# STRING INCLUSION: FINAL REGULATIONS ON 2036 AND 2039

By

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A little over a year ago, on June 6, 2007, the Treasury and IRS published proposed regulations on what part of a trust is includable in a deceased settlor's estate under Sections 2036 or 2039 if the settlor retained an interest in the trust property – a so-called "string." This past month, Treasury finalized those regulations (TD 9419, issued July 11, 2008, effective July 14, 2008).

**Major Points.** Four major points can be made:

(a) inclusion will be computed under section 2036 and its newly amended Reg.Sec. 20.2036-1;

(b) inclusion will not be addressed or computed under section 2039, so says newly amended Reg.Sec. 20.2039-1;

(c) other sections of the Code, such as sections 2035 through 2039, can still be applied where the IRS thinks appropriate (at least one example illustrates that point); and

(d) the amount to be included is not the present value of the stream of payments.

**Trusts Addressed.** The trusts addressed by the regulations all have two things in common: (a) the settlor set up the trust; and (b) the settlor retained some income or other right. The trusts come in many different varieties, from certain charitable remainder trusts (CRTs) such as charitable remainder annuity trusts (CRATs) within the meaning of section 664(d)(1), charitable remainder unitrusts (CRUTs) within the meaning of section 664(d)(2) or (d)(3), and charitable remainder trusts that do not qualify under section 664, as well as other trusts established by a grantor (collectively GRTs) such as grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs), and various forms of grantor retained income trusts (GRITs), such as qualified personal residence trusts (QPRTs) and personal residence trusts (PRTs). A CRT is within the scope of the regulations whether or not the CRT met the qualifications of section 664(d)(1), (d)(2), or (d)(3) because either the CRT was created prior to 1969, there was a defect in the drafting of the CRT, there was no intention to qualify the CRT for the charitable deduction, or for any other reason. A GRT is within the scope of the regulations whether or not the grantor's retained interest was a "qualified interest" as defined in section 2702(b).

**The Basic Computation.** Basically, the new regulations say that the amount includable is determined by taking the stream of payments the decedent was supposed to receive, and then, using the 7520 rate, determining what amount of money would be required to produce that stream of income. The 7520 rate to be used is the one in effect at the death of the decedent (or the alternate valuation date, whichever is applicable). If the payments were to be made at other intervals, then the appropriate adjustment factor or

7520 rate for payment frequency, whether semiannual, quarterly or monthly, is to be used.

The above computation gets more complicated when dealing with unitrusts. The inclusion amount is determined by dividing the trust's equivalent income interest rate by the section 7520 rate. The equivalent income interest rate is determined by dividing the trust's adjusted payout rate by the excess of 1 over the adjusted payout rate.

After the computation, if the principal needed is less than 100% of the value of the trust, the estate inclusion is the lesser amount. If the principal needed is computed to be more than 100% of the trust, then the amount includable in the settlor’s estate is limited to the value of the trust assets.

**Comments.** The proposed regulations were the subject of multiple comments. One commonly made objection was inclusion should be computed by reducing to present value the stream of payments, rather than the above computational method which can cause 100% inclusion. And if the present value is zero, then the stream of payments must have been purchased for full and adequate consideration and, therefore, there should be no inclusion. But the Service argued that section 2036 is the applicable section, and, because of that, the Service said 2036 was originally adopted by Congress, and has been interpreted since then, to cause inclusion of the value of the asset as to which a “string” was held back by the grantor, not the value of just the string.

Similarly, when a commentator suggested that section 2036 applies only to the extent that the trust principal alone is insufficient to fully satisfy the annuity payment, the IRS and Treasury Department responded by saying that this would condition the estate tax treatment on the nature and performance of the investments selected by the trustee, and the application of section 2036 should not be dependent on either the trustee's exercise of his or her discretion to invest in income or nonincome producing assets, or the actual performance of the trust assets.

And where the remainder interest in a trust is zero, some suggested that the full and adequate consideration clause of section 2036 should apply, and, therefore, there should be no inclusion. But Treasury and the IRS argued that there is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a trustee. The former includes negotiation and agreement between two parties operating in his own interest, but when a grantor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property, and there is no other property owner negotiating for his own best interests. All of there terms are dictated by the transferor, and the transferor is retaining certain rights, whether possession, enjoyment in another form, or income. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death, the property is subject to inclusion in the grantor's gross estate under section 2036.

A commentator requested that the regulations address the formulas used to determine a pooled income fund's rate of return, and thus the value of the charitable gift, saying that funds that are at least three years old use the highest of the three last taxable years' rates of return, and funds that are less than three years old generally use the highest of the three calendar-year annual averages of the section 7520 rates minus 1 percent. See section 1.642(c)-6(e)(3) and (4). But Treasury and the IRS said this distinction based on the duration of the fund is not relevant because the retained interest is the right to all of the income, thus mandating the inclusion of the entire share of the fund's corpus attributable to the transferor. But a pooled income fund example was added for clarification.

Some commentators requested specific types of examples, or changes to examples. One request was for an example on how the alternate valuation date rules in Reg. Sec. 20.2032-1(d) affect the trust's value, but Treasury declined to deal with that, saying any such example should go into those regulations. Another request was to have examples or discussions of what happens when a donor creates a CRT for a term of years, and Treasury responded by modifying its examples, and concluded that a term of years CRT versus a lifetime CRT makes no difference on the amount includable. And a request for an example of how to deal with a graduated GRAT was thought to be a good idea, but Treasury declined to create one now, citing the need for further consideration. A similar response was given in response to a request that the example in the existing, non-amended part of the regulations at Reg. Sec. 20.2036-1(c)(1)(ii) be re-written to change the reference to a spouse with a child to avoid complications with section 2523.

**Examples.** The illustrations are very helpful. For example, Example 1 in the annuity-unitrust section, a CRAT is funded with $100,000, and the annual annuity payment back to the settlor is $7,500, with the annuity continuing after settlor dies for the settlor's child for life. At the settlor's death, the trust has grown to $300,000, the 7520 rate at that time is 6%, and the child is 40 years old. Only $125,000 is required, at 6%, to pay $7,500 per year, so only $125,000 is includable in the estate. And the result is the same if the settlor had relinquished his annuity payment within 3 years of death because of section 2035. The child's age is of no importance. If the settlor could change the charitable remainderman or revoke the child's annuity, then section 2038 might apply. And, finally, because of these new regulations, section 2039 does not apply.

Example 2 illustrates a 10 year CRAT with monthly payments. Example 3 is a CRUT, and shows how a computation that exceeds the trust assets can occur (the inclusion is limited to the assets in the trust). Example 4 illustrates a 15 year GRIT. Example 5 shows how to deal with a pooled income fund. And Example 6 shows full inclusion of a residence in a QPRT.

**Revenue Rulings Now Obsolete.** Rev. Rul. 76- 273, 1976-2 C.B. 268, and Rev. Rul. 82-105, 1982-1 C.B 133, are spotlighted in the preamble of the regulations. Basically, the IRS explained that these rulings could have provided a means for claiming only a part of the value of a trust in the decedent's estate. The IRS explained that the new regulations are designed to incorporate those rulings into the regulations, and, in doing so, render them obsolete.