

# **The Secrets to Unleashing The Power of Non-Taxable Lifetime Gifts**

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**TABLE OF CONTENTS**

|  | <u>Pages</u> |
|--|--------------|
| I. INTRODUCTION.....   | 1            |
| II. GRATS GENERALLY .....  | 1            |
| A. How is one Created?.....  | 1            |
| B. The Gift Tax Elements.....  | 2            |
| C. Code Section 2702 Prescribes Rules as to What can be Valued and What Cannot.....      | 2            |
| D. The Gift Tax Benefit of a GRAT.....   | 3            |
| E. The Estate Tax Elements.....  | 3            |
| F. Decisions to be Made at the Time the GRAT is Established.....                         | 4            |
| III. CONGRESS HAS RECOGNIZED THAT GRATS CAN RESULT IN TRANSFER TAX SAVINGS .....         | 5            |
| A. Assumptions Implicit in the GRAT Valuation Methodology.....                           | 5            |
| B. Moral of the Story.....   | 7            |
| IV. STRUCTURING THE GRAT TO TAKE ADVANTAGE OF THE 7520 RATE HEDGE.....                   | 7            |
| V. FIRST COUSIN, ONCE REMOVED, TO THE GRAT: THE SALE-TO-A-GRANTOR TRUST.....             | 8            |
| A. What is It?.....  | 8            |
| B. Why a Sale is Better than a GRAT.....   | 9            |
| VI. I CHOOSE DOOR NUMBER 2: GRATS WITH NO TAXABLE GIFTS AS AN ALTERNATIVE TO SALES ..... | 10           |
| A. Zeroing Out.....  | 10           |
| B. Example 5 .....   | 10           |
| C. The <i>Walton</i> Case.....   | 11           |
| D. The Service’s Position is Unlikely to be Sustained in any Venue.....                  | 11           |

|       |   |    |
|-------|---|----|
| VII.  | GRATS WITH NO TAXABLE GIFTS AS AN ALTERNATIVE TO SALES: THE SHIFTING TIDE ..... | 12 |
| VIII. | INVESTMENTS WITHIN GRATS AS PART OF THE OVERALL PRUDENT INVESTOR RULE. ....     | 14 |
|       | A. Section 7520.....  | 14 |
|       | B. Trustee Authority as to Investments. ....                                    | 15 |
| IX.   | CREATIVE USES OF THE GRAT .....   | 16 |
|       | A. Discounted Assets.....   | 16 |
|       | B. Volatility .....   | 16 |
|       | C. Payment of Income Tax .....  | 16 |
|       | D. Transactions Involving the Investment Portfolio of the Grantor .....         | 17 |
|       | E. Transactions Between the Grantor and the GRAT .....                          | 17 |
| X.    | DRAFTING OF THE GRAT.....   | 26 |
| XI.   | USING THE GRANTOR TRUST FOR GIFTING: THE GRANTOR TRUST EXPLAINED .....          | 27 |
|       | A. From a Policy Perspective .....  | 27 |
|       | B. Who is the Grantor.....  | 27 |
| XII.  | THE STRAIGHTFORWARD.....  | 28 |
|       | A. Living Trusts.....   | 28 |
|       | B. Reversionary Interests.....  | 28 |
|       | C. Insurance Trusts .....   | 28 |
|       | D. Grantor Trusts and Annual Exclusion Gifting ( <i>Crummey Powers</i> ).....   | 29 |
|       | E. A 2503(c) or Minor's Trust. ....   | 29 |
| XIII. | USING GRANTOR TRUSTS OUT OF NECESSITY .....                                     | 30 |
| XIV.  | GRANTOR TRUSTS AS PLANNING STRATEGIES FOR ESTATE TAX REDUCTION .....            | 31 |
|       | A. Unified Credit, Applicable Credit Amount, Gifting Trust.....                 | 31 |

|     |   |    |
|-----|---|----|
| B.  | Grantor Trust Status of a Qualified Personal Residence Trust.....           | 32 |
| C.  | Post Mortem Use of Grantor Trusts in the Credit Shelter Trust Context ..... | 36 |
| D.  | Grantor Retained Annuity Trust and Unitrusts.....                           | 37 |
| E.  | Sale to a Grantor Trust.....  | 38 |
| XV. | DRAFTING A GRANTOR TRUST .....  | 41 |

# **The Secret to Unleashing the Power of Non-Taxable Lifetime Gifts**

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## **I. INTRODUCTION.**

The grantor retained annuity trust (“GRAT”) has been statutorily authorized since 1990 and has been advocated as an effective transfer tax technique since that time. The GRAT has not traditionally been the paramount advanced estate tax reduction strategy, instead being supplanted by family limited partnerships, or sales-to-grantor trusts. But a number of events in the past four years have acted to accelerate the importance of this strategy in the estate planning environment, in fact, perhaps as a go-to advanced estate tax strategy of first choice. These events include the *Strangi II*, TCM 2003-145 (2003 and Walton cases (and subsequent IRS acquiescence in it), *Walton v. Commissioner*, 115 T.C. 589 (2000); Tax Notice 2003-72 (Nov. 3, 2003), the *McCord* case (and what it may or may not mean), *McCord v. Commissioner*, 120 T.C. 358 (2003), the IRS reaction to tax shelters in the income tax area and subsequent fallout in the estate tax area, and the continuing low Code Sec. 7520 rate.

To assist in understanding how the above variables have led to renewed interest in aggressive GRAT planning, the article first develops the GRAT background and its traditional use and efficacy. It then discusses the GRAT’s cousin, the “sale-to-grantor trust” strategy, and how it gained acceptance over the GRAT in the late 1990s. The article then focuses on the above-cited case developments and their importance to elevating GRAT planning over grantor trust sale planning in today’s environment

The following other non-taxable lifetime gifts that must be considered, in addition to the annual exclusion gifting (\$12,000 per donee, per year), include medical and tuition gifts under I.R.C. §2503(e), grantor trust planning, self-canceling installment notes, and gifts of opportunity. The grantor trust planning and GRAT planning, as well as self-canceling installment notes, are discussed in this outline.

## **II. GRATS GENERALLY**

### **A. How is one Created?**

A GRAT is created by a grantor transferring one or more assets into an irrevocable trust and the grantor retaining the right to an annuity interest (“a qualified interest”) for a fixed term of years. *See, e.g.*, 26 U.S.C. 2702(b). When the fixed term of years (referred to in this article as the “retained interest period”) ends, any assets remaining in the trust pass to the named remainder beneficiaries. The required elements include: (1) a trust, which is (2) irrevocable, and (3) includes provisions required by section 2702 of the Code, and (4) receives assets transferred by the grantor to the trust, and (5) sets forth an amount to be distributed to the grantor periodically, for (6) a determined period of years.

**Example 1:** Grantor G transfers \$1,000,000 in a securities account to an irrevocable trust, drafted pursuant to section 2702 of the Code. Under the terms of the trust, G retains the right to \$280,000, payable annually, for a period of 4 years. At the end of four years, any property that remains in the trust is distributed to G's children, in equal shares. The gift tax value of the transfer is 0, calculated assuming a section 7520 rate of 4.6%, which is the section 7520 rate for September, 2004.

**B. The Gift Tax Elements**

Section 2702 provides rules as to how to value the gift tax element of a GRAT. The gift tax value of the transferred assets is determined at the time the trust is created and funded using the "subtraction method." Under this method, the value of the annuity interest the Grantor retains is subtracted from the fair market value of the assets the Grantor placed into the trust to determine the amount of the Grantor's gift. Code Sec. 2702(a). The value of the annuity is determined by reference to section 7520 of the Code, and uses 120 % of the federal midterm rate in effect for the month of the transfer to determine the discounted present value of the annuity. The discounted present value of the annuity is an algebraic calculation, discussed in detail later in the outline, and can be determined by any one of various computer programs. (This author uses a product known as "Z calc," whose email address is \_\_\_\_\_.)

**Example 2:** In Example 1, G retains the right to \$280,000 for 4 years. The required discount rate to value this \$280,000, for September, 2004, is 4.6%. Initially, then, the step is to determine the value of \$280,000 received for four years, assuming the required rate of return on this money would have been 4.6 % per year (stated another way, that the investor could have earned 4.6% per year on the \$280,000, so each time the \$280,000 is received, it is worth \$280,000 less the 4.6% return on that money over each year it is deferred). The value of this is \$1,000,261. Second, the value of the transferred property is \$1,000,000, so the gift tax value is \$1,000,000 less \$1,000,261, or a negative number. Since one cannot have a negative gift, the gift tax value under the rules prescribed by the Code is 0.

**C. Code Section 2702 Prescribes Rules as to What can be Valued and What Cannot**

Section 2702 was enacted to rid the valuation process of perceived abuses that were occurring pre-1990 with a technique called a "grantor retained income right," or GRIT. The most substantial concern with a GRIT was that the gift was valued assuming the grantor retained an "income" right at a certain percentage (like the 4.6% in the above example), but "income" is a trust accounting term; and the GRIT was often invested in assets not producing trust accounting income. So there was a mismatch between the valuation at a defined percentage and the assets flowing back to the grantor as income.

Section 2702 cured this mismatch; it provides that a retention of a right determined by reference to the income, a GRIT, or a contingent reversionary right to trust corpus is for gift tax purposes valued at zero. Code Sec. 2702(a)(2)(A). Only “qualified interests” will be valued, which consist of (1) a fixed amount payable at least annually, a GRAT, (2) an amount payable at least annually which is a fixed percentage of the fair market value of the trust’s assets, a GRUT, or (3) a noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2). Code Sec. 2701(a)(2)(B), 2701(b)(1-3).

