# THE USE OF BENEFICIARY DEFECTIVE TRUSTS IN MODERN ESTATE PLANNING

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*Synopsis: It has become increasingly popular for practitioners to use a sale by a beneficiary to a trust that is owned by the beneficiary for income tax purposes as an alternative to a more traditional sale by a grantor to a grantor trust. This increase in the popularity of sales to beneficiary-owned trusts has resulted from the belief that a beneficiary who sells assets to his or her trust can retain a beneficial interest in the trust corpus while enjoying all of the benefits that are available in a more traditional sale to a grantor trust—benefits such as the removal of future appreciation of the transferred assets from the transferor's gross estate.*

*A properly structured transaction involving a sale to a beneficiary-owned trust may provide a client with opportunities that are unavailable through more traditional estate planning techniques, but these complex transactions will fail to yield the intended benefits unless practitioners carefully structure the trust, its funding, and the sale to the trust. This Article analyzes the statutes, regulations, and rulings that support the use of sales to beneficiary-owned trusts as an estate planning vehicle, and based upon this analysis, sets forth guidance on the proper methods for structuring, funding, and selling assets to beneficiary-owned trusts.*

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## I. INTRODUCTION AND COMPARISON TO ALTERNATIVE TRANSFER TECHNIQUES

An estate planning technique that has become increasingly popular is having a beneficiary sell assets to a trust that is owned by the beneficiary for income tax purposes. The trusts used in the transactions are often referred to as beneficiary-defective inheritor's trusts or intentionally-defective beneficiary trusts (IDBTs). As their name indicates, IDBTs are closely related to intentionally-defective grantor trusts (IDGTs), and both types of trusts are created pursuant to the provisions of sections 671 through 678 of the Internal Revenue Code (Code).[1] An IDBT, like an IDGT, is an irrevocable trust that is designed to be income tax defective in that the trust's income is not taxed to the trust. Rather, in the case of an IDGT the income is taxed to the grantor and in the case of an IDBT the income is taxed to a beneficiary.

Both IDBTs and IDGTs (1) permit the size of a client's gross estate to be frozen by removing from the client's gross estate any future appreciation of the assets sold to the trust and any income that the assets earn in excess of the amount required to fund the payments on the note used in the sale to the trust;[2] (2) allow the trust corpus to grow, income tax free, by having the income generated by the trust be taxed to the grantor or a beneficiary;[3] (3) reduce the overall income tax burden by causing the trust income to be taxed at the individual tax rates rather than the compressed tax rates applicable to trusts;[4] and (4) qualify as eligible S corporation shareholders when wholly owned by an individual (either a grantor or a beneficiary) who is

[1] *See* I.R.C. §§ 671–678.

[2] *See* Estate of Becklenberg v. Comm'r, 273 F.2d 297, 301–02 (7th Cir. 1959), *acq.*, 1959-2 C.B. 3; Cain v. Comm'r, 37 T.C. 185, 187 (1961), *acq.*, 1962-2 C.B. 3; Estate of Bergan v. Comm'r, 1 T.C. 543, 552–53 (1943).

[3] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.

[4] *See* I.R.C. §§ 1, 1411(a); Rev. Proc. 2013-15, 2013-5 I.R.B. 444.

a U.S. citizen or resident.[5] While IDBTs and IDGTs share many common attributes, the distinction regarding who is the owner of the trust for income tax purposes is recognized by commentators as an important distinction because a beneficiary of an IDBT can sell assets to the trust without recognizing gain, whereas only the grantor may sell assets to an IDGT on an income tax free basis. Commentators argue that a sale by a beneficiary to an IDBT, as opposed to a sale by a grantor to an IDGT, permits a client—who is both a trustee and the initial primary beneficiary of the trust—to control the trust and its beneficial enjoyment while at the same time removing the trust corpus from the client's gross estate and the claims of the client's creditors.[6]

An attorney contemplating the use of an IDBT is often not only required to compare the benefits of an IDBT to an IDGT, but must also consider whether the use of a grantor retained annuity trust (GRAT) is appropriate. A GRAT is an estate planning technique in which the settlor of

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[5] *See* I.R.C. §§ 318(a)(2)(B)(ii), 1361(c)(2)(A)(i); Treas. Reg. § 1.1361-1(h)(1)(i); Priv. Ltr. Rul. 2012-16-034 (Apr. 20, 2012); Priv. Ltr. Rul. 2010-39-010 (Oct. 1, 2010).

[6] *See* Richard A. Oshins, *In Search of the Perfect Estate Plan: A Pipe Dream Can Become a Reality*, *in* CCH FINANCIAL AND ESTATE PLANNING 1, 3–4 (1998), *available at* http://www.oshins.com/images/Perfect_Estate_Plan,_Pipe_Dream_Can_Become_a_Reality.pdf; *see also* Robert G. Alexander & Dallas E. Klemmer, *Creative Wealth Planning with Grantor Trusts, Family Limited Partnerships, and Limited Liability Companies*, 2 EST. PLAN. & CMTY. PROP. L.J. 307, 339 (2010) (quoting RICHARD A. OSHINS, THE BENEFICIARY DEFECTIVE INHERITOR'S TRUST (BDIT): CREATING THE IDEAL WEALTH TRANSFER AND ASSET PROTECTION PLAN 8 (Robert G. Alexander ed., 2009) (on file with author)).

> [A] beneficiary of a trust established by a third party may be given substantial rights in that trust without causing estate tax inclusion. These rights include the following: "(1) the right to income; (2) the right to withdraw property from the trust based upon an ascertainable standard; (3) the unlimited (no standard) authorization to have an independent trustee distribute trust property to him/ her; (4) the right to appoint (give) property to anyone other than him/herself, his/her estate or the creditors of either; (5) the right to 'use' trust property for virtually any purpose (a life estate); and (6) the right to manage the property."

Alexander & Klemmer, *supra*; *see also* Robert G. Alexander & Michael W. Halloran, *The Cash Value Beneficiary Defective Inheritor's Trust (The "CASH VALUE BDIT"): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan*, *in* NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION 7–1, § 7.01[3][c], at 7–6 to 7–9 (Alvin D. Lurie ed., 2009). Accomplishing these benefits may also be possible through the use of a properly structured sale to an IDGT established in a state permitting self-settled spendthrift trusts, but the risk of gross estate inclusion under section 2041, if creditors are held under state law to have rights to distributions, may render the use of such trust too risky for many practitioners. *See* PRACTICAL DRAFTING 10482 (Richard B. Covey et al. eds., 2011); *see also* Austin W. Bramwell, *Considerations and Consequences of Disclosing Non-Gift Transfers*, 116 J. TAX'N 19, 25 n.62 (2012).

a trust transfers property to a trust while retaining an annuity interest in the trust corpus. By retaining an annuity interest, the transferor is able to reduce the size of the taxable gift created by the transfer because the gift is limited to the value of the future interest that passes to the nongrantor trust beneficiaries. The value of the retained interest is determined by applying the actuarial tables contained in section 7520 of the Code.[7] Like a sale to an IDBT or an IDGT, a transfer to a GRAT can be an effective estate freezing technique because the value of the gift is determined at the time of the transfer to the GRAT, and if the grantor survives the term of the GRAT, any future appreciation in excess of the section 7520 rate is removed from the annuitant's estate.[8]

The use of a GRAT poses three significant risks to a client that can be ameliorated by using an IDBT. First, if the assets transferred to the GRAT fail to generate sufficient income to offset the section 7520 rate and make the annuity payments, then the size of the remainder interest on which a gift tax was paid will be reduced. This failure could result in a gift tax being paid on assets that are not actually transferred to the intended beneficiaries. To address liquidity and cash flow concerns, a back-loaded GRAT may be used, in which annuity payments increase annually. However, the ability to back load a GRAT is limited because the annuity payments cannot increase to more than 120% of the prior year's payments.[9] Second, the transfer tax savings are lost and the value of the gift is brought into the transferor's gross estate under section 2036(a) if the transferor dies during the annuity term.[10] Third, GRATs are inefficient vehicles for making transfers to skip persons as defined in section 2613 because the Code does not allow allocation of the generation-skipping transfer tax exemption until the end of the estate tax inclusion period, which remains open for the term of the GRAT.[11]

These three risks could be addressed if a transferor sells the property to an IDBT for a promissory note instead of using a GRAT.[12] First, liquidity

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[7] *See* Valuation Tables, 59 Fed. Reg. 30100-01 (June 10, 1994).

[8] *See* I.R.C. §§ 1274, 7520. The section 7520 rate is 120% of the midterm applicable federal rate contained in section 1274.

[9] *See* Treas. Reg. § 25.2702-3(b)(1)(ii), -3(c)(1)(ii), -3(e).

[10] *See* Treas. Reg. § 20.2036-1(c)(2) (calculating gross estate inclusion).

[11] *See* I.R.C. §§ 2613, 2642(f)(1), -(f)(3); *see also* Carlyn S. McCaffrey, Richard A. Oshins & Noel C. Ice, *Planning with GRATs*, *in* 2 NEW YORK UNIVERSITY SIXTY-SECOND INSTITUTE ON FEDERAL TAXATION 27–1, § 27.05[1], at 27–45 to –47 (2004), *available at* www.oshins.com/images/Chapter_27_Planning_with_GRATs.pdf.

[12] "The installment sale to a grantor trust was first envisioned as a method to avoid the special valuation rules of I.R.C. §§ 2701-2704." Alexander A. Bove Jr. & Melissa Langa,

concerns would be reduced because the note only needs to bear interest at the applicable federal rate for the term of the loan compounded semi-annually, rather than 120% of this rate as required for a GRAT.[13] Additionally, a note requiring payments that increase by more than 20% annually can be used since section 2702, which imposes substantial technical rules on GRATs, should not apply to an installment sale to an IDBT because the promissory note used in the sale is not an interest in the trust.[14] Second, unlike a transfer to a GRAT, the entire trust corpus is not included in the transferor's gross estate if the beneficiary, who sold the assets to the IDBT, dies during the term of the note; rather, the includable amount is the fair market value of the note. Third, an IDBT can serve as an effective generation-skipping transfer tax planning tool because in an installment sale to an IDBT, there is a transfer for full and adequate consideration. Accordingly, the buying trust should not be subject to the generation-skipping transfer tax, even if the trust corpus ultimately passes to grandchildren or other skip persons.[15]

Due to the advantages that IDBTs have compared to GRATs and IDGTs, some planners consider sales to IDBTs a nearly ideal estate planning strategy.[16]

## II. BACKGROUND AND HISTORY OF SECTION 678

A trust is generally treated as a separate taxpayer from its settlor and beneficiaries, and is taxed in the same manner as an individual.[17] However, there are exceptions to this general rule that are provided in sections 671 through 679 (Grantor Trust Rules).[18] These rules identify when a settlor or a beneficiary will be treated as the substantial owner of a trust for income tax

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*There's Nothing Defective About a Grantor Trust*, MASS. LAW. WKLY. (Feb. 11, 2002), www.bovelanga.com/publications/news_briefs/trusts_and_estates_forum/Nothing%20Defective%20About%20Grantor%20Trust.pdf (citing Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 1 (1996)).

