complete funding of the trust occurs:*

Annuity Percentage if Complete Funding Occurs in this Month of 2010

	January	*February*
2011	_______*%*	_______*%*
2012	_______*%*	_______*%*"

4. **The GRAT was never properly funded**.

a. **Nature**.

Sometimes, through inadvertence, the grantor fails to properly transfer assets to the GRAT. For example, the grantor may fail to secure consent for the transfer of a limited partnership interest to the GRAT.[117] If the value of the assets thereafter increases, such appreciation will not be shifted to the remainder beneficiaries. However, if the value of the assets decreases (but there is still appreciation potential), the grantor's failure to properly fund the GRAT may work to his advantage. The grantor may fund a new GRAT with those depreciated assets, which may have smaller annuity payments and therefore may have a greater potential for shifting wealth.

b. **Potential Solutions and Planning Considerations**.

There is no viable solution other than to start over. The grantor can create a new GRAT whose annuity payments will be based on the current value of the trust assets and the current Section 7520 rate.

c. **Drafting Suggestions**.

To avoid this problem, the grantor should be encouraged to allow counsel to participate in the funding of the GRAT in order to ensure that all steps required to properly fund the GRAT are taken. This important step should not be left to the grantor alone. Prudent counsel will document who has the responsibility to see to the proper funding of the GRAT in order to avoid later controversies with the client.

5. **The grantor pays expenses that should be paid by the GRAT**.

a. **Nature**.

The GRAT may incur expenses (such as appraisal fees, legal fees, accounting fees, investment advisory fees, insurance premiums, real property maintenance costs, etc.) in connection with the administration of the GRAT or the distribution of assets from the GRAT. The GRAT should pay those expenses itself. If the grantor pays those expenses, the IRS may argue that this is an additional contribution to the GRAT that is forbidden, and the IRS may seek to disqualify the GRAT from favorable treatment under Section 2702 and treat the full value of the grantor's contribution to the GRAT as a gift.[118]

b. **Potential Solutions and Planning Considerations**.

The GRAT should either pay these expenses itself or, if the grantor has paid them, the GRAT should repay the grantor or give the grantor a promissory note obligating the GRAT to pay the amount of the expenses at maturity, with interest.

c. **Drafting Suggestions**.

Consider adding a provision to the GRAT trust agreement stating that the grantor's payment of any expenses properly allocable to the GRAT shall be considered a loan to the GRAT and shall be repaid, with interest, upon termination of the GRAT. Example:

"*The grantor's payment of any expenses properly chargeable to the trust shall be considered a loan by the grantor to the trust. The principal amount of the loan shall bear interest at the applicable federal short-term rate under Section 1274(d) of the Code, compounded semiannually. The principal amount of the loan and all accrued interest shall be payable on demand or, if no demand, upon termination of the trust.*"

6. **Failure to elect out of automatic allocation of GST exemption to the GRAT**.

a. **Nature**.

Allocating GST exemption to a GRAT is normally an inefficient use of the exemption. Certainly this would be true if the GST exemption were allocated to the GRAT upon creation of the trust since much of the exemption would serve merely to reduce the inclusion ratio of assets that will be returned to the grantor in the form of annuity payments. Most practitioners believe that GST exemption cannot effectively be allocated to a GRAT upon creation, because a GRAT is subject to an "ETIP."[119] An ETIP is the period during which, if the grantor dies, the trust property will be included in the grantor's gross estate.[120] Of course, if a grantor dies before the GRAT term expires, some or all of the GRAT assets will be included in the grantor's gross estate under Section 2036.[121] If a trust is subject to an ETIP, an affirmative allocation of GST exemption becomes effective only at the close of the ETIP.[122] Even at that time, allocation to GRAT assets may not constitute an efficient use of the grantor's GST exemption because there is no opportunity for leveraging. Hence, most practitioners recommend that the grantor not allocate his GST exemption to a GRAT. However, the Code provides that, with some exceptions, the grantor's GST exemption will automatically be allocated to a transfer to a "GST trust" to the extent necessary to reduce the inclusion ratio to zero.[123] If such a transfer is subject to an ETIP, the deemed allocation will occur only when the ETIP closes.[124] A "GST trust" is a trust that could have a generation-skipping transfer with respect to the grantor unless any of a number of exceptions apply.[125] If the GRAT is a GST trust, the grantor's GST exemption could be automatically allocated to the GRAT contrary to the grantor's wishes.

b. **Potential Solutions and Planning Considerations**.

(1) **Elect out of automatic allocation**.

The Code allows a grantor to elect not to have the automatic allocation rules apply.[126] It is almost always best to elect out of the automatic allocation of GST exemption to a GRAT. This should be done by attaching a statement to the grantor's gift tax return. If the transfer to the GRAT is subject to an ETIP, the election must be filed by the due date for the gift tax return for the year in which the ETIP closes. Otherwise, the election must be filed by the due date for the gift tax return for the year in which the transfer to the GRAT occurred.[127]

(2) **Seek 9100 relief**.

If the grantor failed to timely elect out of automatic allocation, the grantor may seek an extension of time to make the election under Treas. Reg. § 301.9100-3. In general, relief will be granted if the taxpayer establishes to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interests of the government.[128] To seek such an extension, the grantor will follow the procedures for requesting a private letter ruling.[129] Note that the IRS has issued proposed regulations governing the granting of relief under Section 2642(g)(1), including extensions of time for electing out of automatic allocation of GST exemption.[130] When those regulations become final, they (rather than the 9100 regulations) will govern this issue, although taxpayers will still seek relief by submitting a request for a letter ruling.[131]

c. **Drafting Suggestions**.

(1) **Remainder trust not a GST trust**.

If it meets with the grantor's intent, consider avoiding a deemed allocation to the GRAT by structuring the remainder trust so that it is not considered a "GST trust." A deemed allocation only occurs if the trust to which an indirect skip occurs meets the definition of a GST trust.[132] As indicated above, the term "GST trust" means a trust that could have a generation-skipping transfer with respect to the grantor unless any of a number of exceptions apply.[133]

(2) **Elect out of automatic allocation**.

See II.F.6.b(1), above.

7. **Failure to adequately report the GRAT on a gift tax return**.

a. **Nature**.

Normally, the statute of limitations on assessing gift tax will commence if the gift is "adequately disclosed" on a gift tax return.[134] In the case of a GRAT, the statute of limitations will commence only if the transfer to the GRAT is "adequately shown" on the gift tax return.[135] Additional information is required for a transfer to be "adequately shown" than for it to be "adequately disclosed." Hence, practitioners should ensure that the grantor files a gift tax return reporting the transfer to the GRAT in a manner that contains all of the information necessary for the transfer to be "adequately shown." If the transfer to the GRAT is inadequately reported or not reported at all, the statute of limitations will not commence.

b. **Potential Solutions and Planning Considerations**.

If the grantor wishes the statute of limitations to commence and did not file a gift tax return reporting the transfer to the GRAT or if the return as filed does not contain sufficient information to make the transfer "adequately shown," the grantor should file a late or supplemental return that meets the "adequately shown" requirements. A late filed return or amended return could result in increased IRS scrutiny of the transaction.

8. **Failure to adequately document transactions involving the GRAT**.

a. **Nature**.

Administering a GRAT may necessitate many transactions between the GRAT, the grantor, and perhaps others. Those transactions may include (i) annuity payments by the GRAT to the grantor, (ii) exchanges of assets between the grantor and the GRAT through exercise of the grantor's swap power, (iii) purchases and sales between the grantor and the GRAT, and (iv) loans of GRAT funds to the grantor. It is important that the grantor respect the GRAT as a separate entity, and this is accomplished in part by adequately documenting any transactions between the grantor, the GRAT, and any third parties. For example, suppose that the grantor funds the GRAT with an interest in a limited partnership. When the time for making an annuity payment arrives, it may be tempting simply to transfer cash from the limited partnership to the grantor. However, it is important to observe all of the individual steps in any such transaction and not take shortcuts. The failure to observe all of those steps, and the failure to respect the separate character of the GRAT, may invite the IRS to argue that the GRAT is disqualified and not entitled to favorable treatment under Section 2702 or that other claimed tax attributes of the transaction (such as discounts in valuing limited partnership interests) should be ignored.

b. **Potential Solutions and Planning Considerations**.

If past GRAT transactions were not properly documented, prepare and execute documents evidencing the transactions and comply with formalities in the future.

c. **Drafting Suggestions**.

(1) **Follow formalities.**

Previous sections of this paper discuss specific transactions between the grantor and the GRAT and offer drafting suggestions regarding those transactions. The grantor and the trustee of the GRAT should document all transactions between them and with third parties. In the example above, the limited partnership should first distribute assets to its partners (including the GRAT) and then the GRAT should distribute assets to the grantor to satisfy the annuity payment. If it is desirable to distribute assets directly from the limited partnership to the grantor, the parties should enter into a contemporaneous agreement detailing the nature of the transaction and recognizing that its effect is a distribution from the partnership to the GRAT followed by a distribution from the GRAT to the grantor.

(2) **Facility of payment clause.**

If the grantor is creating rolling GRATs, consider expanding the typical "facility of payment" clause to enable the GRAT to make annuity payments due to the grantor to another GRAT on behalf of the grantor.

III. Installment Sales

A. In General.

An installment sale is a common technique for freezing the value of a client's estate. This technique effectively converts assets with high income or appreciation potential into fixed-yield, non-appreciating assets.

An installment sale transaction is typically structured as follows:

- Client creates a grantor trust for the benefit of family members and funds the trust with cash or other assets. The initial funding will typically equal 10% of the fair market value of the limited partnership interests the client intends to sell to the trust.
- Client sells limited partnership interests (or other assets subject to applicable valuation discounts) to the trust in exchange for a promissory note. The promissory note may be secured by the trust assets (i.e., the limited partnership interests) and typically will bear interest at the applicable federal rate.

The benefits produced by the installment transaction are as follows:

- Assets with substantial appreciation potential are transferred to a trust where they can appreciate for the benefit of the client's family members.
- The transaction "freezes" the value of the client's asset (i.e., after the sale, the client owns a promissory note with a fixed rate of interest).

Accordingly, if the assets outperform the interest rate on the note, additional value is shifted to the client's family members, free of gift tax.

- The sale is not a recognition event for income tax purposes as long as the trust remains a grantor trust.136
- Unlike a gift to a GRAT, an installment to a grantor trust can be effective for leveraged generation-skipping planning, because there is no ETIP. As a result, the client can allocate GST exemption to the initial gift to the trust, which should allow all of the trust assets to pass free of all transfer taxes for future generations.

B. **Problems Relating to Bad Design**.

1. **Installment sale of an interest valued under Section 2701**.

a. **Nature**.

Normally, for gift tax purposes the value of transferred property is its fair market value at the time of the transfer.[137] However, Section 2701 provides different valuation rules if the donor transfers an interest in a corporation or partnership to a member of his family and retains certain kinds of interests in the corporation or partnership.[138] Under those circumstances, the value of the transferred property for gift tax purposes may be significantly in excess of its fair market value. If the grantor enters into an installment sale of an interest in a corporation or partnership whose value is to be determined under Section 2701, but the transaction documents determine the sales price by referring to the fair market value of the transferred interest, the transaction may result in a significant gift to the purchaser.

For example: Suppose a client creates a limited partnership with two classes of limited partnership interests – a preferred interest and a common interest. The client hires an appraiser who concludes (utilizing the hypothetical buyer hypothetical seller approach) that the preferred interests possess a fair market value of $10,000,000 and the common interests possess a value of $5,000,000. The client then sells the common interests to a grantor trust for a promissory note in the amount of $5,000,000. Assume further that the value of the preferred interests under Section 2701 was zero. In that event, for purposes of Chapter 14 of the Code, the client would be deemed to have made a transfer of $15,000,000 (the aggregate value of the preferred and common interests) with no reduction in that transfer for the preferred interests retained by the client. As a result, the client would be deemed to have sold a $15,000,000 interest for $5,000,000 – resulting in a taxable gift of $10,000,000.

b. **Potential Solutions and Planning Considerations**.

(1) **Avoid Section 2701 interests**.

Do not engage in an installment sale with interests in corporations or partnerships that will be valued under Section 2701.