That section applies to transfers to “family members,” a defined term in the statute. These rules mandate, in addition to the fixed annuity amount discussed above, the use of a discount rate based on 120-percent of the applicable federal mid-term rate (“the 7520 rate”) for the month in which the trust is created. The 120-percent applicable federal mid-term (Code Sec. 7520) rate changes monthly and is reported in Revenue Rulings by the IRS in Table 5 and in various financial news publications such as *The Wall Street Journal*. Additionally, the IRS provides this information online at <http://www.irs.gov/taxpros/lists>.

#### **D. The Gift Tax Benefit of a GRAT**

All income and appreciation in excess of that required to pay the annuity accumulates for the benefit of the remainder beneficiaries. Consequently, it may be possible to transfer assets to the beneficiaries when the retained interest period terminates with values that far exceed their original values when transferred into the trust and, more importantly, that far exceed the gift tax value of the transferred assets. In zeroed-out GRATs, the gift tax value is zero, so any amount that remains after the retained interest term has effectively been transferred gift tax free.

**Example 3:** The value of the property that G transfers to the trust in Example 1 increases annually by 10 %. At the end of 4 years, \$164,620 remains and passes to the remainder beneficiaries of the GRAT free of any gift or estate tax consequences.

The transfer tax benefits of the GRAT and how it is achieved from an algebraic perspective is discussed in more detail in section III.

#### **E. The Estate Tax Elements.**

The transfer to a GRAT is a transfer with a retained interest, a term that invokes section 2036 of the Code. Section 2036 applies at a person's death to previously transferred property, and all the transferred property is included in the grantor’s gross estate. With regard to a GRAT, if the grantor dies within the retained interest period, that is, during the time the grantor is required under the terms of the GRAT to receive the annuity, the full value of the GRAT is included in the grantor’s gross estate, as it exists at the grantor’s passing. If there was a taxable gift at the onset of the GRAT (the GRAT was not zeroed out, for example), the grantor is given credit for that gift. Inclusion in the

grantor's gross estate has been held in all circumstances by the Service, which has resorted to section 2039 of the Code as well as 2036 in reaching that result.

## F. Decisions to be Made at the Time the GRAT is Established

In structuring the GRAT, the client and advisor must make various decisions, the enjoyable part of the planning process. These include:

### 1. **How Long is the Retained Interest Period to Be?**

There are a couple of variables here that interplay with one another. First, the longer the period, the longer the grantor must survive in order for the GRAT to be out of the grantor's gross estate. If the grantor dies during the retained interest period, the property is included in the grantor's gross estate. Conversely, the shorter the retained period, the larger the annuity needed in order to zero out the GRAT. And this means that the property does not have as long a period of time to get the benefit of the appreciation.

### 2. **How Much is the Retained Annuity?**

This is really a plug number, if the goal is to zero out the GRAT, which it should be with most GRATs. So, once the term of years is determined, the annuity amount that must be paid each year becomes a plug number: the number necessary to zero out the GRAT.

**Example 4:** G determines that he only wants a 4 year GRAT because at his age, 75, he doesn't want to go longer and risk mortality during the retained term. <sup>1</sup> If \$1,000,000 is transferred to the GRAT and the section 7520 rate is 4.6 %, then the retained annual annuity needs to be about \$280,000 per year in order to avoid any taxable gift with regard to the initial transfer.

Alternatively, the retained annuity amount can be the first determination and then the term of years can become the plug to zero out the GRAT.

**Example 5:** In the GRAT in which G has transferred \$1,000,000, G determines that the GRAT can generate \$98,457 a year and he wants to limit his annuity right to this amount. To zero out the GRAT, assuming that \$98,457 will be received each year, the GRAT must be for a period of 14 years.

### 3. **What is transferred to the GRAT and how is the GRAT invested?**

This becomes the most interesting determination for the planner. As discussed in detail later in the article, the greater the volatility of the asset in the GRAT, the greater the potential upside that is transferred to the children gift tax free. Accordingly, the model asset for a grantor to transfer to a GRAT is an asset that can be discounted in valuation at the time of the transfer (say, for example, a minority interest in an operating business),

and which has substantial possibilities of appreciation (and correspondingly, depreciation, for that matter).

### III. CONGRESS HAS RECOGNIZED THAT GRATS CAN RESULT IN TRANSFER TAX SAVINGS

#### A. Assumptions Implicit in the GRAT Valuation Methodology

In a GRAT, the retained interest is valued under the implicit statutory assumption that the GRAT property will grow at a rate equal to the assumed gift tax discount rate and will return to the Grantor's retained interest a *pro rata* portion of this growth.

**Example 6:** Consider a five-year GRAT funded with \$1,000,000, in which the Grantor retains the right to five percent of the initial fair market value of the GRAT, or \$50,000 per year. The grantor can retain any annuity amount. *See* Code Sec. 2702 (b). Assume that 120-percent of the federal midterm rate in effect for the month of the transfer is 10.6%.<sup>2</sup>

Under this scenario, the Grantor is treated as having retained a .18667 interest of the value of the property transferred, or \$186,670.<sup>3</sup> Conversely, the Grantor is treated as having transferred the remaining fractional interest, .813330 or \$813,330, for gift tax purposes.<sup>4</sup> For there to be a transfer tax benefit at the end of five years, all growth in the GRAT property would have to shift to the transferred interest. If the \$1,000,000 in the GRAT had grown at a 10.60 percent rate,<sup>5</sup> then at the end of five years the property theoretically should be equal to \$1,654,914 (ignoring, for the moment, the need to make annual \$50,000 distributions to the Grantor).<sup>6</sup> As the Grantor had initially retained \$186,670 and had transferred \$813,330, there has been appreciation equal to \$654,914.<sup>7</sup> In a true freeze, this \$654,914 should have passed to the remainder, gifted interest. Stated numerically, at the end of five years, \$1,468,244 should remain in the GRAT had there been an effective freeze.<sup>8</sup>

In a GRAT, however, under this scenario only \$1,345,992 remains at the end of the five years, as follows:

| <u>End of Year</u> | <u>Amount Transferred (Increased Annually by 10.60 percent)</u> | <u>Payout to Annuity Holder</u> | <u>Value of Property After Termination of Annuity Interest</u> |
|--------------------|---|---------------------------------|--|
| 0                  | \$1,000,000   | 0                               | \$1,000,000  |
| 1                  | 1,106,000   | \$50,000                        | 1,056,000  |
| 2                  | 1,167,936   | 50,000                          | 1,117,936  |
| 3                  | 1,236,437   | 50,000                          | 1,186,437  |
| 4                  | 1,312,199   | 50,000                          | 1,262,199  |
| 5                  | 1,395,992   | 50,000                          | <u>1,345,992</u>   |
|                    |   | Amount Remaining:               | <u>\$1,345,992</u>   |

Query, then, what happened to the additional \$122,252 of growth.<sup>9</sup> That amount inured to the benefit of the \$186,670 retained interest. First, the donor received a total payment of \$250,000 (*i.e.*, five annual annuity payments of \$50,000 each). That accounts for \$63,330 of the missing \$122,252 of growth.<sup>10</sup> The remaining \$58,922<sup>11</sup> is more subtle in its accountability. That amount represents the growth attributable to each \$50,000 payment during the five-year period.<sup>12</sup>

As a result, the retained interest of \$186,670 has, in fact, appreciated at a 10.80 percent rate.<sup>13</sup> Because this amount has been retained by the donor, the appreciation has not inured to the benefit of the transferred interest. No transfer tax savings has occurred because both the retained interest and the transferred interest have grown at the same rate.<sup>14</sup> The GRAT in this instance is the functional equivalent of an outright gift transfer of \$813,330.<sup>15</sup>

**Example 7:** A slightly different analysis applies if the GRAT property grows at a rate different than the assumed gift tax discount rate. For example, assume a Grantor establishes a five percent GRAT funded with \$1,000,000, and that 120 percent of the federal midterm rate in effect for the month of a transfer is 10.60%. The value of an annuity interest for five years, at a rate equal to five percent of the property initially transferred, is .18667 of the value of the interest transferred, or \$186,670. Hence, the value of the remainder interest is .813330 of the value of the interest transferred, or \$813,330.

If the after-tax income and appreciation experienced by the property is on average 12%, then at the end of five years the value of the remainder, gifted interest should be \$1,433,365.<sup>16</sup>

In a GRAT, however, under this scenario the remainder, gifted interest is \$1,444,699, as follows:

| <u>End of Year</u> | <u>Amount Transferred (Increased Annually by 12 percent)</u> | <u>Payout to Annuity Holder</u> | <u>Value of Property After Termination of Annuity Interest</u> |
|--------------------|--|---------------------------------|--|
| 0                  | \$1,000,000  | 0                               | \$1,000,000  |
| 1                  | 1,120,000  | \$50,000                        | 1,070,000  |
| 2                  | 1,198,400  | 50,000                          | 1,148,400  |
| 3                  | 1,286,208  | 50,000                          | 1,236,208  |
| 4                  | 1,384,552  | 50,000                          | 1,334,552  |
| 5                  | 1,494,699  | 50,000                          | <u>1,444,699</u>   |
|                    |  | Amount Remaining:               | <u>\$1,444,699</u>   |

This difference occurs because the retained interest was valued assuming a discount rate of 10.60%, when in fact the actual rate of growth was 12%. At a 12% growth rate, the

value of the retained interest should have been \$328,976.<sup>17</sup> In essence, the Grantor's retained interest has increased at only the assumed 10.60% gift tax rate, plus an adjustment to account for the result that the Grantor's received annuity payments increased each year at a 12% rate.<sup>18</sup>

This means that the retained interest has appreciated at a rate greater than 10.60% but less than 12%,<sup>19</sup> whereas the transferred interest has appreciated at a rate slightly higher than 12%.<sup>20</sup>

#### B. Moral of the Story

Therefore, a GRAT in which the value of the property increases<sup>21</sup> at a rate **greater** than the Code Sec. 7520 rate will, permissibly under the statute, allow that appreciation to inure to the benefit of the remainder beneficiaries free of any additional estate or gift tax assuming the retained interest term has expired. Congress recognizes that transfer tax savings are possible with GRATs through the above algebraic permutations.

