

Grantor Retained Annuity Trusts (GRATs) and Sales to Grantor Trusts

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Grantor Retained Annuity Trusts (GRATs) and Sales to Grantor Trusts

I. Introduction

A grantor retained annuity trust (GRAT) or an installment sale to a grantor trust can be useful in transmitting wealth in a tax-efficient way, and often one of these techniques is superior to other estate planning options. These are in effect estate freeze techniques that capitalize on the mismatch between interest rates used to value transfers and the actual anticipated performance of the transferred asset. A sale to a grantor trust also capitalizes on the lack of symmetry between the income tax rules governing grantor trusts and the estate tax rules governing includibility in the gross estate. Like most techniques, GRATs and sales to grantor trusts can be used conservatively, aggressively, or even recklessly, and some of the tax consequences are unclear. Moreover, like most techniques, their availability and usefulness must be evaluated on a case-by-case basis, with a view to the circumstances, and especially the arithmetic, in each case.

II. Basic Concepts

A. The Concept of Estate Freezing

1. A gift is a freeze.
 - a. Future appreciation escapes gift or estate tax. Thus, the best subject of a gift is a “hot asset” that will appreciate greatly over its fair market value today. [Clients usually know what these hot assets are. Lawyers don’t.]
 - b. Any gift tax paid also escapes tax, if the donor survives three years. Section 2035(b).
 - c. An outright gift should be used as the baseline for all other freeze techniques. If a technique does not outperform an outright gift, the estate planner should carefully review the tax and non-tax reasons for recommending it.

2. A sale is a freeze.
 - a. The reasons are similar. The future appreciation escapes gift or estate tax, while the purchase price is generally frozen.
 - b. An **installment sale** is simply a way to assist the buyer to make the purchase by allowing the purchase price to be paid in whole or in part out of the earnings of the purchased asset (but not in such a way as to create in the seller a retained interest in the sold asset that is subject to the rules of section 2701, 2036, or 2038). In some cases, an installment sale also enables the seller to spread the taxable capital gain over several taxable periods (not applicable here).
 - c. Thus, cash can be the subject of an installment sale. That is called a “loan.” If the borrower invests the cash in something that produces a lot of income or appreciation, that is also a type of freeze—the income and appreciation accrue in the buyer’s estate, not the seller’s. A loan is an effective estate planning to the extent the borrower is able to use the loan proceeds to produce income or appreciation at a rate greater than the interest rate on the loan.

B. The Concept of Leveraging, or Freezing off a Discount

1. If what is given—or sold—has a value that is legitimately discounted, then the freeze shelters from future gift and estate tax not only the future appreciation in the intrinsic or ultimate value to the donee or buyer, but also (without regard to such future appreciation) the “appreciation” represented by the discount—that is, the difference between that intrinsic value and fair market value, the standard for estate and gift tax purposes.
2. In the case of discounts in the valuation of property generally, see Reg. §§ 20.2031-1(b) & 25.2512-1; *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Propstra v. United States*, 680 F.2d 1248, 1252 (9th Cir. 1982); *Estate of Andrews v. Commissioner*, 79 T.C. 938, 952-53 (1982); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), *acq.*, AOD 99-006, 1999-35 I.R.B. 314; Rev. Rul. 93-12, 1993-1 C.B. 202.
3. In the case of a GRAT, an additional “discount,” in effect, is provided by the way the present value of the remainder interest, which is the measure of the taxable gift, is calculated. In the case of an installment sale, a similar economic effect is produced by the way the note is valued.

C. The Use of a Grantor Trust

1. For this purpose, a grantor trust is a trust as to all of which the grantor is treated as the owner under section 671.
2. Obvious advantages of using a grantor trust.
 - a. No capital gain is realized on a sale. Rev. Rul. 85-13, 1985-1 C.B. 184.
 - b. Since there is no tax, there is no concern about the additional interest under section 453A on deferred tax liability in excess of \$5,000,000.
 - c. No income is realized when the trust pays interest on an installment obligation to the grantor.
 - d. No gain is realized if property is transferred to the grantor in kind in payment of any part of the annuity obligation in the case of a GRAT or the installment obligation in the case of a sale.
 - e. The trust may be a shareholder of an S corporation, under section 1361(c)(2)(A)(i).
 - f. The grantor, not the trust or the beneficiaries, will pay all the income taxes on income attributable to the trust.
 - g. If a residence is held by a grantor trust, the grantor-beneficiary will be treated as the owner of the residence and the exclusion rules of section 121 will apply. See Rev. Rul. 85-45, 1985-1 C.B. 183; Letter Ruling 199912026.

III. Use of Grantor Retained Annuity Trusts (GRATs)

A. Circumstances in Which a GRAT Might Be Helpful

1. To make a transfer of property expected to appreciate faster than the requirement to make the annuity payment required by a GRAT—*i.e.*, generally at a higher rate than the section 7520 discount rate.
2. To make a transfer of property expected to appreciate at a time when the transferor is cash-poor and desires to reduce the gift tax burden by any means available.

3. To reduce the transferor's holdings in an entity to a minority, to qualify subsequently for a minority discount.
4. To shelter from gift tax the designation of descendants as remainder beneficiaries in a trust created to provide periodic payments to a former spouse following a divorce. Letter Ruling 9235032.

B. Limitations of a GRAT

1. Obviously survival for the necessary period can never be assured. If the grantor dies during the GRAT term, all or part of the value of the GRAT property at that time is included in the grantor's gross estate under section 2036(a).
 - a. *Cf.* Rev. Rul. 82-105, 1982-1 C.B. 133 (describing the portion of a charitable remainder annuity trust that is included in the gross estate under section 2036(a) as the amount of principal required to produce the annuity payment in perpetuity at the applicable section 7520 rate).
 - i. The Service has taken the position that section 2039, not Rev. Rul. 82-105, is the proper standard for this purpose, which would mean that the entire value of a GRAT would always be included in the gross estate. Letter Ruling 9345035; Technical Advice Memorandum 200210009.
 - ii. Proposed regulations released June 6, 2007 (REG-119097-05), however, take the position, effective when final regulations are published, that estate includibility in the case of a GRAT is governed by section 2036 and the principles of Rev. Rul. 82-105, not section 2039. Proposed Reg. § 20.2036-1(c)(2). (It is not clear from the proposed regulations how this would apply to a "graduated GRAT," in which the annuity amount increases each year. See Part E on page 6.)
 - b. For an illustration of the "unwinding" (at least in part) of the gift tax treatment in the case of a "split gift," see Rev. Rul. 82-198, 1982-2 C.B. 206. Because the relief of section 2001(e) is limited to amounts included in the spouse's gross estate under section 2035 (not section 2036 or 2039), "gift-splitting" probably should not be used for a GRIT or GRAT.
 - c. It might be possible to cover the estate tax exposure by term life insurance.

2. If the grantor does survive the GRAT term, the annuity will stop, and the grantor must have sufficient other assets to absorb this loss of income.

C. GRATs as Grantor Trusts

1. Benefits of qualifying as a grantor trust.
 - a. The GRAT will be able to avoid obtaining a taxpayer identification number and filing income tax returns. Reg. § 1.671-4.
 - b. A grantor trust can hold stock of an S corporation (where the mandatory payout could be selected to approximately match the distributions that a profitable S corporation must make anyway to enable its shareholders to pay the income tax on its earnings). *See* section 1361(c)(2)(A)(i).
 - c. If the GRAT distributes appreciated property in kind in satisfaction of the annuity obligation, there is no taxable gain. Rev. Rul. 85-13, 1985-1 C.B. 184. For the importance of preserving grantor trust status until all payments to the grantor have been made, see Part IV.G on page 22.
 - d. If the grantor repurchases the GRAT property before the end of the GRAT term (perhaps just before the end of the term), no gain would be recognized on the sale (Rev. Rul. 85-13, *supra*; *see* Letter Rulings 9146025 & 9239015).
2. Techniques for qualifying a trust as a grantor trust are discussed in Part **Error! Reference source not found.**, beginning on page **Error! Bookmark not defined.**, in the context of an installment sale.
 - a. In addition, paying income for the benefit of the grantor, within the meaning of section 677, is available to qualify a GRAT as a grantor trust. *See* Letter Ruling 9444033 (modified by Letter Ruling 9543049). To ensure this result, there is no reason, for this purpose, why a GRAT could not provide for the grantor to receive the annuity amount or the net income of the trust, whichever is greater, except that for gift tax purposes only the value of the annuity standing alone would be taken into account. Reg. § 25.2702-3(b)(1)(iii) & (c)(1)(iii). (But for a reason not to do this, see Part **Error! Reference source not found.** on page **Error! Bookmark not defined.**)
 - b. If the trust property consists of stock of a publicly traded corporation, before using a power in the grantor to reacquire trust

corpus by substituting other property of an equivalent value (section 675(4)(C), see Part **Error! Reference source not found.**, beginning on page **Error! Bookmark not defined.**), care must be taken that this power would not be considered an option, or its exercise an insider trade, subject to securities laws restrictions. (Indeed, such stock should not be transferred into the GRAT without careful consideration of applicable securities law.)

D. Formula GRATs

1. Reg. § 25.2702-3(b)(1)(ii)(B) allows the annuity amount to be “[a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes.”
2. If this approach is used, and the gift tax value of the property transferred to the trust is changed as the result of a gift tax audit, the annuity, and therefore the value of the grantor’s retained interest, will change proportionately, ensuring that the taxable gift remains the predetermined fraction of the total value of the transferred property.
3. Not only does this contain the damage that might be done by a gift tax, but by that very fact it can serve to discourage an audit—or “audit-proof” the transaction—in the first place.
4. Because it is expressly allowed by the regulations, the use of such a formula cannot run afoul of the rule against “adjustment clauses” identified with *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944).

E. Graduated GRATs

1. Reg. § 25.2702-3(b)(1)(ii) allows the annuity amount (whether expressed as a fixed dollar amount or a fraction of the initial fair market value of the trust property) to be increased by up to 20% each year.
2. By back-loading the return to the grantor to the greatest extent possible, a GRAT with a 20% increase in the annuity payment each year will generally outperform any other GRAT.
3. Possible exceptions include—
 - a. a two-year GRAT, for example, in which the appreciation in the second year is less than the 7520 section rate used to value the gift (regardless of the appreciation in the first year)—a typical scenario

with a “home run” “liquidity event” in the first year followed by conservative investing thereafter, and

- b. a relatively long-term GRAT with an asset tied to a fixed cash flow but still appreciating, such as convertible preferred stock.

F. Two-Life GRATs (Now Obsolete)

1. Example: A transfers property to an irrevocable trust, retaining the right to a qualified annuity for 10 years. Upon expiration of the 10 years, the qualified annuity is payable to A’s spouse, if living, for another 10 years. Upon expiration of the spouse’s interest, the trust terminates and the trust corpus is payable to A’s children. A retains the right to revoke the spouse’s interest.
2. Reg. § 25.2702-2(d)(1), Example 7, holds that the amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A’s qualified interest and the value of the qualified interest payable to A’s spouse subject to A’s power to revoke.
3. Some practitioners, invoking this example, once used “two-life GRATs,” continuing, in effect, for a term of years or, if earlier, the death of the second to die of the grantor and the grantor’s spouse. This technique was welcomed as a means to avoid the harsh and unexpected result of Reg. § 25.2702-3(e), Example (5), which held that a retained unitrust payment (or an annuity) for a fixed term was valued under section 2702 as if it lasted only for the lesser of the stated term or the grantor’s life. Letter Rulings 9352017, 9416009, 9449012, and 9449013 appeared to approve of the two-life valuation technique.
4. Then the Service reversed itself and has ruled that the contingent interest of the grantor’s spouse is analogous to a reversion in the grantor and must be given a value of zero. Technical Advice Memoranda 9707001, 9717008, 9741001 & 9848004. *See also* Letter Rulings 199937043 (modifying Letter Ruling 9352017), 199951031 (modifying Letter Ruling 9449012) & 199951032 (modifying Letter Ruling 9449013).
5. The Tax Court has agreed with the Service’s more recent view. *Cook v. Commissioner*, 115 T.C. 15 (2000) ; *Estate of Focardi v. Commissioner*, T.C. Memo 2006-56. The Court of Appeals for the Ninth Circuit has not. *Schott v. Commissioner*, 319 F.3d 1203 (9th Cir. 2003), *rev’g and remanding* T.C. Memo 2001-110.
6. Meanwhile, the reconsideration of Example 5 in light of *Walton v. Commissioner*, 115 T.C. 589 (2000)) (*see* Notice 2003-72, 2003-44

I.R.B. 964 (announcing IRS acquiescence in *Walton*); Reg. § 25.2702-3(d)(4) & (e), Example (5) (amended February 15, 2005)), has made the two-life GRAT obsolete.

G. Hedging GRATs

1. A better technique than the two-life GRAT is for husband and wife to each create a GRAT.
2. The probability that at least one of them will survive the GRAT term is the same as in the case of the two-life GRAT, except that with this technique, in that case, the GRATs will work to the extent of the funding of the survivor's GRAT.

H. One-Asset GRATs

1. Regardless of the other structural features that are selected, a GRAT is most likely to be effective if it is funded with only one asset—*e.g.*, stock of one closely held corporation or interests in one family limited partnership. In that way, the possible underperformance of one asset will not detract from the superior performance of other assets.
2. To illustrate, using the example of a three-year GRAT funded with \$100 with a \$30 initial annuity increasing 20% each year, the following table shows the result for a “hot asset” that grows in value at a rate of 60% per year, the result for a “cool asset” that does not grow in value at all, and the result if both such assets were combined in the same GRAT:

	<u>Hot Asset</u>	<u>Cool Asset</u>	<u>Both Assets</u>
Beginning value	100.00	100.00	200.00
Year 1 growth	+ 60.00	+ 0.00	+ 60.00
Less annuity	- <u>30.00</u>	- <u>30.00</u>	- <u>60.00</u>
Year 1 balance	130.00	70.00	200.00
Year 2 growth	+ 78.00	+ 0.00	+ 78.00
Less annuity	- <u>36.00</u>	- <u>36.00</u>	- <u>72.00</u>
Year 2 balance	172.00	34.00	206.00
Year 3 growth	+103.20	+ 0.00	+103.20
Less annuity	- <u>43.20</u>	- <u>34.00</u>	- <u>86.40</u>
Ending balance	<u>232.00</u>	<u>0.00</u>	<u>222.80</u>

3. Thus, as two separate GRATs, these assets produce an ending balance for the remainder beneficiaries of \$232.00. The grantor receives the entire “cool asset” back, but even that is not enough to pay \$9.20 of the \$43.20 annuity payment in the third year, and the GRAT simply disappears.
4. As a combined GRAT, these assets produce only \$222.80 for the remainder beneficiaries, but the grantor receives the full annuity payments. Thus, in the case of the combined GRAT, the remainder beneficiaries receive \$9.20 less and the grantor receives \$9.20 more—not the best estate planning result.

I. Prohibition on Making Annuity Payments with a Note

1. Technical Advice Memorandum 9604005 denied qualification under section 2702 to GRATs which depended on such borrowing, even while admitting that “[t]he express terms of the GRATs do satisfy the requirements of §2702 and the regulations thereunder.” It must be acknowledged that the facts of TAM 9604005 were especially bad for the taxpayer. For example, no interest was paid on the notes. As the TAM pointed out, this had no income tax effect (because the GRATs were grantor trusts), but it affected the economics of the arrangement, which was relevant for gift tax purposes.
2. To the same effect, however, was Technical Advice Memorandum 9717008.
3. Finally, amendments to the regulations, proposed on June 22, 1999, and finalized on September 5, 2000, prohibit the use of notes, “directly or indirectly,” to pay a GRAT’s annuity obligation. Reg. § 25.2702-3(d)(5).
 - a. Borrowing from others to make the annuity payments is not addressed in the regulations, and the practice is expressly acknowledged in the preamble to the regulations.
 - i. The preamble warns, however, that the step transaction doctrine will be applied where appropriate, such as when the trust borrows money from a bank but the bank agrees to make the loan only if the grantor deposits with the bank an amount equal to the amount of the loan. The preamble explains that this is the reason for the words “directly or indirectly” to the prohibition on the use of notes.

- ii. Moreover, when borrowing from third parties is outstanding when the GRAT ceases to be a grantor trust, the Service will take the position that the grantor realizes income in the amount of the borrowing. *See* Technical Advice Memorandum 200010010.
- b. Borrowing from the grantor for other purposes, such as to enable the trust to make other investments or to pay expenses, is not addressed, and therefore should be viewed as permissible, subject to the “directly or indirectly” step transaction caveat. Usually it should be quite easy to trace the proceeds of the borrowing to a use by the trust other than to make an annuity payment.
- c. Payment of the annuity amount with trust assets in kind is not prohibited and is expressly acknowledged as a permissible option in the preamble.
- d. For symmetry, the regulations also apply to the use of notes to pay the obligations to the grantor of a grantor retained unitrust (GRUT). Reg. § 25.2702-3(c)(1)(i).
- e. Effective dates.
 - i. The final regulations maintain the requirement that the use of notes or similar arrangements to meet the trust’s obligations to the grantor be prohibited in the governing instruments of trusts created on or after September 20, 1999. Reg. § 25.2702-3(d)(5)(i).
 - ii. Likewise, the final regulations maintain the requirement that notes may not be so used after September 20, 1999, with respect to a pre-September 20, 1999 trust and the requirement that any such notes issued on or before September 20, 1999, must have been paid in full by December 31, 1999. Reg. § 25.2702-3(d)(5)(ii).
- f. The final regulations also clarify that a GRAT may make its annuity payments to the grantor only on the anniversary date of the GRAT, and that the annuity payments need not be prorated to a calendar year in the case of GRATs that are not created on January 1. Reg. § 25.2702-3(b)(1)(i), (3) & (4). This helpful amendment accomplishes what a 1994 amendment of the regulations was apparently intended to accomplish. *See* T.D. 8536 (May 4, 1994).

J. Paying the “Annuity” in Kind

1. Technical Advice Memorandum 9604005 stated that “it is clear that [the grantor], acting as trustee, would not distribute the ... stock to himself and [his wife] in satisfaction of the annuity, since such a distribution would clearly defeat the purpose of creating the GRATs.” Oh, really?
2. Curiously, the TAM went on to conclude that “from the inception of the GRATs, there was never an intention that the annuity payment would be made in cash or in kind according to the terms of the GRATs.”
3. The right to make annuity payments in kind was thus arguably left in some confusion, although it really has never been doubted by estate planners.

K. Reimbursement of the Grantor for Income Tax

See Parts VIII.F and VIII.G, beginning on page 69.