[13] *See* I.R.C. §§ 1274(b)(2)(B), 7872(f)(2)(A); Priv. Ltr. Rul. 95-35-026 (May 31, 1995).

[14] *See* Priv. Ltr. Rul. 95-35-026 (May 31, 1995); Priv. Ltr. Rul. 94-36-006 (Mar. 14, 1994).

[15] *See* I.R.C. § 2624(d).

[16] *See* Oshins, *supra* note 6; *see also* Bramwell, *supra* note 6, at 25; STEVEN R. AKERS, *Estate Planning Current Developments and Hot Topics* 147 (2012), *available at* www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Hot%20Topics%20Current%20Developments%20_FINAL.pdf.

[17] *See* I.R.C. § 641(b).

[18] *See* I.R.C. §§ 671–679.

purposes.[19] When a settlor or beneficiary is treated as a trust's substantial owner, the Code—for income tax purposes—attributes the trust's income, deductions, and credits against the tax of the trust to the settlor or beneficiary, essentially as if the settlor or beneficiary owned the trust assets and the trust did not exist.[20]

Section 671 establishes the framework for the Grantor Trust Rules by providing:

> No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.[21]

One of the exceptions in the subpart is section 678, which identifies when a beneficiary will be treated as a trust's owner for income tax purposes.[22]

A basic understanding of the history of section 678 facilitates the understanding of its application. Section 678 was added to the Code in 1954 to complement the Clifford provisions governing the taxability of trust grantors contained in sections 671 through 677. The section's origin lies in the decision of *Mallinckrodt v. Nunan*.[23] In that case, the petitioner's father established a trust for the benefit of the petitioner and other close family

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[19] *See id.*

[20] *See* Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009); *see also* Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC L.J. 106, 106 (2009).

[21] I.R.C. § 671.

[22] *See* I.R.C. § 678.

[23] 2 T.C. 1128 (1943), *aff'd*, 146 F.2d 1 (8th Cir. 1945); Treas. Reg. 118, § 39.22(a)-22 (1939); Priv. Ltr. Rul. 90-26-036 (June 29, 1990), *rev'd in part*, Priv. Ltr. Rul. 93-21-050 (May 28, 1993) ("The legislative history of section 678 indicates Congress' intent to implement the principles of Mallinckrodt v. Nunan . . . ."); *see also* S. REP. NO. 83-1622, at 89 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4719.

> A person other than the grantor may be treated as the substantial owner of a trust if he has an unrestricted power to take the trust principal or income, or if he has modified this power (by release or otherwise) but has retained powers of the type which would make the grantor taxable, unless the grantor himself is deemed taxable because of such a power. Similar rules are contained in the regulations under existing law (commonly known as the Mallinckrodt Regulations).

S. REP. NO. 83-1622.

members.[24] The trust document provided that after the payment of certain expenses, the first $10,000 of annual income was to be paid to the petitioner's wife, and the remainder was to be added to the trust corpus unless the petitioner exercised a power of appointment that he was granted over the balance of the income.[25] The petitioner was one of the two trustees and had the ability with the other trustee to convey the trust corpus to himself.[26] The Tax Court held that the petitioner's rights to the income and corpus of the trust would result in the trust income being taxed to the petitioner if he was the settlor of the trust. Although the petitioner (1) was a beneficiary of a trust established by a third party, rather than the settlor, and (2) failed to exercise his power to appoint the trust income, these factors did not alter the petitioner's rights over the trust income and corpus. Hence, the court concluded that the trust income should be taxed to him.[27]

Section 678 codifies the holding in *Mallinckrodt* that a power to demand trust income causes a beneficiary to be taxed on all income subject to that power, even if that power is not exercised, by providing:

> A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
>
> (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
>
> (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.[28]

Circumstances may exist when both the grantor and a beneficiary hold grantor trust powers under sections 671 through 677.[29] Subsection (b) of section 678 provides:

> Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the

[24] *See Mallinckrodt*, 2 T.C. at 1128.

[25] *See id.*

[26] *See id.*

[27] *See id.* at 1136; Rev. Rul. 67-241, 1967-2 C.B. 225 (discussing the tax liability of a person other than a grantor treated as a substantial owner).

[28] I.R.C. § 678(a); *see also* Treas. Reg. § 1.678(a)-1.

[29] *See* I.R.C. § 678(b).

> grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.[30]

The use of the language "a power over income" has created ambiguity regarding who is treated as the owner of a trust when (1) the grantor is treated as the owner under the Grantor Trust Rules based on a power related solely to trust income, and (2) a person other than the grantor has a power over principal described in section 678(a).[31] The Service has privately ruled that in such circumstances, section 678(b) shall be read as if it applies to a power over income or principal.[32]

The rules contained in *Mallinckrodt* and section 678 can be distilled into two requirements that must be satisfied for a beneficiary to be the owner of a trust for income tax purposes.[33] First, the beneficiary must either (1) have the ability to vest the income or corpus of the trust in himself, or (2) have previously released or otherwise modified such a power while retaining a power that would make the trust a grantor trust if the beneficiary was its settlor.[34] Second, the settlor cannot hold any powers that would result in the trust constituting a grantor trust.[35]

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[30] I.R.C. § 678(b); *see also* Treas. Reg. § 1.678(b)-1.

[31] Michael A. Yuhas & Carl Radom, *The Grantor Trust Rules: Competing Powers and Ascertainable Standards*, 85 PRAC. TAX STRATEGIES 4, 8 (2010).

[32] *See* Priv. Ltr. Rul. 07-30-011 (July 27, 2007); Priv. Ltr. Rul. 06-03-040 (Jan. 20, 2006); Priv. Ltr. Rul. 93-09-023 (Mar. 5, 1993); Priv. Ltr. Rul. 91-41-027 (Oct. 11, 1991). *But see* RONALD D. AUCUTT, *Installment Sales to Grantor Trusts (Part 1)*, 2013 ALI-ABA EST. PLAN. COURSE MATERIALS J. 5, 8, *available at* http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ1306_Aucutt_thumb.pdf; Jeanne L. Newlon, *Developments Involving Grantor Trusts*, 2010 ALI-ABA EST. PLAN. COURSE MATERIALS J. 27, 35, *available at* http://www.venable.com/files/Publication/0f37c6db-cc39-43b5-ba43-77d1ebfc7895/Presentation/PublicationAttachment/4f223214-65ad-4c44-97ab-86f51d4731d7/Newlon--Grantor_Trusts.pdf. Under section 6110(k)(3), a private letter ruling may not be cited or used as precedent, but the rulings show how the Service might address a similar case. Judicial decisions have cited to these rulings. *See, e.g.*, Xerox Corp. v. United States, 656 F.2d 659, 660 n.3 (Cl. Ct. 1981) (stating that private letter rulings are useful in determining the scope of the doctrine adopted by the Service and demonstrating its continued and consistent application by the Service); Wolpaw v. Comm'r, 47 F.3d 787, 792–93 (6th Cir. 1995) (reversing the Tax Court's decision, see T.C. Memo 1993-322, and allowing the taxpayers to rely on a twenty-year-old private letter ruling); Estate of Blackford v. Comm'r, 77 T.C. 1246, 1252 n.12 (1982), *acq.*, 1983-2 C.B.1 (noting that the Service was adopting a position contrary to an earlier private letter ruling).

[33] *See* I.R.C. § 678; Mallinckrodt v. Nunan 2 T.C. 1128, 1136 (1943), *aff'd*, 146 F.2d 1, 5 (8th Cir. 1945).

[34] *See* sources cited *supra* note 33.

[35] *See* sources cited *supra* note 33.

## III. PRIVATE LETTER RULING 200949012

Private Letter Ruling 200949012 (Private Letter Ruling) identifies the basic structure used by many planners to draft intentionally-defective beneficiary trusts.[36] The settlor in the ruling established a trust with three trustees for the benefit of a single beneficiary.[37] These trustees were: (1) the beneficiary who also served as the investment trustee, (2) an independent trustee who held tax-sensitive powers, such as the right to make discretionary distributions to the beneficiary, and (3) a trust company that served as the administrative trustee.[38] The beneficiary, in his capacity as beneficiary, held two withdrawal rights: (1) the right to withdraw all of the contributions made to the trust, which lapsed in the amount of the greater of 5% of the value of the trust corpus or $5,000 annually; and (2) the non-lapsing ability to direct withdrawals from the trust for his health, education, maintenance, and support.[39] The beneficiary was also granted a limited testamentary power of appointment to address changes in circumstances and to prevent there from being a completed gift if the property sold to the trust was revalued.[40] In addition, the risks created by section 678(b) were mitigated by having the settlor disclaiming any grantor trust powers that may have been inadvertently retained, by providing that neither the grantor nor his spouse may serve as trustee, and by limiting the number of trustees that are related or subordinate parties to the grantor under section 672(c) to no more than half of the trustees.[41]

The beneficiary's right to withdraw the greater of $5,000 or 5% of the trust corpus constituted a section 678(a)(1) power over the entire trust corpus of $5,000 and[42] because the lapse was limited to the greater of

[36] *See* Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009).

[37] *See id.*

[38] *See id.*

[39] *See id.*

[40] *See id.*

[41] *See id.*

[42] The trust should only be funded with $5,000 when a five or five power is used to trigger section 678(a)(1) because one wants the beneficiary to have a general power of appointment over the entire trust corpus that lapses before the transfer to the trust so as to render the trust entirely income tax defective under section 678(a)(2). *See* Priv. Ltr. Rul. 90-34-004 (Aug. 24, 1990). If the trust is only partially income tax defective then gain will be realized in a future sale by the beneficiary to the trust to the extent of the part that is not deemed owned by the beneficiary. *See id.* If a trust is overfunded, then for each year until the five or five power is exercised, released, or allowed to lapse, the beneficiary is treated under section 678(a)(1) as the owner of that portion of the trust that is subject to the beneficiary's

$5,000 or 5% of the trust corpus, the lapse did not constitute a release which would be treated as a gratuitous transfer by the beneficiary to the trust for estate and gift tax purposes.[43] The distinction between a lapse and a release for estate and gift tax purposes[44] may make it appear that a lapse fails to satisfy the requirement under section 678(a)(2) that the beneficiary must release or otherwise modify a section 678(a)(1) power. However, section 678 is an income tax provision and private letter rulings have consistently treated a lapse of a power of withdrawal as a release for section 678(a)(2) purposes without requiring an affirmative act by the power holder.[45] The

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right of withdrawal. *See id.* When the power holder permits the power to lapse, the power holder will be deemed to have partially released the power as to the portion of the corpus that was subject to the power, and because the power holder retains a power that would result in the trust being a grantor trust if the power holder was the settlor, the power holder is treated under section 678(a)(2) as the owner of the portion of the corpus for which the power lapsed. *See id.*; Rev. Rul. 67-241, 1967-2 C.B. 225; Priv. Ltr. Rul. 00-22-035 (June 2, 2000); *see also* Alexander & Klemmer, *supra* note 6, at 342. The power holder is treated as the owner of the portion of the trust on which the power lapses, but is not treated as a grantor of the trust because he neither created the trust nor made a gratuitous transfer to it when the power lapsed. *See* Treas. Reg. § 1.671-2(e)(6) ex. 4.

