Current Thinking on Zeroed Out GRATs and Sales to Grantor Trusts

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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, <u>cash</u> 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 <u>Leveraging</u>, or Freezing off a Discount

1. If what is given—or sold—has a value that is legitimately <u>discounted</u>, 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 <u>fair market value</u>, 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. Reg. § 1.121-1(c)(3)(i).

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)). The Service has taken the position, however, 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.

    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 21.

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 VII.B, beginning on page 35, 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, <u>for this purpose</u>, why a GRAT could not provide for the grantor to receive the annuity amount or the net income of the trust, whichever is <u>greater</u>, 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 IV.H.2.c on page 24.)

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 VII.B.2, beginning on page 36), care must be taken that this power would not be considered an option, or its exercise an insider trade, subject to securities laws restrictions.

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 considerably, 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.

4. 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.

5. Letter Rulings 9352017, 9416009, 9449012, and 9449013 appeared to approve of the two-life valuation technique.

6. 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).

7. 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.

8. 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:

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

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 VI.D and VI.F, beginning on page 28.

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. 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).

2. 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.

3. 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.

4. 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.

5. 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.

a. 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.

b. 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.

   i. 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.

   ii. *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.

   iii. 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."

6. 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).

7. 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.

8. 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.

M. Collapsing an Underperforming GRAT

1. <u>Sale</u> of <u>the GRAT property</u> 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 <u>from</u> 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 <u>to</u> 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 <u>down</u> 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) <u>does</u> 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:** <u>Should</u> a GRAT be <u>exactly</u> 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 VI.E, beginning on page 30) 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. Deferring the payment beyond the due date entails both risk and opportunity—risk that a <u>greater</u> share of the asset will be needed to discharge the annuity obligation if the asset declines in value, and the opportunity to use a <u>smaller</u> 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.

4. 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 <u>one year</u> 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, 2006, the first payment is due June 12, 2006, but may be made any time through August 25, 2007 (105 days after May 12, 2007). The same thing is true of the other eleven payments, due on the 12th day of each month July 2006 through May 2007.

   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.

5. 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.

6. 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. 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?

a. Before *Walton*, this was fairly easy to accomplish with a simple reversion to the grantor's estate, where normal marital deduction planning would work.

b. 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.

c. Although a number of approaches have been discussed, the following seems to this author to be the most appropriate:

    i. 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.)

    ii. In the GRAT instrument, repudiate the 105-day grace period for payment of the annuity, especially if the instrument otherwise recognizes it.

    iii. 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.

    iv. 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.

v. 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.

vi. 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.

vii. 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.)

viii. In the grantor's <u>spouse's</u> 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.

ix. 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.)

x. 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.

xi. 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.

2. **Question:** Are there other ways of dealing with the estate tax exposure?

   a. Some clients will not want the principal amount of the remaining GRAT annuity payments to go to the surviving spouse outright and will prefer to modify step iv above by bequeathing the grantor's interest in the GRAT to a testamentary QTIP trust, from which all income would still flow thought to the spouse.

   b. Other clients will eschew the complexity and possible uncertainty of the marital deduction altogether and simply leave the GRAT remainder to the next generation in all events? After all, the objective of a GRAT is often to provide the grantor's children with <u>their</u> inheritance.

   c. In any event, to keep options open to argue that less than the value of the entire GRAT property is includible in the gross estate if the grantor dies during the term, the GRAT instrument should be drafted to avoid section 2036(a)(1) if possible. If the grantor is entitled only to an undifferentiated annuity "amount," the grantor arguably has not retained the right to the "income" from the GRAT property. Thus, directions such as to pay the annuity amounts "from income and, to the extent that income is not sufficient, from principal" should probably be avoided. (This is a reason not to explicitly provide for the payment of any excess income to the grantor during the grantor's life. See paragraph 1.c.i above.)

   d. The risk of estate tax if the grantor dies during the GRAT term could be covered with term life insurance.

V. Installment Sales: Fundamental Authorities

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

1. Bottom line: <u>For income tax purposes</u>, 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% 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 & 200228019 (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. 2003-3, 2003-1 I.R.B. 113, is the same.)

4. Although the ruling 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% of the purchase price. *See generally* Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 EST. PLAN. 3, 8 (1996).

C. Analysis

1. Thus, yesterday's "<u>**de**</u>fective" grantor trust has become today's <u>**e**</u>ffective briar patch, into which everyone wants to be thrown!

2. 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, and (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), but (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 Grantor Trust That Participates in the Installment Sale

A. Giving Effect to the Grantor's Long-Term 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 to the Trust

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 <u>fund</u> 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.

2. It might even be possible to find a GST-exempt trust that can be <u>made</u> 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.