#### IV. STRUCTURING THE GRAT TO TAKE ADVANTAGE OF THE 7520 RATE HEDGE

There are two variables that need to be determined in each GRAT, the term of the retained interest period (the "term"), and the amount of the annual annuity (the "amount"). The longer the term and the larger the amount, the lower the value of the remainder interest, which is the taxable gift. For example, a three-year GRAT, at a 7520 rate of 5%, needs to return to the grantor 36.72% each year in order for the remainder interest to be zero. A seven-year GRAT, at a 7520 rate of 5%, needs to return to the grantor 17.28% each year in order for the remainder interest to be zero.

Describing these variables in a nutshell is easy. Keeping them there is much more difficult. The larger the amount, the lower the leverage of the appreciation that is transferred; and the longer the term the more risk that there will be estate tax inclusion. For example, if the grantor dies during the retained interest period, the full amount of the GRAT is included in the grantor's gross estate. *See, e.g.*, TAM 200210009 (March 18, 2002). See also Code Secs. 2036 and 2039, which are the appropriate sections for full inclusion.

Because the amount and the term define the taxable gift, it is best to structure all these elements together in order to avoid **any** taxable gift exposure. By so doing, this creates a hedge that the rate of return will turn out to be lower than the 7520 rate. In other words, if the rate of return of the GRAT is less than the 7520 rate then there is a transfer tax loss, that is, the grantor would have been better off making a straight gift of the discounted present value of the remainder interest. But if the straight gift is zero, because it is structured so that the remainder interest is zero, there can be no transfer tax loss.<sup>22</sup> Specifically, the grantor retains an annuity amount large enough so that there is no gift tax element in the remainder interest. In that way, if the rate of return of the GRAT is less than the 7520 rate, then there is no transfer tax gain, but there has correspondingly not been a gift (so only the administrative costs and opportunity costs are lost).

**Example 8.** The grantor transfers \$1,000,000 in securities to a 3-year GRAT. The 7520 rate in effect at the time of transfer is 5%. The grantor retains the right to \$367,200 from the GRAT per year for three years. The discounted present value of the remainder interest is zero. No gift is reported. If the GRAT experiences a rate of return in the GRAT of less than 5% annually, at the end of three years, all GRAT property has been returned to the grantor and there is no transfer to the remainder beneficiaries. But there has been no gift tax cost.<sup>23</sup>

V. **FIRST COUSIN, ONCE REMOVED, TO THE GRAT: THE SALE-TO-A-GRANTOR TRUST**

A. **What is It?**

In its simplest iteration, this is merely a sale between an older generation asset holder (the “grantor”) and a trust created by the grantor. The sale adheres to principles set forth in Reg. § 25.2512-8 that provides that transfers for full and adequate consideration are not taxable gifts. Further, the trust created by the grantor is structured so as not to be included in the grantor’s estate for estate tax purposes. The trust is structured as a grantor trust for income tax purposes, is fully taxable for income tax purposes to the grantor.

If the grantor died immediately after the sale, in a conceptual sense there would be no tax savings because the property received would equal the property transferred. Hence, in a straight sale-to-a-grantor trust strategy, the efficacy of the strategy depends on the grantor surviving for a reasonable numbers of years after the strategy.<sup>24</sup>

The components of the strategy include the following: Assets or asset held by the grantor that are capable of producing cash flow (either by throwing off such cash flow, such as an S corporation that generates substantial free cash flow, or by being readily marketable, such as publicly traded securities); a grantor trust set up by the grantor that has a reasonable amount of assets (as discussed below, for example, 10% of the amount needed to buy the intended assets from the grantor); drafting of the trust in a way in which the trust will be included in the grantor’s income for income tax purposes, but excluded from the grantor’s gross estate for estate tax purposes; purchase agreement and related documentation as to the sale; and valuation justification for the sold asset.<sup>25</sup> Typical aspects of the transaction include:

- A. The trust provides 10% of the consideration back to the grantor in cash, and finances the remainder of the purchase price with a promissory note.
- B. The terms of the promissory note call for interest at the AFR and principal payable either at the end of a fixed term, or amortized over the term of the note.
- C. The transaction is not recognized for income tax purposes, meaning that there is no gain at the time of the sale. See Rev. Rau. 85-13.

- D. The interest generated between the grantor and the grantor's trust, though income in an accounting sense, is not taxable income because it, too, is ignored for income tax purposes.
- E. Any taxable income generated by **the assets in the trust** is taxed back to the grantor.
- F. After the note is paid off, the income generated by assets in the trust continues to be taxed to the grantor. At the grantor's passing, or sooner if the trust ceases to be a grantor trust, it is uncertain whether the trust continues to take the carryover basis or whether there is a recognition of taxable gain at that point to the extent of the unrealized gain in the unpaid portion of the installment note.

As with a GRAT, the primary objective sought to be achieved with the sale, is to transfer future asset value increases that are greater than the AFR to the trust beneficiaries free of transfer tax.

While on its face the planning will appear orderly, the Internal Revenue Code does not explicitly sanction this kind of transaction. There are a number of areas where the Service can strike and has done so, in audits. The most interesting of the possible attacks is the Code Sec. 2036 argument that has been raised in family partnership cases. Sham transaction principles are also possible.

#### B. Why a Sale is Better than a GRAT

The sale-to-a-grantor trust achieves, in broad brush, the same objectives of a grantor trust, in transferring appreciation and rate of return in excess of the used discount rate (for valuation purposes) to the remainder beneficiaries. But it has tremendous flexibility in structuring versus a GRAT. A GRAT must follow the strict structuring and payment regime set forth in Code Sec. 2702 and accompanying regulations. The sale, in contrast, is not governed by these types of stringent Code requirements and results in the following, not achievable in the GRAT setting:

1. Premature death arguably includes in the grantor's gross estate only the remaining note payments unless Code Sec. 2036 is held to apply to include the entire grantor trust in the grantor's gross estate.
2. The grantor trust can be generation skipping, if structured properly.
3. Each year only interest (versus principal) needs to be mandatorily prepaid.
4. The required applicable federal rate for the note will be less than the 7520 rate (by definition).

## **VI. I CHOOSE DOOR NUMBER 2: GRATS WITH NO TAXABLE GIFTS AS AN ALTERNATIVE TO SALES**

### **A. Zeroing Out**

Zeroing out GRATs for gift tax purposes should have been achievable since 1990. The valuation of the retained interest is a straightforward discounted present value of an annuity for a term of years. The term of years should pay out in the GRAT regardless of whether the Grantor is living or has died during that time. If the Grantor dies during that time, the remaining annuity interest should be paid to his estate. In this way, the value of the annuity will not be based on any life expectancy issues.

But from 1990 through 2000, the IRS did not see it that way. For trusts implemented after January 28, 1992, the regulations introduced and applied (and strongly implied) that a life expectancy factor was required, the so-called “Example 5” to the Regulations. Treas. Reg. 25.2702-3(e), Ex. 5. New proposed regulations have now been released to supersede Example 5. *See* 69 Fed. Reg. 44476, 44479 (July 26, 2004). The question was whether the actuarial assumptions mandated by example 5 in the Regulation to Code Sec. 2702 were valid. If valid, then a GRAT could not be zeroed out and there would always be transfer tax risk if the GRAT did not outperform the 7520 rate.

### **B. Example 5**

The Treasury Regulations initially provided that a GRAT would always have a remainder interest. Preamble to T.D. 8395, 1992-1 C.B. 316, 319.<sup>26</sup> “The governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods.” Reg. § 25.2702-3(d)(3) (emphasis supplied). According to the Service, only the value of an annuity payable for the shorter of the stated term or the period ending upon the annuitant’s death may be subtracted from the fair market value of the property contributed to the irrevocable trust in calculating the value of the taxable gift. The Regulations provided an illustration. The illustration provides that when an annuity is retained for a term of years, assuming the annuitant dies within the stated term, and the annuity is then paid to the annuitant’s estate, the valuation of the annuity is not based on the stated term. Instead it is valued for the term of years or the annuitant’s prior death.

“EXAMPLE 5. A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A’s estate for the balance of the term. A’s interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A’s prior death.” Treas. Reg. § 25.2702-3(e).

The value of that mortality risk would, in every case, represent a taxable gift to the remaindermen.

### C. **The Walton Case**

The litigated question in *Walton v. Commissioner 115 T.C. 589 (2002)*, was whether the Regulation illustrating the calculation for a retained term was a valid interpretation of Code Sec. 2702. The initial value of the property transferred in the *Walton* case was just over \$200,000,000. If the Regulation were valid, the gift would be several million dollars, but otherwise the gift would be a few thousand dollars.

In a reviewed decision by the full Tax Court, the Regulation was held to be an invalid interpretation of Code Sec. 2702. *Walton v. Commissioner*, 115 T.C. 589 (2000). The Court primarily looked to the statute itself. The Court reasoned that if it had sustained the IRS position then Congressional intent, found in Code Sec. 2702, would have been frustrated because no taxpayer would have been able to create an annuity for a term of years that would be valued as such:

“[T]here exists no rationale for refusing to take into account for valuation purposes a retained interest of which both the form and the effect are consistent with the statute. We further observe that respondent’s attempts to equate the estate’s rights here with other contingent, post-death interests are premised on the bifurcation of the estate’s interest from that of petitioner. Yet, given the historical unity between an individual and his or her estate, we believe such separation is unwarranted where the trust is drafted in the form of a specified interest retained by the grantor, with the estate designated only as the alternate payee of that precise interest. This is the result that would obtain if the governing instrument were simply silent as to the disposition of the annuity in the event of the grantor’s death during the trust term. Additionally, any other construction would effectively eliminate the qualified term-of-years annuity, a result not contemplated by Congress.”