[43] *See* I.R.C. §§ 2041(a)(2), -(b)(2), 2514(b), -(e); Treas. Reg. § 20.2041-3(d)(3).

[44] Both sections 2041(b)(2) and 2514(e) provide that, "[t]he lapse of a power . . . shall be considered a release of such power." I.R.C. §§ 2041(b)(2), 2514(e). Section 678 does not contain a similar provision treating a lapse as a release. *See* I.R.C. § 678.

[45] *See* Priv. Ltr. Rul. 85-21-060 (Feb. 26, 1985) (stating that a beneficiary's failure to make a withdrawal "will be treated as if he released the power to withdraw the amount under section 678(a)(2) of the Code."); *see also* Priv. Ltr. Rul. 10-39-010 (Oct. 1, 2010); Priv. Ltr. Rul. 10-38-005 (Sept. 24, 2010); Priv. Ltr. Rul. 10-38-004 (Sept. 24, 2010); Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009); Priv. Ltr. Rul. 07-47-002 (Nov. 23, 2007); Priv. Ltr. Rul. 01-04-005 (Jan. 26, 2001); Priv. Ltr. Rul. 93-11-021 (Dec. 18, 1992); Priv. Ltr. Rul. 88-09-043 (Dec. 4, 1987); Priv. Ltr. Rul. 87-07-001 (Sept. 30, 1986); Priv. Ltr. Rul. 86-13-054 (Dec. 31, 1985); Priv. Ltr. Rul. 81-42-061 (July 12, 1981). Other authorities have more literally interpreted "partially released or otherwise modified" and argued that the lapse of a power in one year has no effect on the taxation of the power holder in another year. The positions proffered by these individuals can be broken down into two arguments:

> (1) Section 678(a)(2) does not apply to the lapse of any power of withdrawal, but rather requires an affirmative act of the power holder.

*See, e.g.*, Sherwin P. Simmons, *Drafting the* Crummey *Power*, *in* 15 INST. ON EST. PLAN. 17–1, ¶¶ 1701, 1713.4 (Philip E. Heckerling ed., 1981); Kent A. Mason, *An Analysis of Crummey and the Annual Exclusion*, 65 MARQ. L. REV. 573, 587 (1982).

> (2) Section 678(a)(2) does not apply to the lapse of a noncumulative, amount limited power, such as a five and five power.

*See, e.g.*, JOHN L. PESCHEL & EDWARD D. SPURGEON, FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES ¶ 9.04[2] (3d ed. Supp. 2012). The Service has recently added beneficiary-defective irrevocable trusts to its no ruling list. *See* Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

holdings in these private letter rulings that a lapse constitutes a release are supported by *Mallinckrodt v. Nunan*, which provided that "it does not matter whether the permission [to transfer funds] is given by assent or by failure to express dissent."[46] Also, no express requirement exists in the *Mallinckrodt* regulations—which preceded section 678—that there be an express release by the power holder as opposed to a lapse.[47] Commentators have used two theories to explain why the Service has consistently treated lapses as releases for section 678(a)(2) purposes. The first theory is that if the power holder does not have an additional withdrawal right that can be used in a subsequent year, then the lapse otherwise modifies the beneficiary's interest in the property provided the beneficiary thereafter has other interests in the trust corpus that would have subjected a grantor to income taxes on the income earned by the trust.[48] The second theory is that a lapse is a partial release of the power if one considers the power as a whole over the entire term of the trust and the beneficiary retains other rights under the trust, such as the right to distributions for his health, education, maintenance, and support.[49]

Section 678(a)(2) requires that the beneficiary hold a grantor trust power after the five or five power lapses. To prevent the beneficiary from being treated as having a general power of appointment, which would cause gross estate inclusion, the beneficiary in the Private Letter Ruling was granted the power to withdraw income and principal for his health, education, maintenance, and support.[50] Prior to the Private Letter Ruling, the common belief was that while a settlor's retention of the ability to appoint the trust corpus for his or her health, education, maintenance, or support constitutes a section 677 power, a power held by one other than the settlor that was limited by an ascertainable standard would not satisfy

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[46] Mallinckrodt v. Nunan, 2 T.C. 1128, 1136 (1943), *aff'd*, 146 F.2d 1, 4 (8th Cir. 1945) (quoting Corliss v. Bowers, 281 U.S. 376, 378 (1930)).

[47] *See id.* at 1136.

[48] *See* Priv. Ltr. Rul. 00-22-035 (June 2, 2000); Jonathan G. Blattmachr & Frederick M. Sembler, *Crummey Powers and Income Taxation*, 1995 CHASE REV. 1, at 6; *see also* David Westfall, *Lapsed Powers of Withdrawal and the Income Tax*, 39 TAX L. REV. 63, 69 (1983).

[49] *See, e.g.*, Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009); Priv. Ltr. Rul. 07-47-002 (Nov. 23, 2009); Priv. Ltr. Rul. 01-04-005 (Jan. 26, 2001); Priv. Ltr. Rul. 01-47-044 (Nov. 23, 2001); Blattmachr, Gans & Lo, *supra* note 20, at 116; Blattmachr & Sembler, *supra* note 48, at 6; *PLR 200949012 – Beneficiary Defective Trust(sm) Private Letter Ruling*, STEVE LEIMBERG'S EST. PLAN. EMAIL NEWSL. - ARCHIVE MESSAGE NO. 1559 (Leimberg Services, Havertown, Pa.), Dec. 10, 2009.

[50] *See* Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009).

section 678(a)(2).[51] This belief severely hampered the use of IDBTs as estate planning vehicles because section 2041 would draw the property subject to the power into the beneficiary's gross estate if the beneficiary was required to hold a power that was not limited by an ascertainable standard.[52] The Private Letter Ruling, however, held that the beneficiary's retention of the power to appoint the corpus to himself for his health, education, maintenance and support constituted a section 677 power and satisfied the requirement in section 678(a)(2) that the beneficiary retain a grantor trust power after his ability to appoint the trust corpus to himself lapsed.[53]

The trust in the Private Letter Ruling was settled in Alaska, which permits self-settled spendthrift trusts.[54] The choice of domicile in a state permitting self-settled spendthrift trusts was important because while a power to consume, invade, or appropriate income and corpus held by a power holder

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[51] *See* Blattmachr, Gans & Lo, *supra* note 20, at 108; Yuhas & Radom, *supra* note 31, at 12–14.

[52] *See* Blattmachr, Gans & Lo, *supra* note 20, at 110–13 ("one cannot draft an instrument that would produce estate tax exclusion, while triggering Section 678 . . . .") It appears the Blattmachr article may have been in the stages of being printed before the Private Letter Ruling was issued on December 4, 2009.

[53] *See* Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009); *see also* Priv. Ltr. Rul. 10-38-001 (Sept. 24, 2010); RIA, ESTATE PLANNING COLLECTION: PLANNING WITH INTENTIONALLY DEFECTIVE TRUSTS § 33,313 (2013); *PLR 200949012 – Beneficiary Defective Trust(sm) Private Letter Ruling*, *supra* note 49. In circumstances where enhanced creditor protection is required it may be desirable to avoid granting the beneficiary the right to distributions based on an ascertainable standard and instead grant the beneficiary an alternate grantor trust power because the greatest creditor protection exists if an independent trustee has absolute discretion on whether to make distributions. *See* Oshins, *supra* note 6; *see also* Priv. Ltr. Rul. 12-16-034 (Apr. 20, 2012) (using a substitution power to obtain beneficiary grantor status); Frederick R. Keydel, *Trustee Selection, Succession, and Removal: Ways to Blend Expertise with Family Control*, *in* 23 HECKERLING INST. ON EST. PLAN. 4–1, § 409.1 (John T. Gaubatz ed., 1989).

[54] The general rule is that the situs of the trust controls the extent to which creditors can attach trust interests, but a state may ignore the Full Faith and Credit Clause and the laws of a sister state if it finds the laws of the sister state are against its public policy. *See In re* Huber v. Huber, 493 B.R. 798, 808 (Bankr. W.D. Wash. 2013) (holding that the laws of the transferor's domicile, rather than the laws of a state permitting self-settled spendthrift trusts, applied when a trust was established by an insolvent transferor with actual intent to hinder, delay, or defraud the transferor's creditors). Even if a creditor is successful in having the laws of the sister state permitting self-settled spendthrift trusts be ignored, the value of the judgment against the trustee would be questionable because to collect on the judgment the creditor would have to enforce the judgment in the courts of the state in which the trustee is domiciled, which is the state permitting self-settled spendthrift trusts. IDBTs are typically settled in Alaska and the private letter rulings on the subject often involve the application of that state's laws because of the varying levels of protection afforded by state self-settled spendthrift trust statutes.

is not a general power of appointment if the power is limited by an ascertainable standard relating to the power-holder's health, education, maintenance, or support, the property that is subject to the power will still be included in the beneficiary's gross estate if the beneficiary's creditors can reach it.[55] Commentators have stated that it may be unnecessary for the trust to be settled in a state permitting self-settled spendthrift trusts because the beneficiary does not make any gratuitous transfers to the trust, but two risks are avoided by using a state such as Alaska. First, uncertainty exists as to whether a state court will respect a sale of property by a beneficiary to a trust for his or her benefit at a substantial discount even if the discount is respected for estate and gift tax purposes, or if the state court will treat the discount as a transfer by the beneficiary to the trust. The latter characterization would create a risk that the trust would be treated as a self-settled spendthrift trust, thereby causing inclusion under section 2041.[56] Second, a state court may treat the beneficiary who permitted the five or five power to lapse as the settlor of the trust under state law, thus rendering the entire trust a self-settled spendthrift trust that is subject to the claims of the beneficiary's creditors. This characterization also would cause inclusion under section 2041.[57]

The trust in the Private Letter Ruling avoided triggering section 678(b), which would have caused the settlor to be taxed as its owner, by having the settlor disclaim any grantor trust powers that he may have inadvertently retained. Also, the trust provided that neither the grantor nor his wife could serve as trustee and that no more than one-half of the trustees could be related or subordinate parties to the settlor under section 672(c).[58] While an IDBT should contain a savings clause, one drafting a beneficiary-defective trust must avoid blind reliance on such a clause and remain cognizant of (1) who is the grantor, (2) who is a related and subordinate party to the grantor, and

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[55] *See* I.R.C. §§ 2041(b)(1), 2514(c)(1); Treas. Reg. § 25.2514-1(c).

[56] *See, e.g.*, CONN. GEN. STAT. § 52-552e(a), -f(a) (2012); NY DEBT. & CRED. LAW § 272 (McKinney 2013); *see also* UNIFORM FRAUDULENT TRANSFERS ACT § 4(a)(1) (1984).