(2) **Transfer a "vertical slice"**.

Alternatively, if Section 2701 would otherwise apply, consider transferring a "vertical slice" of the seller's interests in the corporation or partnership—that is, a proportionate part of each class of equity interest held by the seller and not just the subordinate interest that carries the expectation of significant appreciation. This should prevent Section 2701 from applying to the transfer.[139]

(3) **Adjust purchase price**.

If Section 2701 applies, but the value assigned to the transferred interests under Section 2701 is nevertheless advantageous from a wealth transfer perspective, consider using the Section 2701 value for the purchase price in the installment sale transaction. In doing so, the trustee of the purchasing trust would need to ensure that the acquisition of the interests for the Section 2701 value is consistent with his fiduciary duties to the trust beneficiaries. Query: Will the sale of an interest at a value greater than fair market value enhance an argument by the IRS that the debt should be recharacterized as equity thereby invoking Sections 2036, 2701, and 2702?[140]

(4) **Make Section 2701 elections**.

Be sure to timely make any elections under Section 2701 that are necessary to give the seller's retained interest the highest possible value and, consequently, produce the lowest value for the transferred interest. If an election would not be timely, consider asking the IRS for an extension of time to make the election.[141]

c. **Drafting Suggestions**.

Taxpayers have historically utilized two approaches to minimize the tax risk of an IRS redetermination of the fair market value of transferred assets, namely price adjustment clauses and defined value clauses.[142]

(1) **Price adjustment clauses**.

A price adjustment clause provides that if the value of property transferred by gift or sale is later redetermined, then the transferee will either transfer a portion of the property back to the transferor or the sale price will be increased and additional consideration will be provided. The IRS has been successful in its attacks on price adjustment clauses on the basis that they violate public policy.[143]

(2) **Defined value clauses**.

A defined value clause describes the property transferred in terms of a fixed dollar amount ("I hereby transfer $1 million of value in ABC Corp.") rather than in terms of specific assets transferred ("I hereby transfer 500 shares of ABC Corp."). The IRS arguments against defined value clauses are similar to those advanced against price adjustment clauses – namely, that they violate public policy. However, creative uses of defined value clauses have proved successful and offer the client an opportunity to defend against a valuation adjustment by the IRS.[144]

(3) **Formula clauses and Chapter 14**.

The standard price adjustment clause and defined value clause is generally drafted with reference to "fair market value" (*i.e.*, the willing buyer willing seller test) and not with reference to valuation principles under Chapter 14 of the Code. It would appear risky to refer to Chapter 14 valuation methodologies in a price adjustment clause because a Chapter 14 valuation could result in a purchase price significantly in excess of what the parties contemplated or would have considered acceptable. If a price adjustment clause is utilized, a subsequent adjustment to Chapter 14 values could cause the equity of the purchasing trust to fall below the desired level. This type of adjustment would also present troublesome fiduciary issues to the trustee of the purchasing trust. As an alternative to a price adjustment clause, the parties could consider the utilization of a McCord-type of defined value clause so that the excess value (as determined under Chapter 14) would be transferred to a "non-taxable" beneficiary. If respected, this approach could avoid a large taxable gift, but would still result in the an interest being sold for more than its fair market value. As a result, the use of a price adjustment clause or defined value clause would appear to be of little utility in dealing with Chapter 14 valuation issues.

2. **Installment sale and community property**.

a. **Nature**.

Typically, an installment sale transaction is entered into by a client (as the seller) and the trustee of a grantor trust (a trust the assets of which are deemed to be wholly owned by the seller under Sections 671 through 679). The sale is not a recognition event for income tax purposes as long as the trust remains a grantor trust.[145] Consider, however, the income tax results if the purchasing trust is funded with community property or if the seller sells a community property asset to the trust.

(1) **Funding with community property**.

If the seller funds the purchasing trust with husband's and wife's community property, the trust would presumably be treated as a partial grantor trust with respect to husband and a partial grantor trust with respect to wife.[146] If husband sells assets to the trust, he would be deemed to have sold assets to himself, which would be a non recognition event,[147] but would also presumably be deemed to have sold assets to his wife. This deemed sale to wife should not generate any gain recognition on the transaction.[148] However, interest payments on the portion of the note attributable to wife would not be excluded from husband's income under Section 1041, meaning that the sales transaction could result in taxable interest income to husband.

In addition to the potential taxation of a portion of the trust's interest payments, query whether wife's death during the term of the note would result in adverse income tax consequences. At that time, the trust could arguably be a partial grantor trust and a partial non-grantor trust.[149]

(2) **Selling a community property asset**.

Even if the seller funds the purchasing trust with separate property and ensures that the trust is a grantor trust solely as to the seller, adverse income tax consequences could arise if the seller sells community property to the trust. In that event, the seller would be deemed to have sold assets to himself, which should be a non recognition event,[150] but would also presumably be deemed to have sold assets to his spouse. This deemed sale to the spouse should not generate any gain recognition on the transaction.[151] However, interest payments on the note attributable to the non-selling spouse would not be excluded from the spouse's income under Section 1041, meaning that the sales transaction could result in taxable interest income to the seller's spouse.

(3) **Consult with local counsel**.

As discussed earlier, practitioners who do not practice in a community property state but represent clients who wish to implement estate planning strategies with community property should consult with separate counsel in the applicable community property state. If there is any doubt at all as to whether property to be utilized in an installment sale is community property, the grantor and grantor's spouse should partition the property so that the property utilized in the transaction is clearly the grantor's separate property.

b. **Potential Solutions and Planning Considerations**.

(1) **Swap assets**.

If the trust has been funded with community property and the value of the transferred assets has not changed significantly, consider swapping out the community property assets or using the assets to pay off the note in-kind, and restructure the transaction using separate property.

(2) **Characterize as a loan**.

Depending upon the language of the trust agreement, it may be possible to argue that the trustee was only able to accept contributions of separate property and was prohibited from accepting community property assets. In that event husband and wife might be able to characterize a transfer of community property as a loan rather than as a contribution.

(3) **Modify character of the promissory note**.

If a community property asset was sold to a grantor trust which is wholly grantor as to the seller, the spouses could (to the extent permitted by state law) enter into an agreement whereby the promissory note becomes the separate property of the selling spouse. This may prevent a portion of the interest payments being treated as taxable interest income to the non-selling spouse.[152] Furthermore, the transfer of the note to the selling spouse, as the selling spouse's separate property, would not be a disposition of an installment obligation under Section 453B if Section 1041 applies.[153]

c. **Drafting Suggestions**.

Avoid funding the grantor trust with community property and selling community property in an installment sale transaction. If the seller wants to use an asset that is (or arguably could be) community property in the transaction, the seller and his spouse should take steps under applicable state law to partition or exchange the community property in order to create separate property of the seller prior to sale to the purchasing trust.[154].

Consider the inclusion of a provision in the trust agreement which would prohibit a trustee from accepting contributions of community property and an acknowledgment that the receipt of community property by the trustee will be deemed to be a loan rather than a contribution. Example:

"Settlor has delivered to the Trustee, without consideration, _________ Dollars ($_____) of her separate. Settlor and others may transfer to the Trustee properties acceptable to it, to be added to the trust estate. Settlor intends to dispose only of her separate property. The Trustee is prohibited from accepting Settlor's and Settlor's Husband's community property and Settlor's Husband's separate property as a gift to the trust. Settlor reserves to Settlor's Husband his separate property, and to Settlor and Settlor's Husband any community property, that may be delivered to the Trustee. If the Trustee ever possesses any property that is Settlor's Husband's separate property or community property of Settlor and Settlor's Husband, the Trustee shall deliver such separate property to Settlor's Husband or, if he is then deceased, to his estate, and shall deliver such community property to Settlor and Settlor's Husband or, if either is then deceased, to her or his estate."

3. **The purchasing trust is not a grantor trust**.

a. **Nature**.

While the installment sale transaction is typically between the seller and a grantor trust, the sale may still be an effective wealth-shifting strategy even if the purchaser is a non-grantor trust. If the seller intends grantor trust status, but that status is not achieved, gain (but generally not loss)[155] will be recognized on the transaction and the seller will be taxed on interest paid by the trust.

b. **Potential Solutions and Planning Considerations**.

(1) **Be sure of the purchasing trust's status**.

If the purchasing trust initially appears not to be a grantor trust (for example, because it does not contain a swap power), look further. Sometimes the distribution provisions of the purchasing trust will be sufficient to create grantor trust status under Section 674 when more obvious grantor trust triggers are missing.

(2) **Utilize the installment method**.

If the purchasing trust is not a grantor trust, consider utilizing the installment method of reporting any associated gain.[156] When the installment method applies, the seller reports gain each year that payments are received.[157] If the seller has not elected out of the installment method[158], this reporting method could enable the seller to defer the recognition of any gain associated with the sale.

c. **Drafting Suggestions**.

If the seller intends grantor trust status, be sure that the purchasing trust is drafted to achieve this result.[159]

C. Problems Relating to Economic Changes.

1. **The underwater transaction**.

a. **Nature**.

Sometimes the asset transferred in an installment sale will not perform as anticipated. The value of the asset may not appreciate sufficiently to permit the purchasing trust to pay its note to the seller at maturity. Indeed, the value of the asset may decline so that the amount of the note exceeds the value of the asset. Example: Assume that client sold a limited partnership interest with a net asset value of $15,400,000 and a fair market value of $10,000,000 (after applicable valuation discounts) to a grantor trust in exchange for a promissory note. Market conditions change and the net asset value of the limited partnership interest is now $6,000,000 with an outstanding principal balance on the note of $10,800,000. Other than hoping that the net asset value of the partnership recovers, what options does the client have to revive a potential wealth shift?

b. **Potential Solutions and Planning Considerations**.

(1) **Renegotiate the note**.

The parties could renegotiate the promissory note to incorporate a lower interest rate and a longer term. This will buy time for the assets transferred to the purchasing trust to appreciate in value. Most practitioners believe that no gift should occur when the parties renegotiate the note.[160] Based upon these cited authorities, it may also be possible for the parties to renegotiate the promissory note to reduce the outstanding principal balance of the note.

(2) **Contribute the note to a GRAT**.

Another possible solution is to contribute the promissory note to a GRAT whose beneficiaries are the same as those of the purchasing trust. Given the decline in value of the transferred assets, the value of the promissory note should be diminished. If the transferred assets appreciate, the value of the promissory note will increase and wealth will be shifted to the remainder beneficiaries, even if those assets never appreciate to the point the parties originally anticipated.[161]

(3) **Sell the note to a grantor trust**.

A third option is for the grantor to sell the promissory note to a different grantor trust whose beneficiaries are the same as those of the purchasing trust. The trustee's ability to pay the promissory note depends upon the value of the transferred assets. Given the decline in value of those assets, the value of the promissory note should be diminished and the sale price should be discounted below the face amount of the note. If the transferred assets appreciate, the value of the promissory note will increase and wealth will be shifted to the remainder beneficiaries, even if those assets never appreciate to the point the parties originally anticipated.

(4) **Unwind the transaction**.

A final solution is to unwind the installment sale transaction. For example, suppose the seller sold a limited partnership interest at a discount to the purchasing trust in exchange for a promissory note. The purchasing trust (which is now a limited partner) could transfer its interest in the limited partnership to the seller in exchange for a release of liability under the promissory note. Presumably this payment by the purchasing trust is earlier than required under the promissory note, and the early payment forms the consideration for the seller's release. The seller could then deploy the partnership interest in another, and possibly more successful, estate planning strategy. This solution raises a number of questions:

(a)

When do the parties know that the transaction is sufficiently underwater to justify bailing out?

(b)

Is this transaction consistent with the fiduciary duties of the trustee of the purchasing trust?

(c)

Is there a guarantee of the purchasing trust's indebtedness to the seller? If so, how does that guarantee affect the transaction?

(d)

Is there a gift when the seller releases the purchasing trust from liability? See the discussion at III.C.1.b(1) above.

(e)

Should the seller report the transaction on a gift tax return?

c. **Drafting Suggestions**.

(1) **Watch out for default provisions**.