### D. **The Service’s Position is Unlikely to be Sustained in any Venue**

While the decision in *Walton* was not reviewed by an appellate court, it is likely that the *Walton* reasoning would withstand appellate review. The Service’s position is untenable; its interpretation of Code Sec. 2702, as already confirmed by one court, is neither a reasonable interpretation nor a valid extension of Code Sec. 2702. The *Walton* Court specifically found that Congress meant to allow individuals to retain qualified annuity interests for a specified term of years, and that the proper method for doing so is to make the balance of any payments due after the Grantor’s death payable to the Grantor’s estate.

To appreciate why it was easy for the court to reach its conclusion, it is necessary to understand the Congressional purpose of Code Sec. 2702. That section was enacted to prevent under-valuation of gifted interests. The statute was designed primarily to restrict a donor’s ability to calculate the amount of a gift by subtracting certain portions of the transferred value that would likely pass to the donee. A fixed term annuity, however, does not permit a taxpayer to “incorrectly” value the retained interest. The retained interest must conform to Code Sec. 2702, which provides a methodology that fairly values retained interests. Example 5 of the Regulations does not comport with this purpose.

In addition to the policy argument (that Example 5 frustrates rather than furthers Congressional intent), the *Walton* court pointed out that the Service has published regulations defining a term interest as including payments made to an individual's estate for the remainder of a term interest. See, e.g., Reg. §1.664-2(c). Thus, in the charitable context, where a valuation inclusive of annuity payments made to an individual's estate would reduce the charitable deduction (increase taxes), the Service promulgates such definitions. But in an area where a similar calculation would produce a smaller taxable gift (lower taxes), the Service would reverse its position with no comprehensible policy reason (let alone statutory authority) as to why this is the case.

Although reluctant to do so, the Service has now acquiesced in the *Walton* decision. Notice 2003-72 (2003). Zeroed out GRATs can be structured without the Example 5 overhang. This is a tremendous impetus to the use of GRATs, because now highly volatile investments, capable of substantial returns in excess of the 7520 rate, can be put in the GRAT without concern, from a transfer tax standpoint, of these assets severely dropping in value.<sup>27</sup>

## **VII. GRATS WITH NO TAXABLE GIFTS AS AN ALTERNATIVE TO SALES: THE SHIFTING TIDE**

Even in light of the ability to use a GRAT as an estate tax reduction strategy, the GRAT still lagged behind the "sale-to-a-grantor trust" strategy ("sale") as the go-to strategy of choice in the late 1990s. Part of this was due to the uncertainty of the ability to zero out GRATs pre- *Walton*. But most of it was due to the superior flexibility of the sale strategy over the GRAT strategy.

The major advantage of the GRAT over the sale technique is that the GRAT is statutorily authorized. If a practitioner follows the Code Sec. 7520 rules, the risks of the GRAT are the idiosyncratic ones, e.g. the grantor does not outline the retained interest period, the assets underperform the 7520 rate, or the assets are improperly valued going in. But the risk is not structural. If properly created, a GRAT will not result in a taxable gift, even if the valuation is later adjusted by the Service.

**Example 9:** Consider the technique discussed and impliedly accepted by the Tax Court in the *Kerr* case, 113 T.C. No. 3d (1998), *aff'd* 292 F.3d 490 (2002). Assume a client sets up a limited partnership with assets worth \$5,000,000. Ninety percent of the partnership is represented by limited partnership interests. The taxpayer discounts the value of these limited partnership interests by 40%, substantiated by a thorough and specific appraisal. The value of the limited partnership interests are thus \$2,700,000; and are transferred to a 5-year GRAT during a month in which the 7520 rate is 5%. The GRAT is zeroed out and the required annual return is \$630,000. The Partnership experiences a 14% annual rate of return and distributes the entire rate of return (14%) to its partners. The GRAT uses 90% of this 14%, or \$630,000, to make the annuity payment to the grantor. At the end

of 5 years, the remainder beneficiaries have 90% limited partnership interests with a liquidation value of \$4,500,000 (and a fair market value, with discounts, substantially less than this). This was achieved at no transfer tax cost.

Assume the Service pursues and successfully reduces the discount from 40% to 20%. The net effect is that the GRAT is required to pay to the grantor \$831,000 per year versus \$700,000. Back payments, plus interest, are owed to the grantor. But there is no gift tax readjustment. The net value of the technique is reduced by this reduction, but there is still value and still no gift tax cost.<sup>28</sup>

In contrast, the sale technique is not statutorily authorized. If the sale technique is not recognized by the Service (or courts), and there is a valuation readjustment, there could be substantial gift tax concerns. This risk has been exacerbated by the holding of the Tax Court in the *McCord* case, 120 T.C. 358 (2003), *rev'd* 98 AFTR 2d 2006-6147 (5<sup>th</sup> Cir 2006). In *McCord*, the Tax Court refused to recognize that a “definitional” type transfer was to be respected for gift tax purposes:

“We do not believe that the language of the assignment agreement supports petitioners’ argument. The assignment agreement provides a formula to determine not only CFT’s fraction of the gifted interest but also the symphony’s and the children’s (including their trusts’ fractions. Each of the assignees had the right to a fraction of the gifted interest based on the value of that interest as determined under Federal gift tax valuation principles. If the assignees did not agree on that value, then such value would be determined (again based on Federal gift tax valuation principles) by an arbitrator pursuant to the binding arbitration procedure set forth in the partnership agreement. There is simply no provision in the assignment agreement that contemplates the allocation of the gifted interest among the assignees based on some fixed value that might not be determined for several years.”

Though the appellate court reversed this opinion, the fact pattern involved a “gift” versus a “sale,” so there is still doubt as to whether the definitional type sale will be respected. If not respected, and if a valuation turns out to be readjusted, this could result in gift tax liability. *Id.* at 396-97

And the Service, in light of the income tax abuses it is now dealing with it, has become increasingly alarmed at the pervasiveness of estate and gift tax techniques it views as abusive. It is conceivable that the Service will view the sale technique as another taxpayer abusive strategy and seek to aggressively assert gift tax amounts. It is this uncertainty that now militates in favor of the GRAT over the sale technique.

**Example 10:** Client sets up a limited partnership with assets worth \$5,000,000. Ninety percent of the partnership is represented by limited partnership interests. The taxpayer discounts the value of these limited partnership interests by 40%, substantiated by a thorough and specific appraisal. The value of the limited partnership interests are thus \$2,700,000; and are sold to a grantor

trust in exchange for a \$270,000 down payment and a 5-year promissory note at 4% for the balance of \$2,430,000. The Partnership experiences a 14 % annual rate of return and distributes 90% of the entire rate of return (14%) to the grantor trust. The grantor trust uses this 14%, or \$630,000, to make the interest payments and principal payments to the grantor and to effectively pay off the note. At the end of 5 years, the grantor trust has 90% of the limited partnership interests with a liquidation value of \$4,500,000 (and a fair market value, with discounts, substantially less than this). This was achieved at no transfer tax cost. (Assume in this fact pattern that this is especially important because the grantor has already used her entire \$1,000,000 taxable gift amount that is offset by the applicable credit amount.)

In this fact pattern, assume the Service pursues and successfully reduces the discount from 40% to 20%. Pursuant to the *McCord* holding, the IRS ignores the definitional amount in the sales contract and argues that the grantor made a gift of the difference between the purchase price at \$2,700,000, and the purchase price at \$3,600,000. The Service argues that there is a gift of \$900,000, resulting in a gift tax payment of approximately \$360,000, plus interest, plus an array of potential penalties. Though there has been, even in this setting, substantial transfer tax savings even with a 20% discount; but the cost to this is the current payment of gift tax at \$360,000 plus interest (perhaps penalties). This is a substantial disadvantage vis-à-vis the GRAT strategy. Will the client remember and acknowledge this substantial gift tax risk, which could have been avoided entirely with the GRAT strategy?

### **VIII. INVESTMENTS WITHIN GRATS AS PART OF THE OVERALL PRUDENT INVESTOR RULE.**

Investments within GRATs take on a very interesting dynamic in light of the *Walton* case and Service acquiescence. Not enough attention has been spent in recent years emphasizing what should be invested in GRATs. The context gets confused, however, because there are so many excellent investments within a GRAT, and the analysis really becomes one of a hierarchical nature.

#### **A. Section 7520.**

Code Sec. 2702 by its specific terms requires the Code Section 7520 applicable federal rate be used to value interests in GRATs. Therefore, despite a strong logical reasoning not to apply the 7520 rate to discount future cash flows that are based on assets with higher volatility and risk patterns than the 7520 rate, the statute requires the 7520 rate to be used. *See* 2702(a)(2)(B).

**Example 11:** Consider a client worth \$10,000,000 that contributes \$1,000,000 in cash to a zeroed out GRAT at a 7520 rate of 5.0%. There is no preconceived plan to have the GRAT buy assets from

the grantor, but shortly after establishment, the trustee of the GRAT determines to do just that. Which assets should the trustee purchase from the grantor? These should be no income tax on the exchange because the GRAT is a grantor trust. *See* Rev. Rul. 85-13.

- i) \$1,000,000 worth of treasury notes with an interest crediting rate of 5.5%. Note that at the end of 5 years, \$17,876 is transferred to the children free of gift tax.
- ii) \$1,000,000 worth of preferred stock paying 7%. Note that at the end of 5 years, \$74,283 is transferred to the children free of gift tax.
- iii) \$1,000,000 worth of stock in a large cap index fund (*e.g.*, S & P 500 Fund with Vanguard). Note that at the end of 5 years, \$114,298 is transferred to the children free of gift tax if the stock appreciates at 8% annually, on an average basis. But volatility and returns on an annual basis really effect the long-term GRAT performance. For example, if the market goes down by 20% in the first year of the GRAT, and then increases annually by 16.41% (to get to an average 8% yield over 5 years), at the end of 5 years, \$0 is transferred to the children free of gift tax.
- iv) \$1,000,000 worth of pre IPO stock that is expected to double in value in 2 years at the IPO. Note that at the end of 5 years, \$614,159 is transferred to the children free of gift tax.
- v) \$1,000,000 worth of private equity that is expected to earn 30% annually. Note that at the end of 5 years, \$1,624,213 is transferred to the children free of gift tax. If the private equity does nothing in the first two years, but then goes up by 54.847% for the next 3 years, to average out at 30% annually, then at the end of 5 years, \$855, 295 is transferred to the children free of gift tax.