[57] *See* Priv. Ltr. Rul. 09-44-002 (Oct. 30, 2009) (regarding ALASKA STAT. § 34.40.110 (2012)); PETER SPERO, ASSET PROTECTION: LEGAL PLANNING, STRATEGIES AND FORMS ¶ 6.08[5] (1993). *But see* Univ. Nat'l Bank v. Rhoadarmer, 827 P.2d 561, 562 (Colo. App. 1991) (providing that the lapsing of a Crummey power is not a property right subject to the claims of creditors because "a power of appointment is neither property nor a property right. Rather it is a mere right or power, a personal privilege or authority."). Under Alaska law a lapse of a withdrawal right does not result in the beneficiary holding the power being treated as a settlor of the Trust. *See* ALASKA STAT. § 34.40.115 (2012).

[58] *See* Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009).

(3) what powers are in the document that could trigger grantor trust treatment if they were held by a grantor or a related or subordinate party.[59]

The Treasury Regulations define a grantor as "any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer . . . of property [including cash] to a trust."[60] A gratuitous transfer is "any transfer to a trust for less than fair market value."[61] A transfer of property to a trust "can be considered a gratuitous transfer without regard to whether it is treated as a gift for gift tax purposes."[62] If one person creates or funds a trust on behalf of another person, both individuals are grantors.[63] A person who creates a trust but makes no gratuitous transfers to it, or makes a transfer that is reimbursed within a reasonable time, cannot qualify as a grantor.[64] The beneficiary's payment of the tax on the trust's income does not constitute a gift by the beneficiary to the trust which otherwise could render the beneficiary a grantor.[65]

Interests and powers held by the grantor's spouse are treated as being held by the grantor for grantor trust purposes, even though they would not be treated as being held by the grantor for section 2036 purposes.[66] This rule applies if the grantor was married to the spouse at the time the power or interest was created and is not affected by a subsequent divorce. If the grantor and spouse are legally separated under a decree of divorce or separate maintenance at the time the power or interest[67] is created, they are not considered married for purposes of the section.[68]

Certain powers held by a related or subordinate party may result in the Code deeming the trust as a grantor trust.[69] A related or subordinate party is any nonadverse party who is (1) the grantor's spouse, (2) the grantor's father, mother, issue, brother, or sister, (3) an employee of the grantor, (4) a

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[59] Logically if a trust satisfies section 678(a), but is deemed to be owned by a grantor by operation of section 678(b), the trust would be owned by the beneficiary for income tax purposes upon termination of the grantor trust power. However, that result may not be the case. *See, e.g.*, Priv. Ltr. Rul. 93-21-050 (May 28, 1993).

[60] Treas. Reg. § 1.671-2(e)(1).

[61] *Id.* § 1.671-2(e)(2)(i).

[62] *Id.*

[63] *See* Treas. Reg. § 1.671-2(e)(1).

[64] *See id.*

[65] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[66] *See* I.R.C. § 672(e); Treas. Reg. § 20.2036-1(b)(3).

[67] *See* I.R.C. § 672(e)(1)(A).

[68] *See id.* § 672(e)(2).

[69] *See id.* § 674(a), -(c).

corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or (5) a subordinate employee of a corporation in which the grantor is an executive.[70] A power retained by the grantor to remove an independent trustee and appoint another independent trustee will not prevent the trust from avoiding the exceptions to section 674 contained in sections 674(c) and (d).[71] An adverse party is

> Any person having a substantial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. A person having a general power of appointment over the property shall be deemed to have a beneficial interest in the trust.[72]

A draftsman must remain cognizant of the grantor trust powers contained in sections 673 through 677 and section 679—these powers are further enumerated in Treasury Regulation section 1.671-1.[73] These powers include:

> (1) The grantor retaining more than a 5% reversionary interest in the trust.[74]
>
> (2) The retention by the grantor or a non-adverse party of certain powers over the beneficial interests of the trust.[75]
>
> (3) The retention of administrative powers over the trust under which the grantor can or does benefit,[76] including the power to deal with the trust assets for less than full and adequate consideration,[77] the power to borrow trust assets without adequate security,[78] actual borrowing of the trust assets during the tax year without adequate interest or security and repayment during the

[70] *See id.* § 674(c); *see also* Treas. Reg. §§ 1.674(a)-(1)(b)(3), 1.674(c)-1.
[71] *See* Treas. Reg. § 1.674(d)-2.
[72] I.R.C. § 672(a).
[73] *See id.* §§ 673–677, 679; Treas. Reg. § 1.671-1.
[74] *See* I.R.C. § 673.
[75] *See id.* § 674.
[76] *See id.* § 675.
[77] *See id.* § 675(1).
[78] *See id.* § 675(2).

tax year,[79] and certain administrative powers exercisable in a non-fiduciary capacity such as the ability to substitute trust assets for assets of equal value.[80]

(4) The grantor or a non-adverse party having a power to revoke the trust or return the corpus to the grantor without the consent of an adverse party.[81]

(5) The grantor or a non-adverse party having the power to distribute income to or for the benefit of the grantor or the grantor's spouse, including the use of the income to purchase insurance on the lives of the grantor or the grantor's spouse.[82]

The ability to allocate income and principal pursuant to a nonascertainable standard is a grantor trust power that often emerges when drafting an IDBT because the distribution trustee is usually granted absolute discretion in making distributions to the beneficiary. Section 674(a) states that the grantor owns any portion of a trust as to which a nonadverse party holds a power to alter beneficial enjoyment, other than a power specifically permitted under section 674(b).[83] Therefore, the Code would treat the grantor as the owner of any trust fund as to which a nonadverse related or subordinate trustee (such as a close family member) held a power to distribute income and principal among a class of beneficiaries, if the power was not subject to a reasonably definite standard set forth in the trust instrument and if the distributions were not chargeable against the interest of each beneficiary under section 674(b)(5).

## IV. STRUCTURING A SALE TO AN IDBT

Upon the establishment of the IDBT, the beneficiary who is the owner of the trust for income tax purposes transfers highly appreciating or discountable property to the trust in exchange for a note representing the fair market value of the transferred property. The exchange avoids the imposition of the gift tax on the transfer by constituting a sale for estate and gift tax purposes. However, the estate and gift tax code is not in pari materia with the income tax code and the exchange does not constitute a sale for income tax

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[79] *See id.* § 675(3).

[80] *See id.* § 675(4).

[81] *See id.* § 676.

[82] *See id.* § 677.

[83] *See id.* § 674(a).

purposes[84] because for income tax purposes the beneficiary is deemed to own the assets both before and after the transfer.[85] The beneficiary's ownership of the trust results in the beneficiary not merely failing to recognize gain, but also in the trust receiving a transferred basis in the assets. Additionally, the debt is considered to run both to and from the beneficiary for income tax purposes, which results in the trust neither deducting nor the beneficiary reporting the interest paid on the note.[86]

In order to avoid being subject to gift tax or section 2036 gross estate inclusion, the transfer must be structured as a sale for full and adequate consideration. There is a sale for full and adequate consideration when the note used in the transfer constitutes a bona fide debt instrument and has a value equal to the value of the transferred property.[87] For the note to have a value equal to its face amount, the note should bear interest at the applicable federal rate under section 1274.[88] As an additional safeguard against triggering gift tax, the beneficiary is often granted a limited testamentary power of appointment, which prevents the transfer from constituting a completed gift if it is subsequently determined that the sale was for less than fair market value.[89] Some commentators posit that fully disclosing the sale on a

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[84] "A transfer may be complete for gift tax purposes, while at the same time the income from the transferred property may be taxable to the donor." Talge v. United States, 229 F. Supp. 836, 842 (W.D. Mo. 1964) (citing Galt v. Comm'r, 26 F.2d 41, 51 (7th Cir. 1954)). The President's 2014 budget includes many proposals for generating additional tax revenue, one of which would be to coordinate the income and transfer tax rules regarding future sales to grantor trusts. *See generally* DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS (2013), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

[85] *See* Rev. Rul. 85-13, 1985-1 C.B. 184. *But see* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984). Revenue Ruling 85-13 provides that the Service is not going to follow the *Rothstein* decision.

[86] *See* Rev. Rul. 85-13, 1985-1 C.B. 184; Priv. Ltr. Rul. 95-35-026 (May 31, 1995).

[87] A defined value clause is sometimes included in the sale documents when the value of the assets being sold to the trust are particularly hard to determine. *See, e.g.*, Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (2012).

[88] *See* I.R.C. §§ 1274, 7872; Frazee v. Comm'r, 98 T.C. 554 (1992); Priv. Ltr. Rul. 95-35-026 (May 31, 1995).

[89] Treas. Reg. § 25.2511-2(b); Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009). *But see* Chief Couns. Mem. 12-08-026 (Dec. 24, 2012) (holding that the transferor's retention of a limited testamentary power of appointment only renders the gift of a remainder interest incomplete if a beneficiary, as trustee, has absolute discretion to distribute the trust corpus to the beneficiary, the beneficiary's issue, or the beneficiary's spouse). *See also* DEL. CODE ANN. 12, § 3570(11)b.2 (Supp. 2013) (providing that the retention by a transferor of a limited testamentary power of appointment will not prevent the trust from constituting a Delaware asset protection trust).

timely filed Form 709, United States Gift Tax Return, may be prudent so that the statute of limitations will begin to run on the transfer.[90]

A bona fide debt instrument may take many forms, including a note with level payments of principal and interest over a stated term, a note with interest only for a term and a balloon payment of principal at the end of the term, or a self-cancelling installment note. Regardless of its form, however, the note must represent a genuine indebtedness.[91] If the note fails to constitute a bona fide debt instrument, then the transaction will be recharacterized for transfer tax purposes as a gift with a retained interest, subjecting the sale to possible gift taxation as a failed GRAT and causing the assets to be included in the beneficiary's gross estate.[92]

The decisions of the courts examining whether a note is a bona fide debt instrument have analyzed a number of factors. In structuring the sale, care should be taken to comply with these factors in order to support the position that the note constitutes a bona fide debt instrument. These factors are:

> (1) There should be a legally binding promissory note or other evidence of indebtedness;[93]
>
> (2) Interest set at a minimum of the section 1274 Applicable Federal Rate must actually be charged, and if a balloon note is used, interest should be paid at least annually;[94]
>
> (3) The interest rate should not vary based on the trust's income;[95]
>
> (4) There must be a fixed schedule for repayment that is complied with;[96]

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[90] *See* Richard A. Oshins et al., *The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented*, EST. PLAN. NEWSL. (Nat'l Ass'n of Est. Planners & Councils, Cleveland, Ohio) June 22, 2011, *available at* www.naepc.org/journal/issue09d.pdf; *see also* Treas. Reg. § 25.2511-2(b) (discussing completed gifts). *But see* Chief Couns. Mem. 12-08-026 (Feb. 24, 2012); Bramwell, *supra* note 6.

[91] *See* Zimmerman v. United States, 318 F.2d 611, 612 (9th Cir. 1963).

[92] *See* I.R.C. §§ 2036(a), 2702(a)(1).