L. GRATs and Generation-Skipping

1. Making grandchildren the remainder beneficiaries of a GRAT—or even making “descendants per stirpes” the remainder beneficiaries so that grandchildren will succeed to the interests of their deceased parents—is generally not a good idea, unless the parents are deceased when the GRAT is created, because section 2642(f) (the “ETIP” rule) prevents allocation of GST exemption to such a trust until the expiration of the GRAT term, when presumably the property will have increased greatly in value.
2. One technique for dealing with that dilemma is to make only the surviving children the remainder beneficiaries of the GRAT and to “equalize” the treatment of children of a predeceased child in the grantor’s will or revocable trust, where the transfer (possibly funded by term insurance) would be exempt from GST tax under the predeceased parent rule of section 2651(e).
3. A variation is to make all the grantor’s children vested remainder beneficiaries, in the sense that a child need not survive the GRAT term to be entitled to share in the remainder and therefore may, if necessary, bequeath that remainder interest to his or her children or other persons.
 - a. After the creation of the GRAT, the children could sell their vested remainders to a generation-skipping trust (or trust). This trust could be funded by the grantor with whatever cash is needed to

equip it to make the purchase, and the grantor could allocate GST exemption to that trust in the amount of such funding. Neither the grantor nor any children of the grantor may have an interest in this trust.

- b. If the sales are made to one generation-skipping trust for the benefit of all of the grantor's descendants other than children, the valuation rules of section 2702 would prohibit reduction of the purchase price of the remainder interest by the value of the grantor's reversion in the GRAT.
- c. If, instead, the sales can be made to separate generation-skipping trusts (one for the descendants of each of the grantor's children), with each child selling his or her remainder interest to one or more trusts other than the trust for his or her own descendants, these sales would not be made to "members of the family" under section 2702, and the price could be reduced by the value of the grantor's reversion.
 - i. If some of the grantor's children do not have children and local law does not permit the creation of a trust for a class of beneficiaries none of whom is living at the creation of the trust, then one or more of the grantor's living grandchildren could be included as either temporary or permanent beneficiaries of those trusts, as long as no descendant of the selling child is a beneficiary of that trust.
 - ii. This variation is aggressive, in part because of the risk of recharacterization of these sales under the so-called "reciprocal trust doctrine." See *United States v. Estate of Grace*, 395 U.S. 316 (1969), and its progeny.
 - iii. The risk is that each trust would be deemed to have underpaid the selling child by an amount equal to a proportion of the value of the grantor's reversionary interest, so that each child would be deemed to have made a gift to the purchasing trust (or trusts) in that amount. That gift would be deemed a contribution to the generation-skipping trust or trusts by the child, and would therefore require the allocation of the child's own GST tax exemption to the trust (possibly on a late allocation basis) in order to maintain the trust's exempt status for GST tax purposes—a generally inconvenient and costly result. A "price adjustment" clause of the sort given effect in *King v. United States*, 545 F.2d 700

(10th Cir. 1976), might help, but in that case the transaction is likely to be open a very long time.

- iv. *Grace* may be distinguishable on the ground that it applies only for the purpose of identifying the transferor who has retained an interest in the trust for estate tax purposes. Here the selling children will have retained no interest in either the GRAT or the generation-skipping trust.
 - v. Possibly, though, *Grace* will continue to be a risk as long as the transaction is “balanced”—*i.e.*, as long as in the sale transactions each branch of the family “gets” as much as it “gives.”
 - d. A way should be found for the selling children to disclose the transaction on gift tax returns, so as to begin the running of the statute of limitations under section 6501(c)(9).
 - e. It is possible that income tax basis will be lost in the implementation of this technique, but that may be an acceptable cost in any case and might be especially acceptable where the underlying GRAT asset is an asset that the family expects to retain, such as an interest in a closely-held business.
 - f. In drafting the trust instruments involved, care should be taken that the trustee of the generation-skipping trust is authorized to invest in contingent remainders (that is, contingent on the grantor’s survival for the GRAT term) and that any spendthrift clause applicable to the GRATs does not prohibit the sale.
4. On the other hand, a GRAT can be used to leverage the unified credit representing a \$1 million gift tax exclusion into a generation-skipping trust to which the \$2 million (or \$3.5 million) GST exemption can be allocated at the end of the ETIP period.
- a. For example, a two-year GRAT created in 2007 and ending in 2009 could use part of the unified credit (presumably a small part) to shelter the initial transfer from gift tax, and then the grantor could allocate up to \$3.5 million of GST exemption (\$7 million in the case of gift-splitting by spouses) in 2009 when the GRAT terminates and the ETIP ends. The GRAT could be structured to continue only \$3.5 million (or \$7 million) in a generation-skipping trust and distribute the excess outright to children.

- b. For the right asset, even an old-fashioned grantor retained income trust (GRIT) could be used in this way. For example, assuming gift-splitting, if a GRIT funded with \$2 million in 2007 triples in value to \$6 million in 2009, the initial transfer can be sheltered from gift tax by the unified credit and the long-term trust can be sheltered from GST tax by the GST exemption. Again a formula could be used to cap the generation-skipping transfer.

M. Collapsing an Underperforming GRAT

1. Sale of the GRAT property to the grantor (unlike commutation) need not be prohibited. *Cf.* Reg. § 25.2702-5(b)(1) & (c)(9) (prohibiting such sales in the case of a PRT or QPRT).
 - a. Such a sale has no income tax consequences if the GRAT is a wholly-owned grantor trust. Rev. Rul. 85-13. 1985-1 C.B. 184.
 - b. Under section 1041, a sale to the grantor's spouse is likewise non-taxable.
 - c. Unlike notes from the GRAT to make the annuity payments (discussed above), there should be no problem if such a sale is made, at least in part, for notes to the GRAT from the purchasing grantor (or spouse).
2. Following such a sale, presumably at a depressed sale price—
 - a. The repurchased property may be placed in a new GRAT, with a lower annuity payment.
 - b. The original GRAT simply pays out its cash (or notes) and collapses.

IV. Contemporary GRAT Questions

A. Commencement and Duration of the Term

1. **Question:** What is the shortest possible GRAT term?
 - a. Section 2702(b)(1) refers to “fixed amounts payable not less frequently than annually.” Reg. § 25.2702-3(b)(1)(ii) refers to amounts “payable periodically, but not less frequently than annually.”

- b. In Letter Ruling 9239015, the Service ruled that an annuity interest was a qualified annuity interest in a GRAT with a term of two years.
 - c. Subsequently, anecdotal evidence emerged that the Service would refuse to rule that an annuity interest was a qualified annuity interest unless the term of the GRAT is at least five years.
 - d. In *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002), there was a GRAT with a term of 366 days, but there is no indication on the face of the Tax Court opinion that it was challenged or seriously scrutinized.
 - e. The GRATs upheld in *Walton v. Commissioner*, 115 T.C. 589 (2000), had a term of two years, although the case focused on other aspects of the GRATs, namely the valuation of the remainder following a fixed term of years without regard to the mortality of the grantors.
 - f. While most conservative practitioners are comfortable with a minimum term of two years, it is hard to find any restriction at all in the law.
 - g. While some have suggested defining the term with reference to a formula that would adjust as necessary to produce a qualified interest, that would in turn entail defining the annuity amount by formula, which would strain the statutory requirement of “fixed amounts” (qualified only by the reference in Reg. § 25.2702-3(b)(1)(ii)(B) to a “fixed fraction or percentage” of the initial fair market value).
2. **Question:** When is a GRAT “created” for purposes of measuring the dues dates of the annuity payments?
- a. This might be an issue when some time must elapse to perfect or consummate a transfer, such as the reissuance of stock certificates.
 - b. Does the mere signing of a trust instrument “create” a trust? Is a *res* required? (Who knows? In any event, this may vary from state to state.)
 - c. Can the *res* problem be avoided by a nominal cash contribution when the trust instrument is signed? Presumably, this would not violate the prohibition of Reg. § 25.2702-3(b)(5) on additional

contributions, because it is merely part of a recited short-term series constituting a single contribution.

- d. When does the grantor's "dominion and control" cease for purposes of Reg. 25.2511-2? As long as additional steps must be taken, can the transfer be "called back"—effectively revoked?
- e. If the date of funding is really uncertain, perhaps the trust should be left revocable until the funding occurs.
- f. What if the funding could be delayed until the next month and the section 7520 rate used to value the gift could be different?
 - i. A formula can be used, but a formula can be very cumbersome and can, for example, produce a result with infinite decimal places. Care must be taken to provide a rounding rule, making sure that the result is always rounded down and not up, and to establish a target gift that is not zero but is some nominal amount (assuming that a truly zeroed out GRAT is not desired).
 - ii. If the technique of revocability until the trust is fully funded is used, it might be both safer and simpler for the grantor to simply reserve the right to amend the annuity formula until that time.

3. **Question:** Can the annuity be payable on the last day of the "year" that begins on the first day of the GRAT term, or must it be paid on the "anniversary" of that first day?
- a. In other words, if a GRAT is created and funded on May 12, is the first annual payment due on the following May 11? Or May 12? Likewise (and perhaps more interestingly, because of its effect on the need for the grantor to survive), is the last day of the trust, when the last distribution to the grantor is due, the appropriate May 11? Or May 12?
 - b. There seems little reason not to draft a GRAT using May 11 in this example. Any valuation difference would likely be very small and not worth the time of the Service to pursue (unless one believes that a "full" two years, for example, is the minimum required to constitute a qualified payment). Wouldn't a two-year GRAT using May 12 be, in effect, a GRAT for two years and one day?

- c. Letter Ruling 9239015 involved a GRAT that terminated the day before the “anniversary” date.
- d. The preamble to the 2000 amendment of the regulations, T.D. 8899, provides the illustration of “a trust providing for an annuity interest created on May 1st ... [in which] the entire annual payment may be made by April 30th of each succeeding year of the trust term.”
- e. Nevertheless, it is unlikely that “May 11” GRATs are customary, and Reg. § 25.2702-3(b)(3) does refer to “the anniversary date of the creation of the trust.”

B. “Zeroing Out”

1. **Question:** Can a GRAT be “zeroed out”—that is, structured so that the value of the remainder for gift tax purposes is zero or nearly zero?
 - a. It is often assumed that this was settled in *Walton v. Commissioner*, 115 T.C. 589 (2000)); Notice 2003-72, 2003-44 I.R.B. 964 (announcing IRS acquiescence in *Walton*); and Reg. § 25.2702-3(d)(4) & (e), Example (5) (amended February 15, 2005).
 - b. The Service had previously acknowledged that the gift tax value of the remainder following a GRAT term can be as small as 0.829% of the total value transferred into the trust. Letter Ruling 9239015.
 - c. In dicta in Technical Advice Memorandum 200245053 (focusing primarily on the effectiveness of a defined-value clause), after *Walton* but before the acquiescence in *Walton*, the Service remarked that the value of the gift could not be very small (such as 1%).
 - d. The Service will “ordinarily” not issue an advance ruling regarding a GRAT unless the value of the remainder is at least 10%. Rev. Proc. 2006-3, 2006-1 I.R.B. 122, § 4.01(50). Thus, there are no GRAT letter rulings anymore.
 - e. Trying to deal with this issue by formula would generally incur an unacceptable gift tax risk.
2. **Question:** Should a GRAT be exactly zeroed out—that is, designed with no gift tax value for the remainder?

- a. Some advisers question whether there can be an effective estate planning result, or whether there can even be a valid trust, without a net “transfer.”
 - b. Others insist on at least a nominal gift, so there is an occasion to disclose the GRAT on a gift tax return and gain the repose of the gift tax statute of limitations.
 - c. Generally, then, “zeroed out” has come to mean nearly-zeroed-out, with some small taxable gift.
3. **Question:** If a GRAT is exactly zeroed out, so that there is no gift, should it nevertheless be reported on a gift tax return?
- a. Some prefer disclosure on a gift tax return to gain the repose of the gift tax statute of limitations. The regulations expressly permit the disclosure of a “non-gift,” to start the statute of limitations on any assertion by the Service that that transfer or other transaction had a gift element. Reg. § 301.6501(c)-1(f)(4). This is true even though there is otherwise no reason to file a gift tax return. Reg. § 301.6501(c)-1(f)(7), Example 2.
 - b. For others, the greatest source of repose is invisibility, and filing a gift tax return when there is no gift is resisted.
 - c. If a gift tax return is not going to be filed, then it would be inappropriate to define the annuity with reference to values as finally determined for gift tax purposes.

C. “Rolling” GRATs

1. **Question:** If it is contemplated that the grantor will create a new GRAT whenever a payment is made back to the grantor, should the same trust instrument be used?
- a. Generally, there should be no reason not to, and it would save both paper and headaches for the grantor.
 - b. Best practices, however, require a new review of the document—
 - i. by the drafter, to make sure the calculation of the annuity is right (since a flexible formula can be cumbersome, as discussed above) and to ensure that there have been no material changes in the law (such as the prohibition in Reg. § 25.2702-3(d)(5) on the payment of annuity amounts with

notes in a GRAT created on or after September 20, 1999),
and

- ii. by the grantor, to make it clear that each GRAT is independent and not so much a part of a “prearrangement” as to risk that the GRATs will be collapsed into one long-term GRAT with estate tax exposure through the entire long term.
2. **Question:** In any event, can the investments of such successive GRATs be commingled?
 - a. Subject to the above caveats, the answer seems to be clearly yes.
 - b. The “investments” are almost always going to be the same asset, at least initially.

D. A Cap on the Remainder Beneficiaries’ Share

1. **Question:** Can or should a cap be put on the amount of value ultimately passing to the remainder beneficiaries, with any excess being returned to the grantor?
2. Since the most frequently asked question about a GRAT, after “What if it doesn’t work,” may be “What if it works too well,” consideration of such a cap is a good idea. The cap can be an absolute ceiling, or it can be reflected in a proportional sharing in the remainder by the remainder beneficiaries and the grantor, above a stated point. The cap will have no effect on the gift tax value of the remainder.
3. This technique can substitute for the reimbursement of the grantor for income tax (discussed in part VIII.G, beginning on page 71) as a protection against a higher-than-expected capital gain.

E. Payment of a GRAT’s Expenses

1. **Question:** How can be expenses of a GRAT be paid, without violating the prohibition of Reg. § 25.2702-3(b)(5) on additional contributions?
2. Many GRATs require very little maintenance. The trustee does not “manage” the investment. The GRAT is a grantor trust that does not file income tax returns and is typically an unsupervised trust that does not file accountings. There may be little or no other reason to keep “books.” Because of these reasons and the short-term nature of most GRATs, the trustee is often an individual, sometimes the grantor. Thus, expenses are low, and such payments as are required for legal or accounting services

are usually justified as looking out for the grantor's own interests—in the calculation and payment of the annuity, in the proper gift tax treatment of the gift and estate tax treatment of the trust, in the monitoring of grantor trust status, and the like—and thus are properly paid by the grantor, who usually is the client anyway.

3. Difficulties arise when the asset held by the GRAT is purchased by an outsider. Such acquisitions can be very expensive, and the costs should probably be borne proportionately by all the sellers, including the GRAT, in the absence of very strict “tag-along” rights, which are not typically included in a GRAT instrument and which might in any event add more value to the gift.
4. In general, care should be taken to book the grantor's payment of the GRAT's share of expenses as loans to the GRAT, which can easily be traced to a use other than payment of the annuity in violation of Reg. § 25.2702-3(d)(5).

F. Timing of Annuity Payments

1. **Question:** May payment in kind of an annuity payment be deferred beyond the due date?
2. Reg. § 25.2702-3(b)(4) provides that “[a]n annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date.” (The reference to 105 days corresponds to April 15, the date the GRAT's income tax return would be due if it filed one, which is the due date for payments based on a calendar year.) There is no provision for the payment of interest.
3. It is possible to build in safeguards against late payment, for example by providing in the GRAT instrument that if payment is not made within, say, 30 days of the due date, the GRAT terminates to that extent, and the trustee holds that amount as an agent or nominee for the grantor, not as trustee. But that is no substitute for paying attention to annuity payment due dates, and such a feature could encourage a false sense of security.
4. Deferring the payment beyond the due date entails both risk and opportunity—risk that a greater share of the asset will be needed to discharge the annuity obligation if the asset declines in value, and the opportunity to use a smaller share of the asset to discharge the annuity obligation if the asset appreciates in value. This strategy will usually be most appropriate in the case of marketable assets such as stock of a publicly-traded corporation, where changes in the market value are known from day to day. Since the payment may be made at any time

within the 105 days, the trustee may time the payment with regard to apparent trends in the market value.

5. If this an advantage in the case of a GRAT providing for annual payments, it might be even more of any advantage if annuity amounts are made payable more frequently than annually.
 - a. Reg. § 25.2702-3(b)(3) states that “the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly.” While this does not preclude an even more frequent interval, monthly payments are the most frequent payments with specific sanction in the regulations and will be the most frequent payments used by conservative estate planners.
 - b. It appears that even a semi-annual, quarterly, or monthly payment is “[a]n annuity amount payable based on the anniversary date of the creation of the trust” if it measured from the date of the creation of the GRAT and not based on the calendar year. That is the only way to give meaning to the word “based,” which is presumably included in the regulation for a purpose. Therefore, under the regulation, even a monthly payment “must be paid no later than 105 days after the anniversary date.” Here, however, “the anniversary date” can only refer to the date one year after the creation of the trust (and each year thereafter).
 - c. In other words, if a GRAT providing for monthly payments is created on May 12, 2009, the first payment is due June 12, 2009, but may be made any time through August 25, 2010 (105 days after May 12, 2010). The same thing is true of the other eleven payments, due on the 12th day of each month July 2009 through May 2010.
 - d. Annuity amounts payable more frequently than annually are rarely considered, because they complicate both the valuation of the gift and the administration of the trust. But if the fair market value of an asset is reasonably easy to determine and is expected to be very volatile, monthly payments can maximize the flexibility to exploit market highs in the timing of payments in kind. This can be especially welcome to someone who is concerned that the prohibition on “commutation (or prepayment) of the [grantor’s] interest” in Reg. § 25.2702-3(d)(4) prohibits prepayment of any annuity amount due.
6. The 105-day grace period of Reg. § 25.2702-3(b)(3) is not a governing instrument requirement. If a governing instrument explicitly allows a

105-day delay in payment, must valuation of the remainder for gift tax purposes be based on the later permissible payment dates? **If the answer is uncertain, that uncertainty must be balanced against the advantage (described above) of using the 105-day grace period, especially in a GRAT providing for monthly payments, to effectively permit the equivalent of prepayment.**

7. In any event, special care should be taken with respect to the final annuity payment, due at the termination of the GRAT. If the grantor dies before this payment is made, an otherwise avoidable issue of includibility in the gross estate might be raised, and gain might be recognized on the distribution of appreciated property in kind, because the trust will no longer be a grantor trust. (For the importance of continuing grantor trust status, see the next section.)