The moral of the story: invest in volatility within the GRAT to the extent the grantor would ordinarily be invested in those types of assets. In a worst case scenario, the GRAT yields no transfer tax savings because there has been no increase in value or the GRAT assets go down in value. However, in other scenarios, substantial transfers will have occurred.

#### **B. Trustee Authority as to Investments.**

The trustee has broad authority to engage in investments as set forth in the trust. That authority is circumscribed by the terms of the trust, not federal law. *Morgan v. Commissioner*, 309 U.S. 78, 60 S.Ct. 424, 84 L.Ed. 1035 (1940). *See also Brantingham v. United States*, 631 F.2d 542, 545 (7<sup>th</sup> Cir. 1980) (“[A] determination of the legal rights and interests created by an instrument is a question of state law.”) If the trustee is authorized to engage in investments that include private equities and other riskier (versus traditional publicly traded stocks) investments, that investment authority is permissible,

despite the riskiness or volatility of the investment. A standard that is typical in most documents is as follows:

In addition to all powers granted by law, the trustee shall have the following powers, to be exercised in a fiduciary capacity: To invest in bonds, common or preferred stocks, notes, options, common trust funds, mutual funds, shares of any investment company or trust, or other securities, life insurance, partnership interests, general or limited, joint ventures, or other property of any kind, regardless of diversification and regardless of whether the property would be considered a proper trust investment....

The liability of the trustee to make the annuity payments to the grantor extends only to the value of the trust estate. The liability to make payments to the grantor does not extend to the trustee personally. Restatement (Second) Trusts. §265. Although the development of the law in this area originated in the context of feudal obligations incident to estates (where a trustee could be held personally liable for rents *Board of Education of City of Chicago v Crilly*, 37 N.E.2d 873 (1941).), the majority view is to limit a trustee's liability solely to the trust corpus. *See Irvine v MacGregor*, 203 Cal. 583 (1928).

## **IX. CREATIVE USES OF THE GRAT**

### **A. Discounted Assets**

Once the zeroed out GRAT concept is accepted and the importance of GRAT planning understood, the GRAT itself becomes an interesting technique to iterate. For example, if, as in *Kerr, infra*, the GRAT is funded by limited partnership interests, these partnership interests are discounted going into the GRAT. The effect of the discount is to lower the hurdle rate required for the GRAT to be transfer tax efficient. For example, if the 7520 rate is 5%, an asset that is discounted by 40% and used to fund the GRAT will require a rate of return, before tax, of only 3% to achieve a transfer tax gain.

### **B. Volatility**

In addition to discounted assets, can the GRAT portfolio consist of the grantor's most volatile assets? The answer is clearly yes under the current regulations to Code Sec. 7520. And as discussed in Section IV, to the extent increased volatility can lead to an increase in expected return, that investment should be within the GRAT (assuming it is consistent with the family's overall investment objectives).

### **C. Payment of Income Tax**

Further, the grantor must pay the income tax on the GRAT during the retained term. This is both required and a positive net cash flow result to the GRAT. The payments by the GRAT to the grantor are in effect the payment of an after income tax obligation (to the grantor) with before income tax dollars. After the retained term, the grantor trust status can be continued in order for the grantor to continue to pay the income tax related to the

GRAT assets. These results were recently affirmed, in sort of a backhanded way, by the Service. The question has been raised as to whether the payment by the grantor of income tax, as mandated by law, is nevertheless a gift by the grantor to the trust. The Service in Revenue Ruling 2004-64 ruled "no," that there is no gift if the grantor pays the income tax. But the Service required care here. A gift could occur:

"If, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under §2036(a)(1)."

Therefore, in drafting a GRAT, the grantor should include a provision in the GRAT that specifically precludes reimbursement to the grantor.

#### D. Transactions Involving the Investment Portfolio of the Grantor

Investments within the GRAT can be coordinated with the grantor's individual investment philosophy to take advantage of risk in a grantor's portfolio. For example, if the grantor already has a single stock exposure (say 20 % of her overall equity portfolio is made up of Microsoft), the GRAT could be the right vehicle to hold that investment. First, single stock risk within a GRAT takes advantage of the volatility play that a GRAT should be seeking. Second, the chances of beating the 7520 rates can be increased by having that single stock GRAT sell off call options for the GRAT, thereby reaping at a minimum the call premium as additional proceeds of the GRAT. The effect of selling the call will be to limit upside, but at the assurance of beating of the 7520 rate provided the stock value (at the time of contribution) does not decline. Derivative spreads can be concocted and implemented that are more creative than simply selling a call.

**Example 12:** Consider Google options. On September 7, 2004, the stock was trading at \$101. The GRAT sells call options that expire January 19, 2007 (2.3 years, roughly). At a strike price of \$105, these options were selling for \$28.5. Ponder the result inside a GRAT that must return 4.6% a year to the grantor. Assume Google increases in value to \$105 over this 2.3 year period. At \$28.5 + the \$4 (the amount that would be returned if the options expire in the money, \$105-\$101), the cumulative return is 13.01%, hence beating the 4.6% rate of return and ensuring that the differential will be transferred free of gift tax to the remainderpeople.

#### E. Transactions Between the Grantor and the GRAT

In a zeroed out GRAT, the grantor will receive a prescribed return based on essentially a risk free investment. That is, the grantor will receive back the grantor's principal contributed to the GRAT plus an interest amount (in effect) currently at 4.6%. Ponder the result if the grantor and GRAT engage in a fair market value transaction of a more risky variety.

**Example 13:** Assume that the trustee of the GRAT believes that the future of Microsoft is very compelling, and believes that stock options will be worth quite a bit. The trustee

could go out on the market and buy these options, but would prefer to avoid the bid-ask spread inherent in these purchases. The grantor believes that Microsoft will go down, and is willing to sell these options to the GRAT, for a price equal to the mean bid-ask price of these options at the time of consummation of the deal between the grantor and the GRAT (as reported real time in the public market). The net effect is that to the extent the options hit, the GRAT has substantially more funds that it can pass to the remainderpeople free of gift tax. If the options expire worthless, then the GRAT will have less money than is needed to pay off the grantor's remaining annuity obligation; that is, the GRAT will expire without any money passing to the remainderpeople. However, as a zeroed out GRAT, no transfer tax cost was incurred initially.

This relatively straightforward transaction carries with it a good amount of risk, all premised on whether a grantor can engage in transactions with the grantor's GRAT. The major risks fall within each of the following four categories: (1) is there adequate and full consideration, (2) does it satisfy the willing buyer/willing seller test, (3) is it bona fide, and (4) will a sham transaction principle apply.

1. **Is this a gift between the grantor and the GRAT?**

In order for the buyer of the option not to be considered to have made a gift to the GRAT, the fair market value of the consideration received must be equal to the consideration given. "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year." I.R.C. §2512.

A transaction between the grantor and GRAT that reflects trades that could be made on the open market can use the market as a definitive guide as to the pricing of the trades. The regulations are fairly clear that when there is a public market for a transferred asset, that public market price will act as a substantial guide to fair market value. Treas. Reg. 20.2031-1(b).

2. **Willing buyer/willing seller test.**

A quirk in the arrangements occurs notwithstanding that the grantor is entering into a transaction which, as an isolated transaction, will be an equal exchange for fair market value. At first blush, there should be no gift tax exposure because of the express language of the statute. However, if all transactions between this seller (grantor) and this buyer (GRAT) are grouped together, then an argument can be made that this specific buyer is not obtaining equal value in the trade.

The best that the grantor can do with the sale to the GRAT is to speed up the timing in obtaining the amount that the grantor would otherwise receive. Therefore, looked at in the totality of all other transactions between the buyer and seller, the buyer of the options would not pay expected value for the option payoff, but rather something substantially less tied only to this timing differential.

The Regulations under Section 2512 speak in terms of a hypothetical willing buyer and a hypothetical willing seller. Reg. 20.2031-1(b) provides that the “fair market value is the price at which the property *would* change hands between *a* willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts” (emphasis supplied). One extrapolation is that other transactions entered into by these same parties should not be relevant to the valuation of the property exchanged in the option transaction. A hypothetical buyer would not necessarily know what other transactions the seller had entered into.

The case law has defined the relevant facts to be those that the hypothetical willing buyer and willing seller could reasonably have expected to know at the time of the transaction. *Andrews v United States*, 850 F.Supp. 1279, E.D.Va.,1994, (“[t]he individual characteristics of the hypothetical buyer and seller are not necessarily the same as the individual characteristics of the actual buyer or actual seller” at 1289). Individual characteristics of a seller would be unlikely to be known by a hypothetical buyer. Accordingly, individual characteristics are not to be looked at.

The ‘willing buyer’ and ‘willing seller’ refer to hypothetical parties and not the actual person involved in the transaction. *See also* Rev. Rul. 59-60, 1959-1 C.B. 237, 1959 WL 12594 (IRS RRU) Modified by 65-193, Amplified by 77-287, Amplified by 80-213 and Amplified by 83- 120. Under the hypothetical willing buyer-willing seller standard, decedent's interest cannot be valued by assuming that sales would be made to any particular person. *See Estate of Bright v. United States*, 658 F.2d 999, 1001 (5<sup>th</sup> Cir. 1981).

Recent cases, including *Magnin v Commissioner*, T.C. Memo 2001-31, have emphasized that the actual buyer and actual seller standard is not the relevant standard for valuation purposes. *See also. U.S. v. Simmons*, 346 F.2d 213 (CA Ga. 1965); *Rothgery v. U. S.*, 475 F.2d 591 Ct.Cl.,1973; *Bright v. U.S.*, 658 F.2d 999 (5<sup>th</sup> Cir. 1981).