[93] *See Zimmerman*, 318 F.2d at 613; Rude v. Comm'r, 48 T.C. 165, 173 (1967); Estate of Bergan v. Comm'r, 1 T.C. 543, 554 (1942).

[94] *See Zimmerman*, 318 F.2d at 613; Estate of Maxwell v. Comm'r, 98 T.C. 594, 604 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993).

[95] *See* Clark v. Comm'r, 18 T.C. 780, 783 (1952), *aff'd per curium*, 205 F.2d 353 (2d Cir. 1953).

[96] *See Zimmerman*, 318 F.2d at 613; *Estate of Maxwell*, 98 T.C. at 604; *Rude*, 48 T.C. at 173; *Clark*, 18 T.C. at 783.

> (5) The trust's and the beneficiary's records, if any, must reflect the transaction as a loan;[97]
>
> (6) The borrower must be solvent at the time of the loan;[98]
>
> (7) The note should be secured or collateralized;[99] and
>
> (8) The obligation under the note should be charged against the entire trust fund rather than just the transferred property.[100]

The requirement that the trust either collateralize or secure the loan, which is often done in the form of seed money the grantor transfers to the trust or a personal guarantee, is an essential element because one typically would not lend money in a bona fide transaction to a debtor who has no other assets. In the absence of collateral or a security interest, the transfer resembles a gift with a reserved income interest in the form of the loan amortization payments rather than a sale.[101] As a leading authority stated, the risks created by "thin capitalization" are:

> [1] includability in the transferor's gross estate under section 2036;
>
> [2] a gift upon the cessation of section 2036 exposure [caused by the transfer being re-characterized as simply a transfer of the asset with a retained interest, rather than a bona fide sale];
>
> [3] applicability of section 2702 to such a gift;
>
> [4] the creation of a second class of equity in the underlying property with possible consequences under section 2701;
>
> [5] possible loss of eligibility of the trust to be a shareholder of an S corporation;
>
> [6] continued estate tax exposure under section 2035 for three years after cessation of section 2036 exposure;

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[97] *See* Estate of Kelley v. Comm'r, 63 T.C. 321, 323–24 (1974).

[98] *See* Hirsh v. United States, 35 F.2d 982, 985 (Ct. Cl. 1929).

[99] *See Estate of Kelley*, 63 T.C. at 323–24.

[100] *See Clark*, 18 T.C. at 783.

[101] A note is not an interest in a trust, so section 2701 should not apply and make the sale to the trust a transfer with a retained interest unless the trust is thinly capitalized. *See* Priv. Ltr. Rul. 95-35-026 (May 31, 1995); Spero, *supra* note 57, ¶ 5.07[4][b].

> and inability to allocate the GST exemption during the ensuing ETIP.[102]

If the grantor uses seed money, there is no case or ruling that declares a specific amount of seed money to be sufficient. However, the trust should have sufficient assets to justify the making of the loan, taking into account all relevant facts and circumstances. Some level of guidance is provided by the rule of thumb of many commentators that the trust should be seeded with assets that have a value equal to at least 10% of the amount of the note.[103] This figure is primarily based on commentator analysis, but it also reflects a concession demanded by the Service for the issuance of Private Letter Ruling 9535026.[104] In that instance the Service reportedly demanded that the parties agree to commit at least 10% of the purchase price to trust equity.[105]

The use of seed money raises four concerns. First, the seed money transferred to the trust by the settlor is subject to gift tax. Second, the trust may be only a partially income tax defective trust if the amount of the seed money exceeds the beneficiary's withdrawal right. Third, the Service may seek to apply the step transaction doctrine if seed money is transferred to the trust and the sale is consummated shortly thereafter.[106] Fourth, in a

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[102] RONALD AUCUTT, GRANTOR RETAINED ANNUITY TRUSTS (GRATS) AND SALES TO GRANTOR TRUSTS 75 (2011), www.mcguirewoods.com/news-resources/publications/taxation /grats.pdf. However, "[t]he section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain." *Id.*

[103] *See* Estate of Petter v. Comm'r, 98 T.C.M. (CCH) 534 (2009), *aff'd*, 653 F.3d 1012 (2011).

[104] *See The Beneficiary Defective Inventor's Trust: Is It Really Defective?*, STEVE LEIMBERG'S EST. PLAN. EMAIL NEWSL. - ARCHIVE MESSAGE NO. 1730 (Leimberg Services, Havertown, Pa.), Dec. 14, 2010.

[105] *See id.*; *see also* Byrle M. Abbin, *[S]He Loves Me, [S]He Loves Me Not—Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selecting from the Cafeteria of Techniques*, *in* 31 HECKERLING INST. ON EST. PLAN. 13–1, ¶ 1300.1 (Tina Portuondo ed., 1997).

[106] The step transaction doctrine is a common law doctrine that is sometimes used by the Service to deny a taxpayer the benefits of a particular transaction involving several interrelated steps that if viewed independently do not create any tax issues. *See* Linton v. United States, 638 F. Supp. 2d 1277, 1288 (W.D. Wash. 2009). Once the step transaction doctrine is applied, the Service will collapse the interrelated steps into a single transaction. *See* Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987). There are three tests that are applied by the Service in determining if the step transaction doctrine should apply. *See Linton*, 638 F. Supp. at 1288. The tests are: (1) The binding commitment test, which collapses a series of transactions into one if at the time the first step was entered into a binding commitment existed to enter into the later steps. *See Penrod*, 88 T.C. at 1429; (2) The end result test, which asks, if

typical sale to an IDBT, the beneficiary transfers highly appreciating assets to the trust. Nonetheless, if the assets appreciate at a rate lower than the interest rate called for under the promissory note, then the payments to the note holder (the beneficiary) could exhaust the trust corpus.[107] If the trust was initially funded with seed money, this exhaustion would be especially painful because a gift tax was paid on the seed money and the money on which the gift tax was paid will then be included in the beneficiary's estate as payments on the note.[108]

To avoid the four issues created by the use of seed money, planners often fund the trust with gifts and inheritances that the beneficiary would otherwise receive and cause the trust to reinvest the seed money in

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a "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result." *Id*.; and (3) The mutual interdependence test, which examines "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series [of transactions]." Cal-Maine Foods v. Comm'r, 93 T.C. 181, 199 (1989). Commentators have stated that the step transaction doctrine should not apply since the seed money comes from a third party. *See* Richard A. Oshins & Noel C. Ice, *The Inheritor's Trust: The Art of Properly Inheriting Property*, 30 EST. PLAN. 419, 424 (2003). Providing sufficient time (that is, 30 days from funding to lapse of withdrawal right) and investing the funds in marketable securities can also reduce the risk of the doctrine's application. *See* Oshins, *supra* note 90.

> If the Service successfully argues that the "seed" gift and the sale were part of a step transaction, the seller will have transferred $10 million to the trust and received only the $9 million note back. That would cause the transaction to fail section 2036 and if the note was outstanding at death, there would be estate tax inclusion, including appreciation. Because the [private annuity sale] transaction is designed so that the annuity is paid until death, if the Service were to prevail on the step transaction argument, there could be estate tax inclusion. In most instances, the amount included would also be valued as part of a control block, and the discount would be includable. The same result would occur if the [beneficiary grantor trust] lease was a "favorable" lease. The gift portion would expose the BGT to [section] 2036 inclusion. This result does not occur with the note sale to the [beneficiary-defective inheritor's trust] since the third party would have transferred the "seed" money. Since the estate owner never transferred the "seed" money, the step transaction does not apply to aggregate the two transfers.

Oshins, *supra* note 90.

[107] The best use of an IDBT is where the beneficiary has a new business opportunity that has a low value and the beneficiary seeks to insulate this business from claims of his or her creditors and remove future appreciation from his or her estate.

[108] The result would still be better than with a sale to an intentionally-defective grantor trust in which the payments would end up back in the grantor's gross estate.

marketable securities before the transfer to the trust occurs.[109] When it is not possible to adequately seed the trust, planners often have someone of sufficient means personally guarantee the note or a portion thereof.[110] While many practitioners consider a personal guarantee as an option when seeding the trust is not viable, a personal guarantee may in fact add greater substance to the transaction than the use of seed money alone for two reasons. First, the beneficiary's right to withdraw the trust corpus reduces the security that would otherwise be provided by a lower debt to equity ratio. Second, the corpus of an IDBT typically is not diversified, and a risk exists that the trust corpus may experience a significant decline in value. A guarantor's assets, on the other hand, typically are diversified.

If a guaranty is used, care must be exercised to ensure that the guaranty is not treated as a gratuitous transfer to the trust because for the purposes of the income taxation of estates, trusts, and beneficiaries, a grantor includes any person to the extent the person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to the trust.[111] A guaranty, therefore, could trigger the Crummey right under the trust and make the guarantor a grantor of the trust for income tax purposes, thus possibly causing the beneficiary to recognize gain on part of the sale because the trust would only be partially taxable to the beneficiary for income tax purposes.[112] While a persuasive argument exists that guaranteeing a debt does not result in a gift from the guarantor to the debtor, to prevent the guarantee from being characterized as a gratuitous transfer a guarantee fee is often paid from the trust to the guarantor.[113] A guarantee fee of 1–2% of

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[109] *See, e.g.*, Beau C.T. Barrett, *Grantor Trusts in South Dakota: Preserving a Planning Tool to Maintain the State's Trust Friendly Status*, 58 S.D. L. REV. 89, 110 (2013).

[110] *See* Priv. Ltr. Rul. 95-15-039 (Apr. 14, 1995); *see also* Christopher P. Cline, *Installment Sale to Grantor Trusts*, *in* 838-1st ESTATES, GIFTS AND TRUST PORTFOLIOS: TRUSTS, 838 n.257 (2008); Milford B. Hatcher & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (2000); Aucutt, *supra* note 102, at 7.

[111] *See* Treas. Reg. § 1.671-2(e)(1); *see also* Dickman v. Comm'r, 465 U.S. 330, 333–35 (1984); Priv. Ltr. Rul. 91-13-009 (Mar. 29, 1991). *But see* Priv. Ltr. Rul. 94-09-018 (Mar. 4, 1994), *withdrawing*, Priv. Ltr. Rul. 91-13-009; Steven B. Gorin, *Planning For Baby Boomers: Leveraging Increased Federal Gift Tax Exemptions for Gifts and Sales of Closely Held Business Interests in 2011*, *in* ABA SECTION OF TAXATION & TRUST & ESTATE DIV. OF REAL PROP. TRUSTS & ESTATE LAW 2011 JOINT FALL CLE MEETING (2011), *available at* http://www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-nemzin-gifting-paper.authcheckdam.pdf.

[112] *See* Crummey v. Comm'r, 397 F.2d 82, 88 (9th Cir. 1968); Treas. Reg. §§ 1.671-3(a)(3), 1.672-2(e)(1).