G. Grantor Trust Status After the GRAT Term

1. **Question:** When does the grantor trust status of a GRAT terminate?
2. Some GRATs include a grantor trust feature, such as the power in the grantor to reacquire trust corpus by substituting other property of an equivalent value (section 675(4)(C)), “for as long as the grantor is living during the GRAT term”—that is, for two years or three years (or whatever term is selected) from the creation of the GRAT. But grantor trust status is needed when the final annuity payment is made to the grantor, if it is made in kind with appreciated assets, which will often be the case. This type of drafting, then, risks exposing the final annuity payment to income tax. Moreover, this tax will be imposed on the trust, not the grantor, frustrating the estate planning objective of the GRAT to move assets in a tax-efficient manner to the next generation.
3. Usually, as long as there is still a substantial payment to be made to the grantor, it is reasonable to assume that section 677(a)(1) confers the necessary grantor trust status.
4. In some cases, the GRAT continues as a grantor trust after the GRAT term for other reasons anyway.
5. The best approach is to provide the grantor trust feature itself “for as long as the grantor is living during the GRAT term and thereafter until all payments due the grantor have been made.”

H. Measuring the Amount That Is Included in the Gross Estate

1. **Question:** What is the estate tax exposure if the grantor dies during the GRAT term?
2. Item 8 on the 2007-08 Priority Guidance Plan was entitled “Final regulations under sections 2036 and 2039 regarding the portion of a split-interest trust that is includible in a grantor’s gross estate in certain circumstances in which the grantor retains an annuity or other payment for life.”
 - a. Although a reference to “split-interest” trusts typically brings to mind a charitable remainder trust, the estate tax charitable deduction usually diminishes the importance of estate inclusion in the case of a CRT.
 - b. The more interesting question, of course, is presented by a grantor retained annuity trust (GRAT), where there can be a large difference, for example, between the present value of the unpaid annuity amounts, the amount needed to generate the prescribed annuity without depleting the principal (*cf.* Rev. Rul. 82-105, 1982-1 C.B. 133, describing the portion of a CRT that is included in the gross estate), and the entire value of the trust assets that the Service has viewed as included in the gross estate under section 2039 (Letter Ruling 9345035; Technical Advice Memorandum 200210009).
3. Proposed regulations (REG-119097-05) were published in the Federal Register on June 7, 2007, taking the relatively welcome position that the Service will apply section 2036 and will refrain from applying section 2039. Final regulations, Reg. §§ 20.2036-1(c) & 20.2039-1(e), T.D. 9414, published on April 23, 2008, took the same view.
4. Under the new regulations, the amount includible in the gross estate with respect to a retained interest in trust is the amount needed to generate the retained interest without invasion of principal – that is, in perpetuity – up to the entire date-of-death value of the trust assets. Reg. § 20.2036-1(c)(2)(i). In the case of a GRAT, this will usually result in inclusion of the entire value of the assets, unless the assets have increased enormously in value.
5. The preamble to the 2008 final regulations revealed that Treasury and the Service considered and rejected the argument that section 2036 is not applicable to a retained annuity interest in a GRAT to the extent the annuity is not payable from trust income. This argument was made in

Whitty, “Repercussions of *Walton*: Estate Tax Inclusion of GRAT Remainders,” PROBATE & PROPERTY, May/June 2005, at 13; and Whitty, “Heresy or Prophecy: The Case for Limiting Estate Tax Inclusion of GRATs to the Annuity Payment Right,” 41 REAL PROP., PROBATE & TR. J. 381 (Summer 2006). Although the argument was viewed as aggressive by some estate planners, it resulted in the deletion from many GRAT forms of directions such as to pay the annuity amounts “from income and, to the extent that income is not sufficient, from principal,” in order to preserve the opportunity to make the argument if the occasion arises. Under the regulations, it is likely that the result is the same whether the annuity is paid from income or principal, because the regulation looks only to the generic amount of the annuity. See Reg. § 20.2036-1(c)(2)(i) & (iii), *Example 2*. Nevertheless, it is unlikely that such directions (which do not have much substantive effect either) will be reinstated in GRAT forms.

6. The proposed regulations offered one GRAT example, which is retained in the final regulations. Reg. § 20.2036-1(c)(2)(iii), *Example 2*. But unlike most GRATs, the GRAT in the example
 - a. runs for the shorter of the stated term or the grantor’s life, not as a *Walton* style GRAT, running for a fixed term with annuity payments directed to the grantor’s estate if the grantor dies before the expiration of the term;
 - b. is not graduated (that is, does not include an annual increase in the annuity, which, if paid in perpetuity, will always exhaust the GRAT if the graduation rate – usually 20% – exceeds the 7520 rate);
 - c. provides for monthly, not annual, GRAT payments;
 - d. continues for ten years, relatively long as modern GRATs go; and
 - e. produces a relatively high taxable gift, equal to about 10.3% of the initial value transferred to the GRAT (for a 60-year-old grantor in July 2008).

The final regulations added a statement to the example that the calculation of the amount included in the gross estate is the same for a fixed term as for a term ending on the earlier of a fixed date or the grantor’s death. The preamble to the final regulations acknowledged that an example using a graduated GRAT would be helpful and appropriate, but stated that the issue requires further consideration. This 2008-09 project is the result.

7. Proposed regulations (REG-119532-08) pursuant to this project were published in the Federal Register on April 30, 2009.
 - a. Proposed Reg. § 20.2036-1(c)(2)(ii) provides that, in the case of a graduated GRAT, the amount includible with respect to the amount payable for the year of the decedent's death (called the "base amount") is the amount required to make that payment in perpetuity. (This is the same as the rule under the current regulations.) The additional amount includible with respect to each annual increment in future years (called the "periodic addition" for each year) is the amount required to make **that** incremental payment in perpetuity, discounted for the passage of time before that increment takes effect. The total amount includible in the gross estate is the sum of the base amount and all the periodic additions, but not to exceed the total fair market value of the trust property on the date of the decedent's death.
 - b. The new proposed regulations also provide rules for valuing the annuity payments when those payments are paid for the joint lives of the decedent and another recipient, or to the decedent following the life of another recipient.
 - c. The new regulations are proposed to be effective when final regulations are published in the Federal Regulations.
8. The risk of estate tax if the grantor dies during the GRAT term could be covered with term life insurance.

I. Qualifying the GRAT for the Estate Tax Marital Deduction

1. **Question:** If the grantor dies during the GRAT term, what is the best way to ensure that whatever value is included in the grantor's gross estate with respect to the GRAT qualifies for the marital deduction?
2. Before *Walton*, this was fairly easy to accomplish with a simple reversion to the grantor's estate, where normal marital deduction planning would work.
3. Since *Walton*, and before *Walton* for those who provided for an annuity payable to the grantor or his or her estate for a complete term of years in the hope that Example 5 of Reg. § 25.2702-3(e) would be held invalid, this is more complicated. The focus is on both the remaining annuity payments (which could look like a terminable interest) and the remainder at the end of the GRAT (which is not immediately possessory). Simply combining these interests by making both payable

to the surviving spouse would violate the prohibition of Reg. § 25.2702-3(d)(2) on payments to anyone other than the grantor (or, by implication, the grantor's estate) during the GRAT term.

4. Although a number of approaches have been discussed, the following seems to this author to be the most appropriate:
 - a. In the GRAT instrument, provide that if, after the grantor's death survived by a spouse, income exceeds the annuity amount, that excess income is also paid to the grantor's estate. Alternatively, this could be provided throughout the GRAT term; it would ordinarily make no difference, because the annuity amount alone would probably exceed the income. (But for a reason not to do it this way, see paragraph 2.c below.)
 - b. In the GRAT instrument, repudiate the 105-day grace period for payment of the annuity, especially if the instrument otherwise recognizes it.
 - c. In the GRAT instrument, provide that the grantor's executor can require the trustee to make the trust property productive of income or convert it into productive property within a reasonable time (within the meaning of Reg. § 20.2056(b)-5(f)(4)), and provide in the grantor's will that the surviving spouse can require the executor to exercise this right. Alternatively, the GRAT instrument could give the right directly to the surviving spouse, although it is a bit awkward to do this when the spouse as such is not a beneficiary of the GRAT.
 - d. In the GRAT instrument, provide that at the end of the GRAT term, if the grantor has died during the term survived by a spouse who survives the GRAT term, the trust continues for the spouse's life, with all income (not an annuity amount) paid to the grantor's estate.
 - e. In the grantor's will (or more typically a codicil executed at the same time as the GRAT), bequeath the grantor's entire interest in the GRAT to the spouse.
 - f. Also in the grantor's will (or codicil), as a reminder if for no other reason, specifically encourage the executor to consider a QTIP election with respect to the GRAT.
 - g. In the grantor's will (or codicil), expressly exonerate the GRAT from section 2207B or any comparable state apportionment rule

during the GRAT term. This should permit the GRAT to comply with the prohibition of Reg. § 25.2702-3(d)(2) on payments to anyone other than the grantor (or, by implication, the grantor's estate) during the GRAT term, without relying on the grantor's executor's QTIP election. Reimbursement can be allowed after the end of the GRAT term. (If this is a problem, it is a potential problem with all GRATs, not just where the marital deduction is sought.)

- h. In the grantor's spouse's will (or codicil executed at the same time as the GRAT), expressly exonerate the GRAT from section 2207A or any comparable state apportionment rule during the GRAT term, again to comply with Reg. § 25.2702-3(d)(2). Again, reimbursement can be allowed after the end of the GRAT term.
- i. In the GRAT instrument, specifically ratify reimbursement of taxes consistently with the above provisions. It might also be prudent to consider an indemnity from the grantor for any estate tax that must be paid notwithstanding the above provisions (if, for example, either the grantor or the grantor's spouse revokes or modifies the waiver of section 2207B or 2207A). (But it is not clear whether such an indemnity would make the grantor's retained annuity interest only the stated annuity interest less the value of the indemnity.)
- j. In the GRAT instrument, provide for the appropriate division of the trust into two shares if the grantor's executor makes only a partial QTIP election with respect to the GRAT.
- k. Because of the potential duration of the GRAT for the spouse's life, if state law does not clearly permit the grantor's executor to assign all GRAT payments to the spouse and close the estate, provide for such assignment in the will, and provide in the GRAT instrument that the trustee of the GRAT must honor such an assignment.

J. Avoiding Patent Infringements with a GRAT

1. **Question:** What is the status of the "SO-GRAT," a GRAT funded with stock options?
2. In a consent judgment entered March 9, 2007, in *Wealth Transfer Group, Inc. v. Rowe*, Case No. 3:06CV00024 (D. Conn.), United States Patent 6,567,790 was, pursuant to a stipulation of the parties, adjudged

to be valid and enforceable. Details of the parties' settlement were not disclosed.

3. Various congressional efforts have been launched to prohibit or limit the patenting of tax techniques, and on September 25, 2007, the Service proposed regulations to designate the use of a patented technique a "reportable transaction" for purposes of sections 6011 and 6111.
4. On October 30, 2008, the Court of Appeals for the Federal Circuit held that under the Supreme Court's "machine-or-transformation test" the patentability of "business methods," allowed in *State Street Bank & Trust Co. v. Signature Financial Group Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), *cert. denied*, 525 U.S. 1093 (1999), which is the rationale for the SO-GRAT patent, had to be rejected. *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008) (en banc). The Supreme Court has granted certiorari. *Bilski v. Doll*, No. 08-964 (June 1, 2009).

V. Installment Sales: Fundamental Authorities

A. Rev. Rul. 85-13, 1985-1 C.B. 184.

1. Bottom line: For income tax purposes, a grantor trust is disregarded. There can be no transactions between a grantor and the trust. The trust is simply a pocket of the grantor.
2. Rev. Rul. 85-13 essentially involved a grantor's 1981 installment purchase (for a note) of closely-held stock from a *Clifford*-type trust. The income beneficiary of the trust was the grantor's son for 15 years, which, prior to the replacement of the ten-year standard by a 5-percent standard in section 673, did not render the trust a grantor trust. Neither was there any other feature of the trust that would render it a grantor trust.
 - a. Nevertheless, the Service treated the trust as a grantor trust, because the installment purchase was the economic equivalent of the grantor's purchase of the trust's property for cash followed by the grantor's borrowing the cash from the trust in exchange for the note, and the grantor's borrowing from the trust, until repayment, rendered it a grantor trust under section 675(3).
 - b. Since the trust was a grantor trust, the grantor was treated as the owner of the trust and therefore the owner of the note. Therefore, the transaction could not be a sale, because the grantor was both the maker and owner of the note, and a transaction cannot be a sale

if the same person is treated as owning the purported consideration both before and after the transaction.

- c. Since the transaction was not a sale, the grantor did not obtain a new cost basis in the stock.
3. The Service acknowledged that *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), had reached the opposite result on essentially identical facts, but the Service announced that it would not follow *Rothstein* (without even an exception for the Second Circuit).
4. The Service has consistently cited Rev. Rul. 85-13 for the proposition that a grantor and a grantor trust cannot have transactions with income tax significance. See Letter Rulings 200247006 (Aug. 9, 2002) and 200228019 (July 12, 2002) (transfer for consideration of a life insurance policy from a grantor trust to another grantor trust treated as owned by the same person ruled not a transfer for value for purposes of section 101).

B. Letter Ruling 9535026 (May 31, 1995).

1. Bottom line: An installment sale to a grantor trust works!
2. Letter Ruling 9535026 involved installment sales of stock to trusts that were grantor trusts under section 677(a)(1) because the trustees (the grantors' mother and a bank), who had no interest in the trusts, could pay income or principal to the respective grantors for any reason. Citing Rev. Rul. 85-13, the Service held that the sales were therefore nontaxable, and the trusts took the respective sellers' basis in the stock.
3. The Service went on to give three other rulings.
 - a. There would be no imputed gift if the value of the stock equaled the face amount of the note in each case, because the notes bore interest at the rate prescribed under section 7872. In ruling, in effect, that the notes would be valued at face if they bore interest at the section 7872 rate, the Service cited the Tax Court's holding to that effect in *Frazee v. Commissioner*, 98 T.C. 554 (1992).
 - b. Section 2701 did not apply to the transaction, because debt is not an "applicable retained interest."
 - c. Section 2702 did not apply to the transaction, because the notes were not "term interests" in the trusts.

These three rulings were all conditioned on the status of the notes as debt and not equity, which the Service viewed as primarily a question of fact as to which, citing section 4.02(1) of Rev. Proc. 95-3, 1995-1 C.B. 385, the Service refused to rule. (Section 4.02(1) of Rev. Proc. 2009-3, 2009-1 I.R.B. 107, is the same.)

4. Although Letter Ruling 9535026 does not refer to any “equity” in the trusts, such as other property to secure the debts or property with which to make a down payment, it is well known that the Service required the applicants for the ruling to commit to such an equity of at least 10 percent of the purchase price. *See generally* Mulligan, “Sale to a Defective Grantor Trust: An Alternative to a GRAT,” 23 EST. PLAN. 3, 8 (1996).
5. In Letter Ruling 9251004 (September 4, 1992), the Service had held that a transfer of stock to a trust with no other assets, in exchange for the trust’s installment note, “must be considered a retention of the right to receive trust income” for purposes of section 2036. In Letter Ruling 9535026, the Service specifically stated that “we are expressing no opinion regarding the application of section 2036 to the transaction.”
6. Thus, yesterday’s “defective” grantor trust has become today’s effective briar patch, into which everyone wants to be thrown!
7. In the settlement of a widely-discussed Tax Court case, *Karmazin v. Commissioner*, Dkt. No. 2127-03 (stipulated decision entered Oct. 15, 2003), the parties agreed (i) that the sale of partnership units to a grantor trust was a bona fide sale and not the gratuitous transfer of partnership units with the reservation of an annuity, as the Service had originally argued, (ii) that the interest payments made by the trust were interest and not an annuity, (iii) that neither section 2701 nor section 2702 applied to the transaction, (iv) that for purposes of determining the sale price the discount applied in valuing the partnership units was 37% and not 42% as the transaction originally contemplated (based on an appraisal), and (v) that the defined-value clause (“that number of units equal to a value of \$_____”) was invalid for purposes of the settlement.

VI. Structuring the Trust

A. Drafting for Long-Term Non-Tax Dispositive Objectives

1. If the subject of the installment sale is going to be something like the family business, then the drafting of this trust is the occasion for making

decisions about the ultimate disposition of both the control of and the economic benefit from the business.

2. In all cases, this is the occasion for making decisions about beneficiaries, standards for distributions, incentives and rewards, control by younger generations, and the like.
3. This is also the time to consider and apply to this family situation the pros and cons of locating the trust in a jurisdiction with a relaxed rule against perpetuities and maximum protection from potential creditors.
4. Obviously, flexibility is important, particularly with respect to issues such as the succession of trustees and the situs of the trust.

B. Allocating GST Exemption

1. There is generally nothing about an installment sale that prevents that, as there is, for example, in the estate tax inclusion period (“ETIP”) of section 2642(f) in the case of a GRAT.
2. The installment purchase, particularly by a generation-skipping trust, contemplates that the grantor will fund the trust (and allocate GST exemption), probably at least in the amount needed for the down payment.
3. Indeed, it might be desirable to structure the trust as a “skip person”—*i.e.*, by omitting the generation of the grantor’s children (*see* section 2613(a)(2))—so that, if there is an error in valuation and a partial gift results, GST exemption will be automatically allocated (*see* section 2632(b)). But then care must be taken in using GST exemption for other transfers and other arrangements.

C. Finding an Existing Grantor Trust

1. It is so much the better if such a trust is a GST-grandfathered trust (generally a pre-September 25, 1985 irrevocable trust), to which it is unnecessary to allocate GST exemption. Such a trust, however, should be reviewed for withdrawal powers, discussed below.
2. It might even be possible to find a GST-exempt trust that can be made a grantor trust, perhaps by the trustee’s relinquishment of a safeguard that would otherwise prevent grantor trust status, such as the requirement for adequate security within the meaning of section 675(2) for any loans to the grantor. In practice, this is not easy, however, because it strains

fiduciary duty and it can create the risk of including the trust property in the grantor's gross estate under section 2036 or 2038.

VII. Ensuring Grantor Trust Treatment

It is of supreme importance, of course, that the trust be a grantor trust under subpart E of part I of subchapter J of chapter 1 of the Internal Revenue Code. Since the conventional indicia of grantor trust status—revocability by the grantor, payment of income to the grantor, reversion in the grantor, etc.—would result in inclusion of the value of the trust assets in the grantor's gross estate and thereby defeat the purpose of the trust, it is necessary to examine the more “exotic” provisions of subpart E.

A. Objectives

1. Achieve grantor trust status for the entire trust until the note is paid, the grantor dies, or grantor trust status is intentionally terminated.
 - a. Under the grantor trust rules, a grantor may be treated as the owner of “any portion” (including the entire portion) of a trust for income tax purposes. Section 671 provides that any “remaining portion” of the trust (*i.e.*, any portion of which the grantor is not treated as the owner) is subject to the generally applicable trust income tax rules of subchapter J (section 641 *et seq.*).
 - b. A grantor may be treated as owner of only a portion of the trust if the grantor trust power applies to only a portion of the trust assets. For example, a grantor may be treated as the owner of only (i) income, (ii) corpus, (iii) a fractional or pecuniary share, or (iv) a specific asset. Reg. §1.671-3(a)(3).
 - c. In addition, different persons may be treated as owners of different portions of the same trust. For example, if someone other than the initial grantor contributes assets to the trust, the initial grantor generally will not be treated as the owner of those assets. A power of withdrawal (such as a *Crummey* power or a “5 & 5” power) or the lapse thereof may cause the powerholder to be treated as the owner of the assets subject to the lapsed power.
2. Avoid inclusion of the trust assets in the grantor's gross estate.
3. Avoid potential conflict of interest or breach of fiduciary duty.

