

REMOVING ASSETS FROM THE TRANSFER TAX SYSTEM

PRACTICAL CONSIDERATIONS

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August 2, 2004

I. INTRODUCTION

A. Objectives

1. To reduce the size of an individual's transfer tax base, that is, assets and transfers subject to gift, estate, and generation skipping transfer (GST) taxes.
2. To avoid the payment of gift taxes and the waste of the individual's gift tax applicable exclusion amount.
3. To carry out the individual's nontax objectives, including preserving the individual's cash flow needed to sustain the lifestyle of the individual and his or her family.
4. To keep unneeded assets in the trust for as long as possible (dynasty trust), by creating trusts in states that have abolished or allow the grantor to opt out of the rule against perpetuities.
5. To protect the trust assets from the beneficiaries' creditors.

B. Available Techniques

1. GRATs, grantor retained annuity trusts designed to qualify the grantor's retained right to receive a fixed dollar amount each year (usually based on a percentage of the fair market value of the asset transferred to the trust, and which can increase each year by 20% of the amount payable in the previous year) as a qualified interest under I.R.C. § 2702 so that the value of the gift to the remainder beneficiaries is reduced by the value of the grantor's retained annuity interest.
2. CLATs, charitable lead annuity trusts designed to qualify the right of a charitable organization to receive a fixed dollar amount each year (usually based on a percentage of the fair

market value of the transferred assets) for the gift tax charitable deduction so that the value of the charitable organization's right to receive the annuity reduces the value of the gift to the remainder beneficiaries.

- a. Charitable lead unitrusts (CLUTs), because the GST exemption can be allocated at the creation of the trust without further adjustments and because the charitable organization shares in increases in the value of the gifted assets, may be more appealing to some wealthy individuals, although for the very wealthy, the CLAT can provide more benefit to the family if substantial gifts in excess of the GST exemption are intended.
3. Installment sales to grantor trusts, designed to avoid recognition of income as a result of the sale and to shift future growth of the transferred asset to the beneficiaries of the trust without any transfer tax.
4. Preferred equity interests, (also called frozen equity interests) designed to qualify the right to receive a preferred payment from an entity, usually a limited partnership or limited liability company (LLC), as a qualified payment right under I.R.C. § 2701, thereby reducing the value of the transferred residual interests and shifting future growth to the holders of the residual interests.
5. SCINs, self canceling installment notes under which payments cease at the death of the seller if he or she dies before the note is paid off, thus eliminating the balance of the note in the seller's estate.
6. Private annuities, annuities issued by a person not in the business of selling commercial annuities in exchange for cash or an asset that are unsecured to avoid current recognition of gain, and that terminate at the annuitant's death thereby excluding the value of the asset exchanged for the annuity from the annuitant's transfer tax base to the extent such value exceeds the value of the annuity payments actually made to the annuitant during his or her life.
7. A combination of techniques, such as the purchase of assets from a GRAT by a grantor trust for a SCIN.

C. General Valuation Concepts

1. Split-interest transactions, involving the transfer of an asset with the transferor retaining a frozen interest to reduce the value of the transferred asset, with the expectation that the value of the transferred interest would increase at a greater rate than the interest rate or discount rate used for determining the value of the transferred interest.
2. Fractionalization discounts, involving the transfer of assets to an entity followed by the transfer of interests in the entity, with the expectation that the transferred equity interests would have a value lower than a pro rata share of the net asset value of the entity because of lack of control and lack of marketability discounts. A similar result may be obtained with a transfer of an undivided interest in an asset, such as real property.
3. Combining the two concepts, to take advantage of reduced values and shifting of future growth.

D. Variables to Consider

1. Interest rates, including the current applicable federal rate, which must be used to avoid gift tax consequences when the transferor takes back a promissory note and the so-called 7520 rate (120% of the mid-term rate), which must be used in valuing a remainder interest for transfer tax purposes.
 - a. The 7520 rate for August is 4.8%.
 - b. The applicable federal rates, compounded annually, for August are: short-term, 2.37%; mid-term, 4.00%; and long-term, 5.21%.
 - c. Note that higher rates produce better results for QPRTs (qualified personal residence trusts), CRATs (charitable remainder annuity trusts), and charitable gift annuities and lower rates produce better results for GRATs, CLATs, and private annuities. Lower rates also produce better results for installment sales to grantor trusts, preferred equity transactions, and SCINs, because the transferor receives less back in interest payments.