Be cautious in drafting the default provisions of the promissory note. Ideally, the seller should have the ability to foreclose without the necessity of foreclosing, in order to avoid a possible gift by the seller to the purchasing trust if he does not foreclose. Some planners suggest that the note require the purchasing trust to maintain a particular debt-to-equity ratio and to provide that the failure to do so is an event of default. This structure creates the risk that a decline in the value of the transferred asset will trigger an event of default and the seller's failure to foreclose may be a deemed gift.

(2) **Eliminate duty to diversify**.

Exonerate the trustee of the purchasing trust from any duty to diversity the investments of the purchasing trust so as to avoid any fiduciary liability for failing to do so.

(3) **Structure note to permit prepayment**.

Often the promissory note will permit the purchaser to prepay the note without penalty. Not only can this prepayment option be useful in unwinding the transaction early, it can also be a beneficial provision to have when renegotiating the promissory note.[162]

(4) **Limit guarantees**.

Most practitioners want the purchasing trust to have a significant amount of equity (*e.g.* 10% of the value of the assets to be sold to the trust) to provide economic substance to the transaction. In many instances, it may be impossible to achieve the desired level of equity by way of gift. In those instances, many planners will utilize guaranty agreements to enhance the level of equity (*e.g.*, guarantees provided by a beneficiary, another trust for a beneficiary, etc.).[163] However, if the assets underperform, so that the transaction is underwater, the guaranty can produce a reverse wealth shift. To mitigate this result, as well as the adverse affect on the guarantor's wealth, consider limiting the guaranty to a specified percentage of the purchase price or outstanding obligation (*e.g.*, 10% of original purchase price).

2. **Transferred assets perform well (the "home run")**.

a. **Nature**.

Sometimes the assets transferred to the purchasing trust will enjoy significant early appreciation, suggesting that the purchasing trust will not only be able to satisfy its debt to the seller but will have significant assets. However, today's appreciation could easily be lost to tomorrow's declining market. Retaining the appreciated assets in the purchasing trust subjects the potential wealth shift to market risk. Locking in the appreciation and avoiding market risk for the purchasing trust may be appropriate.

b. **Potential Solutions and Planning Considerations**.

(1) **Prepay the Note**.

If the note allows for prepayment, the Trustee could prepay the note by making an in-kind transfer of the trust assets to the seller. This would ensure that the note is satisfied at a time when the assets have an appreciated value. It should be noted, however, that if the Trustee satisfies the note in this fashion, any future appreciation associated with the transferred assets would occur in the seller's gross estate.

(2) **Swap for a less risky asset**.

If the seller has retained a swap power, the seller can simply substitute assets with less market risk for the appreciated asset. If the appreciated asset has further appreciation potential, the seller can deploy it in a new estate planning transaction, such as another installment sale or a GRAT. The easiest asset to substitute in the purchasing trust is, of course, cash. However, there may be times when the seller cannot, or prefers not to, transfer cash to the purchasing trust. In this case, the seller could substitute a promissory note for the appreciated asset, so long as the promissory note has a value equal to the asset reacquired from the purchasing trust.

(3) **Sell the appreciated asset**.

If consistent with the trustee's fiduciary duty, the trustee can sell the appreciated asset at its current fair market value, in exchange for cash, a promissory note, or some other asset that is not susceptible to market risk. The trustee could sell to the seller; this would be an option if the trust agreement omitted a swap power. The trustee could also sell to another trust. If the purchaser is either the seller or a trust that is a grantor trust as to the seller, this transaction should not have income tax consequences.

c. **Drafting Suggestions**.

(1) **Include a swap power**.

Always include a swap power in a purchasing trust unless there are specific reasons not to do so.

(2) **Omit prohibitions against self-dealing**.

Make sure the purchasing trust does not include provisions that would prohibit the sale of its assets to the grantor or to another trust with the same trustee, or other self-dealing provisions that would interfere with the sale of the appreciated asset to a desirable purchaser.

3. **Transferred assets perform too well (the "grand slam home run")**.

a. **Nature**.

Sometimes the assets transferred to the purchasing trust will appreciate to the point that the installment sale transaction promises to shift more wealth to the beneficiaries of the purchasing trust than the seller intended.

b. **Potential Solutions and Planning Considerations**.

Assuming the seller has not otherwise drafted in anticipation of this issue (see III.C.3.c(3), below), when the desired level of appreciation has been reached, the seller may have several options:

(1) **Exercise a swap power**.

If the seller has retained a swap power, the seller can exercise that power, recover the appreciating asset, and lock in the amount of appreciation that will be used to shift wealth to the beneficiaries of the purchasing trust. This is particularly effective if the asset to be required by the seller is valued at a discount for purposes of the equivalent value substitution. Appreciation in excess of this amount will benefit the seller. Alternatively, the seller can deploy the appreciating asset in another estate planning strategy, such as another installment sale or a GRAT, with a different beneficiaries. Exercise of the swap power should not be a taxable event and is not reportable to the IRS.

(2) **Sell assets**.

If the purchasing trust does not contain a swap power and if consistent with the trustee's fiduciary duty, the trustee can sell the appreciating asset back to the seller. Additionally, the trustee can sell the appreciating asset to another trust. The sale would be at current fair market value and thereby shift post-transfer appreciation away from the beneficiaries of the purchasing trust and to the seller or the beneficiaries of the second trust. If the second trust is also a grantor trust, this transaction should not have income tax consequences to the seller or the selling trust.

(3) **Add or change beneficiaries**.

If the trust agreement permits (see III.C.3.c(4), below), a third-party trustee or independent powerholder can add other beneficiaries to the purchasing trust, such as members of the seller's family or friends of the seller. The trustee can then distribute the excess wealth shift to these other beneficiaries. This will prevent the original beneficiaries of the purchasing trust from receiving more than the seller intended.

(4) **Turn off grantor trust status for purchasing trust**.

If excess wealth has already shifted to the purchasing trust and the purchasing trust is a grantor trust, the grantor can ameliorate the wealth shift by taking action (such as changing the trustee or releasing powers) that will terminate grantor trust status and cause the purchasing trust to be taxed on its own income. Be sure that the note has been paid before the conversion in order to avoid recognition of gain on the conversion and taxable income from interest payments after the conversion. Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

c. **Drafting Suggestions**.

(1) **Include a swap power**.

See II.C.1.c(1), above.

(2) **Omit prohibitions against self-dealing**.

Omit any provisions from the purchasing trust that would prevent the trustee from selling trust assets to the seller and include provisions that would specifically authorize such a sale. See II.C.1.c(2), above.

(3) **Include a "waterfall" provision**.

If the seller knows in advance how much wealth he wants to transfer to the specific beneficiaries of the purchasing trust at the outset, he can include a "waterfall" provision in the purchasing trust stating that assets up to a certain amount will benefit those beneficiaries and assets in excess of that amount will benefit other beneficiaries.

(4) **Permit changes in beneficiaries.**

Consider appointing a third party trustee or independent powerholder and conferring on that trustee or powerholder the power to add to or change the beneficiaries of the purchasing trust. This could include a power to add the seller's spouse or other family members or friends as beneficiaries of the purchasing trust in order to make excess wealth in the purchasing trust available to the seller's family and friends. This should not result in adverse gift or estate tax consequences for the seller. However, while this power exists it would be difficult for the seller to avoid grantor trust status. See II.C.3.c(4), above.

(5) **Draft to facilitate grantor trust termination.**

Avoid provisions in the purchasing trust that would prevent the seller from successfully turning off grantor trust status**.** By example, this would be the case if the purchasing trust names the seller's spouse as a beneficiary even if a divorce later occurred.

(6) **Include power to lend to grantor.**

Consider authorizing the trustee of the purchasing trust to lend trust funds to the seller. This will enable the seller to use the excess wealth shifted to the purchasing trust. However, there are risks, as discussed in II.E.1.c(5) above.

4. **Transferred assets do not generate sufficient liquidity to make the note payments**.

a. **Nature**.

For various reasons, the purchasing trust may find itself without the liquidity to make note payments that the grantor expected. For example, the grantor may have sold a business interest to the purchasing trust, anticipating an early liquidity event that would convert the purchasing trust's assets to cash and enable the purchasing trust to make its note payments in cash, but that liquidity event did not occur when expected. Or the grantor may have sold assets to the purchasing trust that the grantor expected to generate significant cash flow, but the actual cash flow is less than anticipated. The purchasing trust's assets could be distributed in kind to satisfy the note payments. However, the purchasing trust's assets are difficult to value (*i.e.*, they are not marketable securities or other assets that can be valued without an appraisal) and they may be subject to valuation discounts (*e.g.*, they are closely-held business interests). These considerations also make the exercise of the grantor's swap power or a sale of the illiquid assets to generate cash less than optimal as solutions.

b. **Potential Solutions and Planning Considerations**.

In administering the installment sale transaction, it is important to respect the terms of the transaction. By example, if the promissory note provides for annual interest payments, the payments should be timely made as would occur in an arm's length debtor/creditor situation. Similarly, if principal payments are required throughout the term of the note, these should be paid in accordance with the note's provisions. Otherwise, the note would be in default and unless the grantor were to take curative action to enforce the note, the integrity of the transaction would be weakened. See II.F.2, below, for discussion of importance of following the terms of the promissory note.

(1) **In-kind distribution**.

The trustee can always distribute assets of the purchasing trust in kind to the grantor in satisfaction of the note payments. For a number of reasons, this may not be a good solution. It may transfer assets with appreciation potential back to the grantor. If the assets were valued at a discount upon sale to the purchasing trust, they will likely be subject to a discount for note payment purposes as well, requiring a larger share of the assets to be distributed than if no discount were involved. Finally, it may be necessary to obtain an appraisal of the assets to support the value used for note payment purposes, adding to the expense of administering the installment sale transaction.

(2) **Loan from third party**.

The purchasing trust can borrow funds from a third party sufficient to permit it to make the note payment. The third party lender could be someone related to the grantor, such as another trust of which the grantor is the settlor or trustee, the grantor's spouse or other family member. If the grantor guarantees the third-party loan, the purchasing trust should pay the grantor a an adequate guarantee fee (typically around 1% to 2% of the guaranteed amount per year). In this connection, note that the IRS once asserted in a letter ruling that a loan guarantee was a taxable gift from the guarantor to the debtor.[164] The IRS later withdrew that letter ruling.[165]

c. **Drafting suggestions**.

(1) **Promissory note.**

Consider drafting the promissory note to allow for accrual of interest with a balloon payment at maturity. This will minimize the liquidity problem that would otherwise occur if there is insufficient liquidity to make payments on the note throughout its term, and the note will not be in default for lack of payment. The trustee of the purchasing trust can still make payments (interest and/or principal) on the note during its term if it has liquidity to do so, keeping in mind its fiduciary duties to the trust beneficiaries.

(2) **Initially fund the purchasing trust with some liquid assets**.

In addition to the illiquid asset sold to the purchasing trust, consider having the grantor, contribute some cash, marketable securities, or other liquid assets to the purchasing trust to enable it to make early note payments without resorting to the illiquid asset or a third-party loan.

5. **Interest rate falls**.

a. **Nature**.

Typically, the promissory note will bear the applicable federal rate as of the date of the transaction. If interest rates subsequently decline, the rate prescribed in the promissory note from the purchasing trust may be significantly higher than current market interest rates, adversely affecting the wealth shift.

b. **Potential Solutions and Planning Considerations**.

Restate the note to provide for a lower interest rate. As consideration for reducing the interest rate, the purchaser could pay down the principal, shorten the note term, provide additional security, and/or provide a third-party guarantee (with an appropriate guarantee fee). However, as discussed at III.C.1.b(1) above, consideration may not be required and, if properly structured, the renegotiation of the promissory note should not result in a taxable gift.

c. **Drafting Suggestions**.

Be sure the promissory note does not prevent prepayment or otherwise prevent restatement of the note's terms.

D. Problems Relating to Mortality.

1. Seller's life expectancy diminishes.

a. Nature.