- a. If exercise of the power may constitute a breach of fiduciary duty by the powerholder (for example, a trustee), the power might be challenged, with the result that grantor trust treatment is not achieved.
- b. Apart from tax consequences, exercise or termination of the power in an alleged breach of fiduciary duty could expose the powerholder to liability and risk depletion of trust assets in litigation.

B. Alternatives

- 1. Power to use trust income to pay premiums on insurance on the life of the grantor or grantor's spouse. Section 677(a)(3).
 - a. A few ancient cases questioned whether the power to pay premiums is enough, if the power is not exercised. *See generally Rand v. Helvering*, 116 F.2d 929 (8th Cir.), *cert. denied*, 313 U.S. 594 (1941); *Schoellkopf v. McGowan*, 43 F. Supp. 568 (W.D.N.Y. 1942); *Weil v. Commissioner*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29; *Moore v. Commissioner*, 39 B.T.A. 808 (1939), *acq.*, 1939-2 C.B. 25.
 - b. In modern times, the Service has ruled that it is. Letter Ruling 8852003 (Aug. 31, 1988). *Cf.* Letter Ruling 8103074 (Oct. 23, 1980) (entire trust treated as a grantor trust where only a part of the income was to be used to pay premiums).
 - c. For life insurance trusts, the Service now generally regards the issue as one for which "rulings or determination letters will not be issued" and declines to rule. Rev. Proc. 2009-3, 2009-1 I.R.B. 107, § 3.01(53); *see* Letter Ruling 9413045 (Jan. 4, 1994).
 - d. Reliance on the power to use trust income to pay life insurance premiums is risky in any event.
 - i. Sometimes it is hard to tell whether payments are made from "income" rather than principal (to the extent that even makes a difference anyway).
 - ii. The trust law of some jurisdictions grants this power to all trustees. *See, e.g.*, CODE OF VA. § 64.1-57(1)(r) (which is routinely incorporated by reference into Virginia trust instruments). The result that every inter vivos trust is therefore a grantor trust just seems too far-fetched.

- iii. Despite the broad language of section 677(a), an “income” interest under section 677(a) will apparently make the grantor the owner of only the trust income, not the trust corpus. *See* Reg. §§ 1.671-3(b)(1); 1.677(a)-1(g), *Example 1*.
2. Power to reacquire the trust corpus by substituting other property of an equivalent value. Section 675(4)(C).
- a. This power has often been favored, because it does not affect the interests of the beneficiaries.
 - b. Nevertheless, “[t]he Section 675(4)(C) power of substitution is one of the most historically contentious powers in the grantor trust pantheon.” Janes & Kelly, “When Using a Power of Substitution – Take Nothing for Granted,” 34 ESTATE PLANNING 3 (Aug. 2007) (a sober analysis of both the risks that the power is insufficient for income tax purposes and that it goes too far for estate tax purposes).
 - c. In 1994, the Service adopted the view for advance ruling purposes that this power will be reviewed on audit to determine if it is held in a nonfiduciary capacity and therefore makes the trust a grantor trust. *See, e.g.*, Letter Rulings 9504024 (Oct. 28, 1994) and 200434012 (April 23, 2004). *Cf.* Letter Ruling 9442017 (July 19, 1994) (same as to investment power).
 - d. It seems unlikely that a grantor who is not a trustee or cotrustee of the trust would be treated as holding this power in a fiduciary capacity.
 - e. The apparent power to reacquire the trust assets by foreclosing on the security for the loan might be merely the right of a creditor, not a power of trust administration, and not exercisable unconditionally in any event. Moreover, such a power might have less substance if the trust has ample other assets or when the note has been paid down significantly. Therefore, if this power is to be relied on to confer grantor trust status, it is important that it be expressly granted in the trust instrument.
 - f. Both the power that qualifies the trust as a grantor trust and the sale of assets to that trust presumably must be “real.” If an apparent “sale” is in substance only a financing arrangement, it should not be expected to transfer future appreciation from the “seller’s” gross estate.

- g. Income tax cases addressing this concern are hard to find.
 - i. The typical income tax case, usually arising in a tax shelter context, is a search for a “sham,” for which claimed income tax benefits are denied. Such cases are not very apt in the use of grantor trusts, which, while not “shams,” are in a sense intended to lack independent “reality.”
 - ii. Compare AM 2006-001 (Sept. 7, 2006), in which, in a cross-border context where one party to the transactions was a disregarded entity, a promissory note and a forward purchase agreement were considered together in reaching the conclusion that they constituted an equity instrument. Relying on several court cases, the IRS Chief Counsel’s office stated that the intention of the parties to create a debtor-creditor relationship is a significant factor in determining whether an instrument is debt, particularly when the parties are related. Citing Rev. Rul. 2002-69, 2002-2 C.B. 760, the Chief Counsel’s office said that the presence of offsetting obligations in two transactions between the same parties can show that the substance of the transactions differs from their form. The Chief Counsel’s office discussed *Blue Flame Gas Co. v. Commissioner*, 54 T.C. 584 (1970). It also cited *Helvering v. Le Gierse*, 312 U.S. 531 (1941), which found that, when two contracts between the same parties are in existence, the second contract can cause the first to be treated as different from its form. The Chief Counsel’s office concluded that the forward purchase agreement and the promissory note should be treated as a single instrument, with the result that they constituted equity, not debt.
- h. Modern tax shelter opinions, however, have applied analyses of economic substance and of the “benefits and burdens” of ownership. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Rice’s Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983); *Saba Partnership v. Commissioner*, T.C. Memo 1999-359. Even in the absence of express authority, those analyses suggest that there is little reason to fear that a sale to a grantor trust subject to a section 675(4)(C) power of substitution would be viewed as a sham, where typically all or most of the following factors are present:
 - i. The substitution must be at the then fair market value, not the initial sale price.

- ii. The seller retains no control over the trust or the sold property, leaving the trustee, for example, free to transfer the property. (Where, to make the terms of the sale commercially reasonable, the seller retains a security interest in the sold property, this factor is not as strong, but most of the other factors in this list will typically still be present.)
 - iii. The power of substitution applies to all trust property, not just the sold property. (Where the trust holds no other property, this factor is not as strong, but most of the other factors in this list will typically still be present.)
 - iv. There is no prearrangement or expectation at the time of the sale that the property will be reacquired by an exercise of this power.
 - v. The property in fact is not reacquired, at least not soon.
- i. The exclusion of the property from the grantor's gross estate is generally viewed as secure under *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1 (power to reacquire an insurance policy from a trust and substitute other property of equal value held not to be the retention of incidents of ownership in the policy and therefore held not to bring the insurance into the insured's gross estate under section 2038 or 2042).
- i. In *Jordahl*, the grantor, his wife, and a corporate trustee were the three trustees of a trust he created in 1931. His wife died in 1967 and thereafter he and the corporate trustee were the only trustees. In the trust agreement, the decedent retained the powers to substitute insurance policies of equal value for insurance policies held by the trust and to substitute "securities or property" of equal value for other "securities and/or property" held by the trust. The Tax Court cited ten cases (including *United States v. Byrum*, 408 U.S. 125 (1972)) in which the decedent had reserved certain powers over investments, but in only three of those ten cases was the decedent a cotrustee. The court went on to say:

Decedent's power to substitute property "of equal value" would modify or alter the trust no more than those powers to direct investments involved in the cases cited above. Moreover, like the settlors involved in those cases,

decedent was bound by fiduciary standards. Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of “equal value” indicates that the power was held in trust.

It is clear that the court was talking about “fiduciary standards” that do not depend on the decedent’s fiduciary *office* as trustee. Besides, under the regulations, the capacity in which a power is held – *i.e.*, fiduciary or nonfiduciary – should make no difference under sections 2036 and 2038. Reg. §§ 20.2036-1(b)(3) & 20.2038-1(a).

- ii. The grantor’s status as trustee was not emphasized by the Service in the earliest rulings that followed *Jordahl*. See Letter Rulings 9413045 (Jan. 4, 1994) (power of substitution held in a nonfiduciary capacity does not result in inclusion in the gross estate under section 2036, 2038, or 2042) and 9227013 (March 30, 1992) (power of substitution that is a “general power of administration” under section 675(4)(C) does not result in inclusion in the gross estate under section 2038).
- iii. Then in Letter Ruling 200603040 (Oct. 24, 2005), the Service considered a trust that was a grantor trust because the trustee had discretion to distribute income and principal to the grantor’s spouse. The grantor retained the power to acquire trust property by substituting property of equivalent value, a power the ruling recited “may only be exercised in a fiduciary capacity ... defined as action that is undertaken in good faith, in the best interests of the Trust and its beneficiaries, and subject to fiduciary standards imposed under applicable state law.” The ruling described *Jordahl* as follows:

The court concluded that the requirement that the substitute property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent

could not exercise the power to deplete the trust or to shift benefits among the beneficiaries.

The ruling continued:

In the instant case, under Article VII, Section 7.7, Grantor has retained the power to acquire Trust property by substituting other property of equivalent value to the property acquired, measured at the time of substitution. Under the terms of Trust, the Grantor's power to acquire Trust property under this section may only be exercised in a fiduciary capacity.

Based solely on the facts and representations submitted, we conclude that the retention by Grantor of the power of substitution, as described above, will not cause the property of Trust to be included in Grantor's gross estate under §§ 2033, 2036(a), 2036(b), 2038 or 2039.

- iv. To the same effect are Letter Rulings 200606006 (Oct. 24, 2005) and 200842007 (June 24, 2008), in which publicly traded stock was substituted for other publicly traded stock under a power of substitution exercisable in a fiduciary capacity.
- v. Thus, the status under case law and the letter rulings was a linguistic and statutory riddle. The extent to which it is impossible to subject a power of substitution to the "fiduciary standards" of *Jordahl* (which seem most closely related to the "equal value" requirement) without creating the "fiduciary capacity" that was important in Letter Ruling 200603040 (which would disqualify the power under section 675(4)) is unclear.
- vi. Meanwhile, on April 18, 2008, the Service issued Rev. Rul. 2008-22, 2008-16 I.R.B. 796, which cited *Jordahl* and reached a result consistent with the foregoing analysis, expressed as follows:

A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of

equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under §2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

- (a) In the facts of Rev. Rul. 2008-22, the grantor was prohibited from serving as trustee. There does not seem to be any significance to that, other than to accent the fact that the grantor's fiduciary duty as in *Jordahl* cannot be relied on.
 - (b) Rev. Rul. 2008-22 did not state an "effective date." In the case of existing trusts that do not qualify for either of the "shift benefits" safe harbors – trusts, for example, in which the trustee is required to hold the originally contributed asset and distributions are limited to simple income interests – the foregoing *Jordahl* analysis should still be available.
- vii. In Letter Ruling 200846001 (July 31, 2008), the Service ruled that the exercise of a retained power to substitute assets

was not a taxable event for gift or income tax purposes. The ruling does not mention estate tax.

- j. If the property of the trust includes voting stock of a “controlled corporation” within the meaning of section 2036(b)(2) – generally, a corporation more than 20%-owned by the grantor and the grantor’s family—then the retention of a right to reacquire the voting stock could be an indirect retention of the right to vote the stock, which would bring the value of the stock back into the grantor’s gross estate under section 2036(b)(1). Under sections 2036(b)(3) and 2035(a), this estate tax exposure could continue for three years after cessation of the reacquisition right. A section 675(4)(C) power involving voting stock of a closely-held corporation should therefore be used only with great care.
- k. A power in another to “reacquire” trust property by substituting property of an equivalent value has been held to support grantor trust status (again subject to review on audit to determine if the power is held in a nonfiduciary capacity).
 - i. Letter Ruling 200434012 (power of “reacquisition” in the grantor’s father sufficient to make trust a grantor trust). *Accord*, Letter Rulings 199908002 (Nov. 5, 1998) (power in grantor’s brother); 9810019 (Dec. 5, 1997) (the *Karmazin* ruling, with a power in a “disinterested party”); 9037011 (June 14, 1990) (power in cotrustee); 9026036 (March 28, 1990) (power in grantor’s spouse).
 - ii. On July 25, 2008, when the Service promulgated sample inter vivos charitable lead unitrust forms, including forms for both nongrantor and grantor CLUTs, the feature used to confer grantor trust status was a right during the donor’s life, in an individual other than the donor, the trustee, or a disqualified person as defined in section 4946(a)(1), exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. Rev. Proc. 2008-45, 2008-30 I.R.B. 224.
 - iii. Although section 675(4)(C) uses the word “reacquire,” it uses that word in reference to a power held “by any person.”
 - iv. Such a power gives no protection, however, if the power holder dies, unless a successor power holder is specified.

- v. Such a power avoids a 2036 or 2038 problem.
3. Other administrative powers. Section 675.
- a. The powers of the grantor (or the grantor's spouse) to deal with the trust for less than adequate and full consideration (section 675(1)) and to borrow without adequate interest (section 675(2)) have always raised concerns about includibility of the trust assets in the grantor's gross estate under section 2036 or 2038 (or in the grantor's spouse's gross estate under section 2041).
 - b. The grantor's power to borrow from the trust without adequate security (section 675(2); *see* Letter Ruling 199942017 (July 22, 1999)) may be less of a problem, and may even be addressed by compensating for the lack of security with a premium interest rate, which actually enhances the estate planning utility of the trust by increasing the transfers to younger generations. But it is hard to tell what rate of interest, if any, would avoid the estate tax risk created by a lack of security which by statute (section 675(2)) is not "adequate."
 - c. Actual borrowing of trust funds by the grantor (section 675(3)) is hard to reconcile with the installment sale. Borrowing by the grantor would presumably be nominal compared to the amount of the trust's installment sale note, and might simply be an offset against that note. Often the trust will have no other assets to lend.
 - d. The powers to vote stock (section 675(4)(A)) and control investments (section 675(4)(B)) are limited to certain control situations, and in any event they raise issues under sections 2036 and 2038, especially section 2036(b).
4. Certain spousal rights or powers. Sections 672(e) & 677(a).
- a. The ability to qualify a trust as a grantor trust by making the income (or even a reversion) payable to the grantor's spouse (section 677(a)(1) & (2)) is intriguing. The gift tax marital deduction is not a consideration, because it is not desirable to subject the trust corpus to estate tax when the spouse dies.
 - b. Grantor trust status achieved through the grantor's spouse evidently survives divorce (section 672(e)(1)(A)), but it does not survive the spouse's death (and other scenarios such as annulment are unclear). For that reason, and because it is not available to single people at all, this technique is unreliable.

5. Power of an independent trustee or other independent person to add beneficiaries and cause a distribution to be made to them. Section 674.
 - a. This is the feature most frequently used by those who are concerned about the 2036/2038 implication of a section 675(4)(C) substitution power.
 - b. The reason for specifying an “independent” trustee (or other person) is to avoid an “adverse party,” whose consent would prevent the power from rendering the trust a grantor trust. Section 674(a). An “adverse party” is a person with a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power. Section 672(a). Nearly any beneficiary’s interest would be adversely affected by the addition of new beneficiaries and a distribution to them.
 - c. The reason for specifying the addition of beneficiaries is that it is essential to fail to “qualify” for any of the exceptions in section 674(b) and (c).
 - i. In general, section 674(a), by its terms, will not be triggered by a “sprinkle” or “spray” power held only by an adverse party, and section 674(c) will prevent section 674(a) from being triggered if such a power is held by a nonadverse party.
 - ii. Section 674(c) does not apply when the grantor or the grantor’s spouse is a trustee or when more than half of the trustees are “related or subordinate parties who are subservient to the wishes of the grantor.” But it is awkward to rely on the identity of trustees for grantor trust status, because the grantor’s service as trustee can create or aggravate estate tax problems, and other trustees can die or become incompetent (while corporate trustees are generally not related or subordinate or subservient) or can simply resign. It can also artificially limit the recruitment of capable trustees.
 - iii. On the other hand, the flush language in section 674(c) provides that the exceptions in that subsection do not apply when someone has the power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, other than to provide for after-born or after-adopted children.

- d. The reason for specifying that the power to add beneficiaries include the power to cause a distribution to be made to them is that section 674(a) is triggered only by a “power of disposition.”
 - i. If an independent trustee has the power to add beneficiaries to a discretionary trust, but the consent of a cotrustee, who might be an adverse party, is required to actually make a distribution, the power might not go far enough to ensure grantor trust status. **It is important not only to fail to qualify for the exceptions in sections 674(b) and 674(c), which often get most of the attention, but also to trigger the general rule of section 674(a) itself.**
 - ii. On the other hand, if an independent trustee or other nonadverse party has the power to add beneficiaries other than to provide for after-born or after-adopted children, section 674(a) might still be triggered if other trustees, without the consent of an adverse party, hold a power of disposition over trust corpus or income that is not covered by one of the exceptions in section 674(b) (powers subject to a standard, exercisable only by will or after an event, limited to charities, affecting only timing of distributions, and so forth). **But, as stated above, grantor trust status that depends on the identity of trustees from time to time can be fragile and unpredictable.**
- e. The beneficiaries that might appropriately be added by an independent trustee or other independent person in “violation” of section 674(c) are spouses (or companions) of descendants, their ancestors or siblings (*i.e.*, a descendant’s in-laws), their siblings’ descendants (*i.e.*, a descendant’s “nieces” and “nephews” by marriage), their descendants (*i.e.*, a descendant’s stepchildren), and charitable organizations.
 - i. In the case of a power to add spouses or in-laws, such a power can permit the trustee to avoid the hardship that might otherwise result when a descendant who is dependent largely on the trust for support dies, perhaps at a relatively young age, leaving a spouse without support. This result is aggravated when there are no descendants who could otherwise become successive beneficiaries. In the case of a power to add charities, such a power can have significance, when, for example, it is contemplated that the trustee will shift the beneficial interest away from a descendant or other

beneficiary who engages in some conduct that the grantor presumably would want to discourage.