[113] *See* Hatcher & Manigault, *supra* note 110, at 152. The Service has indicated that the giving of a guarantee confers a valuable financial benefit, and absent consideration, constitutes

the amount of the outstanding balance of the note may be considered reasonable,[114] but some commentators have argued that while 1–2% may represent a standard guaranty fee for a letter of credit, the relationship is significantly different for a guaranty in an IDBT sale situation because no assets are being put up for security and it may be advisable to have an appraiser provide an opinion as to a reasonable fee.[115]

A. The Form of the Note Used

The note used in the sale to the trust often takes the form of a self-cancelling installment note (SCIN) because (1) the value of the note is included in the beneficiary's gross estate if the beneficiary dies during its term and a SCIN has no value at the time of a creditor's death, and (2) uncertainty exists regarding the income tax effect of a beneficiary dying during the term of the note at which time the trust converts to a complex trust.[116]

*1. Inclusion of Note Value in the Beneficiary's Gross Estate*

The fair market value on the date of death of an unpaid installment obligation is included in the gross estate of a creditor who dies before the debt is fully satisfied. There is no inclusion in a decedent's gross estate, however, if the note contained a bona fide negotiated cancellation provision under which the debt automatically terminates on the creditor's death.[117] Such self-cancelling installment notes (SCINs) can be especially valuable in removing assets from a transferor's gross estate when the transferor is not expected to survive his actuarial life expectancy,[118] but because a premium must be paid for the cancellation feature, if the seller out lives his or her

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a gift. *See also* Priv. Ltr. Rul. 91-13-009 (Mar. 29, 1991). In 1993 the Service issued Private Letter Ruling 9409018 which withdrew Private Letter Ruling 9113009 and the decision of Bradford v. Comm'r, 34 T.C. 1059, 1063 (1960) (holding that the issuing of a guarantee does not constitute a gift may control despite being issued under the prior version of the Tax Code.).

[114] *See* Cline, *supra* note 110, at 838 n.257.

[115] *See* Hatcher & Manigault, *supra* note 110, at 153. Attorneys should ensure that the guarantor does not believe they are being represented by the attorney who is also representing the beneficiary. It may be prudent to advise the guarantor to obtain separate counsel in negotiating the terms of the guaranty and the guaranty fee.

[116] *See* Burton W. Kanter & Michael J. Legamaro, *The Grantor Trust: Handmaiden to the IRS and Servant to the Taxpayer*, 75 TAXES 706, 756 (1997).

[117] *See* Estate of Moss v. Comm'r, 74 T.C. 1239, 1247 (1980).

[118] *See* Gen. Couns. Mem. 39, 503 (May 7, 1986). One cannot use a SCIN that has a term exceeding the seller's life expectancy because the note will be treated as a private annuity.

actuarial life expectancy, the additional payments will increase the seller's gross estate.[119]

Treasury guidance has not been forthcoming regarding how to determine the premium that must be paid for the cancellation feature. In the absence of such guidance, the use of sound actuarial principles in setting the premium is important because the transactions in which SCINs are used often involve intra-family transfers, to which a court will apply close scrutiny. In determining the premium that must be paid for the cancellation provision

> the accepted practice is to determine the present value of each payment, taking into account the interest rate charged and the probability that the seller will be alive on the date of payment. Thus, a larger premium is required for a sale by an older seller [because of the increased risk that the seller will predecease the payments]. Similarly, a note that requires larger payments at the end of the note [such as a balloon note,] will have a higher premium than [a note with equal payments during its term].[120]

A nine-year installment note is used in most installment sales to capture the favorable midterm AFR rates,[121] but the notes typically provide that principal can be paid early without penalty and to avoid the possibility of gain recognition at the time of the beneficiary's death, the transaction is usually structured so that the note can be paid as quickly as possible.[122]

### 2. *Conversion to Complex Trust on Beneficiary's Death*

The second motivation for the use of a SCIN is the uncertainty surrounding the tax effect of the beneficiary dying while the note is outstanding, at which time beneficiary-defective trust status terminates and the trust becomes a complex trust. A general consensus exists among commentators that upon the beneficiary's death, when the beneficiary

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[119] *See Estate of Moss*, 74 T.C. at 1247.

[120] HOWARD M. ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶ 12.04[3][a][i] (2013).

[121] The interest rates for a conventional note for a term of not more than three years would be the short term Applicable Federal Rate (AFR); for a term of more than three years, but not more than nine years, the midterm AFR; and for a term of more than nine years, the long term AFR.

[122] The term of the note should not exceed 15 to 20 years because of the risk that the note could be treated as a second class of equity interest in an S corporation. A shorter term may be necessary to ensure that the term does not exceed the beneficiary's actuarial life expectancy.

ceases to be the owner of the trust for income tax purposes, assets and liabilities are transferred from the trust owner to the trust for income tax purposes.[123] Beyond this initial consensus, substantial debate emerges regarding the type and timing of the transfer, which affects (1) whether gain is recognized to the extent that the balance of the note exceeds the beneficiary's basis in the assets sold to the trust, (2) whether any recognized gain constitutes income in respect of a decedent, and (3) the trust's basis in its assets.[124]

*a. Income Tax Treatment*

No case, regulation, or ruling directly addresses the termination of grantor trust status that occurs on the death of the settlor or beneficiary who owns a trust for income tax purposes, but the case law, regulations, and rulings that do exist indicate that the termination of grantor trust status on the owner's death results in a deemed transfer of the assets from the owner to the trust, for income tax purposes. Nonetheless, even if a balance remains on the note, this deemed transfer should not constitute a recognition event.

In *Crane v. Commissioner*[125] the legatee inherited an asset that was encumbered by a liability equal to the asset's fair market value.[126] Given this liability the Supreme Court could have treated the transfer as a sale for the property's value and given the legatee a cost basis in the property, but the Supreme Court did not. Instead, the Supreme Court treated the property as a devise and gave the legatee a basis in the property equal to its estate tax

[123] *See* Treas. Reg. § 1.1001-2(c) ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222 (stating that when the grantor and owner of a trust holding a partnership interest subject to liabilities renounces all grantor trust powers over that trust during life, the grantor is treated as having transferred the interest to the trust and will recognize gain or loss as if it was transferred to a third party); *see also* Madorin v. Comm'r, 84 T.C. 667, 673 (1985).

[124] The discussion regarding the income tax effects of the termination of grantor trust status and the conversion of the trust to a complex trust on the beneficiary's death is primarily derived from case law, rulings, and commentary regarding trusts that are owned by the trust's settlor for income tax purposes due to a dearth of information regarding the termination of grantor trust treatment on a beneficiary's death. Sections 671 and 678(a) provide that when a beneficiary is treated as owning the trust for income tax purposes, the income, deductions, and credits of the trust shall be treated in the same manner as if the trust was owned by the settlor for income tax purposes and an analysis regarding the termination of the ownership of trusts that are owned by a settlor for income tax purposes is appropriate for analyzing the termination of ownership by a beneficiary of a beneficiary-defective trust. *See* I.R.C. §§ 671, 678(a).

[125] 331 U.S. 1 (1947).

[126] *See id.* at 1.

value.[127] By giving the legatee a basis in the property equal to its estate tax value, the Supreme Court tacitly rejected the position that when a person dies holding an encumbered asset there is a sale or exchange by the decedent which would cause the decedent or his estate to recognize gain to the extent the liability exceeds the decedent's adjusted basis[128] and result in the legatee receiving a purchase price basis in the inherited asset.[129] Recently, when the House of Representatives Conference Committee was discussing section 1022 of the Code, involving the transferred basis rules under section 1022 for 2010 decedents, the Conference Committee confirmed the holding in *Crane* that death is a nonrecognition event by stating, "[t]he bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property."[130]

In contrast to its holding in *Crane* that death is a nonrecognition event, the Supreme Court held in *Diedrich v. Commissioner*[131] that when a transferor makes a lifetime gift and the transferee agrees to pay the gift tax on

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[127] *See id.* at 11.

[128] *See id.*

[129] *See id.*

[130] H.R. REP. NO. 107-84, at 113 (2001), *reprinted in* 2001 U.S.C.C.A.N. 46, 311; *see also* H.R. REP. NO. 1337, at 192 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4331 *and* S. REP. NO. 83-1622, at 340 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4901 ("The . . . passing of property to an executor or administrator on the death of a decedent does not constitute a taxable realization of income even though the property may have appreciated since the decedent acquired it."); Rev. Rul. 73-183, 1973-1 C.B. 364 (holding that a transfer of stock by a decedent to the decedent's executor is not a disposition within section 1001(a) and an executor cannot take a loss on the decedent's final income tax return when the decedent's basis in the stock exceeds its date of death valuation); The Service stated in Revenue Ruling 73-183 that no loss is recognized on the decedent's final income tax return as a result of the transfer of stock to the executor of the decedent's estate even though the stock had an adjusted basis in excess of its fair market value at the date of the decedent's death. *See* Rev. Rul. 73-183, 1973-1 C.B. 364. Similarly, if the fair market value of the stock at the date of the decedent's death is in excess of the adjusted basis of the stock, no gain is recognized on the decedent's final income tax return as a result of the transfer of such stock to the executor of the decedent's estate. This result was confirmed by the House and Senate committee reports on the recodification of the tax law in 1954. *See* H.R. REP. NO. 83-1337, at 192 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4331, *and* S. REP. NO. 83-1622, at 340 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4981 (stating that the mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it); Elliott Manning & Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRAT's, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST. GIFTS & TR. J. 3, 24–25 (1999).

[131] 457 U.S. 191 (1982).

the gift, the transferor is treated as having made a part-sale-part-gift and recognizes gain to the extent that the liabilities encumbering the transferred asset (the gift taxes owed) exceed the donor's adjusted basis in the asset.[132] The logic for the departure from the *Crane* holding that there is not a recognition event when one devises an encumbered asset, and the holding in *Diedrich* that there is gain recognition when an encumbered asset is gifted is clear. Absent such a rule, a donor could encumber an asset with a loan and then gift the asset away subject to the liability, thus converting the asset to cash without recognizing gain. This risk is not present when one must die for the scheme to work. *Madorin v. Commissioner*[133] provides an example of such a gifting scheme. In *Madorin*, grantor trusts were established and the grantor enjoyed partnership losses on assets transferred to the trust.[134] Once the partner's outside basis (which was increased by partnership liabilities) was reduced to zero, and the partnership began generating income, the trustee attempted to shift the trust income to the beneficiaries' lower tax brackets by renouncing the grantor trust powers and thereby converting the trusts to complex trusts.[135] A similar tax avoidance scheme was analyzed in Revenue Ruling 77-402.[136] In that ruling, the settlor established an irrevocable grantor trust through which he purchased an interest in a partnership. At the time of the purchase, the partnership was generating losses derived from accelerated depreciation.[137] The grantor then renounced the grantor trust power immediately before the grantor's outside basis was reduced to zero and the partnership began generating a profit.[138] The court's ruling, consistent with *Diedrich*, held that the excess of the partner's share of the partnership liabilities over the partner's outside basis constituted gain.[139] Example 5 of Treasury Regulation section 1.1001-2(c) reflects these holdings and combats similar abusive tax shelters by providing, in an inter vivos context, that a deemed sale occurs when a grantor renounces a grantor trust power and converts a trust to a complex trust.[140]

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[132] *See id.* at 198–99.