2. Income tax rates, which can affect the overall tax savings when considering a particular technique.
3. Transfer tax rates, which will directly affect the tax savings in excluding assets or future growth from the transfer tax system.
4. Investment Returns, which will determine whether a particular technique has indeed saved taxes.
5. Volatility of the assets transferred, which may affect the type of technique and the optimal term of a retained interest. For example, a highly volatile stock may suggest the use of a short-term GRAT.
6. Possible repeal of the estate and GST taxes with or without repeal of the gift tax, which will make most individuals reluctant to pay gift taxes, despite the fact that the gift tax rate is generally 2/3rds the rate of the estate tax because the gift tax is tax exclusive as opposed to the estate tax, which is tax inclusive, assuming the donor lives for three years after the gift (otherwise the gift tax paid will be included in the donor's gross estate).
7. The date of death of the client (and perhaps other members of the client's family whose death may have an impact on the estate plan). The transferor's premature death could cause either unfavorable transfer tax results, as in the case of a GRAT, or favorable results, as in the case of a SCIN or private annuity.

E. Factors to Consider

1. The client's profile will often dictate the type of estate planning technique that will work. For example, a complicated plan may work only if the client has a family office that will see to the implementation of the details. In addition, a client adverse to risk may be more willing to use a GRAT that is statutorily sanctioned and may offer certainty as to valuation, as opposed to an installment sale to a grantor trust that is based on general tax principles and some private letter rulings and does not offer certainty as to valuation.
2. The nature of the assets will often dictate the type of technique that is most appropriate. For example, hard-to-

value assets may be more suitable for a GRAT than other techniques and assets that are likely to appreciate in value are more likely to produce higher tax savings in split interest transactions. If publicly traded securities are involved, securities laws, such as the short-swing profits rules and other restrictions on transfers, must be considered.

3. The need for cash flow will often dictate the technique to be used. For example, if the donor has a continuing need for cash from the transferred asset, a preferred equity interest, SCIN or private annuity may be preferable to a GRAT or an installment sale to a grantor trust.
4. Willingness to make taxable gifts. Most individuals today are reluctant to make taxable gifts that actually incur the payment of gift taxes because of the possible repeal of the estate tax.
5. Recognition of income for tax purposes, which may occur in the case of sales to a non-grantor trust or exchanges for a private annuity.
6. Step-up in basis, which will not occur with respect to most of the techniques, except for a taxable sale or a private annuity if the transferee is not a grantor trust. The transfer tax savings resulting from a particular technique must be offset by the loss of a step-up in basis at the donor's death for an appreciated asset under current law (which under current legislation will no longer apply, except to a limited extent, in 2010, when carryover basis will apply at death).
7. Audit/revaluation risk, which is reduced in the case of a GRAT, and is increased in the case of hard-to-value assets, including interests in limited partnerships and LLCs, and may be exacerbated in the case of a preferred equity interest.
8. Charitable desires, which may mean that the use of a CLAT is more palatable to a particular individual.
9. GST tax issues, which are often present (as they will be if the desire is to get the asset out of the transfer tax system), will be more difficult to deal with in the case of a GRAT or a CLAT than in some of the other techniques.
10. Mortality risk, which will affect the benefit of a particular technique. Remember, the mortality tables can be used only

if the individual is not terminally ill, which means that the likelihood of dying in the next 12 months is greater than 50% (but if the individual lives for 18 months, there is a strong presumption that he or she was not terminally ill).