- ii. In drafting any standards for adding beneficiaries, though, care must be taken to avoid simply designating the class in the instrument and, in effect, taking away the trustee's discretion to "add" beneficiaries that is relied on under section 674. In addition, the power to "add" beneficiaries might create too many "potential current beneficiaries" under section 1361(c)(2)(B)(v) and thereby prevent the trust from electing to be an electing small business trust ("ESBT"), if necessary, after the grantor's death. *Cf.* section 1361(e)(2), as amended by the American Jobs Creation Act of 2004 and Gulf Opportunity Zone Act of 2005, under which powers of appointment are ignored in counting the "potential current beneficiaries" of an electing small business trust (ESBT).
- iii. Presumably, the pressure is lessened when the power is held by another person, not the trustee. The power of such a person even to add after-born children would seem sufficient to make the trust a grantor trust, because the exception for a power to add after-born children in section 674(c) applies only to independent trustees.
- iv. Under section 674(a) itself, however, it is not enough that a person merely have the power to add beneficiaries to a discretionary trust. That person must also have the power, without the approval or consent of an adverse party, to direct a distribution to such added beneficiaries. Some estate planners, however, do not share this concern and regard this precaution as unnecessarily conservative.
- v. Care is needed in drafting "bomb clauses" to dispose of the trust property if there ever are no living descendants. A clause giving the trustee the power to distribute the trust property at that time to charities of the trustee's choice might be construed as making all potential charitable distributees contingent beneficiaries of the trust already, thereby making the power to "add" charitable beneficiaries meaningless. This problem might be avoided by making the power to add beneficiaries clearly applicable during the life of the trust, not just at termination. A better approach might be to limit the charities specified in the "bomb clause" to certain purposes (which could be very broadly expressed, so long as some

charities are left out), and giving the trustee the power to add any charity.

- vi. Similarly, if the power to add beneficiaries is given to a person who is not a trustee (*e.g.*, a sibling of the grantor), care must be taken that that person is not in the class of persons (*e.g.*, the grantor's heirs-at-law) who would succeed to the trust property under a "bomb clause."
- vii. If the power is limited to periods after the death of the grantor, then a hypothetical reversion in the grantor must exceed 5 percent of the value of the trust. Sections 674(b)(2) & 673(a). This rule, however, does not necessarily solve the problem of "bomb clauses" discussed in the preceding paragraph. Even though the likelihood that a bomb clause will take effect is probably much smaller than 5 percent, the concern persists that the trustee's power to add charitable beneficiaries during the grantor's life does not really allow the "addition" of beneficiaries. The 5-percent rule addresses, in effect, the present value of the trustee's power, not the determination of who or what are already "beneficiaries."
- viii. The power to add charitable beneficiaries was acknowledged to render a trust a grantor trust in *Madorin v. Commissioner*, 84 T.C. 667 (1985) (holding that the trustee's renunciation of that power was a deemed disposition of trust assets and a realizing event). The Service has followed *Madorin*. See, *e.g.*, Letter Rulings 9710006 (Nov. 8, 1996), 9709001 (Nov. 8, 1996), and 9304017 (Oct. 30, 1992).
- f. Because sections 674(a) and 674(c) explicitly refer to both income and corpus, they leave no doubt that under those provisions a grantor would be treated as the owner of the entire trust.

C. "Toggling" Grantor Trust Status Off and On

1. The easiest type of toggle is to provide that the power that makes the trust a grantor trust terminates at the grantor's death, if desired. Grantor trust status is no longer relevant, and there seem to be no tax issues with such a provision.
2. Enabling the powerholder to renounce or terminate a grantor trust power may be desirable to permit reaction to unknown financial or personal circumstances or changes in trust or tax law.

3. It helps if there is specific authority for the relinquishment of the power—either in the instrument or in applicable trust law. *See, e.g.*, CODE OF VA. § 64.1-57(3) (authorizing a trustee’s “disclaimer” of certain administrative powers). But such authority, especially in local law, might not necessarily extend to the powers (typically powers of distribution) that are relied on for grantor trust status. (In Virginia, a possible exception is the power to use trust income to pay life insurance premiums, discussed above.)
4. One must face the dilemma that a trustee ordinarily would have no reason consistent with fiduciary duty to voluntarily relinquish powers that might be exercised in the future in the best interests of the trust beneficiaries. This is particularly true when an obvious result of such relinquishment would be to subject the trust or its beneficiaries to an income tax that they otherwise would avoid. Broad discretion in the trust instrument might not be sufficient to authorize the trustee to relinquish a power when there is no reason to do so. **Mere accommodation of the grantor does not appear to ever be a proper reason. Recent family limited partnership cases under section 2036(a) should give us pause.**
5. One solution may be to provide that the trustee acquires a desirable power by relinquishing the power that makes the trust a grantor trust. For example—
 - a. A trust instrument with an independent trustee might provide that during the grantor’s life the trustee, in general, does not have the power to vary the shares of the grantor’s children (or other living descendants), perhaps on the theory that the grantor, who knows those beneficiaries, has adequately determined their shares and that the grantor, while alive, is able personally to make any necessary adjustments by other inter vivos arrangements. To allow a response to subsequent changes (for example, in a beneficiary’s lifestyle), the trust instrument might give the trustee the power to divert any beneficiary’s share to charity (but not to siblings or other family members), thereby rendering the trust a grantor trust by failing to qualify for the section 674(c) exception. In that way, while the grantor is alive, the trustee will escape possible badgering by family members to increase their shares.
 - b. The trust instrument could also provide that during the grantor’s life the trustee could acquire the power to vary the shares of family members, but only if the trustee irrevocably relinquishes the power to add charitable beneficiaries during the grantor’s life. In that

way, while the trustee would then be exposed to possible badgering by family members, at least the family members would have the assurance that the entire pot available to them would not be depleted by a diversion to charity.

- c. A variation, not so dependent on the provision of mandatory distributions, would be to simply allow an independent trustee, by relinquishing the power to add charitable beneficiaries, to expand the standard of distributions to family members from an “ascertainable” standard to a broader standard including such objectives as “welfare” or “happiness.” **To make such a relinquishment “real,” it might be desirable for such a distribution to actually be contemplated and actually be made.**

- 6. Another solution might be to give the power in the first place to a person who is not a trustee. It is in this light that that a power (for example, a power of substitution) held *by the grantor* can be most convenient. The notion that the grantor’s relinquishment of such a power would be an additional gift to the trust is not known to have been seriously pursued.
- 7. Of course, if grantor trust status is terminated during the grantor’s life while any part of the installment note is still unpaid, the capital gain is accelerated and taxed to the grantor at that time. *Madorin v. Commissioner, supra.*; Reg. § 1.1001-2(c), *Example (5)*; Rev. Rul. 77-402, 1977-2 C.B. 222. The trust would then presumably receive an adjustment to basis equal to the amount of gain recognized.
- 8. It is not completely clear whether grantor trust status is determined year-by-year in some cases, meaning that grantor trust status would continue until the end of the year in which a terminating event occurs.
- 9. Toggling grantor trust status back on is more difficult.
 - a. The ability to reacquire the power may be viewed as tantamount to having the power itself. Even if the power is held by someone other than the trustee (such as a “protector”), that probably only means that the trustee and the protector together still have the power. It is tempting to provide that the relinquished power will be reinstated after the grantor’s death, when grantor trust status is no longer relevant. But, in that case, the interrelationship of section 674(b)(2) and section 673 might cause grantor trust status to continue, if the value of a remainder following the grantor’s death is at least 5 percent, as it almost always is.

- b. On the other hand, some estate planners are more comfortable with toggling off and on, for example by using the grantor's spouse as a trustee with a section 674(a) distribution power (the spouse could suspend grantor trust status by resigning and in the future could reinstate grantor trust status by being reappointed (by someone other than the grantor)) or by relying on actual borrowing of trust funds by the grantor under section 675(3).
- c. Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the replacement of an independent trustee with a related or subordinate party] results in taxable income to the grantor." Because of the interrelationship with certain partnership transactions and section 754 basis elections, the Chief Counsel's office viewed the overall transaction as "abusive" and wanted to explore other ways to challenge it. But it nevertheless believed that "asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations."

D. Beneficiary Withdrawal Powers

- 1. A holder of a *Crummey* power or other withdrawal power might be the owner of a part of a trust under section 678(a)(1). This was the result in Letter Rulings 199935046 & 199942037 (June 7, 1999) and 200011054-056 & 200011058 (Dec. 15, 1999) (the holder of a 30-day *Crummey* power treated as the owner of the trust under section 678(a)(2) after the *Crummey* power lapsed, and therefore the trust was an eligible shareholder of an S corporation under section 1361(c)(2)(A)(i)). See also Letter Ruling 200747002 (June 21, 2007) (*Crummey* trusts treated as grantor trusts as to the *Crummey* power-holders, "assuming no additional contributions are made").
 - a. It is sometimes thought that section 678(b) avoids this result as to income when the grantor is the owner of the trust, but section 678(b) does not clearly apply when a beneficiary holds a power to withdraw corpus.
 - b. Moreover, the challenge facing estate planners in such cases is to determine who the "grantor" is. Specifically, when a holder of a withdrawal power has had the right to acquire trust property outright, and the original grantor holds only the power to substitute assets or even holds no power at all but is treated as the owner only by reason of a power held by an independent trustee, is the original grantor's status as an owner robust enough to survive the

intervening power of withdrawal, for purposes of determining grantor trust status?

- c. Section 678(a)(2) continues the powerholder's status as owner of the trust in certain circumstances following a release or modification of a withdrawal power, but not necessarily following a mere lapse of a withdrawal power, as typically occurs after a short period of time in the case of a *Crummey* power. The Service reached the opposite result, however, in Letter Rulings 8142061 (July 21, 1981) and 8521060 (Feb. 26, 1985), which essentially treated a lapse as the same as a release, and, in the 1999 rulings, apparently confirmed that result.
 - d. In addition, there has been concern that even if the powerholder is no longer treated as the *owner*, the powerholder may still have become the new "grantor" as to part of the trust, with the result that the trust is not a grantor trust at all to that extent. Recent regulations provide that a person other than the original grantor with a withdrawal right may not become a new "grantor" of the trust, but may still be treated as the *owner* of the trust under section 678(a)(1). Reg. § 1.671-2(e)(6), *Example 4*.
 - e. In contrast, Letter Rulings 200730011 (April 25, 2007) and 200732010 (August 10, 2007), citing section 678(b), viewed a *Crummey* power as having no effect on the grantor's status as owner.
 - f. Thus, many no longer view a *Crummey* power as a serious barrier to grantor trust status. For other, it is still impossible to be sure that the original grantor's "owner" status revives following the lapse of the withdrawal power.
2. As a result, the conservative approach is still to avoid *Crummey* powers in trusts intended to be wholly grantor trusts.

VIII. Structuring the Sale

A. Assets

- 1. There are generally two types of assets that will be sold to a grantor trust in an installment sale.
 - a. Income-producing assets which the client hopes can remain in the family. The estate planning objective is to protect those assets

from erosion and jeopardy of a forced sale, caused by a large estate tax obligation. A typical example is a family-owned business.

- b. Any other kind of asset that is expected to outperform the interest rate on the installment note, so the buildup of value in the trust (which the sale allows the seller to avoid) exceeds the buildup in value in the seller's estate by reason of the payment or accrual of interest on the note.
2. Typical examples include real estate in the path of development and a business that is expected to rapidly increase in value and/or might soon go public or be acquired by a public company.
3. A life insurance policy can be the subject of a sale to a grantor trust, whether or not it is an installment sale. Because a purchase by the insured's grantor trust is treated as a purchase by the insured, it would avoid transfer-for-value treatment under section 101(a)(2)(B). See Letter Rulings 200247006 (Aug. 9, 2002) and 200228019 (July 12, 2002).
4. If the asset itself is leveraged, such as closely-held stock or a limited partnership interest, that is so much the better.
5. A sale of a remainder interest, for its actuarially determined value, is gaining acceptance. See *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), *rev'g* 105 T.C. 252 (1995), *cert. denied*, 520 U.S. 1230 (1997); *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997); *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999), *rev'g* T.C. Memo 1996-25. *But see Gradow v. United States*, 897 F.2d 516 (Fed. Cir. 1990), *aff'g* 11 Ct. Cl. 807 (Cl. Ct. 1987). See generally *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). On remand in *Magnin*, the Tax Court seemed to accept the principle of valuing the remainder at its actuarial value, but it still found that the seller had gotten the valuation wrong. *Estate of Magnin v. Commissioner*, T.C. Memo 2001-31. Under section 2702, such remainder sales would ordinarily be limited to personal residences (where the terms of the sale are patterned after a qualified personal residence trust) and sales to non-family members such as nieces and nephews.
6. As in the case of a GRAT, S corporation stock is well suited to an installment sale to a grantor trust, because a wholly-owned grantor trust can be an S corporation shareholder under section 1361(c)(2)(A)(i), and because the distributions from the S corporation needed to enable the

shareholders to pay income tax on the corporation's income are generally available to make payments on the note. For example, if the grantor owns 100 percent of the stock of an S corporation and sells 10 percent of it to a grantor trust, and the income tax on the corporate earnings is \$100,000, then the grantor (now a 90-percent owner) might receive \$90,000, and the trust would receive \$10,000, which it could use to make a payment on the installment note, giving the grantor \$100,000 to pay the income tax.

7. But a purchase of stock from an S corporation is not the same as a purchase from the grantor/shareholder. An S corporation is a pass-through entity for income tax purposes, but it is not disregarded, as a grantor trust is under Rev. Rul. 85-13.
8. If the grantor's estate may be eligible for special tax treatment under sections 303, 2032A, or 6166, attention should be paid to the effect of the sale on that eligibility, as with any major transfer.

B. Documentation

1. Since the sale is intended to be a fully effective sale for property law purposes and for gift, estate, and GST tax purposes (although not for income tax purposes), it should be as fully documented as any sale to an unrelated party would be. This includes a contract of sale, an assignment, a promissory note, and, if applicable, a deed of trust, mortgage, or similar security document (although the terms that might otherwise appear in a contract of sale are sometimes simply incorporated into the promissory note).
2. If the sale involves a hard to value asset or appropriate valuation discounts, documentation should include independent appraisals and possibly a gift tax return reporting the transaction. *See* Reg. § 301.6501(c)-1(f) (adequate disclosure of gifts in order to rely on the gift tax statute of limitations), especially § 301.6501(c)-1(f)(4) (disclosure of non-gift transactions).
3. Where recording is required or customary, it should be done.
4. Thereafter, the parties' conduct should be consistent with a completed sale. The trustee, not the grantor, should exercise the rights and assume the responsibilities of ownership, and the grantor should enforce all available rights as a creditor.

C. Use of a “Value Definition Clause”

1. Technical Advice Memorandum 8611004 (Nov. 15, 1985) approved a gift expressed as “such interest in X Partnership, an ... limited partnership, as has a fair market value of \$13,000”.
2. A principal drawback of such clauses is frequently the fact that the entitlement to and taxation of future distributions is left ambiguous. This is arguably less of a concern in a grantor trust, where all of the income from both the transferred property and the retained property is going to be taxed to the grantor anyway, probably for a term that extends beyond the gift tax statute of limitations.
3. In *Knight v. Commissioner*, 115 T.C. 506 (2000), the Tax Court disregarded the use of such a technique to transfer “that number of limited partnership units in [the partnership] which is equal in value, on the effective date of this transfer, to \$600,000.” It is generally recognized, however, that that result in *Knight* could have been avoided if the taxpayers had acted more consistently and carefully. Despite the apparent attempt to make a defined-value gift, the gifts shown on the gift tax return were stated merely as percentage interests in the partnership (two 22.3% interests on each return). Moreover, the taxpayers contended in court that such interests were actually worth less than the “defined value.”
4. Field Service Advice 200122011 (Feb. 20, 2001) addressed the facts generally known to be those at issue in *McCord v. Commissioner*.
 - a. Facts as stated in the Field Service Advice.
 - i. The taxpayers had created a partnership with their sons, receiving limited partnership interests in exchange for their contributions. The taxpayers then gifted the limited partnership interests to GST-exempt trusts for their sons, their sons directly, and two charities.
 - ii. The amount of the partnership interest received by each donee was determined by formula: The trusts received partnership interests equal to the donors’ remaining GST exemption. The sons received, directly, partnership interests equal to a fixed dollar value above the amount passing to the trusts. One charity received a fixed dollar amount above the amount transferred to the sons’ trusts. All remaining value (if any) was allocated to the other charity. Thus, if the Service increased the value of the transferred partnership

interests on audit, the increase would automatically pass only to this charity.

- iii. The sons agreed to assume any gift tax liability imposed on the donors as a result of the transfer.
 - iv. The partnership interests were subject to a call provision. Approximately six months after the transfers, the partnership redeemed the charities' interests at fair market value, determined by a subsequent appraisal. Upon redemption, the charities executed releases acknowledging payment in full and releasing the partnership from "any and all obligations, including, but not limited to (1) any and all obligations pursuant to the call agreement and (2) any and all obligations pursuant to the [partnership agreement]."
- b. Arguments.
- i. On examination, the Service increased the value of the partnership interests.
 - ii. The taxpayers argued that if the increase was sustained, an offsetting charitable deduction should be allowable because the formula clause would allocate that increase to charity. The Service disallowed any offsetting charitable deduction, noting that nothing in the partnership agreement or the releases provided a mechanism for the charity to obtain any additional consideration for its redeemed interest in the event the value of the transferred partnership interest was redetermined. As a result, the charity had no right to anything other than the cash it actually received. Any increase in value accrued to the benefit of the sons alone.
 - iii. The Service also refused to respect the valuation clause, citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The Service acknowledged that the valuation clause in question was not identical to the valuation clause in *Procter*, because it was a "formula" clause that defined how much was gifted to each donee, while *Procter* involved a so-called "savings" clause which provided that a gift would be "unwound" in the event it was found to be taxable. Nevertheless, the Service believed the principles of *Procter* were applicable, because both types of clause would recharacterize the transaction in a manner that would render any adjustment nontaxable.

- c. Clearly, FSA 200122011 demonstrates that the Service has little use for the distinction between “formula” valuation clauses and *Procter*-like “savings” clauses that “unwind” the gift. If the valuation clause results in no additional gift tax, under the reasoning of FSA 200122011 the Service will ignore it.
 - d. When *McCord* itself was decided by the Tax Court, the court essentially avoided the formula issue by seizing on the fact that the assignment document had used only the term “fair market value” not “fair market value as determined for federal gift tax purposes.” *McCord v. Commissioner*, 120 T.C. 358 (2003). See the discussion of the Fifth Circuit’s reversal of the Tax Court in paragraph 8, beginning on page 57.
5. Technical Advice Memorandum 200245053 took the dialogue over defined-value clauses to the next level.
- a. Facts.
 - i. The taxpayer, as trustee of an irrevocable trust, and her three children formed a family limited partnership. The trust received a 0.85% general partnership interest and a 99% limited partnership interest. Each of the three children received a 0.05% general partnership interest. The trust contributed cash, publicly traded securities, and real estate in exchange for its interests, and the children contributed cash in exchange for general partnership interests.
 - ii. At the same time as the limited partnership was created, the taxpayer created another irrevocable trust for the benefit of her descendants with herself as trustee. To make it a grantor trust, the children were given rights to acquire trust property by substituting assets of equivalent value.
 - iii. Finally, as trustee of the first irrevocable trust, the taxpayer made a gift of a 0.1% limited partnership interest to the new irrevocable trust. In addition, the taxpayer sold a fractional share of the first trust’s remaining 98.9% limited partnership interest to the second trust. The sales agreement defined the term “Purchase Price” as the value determined by an appraisal of the 98.9% limited partnership interest made as soon as practical after date of the sale. The sales agreement defined the fractional share sold as follows:

The numerator of such fraction shall be the Purchase Price and the denominator of such fraction shall be the fair market value of the [98.9% limited partnership interest]. The fair market value of [the 98.9% limited partnership interest] shall be such value as finally determined for gift tax purposes based upon other transfers of limited partnership interests in the Partnership by Seller as of [the date the gift was made] in accordance with the valuation principles set forth in regulation section 25.2512-1 as promulgated by the United States Treasury under Section 2512 of the Internal Revenue Code of 1986, as amended.