[133] 84 T.C. 667 (1985).

[134] *See id.* at 668–69.

[135] *See id.* at 669–70.

[136] *See* Rev. Rul. 77-402, 1977-2 C.B. 222.

[137] *See id.*

[138] *See id.*

[139] *See id.*

[140] *See* Treas. Reg. § 1.001-2(c) ex. 5. The examples in the Treasury Regulations also fail to support recognition at the time of the beneficiary's death in a sale by a beneficiary to a trust that the beneficiary is the owner of, because in a sale to an IDBT, the trust acquires the

The dichotomy in tax treatment between an inter vivos conversion of a grantor trust to a complex trust,[141] which triggers gain, and the general rule that death is a nonrecognition event,[142] makes the determination of whether the termination of grantor trust status occurs the moment before the beneficiary's death or upon the beneficiary's death, central to the analysis of the tax effects of the beneficiary dying.[143]

Revenue Ruling 85-13 and *Madorin* provide compelling support for the position that the earliest moment the transfer can be deemed to occur, in a metaphysical sense, is the moment of the trust owner's death because during the grantor's lifetime the grantor and his trust are one and the same for income tax purposes.[144] This approach is analogous to the approach taken when a power is retained by a transferor that makes a gift incomplete for gift tax purposes. In the gift context, the subsequent termination of the power completes the transaction and triggers a taxable gift if the termination is before the transferor's death; however, if the power terminates upon the

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assets in return for its promise to make the payments due under the note issued to the transferor and the Regulations provide that the general rule of gain recognition upon the discharge of liabilities does not apply "in the case of a liability incurred by reason of the acquisition of the property" transferred. Treas. Reg. § 1.1001-2(a)(3); s*ee also* Tech. Adv. Mem. 00-11-005 (Mar. 20, 2000).

[141] *See, e.g.*, Diedrich v. Comm'r, 457 U.S. 191, 197–98 (1982); Madorin v. Comm'r, 84 T.C. 667, 667 (1985); Treas. Reg. § 1.1001-2(c); Rev. Rul. 77-402, 1977-2 C.B. 222.

[142] *See, e.g.*, Crane v. Comm'r, 331 U.S. 1, 11 (1947); Gen. Couns. Adv. 09-23-024 (June 5, 2009).

[143] *Compare* F. LADSON BOYLE & JONATHAN G. BLATTMACHR, BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS 5–137, § 5:7.2[A] (16th ed. 2013), *and* Mitchell Gans, Jonathan Blattmachr, & Hugh Jacobson, *Income Tax Effects of Termination of Grantor Trust Status*, 97 J. TAX'N 149, 149–50 (2002), *with* Carol A. Cantrell, *Gain is Realized at Death*, 149 TR. & EST. 20, 20 (2010). A similar metaphysical question exists regarding whether a transfer occurs the moment before or the moment after death for estate tax valuation issues. While the question of whether a moment before or moment after analysis should be applied has never been definitively answered, a moment after analysis appears favorable and the focus of the estate tax should be on what is passed, not on what the decedent owned. *See* United States v. Land, 303 F.2d 170 (5th Cir. 1962); Goodman v. Granger, 243 F.2d 264, 268 (3d Cir. 1957); Estate of Moss v. Comm'r, 74 T.C. 1239, 1247 (1980).

[144] *See* Gans, Blattmachr, & Jacobson, *supra* note 143, at 149–50; *see also* Gen. Couns. Adv. 2209-23024 (Dec. 31, 2008) (discussing the inter vivos termination of grantor trust status and stating "we would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner, which is generally not treated as an income tax event."); Manning & Hesch, *supra* note 130, at 21, 22 (stating that whether the transaction occurs the moment before or the moment after death is irrelevant because death is a nonrecognition event, and there is no reason to depart from this longstanding rule for when grantor trust status terminates on the grantor's death).

grantor's death, the termination is treated as a testamentary transfer and the estate tax, not the gift tax, applies.[145]

The Treasury Regulations promulgated under section 684 provide additional support for the position that the conversion occurs only on the grantor's death and that the conversion constitutes a nonrecognition event by carving out an exception to such a rule for foreign trusts.[146] Section 684(a) provides that when a U.S. person transfers property to a foreign estate or trust, the transfer is treated as a sale or exchange and the transferor recognizes gain in the amount of the excess of the fair market value of the property transferred over the transferor's adjusted basis in the property.[147] This rule, however, does not apply if the trust is a grantor trust.[148] Section 684 then tracks the provisions of section 1001, but the regulations under section 684 establish a timing fiction by providing that when a foreign trust ceases to be treated as a grantor trust due to the death of the grantor, the grantor will be deemed to have transferred the trust assets "immediately before (but on the same date that) the trust is no longer" a grantor trust (in this context, the date of the grantor's death).[149]

An alternative theory exists that also supports the nonrecognition of gain. The alternative theory is not based on death being a nonrecognition event, but rather on the sale to the trust occurring the moment after the grantor's death and the assets being transferred to the trust from the decedent's estate receiving a section 1014(a) basis adjustment.[150]

This alternative theory is based on a close reading of section 1014, which provides a basis step up for "property in the hands of a person acquiring the property from a decedent"[151] and which does not literally require the assets to

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[145] *See* Treas. Reg. § 25.2511-2(b), -(2)(f); *see also* DiMarco v. Comm'r, 87 T.C. 653, 662 (1986).

[146] *See* T.D. 8956, 2001-32 C.B. 112. An exception is contained in Treasury Regulation sections 1.684-3(c) and 1.684-2(e)(2) ex. 2 where gain will not be recognized if the basis of the assets in the hands of the trustee is determined under section 1014(a). *See* Treas. Reg. §§ 1.684-3(c), 1.684-2(e)(2) ex. 2. Some commentators argue that section 1014(a) may apply in a sale to an IDGT and permit there to be a basis adjustment to reflect the value of the trust assets on the owner's death. *See* Gans, Blattmachr, & Jacobson, *supra* note 143, at 149.

[147] *See* I.R.C. § 684(a).

[148] *See id.* § 684(b).

[149] Treas. Reg. § 1.684-2(e)(1)-(2) ex. 2; *see also* Treas. Reg. §§ 1.443-1(a)(2), 1.451-1(b)(1).

[150] *See* Deborah V. Dunn & David A Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. TAX'N 49 (2001).

[151] I.R.C. § 1014(a).

have been included in the decedent's gross estate for estate tax purposes.[152] The proponents of this theory then examine the rules regarding the adjustment to basis contained in section 1014(b) and argue that while section 1014(b)(9) requires gross estate inclusion to obtain a stepped up basis, section 1014(b)(1) simply requires that the asset be acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent. While one may not think of a transfer in trust during a decedent's lifetime as being a bequest or a devise, for income tax purposes, the trust and the beneficiary are the same until the decedent's death and for income tax purposes (including section 1014(b)(1)), the transfer is deemed to occur on the decedent's death.[153] The commentators propounding this position find support for it in the public policy argument that if the assets transferred to the trust fail to receive a stepped up basis, then there would be two systems—one for beneficiaries who had cash and could purchase the assets from the trust immediately before their death in a transaction that would not be recognized for income tax purposes, and one for beneficiaries who do not have cash. The beneficiaries who have cash would then receive a stepped up basis for the assets acquired from the trust, which would be included in their gross estates. The beneficiaries who do not have cash would be unable to enjoy a date of death basis adjustment for the trust assets.

Accordingly, under this alternative theory, because the assets that the trust purchased with the note receive an adjusted basis equal to their date of death value, gain is not realized on the deemed transfer from the decedent to the trust even if death is a recognition event.[154]

*b. Trust's Basis in Transferred Assets*

During the lifetime of the beneficiary, the trust and the beneficiary are one and the same for income tax purposes so gain is not recognized on the transfer of assets in exchange for the note, and the trust does not enjoy a purchase price basis adjustment under section 1012; rather, the trust's basis is the same as that of the transferor and gain in excess of the transferred

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[152] *See* Gans, Blattmachr, & Jacobson, *supra* note 143, at 154–55.

[153] *See* Madorin v. Comm'r, 84 T.C. 667, 675 (1985); Rev. Rul. 85-13, 1985-1 C.B. 184; *see also* HOWARD M. ZARITZKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶ 12.07[3][c][ii] (2d ed. 1991) (stating that the grantor is treated as owning the trust for all income tax purposes).

[154] *But see* I.R.C. § 1014(b)(2), -(b)(3) (providing specific instances in which property held by a grantor trust will receive a stepped up basis, and by implication indicating that in other instances property held by a grantor trust does not receive a stepped up basis).

basis is recognized when the trust sells the assets.[155] Upon the beneficiary's death, when the trust becomes a separate taxpayer, the trustee's acquisition of the assets from the beneficiary may be characterized as either: (a) a bequest or devise, in which case the trust's basis would be determined under section 1014, (b) a purchase, in which case the trust's basis would be determined under section 1012, or (c) a gift, in which case the trust's basis would be determined under section 1015.

Despite the logical argument of at least one respected commentator that the assets qualify for a section 1014 basis adjustment, a more likely argument is that the basis would be determined pursuant to section 1012, resulting in the trust assets having a basis equal to the balance of the note at the time of the beneficiary's death. This determination of course results in an asymmetrical situation where the trustee is treated as having purchased the assets while neither the decedent nor his estate is treated as having made a sale, but it also produces symmetry between the estate tax inclusion value of the note used in the sale and the basis adjustment that the trust receives in the assets.[156]

The commentators who assert that the trust obtains a date of death basis adjustment premise their position on a close reading of section 1014(b)(1), which provides for a section 1014(a) adjustment when property is "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." Although a literal reading of section 1014(b)(1) indicates that a section 1014(a) basis adjustment may be available because the trust acquired the assets for income tax purposes at the time of the beneficiary's death, no basis adjustment is available because for section 1014(b)(1) purposes, the acquisition must be an acquisition in a property law sense from the decedent's estate, and for property law purposes, there was a completed transfer at the time the assets were transferred for the note.[157]

Section 1014(b)(2) provides additional support for the position that the trust assets do not receive a basis adjustment.[158] Section 1014(b)(2) provides that property will be considered to have been acquired from a decedent when the property was transferred during life by the decedent to a trust that pays "income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the

[155] *See* I.R.C. § 1015(b); Rev. Rul. 85-13, 1985-1 C.B. 184.

[156] *See* Manning & Hesch, *supra* note 130, at 16.

[157] *See* Treas. Reg. § 1.1014-2; s*ee also* Crane v. Comm'r, 331 U.S. 1, 6 (1947) ("Property is the physical thing which is the subject of ownership or that is the aggregate of the owner's rights to control and dispose of the thing.").