The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 218, 1990 WL 17251 (1990) (citing *Estate of Bright v. United States*, 658 F.2d 999, 1006 (5<sup>th</sup> Cir.1981)).

### 3. **Bona Fide Nature of the Transaction.**

Transactions between family members are closely scrutinized in accordance with the adequate and full consideration criterion. Because they are outside of the normal business context, these transactions are not assumed to be for adequate and full consideration.

Typically, the statute is structured so that the bona fides test is a predicate to a determination of whether the court will look further to the consideration to determine if it is “adequate and full.” For example, if the transaction is in the ordinary course of business, then the consideration received need not be reviewed further. Treas. Reg.

25.2512-8. A transaction is considered to have been made in the ordinary course of business when it is bona fide, at arm's length, and free from any donative intent. Treas. Reg. 25.2512-8.

As a result, one argument is that the bona fides test should not be in addition to adequate and full consideration once that latter test is applied. 26 USCA § 2512(b). The statute provides for the imposition of a gift tax only where there is a transfer wherein the value received and transferred is unequal (not imposing a second layer bona fides criterion.)

And it is strongly arguable that the hypothetical willing buyer, the grantor, does not take into account that that person also has another obligation to the hypothetical willing seller, such that the economic results from both transactions need to be collapsed in the valuation. However, it is still uncertain whether a court would be influenced, and tempted to consider other factors known by the hypothetical buyer and seller, to include the GRAT transaction. A court, even applying the hypothetical buyer seller standard, could still resort to a bona fides test to focus on the totality of the transaction. And in this regard, the court could try to use the bona fides concept by looking at what in totality the buyer will get (sort of an end run around the hypothetical willing buyer, willing seller test). This test stems from Section 2512 and the Regulations thereunder.

The case law is not entirely even on this logical read of the statute. In *Strangi II* (*Strangi v. Commissioner* T.C. Memo.2003-145), which was a Section 2036(a) case, the court held that the availability of the “full and adequate consideration exception” rests on two requirements: (1) a bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration. Will *Strangi II*'s reasoning extend to the gift tax “adequate and full consideration” requirement in the gift tax statutes. It would be a stretch, but that concern remains.

#### 4. **Sham Transaction Doctrine.**

The IRS could argue that the Transaction is solely tax motivated, and therefore, should be disregarded under one of the “sham transaction” doctrines.

Courts have used the sham transaction doctrine, through the application of theories such as sham “in fact,” sham “in substance,” step transaction, lack of economic substance, or substance over form, to invalidate tax planning strategies because the end result achieved by the taxpayer is, for lack of a better phrase, “too unjust,” to allow it to stand.

Often, courts use a litany of amorphous sham-related concepts to justify their decisions to invalidate a transaction. For example, Judge Beghe, in his dissent in *Strangi I*, noted that the estate planning transaction at issue should be invalidated because a “factual sham analysis can be used in appropriate cases in the transfer tax area.” He also would have applied the step transaction doctrine to invalidate the family partnership in that case because under “the end-result test,” the “series of formally separate steps are really prearranged parts of a single transaction that are intended from the outset to reach the ultimate result.” Under the quoted language, an inevitable conclusion is that adherence to that kind of amorphous test will allow a court to invalidate any tax motivated transaction

when the results appear too generous to what the court believes should have happened, or perhaps to what the court believes Congress would have allowed had Congress legislated specifically for that transaction. However, in the estate and gift tax area (federal estate and gift taxes are sometimes referred to collectively hereafter as “transfer taxes”), only a relatively few courts have invalidated transactions based on a sham transaction analysis, and none under this heightened standard of review. It is arguable that a court would not apply any of the following sham transaction doctrines to invalidate the gift tax effects of the Transaction.

Interestingly, these judicial sham transaction doctrines are not raised by the Service on a consistent basis, i.e., in each case in which they could be raised. For example, rare is the IRS argument in court that a *Crummey* power given to a minor child is a sham to obtain an annual exclusion gift. In fact, even remote contingent beneficiaries can have *Crummey* powers that convey a present interest. *Cristofani v. Commissioner*, 97 TC 74 (1991). The Service has acquiesced: Action on Decision CC-1996-010, 1996 WL 390089 (IRS AOD Jul 15, 1996).

In accepting the result in the original *Crummey* decision, the court had to indirectly consider the step transaction doctrine. Therefore, in upholding the withdrawal power in *Crummey*, the court in effect was applying the “binding commitment” test only of the step transaction doctrine, because the withdrawal right could have been exercised even though the subjective intent of the parties (the “end result” test) would have ignored the withdrawal right.

**i. Substance Over Form.** In certain circumstances courts have applied substance over form of a transaction and have instead ruled that its substance controls. For example, if a taxpayer sets up the structure of a transaction to do one thing, but actually took steps to accomplish another (ignoring the structure that was set up), the court could ignore the form that was set up and instead rule on what actually took place. That is, the taxpayer must act consistently with what the taxpayer is purporting to do. *cf. ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Circuit 1998), *cert. denied*, 526 U.S. 1017 (1999) (form was too contrived in light of end tax benefit to allow court to give any credence to intervening steps) *But see, Boca Investering Partnership v. United States*, 167 F. Supp.2d 298 (D.C., 2001), (reaching an opposite conclusion on facts essentially the same as those in *ACM*.)

A crucial inquiry relates to fact finding: it seeks to analyze whether what the taxpayer purportedly has done is what the taxpayer has actually done. The court is able to make factual determinations in these circumstances. For example, in *Reichardt*, 114 T.C. No. 9 (2000) the taxpayer set up a partnership form to hold assets, but then ignored the partnership formalities in operating the partnership. Because in substance there was no partnership, the court in essence looked through the transaction and ignored the form(alities) imposed by the partnership on the assets. Although the court did not cite “substance over form,” as the IRS abandoned this argument at trial, in essence the court applied a substance over form analysis. *See also Estate of Schauerhammer v Commissioner*, T.C. Memo. 1997-242 in which the court indicated that “where a decedent's relationship to transferred assets remains the same after as it was before the

transfer, section 2036(a)(1) requires that the value of the assets be included in the decedent's gross estate.”

In *Reichardt*, the taxpayer transferred all of his property to a partnership. After the transfer of the limited partnership interests to the children, the taxpayer essentially ignored the partnership requirements and continued to control the partnership assets as if he owned them individually. The taxpayer, for instance, transferred partnership funds directly into his personal checking account. Also, although his house was owned by the partnership, the taxpayer continued to live in the residence and did not pay rent. Since the taxpayer’s relationship with his assets did not change following his conveyance to the partnership, the court in essence was able to look through the transaction and ignore the form(alities) imposed by the partnership on the assets.

An often-cited estate and gift tax sham case, *Heyen*, *Heyen v. U.S.*, 945 F.2d 359 (10<sup>th</sup> Cir. 1991) is another substance over form application. In that case, annual exclusion gifts were made to donees (the “intermediaries”) who immediately signed blank stock certificates so that stock could be reissued to the original donors’ descendants. The court ignored those transfers to the intermediaries. The form of the transaction, a gift of annual exclusion amounts to intermediaries, did not match up with the substance of what occurred, an immediate transfer by the intermediaries, without any cognitive recognition that they could retain the stock, to the donor’s descendants. Interestingly, two of the intermediaries retained the stock interest, but the transfer agent still transferred it on the transfer agent’s records; if nothing else, reflecting that there was no substantive acknowledgement, most notably by the transfer agent, that the intermediaries would be given real control.

At its core, *Heyen* is another case where the i’s were not dotted and the t’s crossed, in that the substance of what happened reflected a direct transfer from the donors to the donors’ children, with no rights being vested in the intermediaries.

Therefore, to date, the substance over form estate and gift tax cases have really focused on the “substance” of the taxpayers’ actions as not being consistent with the “form” set up by the taxpayers as to those transactions. Based on these cases, strategies, where the taxpayer fulfills all of the statutory and administrative requirements and in which the form of the transaction is in fact respected by the parties involved can arguably withstand a substance over form argument attacking the transaction.

But like other sham doctrines, the substance over form principle is of uncertain dimension and can be extended, sometimes improperly so, by courts. Often times, a court will in the income tax area not focus on the “substance” of what was done, but on why it was done. In those cases, like *ACM*, the test looks like a “tax savings smell test.” If the strategy employed by the taxpayer is too successful, the intent to avoid taxes motivates the court to invalidate the transaction on a substance over form doctrine even if the “i’s” were dotted and “t’s” crossed.

But estate and gift tax statutes are unlike their cousins in the income tax area. Many rules in the estate and gift tax area rarely make sense other than to allow for gift and estate tax

planning, that reduce the overall burden of these taxes. For example, annual exclusion gifts under Section 2503(b) are allowed free of estate and gift tax. A family with five children, all married, and 10 grandchildren, could effectively give away over \$5,000,000 in assets otherwise subject to estate tax. These assets can be transferred to trusts and held until the grandparents pass away, and effectively turn a testamentary transfer of in excess of \$5,000,000 from a transfer subject to estate tax to one free of estate tax.

Less obvious, but equally telling, are the qualified personal residence trust (“QPRT”) allowances under Section 2702, the GRAT allowance under Section 2702, the lifetime use of the unified credit versus testamentary use of the same amount of credit, and the inter vivos payment of gift tax versus estate tax. These strategies are all tax motivated, and transactions under these sections are, when all is said and done, implemented only for tax reasons. Such statutorily sanctioned devices for savings of transfer taxes therefore should, by their very nature, withstand a sham analysis (assuming, as we do here, that the form of the transaction actually was utilized by the parties).

Applying a broad reach of the substance over form principle to a GRAT would not be in keeping with the implicit Congressional intent underlying the transfer tax provisions of the Code.