3. Care must be taken, however, since the assets already in the trust will probably be exposed to the installment obligation, setting the trust up to "backfire" if the asset does not appreciate as expected.

D. Reimbursing the Grantor for Income Tax—Historically

1. Letter Ruling 9444033, 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.

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, 9709001, 1999919039 & 199922062.

6. The Service likewise ruled that <u>permissible</u> reimbursement, in the discretion of someone who is independent, did not present a section 2036 problem. Letter Ruling 200120021. If such a power is held by an independent <u>trustee</u>, 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 <u>relinquishment</u> of a right of reimbursement, to toggle off grantor trust status, would arguably be an additional gift to the trust.

E. Reimbursing the Grantor 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 be 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 date at least from the 1992 gift tax regulations under section 2701, which had used grantor trust status in their attribution rules and had treated the termination of grantor trust status as a deemed transfer under section 2701. Reg. §§ 25.2701-6(a)(4)(ii)(C); 25.2701-1(b)(2)(i)(C)(*1*). The most prominent such attempt, however, was probably 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 likely 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 sample provisions have been drafted with Rev. Rul. 2004-64 in mind:

a. Total negation of reimbursement (the recommended 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<u>, or reimburse me for the payment of,</u> 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.]*

F. Other 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.

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 in Selecting a Feature To Support Grantor Trust Status

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. *Cf.* Letter Ruling 8103074 (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. 2003-3, 2003-1 I.R.B. 113, § 3.01(42); *see* Letter Ruling 9413045.

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 <u>every</u> 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 historically been favored, because it does not affect the interests of the beneficiaries.

b. In 1994, the Service adopted the view for advance ruling purposes that this power will be <u>reviewed on audit</u> to determine if it is held in a nonfiduciary capacity and therefore makes the trust a grantor trust. *See, e.g.*, Letter Ruling 9504024. *Cf.* Letter Ruling 9442017 (same as to investment power). This continues to be the Service's policy. *See, e.g.*, Letter Ruling 200434012.

c. 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.

d. 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.

e. 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.

f. Income tax cases addressing this concern are hard to find. 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 <u>intended</u> to <u>lack</u> independent "reality." 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.

g. 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). In *Jordahl*, the grantor was one of three trustees, and the court referred to his fiduciary duty, but this feature was not emphasized by the Service in the earliest rulings that followed *Jordahl*. *See* Letter Rulings 9413045 & 9227013. In Letter Ruling 200603040, however, the Service ruled that a retained to substitute assets would not cause inclusion in the gross estate, but the ruling gave more emphasis to the fact that the power could be exercised only in a fiduciary capacity. **Nevertheless, 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).

h. 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 <u>after</u> 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.

i. A power in <u>another</u> to "reacquire" trust property by substituting property of an equivalent value has been held to support grantor trust status (again subject review on audit to determine if the power is held in a nonfiduciary capacity). Letter Ruling 200434012 (power of "reacquisition" in the grantor's <u>father</u> sufficient to make trust a grantor trust). *Accord,* Letter Rulings 199908002 (power in grantor's brother); 9810019 (the *Karmazin* ruling, with a power in a "disinterested party"); 9037011 (power in cotrustee); 9026036.

    i. Although section 675(4)(C) uses the word "reacquire," it uses that word in reference to a power held "by any person."

    ii. Such a power gives no protection, however, if the power holder dies, unless a successor power holder is specified.

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) 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. 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. The reason for specifying an "<u>independent</u>" 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.

b. The reason for specifying the <u>addition</u> of beneficiaries is that it is essential to <u>fail</u> to "qualify" for any of the exceptions in section 674(b) and section 674(c).

    i. 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 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.

    ii. On the other hand, the flush language in section 674(c) provides that the exceptions in that subsection do not apply to an independent trustee's power to <u>add</u> 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.

c. The reason for specifying that the power to add beneficiaries include the power to cause a <u>distribution</u> to be made to them is that section 674(a) is triggered only by a "power of disposition." 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.**

d. 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 (e)(2) and thereby prevent the trust from electing to be an electing small business trust ("ESBT"), if necessary, after the grantor's death.

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 <u>trustees</u>. 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 to direct a distribution to such added beneficiaries.

iv. 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.

v. 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."

vi. If the power is limited to periods after the death of the grantor, then a hypothetical reversion in the grantor must exceed 5% 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%, 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% rule addresses, in effect, the present value of the trustee's power, not the determination of who or what are already "beneficiaries."

e. 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, 9709001 & 9304017.

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 <u>reason</u> to do so. **Mere accommodation of the grantor does not appear to ever be a proper reason.**

5. One solution may be to provide that the trustee <u>acquires</u> a desirable power by relinquishing the power that makes the trust a grantor trust.

   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 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. **Toggling grantor trust status back on is more difficult.** 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 <u>together</u> 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%, as it almost always is.