The seller believed his life expectancy extended beyond the maturity date of the note, but changes in his health suggest that his life expectancy may be shorter. If the grantor dies before the note is paid in full, the purchasing trust's status as a grantor trust will terminate and the purchaser and the seller in the installment sale transaction will no longer be identical for income tax purposes. This may result in a taxable event (possible trigger of gain recognition by grantor's estate at grantor's death, possible deferral of gain recognition until obligation is satisfied after grantor's death with the recipient of installment payments treating the payments as income in respect of a decedent, or possible non-recognition event either by grantor's estate or by recipient of note payment as IRD) and future interest payments to the grantor's estate will be taxable.[166] While the income tax effect on the grantor's estate, recipient of installment payments on the note, and the grantor trust is a source of continuing debate among commentators,[167] the prevailing view seems to be that death is not a recognition event.[168]

b. Potential Solutions and Planning Considerations.

(1) Pay off the note before death.

This will prevent a potential taxable event at the seller's death. However, consider that, due to factors such as interest rate, term, security, etc., the promissory note may be subject to a discount in the seller's estate that would reduce its value below the payoff amount.

(2) Exchange low basis assets in purchasing trust for high basis assets owned by the seller.

Since the assets in the purchasing trust will not be included in the grantor's estate, appreciated assets owned by the trust at the grantor's death will not receive a step-up in income tax basis.[169] If the trust is a grantor trust and has appreciated assets, the grantor can exchange the trust's appreciated assets for cash or an asset with an income tax basis approximating fair market value - essentially effecting a step-up in the income tax basis of the trust's assets. After the exchange, the grantor will own the low basis assets which, upon the grantor's death, will receive a stepped-up basis.[170]

(3) Sell the note for an annuity.

If the grantor dies owning the note, the outstanding balance on the note as of grantor's death will be included in grantor's gross estate for estate tax purpose. If the grantor has a shortened life expectancy but death is not imminent (there is at least a 50% chance of the grantor living at least a year),[171] the grantor could sell the promissory note to family members for a private annuity payable to the grantor (usually the lifetime of the grantor). Annuity payments will be calculated based on the grantor's actuarial life expectancy and will end when the grantor dies. If the grantor dies before his actuarial life expectancy ends, the annuity payments actually received will not equal the value of the transferred note, and the wealth will have been shifted from the grantor to the grantor's family members.

(4) Restate the note as a self-canceling installment note ("SCIN").

As long as the grantor is not terminally ill (having an incurable illness or other deteriorating physical condition such that there is at least a 50% probability that the individual will die within 1 year),[172] the grantor could restructure the note as a self-canceling installment note (SCIN). This will likely require an additional actuarially-determined premium to be paid in either interest or principal, but will cause the note to be extinguished if the grantor dies during the term. Under a SCIN, the obligation to repay the note terminates on the death of grantor. As such, there would be no inclusion and a greater value will have been shifted to the next generation (purchasing trust) free of transfer tax.[173]

c. **Drafting Suggestions**.

(1) **Choose a reasonable note term**.

Choose a note term that is well within the seller's normal life expectancy.

(2) **Allow prepayment**.

Be sure the promissory note from the purchasing trust allows the holder to transfer or prepay the note.

(3) **Include "self-cancellation" feature**.

If in line with circumstances and it economically meets with grantor's intent, include a "self-cancellation" feature in the initial installment note.

E. Problems Relating to Changes in Client Wishes.

1. **The too-successful installment sale**.

a. **Nature**.

If the transferred assets appreciate significantly, the seller may conclude that the installment sale has been too successful; that is, the seller may decide that the installment sale threatens to transfer more wealth to the purchasing trust than the seller intended. This is similar to the problem discussed in III.C.3 above, and the solutions are the same.

b. **Potential Solutions and Planning Considerations**.

(1) **Exercise swap power**.

If the purchasing trust contains a swap power, the seller can freeze the amount of the wealth shift at the current level by substituting cash or other assets of equivalent value for the appreciating asset. This is particularly effective if the asset to be reacquired by the seller is valued at a discount for purposes of the equivalent value substitution and the seller recovers it from the purchasing trust before it realizes its full value. Exercise of the swap power should not be a taxable event and is not reportable to the IRS.

(2) **Sell assets**.

If the purchasing trust does not contain a swap power and if consistent with the trustee's fiduciary duty, the trustee can sell the appreciating asset back to the seller. Additionally, the trustee can sell the appreciating assets to another trust. The sale would be at current fair market value and thereby shift post-transfer appreciation away from the beneficiaries of the purchasing trust and to the seller or the beneficiaries of the second trust. If the second trust is also a grantor trust, this transaction should not have income tax consequences to the seller or the selling trust.

(3) **Add or change beneficiaries**.

If the trust agreement permits (see III.E.1.c(4), below), a third-party trustee or independent powerholder can add other beneficiaries to the purchasing trust, such as members of the seller's family or friends of the seller. The trustee can then distribute the excess wealth shift to these other beneficiaries. This will prevent the original beneficiaries of the purchasing trust from receiving more than the grantor intended.

(4) **Turn off grantor trust status for purchasing trust**.

If excess wealth has already shifted to the purchasing trust and the purchasing trust is a grantor trust, the grantor can ameliorate the wealth shift by taking action (such as changing the trustee or releasing powers) that will terminate grantor trust status and cause the purchasing trust to be taxed on its own income. Be sure that the note has been paid before the conversion in order to avoid recognition of gain on the conversion and taxable income from interest payments after the conversion. Alternatively, consider naming an third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

c. **Drafting Suggestions**.

(1) **Include a swap power in the purchasing trust.**

See II.C.1.b(1), above.

(2) **Avoid prohibitions against self-dealing**.

Omit any provisions from the purchasing trust that would prevent the trustee from selling trust assets to the seller and include provisions that would specifically authorize such a sale.

(3) **Include a waterfall provision**.

If the seller knows how much wealth he wants to transfer to the specific beneficiaries of the purchasing trust at the outset, he can include a "waterfall" provision in the purchasing trust stating that assets up to a certain amount will benefit those beneficiaries and assets in excess of that amount will benefit other beneficiaries.

(4) **Include power to add or change beneficiaries**.

Consider appointing a third party trustee or independent powerholder and conferring on that trustee or powerholder the power to add or change beneficiaries of the purchasing trust. This could include power to add the seller's spouse or other family members or friends as beneficiaries of the purchasing trust in order to make excess wealth in the purchasing trust available to the seller's family and friends. This should not result in adverse gift or estate tax consequences for the seller. However, while this power exists it would be difficult for the seller to avoid grantor trust status. See II.C.3.c(4), above.

(5) **Draft to facilitate termination of grantor trust status.**

Draft the purchasing trust to facilitate termination of grantor trust status. For example, do not include provisions that will result in grantor trust status and that cannot be altered. Also, permit the relinquishment of powers or interests that would result in grantor trust status. Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

(6) **Include power to lend to grantor.**

Consider authorizing the trustee of the purchasing trust to lend trust funds to the seller. This will enable the seller to use the excess wealth shifted to the purchasing trust. However, there are risks, as discussed in II.E.1.c(5) above.

2. **The impecunious seller**.

a. **Nature**.

Suppose the seller encounters financial difficulties and fears that the note from the purchasing trust may fall into the hands of a bankruptcy trustee.

b. **Potential Solutions and Planning Considerations**.

Assuming the facts are such that there would be no fraud on creditors, the seller and the purchaser might renegotiate the note to provide for an extended maturity date and a lower interest rate.[174] The restructure of the note might provide additional time for the assets to recover economically.

c. **Drafting Suggestions**.

Structure the note to facilitate renegotiation.

3. **The objects of the seller's bounty change.**

a. **Nature**.

The seller may later decide that the beneficiaries of the purchasing trust are no longer persons whom he wishes to benefit, or perhaps consist of a class of persons from which one formerly disfavored, but now favored, person was excluded. If so, the seller may find that he is shifting wealth to people who are no longer the objects of his bounty or who do not include all of his now intended objects. See II.E.3.a, above, giving examples of circumstances (involving former spouses, children of former spouses, once favored family members, and formerly excluded family members) that could give rise to this predicament and cause the seller to conclude that he is shifting wealth to people whom he no longer favors.

b. **Potential Solutions and Planning Considerations**.

(1) **Exercise swap power**.

If the purchasing trust contains a swap power, the seller can freeze the amount of the wealth shifted to the now disfavored beneficiaries by substituting other assets of equivalent value for the appreciating asset. If the seller substitutes other assets, future appreciation in the reacquired assets will not benefit the disfavored beneficiaries. The seller can either retain the appreciating asset himself, sell it to a grantor trust for the benefit of his now favored beneficiaries, or transfer it to a GRAT with remainder beneficiaries who are now the objects of the seller's bounty.

(2) **Sell the appreciating asset to another trust with favored beneficiaries**.

The purchasing trust can freeze the amount of the wealth shifted to the now disfavored beneficiaries by selling the appreciating asset to another trust with favored beneficiaries. The purchase price could be paid with cash or a promissory note, so long as the cash or value of the note equals the value of the appreciating asset at the time of the sale. As a result, future appreciation will not benefit the disfavored beneficiaries. However, this transaction must be consistent with the trustee's fiduciary duties. If both trusts are grantor trusts, for income tax purposes, the transaction should not be a taxable event.

(3) **Change beneficiaries**.

If the trust agreement permits, change the beneficiaries of the purchasing trust. See II.C.3.b(3), above.

(4) **Turn off grantor trust status**.

If the trust agreement permits, grantor trust status could be turned off so that the purchasing trust is required to pay its own income tax liability. In this connection, note that turning off grantor trust status may be problematic if the grantor's former spouse is a beneficiary. The grantor will be deemed to hold the former spouse's interest in the purchasing trust[175] and that interest may be sufficient to cause grantor trust status.[176] Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

c. **Drafting Suggestions**.

(1) **Include a swap power in the purchasing trust**.

See II.C.1.c(1), above.

(2) **Permit changes in beneficiaries**.

Consider appointing a third party trustee or independent powerholder and conferring on that trustee or other powerholder the power to change beneficiaries of the purchasing trust. This should not result in adverse gift or estate tax consequences for the seller. However, while this power exists it may be difficult for the seller to avoid grantor trust status. See II.C.3.c(4), above.

(3) **Draft to facilitate termination of grantor trust status.**

Draft the purchasing trust to facilitate termination of grantor trust status. For example, do not include provisions that will result in grantor trust status and that cannot be altered. Also, permit the relinquishment of powers or interests that would result in grantor trust status. Alternatively, consider naming a third party trustee and granting that trustee discretion to make distributions to the grantor to cover the grantor's income tax liability associated with the trust's income.

(4) **Define "spouse".**

If the purchasing trust names the seller's spouse as a beneficiary, protect against continuing to benefit the spouse in the event of divorce by defining "spouse" to exclude the grantor's named spouse if a divorce occurs.

F. Problems Relating to Bad Administration.

1. **Failure to complete transaction documents**.

a. **Nature**.

Through inadvertence or inattention, the parties may fail to complete all of the required transaction documents. Appraisals may be missing. The promissory note may not have been finalized. The sold asset may not have been effectively transferred to the purchasing trust (for example, because a required consent under a limited partnership agreement was never obtained).

b. **Potential Solutions and Planning Considerations**.

Complete any missing transaction documents upon discovery. If the problem is that the assets have not been effectively transferred (for example, due to the absence of required consents), the seller may argue that this is immaterial to the transaction since the seller had a contractual obligation to complete the transfer. Note that this argument is stronger in the case of an installment sale than in the case of a GRAT with missing or incomplete transfer documents.

c. **Drafting Suggestions**.

(1) **Checklist**.

Consider using a checklist to ensure that all required steps in the transaction have been accomplished and that all required transaction documents have been completed.

(2) **Nominee provision**.

Consider including in the installment sale agreement a provision stating that the transferred asset has been sold to the purchasing trust and that, if for any reason title to the transferred asset remains in the seller, the seller will hold that property as the purchasing trust's nominee and will dispose of that property as directed by the purchasing trust. Example:

"*Seller agrees that he will at any time and from time to time do, execute, acknowledge and deliver all and every such further acts, bills of sale, transfers, purchases, confirmations and assurances as Purchaser shall reasonably request to further evidence the purchase herein provided. Seller further agrees that until the acquired limited partnership interests are transferred to Purchaser on the books of the Partnership, Seller shall hold such interests (and any proceeds attributable thereto) exclusively as nominee and agent for Purchaser*."