Thus, if the fair market value of the 98.9% limited partnership interest were increased for gift tax purposes, the denominator of the fraction increased, and the result would be that a lesser amount of the partnership interests was actually sold.

- iv. The taxpayer, as trustee of both trusts, and her children, the general partners, signed an “Agreement Regarding Limited Partnership Interest,” stating that they had reached a “tentative agreement” that a 98.9% limited partnership interest had been transferred to the second irrevocable trust by the sale, but that the agreement was subject to modification if it was determined that a different percentage was conveyed.
- v. The buying trust made a promissory note (presumably at the then current mid-term AFR rate) in an amount equal to the Purchase Price under the sales agreement. The note provided that interest is payable annually and the principal is due one day short of nine years from the date of the note. The note was secured by all of the irrevocable trust’s interests in the limited partnership.
- vi. The taxpayer filed a gift tax return reporting the gift of the 0.1% limited partnership interest to which a discount was applied by the appraiser for lack of marketability and lack of control.

- b. Arguments.
 - i. The taxpayer argued that *Procter* and similar precedents were distinguishable because in this case some small tax could result if the Service successfully contested the value of the 0.1% gift. The taxpayer also argued that the Service has sanctioned the use of “valuation formula clauses” in other situations, such as testamentary marital deduction formula clauses and retained annuity formulas in GRATs.
 - ii. The Service concluded that the gift and the sale were part of an integrated transaction, with only an insignificant portion of the transaction placed at issue (meaning subject to gift tax) in an effort to circumvent the case law. In addition, the Service stated that marital deduction formula clauses are necessary to take advantage of “Congressionally authorized” benefits, and that formulas to define retained annuities in GRATs, which are authorized in Reg. § 25.2702-3(b)(1)(ii)(B), are also a practical method to enable a donor to take advantage of a “Congressionally approved” mechanism for transferring a remainder interest in trust property. (It seemed not to occur to the Service to regard the gift tax annual exclusion, the gift tax unified credit, or the adequate consideration exception as “Congressionally authorized.”)

6. Next came Technical Advice Memorandum 200337012.

- a. This TAM considered an assignment, which said: “Assignor desires to transfer as a gift to Assignee that fraction of Assignor’s Limited Partnership Interest in Partnership which has a fair market value on the date hereof of \$a.”
- b. The TAM goes on to say that on the gift tax return the taxpayer reported the gift as an “e% interest,” valued at “\$b, an amount equal to \$5,000 less than \$a.”
- c. The Service, citing *Procter*, rejected this attempted use of a value definition. The Service concluded:

Taxpayer argues that Paragraph B is distinguishable from the clauses in *Procter* [*sic*] because Paragraph B is purportedly a “definitional clause,” not a “formula clause.” A different label does not nullify the effect Paragraph B would have on the gift. The

Taxpayer argues that “the donor gets nothing “back” as he never intended to transfer any interest beyond that having a value of \$a.” However, pursuant to the assignment, Trust received an e% interest in Partnership from Taxpayer. If Paragraph B is given effect and the value of the e% interest, as finally determined by the Service, is greater than \$a, a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in *Proctor* and *Ward* conclude are void as contrary to public policy. Accordingly, in conclusion, Paragraph B is void as contrary to public policy and the Service will make adjustments to the gift tax on the Year 1 return to reflect the value of the e% interest, as finally determined by the Service.

7. In the settlement of the widely-discussed Tax Court case of *Karmazin v. Commissioner*, Dkt. No. 2127-03 (stipulated decision entered Oct. 15, 2003), the parties agreed that the defined-value clause (“that number of units equal to a value of \$_____”) was invalid for purposes of the settlement.
8. *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev’g* 120 T.C. 358 (2003).
 - a. This well-known case involved Charles T. McCord, Jr. (now deceased) and his wife Mary S. McCord, of Shreveport, Louisiana. On June 30, 1995, the McCords created a partnership with their sons, McCord Interests, Ltd., L.L.P. (“MIL”), receiving Class A and Class B limited partnership interests in exchange for their contributions. The Class B interests held a “put right” to withdraw from MIL prior to MIL’s stated termination date of December 31, 2025, and upon withdrawal would receive the fair market value of that Class B interest, determined without regard for the put right itself. All MIL interests transferred to a charity were subject to a “call right” in MIL to repurchase the interest at fair market value. (The MIL partnership agreement was amended and restated in mid-October 1995, effective November 1, 1995. On November 20, 1995, the McCords gave their Class A MIL interests to a school foundation, and all partners joined an agreement providing that the foundation would become a Class A limited partner.

- b. On January 12, 1996, the McCords made gifts of their Class B interests in MIL, accomplished by means of an “Assignment Agreement” that used what the Fifth Circuit later described as a “sequentially structured ‘defined value clause’”:
 - i. to a generation-skipping trust, the dollar amount of fair market value in interest in MIL equal to the donors’ remaining GST exemption, on a net gift basis,
 - ii. to the donors’ sons, \$6,910,932.52 of fair market value in interest in MIL, less the amount given to the generation-skipping trust, on a net gift basis,
 - iii. to the Shreveport Symphony, \$134,000 of fair market value in interest in MIL, and
 - iv. to the Community Foundation of Texas, the remaining dollar amount of interests in MIL.
- c. In March 1996, on the basis of an appraisal by Will Frazier of Howard Frazier Barker Elliott, all the donees of the January gifts executed a “Confirmation Agreement” that translated their gifts into percentage interests in MIL. The percentage interest of the Community Foundation of Texas, which was represented by its own counsel, was confirmed to be 3.62376573%.
- d. On examination, the Service roughly doubled the value of the partnership interests. In Field Service Advice 200122011 (Feb. 20, 2001), the Service acknowledged the taxpayers’ argument that if that increase in value were sustained, an offsetting charitable deduction should be allowable because the formula clause would allocate that increase to charity. The Service disallowed any offsetting charitable deduction, noting that nothing in the partnership agreement or the Confirmation Agreement provided a mechanism for the charity to obtain any additional consideration for its redeemed interest in the event the value of the transferred partnership interest was redetermined. As a result, the charity had no right to anything other than the cash it actually received. Any increase in value accrued to the benefit of the sons alone.
- e. The Service also refused to respect the valuation clause, citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The Service acknowledged that the valuation clause in question was not identical to the valuation clause in *Procter*, because it was a “formula” clause that defined how much was gifted to each donee,

while Procter involved a so-called “savings” clause which provided that a gift would be “unwound” in the event it was found to be taxable. Nevertheless, the Service believed the principles of Procter were applicable, because both types of clause would recharacterize the transaction in a manner that would render any adjustment nontaxable. (*See also* TAMs 200245053 and 200337012.)

- f. When *McCord* was decided by the Tax Court, the majority of the court essentially avoided the formula issue, stating: “Had petitioners provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes, we might have reached a different result. However, that is not what the assignment agreement provides.” 120 T.C. at 397.
- g. In a widely discussed and debated decision, the Fifth Circuit reversed totally, scolded the Tax Court majority soundly, and remanded the case to the Tax Court to enter judgment for the taxpayers. The court said [footnotes omitted]:

The [Tax Court] Majority’s key legal error was its confecting sua sponte its own methodology for determining the taxable or deductible values of each donee’s gift valuing for tax purposes here. This core flaw in the Majority’s inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement’s dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement’s plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation Agreement’s intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

In this respect, we cannot improve on the opening sentence of Judge Foley’s dissent:

Undaunted by the facts, well-established legal precedent, and respondent’s failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law.

... Judge Foley’s use of “olfaction” is an obvious, collegially correct synonym for the less-elegant vernacular term, “smell test,” commonly used to identify a decision made not on the basis of relevant facts and applicable law, but on the decision maker's ‘gut’ feelings or intuition. The particular olfaction here is the anathema that Judge Swift identifies pejoratively in his concurring opinion as “the sophistication of the tax planning before us.”

The court could just as well have quoted Judge Laro in dissent, who railed against “an avoidance of Federal gift taxes, while, at the same time, discouraging audit of the transfer and manufacturing phantom charitable gift and income tax deductions in the event that the value of the transfer was later increased ... a prime example of clear taxpayer abuse.” In contrast, the Court of Appeals itself viewed the McCords as having “embarked on a course of comprehensive family wealth preservation and philanthropic support planning.”

- h. The Government did not seek a rehearing in *McCord*.
- i. The big question after *McCord* was whether the Fifth Circuit had approved, or “blessed,” the use of “defined value clauses.”
 - i. On the one hand, it is clear that the Court of Appeals did not discuss the IRS attack on defined value clauses as such. The court said:

At the outset, we reiterate that, although the Commissioner relied on several theories before the Tax Court, including doctrines of form-over-substance, violation-of-public

policy [the *Procter* attack], and, possibly, reasonable-probability-of-receipt, he has not advanced any of those theories on appeal. Accordingly, the Commissioner has waived them.

- ii. But, on the other hand, the court said other things that are hard to understand unless the court had made peace with the use of defined value clauses – certainly hard to understand if it harbored a serious suspicion that such clauses represented an abusive breach of public policy:

At the heart of this case lies the question of the value of the Class B limited partners interests in MIL thus transferred by the Taxpayers to the exempt and non-exempt donees via the Assignment Agreement of January 12, 1996. We have observed that these gifts divested the Taxpayers of their entire interest in MIL then remaining. It did so, however, not in percentages of interest in MIL, however, but in dollar amounts of the net fair market value of MIL, according to a sequentially structured ‘defined value clause’...

...[H]elping to frame our review is the fact that this is not a run-of-the-mill fair market value gift tax case. Rather, as recognized by the Majority and by Judges Chiechi and Foley in dissent, the feature that most fractionated the Tax Court here is the Taxpayers’ use of the dollar-formula, or ‘defined value,’ clause specified in the Assignment Agreement (the gift instrument, not either the original or the amended partnership agreement nor the Confirmation Agreement) to quantify the gifts to the various donees in dollars rather than in percentages....

...As we hereafter hold, as a matter of law, that the methodology employed by the [Tax Court] Majority in determining the taxable and non-taxable values of the various

donations constitutes legal error, the results of the Majority's independent appraisal of the donated interests in MIL and their values for gift tax purposes become irrelevant to the amount of the gift taxes owed by the Taxpayers.... [The holding as "a matter of law" that the court refers to here is, as seen above, the court's holding that the Tax Court erred by considering the post-valuation-date event of the Confirmation Agreement, not necessarily a holding that the Service's public policy argument is wrong.]

...It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording....

In the end, whether the controlling values of the donated interests in MIL on the date of the gifts are those set forth in the Assignment Agreement based on Mr. Frazier's appraisal of \$89,505 per one per cent or those reached by the Majority before it invoked the Confirmation Agreement (or even those used by the Commissioner in the deficiency notices or those reached by the Commissioner's expert witness for that matter), have no practical effect on the amount of gift taxes owed here.

- iii. Even if the court has not explicitly "blessed" defined value clauses, it has, at least in the Fifth Circuit, effectively taken away an important tool (but not necessarily the only tool) for attacking them – namely, the ability to look at "what really happened" down the road.

- 9. So what were the planning implications of *McCord*?
 - a. Will the IRS agree that the Fifth Circuit has implicitly addressed defined value clauses, or will it be emboldened by the fact that the Fifth Circuit refused to explicitly bless them? The latter is almost certain.
 - b. Will *McCord* give a boost to the use of defined value clauses? In the Fifth Circuit, this seems likely. Elsewhere, it is hard to say.

- c. If so, will donors use words like “as finally determined for federal tax purposes”?
 - i. To do so might seem to increase the odds of favorable treatment in the Tax Court. But it might be most likely to annoy the IRS and provoke a court to look closely at the public policy issues largely avoided by both the Tax Court and the Fifth Circuit in *McCord*.
 - ii. To “play it straight” and avoid such words would make the case most like *McCord*, improve the value of *McCord* as a precedent, further distance the transaction from the “trifling with the judicial process” that seemed to be the last straw in *Procter*, and perhaps reduce the chance of provoking a confrontation.
 - iii. “Activists” who like to see things resolved will like the *McCord* model. Clients more nervous about getting a tax bill will prefer an “as finally determined” approach. The somewhat unusual fact pattern in *McCord* – especially the donors’ disengagement from the ultimate outcome and the participation of an independent charity – lends itself to the “activist” approach.
- d. Will variations such as the use of formula disclaimers, or sales rather than gifts (as in *Dallas, supra*), be more popular or more effective? It is hard to tell.
- e. In any event, has the Fifth Circuit delivered what clients want? If clients want a guarantee that they will not have a hassle with the IRS, *McCord* comes up short.
- f. How can clients cope with the uncertainty of not knowing exactly what they have transferred?
 - i. More than one trust with the same trustee, with joint investments authorized, can help.
 - ii. In any event, grantor trusts should be used whenever possible, where all of the income from all the transferred property and even any retained property will be taxed to the grantor anyway, ideally for a term that extends beyond the gift tax statute of limitations.

- iii. Issues of GST exemption allocation need to be considered also.
- g. Who or what should be the “pourover” recipient of any transferred property in excess of the defined value?
- i. A public charity, as in *McCord*, is ideal, but the *McCord* fact pattern might be a luxury that many clients cannot emulate.
 - ii. A private foundation can be convenient, if the self-dealing shoals can be navigated.
 - iii. A “zeroed-out” charitable lead annuity trust presents opportunities and challenges similar to those with a private foundation.
 - iv. The donor’s spouse is a possibility, although this might just shift the gift tax exposure to the spouse. And obviously this is not much help to unmarried clients.
 - v. Depending on a charitable or marital deduction always faces some risk that the very uncertainty will jeopardize the deduction. See Technical Advice Memoranda 9050004 & 9403005 (all stock owned by decedent valued as a control block for purposes of the gross estate, but marital bequest valued separately for purposes of the marital deduction), relying on *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (estate of a decedent who owned all the stock of a corporation entitled to prove a control premium for a 51-percent block of stock bequeathed to spouse), and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).
 - vi. A formula GRAT is easy to use, so long as the prohibition of Reg. § 25.2702-3(b)(5) on additional contributions is not violated.
 - vii. An “incomplete gift trust” – for example, where the grantor retains a power of appointment treated as retained “dominion and control” for purposes of Reg. 25.2511-2 – is a possibility.
 - viii. The donor himself or herself is the easiest of all, and this is the default result of a simple defined value transfer – “I give/sell _____ so much of _____ as has a value of \$_____.” But then the donor can never step out of the transaction and let other parties sort out value in arm’s-length discussions,

which seemed so important in *McCord*. (A CLAT, GRAT, or incomplete gift trust may present similar risks, because ultimately the limitation on the gift tax exposure depends on what comes back to the donor.)

- h. There will be more attention to the technique of “backing into” a defined value transfer by the use of defined value disclaimers.
 - i. There is support for this in Reg. § 25.2518-3(d), Examples 18 & 19.
 - ii. The Service has ruled favorably in the estate tax context in modern times. *See* Letter Ruling 200420007.
 - iii. But at other times, the Service seems reluctant to “bless” the use of disclaimers beyond the strict terms of the examples in the regulations – and sometimes even that is difficult. That reluctance set up the next case, *Christiansen*.

10. *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court).

- a. In *Christiansen*, the decedent will left everything to her daughter (her only child), who was also her executor, with the proviso that anything her daughter disclaimed would pass three-fourths to a charitable lead trust and one-fourth to a charitable foundation the decedent had established. Her daughter disclaimed a portion of the estate, using the following language:

Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 Dollars (\$6,350,000.00) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 (“the Disclaimed Portion”). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17,

2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes.

- b. After quoting that language of the disclaimer, the court stated: “But note especially the final phrase: ‘as such value is finally determined for federal estate tax purposes.’” In other words, the court emphasized the presence of the language the absence of which it had found significant in *McCord*.
- c. A divided court (11-2) held the disclaimer to be disqualified to the extent of the three-fourths that passed to the charitable lead trust, because the disclaimant had not also explicitly disclaimed her contingent remainder interest in the charitable lead trust.
- d. But the court, without dissent, upheld the disclaimer to the extent of the one-fourth that passed to the foundation. The court rejected the Service’s argument, based on *Procter*, that the valuation formula clause in the disclaimer violated public policy. The court said:

This case is not *Procter*. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn’t in any way upset the finality of our decision in this case.

- e. On December 13, 2008, the Government filed a notice of appeal to the Eighth Circuit.

D. Interest Rate

- 1. The interest rate on an installment sale to a grantor trust should be the rate prescribed by section 7872(f)(2)(A) for term loans.
 - a. The Tax Court has held that section 7872 is the applicable provision. *Frazee v. Commissioner*, 98 T.C. 554 (1992). The

court stated: “We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept.” *Id.* at 590.

- b. At times, though, the Service does seem to embrace a market interest rate standard. *See* Letter Ruling 200147028 (Aug. 9, 2001).
 - c. Section 7872(d)(2) provides that in a gift context (which includes a transfer to a grantor trust) the gift tax consequences of a term loan are analyzed under section 7872(b)(1). Section 7872(b)(1) treats as a transfer from the lender (the grantor/seller) to the borrower (the trust) an amount equal to the excess of the amount lent (the value of the property transferred, less any down payment) over the present value of the payments to be made under the terms of the loan. Section 7872(f)(1) defines “present value” with reference to the “applicable Federal rate.” Section 7872(f)(2)(A) defines the “applicable Federal rate” for a term loan.
2. The rate prescribed by section 7872(f)(2)(A) is the applicable Federal rate in effect under section 1274(d) for the period represented by the term of the loan, compounded semiannually. Since installment sales most often involve only annual payment of interest of annual compounding, the rates under section 1274(d) for annual compounding are typically used, but they will never be lower than the rates for semiannual compounding.
- a. Section 1274(d) divides loans into “short-term” (not over three years), “mid-term” (over three years but not over nine years), and “long-term” (over nine years). Under Rev. Rul. 2009-33, 2009-40 I.R.B. ____, those rates, compounded annually, are as follows for October 2009:
 - i. Short-term (not over 3 years): 0.75 percent.
 - ii. Mid-term (over 3 years but not over 9 years): 2.66 percent.
 - iii. Long-term (over 9 years): 4.10 percent.

The Revenue Ruling prescribes an October rate under section 7520 for valuing annuities, life interests, term interests, remainders, and reversions of 3.2 percent.