D. Withdrawal Powers

1. A holder of a *Crummey* power or other withdrawal power (including a "five-and-five 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 and 200011054-056 & 200011058 (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 a eligible shareholder of an S corporation under section 1361(c)(2)(A)(i)).

   a. It is sometimes thought that section 678(b) avoids this result as to <u>income</u> 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 <u>corpus</u>.

   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 <u>release</u> or <u>modification</u> of a withdrawal power, but not necessarily following a mere <u>lapse</u> 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 and 8521060, 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. 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 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 & 200228019.

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); *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% of the stock of an S corporation and sells 10% of it to a grantor trust, and the income tax on the corporate earnings is $100,000, then the grantor (now a 90% 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 <u>from</u> 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 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 <u>less</u> 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. No. 13 (2003).

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 <u>a fractional share</u> 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 <u>the fractional share</u> 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 *Proctor* 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.

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.

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, <u>compounded semiannually</u>.

3. 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. 2006-22, 2006-14 I.R.B. ___, those rates, compounded semiannually, are as follows for April 2006:

   a. Short-term (not over 3 years): 4.71%.

   b. Mid-term (over 3 years but not over 9 years): 4.67%.

   c. Long-term (over 9 years): 4.73%.

   The Revenue Ruling prescribed an April rate under section 7520 for valuing annuities, life interests, term interests, remainders, and reversions of 5.6%.

4. 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 *Frazee*.

5. The rate for demand loans is the floating short-term rate in effect from time to time—*i.e.*, 4.71% for April. There is also an optional "blended" rate, announced mid-year, which for 2005 was 3.11%. Rev. Rul. 2005-38, 2005-27 I.R.B. 6.

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.**

F. 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, 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 IX, beginning on page 58.)

G. 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.

H. 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% 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. On the other hand, 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).

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. There is a credible argument, however, that the 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 risks created by "thin capitalization" are includibility in the gross estate under section 2036, a gift upon the cessation of section 2036 exposure, applicability of section 2702 to such a gift, the creation of a second class of equity in the underlying property with possible consequences under section 2701 and possible loss of eligibility of the trust to be a shareholder of an S corporation, treatment of the trust as an association taxable as a corporation, continued estate tax exposure under section 2035(a) for three years after cessation of section 2036 exposure, and 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.

7. 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.

I. 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.

   a. Such purchases may, of course, be at a higher price reflecting the growth in value of the investment.

   b. In addition, as in the case of any existing trust (discussed in Part VI.C on page 28), care must be taken, since the assets already in the trust will probably be exposed to the installment obligation, setting the trust up to "backfire" if the asset does not appreciate as expected.

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.

IX. Tax Treatment of an 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 and 200011005, 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, 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 <u>not</u> 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 <u>for income tax purposes</u>, under Rev. Rul. 85-13, there is no transfer of the underlying property to the trust while the trust is a grantor trust. Therefore, <u>for income tax purposes</u>, 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, <u>for estate tax purposes</u>, 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.

B. Estate Tax Treatment

1. Meanwhile, although the note is included in the decedent's gross estate, it is possible that it is valued <u>for estate tax purposes</u> 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(h)(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(h)(2) itself, the loan is not made "with donative intent" because the transaction is a sale.

    b. Under section 7805(b)(1)(B), the proposed regulation could probably be expanded and made effective retroactively to its publication date in proposed form in 1985. But until it is, 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.

c. 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 Tannewald 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).

X. 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 expect this mismatch to be addressed soon.

   a. Nothing is known to be pending in this regard.

   b. Rev. Rul. 2004-64 (discussed in Part VI.E, beginning on page 30) 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. 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.

d. 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.

XI. Comparing Freeze Techniques

A. Analysis

GRATs and installment sales to grantor trusts are frequently compared. 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 <u>necessary</u> 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% of the "federal midterm rate." The 7872 rate, used for an installment sale, is often (but not always) less than the 7520 rate, because it avoids the 120% 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% 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%, under section 2701(a)(1). In a GRAT, no. In an installment sale, probably enough to avoid “dry trust” characterization, perhaps 10%, 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, but each of these techniques has its complications and drawbacks. See Part VIII.C, beginning on page 48.

   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 purchased by the grantor or distributed in kind in satisfaction of the annuity obligation). An installment note may be prepaid.

    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 available for an S corporation. A GRAT or installment sale are.

b. Advantage: GRAT and installment sale.

B. Summary of the Advantages

1. In the following table, **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. *Permitted* payout	**Can be perpetuity**	Limited to GRAT term	Limited to sale term
3. Payments *required* 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**

2. **But 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 lack of need to survive for a term (#18),

and the ability to allocate GST exemption (#19). All those factors (except # 5 and #7) 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.