[158] *See* I.R.C. § 1014(b)(2). A similar argument could be made under section 1014(b)(3).

trust . . . ."[159] Thus, section 1014(b)(2) provides that there is a basis adjustment for the assets held in one form of a grantor trust.[160] If the property transferred to any grantor trust qualifies for a date of death adjustment to basis under section 1014(b)(1), then section 1014(b)(2) would be meaningless and "[i]t is a long-held tenet of statutory interpretation that one section of the law should not be interpreted so as to render another section meaningless."[161]

The basis of the trust's asset is also not determined at the time of the trust owner's death under section 1015 because for property law purposes, the assets were transferred at the time of the original sale and a transfer under section 1015 occurs when the transfer occurs for property law, not income tax, purposes.[162]

Section 1012 contains the general rule that the basis of property shall be its cost, unless an exception such as section 1014 or 1015 applies.[163] Since neither section 1014 nor section 1015 should apply at the time of the trust owner's death when the trust converts to a complex trust, one must apply the general rule that basis equals cost.[164] The cost of property is the amount paid for the property, not the amount of gain recognized by the seller.[165] The Code contains many nonrecognition rules that are supplemented by substituted basis rules requiring a taxpayer to either (1) transfer the basis of the property transferred to the property received, or (2) assume the basis of the previous owner. However, the failure to recognize gain at the time of the trust owner's death when the trust converts to a complex trust is not the result of a Code provision and the trust owner's basis should not transfer to the trust.[166] This inability to transfer the trust owner's basis to the trust, which has become a separate taxpayer, forces one to apply the general rule

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[159] *Id.*

[160] *See id.*

[161] *See* Princess Cruises, Inc. v. United States, 201 F.3d 1352, 1362 (Fed. Cir. 2000).

[162] *See* Treas. Reg. § 1.015-1(c) ("The date the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee.").

[163] *See* I.R.C. § 1012(a).

[164] *See id.*

[165] *See* Treas. Reg. § 1.1012-1(a).

[166] *See* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 41.5 (2013).

contained in section 1012 and the trust's basis in the assets should equal the outstanding balance of the note at the time of the beneficiary's death.[167]

#### *c. Transferor's Basis in Note*

Unlike the assets acquired by the trust for the note that are unlikely to enjoy a section 1014(a) basis adjustment, the note that is used in the purchase from the beneficiary is included in the beneficiary's gross estate and will receive an adjustment to its basis under section 1014(a) for its date of death value or its value on the alternative valuation date.[168] An exception to this rule would apply and the note would not receive a basis adjustment if the note constitutes an item of income in respect of a decedent under section 691, which is excluded from section 1014(a) by application of section 1014(c), but it is reasonably clear that the note would not constitute income in respect of a decedent.[169]

Section 691, which defines income in respect of a decedent, was enacted "to deal with the problem of how to tax income that has been earned but not received by an individual as of the date of his or her death,"[170] such as accrued interest or the unrecognized gain from a sale being reported under the section 453 installment sale rules. In enacting the provision it was "Congress' intent that amounts of income in respect of a decedent—be treated, in the hands of the persons receiving them, as income of the same nature and to the same extent as such amounts would be income if the decedent had remained alive and received them."[171] When a decedent enters into a contract that provides the sale is to occur upon the decedent's death, the sale proceeds cannot constitute income in respect of a

[167] *See* Manning & Hesch, *supra* note 130. It may also be argued that the grantor's original basis in the assets remains the trust's basis in the assets. *See* MILFORD B. HATCHER JR., NOW THAT YOU HAVE ME HERE, WHAT ARE WE GOING TO DO? MERITORIOUS AND OCCASIONALLY MERETRI-CIOUS PLANNING FOR AN EXISTING FLP 21 (2001), *available at* http://www.actec.org/Documents/misc/NowThatHatcher.pdf.

[168] *See* I.R.C. § 1014(a). An advantage of a sale to a trust that is owned by a grantor or beneficiary over a GRAT is that the entire value of the transferred asset is not included in the transferor's gross estate if the transferor dies while the payments are outstanding; rather the value of the note the transferor receives is included, and because section 7872 is not an estate tax valuation rule, the value of the note for gross estate purposes may be less than its face amount.

[169] *See* I.R.C. §§ 691, 1014(c).

[170] Rollert Residuary Trust v. Comm'r, 80 T.C. 619, 637 (1983).

[171] *Id.* (citation omitted) (internal quotation marks omitted).

decedent.[172] Revenue Ruling 85-13 provides that during the beneficiary's lifetime the payments by the trust to the beneficiary do not result in income to the beneficiary, and the earliest moment at which the sale could be deemed to occur is the beneficiary's death. Because the deemed sale does not occur during the beneficiary's lifetime, the payments cannot trigger income in respect of a decedent because sales that occur upon a decedent's death cannot give rise to income in respect of a decedent.[173]

*d. Argument for Gain Recognition at Death*

The treatment of an inter vivos termination of grantor trust status is settled law and some commentators posit that a transfer that occurs at the time of a grantor's death should be treated no differently.[174] Under this theory, the trust's owner is deemed to have transferred the assets and liabilities to the trust immediately before his death, thereby recognizing gain to the extent the trust liabilities exceed the grantor's basis in the trust assets. This gain may be reported under the section 453 installment sale rules, but it constitutes income in respect of the decedent.[175] A significant flaw in the argument for gain recognition at death is that the argument is based on a regulation, a revenue ruling, and a Tax Court case, which are not directly on point in that the sources address inter vivos terminations of grantor trust status. The proponents of this theory extend these sources to terminations of grantor trust status at death by stating that it does not matter if the termination is deemed to occur before or after the grantor's death because pursuant to Treasury Regulations section 1.145-1(b)(1) and section 1.443-1(a)(2), a taxpayer's taxable year ends on the date of his death.[176]

Under this theory, the transferor's estate is not entitled to a section 1014 adjustment for the portion of the note constituting income in respect of a decedent. A debate exists among the commentators who argue for gain recognition at death regarding if the trust assets enjoy a section 1014(a) basis adjustment.[177] If the transfer occurs immediately before the beneficiary's death, the commentators state that there will not be a step up in

[172] *See* Estate of Peterson v. Comm'r, 74 T.C. 630, 641 (1981); Treas. Reg. § 1.691(a)-(2)(b) ex. 4.

[173] *See* Rev. Rul. 85-13, 1985 C.B. 184.

[174] *See* ZARITSKY, *supra* note 120; Cantrell, *supra* note 143, at 20; Dunn & Handler, *supra* note 150.

[175] *See* Treas. Reg. § 1.1001-2(c) ex. 5; *see also* Madorin v. Comm'r, 84 T.C. 667, 677 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

[176] *See* Treas. Reg. §§ 1.145-1(b)(1), 1.443-1(a)(2).

[177] *See* Cantrell, *supra* note 143, at 28; Newlon, *supra* note 32, at 46.

basis under section 1014(a) because the trust assets were not owned by the beneficiary at the time of the beneficiary's death.[178]

## V. SECTIONS 2036 AND 2038 GROSS ESTATE INCLUSION OF TRUST CORPUS

Until recently the private letter rulings regarding IDBTs, such as Private Letter Ruling 200949012, discussed the income taxation of trusts and failed to discuss whether or not trust assets would be included in a beneficiary's gross estate.[179] However, Private Letter Ruling 201216034 discusses, in part, gross estate inclusion.[180] Practitioners using IDBTs must remain aware of the risk that sections 2036, 2038, and 2041 may cause the trust corpus of an improperly structured or administered IDBT to be included in the transferor's gross estate. In a properly structured transaction involving a sale to an IDBT, there should not be any gratuitous transfers to the trust by the beneficiary.[181] Therefore, sections 2036 and 2038 should not apply, and section 2041 would pose the more likely hazard.

Section 2036(a) provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of (usually real property), or the right to the income from the property (usually trust property), or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[182]

Section 2038 provides:

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[178] *See* Newlon, *supra* note 32, at 45.

[179] *See generally* Priv. Ltr. Rul. 09-49-012 (Dec. 4, 2009).

[180] *See generally* Priv. Ltr. Rul. 12-16-034 (Apr. 20, 2012).

[181] *See* Alexander & Klemmer, *supra* note 6, at 339; Oshins & Ice, *supra* note 106, at 422.

[182] I.R.C. § 2036(a).

> The value of the gross estate shall include the value of all property—
>
> (1) To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.[183]

There could be gross estate inclusion under sections 2036 and 2038 if the beneficiary transfers property to the trust in a transaction that is not a bona fide sale or for less than full and adequate consideration, because the limited testamentary power of appointment that the beneficiary holds is a right to designate the person who can enjoy the income and principal of the transferred property as required by section 2036 and a right to amend, revoke, or terminate under section 2038.[184] Omitting the limited testamentary power of appointment from the trust document would not foreclose the risk of gross estate inclusion because the beneficiary also holds the right to withdraw the income for the beneficiary's health, education, maintenance, and support. An exception for section 2036(a)(2) and section 2038 has been recognized when a power-holder is granted the ability to distribute property to someone other than the power-holder under an ascertainable standard,[185] but it is unclear if a power-holder's ability to appoint the property to himself of herself based on an ascertainable standard triggers section 2036 or the section 2038 inclusion.[186]

Courts have applied the requirement that the sale be not only for full and adequate consideration, but that it also be bona fide to attack transfers

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[183] *Id.* § 2038.

[184] *See* Alexander & Klemmer, *supra* note 6, at 339.

[185] *See* Old Colony Trust Co. v. United States, 423 F.2d 601, 602–04 (1st Cir. 1970); Jennings v. Smith, 161 F.2d 74, 77–78 (2d Cir. 1947); Estate of Budd v. Comm'r, 49 T.C. 468, 474–75 (1968); Estate of Pardee v. Comm'r, 49 T.C. 140, 143–44 (1967).

[186] *See* Estate of Hanes v. United States, 1981 WL 176175, *action on dec.*, 1981-101 (Apr. 14, 1984).

to family limited partnerships.[187] In the context of a family limited partnership, a sale is not regarded as being bona fide unless a significant nontax motivation for the transaction exists.[188] The requirement that there be a significant nontax motivation for a transfer has not been, nor should it be, applied to sales to grantor trusts.[189]

## VI. CONCLUSION

Estate planners may use sales to IDBTs to overcome the risks associated with transfers to GRATs and a widespread belief among commentators is that planners can also use IDBTs to provide benefits that are unavailable when a sale to a traditional IDGT is used. While substantial support exists for the position of these commentators, a practitioner contemplating the use of a sale to an IDBT must consider if there is in fact a benefit to using an IDBT instead of an IDGT and must structure the transaction to avoid the risks created by sections 2036, 2038, and 2041. An inevitable conversion from a grantor trust to a complex trust occurs at the time of the trust owner's death, and practitioners should apprise clients of the effects of both inter vivos and testamentary terminations of grantor trust status.

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[187] *See* Alexander & Klemmer, *supra* note 6, at 376.

[188] *See, e.g.*, Estate of Strangi v. Comm'r, 417 F.3d 468, 479 (5th Cir. 2005); Estate of Bongard v. Comm'r, 124 T.C. 95, 113–14 (2005).

[189] *See* PRACTICAL DRAFTING, *supra* note 6.