**ii. Business Purpose.** In its broadest read, and as applied by cases in the income tax area, the business purpose doctrine postulates that transactions must be driven by business rather than tax motivations or courts will deny the tax benefits sought. For example, if a transaction lacks a profit potential (aside from its tax effects), courts may disallow what the provision of the Code itself would otherwise allow. *Goldstein v. Commissioner*, 364 F.2d 734,740 (2<sup>nd</sup> Circuit 1966) Cert. Denied by 385 U.S. 1005, (1967). Typically, the subjective intent of the taxpayer in entering into the transaction is examined. See *ASA Investering v. Commissioner*, T.C. memo 1998-305 aff’d by 201 F.3d 505 (2000) cert. denied 531 U.S. 871 (2000).

The seminal case in this area, *Gregory v. Helvering*, 293 U.S. 465 (1935) and the one that forms the foundation for its application in subsequent cases, concerned a statute that required a business purpose. Section 112(i)(1)(B) of the Revenue Act of 1928. Specifically, in that case, the taxpayer, in an attempt to avoid a taxable event, transferred shares of a stock to a new corporation, then liquidated the corporation, transferred the stock to herself and asserted she had not recognized any taxable gain. Her transaction satisfied each element of the statute, because her actions constituted a transfer of assets between corporations under common control. The statute at issue exempted the gain realized from a corporate reorganization “if there is distributed, in pursuance of a plan of reorganization, to a shareholder, . . . , stock . . . in such corporation.” Section 112(g) of the Revenue Act of 1928. But the Court considered “whether what was done, apart from the tax motive, was the thing which the statute intended.” The Court concluded that the taxpayer’s actions were not ‘pursuant to a plan of reorganization’ as the statute required because business purpose was an explicit prerequisite of the statute.

A further example of the extension of the business purpose doctrine is given by a series of recent income tax cases. *ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Circuit

1998), *cert. denied*, 526 U.S. 1017 (1999); *Winn-Dixie Stores v Commissioner*, 113 T.C. 254 (1999), *aff'd*, 254 F.3d 1313(11th Circuit 2001); *Compaq Computer Corp. v Commissioner*, 113 T.C. 214 (1999), *rev'd* 277 F.3d 778, (5th Cir. 2001); *ASA Investering v Commissioner*, T.C. Memo 1998-305, *aff'd*, F.3d 505 , (D.C.Cir. 2000) *rehearing and rehearing en banc denied* (Apr 24, 2000) *cert. denied* 531 U.S. 871 (2000) . A review of those cases reveal that if the transaction has a practical economic effect other than the creation of tax losses, courts will likely rule in the taxpayer's favor. But if a transaction is strictly tax driven, courts (in the income tax arena) will rule in the Service's favor. *See, e.g., Winn Dixie Stores, infra, Compaq Computer, infra, and UPS, infra.* Thus, courts will look at the motivation of the taxpayer to determine whether there was some business purpose in the transaction, notwithstanding the tax benefits:

“A ‘business purpose’ does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a ‘business purpose’... as long as it figures in a bona fide, profit-seeking business (citation omitted). This concept of ‘business purpose’ is a necessary corollary to the venerable axiom that tax-planning is permissible (citation omitted)”

In sharp contrast of the above, in an array of recent transfer tax cases, the Tax Court has rejected the implied business purpose arguments advanced by the Service. For example, in *Strangi I*, the court denied the Service's economic substance argument because ‘the i's were dotted and the t's were crossed’. As the Court stated, “the partnership, as a legal matter, changed the relationships between decedent and his heirs and decedent and potential and actual creditors. Regardless of subjective intentions, the partnership had sufficient substance to be recognized for tax purposes. Its existence would not be disregarded by potential purchasers of decedent's assets, and we do not disregard it in this case.” *Estate of Strangi v. Commissioner*, 115 T.C. 408 (2002).

Further, in *Strangi I* the Tax Court refused to impose a business purpose requirement while the court all but acknowledged the taxpayer had no purpose other than to reduce transfer taxes. *See also Knight v. Commissioner*, 115 T.C. 506 (2000): “[W]e believe the form of the transaction here (the creation of the partnership) would be taken into account by a willing buyer; thus the substance and form of the transaction are not at odds for gift tax valuation purposes.” Courts have systematically rejected the Service's opposition to these kinds of arrangements. For example, courts have declared that the management of a portfolio and its orderly transfer to the next generation is a sufficient business purpose. *Estate of Church v Commissioner*, 2000 WL 206374 (W.D. Tex) *aff'd* 268 F.3d 1063 (5th Cir. 2001); *Estate of Harper v Commissioner*, 79 T.C.M. 2232 (2000). The Court was unwilling to use any of the sham transaction doctrines to invalidate the validity of the partnership for estate and gift tax purposes.

Indeed, it is easy to see why the business purpose/economic substance doctrine has found little if any foothold in the transfer tax arena. Gifts and bequests are not, and should not be expected to be, motivated by business or profit-making considerations. Rather, such transfers are driven by the desire to transfer wealth to the natural objects of one's bounty. As Judge Foley stated in his concurring opinion in *Knight*, 115 T.C. 506 at 522;

“Generally, the economic substance doctrine, with its emphasis on business purpose is not a good fit in a tax regime dealing with typically donative transfers.”

To date, then, the business purpose argument by the Service has not been successful in the transfer tax area and it is more likely than not, that such an approach will not prevail in the present case.

### iii. Step Transaction Doctrine.

Courts will sometimes view all the steps of a transaction as a whole. In essence, if taxpayer takes steps A → B → C to lead eventually to result D, and if the step transaction doctrine is deemed to apply, the court then recharacterizes the taxpayers' actions as going from step A directly to result D and disregarding the intermediate steps. *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938). Its application to the current Transaction, in which a series of option agreements are entered into so that the end result is to transfer the option premiums to the GRAT, would fit within a transaction that the IRS would attempt to collapse under the step transaction doctrine. This will be the most difficult theory to avoid, and will allow the Transaction to be subject to its most difficult test. The question, then, is whether the Service would be successful.

There are three different tests that have been applied to determine if the steps of a transaction should be ignored. Although the courts may discuss these tests as alternatives in determining if a step transaction is to be found, often a court will focus on just one of these tests in its determination. *Penrod v. Commissioner*, 88 T.C. 1415 (1987).

One test, the “binding commitment” test, collapses the steps if, “at the time the first step is entered into, there was a binding commitment to undertake the later step. *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968).

A more liberal standard, the “interdependence test,” asks whether the steps are so interdependent that “the legal relations created by one transaction would have been fruitless without a completion of the series.” *Redding v. Commissioner*, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert denied* 450 U.S. 913 (1981). The interdependence test focuses upon each step in a series of events, and asks whether those steps were interdependent of the other steps or whether they have independent significance.

The most liberal standard is the “end result” test. This test ignores intermediate steps if it appears that a series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result. *King Enterprises v. United States*, 418 F.2d at 516. The end result test skips to the end of the entire series of Transaction, and evaluates whether this is what the parties were trying to achieve, without regard to the steps interposed between the beginning and end. Subjective intent is relevant because it allows the court to determine whether the taxpayer directed a series of transactions for an intended purpose. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a specific end result. *True v. U.S.*, 84 AFTR2d Par. 99-524 (1999).

Conceivably, the Service might rely on step transaction principles to disregard the grantor's sale to the GRAT and re-characterize it as a direct gift to the remainder beneficiary using the end result test.

Important to the present discussion is the opinion in the pivotal family partnership case, *Kerr v. Comm'r*, 113 T.C. No. 30 (1999) *aff'd* by 292 F.3d 490 (5th Cir. 2002). In *Kerr*, a family limited partnership was established followed closely by the gifting of discounted partnership interests to a GRAT. The valuation of the gift to the GRAT was, not surprisingly, reduced by the discounting that occurred of the partnership interests gifted to the GRAT. *Kerr* was certainly a case in which the "end result" version of the step transaction could have been applied to collapse the three steps into one: Step A → formation of partnership. Step B → transfer of assets to partnership. Step C → transfer of limited partnership interests to a GRAT. The intent of the taxpayers: to use the partnership discount to reduce the value of the transfer to the GRAT transfer. Therefore, using the "end result" step test, the court arguably might have collapsed all steps into step C, transfer to the GRAT, and ignored the partnership steps.

However, the Tax Court in that case did not even comment on ignoring the partnership formalities using the step transaction doctrine. This presents evidence of either benevolent ignorance, or reasonable sidestepping of a very aggressive interpretation of the step transaction doctrine that would invalidate many estate and gift tax strategies.

The extension of the step transaction to the transfer tax area is the exact approach U.S. Tax Court Judge Renato Beghe urged in his dissenting opinion in *Strangi*:

"[T]he facts of this case invite us to use the end-result version of the step-transaction doctrine to treat the underlying partnership assets – the property originally held by the descendant – as the property to be valued for estate tax purposes." *Strangi, supra*.

Notably, the step transaction analysis dissent in *Strangi* was joined only by Judge Robert Ruwe; and was implicitly rejected by the majority of the Tax Court. It is likely that the step transaction doctrine would not apply to invalidate a strategy Congressionally sanctioned in the estate and gift tax area.

## **X. DRAFTING OF THE GRAT**

GRAT planning will revolve around structuring the assets going into the GRAT, the retained interest period and amount, the valuation of those assets, and the investments during the term. The actual drafting of the GRAT will not be perceived as a value-added to the client. Nevertheless, because of the complex requirements under the regulations to Code Sec. 2702, the actual drafting must be done with care and precision. The attachment is a form GRAT that meets with all of the statutory requirements.<sup>29</sup>

## **XI. USING THE GRANTOR TRUST FOR GIFTING: THE GRANTOR TRUST EXPLAINED**

### **A. From a Policy Perspective**

The term "grantor trust" describes a trust which has one or more characteristics described in Internal Revenue Code ("Code") Sections 673 through 678. A grantor trust is not a separate taxable entity.<sup>1</sup> All items of income, deduction, and credit against tax are reported on the individual return of the grantor or, in limited situations, on the return of the individual possessing a grantor-type power over the trust described in Code Section 678.