2. **Failure to follow the terms of the promissory note**.

a. **Nature**.

If the seller expects the IRS to respect the installment sale transaction, the purchasing trust and the seller must respect the transaction themselves and observe the formalities of the transaction documents. For example, the purchasing trust must make principal and interest payments as required by the terms of the promissory note. Failure to do so can render the transaction subject to challenge by the IRS. Other problems result if the purchasing trust defaults in the payment of amounts due under the promissory note, that default extends beyond the period of the statute of limitations, and the note becomes unenforceable. The seller's failure to enforce the purchasing trust's liability under the note may be a gift by the seller to the purchasing trust.

b. **Potential Solutions and Planning Considerations**.

If the purchasing trust has failed to make principal or interest payments timely and the promissory note is still enforceable, the purchasing trust should immediately make up those payments, together with interest and any penalties prescribed by the terms of the note. If the statute of limitations has run and the note is unenforceable, voluntary payment by the purchasing trust could be problematic. If payment is made without the beneficiaries' consent, this may be a breach of the trustee's fiduciary duty which could subject the trustee to liability. If the beneficiaries consent to the payment, this may be a gift by the beneficiaries to the seller.

c. **Drafting Suggestions**.

(1) **Do not set the transaction up to fail**.

If it is clear at the outset that the assets to be sold to the purchasing trust will not yield the liquidity necessary to service the promissory note as contemplated, then change the note's terms to those that the purchasing trust can realistically honor.

(2) **Waive or extend the statute of limitations**.

If local law permits, include provisions in the promissory note that waive or extend the statute of limitations. This may prevent lapses in payments from creating gift tax issues.

(3) **Include payment flexibility**.

In designing the promissory note, one important goal is to ensure that the amount of the indebtedness is respected as debt and is not characterized as equity by the IRS. In this connection, the most conservative approach is to provide for periodic payments of principal and interest throughout the term of the note. This is not practical for some installment sale transactions, and many practitioners are comfortable with a promissory note that provides for a balloon payment of principal, or of principal and interest, at the end of the term. So long as it can be done without rendering the terms commercially unreasonable, practitioners may want to build flexibility into the promissory note to allow the purchasing trust to defer interest or principal payments if necessary without causing a default. However, if the terms of the note become commercially unreasonable, this may increase the chance that the amount of the note will not be respected as debt but will be characterized by the IRS as equity, raising issues under Sections 2036 and 2701.

(4) **Fund purchasing trust with liquid assets**.

Fund the purchasing trust with some amount of cash or other liquid assets in addition to the primary transferred asset, in order to enable the purchasing trust to make early interest payments without difficulty.

(5) **Enlist other advisers**.

Include the seller's CPA, financial adviser, and other appropriate persons (including the trustee's advisers) in the planning and implementation of the transaction so they can help the seller and the purchasing trust adhere to the terms of the note and the other transaction documents.

(6) **Comply with filing requirements**.

Some practitioners want the purchasing trust's debt to be secured, while others are content with unsecured debt. If the debt is to be secured, consider whether it is necessary or advisable to file UCC statements to perfect the seller's security interest. If UCC statements are filed, be sure they are kept up to date.

3. **Failure to respect the sale documents**.

a. **Nature**.

Respecting the formalities of the transaction also requires the parties to ensure that the transferred asset is re-titled in the name of the purchasing trust and that, following the sale, all transactions with respect to the transferred asset are handled in a way that is consistent with the purchasing trust, rather than the seller, being the owner. For example:

- If the purchasing trust files a separate tax return, the tax return should reflect the purchasing trust as the owner. Similarly, any tax reporting statements associated with the purchased assets (e.g., K-1s, 1099s, etc.) should reflect the purchasing trust as the owner.
- All voting rights and consent rights attendant to the transferred asset should be exercised by the purchasing trust.
- All distributions with respect to the transferred asset should be made to the purchasing trust. If those distributions are to be used to make interest or principal payments to the seller, they should first be paid to the purchasing trust and then by the purchasing trust to the seller. Do not omit the necessary intermediate step just for the sake of convenience.
- If the transferred asset is a partnership interest, the relevant capital account should be shown as owed by the purchasing trust.
- The financial statements of the seller and the purchasing trust should be consistent with the purchasing trust owning the transferred asset.

Failure to respect the formalities and consequences of the transfer of title may invite the IRS to question the efficacy of the transaction.

b. **Potential Solutions and Planning Considerations**.

(1) **Rely on nominee provision**.

If the transaction documents include a nominee provision (see 0 above), rely on it to explain assets held by or proceeds paid to the seller.

(2) **Treat receipts as a loan**.

If receipts attributable to the transferred asset have been paid to the seller rather than the purchasing trust, treat those receipts as a loan from the purchasing trust to the seller. The loan should either be repaid with interest or offset against the purchasing trust's note obligation to the seller. In either case, the transaction should be documented by the parties.

c. **Drafting Suggestions**.

Consider including in the transaction documents a provision stating that the transferred asset has been sold to the purchasing trust and that, if for any reason title to the transferred asset remains in the seller or proceeds with respect to the transferred asset are paid to the seller, the seller will hold that property as the purchasing trust's nominee and will dispose of that property as directed by the purchasing trust (see 0 above).

4. **Note payments match income on transferred asset**.

a. **Nature**.

If the note payments made by the purchasing trust to the seller match the income produced by the transferred asset, this may invite the IRS to argue that the seller and the trustee of the purchasing trust agreed that the seller would retain the economic benefits of the transferred asset. Such an argument, if successful, could result in including the transferred asset in the seller's gross estate under Section 2036.

b. **Potential Solutions and Planning Considerations**.

Be sure that the payments under the promissory note follow the terms of the promissory note and not the income produced by the transferred asset.

c. **Drafting Suggestions**.

Do not include provisions in the promissory note that would link the payments to the seller to the income produced by the transferred asset.

5. **Potential impact of step-transaction doctrine**.

a. **Nature**.

Over the past year, the IRS has attempted to apply the step-transaction doctrine, with some success, to transactions involving transfers of interests in partnerships and limited liability companies that were formed shortly before taxpayers have transferred interests in those entities.[177] The step transaction doctrine collapses separate steps into a single step if the steps are "in substance integrated, interdependent and focused toward a particular result."[178] In deciding whether to apply the step-transaction doctrine, these cases have focused not just on appropriate tracking of capital accounts upon formation of the entity, but also on the "appropriate" amount of time required between funding the entity and transferring interests in the entity by gift and sale. As expected, there is no clear minimum time between funding and transferring interests that will avoid the step-transaction doctrine. However, the courts have focused on the nature of the asset transferred to the entity. Assets subject to short term market fluctuation (such as publicly traded stock)[179] may require a shorter period than less volatile assets (such as cash or real estate).[180] Additionally, the courts have been troubled by taxpayers calculating the amount of assets to transfer to an entity based on the anticipated discounted from a subsequent transfer of an interest.[181]

b. **Potential Solutions and Planning Considerations**.

In light of the recent emphasis on the step-transaction doctrine, taxpayers who wish to create new entities for purposes of an installment sale transaction should allow the entities to "age" before transferring interests in those entities. Although the courts have not established a specific time requirement, a delay of at least a month or more (depending on the nature of the asset) may be advisable.

6. **Whether to file a gift tax return reporting the installment sale**.

a. **Nature**.

Assume the installment sale transaction succeeds in transferring wealth to the purchasing trust but the transaction was never reported on a gift tax return and the seller now wants to bring closure to any potential gift tax issues.

b. **Potential Solutions and Planning Considerations**.

The seller could file a gift tax return for the year in which the installment sale occurred and report the transaction. If the seller filed a gift tax return but did not report the installment transaction, he could file a supplemental return and disclose the transaction late. Here are some of the considerations:

(1)

Not reporting the transaction will prevent the statute of limitations from commencing.

(2)

Reporting the transaction may invite an audit.

(3)

If the seller decides to report the transaction, what level of disclosure is necessary to trigger the statute of limitations?

c. **Drafting Suggestions**.

The sale to the grantor trust (if properly structured and respected) is not a gift and, therefore, is not required to be disclosed on a federal gift tax return. However, the Code permits the disclosure of non-gift transactions for purposes of commencing the statute of limitations.[182] Accordingly, proper disclosure of the installment sale transaction on a gift tax return can commence the statute of limitations with respect to that transaction.

Prior to October 2006, many taxpayers chose not to disclose installment sale transactions despite the fact that such disclosure could commence the statute of limitations. The rationale behind this approach was as follows: If the transaction was never reported on a return and if the note was paid in full prior to the taxpayer's death, there would not be any reported evidence of the transaction that could generate IRS scrutiny.

In October 2006, the IRS issued a new Form 706. That form includes a new question (Question 12(e)) which asks "Did the 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?" In light of this question, more taxpayers may wish to report the transaction on a gift tax return in order to commence the statute of limitations.

Consider disclosing the transaction as an attachment to the return – rather than on Schedule A itself.[183] By structuring and reporting the transaction in this fashion, the installment sale transaction can still be disclosed for purposes of commencing the statute of limitations, but minimize the "profile" of the transaction on the gift tax return.[184]

IV. Qualified Personal Residence Trusts

A. In General.

1. Overview of QPRTs.

Section 2702 specifically authorizes the "personal residence trust" and the "qualified personal residence trust", or "QPRT". Generally practitioners employ QPRTs much more frequently than personal residence trusts. This paper will focus on QPRTs but several of the issues and solutions may also apply to a personal residence trust. Like a GRAT, a QPRT is a wealth-shifting strategy involving the grantor's retention of an interest in property for a terms of years with the remainder interest passing to intended beneficiaries (or a remainder trust for their benefit). Unlike a GRAT, however, which may be funded with any type of asset, a QPRT is a trust to which the grantor transfers a personal residence, which may include appurtenant structures used for residential purposes and a reasonably appropriate amount of adjacent land.[185] The QPRT may also hold cash in a separate account in an amount not to exceed what is reasonably expected to be paid toward trust expenses (mortgage, taxes, insurances, utilities, etc.) or improvements already incurred or expected to be incurred within six months of the cash contribution.[186] Additions of cash are also permitted to purchase the initial personal residence (or a replacement residence) within 3 months of the transfer if the grantor has already entered into a purchase contract.[187]

Unlike a GRAT, the grantor does not retain the right to receive annuity payments, rather he retains the right to live in the personal residence during the QPRT's term. If the trust satisfies all of the requirements for a QPRT, the grantor's retained interest will be a "qualified interest" and, for purposes of determining the amount of the grantor's gift to the remainder beneficiaries, the value of the grantor's retained interest will be a function of his life expectancy and the Section 7520 in effect at the time of creation of the QPRT.[188] The gift is then determined by subtracting the value of the grantor's retained interest from the fair market value of the residence at the creation of the QPRT. Thus, unlike a GRAT which can be zeroed-out, a QPRT will consume a portion of the grantor's lifetime gift exemption (or, if none remains, generate gift tax) upon creation. On the other hand, if the trust does not satisfy the requirements for a QPRT, the grantor's retained right to live in the residence will be valued at zero. In this instance, the grantor will be deemed to have made a gift to the remainder beneficiaries equal to the value of the residence transferred to the trust, undiminished by the grantor's retained interest. [189]

In order for the QPRT to be "successful," the grantor must survive the term. In addition, since the taxable gift assumes the residence will appreciate at the Section 7520 rate, it can be argued that the residence must appreciate by more than this rate for an effective wealth shift. When the grantor's retained term interest ends, the QPRT terminates. If the grantor survives the QPRT's term, the residence is distributed to the remainder beneficiaries free of further gift tax (or further use of gift exemption). If the grantor dies during the term of the QPRT, the residence will be included in the grantor's estate under Section 2036 and there will be no transfer tax benefits.[190]

In addition to the above requirements, Section 2702 and the regulations promulgated under it describe other requirements that must be met by a QPRT. Many of these requirements are as follows:

a. Number of QPRTs.