- b. In the case of a “sale or exchange,” section 1274(d)(2) allows the use of the rate for either of the two preceding months, if it is lower. But it seems dangerous to rely on the existence of a “sale” as that word is used in section 1274(d)(2) [in the income tax subtitle] in the context of a transaction that is intended not to be a “sale” for income tax purposes. The 7872/1274 rate for the current month seems to best fit the precedent of *Frazer*.
 - c. The rate for demand loans is the floating short-term rate in effect from time to time—*i.e.*, 0.75 percent for October. There is also an optional “blended” rate, announced mid-year, which for 2009 is 0.82 percent. Rev. Rul. 2009-20, 2009-28 I.R.B. 112. (In contrast, the 2008 blended rate was 2.80 percent. Rev. Rul. 2008-33, 2008-27 I.R.B. 8.)
3. In periods of low interest rates, consideration is often given to “refinancing,” or “renegotiating” a note to a lower interest rate.
- a. The technique is generally supported in Blattmachr, Crawford & Madden, “How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note,” 109 JOURNAL OF TAXATION 22 (July 2008).
 - b. Caution is advised in Feder, “The Promissory Note Problem,” 142 TRUSTS & ESTATES 10 (Jan. 2003), and Hayes, “Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners,” 13 CALIF. TRUSTS & ESTATES QUARTERLY 5 (2007).
 - c. Proposed Reg. § 1.7872-11(e) is labeled “Treatment of renegotiations” but is only “Reserved.” The proposed regulations have been outstanding since August 1985.

E. Payment

- 1. There is no requirement for a particular term for the note, but to ensure treatment as debt, conventional wisdom suggests a term no longer than 15-20 years.
- 2. Likewise, there is no requirement for any particular payment schedule. Payment of principal may balloon at the end. While there is no requirement to pay interest currently, and therefore interest may be added to principal and paid at the end, it may be most commercially reasonable to require the payment of interest at least annually (but compounded semiannually), even if all principal balloons at the end.

3. Attention must be paid to the fact that the grantor will be paying income tax on all the income realized by the trust (since it is, after all, a grantor trust). If the trust has extraordinary income, such as by reselling the asset, the grantor may owe a lot of income tax. A “due-on-sale” clause in the note might help, if the note is not a demand note, but neither a due-on-sale clause nor a demand note will necessarily cover tax on the appreciation that accrues after the grantor’s sale to the trust. **Generally, grantor trusts are not for those who can’t afford them.**
4. The sale can be structured to provide asset-protection benefits, by providing that if the trustee determines that any creditor of the grantor has obtained or is attempting to obtain a judgment that could jeopardize the grantor’s ability to benefit from the note payments, then the trustee can divert those payments to a discretionary trust for the grantor’s benefit, over which the grantor has a testamentary power of appointment, perhaps in a protective jurisdiction.

F. Reimbursement for Income Tax—Historically

1. Letter Ruling 9444033 (Aug. 5, 1994), dealing with two GRATs, included the following notorious paragraph (emphasis added):

Further, each proposed Trust agreement requires the trustee to distribute to the grantor, each year during the trust term, *the amount necessary to reimburse the grantor for the income tax liability with respect to the income received by the trustee and not distributed to the grantor.* Under this provision, a grantor will not make an additional gift to a remainderperson in situations in which a grantor is treated as the owner of a trust under §§ 671 through 679 and the income of the trust exceeds the amount required to satisfy the annuity payable to the grantor. Ordinarily, if a grantor is treated as the owner of a trust under §§ 671 through 679, the grantor must include in computing his tax liability the items of income (including the income in excess of an annuity), deduction, and credit that are attributable to the trust. *If there were no reimbursement provision, an additional gift to a remainderperson would occur when the grantor paid tax on any income that would otherwise be payable from the corpus of the trust.* Accordingly, since there is a reimbursement provision, we rule that, if the income of either trust exceeds the annuity amount, the income tax paid by the grantor on trust income not paid to the grantor will not constitute an additional gift to the remainderpersons of the Trust.

2. This paragraph was immediately controversial. One year later, the ruling was reissued with this paragraph deleted. Letter Ruling 9543049 (Aug. 3, 1995).
3. Nevertheless, questions remained.
 - a. Was the italicized dictum about the result without reimbursement right?
 - b. Did the dictum apply only to trust accounting income—*i.e.*, “income *received* by the trustee”—and not to passthrough income for income tax purposes such as a trust’s undistributed share of the income of an S corporation?
 - c. Was such a doctrine effectively limited to GRATs, where the right to receive “fixed amounts” arguably means fixed *net* amounts and where the addition of assets to the trust is prohibited? (The Service continued to insist on reimbursement as a condition for issuing a ruling with respect to a GRAT, but has not extended this policy to other types of grantor trusts.)
4. Generally, it was not thought by estate planners to be necessary, and was often thought not even to be appropriate, to include this type of reimbursement language in grantor trusts in general, including grantor trusts to which installment sales are intended—subject, of course, to the foregoing observation about the grantor’s ability to pay income tax.
5. Inclusion of a reimbursement clause was thought to risk inclusion of the trust assets in the grantor’s estate. Although Reg. § 20.2036-1(b)(2) provides that property is included in the transferor’s estate if its income may be applied toward the discharge of the transferor’s legal obligation (in this case, the grantor’s income tax liability), the Service occasionally ruled that such a clause did not cause inclusion under section 2036. See Letter Rulings 9413045 (Jan. 4, 1994), 9709001 (Nov. 8, 1996), 1999919039 (Feb. 26, 1999) & 199922062 (Feb. 26, 1999).
6. The Service likewise ruled that permissible reimbursement, in the discretion of someone who is independent, did not present a section 2036 problem. Letter Ruling 200120021 (Feb. 13, 2001). If such a power is held by an independent trustee, it would present the question of when it would ever be consistent with the trustee’s fiduciary duty to make this reimbursement to someone (the grantor) who is not a beneficiary of the trust.

7. The grantor's relinquishment of a right of reimbursement, to toggle off grantor trust status, would arguably be an additional gift to the trust.

G. Reimbursement for Income Tax—Currently

1. Just before the Fourth of July weekend in 2004, the Service promulgated Rev. Rul. 2004-64, 2004-27 I.R.B. 7. The Revenue Ruling poses three situations involving “defective” grantor trusts, with a trustee who the ruling recites is required by the trust instrument not to be related or subordinate to the grantor within the meaning of section 672(c). Because the trusts are grantor trusts, the grantor is liable for the income tax on the trust income.
 - a. In Situation 1, neither state law nor the governing instrument requires or permits the trustee to reimburse the grantor for the income tax, and the grantor pays the tax. The ruling holds that the value of the trust assets is not includible in the grantor's gross estate.
 - b. In Situation 2, the governing instrument *requires* the trustee to reimburse the grantor for the income tax. The ruling holds that the value of the trust assets *is* includible in the grantor's gross estate in this case, because the grantor has retained the right to have trust assets used to pay the estate's obligations. The ruling states that the result would be the same if the reimbursement right flowed from state law, rather than from the governing instrument. The ruling goes on, however, to provide that it will not apply the holding of Situation 2 to trusts created before October 4, 2004.
 - c. In Situation 3, the trustee has the *discretion* to reimburse the grantor for the income tax. The ruling holds that the value of the trust assets is not includible in the grantor's gross estate in this case, unless the discretion is accompanied by other bad facts, which the ruling describes as “including but not limited to: an understanding or pre-existing arrangement between [the grantor] and the trustee regarding the trustee's exercise of this discretion; a power retained by [the grantor] to remove the trustee and name [the grantor] as successor trustee; or applicable local law subjecting the trust assets to the claims of [the grantor's] creditors.”
2. In all three situations, the ruling holds that the grantor's payment of the income tax is not a gift to the trust beneficiaries, because the grantor is liable for the tax. In Situations 2 and 3, the ruling holds that the trustee's reimbursement of the income tax is not a gift to the grantor by the trust

beneficiaries, because it is made pursuant to the terms of the trust instrument.

3. The clarifications provided by Rev. Rul. 2004-64 were generally welcomed by the estate planning community, and the ruling seemed to reach the right results, given the historical disconnect between the income tax and estate tax rules. The grace period until October 4, 2004, was also welcomed.
4. Moreover, the October 2004 effective date was generally viewed as applicable for purposes of implied retained rights to reimbursement (Scenario 3) as well as explicitly retained rights to reimbursement (Scenario 2). It would be quite odd for rights that are only arguably implied to be treated more harshly than rights that are overtly retained, especially in light of the historical ruling positions described above. Contemporaneous reactions from Treasury and Service personnel seemed to confirm this view.
5. Where Rev. Rul. 2004-64 has raised eyebrows among estate planners is the requirement in its facts that the trustee must not be related or subordinate to the grantor within the meaning of section 672(c) and its somewhat expansive articulation of fact patterns that could cause estate inclusion when coupled with a trustee's discretion to reimburse the grantor for income taxes (Situation 3).
 - a. Attempts by the Service to engraft the income tax concept of "related or subordinate" on the transfer tax originate at least from Rev. Rul. 95-58, 1995-2 C.B. 191, which revoked the extremely unpopular holding of Rev. Rul. 79-353, 1979-2 C.B. 325, that a trust would be included in the gross estate of a grantor who retained the right to remove and replace a corporate trustee with unlimited discretion over distributions with another corporate trustee. Rev. Rul. 95-58 expressly overrode the holding of Rev. Rul. 79-353 only in cases where the successor trustee could not be related or subordinate to the grantor. For the most part, the estate planning community has not accepted that restriction as a defensible gloss on the substantive law, believing instead that the only legitimate restriction of substantive law (as alluded to in the portion of Rev. Rul. 2004-64 quoted above) applies if the decedent had "the unrestricted power to remove or discharge a trustee at any time and appoint *himself*" as trustee. Reg. §§ 20.2036-1(b)(3) & 20.2038-1(a)(3) (emphasis added). Nevertheless, there is very little that can be done about the Service's disposition to draft Revenue Rulings narrowly in this way. It is generally recognized

that Revenue Rulings like this provide only a safe harbor, and a client is free to take a more aggressive position. Few clients will want the risk or hassle, however, although where the stakes are sufficiently high some might seek a private letter ruling.

- b. Because of concerns about includibility where an independent trustee (or another independent person) has discretion to reimburse the grantor for income tax, it is possible that after October 3, 2004, such discretion will be granted only sparingly, and will perhaps be limited to direct payments to tax authorities, not to the grantor so as to risk placing the discretion within the reach of the grantor's creditors.
6. Whether or not reimbursement discretion is desired, it will become more common, as a precaution, to include in trust instruments specific language negating or limiting any right of reimbursement that might be implied from applicable state law. The following are some samples:
- a. **Total negation of reimbursement (a good default provision):** My Trustee may not pay, or reimburse me for the payment of, any income taxes imposed with respect to income or gains of the trust, notwithstanding any contrary rule of law.
 - b. **Negation after a prescribed term in which estate tax is conceded:** At no time after the expiration of the QPRT Term shall my Trustee pay, or reimburse me for the payment of, any income taxes imposed with respect to income or gains of the trust, notwithstanding any contrary rule of law.
 - c. **Discretion in trustee:** My Trustee *[not related or subordinate under § 672(c)]*, in his/her/its sole discretion, may pay to the appropriate tax authorities, or reimburse me for the payment of, any incremental income taxes imposed with respect to income or gains of the trust. This discretion shall govern such payments or reimbursements notwithstanding any contrary rule of law. *[When there is more than one cotrustee, limiting this discretion to only one of the cotrustees is of course appropriate. If there is concern about exposing the trust assets to the grantor's creditors, deletion of the underlined words, and the inconvenience that such deletion would create, should be considered.]*
 - d. **Discretion in someone else:** At any time, _____ *[not related or subordinate under § 672(c)]*, in his/her/its sole discretion, may direct my Trustee to pay to the appropriate tax authorities, or reimburse me for the payment of, any incremental

income taxes imposed with respect to income or gains of the trust. This discretion shall govern such payments or reimbursements notwithstanding any contrary rule of law. *[If there is concern about exposing the trust assets to the grantor's creditors, deletion of the underlined words, and the inconvenience that such deletion would create, should be considered.]*

H. Use of a Self-Canceling Installment Note (“SCIN”)

1. There is no reason not to use an installment note that is payable until the expiration of a stated term or the death of the holder, whichever occurs first—that is, a note that “self-cancels” at the holder’s death. *See Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003) (upholding the use of a SCIN).
 - a. If such a note is used, it is important that there be a commercially reasonable interest or principal premium for that feature, bearing a reasonable relationship to the age and probably the health of the holder. (Section 7520 probably does not apply in determining the value of such contingencies.)
 - b. In addition, if such a note is used, it is important that principal and interest both be paid in level payments or in some equivalent manner.
2. The holding of *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992) (reviewed by the Court), *aff’d*, 998 F.2d 567 (8th Cir. 1993), that the holder’s death constitutes a disposition of the SCIN for purposes of section 453B should not be particularly important in the case of a grantor trust, where the Service should be expected to make that argument anyway. (*See Part X*, beginning on page 78.)

I. Use of a Private Annuity Instead of an Installment Note

1. The most common objection to the use of a private annuity—that it converts capital gain to ordinary income under section 72—is not applicable to a transaction between a grantor and a grantor trust.
2. Nevertheless, the payments would probably have to reflect the higher section 7520 rates, rather than the 7872/1274 rates.

J. Features Advisable for Estate Tax Purposes

1. The Supreme Court has held that the irrevocable assignment of rights in life insurance policies coupled with retention of annuity contracts did

not subject the insurance policies to estate tax under the predecessor to section 2036. *Fidelity-Philadelphia Trust v. Smith*, 356 U.S. 274, 277 (1958). The Court based this holding on two significant observations:

- a. The annuity payments were not linked to income produced by the transferred insurance policies.
 - b. The obligation was not specifically charged to the transferred policies.
2. *Fidelity-Philadelphia Trust* has been rather consistently followed in both income tax and estate tax cases. *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984); *LaFargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982); *Lazarus v. Commissioner*, 513 F.2d 824 (9th Cir. 1975); *Samuel v. Commissioner*, 306 F.2d 682 (1st Cir. 1962); *Estate of Becklenberg v. Commissioner*, 273 F.2d 297 (7th Cir. 1959); *Cain v. Commissioner*, 37 T.C. 185 (1961). *See also Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984) (an annuity given in exchange for property treated for estate tax purposes as adequate consideration and not as a retained interest in the transferred property).
3. The reasoning in *Fidelity-Philadelphia Trust* suggests that the estate tax case is strongest when the following features are carefully observed:
- a. The note should be payable from the entire corpus of the trust, not just the sold property, and the entire trust corpus should be at risk.
 - b. The note yield and payments should not be tied to the performance of the sold asset.
 - c. The grantor should retain no control over the trust.
 - d. The grantor should enforce all available rights as a creditor.
4. In the settlement of the widely-discussed Tax Court case of *Karmazin v. Commissioner*, Dkt. No. 2127-03 (stipulated decision entered Oct. 15, 2003), *Fidelity-Philadelphia Trust* reasoning was helpful in permitting the taxpayer to avoid the application of section 2702. The parties agreed (i) that the sale of partnership units to a grantor trust was a bona fide sale and not the gratuitous transfer of partnership units with the reservation of an annuity, as the Service had originally argued, (ii) that the interest payments made by the trust were interest and not an annuity, (iii) that neither section 2701 nor section 2702 applied to the transaction, (iv) that for purposes of determining the sale price the discount applied in valuing the partnership units was 37% and not 42% as the transaction originally

contemplated (based on an appraisal), and (v) that the defined-value clause (“that number of units equal to a value of \$_____”) was invalid for purposes of the settlement.

K. Equity/Down Payment/Capitalization

1. As previously stated, it is well known that the Service required the applicants for Letter Ruling 9535026 to commit to trust equity of at least 10 percent of the installment purchase price.
2. More recently, the Service has refused to rule on proposed installment sales to “dry” trusts—*i.e.*, trusts with no other assets.
3. “Equity,” in the form of either a down payment or other assets to secure the loan, is usually considered a good idea. Ten percent is usually regarded as safe, although lower percentages are often considered acceptable and higher percentages are often viewed as prudent.
4. The need for equity is very thoughtfully challenged in Hesch & Manning, “Beyond the Basic Freeze: Further Uses of Deferred Payment Sales,” 34 UNIV. MIAMI INST. EST. PLANNING ch. 16 (2000), which concludes, however: “Nevertheless, the issue is an intensely factual one, requiring a careful exercise of judgment by the estate planner, including sound advice to the client concerning the degree of risk involved, with our advice remaining that only those who are willing to take substantial risks should use a trust with no other significant assets.” *Id.* at ¶ 1601.11.
5. Guarantees by beneficiaries are sometimes viewed as ways to provide “equity” without a substantial taxable gift.
 - a. If the trust does not pay a fee for such guarantees, or the fee is not adequate, the guarantor might become a contributor and thus a grantor, with the result that the trust is not wholly owned by the original grantor as desired.
 - b. A credible argument can be made, however, that the mere giving of a guarantee is not a gift, particularly by remainder beneficiaries (who otherwise would appear to just be making gifts to themselves). *See* Hatcher & Manigault, “Using Beneficiary Guarantees in Defective Grantor Trusts,” 92 J. TAXATION 152 (2000).
 - c. Guarantees by the grantor’s spouse are sometimes used, relying on section 1041 to prevent the realization of gain even if there are two

owners (husband and wife). But section 1041 does not apply to the payment or accrual of interest, and the gift tax marital deduction is never assured when the gift in effect goes into a trust.

6. The intriguing alternative of making the “equity” portion of the trust an incomplete gift through retention of a limited power of appointment was persuasively outlined in Dunn, Such & Park, “The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts,” 34 ESTATE PLANNING 39 (2007).
7. The risks created by “thin capitalization” are
 - a. includibility in the gross estate under section 2036,
 - b. a gift upon the cessation of section 2036 exposure,
 - c. applicability of section 2702 to such a gift,
 - d. the creation of a second class of equity in the underlying property with possible consequences under section 2701,
 - e. possible loss of eligibility of the trust to be a shareholder of an S corporation,
 - f. treatment of the trust as an association taxable as a corporation,
 - g. continued estate tax exposure under section 2035(a) for three years after cessation of section 2036 exposure, and
 - h. inability to allocate GST exemption during the ensuing ETIP.

The section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain.

8. If the grantor’s gift to the trust to equip it to pay the down payment is followed too closely (for example, at the same time!) by the installment purchase, there might be some concern that the transaction would be collapsed and recharacterized as a part-sale and part-gift, although it is hard to see what overall difference that would make.

IX. Advanced Installment Sale Applications

1. After a grantor trust has purchased property from the grantor, there is no reason, if done in a commercially reasonable manner, that the grantor

cannot lease the property back from the trust, thereby minimizing the disruption in the grantor's use of the property while still removing the appreciation in the property from the grantor's gross estate.