II. COMPARING VARIOUS TECHNIQUES

A. Gift Tax Consequences

1. GRATs can be designed to minimize current gift tax consequences by structuring the annuity amount and term of the retained annuity interest so that the value of the grantor's retained interest is nearly equal to the value of the asset transferred to the GRAT.
2. CLATs can also be designed to minimize current gift tax consequences by structuring the annuity amount and term of the charitable organization's interest so that the charitable deduction is nearly equal to the value of the asset transferred to the CLAT.
3. An installment sale to a grantor trust may involve a substantial taxable gift (which may be offset by the gift tax applicable exclusion amount) if there are not already assets in the trust equal to 10% of the installment note and the transferor does not want beneficiaries to guarantee the note (with or without receiving payment for the guarantee).
 - a. Although not entirely certain, a guarantee should not be treated as a taxable gift because there is no transfer of property or an interest in property and there is no depletion of the guarantor's estate as a result of the guarantee.
 - b. If a guarantee would be treated as a taxable gift, the amount that must be paid to the guarantor to avoid a taxable gift is uncertain.
4. A preferred equity interest may involve a taxable gift (which may be offset by the gift tax applicable exclusion amount) depending upon whether the transferor sells or gives away the residual interest.
5. A SCIN should not involve a taxable gift if the note is equal to the fair market value of the transferred asset and the

principal and/or interest on the note is increased to reflect the self-canceling feature.

6. A private annuity should not involve a taxable gift if the actuarial value of the annuity is equal to the fair market value of the asset transferred.

B. GST Tax Consequences

1. Because the estate tax inclusion period (ETIP) rules prevent the grantor of a GRAT from allocating his or her GST exemption to the GRAT until the retained interest terminates, the transferred asset will usually only be excluded from the transfer tax base of the original grantor unless the beneficiaries give or sell their remainder interests to another trust that is effective in changing the transferor to the beneficiaries for GST purposes.
2. The GST exemption allocated to the value of the remainder interest in a CLAT must be adjusted at the termination of the charitable organization's interest using the same 7520 rate used for determining the value of the remainder interest. Consequently, if the transferred asset increases in value more rapidly than the 7520 rate used in determining the value of the remainder interest, the trust will have an inclusion ratio of greater than zero (assuming that at the creation of the trust, the amount of exemption equaled the value of the transferred asset) and if the value of the asset does not grow as rapidly as the 7520 rate used to value the remainder interest, some of the exemption will have been wasted.
3. In PLR 20010715, the IRS ruled that a beneficiary of a CLAT who assigned his remainder interest became the transferor for GST purposes only with respect to a portion of the trust assets based on the present value of his remainder interest at the time of the assignment.
4. If the installment sale to a trust is for full and adequate consideration because the value of the note is equal to the value of the transferred asset, and the donor allocates GST exemption to any gifts to the trust, the trust will have an inclusion ratio of zero.
5. If the residual interest involved in a preferred equity arrangement is given or sold to a dynasty trust having an inclusion ratio of zero, and in the case of a gift, the donor

allocates GST exemption to the transfer, the trust will have a zero inclusion ratio.

6. If the purchaser of the asset in the case of a SCIN is a dynasty trust that has an inclusion ratio of zero, the trust will continue to have a zero inclusion ratio as long as the value of the SCIN is equal to the value of the transferred asset.
7. If the purchaser of the asset in the case of a private annuity is a dynasty trust that has an inclusion ratio of zero, the trust will continue to have a zero inclusion ratio as long as the value of the private annuity is equal to the value of the transferred asset.

C. Mortality Risk

1. The only technique that fails if the individual dies prematurely (before the termination of the retained annuity interest) is the GRAT, because the trust assets will be included in the grantor's gross estate in that situation.
2. In a typical CLAT, where the charitable organization's interest lasts for a specified term of years, mortality is not a factor.
3. Of course, the longer the individual lives the more of the future growth of the value of the transferred asset will have been excluded from his or her estate in the case of an installment sale to a grantor trust or the transfer of a residual interest in preferred equity interest transaction.
4. On the hand, the sooner the individual dies, the fewer annuity payments or installment payments will have been made pursuant to a SCIN or a private annuity that would have increased the recipient's gross estate.
5. Note that if the grantor dies before a promissory note from a grantor trust has been paid in full, the IRS may assert that the grantor's estate recognizes gain with respect to the unpaid balance.