A person may create up to two QPRTs funded with either the principal residence, one other residence, or an undivided fractional interest in either.[191] If married, spouses can either transfer interests in their personal residence to the same QPRT or split the ownership into a tenancy-in-common and establish two separate QPRTs with undivided interests in the same residence.[192] The latter positions the strategy for a higher probability of success, as the value of the undivided interests being transferred to the QPRTs should be subject to a fractional interest discount and, if one spouse dies during the term of his or her QPRT, the interest of the other spouse (in a separate QPRT) may still achieve the desired wealth-shift if such spouse survives the retained term.

b. **Use of residence**.

The residence's primary use must be as a residence of the term holder.[193]

c. **Income distribution.**

The governing instrument must require that any income of the QPRT be distributed to the term holder at least annually.[194]

d. **Prohibit distributions to others**.

The governing instrument must prohibit distributions of corpus to any one other than the transferor during the retained term interest.[195]

e. **Prohibit holding other assets**.

The governing instrument must prohibit the trust from holding any asset other than one residence, with the exception of cash additions for enumerated permissible purposes.[196]

f. **Distribution of excess cash.**

In addition, the Trustee must be required to determine, at least quarterly, if cash exceeds the permissible amount for payment of expenses, and if so, to immediately distribute the excess.[197]

g. **Improvements.**

The governing instrument may permit improvements to be made to the residence as long as the residence, as improved, continues to meet the residential requirements.[198]

h. **Sale proceeds.**

The governing instrument may permit sale of the residence (except to the grantor, the grantor's spouse, or an entity controlled by either of them during the retained term, or at any time thereafter that the trust is a grantor trust), and may permit the trust to hold proceeds from the sale in a separate account.[199]

i. **Insurance and proceeds.**

The governing instrument may permit the trust to hold one or more policies insuring the residence. In addition, the trust may hold, in a separate account, insurance proceeds received as a result of damage or destruction of the residence.[200]

j. **Prohibit commutation.**

The governing instrument must prohibit commutation (prepayment) of the term holder's interest.[201]

k. **Cessation of use.**

The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to held for use as a personal residence of the term holder. Occupancy of the residence by any other person (other than the spouse or a dependent of the term holder) in a manner that causes the residence to be unavailable to the term holder causes the trust to cease to be a QPRT.[202]

l. **Sale of personal residence.**

The governing instrument must provide that the trust ceases to be a QPRT upon sale of the residence unless it permits the trust to hold sale proceeds in a separate account. If so permitted, the governing instrument must provide that the trust ceases to be a QPRT with respect to the sale proceeds upon the earlier of (i) the date that is two years after the sale date, (ii) the termination of the retained term, or (iii) the date a new residence is acquired by the trust.[203]

m. **Damage to or destruction of residence.**

The governing instrument must provide that, if damage or destruction causes the residence to be unusable, the trust ceases to be a QPRT after two years (or, if earlier, the termination of the retained term) unless, prior to such date either (i) replacement or repairs are completed or (ii) a new residence is acquired.[204] If the governing instrument permits the trust to hold insurance proceeds received as a result of damage or destruction, the governing instrument must contain provisions similar to those pertaining to sale proceeds as discussed above.

n. **Disposition of assets upon cessation of QPRT.**

The governing instrument must provide that, within 30 days of ceasing to be a QPRT with respect to certain assets, the assets either (i) be distributed outright to the term holder, (ii) be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a GRAT or (iii) in the sole discretion of the trustee, either be so distributed or converted.[205]

o. **Prohibition against sale of residence to grantor, grantor's spouse, or entity controlled by either.**

The governing instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by either of them during the retained term, or at any time after the retained term that the trust is a grantor trust.[206] For this purpose, the sale or transfer of the residence to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse. However, a distribution (for no consideration) upon or after the expiration of the retained term to another grantor trust of the grantor or the grantor's spouse per the express terms of the QPRT is permissible as long as the other grantor trust prohibits the sale or transfer of the residence to the grantor, the grantor's spouse, or an entity controlled by either of them.[207]

B. Problems Relating to Bad Design.

1. **Naming the grantor as the trustee with powers that are too broad**.

a. **Nature**.

If a trust ceases to be a QPRT, the trustee must either distribute the trust assets to the term interest holder or convert those assets into a GRAT for the term holder's benefit. The trust agreement may also give the trustee discretion as to which option to choose.[208] A trust will cease to be a QPRT if (i) the residence is sold and the proceeds are not reinvested in another residence;[209] (ii) the residence is destroyed and insurance proceeds are not reinvested in another residence;[210] or (iii) the grantor ceases to use the property as a residence during the retained term. If the grantor is the trustee and the trustee has the discretion to sell the residence and decide whether to reinvest the sales proceeds in another residence, then the grantor effectively has the power to recover the trust property simply by selling the residence and failing to reinvest the proceeds in another residence. Even if the trust agreement requires a reinvestment of sales proceeds, the grantor may have a power to recover the trust property if the residence is destroyed by fire or other casualty or if the grantor ceases to use the property as a residence. These examples pose tax risks:

(1) **Incomplete gift**.

If the grantor is the trustee and has discretion to sell and whether to reinvest the sales proceeds in another residence, the grantor's gift to the QPRT may be incomplete until the grantor's power ends. As the residence appreciates in value and the length of the grantor's retained interests diminishes, this means that the value of the remainder interest, and therefore the amount of the grantor's potential gift, will steadily increase.

(2) **General power of appointment**.

The grantor's retained power to re-vest the trust property in himself may be a general power of appointment. Lapse of this general power at the termination of the QPRT may be a taxable transfer.[211]

b. **Potential Solutions and Planning Considerations**.

(1) **Judicial modification**.

The QPRT beneficiaries and trustee may consider a judicial modification of the trust to eliminate the problematic provisions. However, the IRS may not respect the modification, although the IRS has shown some willingness to respect a retroactive modification that attempts to correct a scrivener's error, if the modification was consistent with applicable state law. See II.B.1.b(3).

(2) **Grantor resign as trustee to cause completed gift.**

If the grantor is the trustee of the QPRT with powers that may cause the transfer to be an incomplete gift, the grantor could resign as trustee (and release any powers relating to the removal and appointment of the trustee that might attribute the trustee's powers to the grantor) which should result in a completed gift at that time based on the value of the residence and the remaining QPRT term.

(3) **Grantor resign as trustee to avoid inadvertent general power of appointment**.

If the trust agreement is structured so that the contribution of the residence to the QPRT is a completed gift but, the trust agreement provides that the grantor, as trustee, has discretion regarding the use of insurance proceeds received as a result of damage or destruction to the residence, prior to any such damage, the grantor to should resign as trustee (and release any powers relating to the removal and appointment of the trustee that might attribute the trustee's powers to the grantor). This should avoid the risk of the grantor holding a general power of appointment over the QPRT assets in the event of damage or destruction to the residence.

c. **Drafting Suggestions**.

(1) **Conversion to a GRAT**.

If the grantor also will be the trustee, limit the trustee's discretion and require that if the trust ceases to be a QPRT, during the QPRT term, the trust assets will be transferred to a grantor retained annuity trust. If the trustee's discretion is not limited, designate a third party trustee and limit the grantor's powers to remove and replace the trustee so that the trustee's powers are not attributed to the grantor.

(2) **Power of sale**.

If the grantor also will be the trustee, require the remainder beneficiary to consent to a sale of the residence. This should avoid an incomplete gift and the grantor's retention of a general power of appointment. If beneficiary consent is not required, designate a third party trustee and limit the grantor's powers to remove and replace the trustee so that the trustee's powers are not attributed to the grantor

(3) **Power with respect to proceeds**.

If the grantor also will be the trustee, require the trustee to reinvest the proceeds of a sale (or insurance proceeds resulting from destruction of the property) in a new residence or, alternatively, require the trustee to do so unless the remainder beneficiary consents to an alternate disposition. If the trustee has discretion and beneficiary consent is not required, designate a third party trustee and limit the grantor's powers to remove and replace the trustee so that the trustee's powers are not attributed to the grantor.

C. Problems Relating to Economic Changes.

1. The impecunious grantor.

a. Nature.

Suppose the grantor's financial status has deteriorated since he created the QPRT and he now wishes he had the residence, or the wealth represented by it, back. For example, suppose that the grantor transferred an expensive residence to a QPRT several years earlier. The grantor has fallen on hard times and feels burdened by the significant costs and upkeep associated with the residence. Ideally, he would prefer to down-size and use the cash from the sale of the residence to help maintain his lifestyle.

b. Potential Solutions and Planning Considerations.

If the trust agreement allows the trustee to elect not to reinvest the proceeds of sale into a new residence (either with consent of the remainder beneficiary, if the grantor is trustee, or with a third party trustee as described above, the trustee could sell the residence to a third party and elect not to reinvest the proceeds. As a result, the sale proceeds would be distributed to a GRAT for the grantor or to the grantor, himself, depending the terms of the trust. See discussion in IV.B.1.c(1), above, regarding tax issues, if trustee has discretion. If the proceeds are ultimately transferred to a GRAT, the grantor can access the cash through the GRAT annuity payments or by selling or swapping his illiquid assets for cash from the GRAT.

c. Drafting Suggestions.

Care should be taken in the level of discretion, if any, given to the trustee on (1) whether to sell the residence, (2) how to investment the proceeds, and (3) whether assets are distributed to the grantor or to a GRAT if the trust ceases to be a QPRT.

D. Problems Relating to Mortality.

1. Grantor's life expectancy diminishes.

a. Nature.

If the grantor dies during the term of the QPRT, the trust assets will be included in the grantor's gross estate under Section 2036. For this reason, practitioners will choose a QPRT term that is well within the grantor's actuarial life expectancy. However, due to illness or injury, the grantor's life expectancy may diminish faster than expected, making it less likely that the grantor will survive the QPRT term and, therefore, more likely that the residence will be included in the grantor's gross estate under Section 2036.

b. Potential Solutions and Planning Considerations.

(1) Sell residence and convert to a GRAT.

The trustee of the QPRT could sell the residence and convert the proceeds into a GRAT.[212] Depending on the term of the GRAT, the amount includible in the grantor's gross estate may be less than the entire GRAT assets.[213] If so, it should also be less than the amount includible if the residence were still held by the QPRT. It is unclear whether Section 2035(a) would apply in this situation. Potentially, Section 2035(a) should not apply, provided that the sale qualifies as a bona fide sale for adequate consideration in money or money's worth.[214] Under that line of argument, the end result should be inclusion of the residence, itself, in the grantor's gross estate under Section 2031 (assuming that it is still owned by the grantor at death), and inclusion of only a portion of the assets converted to the GRAT if the grantor fails to survive the term.

(2) **Purchase remainder interest**.

As with the GRAT (see II.D.1.b, above), there is no solution to the problem of dying earlier than expected. However, there may be a solution to the problem of reducing the estate tax imposed on the QPRT assets. If the trust agreement permits (see IV.D.1.c, below), the grantor could purchase the remainder interest in the QPRT from the remainder beneficiary for its actuarial value. The grantor would then own the term interest and the remainder interest. This should cause a merger and a termination of the QPRT, putting the residence back into the hands of the grantor where tax can be deferred (through use of the marital deduction) or avoided (through use of the charitable deduction). The remainder beneficiary will be left with cash or other assets equal to the value of the remainder interest at the time of the transaction, undiminished by estate tax. Note that the Treasury Regulations provide that the trust agreement must prohibit the trustee from "directly or indirectly" selling the residence to the grantor, but do not expressly require a prohibition on the sale of a remainder interest to the grantor by the remainder beneficiary.[215] The IRS would probably assert that the grantor's purchase of a QPRT remainder interest is an indirect purchase of the residence.

c. **Drafting Suggestions**.

(1) **Omit or modify spendthrift clause**.

The typical spendthrift clause would prevent the remainder beneficiary from selling its beneficial interest to the grantor. To permit the potential solution discussed above, do not include a spendthrift clause in the QPRT.

(2) **Consider trustee powers in remainder trust**.

Be sure the remainder trust does not include self-dealing provisions that prohibit the trustee from selling the remainder interest in the QPRT to the grantor.

E. Problems Relating to Bad Administration.

1. **Grantor stays too long**.

a. **Nature**.