2. When a grantor trust that has made an installment purchase becomes "in the money"—*i.e.*, when the cash flow from the investment exceeds the debt service and/or permits the debt to be paid off—the trust can use that cash as the down payment in buying more of the asset on an installment basis, without additional funding by the grantor. Such purchases may, of course, be at a higher price reflecting the growth in value of the investment.
3. If a grantor trust purchases the grantor's right to the retained annuity in a GRAT, the appreciation represented by assets that the GRAT distributes in kind in satisfaction of its annuity obligation will not accumulate in the grantor's estate, and the payback at the 7520 rate will, in effect, be converted to a lower payback at the 7872 rate.

X. Tax Treatment of the Installment Note at the Grantor's Death

A. Income Tax Treatment

1. If the grantor/seller/note-holder dies before the note is paid off, the Service may argue that that causes a realization of the grantor's gain, to the extent the note is unpaid.
 - a. That would arguably be similar to the realization that occurs when a grantor cures the defect or renounces the power that causes the trust to be a grantor trust. *Madorin v. Commissioner, supra*; Reg. § 1.1001-2(c), *Example (5)*; Rev. Rul. 77-402, 1977-2 C.B. 222. It would be no more aggressive than the Service's argument that the death of the holder of a SCIN causes a realization. *Estate of Frane v. Commissioner, supra*. (Both the Service's argument and the courts' holdings are open to serious question; this writer believes that *Frane* was wrongly decided.)
 - b. *Cf.* Technical Advice Memoranda 200010010 (Nov. 23, 1999) and 200011005 (Nov. 23, 1999), where the Service took the position that the grantor of a GRAT realized income in the amount of the GRAT's borrowing (from third parties) outstanding when the GRAT ceased to be a grantor trust. (This result could apparently have been avoided if the grantor bought the assets from the GRAT before the end of the term, or in any event if the GRAT continued

as a grantor trust for income tax purposes after the end of the GRAT term.)

- c. In Letter Ruling 200434012 (April 23, 2004), involving a sale from one grantor trust to another, the Service included the caveat that “when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 by reason of A’s death or the waiver or release of any power under § 675, no opinion is expressed or implied concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), a change in the basis of any property under § 1012 or § 1014, or any deductible administration expense under § 2053.”
2. Estate planners at first assumed, without much analysis, that this would be the result – perhaps on some type of IRD theory.
 3. But in 1999, a thoughtful and rigorous article, reflecting considerable peer review and collegial advisory board input, plowed new ground in articulating the argument that there should not be such realization at death. Manning & Hesch, “Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements,” 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999).
 - a. The argument is that for income tax purposes, under Rev. Rul. 85-13, there is no transfer of the underlying property to the trust while the trust is a grantor trust. Therefore, for income tax purposes, the transfer to the trust occurs at the grantor’s death. But there is no rule that treats a transfer at death as a realization event for income tax purposes, even if the transferred property is subject to an encumbrance, as the property here is subject to the unpaid installment note. *See* Rev. Rul. 73-183, 1973-1 C.B. 364 (transfer of stock of a decedent to the decedent’s executor held not to be a disposition within the meaning of section 1001(a)). Thus, there is no gain realized on the property in the trust. Because, for estate tax purposes, the property is not included in the decedent’s gross estate, it does not receive a new basis under section 1014.
 - b. Since the note is included in the decedent’s gross estate, it receives a new basis—presumably a stepped-up basis—under section 1014, unless it is an item of income in respect of a decedent (“IRD”) under section 691, which is excluded from the operation of section 1014 by section 1014(c). Since the fact, amount, and character of IRD are all determined in the same manner as if “the decedent had lived and received such amount” (section 691(a)(3); *cf.* section

691(a)(1)), and since the decedent would not have realized any income in that case (Rev. Rul. 85-13), there is no IRD associated with the note. Thus, the note receives a stepped-up basis, and the subsequent payments on the note are not taxed.

- c. Confirmation of this treatment is seen in sections 691(a)(4) & (5), which set forth rules specifically for installment obligations “reportable by the decedent on the installment method under section 453.” In the case of installment sales to grantor trusts, of course, there was no sale at all for income tax purposes, and therefore nothing to report under section 453.
 - d. This is not unreasonable, since the income tax result is exactly the same as if the note had been paid before the grantor’s death – no realization – which fulfills the policy behind section 691.
 - e. Moreover, if the unpaid portion of the note were subject to income tax on the grantor’s death, the result would be double taxation, because the sold property, being excluded from the grantor’s estate, does not receive a stepped-up basis.
4. Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that “the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the replacement of an independent trustee with a related or subordinate party] results in taxable income to the grantor.”
- a. After citing and discussing *Madorin* and Rev. Rul. 77-402 (which addressed the reverse conversion to nongrantor trust status), the Chief Counsel’s office noted (emphasis added) 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.*”
 - b. Because of the interrelationship with certain partnership transactions and section 754 basis elections, the Chief Counsel’s office viewed the overall transaction as “abusive” and wanted to explore other ways to challenge it. But it nevertheless believed that “asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.”

B. Estate Tax Treatment

1. Meanwhile, although the note is included in the decedent's gross estate, it is possible that it is valued for estate tax purposes at less than its face amount, under general valuation principles, because section 7872 is not an estate tax valuation rule.
2. That would be especially true if interest rates rise between the date of the sale and the date of death.
3. Section 7872(i)(2) states that “[u]nder regulations prescribed by the Secretary [of the Treasury], any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans].” Regardless of what Congress had in mind, Congress said “Under regulations prescribed by the Secretary” and did not write a self-executing rule.
4. Proposed Reg. § 20.7872-1 provides that a “gift term loan” shall be valued for estate tax purposes at no less than (a) its unpaid stated principal plus accrued interest or (b) the present value of all the future payments under the note using the applicable federal rate in effect at the time of death.
 - a. The estate planner's answers to the proposed regulation would include the arguments that (1) the proposed regulation is not effective unless and until it is finalized, (2) the loan represented by the installment note is not a “gift term loan” because it uses an interest rate calculated to avoid below-market treatment under section 7872(e), and (3) with respect to section 7872(i)(2) itself, the loan is not made “with donative intent” because the transaction is a sale.
 - b. Under section 7805, the proposed regulations could probably be expanded even beyond the strict mandate of section 7872(i)(2), and, under section 7805(b)(1)(B) such expanded final regulations might even be made effective retroactively to the publication date of the proposed regulations in 1985. But, unless and until that happens, most estate planners will see no reason why the estate tax value should not be fair market value, which, after all, is the general rule, subject to Reg. § 20.2031-4.
 - c. Reg. § 20.2031-4 states that “[t]he fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid

principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.”

5. See Judge Tannenwald’s discussion distinguishing between “how” regulations and “whether” regulations in *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996). Section 2663(2) provides that “[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this chapter, including ... regulations (consistent with the principles of chapters 11 and 12) providing for the application of this chapter [the GST tax] in the case of transferors who are nonresidents not citizens of the United States.” This, Judge Tannenwald held, refers to a “how” regulation that is not a necessary condition to the imposition of the GST tax on transfers by nonresident aliens. A similar result with reference to the phrase “under regulations” was reached in *Francisco v. Commissioner*, 119 T.C. 317 (2002), and *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (2000). Compare section 465(c)(3)(D), which provides that a special rule “shall apply only to the extent provided in regulations prescribed by the Secretary.” *Alexander v. Commissioner*, 95 T.C. 467 (1990), *aff’d sub nom. Stell v. Commissioner*, 999 F.2d 544 (9th Cir. 1993).

XI. The Future of the Grantor Trust Briar Patch

1. The benefits of an installment sale to a grantor trust, including the tax-free treatment at death addressed in the foregoing discussion, depend principally on the historical mismatch of the rules for grantor trust treatment in subpart E of part I of subchapter J of chapter 1 of the Code and the rules for inclusion in the gross estate under chapter 11. This mismatch, and the fact that Rev. Rul. 85-13 is being invoked in applications well beyond what was contemplated in 1985, are no secret.
2. Nevertheless, we should not look for this mismatch to be addressed at any time soon.
 - a. Nothing is known to be pending in this regard

- b. Rev. Rul. 2004-64 (discussed in Part VIII.G, beginning on page 71) signals resignation to the disconnect between the income tax rules and the estate tax rules and provides clarification to help cope with that disconnect in the context of income tax reimbursement.
- c. Additional evidence of acceptance of the use of grantor trusts might be seen in Rev. Rul. 2007-13, 2007-11 I.R.B. 684, which held that the transfer of life insurance contracts between two grantor trusts treated as owned by the same grantor is not a transfer for a valuable consideration for purposes of section 101.
- d. This present state of affairs causes no harm. The value of the asset transferred does come back to the grantor/seller in the form of the installment note and is subject to estate tax to the extent it is not paid before death. Thus, the transfer tax base is preserved. To the extent that additional advantages flow from valuation, these advantages are not unique to grantor trusts.
- e. Any change would entail tremendously complex effective date and transitional rules. Changing an entire regime like this usually is not justified unless the reasons are compelling.

XII. Comparing Techniques

A. Comparison

The technique with which an installment sale to a grantor trust is most frequently compared is a grantor retained annuity trust (GRAT). Another—“classic”—freeze technique is the entity capital freeze, using preferred stock or a preferred partnership interest, generally policed by section 2701. The following discussion compares these three techniques:

1. Is it necessary to make payments?
 - a. “Qualified payments” are required in a capital freeze, a GRAT must pay the annuity, and the purchase price plus interest must be paid in an installment sale. In an installment sale, however, the payments can balloon at the end.
 - b. Advantage: Installment sale.
2. Can the grantor count on payments for cash flow? For example, could the transferor receive payments for life?

- a. Preferred payments from an entity freeze can be, and ordinarily are, payable in perpetuity. GRAT payments and installment sale payments are generally limited to the prescribed term.
 - b. Advantage: Capital freeze.
3. Is it necessary for the transferor to receive payments for life (which increase the transferor's estate)?
 - a. In a capital freeze, yes, unless the preferred interest is sold or redeemed, which also increases the transferor's estate. Not in a GRAT or installment sale.
 - b. Advantage: GRAT and installment sale.
4. Are payments easy to value?
 - a. In a capital freeze, an appraisal—often a costly appraisal—is generally needed. In a GRAT, the statute and regulations insist upon the use of section 7520, which is very simple. In an installment sale, *Frazee* indicates that section 7872 can be used, which is also relatively simple, except for questions of ability to pay (coverage).
 - b. Advantage: GRAT. Runner-up: Installment sale.
5. Can the rate of return be low, to minimize the return that builds up the transferor's estate?
 - a. In a capital freeze, the rate of return, often determined by the appraiser, will generally be greater than the 7520 rate. A GRAT, of course, uses the 7520 rate, which is 120 percent of the "federal midterm rate." The 7872 rate used for an installment sale, especially the short-term or mid-term rate, is often (but not always) less than the 7520 rate, because it avoids the 120-percent factor.
 - b. Advantage: Usually an installment sale.
6. Can other features be used to prop up the value of what the transferor retains or receives for gift tax purposes, to reduce the need to make monetary payments?
 - a. In a capital freeze, within limits, such features as voting rights and preemptive rights associated with a preferred interest might be

given value under section 2701. This cannot be done in a GRAT and probably not in an installment sale.

- b. Advantage: Capital freeze.
7. Is it possible to “zero out” the transaction, resulting in no taxable gift at all?
- a. In a capital freeze, this is effectively limited by the 10-percent equity floor of section 2701(a)(1). A GRAT can be “zeroed out,” now that old Reg. § 25.2702-3(e), *Example 5* has been acknowledged to be invalid. *Walton v. Commissioner*, 115 T.C. 589 (2000)); Notice 2003-72, 2003-44 I.R.B. 964 (announcing IRS acquiescence in *Walton*); Reg. § 25.2702-3(d)(4) & (e), *Example 5* (amended February 15, 2005). (Nevertheless, to ensure the validity of the trust and to provide the occasion for gift tax disclosure, most GRATs are designed to produce a relative small amount of reported gift.) A sale is, by definition, a value-for-value—*i.e.*, zeroed-out—transaction. Nevertheless, the initial funding of the trust to equip it to pay the desired down payment is usually a gift, which a GRAT avoids.
 - b. Advantage: GRAT.
8. Is an equity floor needed?
- a. In a capital freeze, 10 percent, under section 2701(a)(1). In a GRAT, no. In an installment sale, probably enough to avoid “dry trust” characterization, perhaps 10 percent, but this can be supplied from other assets.
 - b. Advantage: GRAT. Runner-up: Installment sale.
9. Can one attempt to “audit-proof” by formula?
- a. In a capital freeze this is difficult or impossible. In a GRAT, such a formula is explicitly permitted by Reg. § 25.2702-3(b)(1)(ii)(B). An installment sale can use either a price adjustment clause of the sort addressed in *In re King*, 545 F.2d 700 (10th Cir. 1976), or a “value definition clause” of the sort addressed in Technical Advice Memorandum 8611004 (Nov. 15, 1985), but each of these techniques has its complications and drawbacks. See Part VIII.C, beginning on page 52.
 - b. Advantage: GRAT.

10. Is it necessary to obtain cooperative actions from other family members?
 - a. In a capital freeze, “elections” by other “applicable family members” are often needed under Reg. § 25.2701-2(c)(4). There is no such requirement in the case of a GRAT or installment sale.
 - b. Advantage: GRAT and installment sale.
11. Is there a gift if the payments are not made?
 - a. Maybe not in the case of a capital freeze, under the principles of *Snyder v. Commissioner*, 93 T.C. 529 (1989). Probably so in the case of a GRAT or installment sale.
 - b. Advantage: Capital freeze.
12. Is there a grace period, without tax consequences, for making the required payments back to the transferor?
 - a. Section 2701(d)(2)(C) provides a four-year grace period for making “qualified payments” in a capital freeze. There is no such provision in the case of a GRAT or installment sale.
 - b. Advantage: Capital freeze.
13. Is there a harsh result if payments are not made?
 - a. In the case of a capital freeze, the compounding provisions of section 2701(d) are very harsh. In the case of a GRAT or installment sale, the penalty is probably the normal gift tax consequences.
 - b. Advantage: GRAT and installment sale.
14. Must payments be made if the underlying investment does not work out?
 - a. Under section 2701(d)(2)(B), there is no penalty for not making “qualified payments” if the entity does not increase in value. In a GRAT or installment sale, payments are absolute obligations that must be made until the trust is exhausted.
 - b. If the grantor trust has other assets, it can be a disaster if the property that was the subject of an installment sale declines in value, but the promissory note is included in the grantor’s gross estate at face value. And even a grantor trust designed and used solely for the sale may have assets representing the “equity” that is

conservatively required, or possibly has already made a payment to the grantor in the form of a down payment.

c. Advantage: Capital freeze (slightly).

15. Is there a double income tax on the arrangement?

a. This is generally thought to be a disadvantage of a preferred stock freeze, but, of course, a preferred capital freeze in a partnership form avoids a double tax. There is no double tax in a GRAT or installment sale, and, indeed, the grantor's payment of income tax on capital gain or other income retained by the trust can be an additional advantage.

b. Advantage: GRAT and installment sale (slightly).

16. Can future transfers be made to reduce the buildup of payments made back to the transferor?

a. In a capital freeze, the preferred interest can subsequently be transferred. A precisely equivalent transfer is not available in a GRAT or installment sale.

b. Advantage: Capital freeze (slightly).

17. Can the arrangement be unwound when it has served its purpose?

a. A capital freeze may be amended. A GRAT generally may not be amended or commuted (although the GRAT asset may be distributed in kind in satisfaction of the annuity obligation or purchased by the grantor). An installment sale note may be prepaid or even renegotiated, with perhaps some risk of jeopardizing the original transaction.

b. Advantage: Capital freeze and installment sale.

18. Is survival required for a prescribed term to ensure that future appreciation will escape tax?

a. Not at all in a capital freeze. Perhaps not in the case of an installment sale either; it could be complicated if the grantor/holder died before the note was fully paid, but the only question in such a case would be whether gain were recognized for income tax purposes, not whether the future appreciation escaped tax. The

grantor of a GRAT must survive the GRAT term for the GRAT to work.

b. Advantage: Capital freeze and installment sale.

19. Can GST exemption be allocated to the arrangement?

a. In a capital freeze and installment sale, yes, but not in a GRAT, because of the ETIP rules during the GRAT term.

b. Advantage: Capital freeze and installment sale.

20. Do the payment rules apply when the family-owned interest is only a minority interest?

a. Generally not in a capital freeze, because distribution rights are subject to section 2701 only if the family controls the entity, under section 2701(b)(1)(A). The presence or absence of family control does not affect a GRAT or an installment sale.

b. Advantage: Capital freeze.

21. Is the technique available for stock of an S corporation?

a. A capital freeze is not. A GRAT and installment sale are.

b. Advantage: GRAT and installment sale.

B. Summary of the Above Advantages

1. Capital freeze: 10.

2. GRAT: 10.

3. Installment sale to a grantor trust: 10.

C. Significance of the Above: Absolutely None

1. Each case is different. The factors must be weighed, not merely counted. Generally, the most important factors are thought to be the required rate of return (#5), the ability to zero-out (#7), the mortality risk (#18), and the ability to allocate GST exemption (#19). All those factors (except #7 and maybe #5) favor an installment sale, while a GRAT is predictable under section 2702 and the regulations thereunder and a capital freeze is a traditional technique obviously contemplated by section 2701 and the regulations thereunder.

2. Depending on the assets used, and the client's ability and willingness to pay gift taxes, a taxable gift almost always outperforms any other freeze technique (provided the donor survives for three years).

D. Illustration

The foregoing comparisons may be illustrated in the following table, in which **bold** entries indicate the probable advantages identified above:

	Capital Freeze	GRAT	Installment Sale to a Grantor Trust
1. Payments required?	Yes	Yes	Can balloon at end
2. <i>Permitted</i> payout	Can be perpetuity	Limited to GRAT term	Limited to sale term
3. Payments <i>required</i> for life?	Yes	No	No
4. Payments easy to value?	No (appraisal needed)	Yes (section 7520)	Somewhat (section 7872)
5. Rate of return	Market rate, presumably higher	Section 7520 rate [sometimes lower]	AFR under section 7872 [usually lower]
6. Able to use other valuable features?	Within limits	No	Probably not
7. Able to "zero-out"?	Limited by 10% floor	Yes	Yes, except for down payment, if any
8. Need equity floor?	Yes (10%)	No	Probably
9. Can "audit-proof" by formula?	Difficult or impossible	Yes	Difficult
10. Need elections?	Sometimes	No	No
11. Gifts if payments not made?	Probably not (Snyder)	Probably	Probably
12. Grace period?	Four years	None	None
13. Section 2701(d) applies?	Yes	No	No
14. Must pay if losing money?	No (section 2701(d)(2)(B))	Yes	Yes
15. Double income tax?	Only in a corporation	No	No
16. Can make future transfers?	Yes	No	No
17. Able to unwind?	Yes, by amendment	No	Yes, can prepay
18. Survival required for future growth to escape tax?	No	Yes	No
19. GST exemption available?	Yes	No	Yes
20. Rules apply when family interest is a minority interest?	Generally not	Yes	Yes
21. Available for an S corporation?	No	Yes	Yes