D. Audit Risk

1. A GRAT or a CLAT, because they are based on statutory and regulatory provisions, and because the annuity can be based on a percentage of the fair market value of the transferred

assets, provides the most conservative approach to excluding value from the individual's transfer tax base and minimizes any increase in gift tax liability if the initial value of the transferred asset is later determined to be greater than the reported value.

2. In the case of the other techniques, valuation will always be an issue, and in the case of an installment sale to a grantor trust, other issues may be advanced by the IRS to challenge the desired tax consequences, such as treating the transfer as subject to I.R.C. § 2701 or 2702.

E. Required Interest Rate or Discount Factor

1. The 7520 rate must be used in valuing the retained interest in a GRAT or the charitable deduction in a CLAT or in determining whether the actuarial value of a private annuity equals the fair market value of the transferred asset.
2. To avoid a taxable gift, the applicable federal rate (AFR) must be used in an installment sale to a grantor trust or a SCIN.
3. For purposes of valuing a preferred equity interest, the discount rate that must be used for valuing the preferred equity interest is the fair market value for such an interest, taking into account all the facts and circumstances at the time the interest is created, including the amount of the annual payment. Consequently, there is a great deal of uncertainty as to the appropriate discount rate in most cases.
4. Generally, the AFR will be lower than the 7520 rate, except that currently, because of the low interest rate environment, the long-term AFR is higher than the 7520 rate.

F. Restrictions on Distributees and Cash Flow Needs

1. A GRAT must restrict payments during the term of the grantor's retained interest to the grantor.
2. Of course a CLAT provides for distributions only to the charitable organization during the term of the organization's annuity interest.
3. Because distributions from a GRAT or installment payments from a grantor trust, including payments pursuant to a SCIN,

will cease at some point, they are not good techniques if the transferor needs cash to maintain his or her lifestyle for the rest of his or her life and a CLAT will provide no cash to the grantor.

4. The grantor will continue to receive annuity payments for life in the case of a private annuity and preferred payments for life in the case of a preferred equity interest.
5. Payments from a GRAT cannot only increase by more than 20% each year for purposes of valuing the retained interest, but an installment sale can provide for a balloon payment.

III. Recent Developments

A. Grantor Trusts

1. Revenue Ruling 2004-64 clarifies the tax treatment of a grantor who pays the income tax on the income earned by the trust assets.
2. The grantor's payment of the income tax is not treated as a gift to the trust beneficiaries. In essence, the payment of the income tax is a tax-free transfer to the trust beneficiaries.
3. If the trust agreement or state law requires the trust to reimburse the grantor for paying the income tax, the trust assets will be included in the grantor's estate under I.R.C. § 2036(a)(1).
 - a. If the trust agreement prohibits reimbursement, there will be no inclusion.
 - b. If the trust agreement and state law are silent on the issue or give the trustee discretion to reimburse the grantor for payment of the income tax on the trust's income, then whether the trust assets are included in the grantor's estate depends on the facts and circumstances.
 - c. The trust assets are likely to be included in the grantor's estate if the grantor can remove the trustee and appoint himself or herself as trustee, if there is an implied agreement that the trustee would always reimburse the grantor for the income taxes the grantor pays on the trust's

income, if the grantor's creditors can reach the trust assets under local law, or, perhaps, if the grantor can remove the trustee and appoint a related party, as defined in I.R.C. § 672 (c), as the trustee.

B. *Walton* Regulations

1. The IRS recently issued proposed regulations to comply with the holding in the *Walton* case.
2. The *Walton* case held as invalid an example in the regulations that indicated that the grantor's retained interest in a GRAT must be valued as a right to receive payments for only the shorter of the term of the retained interest or the grantor's life, even though the GRAT provided that the annuity would continue to be paid to the grantor's estate if the grantor died before the termination of the grantor's interest.
3. The proposed regulations make it clear that, if the balance of the annuity payments are paid to the grantor's estate, the value of the retained interest would be based on the value of the annuity payments for the term and not the shorter of the term or the grantor's life.
4. As a result, it will be possible to structure the GRAT so that there is no gift because the actuarial value of the retained interest is equal to the fair market value of the transferred assets. However, it is advisable to have some small gift to ensure that there is a transfer of something to the trust.