The grantor continues to live in the residence without paying rent after the QPRT terminates. This may embolden the IRS to assert that the grantor may have retained a right to enjoy the residence causing inclusion under Section 2036. This issue is raised in a case currently pending before the U.S. Tax Court.[216]

b. **Potential Solutions and Planning Considerations**.

If the QPRT has terminated and the grantor has continued to reside in the residence without paying rent, the grantor and the owner of the residence should sign a lease agreement that provides for a market rental rate and the grantor should pay "back rent" plus interest to the residence owner.

c. **Drafting Suggestions**.

Nothing prohibits the grantor from leasing the residence after the QPRT term expires. In fact, the right to lease the residence may be expressly set forth in the trust agreement creating the QPRT.[217] The grantor could sign a lease before the QPRT terminates, or even contemporaneously with the creation of the QPRT, that gives the grantor the right to continue to occupy the residence and prescribes the rental payments.[218]

V. Conclusion

This paper discusses three of the most commonly used planning techniques among sophisticated practitioners – GRATs, installment sales, and QPRTs – and identifies the five general ways in which these strategies can go awry. While there is not a solution for every problem, hopefully this paper provides insight into potential ways to salvage wayward existing plans and suggests drafting ideas that can provide flexibility and minimize the risk of potential problems for future planning.

Notes

[1] John F. Bergner, Derek L. Fletcher, Cheryl Cain Crabbe, Benjamin G. Carter, and Alan B. Jones, all of Winstead PC, contributed to the preparation of this paper.

[2] "But, Mousie, thou art no thy lane,/In proving foresight may be vain:/The best-laid schemes o' mice an' men/Gang aft agley,/An' lea'e us nought but grief an' pain,/For promis'd joy!" Robert Burns, *To a Mouse, on Turning Her Up in Her Nest with the Plough*.

[3] In this paper, all references to the "Code" are to the Internal Revenue Code of 1986 and all references to "Section" are to sections of the Code, unless otherwise indicated.

[4] *See* Treas. Reg. § 25.2702-3.

[5] I.R.C. § 2702(a)(2)(B).

[6] I.R.C. § 2702(a)(2)(A).

[7] *See* Treas. Reg. 25.2702-2(d)(1), Example 1.

[8] The Section 7520 rate equals 120% of the mid-term applicable federal rate, with annual compounding, rounded to the nearest 2/10 of one percent. I.R.C. § 7520(a).

[9] Treas. Reg. § 20.2036-1(c).

[10] Treas. Reg. § 25.2702-3(b)(1)(i).

[11] Treas. Reg. § 25.2702-3(b)(1)(ii).

[12] Treas. Reg. § 25.2702-3(b)(1)(iii).

[13] Treas. Reg. § 25.2702-3(b)(2).

[14] Treas. Reg. § 25.2702-3(b)(3).

[15] Treas. Reg. § 25.2702-3(b)(4).

[16] Treas. Reg. § 25.2702-3(b)(5).

[17] Treas. Reg. § 25.2702-3(d)(3).

[18] Treas. Reg. § 25.2702-3(d)(4).

[19] Treas. Reg. § 25.2702-3(d)(5).

[20] Treas. Reg. § 25.2702-3(d)(6).

[21] Treas. Reg. § 25.2702-3(b)(1)(i).

[22] Treas. Reg. § 25.2702-3(b)(1)(ii).

[23] *See* Walton v. Commissioner, 115 T.C. 589 (2000).

[24] Treas. Reg. § 25.2702-3(b)(1)(ii).

[25] *See* Treas. Reg. § 25.2702-3(e), Example 2.

[26] Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 393 U.S. 756 (1944); Rev. Rul. 65-144, 1965-1 C.B. 442.

[27] Rev. Rul. 75-440, 1975-2 C.B. 372. For an excellent discussion of savings clauses, *see* Covey and Hastings, "No More, No Less: Savings Clauses, Formulas and Defined Values," 41st University of Miami Heckerling Institute on Estate Planning, Recent Developments, pages 68-110 (2007).

[28] Tex. Trust Code § 112.054(a)(4).

[29] Tex. Trust Code § 112.054(c).

[30] *See* Commissioner v. Bosch, 387 U.S. 456 (1967).

[31] *See, e.g.,* Rev. Rul. 93-79 (declining to grant retroactive relief to court reformation of a trust to allow it to hold S corporation stock).

[32] *See, e.g.,* Ltr. Rul. 200144018 (Aug. 3, 2001). In this ruling, the beneficiary, as trustee, could distribute principal to herself for her "health, welfare and maintenance." This power gave the beneficiary a general power of appointment over the trust assets. The IRS ruled that a court reformation that modified this language retroactively to "health, education, support and maintenance" would not be a release of a general power for gift tax purposes because the modification was based on a scrivener's error and was consistent with state law.

[33] *Bosch*, 387 U.S. 456, at 465 ("If there be no decision by that court then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court .").

[34] *See, e.g.,* Krauss v. Comm'r, T.C. Memo, 1990-399. In *Krauss*, the decedent died and left his estate in a trust for his wife that was intended to qualify for the marital deduction. However, at the time, it was necessary that the trust contain a testamentary general power of appointment to qualify for the marital trust, but the trust as written only contained a limited power of appointment. The decedent's estate obtained a reformation of the trust provisions to change the limited power to a general power, based on a scrivener's error. The Tax Court ultimately agreed that the state court ruling was consistent with applicable state law and, therefore, allowed the marital deduction.

[35] For a thorough discussion of the consequences of court modifications and constructions, *see* Carlyn S. McCaffrey, "Fix-Ups for Estate Planning Documents," (2002).

[36] Treas. Reg. § 25.2702-3(b)(1)(ii).

[37] *See* Treas. Reg. § 25.2702-3(e), Example 2.

[38] *See* Treas. Reg. § 25.2702-3(d). *See* II.A.1 for a more comprehensive discussion of the requirements for a GRAT.

[39] *See* Ltr. Rul. 200319001 (May 9, 2003) and TAM 9717008 (April 25, 1997). In TAM 9717008, a GRAT permitted the trustee to satisfy the required annuity payments with a promissory note. However, the GRAT contained a limited power of amendment in which the GRAT could be amended to negate the authority of the trust to satisfy the annuity payments with a note if such authority disqualified the retained interest. Citing Procter, the IRS refused to respect the limited power of amendment.

[40] I.R.C. § 2512(a); Treas. Reg. § 25.2512-1.

[41] *See* I.R.C. § 2701.

[42] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[43] *See* Treas. Reg. 301.9100-3.

[44] Treas. Reg. § 25.2701-1(c)(4).

[45] Treas. Reg. § 25.7520-3(b)(2)(i).

[46] For a discussion of the Securities Laws application to GRATs, *see* Diane Hastings and Nicholas Unkovic, "Federal Securities Laws and Administration of the Grantor Retained Annuity Trust" ACTEC Journal (Spring 2004).

[47] Peter J. Kight, SEC No-Action Letter, 1997 SEC No-Act. (October 16,1997).

[48] Morales v. Quintiles Transnational Corp., 25 F.Supp.2d 369 (S.D.N.Y. 1998) (substitution of insider stock for a promissory note constituted a purchase for purposes of section 16(b) of the Securities Exchange Act of 1934); Dreiling v. Kellett, 281 F.Supp.2d 1215, 1244 (W.D. Wash. 2003) (unauthorized transfers from GRATs to or for the benefit of the insiders constituted purchases for purposes of section 16(b)).

[49] Treas. Reg. § 25.2702-3(b)(1)(iii).

[50] The swap power results in grantor trust status under I.R.C. § 675(4).

[51] *See* Treas. Reg. § 25.2702-3(b)(4) ("An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid 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)").

[52] Rev. Rul. 98-21, 1998-1 C.B. 975; Rev. Proc. 98-34, 1998-1 C.B. 983.
[53] State law determines the extent and character of legal interests in property for purposes of applying federal transfer taxes *See* Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). For an example of a state court recognizing the character of nonvested options and retirement benefits as a contingent property right, *see* Cearley v. Cearley, 544 S.W.2d 661 (Tex. 1976) and Bodin v. Bodin, 955 S.W.2d 380 (Tex. App. – San Antonio 1997, n.w.h.)
[54] U.S. Patent No. 6,567,790.
[55] *See* Treas. Reg. § 20.2036-1(c).
[56] I.R.C. § 2036(b)(3).
[57] For a discussion of the swap power, *see* Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks" (January 14, 2009).
[58] *See* I.R.C. § 2035(d).
[59] *See* Rev. Rul. 95-58, 1995-2 C.B. 191. *See* I.R.C. § 672(c) for the definition of "related or subordinate party."
[60] Ltr. Rul. 200603040 (January 20, 2006).
[61] Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
[62] *See, e.g.*, Howard M. Zaritsky, Tax Planning for Family Wealth Transfers: Analysis with Forms, § 3.02.
[63] I.R.C. 2523(b).
[64] *See* I.R.C. § 1041.
[65] Treas. Reg. § 25.2702-3(d)(5).
[66] For a discussion of the swap power (as well other powers that produce grantor trust status), *see* Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks" (January 14, 2009).
[67] *See* I.R.C. § 675(4).
[68] *See* Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
[69] *See* Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109 Journal of Taxation 22 (July 2008).
[70] *See* Edward F. Koren, "You Got Me Into This, Now How Do I Get Out?: Planning With Underwater Estate Planning Strategies," ABA Joint Fall Meeting, RPTE and Tax Sections (September 25, 2009). (crediting Edward M. Manigault with the development of this technique.)
[71] Treas. Reg. § 25.2702-3(d)(5).
[72] *See* Stephen R. Akers, "Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure," (September 28, 2007).
[73] For a discussion of such a power, *see* Carlyn S. McCaffrey, "The Care and Feeding of GRATs – Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring" 42nd U. Miami Heckerling Inst. at 6-19 (2005).
[74] I.R.C. § 674(a).
[75] Treas. Reg. § 25.2702-3(d)(6).
[76] *See* Treas. Reg. § 25.2702-3(b)(1) (prohibiting a GRAT from issuing a note "directly or indirectly" to satisfy an annuity payment).
[77] Ltr. Rul. 9113009 (December 21, 1990).
[78] Ltr. Rul. 9409018 (December 1, 1993).
[79] *See* Treas. Reg. § 20.2036-1(c).
[80] Treas. Reg. § 25.2702-3(d)(5).
[81] *See* Stephen R. Akers, "Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure," (September 28, 2007).
[82] *See* Treas. Reg. §25.2702-3(b)(1).

[83] Treas. Reg. § 25.2702-3(d)(5).
[84] *See* Treas. Reg. § 25.7520-3(b)(3).
[85] *See* Treas. Reg. § 20.2036-1(c).
[86] The topic of Walton-style GRATs and qualifying for the marital deduction when the grantor predeceases the end of the GRAT term has been the subject of considerable discussion. *See, e.g.*, Steve R. Akers, "Transfer Planning, Including Use of GRATS, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure," 2007 Fall Meeting of American Bar Association – Section of Taxation and Section of Real Property, Trust and Estate Law, at 7 (September 29, 2007); Milford B. Hatcher, Jr. and Ronald D. Aucutt, "Beyond the Basics in Freeze Planning: All of the Questions Which You Have Been Afraid to Ask-And Which We Are Game to Address," 2006 ACTEC Annual Meeting at 76-77 (March 9, 2006).
[87] *See* I.R.C. § 2613.
[88] *See* I.R.C. § 2651(e).
[89] I.R.C. § 2651(e); Treas. Reg. § 26.2651-1(c), Example 4.
[90] I.R.C. § 2603(a)(2).
[91] I.R.C. § 2641.
[92] *See* Carlyn S. McCaffrey, "The Care and Feeding of GRATs – Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring," 42nd U. Miami Heckerling Inst. at 6-21 (2005).
[93] I.R.C. § 2612(b).
[94] *See*, I.R.C. § 2603(a)(1).
[95] *See* I.R.C. § 2642(f); Treas. Reg. § 26.2632-1(c).
[96] *See* Treas. Reg. § 26.2642-6.
[97] I.R.C. §§ 2612(a)(1) and 2613.
[98] I.R.C. § 2612(b).
[99] *See* Treas. Reg. § 26.2642-6.
[100] *See* Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks," (January 14, 2009).
[101] *Id*.
[102] I.R.C. § 672(e)(1)(A). *But see* I.R.C. §682 (regarding the taxation of trust income which is paid, credited or required to be distributed to a divorced spouse).
[103] *See* Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks," (January 14, 2009).
[104] For an excellent discussion of the reciprocal trust doctrine *see* Paul Van Horn, "Reciprocal Trusts Revisited," Tax Management Estate Gift and Trusts Journal (July 14, 2005).
[105] I.R.C. § 672(e)(1)(A). *But see* I.R.C. §682 regarding the taxation of trust income which is paid, credited or required to be distributed to a divorced spouse.
[106] *See* Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks," (January 14, 2009).
[107] *Id*.
[108] I.R.C. § 672(e)(1)(A). *But see* I.R.C. §682 (regarding the taxation of trust income which is paid, credited or required to be distributed to a divorced spouse).
[109] I.R.C. § 677(a).
[110] Treas. Reg. § 25.2702-3(b)(4).
[111] *See* I.R.C. § 2702(b).
[112] I.R.C. § 2702(a)(2)(A).
[113] Atkinson v. Commissioner, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002) (where the court found that a CRAT's failure to make annuity payments to the grantor disqualified the CRAT from inception).
[114] Sample form is based on a form prepared by Diana S.C. Zeydel and Jonathan G. Blattmachr.
[115] Treas. Reg. § 25.2702-3(b)(5).

[116] *See, e.g.*, Tex. Trust Code § 112.005.
[117] The gift tax applies to a transfer of property by way of gift. I.R.C. § 25.2511-1(a). If consent to the transfer of a limited partnership interest is required but not obtained, then the grantor has not effectively transferred the limited partnership interest to the GRAT.
[118] Teas. Reg. § 25.2702-3(b)(5).
[119] *See* I.R.C. § 2642(f) and Treas. Reg. § 26.2632-1(c).
[120] Treas. Reg. § 26.2632-1(c)(2)(i).
[121] *See* Treas. Reg. § 20.2036-1(c).
[122] Treas. Reg. § 26.2632-1(c)(1)(ii).
[123] I.R.C. § 2632(c).
[124] I.R.C. § 2632(c)(4).
[125] *See* I.R.C. § 2632(c)(3)(B).
[126] I.R.C. § 2632(c)(5)(A)(i).
[127] Treas. Reg. § 26.2632-1(b)(2)(iii)(C).
[128] Notice 2001-50, 2001-2 C.B. 189.
[129] Treas. Reg. § 301.9100-3(e)(5).
[130] Prop. Reg. § 26.2642-7.
[131] For a comprehensive discussion of these issues, *see* Lloyd Leva Plaine, "GST Tax – Divide Trusts in Qualified Severances/Conquer Missed GST Exemption Allocations and Elections," 43rd Heckerling Institute on Estate Planning; University of Miami School of Law (2009).
[132] I.R.C. § 2632(c)(3)(A).
[133] I.R.C. § 2632(c)(3)(B).
[134] Treas. Reg. § 301.6501(c)-1(f).
[135] Treas. Reg. § 301.6501(c)-1(e).
[136] Rev. Rul. 85-13, 1985-1 C.B. 184.
[137] I.R.C. § 2512(a); Treas. Reg. § 25.2512-1.
[138] *See* I.R.C. § 2701.
[139] Treas. Reg. § 25.2701-1(c)(4).
[140] In *Karmazin* (T.C. Docket N. 2127-03), the IRS advanced these debt versus equity principles in attacking an installment sale transaction. The case was later settled on terms favorable to the taxpayer.
[141] *See* Treas. Reg. § 301.9100-3.
[142] For an excellent discussion of defined value clauses, *see* Carlyn S. McCaffrey, "Gifting and Selling by Formula–Shield Against Gift Tax Valuation Risk or Invitation to Audit Exposure?" 42nd U. Miami Heckerling Inst. (2008).
[143] *See, e.g.*, Procter v. Commissioner, 142 F.2d 824 (4th Cir. 1944); Ward v. Commissioner, 87 T.C. 78 (1986).
[144] *See* McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) and Estate of Christiansen v. Commissioner, 130 T.C. 1 (2008) *aff'd* 104 AFTR2d 2009-XXXX (8th Cir. Nov. 13, 2009, corrected Nov. 18, 2009).
[145] Rev. Rul. 85-13, 1985-1 C.B. 184.
[146] *See* I.R.C. § 672(e).
[147] Rev. Rul. 85-13, 1985-1 C.B. 184.
[148] I.R.C. § 1041.
[149] See the discussion at III.D.1.a regarding the debate surrounding the income tax consequences of the death of a grantor when an installment note is outstanding.
[150] Rev. Rul. 85-13, 1985-1 C.B. 184.
[151] I.R.C. § 1041.

[152] I.R.C. §453B(g)(2) provides that "the same tax treatment with respect to the transferred installment obligation shall apply to the transferee as would have applied to the transferor." Presumably, this is intended to ensure that the transferee spouse steps into the shoes of the transferor with respect to any gain associated with future payments and the income tax consequences of any subsequent disposition of the note. It is unclear whether this rule would prevent the spouses from altering the income tax consequences associated with the interest payments on the note.

[153] See I.R.C. §453B(g).

[154] The partition or exchange should also provide that future earnings and income arising from the transferred property shall be the separate property of the owning spouse.

[155] *See* I.R.C. § 267.

[156] Section 453(a) provides that income from an installment sale shall be taken into account under the installment method. Section 453(b)(1) defines an installment sale as a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

[157] I.R.C. §453(c).

[158] *See* I.R.C. §453(d).

[159] *See* Stephen R. Akers, "Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks," (January 14, 2009).

[160] Treas. Reg. §25.2512-4 and Prop. Reg. §1.7872-3(c)(3), Example 5(iii). *See also* Milford B. Hatcher, Jr., "Planning with Underwater Estate Planning Strategies (GRATs, Installment Sales, Etc.)" (September 25, 2009); Edward F. Koren, "You Got Me Into This, Now How Do I Get Out? Planning with Underwater Estate Planning Strategies" (September 25, 2009); Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109 Journal of Taxation 22 (July 2008) and LISI Estate Planning Newsletter #1447 (April 26, 2009) at http://www.leimbergservices.com. For a differing view *see* Philip J. Hayes, "Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners," Vol. 13, Issue 2 California Trusts and Estates Quarterly 5 (2007).

[161] *See* Milford B. Hatcher, Jr., "Planning with Underwater Estate Planning Strategies (GRATs, Installment Sales, Etc.)" (September 25, 2009).

[162] *Id*.

[163] For an excellent discussion of beneficiary guarantees, *see* Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts, 92 Journal of Taxation 152, 161-64 (2000).

[164] Ltr. Rul. 9113009 (December 21, 1990).

[165] Ltr. Rul. 9409018 (December 1, 1993).

[166] *See* Madorin v. Commissioner, 84 T.C. 667 (1985), and Rev. Rul. 77-402, 1977-2 C.B. 222 (death of grantor during term of the note results in income realization because grantor trust status is lots and there is a relief of indebtedness).

[167] *See* Stephen R. Akers, "Planning with Grantor Trust – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks," (January 14, 2009), discussing competing positions taken by Dunn & Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," 95 Journal of Taxation (July 2001) as compared to Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 Tax Management, Estates, Gifts & Trusts Journal 3 (1999), as compared to Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 Journal of Taxation 152, 161-64 (2000), and as compared to Blattmacher, Gans & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of Grantor's Death," 97 Journal of Taxation 149 (Sept. 2002).

[168] *See* CCA 200923024 (June 5, 2009).

[169] *See* CCA 200937028 (September 11, 2009).

[170] I.R.C. § 1014.

[171] *See* Treas. Reg. §§ 20.7520-3(b)(3) and 25.7520-3(b)(3).

[172] *Id.*

[173] *See* Estate of Moss v. Commissioner¸74 T.C. 1239 (1980).

[174] *See* Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109 Journal of Taxation 22 (July 2008).
[175] I.R.C. § 672(e)(1)(a).
[176] I.R.C. § 677(a).
[177] *See* Linton v. United States, 104 AFTR 2d 2009-5176 (W.D. Wash. 2009); Heckerman v. United States, 104 AFTR 2d 2009-5551 (W.D. Wash. 2009); Pierre v. Commissioner, 133 T.C. 2 (2009).
[178] *See* Linton v. United States, 104 AFTR 2d 2009-5176 (W.D. Wash. 2009), *quoting* Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).
[179] *See, e.g.,* Holman v. Commissioner, 130 T.C. 170 (2008) (holding that six days between funding LLC and transferring LLC interests to children was sufficient to avoid the step transaction doctrine when the LLC was funded with Dell stock).
[180] *See, e.g.,* Linton v. United States, 104 AFTR 2d 2009-5176 (W.D. Wash. 2009) (holding that step transaction doctrine applied when funding of LLC with cash, municipal bonds and real estate and transfer of LLC interests occurred on the same day).
[181] *See e.g.* Linton v. United States, 104 AFTR 2d 2009-5176 (W.D. Wash. 2009) (noting that taxpayer testified that he based amount transferred to entity on the anticipated discount for a transfer of an interest in that entity.).
[182] *See* Treas. Reg. §301.6501(c)-1(f)(4).
[183] Schedule A only requires disclosure of gifts made by the taxpayer. *See* Instructions for Form 709, United States Gift (and Generation Skipping Transfer) Tax Return, page 5.
[184] For an example of a gift tax return utilizing this reporting option, *see* Akers, Bergner, Fletcher, Hundley & Manigault, "Installment Sales: Myths, Legend, Pitfalls and Difficult Issues," ABA Section of Taxation and Section of Real Property, Trust and Estate Law, 2007 Joint Fall Meeting (September 29, 2007).
[185] Treas. Reg. § 25.2702-5(c)(2)(ii).
[186] Treas. Reg. § 25.2702-5(c)(5)(ii).
[187] *Id*.
[188] Treas. Reg. § 25.2702-1(b).
[189] *Id*.
[190] For a comprehensive discussion of QPRTs, *see* Natalie R. Choate, The QPRT Manual – The Estate Planner's Guide to Qualified Personal Residence Trusts (2004).
[191] Treas. Reg. § 25.2702-5(c)(2)(i).
[192] Treas. Reg. § 25.2702-5(c)(2)(iv).
[193] Treas. Reg. § 25.2702-5(c)(2)(iii).
[194] Treas. Reg. § 25.2702-5(c)(3).
[195] Treas. Reg. § 25.2702-5(c)(4).
[196] Treas. Reg. § 25.2702-5(c)(5).
[197] Treas. Reg. § 25.2702-5(c)(5)(ii)(A)(2).
[198] Treas. Reg. § 25.2702-5(c)(5)(ii)(B).
[199] Treas. Reg. § 25.2702-5(c)(5)(ii)(C).
[200] Treas. Reg. § 25.2702-5(c)(5)(ii)(D).
[201] Treas. Reg. § 25.2702-5(c)(6).
[202] Treas. Reg. § 25.2702-5(c)(7)(i).
[203] Treas. Reg. § 25.2702-5(c)(7)(ii).
[204] Treas. Reg. § 25.2702-5(c)(7)(iii)(A).
[205] Treas. Reg. § 25.2702-5(c)(8).
[206] Treas. Reg. § 25.2702-5(c)(9).
[207] *Id*.
[208] Treas. Reg. § 25.2702-5(c)(8)(i).

[209] Treas. Reg. § 25.2702-5(c)(7)(ii).
[210] Treas. Reg. § 25.2702-5(c)(7)(iii).
[211] I.R.C. § 2514.
[212] *See* Treas. Reg. § 25.2702-5(c)(8).
[213] *See* Treas. Reg. § 20.2036-1(c).
[214] *See* I.R.C. § 2035(d).
[215] *See* Treas. Reg. § 25.2702-5(c)(9).
[216] Estate of Riese v. Commissioner, Docket No. 5388-08.
[217] T.D. 8743 (December 22, 1997).
[218] Ltr. Ruls. 9626041 (June 28, 1996), 9448035 (December 2, 1994), and 9249014 (September 4, 1992).