The grantor trust was initially established as a weapon of the courts (via common law dominion and control arguments) and the Internal Revenue Service against perceived income tax abuses. The rules essentially will apply and treat the grantor as the owner of a trust for income tax purposes if the grantor has sufficient dominion and control over the trust such that the grantor should, from a policy perspective, be treated as the owner. With the compression and decrease of income tax rates, especially at the trust level, the need of the grantor trust concept as a weapon to fight income tax abuse has been greatly eroded. However, the statutory dictates remain in the Internal Revenue Code. Perhaps they must remain to address the income tax abuse area should (when?) Congress change(s) the income tax laws.

Interestingly, the grantor trust concept allows for the creative use of estate tax strategies that incorporate the concept into the planning. As a premise, the grantor trust presents one consistent planning opportunity: it can shift the income tax burden away from the trust to the "grantor" of the trust.

### **B. Who is the Grantor**

The term "grantor trust" is somewhat of a misnomer. The issue is not who is the creator or "grantor" of a trust, but rather who contributes property to the trust or who has a withdrawal right over trust property. In the tax sense, the "grantor" is the contributor of funds (without adequate consideration) to the trust.<sup>2</sup>

The use of grantor trusts in estate planning ranges from the straightforward to the necessary to the complicated. The outline divides the topics into these categories.<sup>3</sup>

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<sup>1</sup> I.R.C. §671.

<sup>2</sup> Prop. Treas. Reg. 1.671-2(e) (grantor includes any person to the extent such person makes a gratuitous transfer of property to a trust).

<sup>3</sup> There is a distinction between a grantor trust as to income and one as to principal. If a trust is a grantor trust as to income only, then only ordinary income (for example, interest and dividends) are taxable to the grantor. If the trust is a grantor trust as to principal, capital gains are taxable to the grantor as well. Unless otherwise distinguished, references in this article to "grantor trusts" refer to full grantor trusts, ones that tax both ordinary income and capital gains (or must tax those items in this fashion, such as with S corporation stock) to the grantor.

## **XII. THE STRAIGHTFORWARD**

### **A. Living Trusts**

Grantor trust planning is used by the majority of estate planners, but perhaps without any forethought, in one common type of planning, the Living Trust. The Living Trust is a revocable trust established by the grantor and available for the grantor's benefit during the grantor's lifetime. It is a strategy intended to avoid probate, provide a mechanism to manage assets in the event of disability, prevent ancillary administration, and ensure privacy.

It is a grantor trust under many sections of the Code, including sections 676, 674, 677 and 673. (Qualification under one section is sufficient.)

As a grantor trust, all taxable income is taxed to the grantor. There is no estate tax advantage because the trust is included in the grantor's estate under Code sections 2036 and 2038. In actuality, the Living Trust really has no tax advantages achieved by its creation, at least during the lifetime of the grantor. Importantly, there is no reason for the trust not to be a grantor trust. Planners accordingly pay minimal attention to the grantor trust results of these trusts. One important administrative result occurs. Because it is a grantor trust, typically with the grantor as the trustee, a separate taxpayer identification number need not be applied for; the grantor's social security number suffices.

### **B. Reversionary Interests**

If the grantor retains the right to receive the property after a certain period of time, the grantor trust rules may apply. For example, the old Clifford trust rules, in which the grantor would transfer property to a trust for a period slightly in excess of 10 years, during which the time the property would be taxed at the trust's rates, and after which time the property would pass back to the grantor, have been in effect repealed. Section 673 now requires that the value of the reversion, that is, the grantor's right to receive the property back, must be less than five percent of the initial fair market value of the property contributed. This is dependent on the length of the trust and the applicable discount rates to be used in valuing the grantor's retained interest (*See* Code '7520), and could, for example, require a trust whose term is 32 years or more.

### **C. Insurance Trusts**

Irrevocable insurance trusts in which trust income may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse may be grantor trusts. Although this is the literal rule (Code '677(a)(3)), the IRS has not, to the author's knowledge, ever applied the rule. Therefore, though life insurance trusts should be carefully drafted to address this area (but not necessarily to avoid it), the Service's lack of attention should be noted.

D. **Grantor Trusts and Annual Exclusion Gifting (*Crummey Powers*)**

Another common use of grantor trusts is in annual exclusion gifting involving the *crummey* power. This is a trust that allows the beneficiary to withdraw all or part of each contribution to the trust, when such contributions are made, to qualify for the \$12,000 per donee annual exclusion from gift tax.

In those cases, the withdrawal power invokes section 678, a grantor trust provision. That section provides, in essence, that if a person can distribute property to himself or herself, the trust is a grantor trust as to that portion. In a *crummey* trust, the powerholder has the right to receive property from the trust, usually limited by the annual exclusion. The right to withdraw trust funds should be a grantor trust as to a portion of the trust. Once the withdrawal right becomes exercisable, items of income, deduction, and credit attributable to the amount of principal subject to withdrawal are taxable directly to the beneficiary. Also, as to a lapse of the withdrawal right, the Service takes the reported position that those tax items attributable to the amount not withdrawn continue to be taxed directly to the beneficiary.<sup>4</sup> In effect, the beneficiary becomes the grantor of the unwithdrawn portion.

If a trust provides that only part of the trust contribution (not the entire contribution) may be withdrawn, a portion of the trust's tax items may be allocable to the creator or to the trust and another portion to the withdrawal right holder. This would occur, for example, when the withdrawal right is limited to the "5 or 5" amount under Code Section 2514 and the contribution to the trust exceeds the "5 or 5" amount.

If there is a *crummey* power and another grantor trust provision under sections 671 through 677, applying to the original grantor of the trust, the 671 through 677 provisions control.<sup>5</sup>

The above seems complicated and one may wonder why this discussion is in the straightforward section. The answer is that the issue of grantor trust status in *crummey* trusts can best be characterized by the phrase "benevolent disregard," both by practitioners and by the Service (for the record, not by all practitioners). Tax preparers perhaps do not want to burden their clients with the costs of complicated accountings and adjustments to do the allocation of *crummey* trusts as between trusts taxed under traditional subchapter J and grantor trusts. The Service is not all that concerned in that burdening the trust with the tax usually results in more tax collected: the 39.6 % rate was reached for trusts in 1998 at \$8,350 of ordinary income.

E. **A 2503(c) or Minor's Trust.**

In these trusts, the beneficiary has a right to withdraw the entire trust principal upon reaching age 21. The beneficiary will be treated as the owner of the trust commencing when the withdrawal right becomes exercisable, i.e., when the beneficiary reaches age

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<sup>4</sup> See, e.g., PLR 88-05033.

<sup>5</sup> I.R.C. § 678(b).

21.<sup>6</sup> If the beneficiary allows the withdrawal right to lapse so that the trust principal will continue to be held in trust for that beneficiary, the beneficiary should also be treated as the owner of the entire trust for income tax purposes under Code Section 678(a)(2).

### **XIII. USING GRANTOR TRUSTS OUT OF NECESSITY**

Grantor trusts are often used in the S corporation context to qualify trusts as shareholders. Only certain types of trusts are permissible S corporation shareholders.<sup>7</sup> One permissible type is a trust that is a grantor trust.

When a gifting trust or other type of trust will hold S corporation stock, qualifying as a grantor trust allows it to be a permissible shareholder. Living trusts are grantor trusts and therefore automatically qualify as S corporation shareholders.

Other trusts need to have grantor trust specific provisions, such as the power to borrow without adequate security, or the power to substitute assets of equivalent value.

When structuring a trust as a grantor trust to be a permitted shareholder of an S corporation, the entire trust, not merely a portion, must be deemed to be owned by one individual who is a citizen or resident of the United States. A withdrawal power limited to the "5 or 5" amount described in Code Section 2514(e) will not cause the entire trust to be treated as owned by the beneficiary if the value of the stock contributed to the trust exceeds the "5 or 5" amount. Likewise, a grantor-type power granted with respect to only a portion of the trust will not be sufficient to cause the entire trust to be treated as a grantor trust. Therefore, S corporation status would then be jeopardized.

In the S corporation context, the deemed grantor of the trust will be taxable on the trust's pro rata share of S corporation income. This is true whether that income is distributed by the corporation to the trust or from the trust to the beneficiary. Therefore, the potential for unrealized income to the deemed grantor must be recognized. When the beneficiary is the deemed grantor, this problem may be mitigated by including in the trust express language that directs the trustee to distribute to the beneficiary an amount necessary to cover the beneficiary's increased income tax liability resulting from the trust's pro rata share of S corporation income.<sup>8</sup>

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<sup>6</sup> I.R.C. §678(a)(1).

<sup>7</sup> Two types not discussed in this outline are qualified subchapter S trusts and electing small business trusts. *See* I.R.C. §§ 1361(d) and 1361(e).

<sup>8</sup> In the GRAT or sale to grantor trust strategy, there is an excellent interplay between this result and income tax basis planning. If the cash flow needed to sustain the GRAT or sale strategy is less than the S corporation earnings, the Corporation should not distribute out all earnings. Undistributed earnings will increase the basis in the hands of the beneficiaries of the GRAT or grantor trust (a good result), and cause the income tax associated with this increase to be paid by the grantor (a good result).

#### **XIV. GRANTOR TRUSTS AS PLANNING STRATEGIES FOR ESTATE TAX REDUCTION**

The most interesting use of grantor trusts in today's environment is as a positive means of estate tax reduction. In many situations it is advantageous to draft a trust so that the trust has one or more of the characteristics that create a grantor trust. A trust designed in this fashion is often referred to as a "defective grantor trust." The proper nomenclature, however, should be an "effective grantor trust."

The threshold issue is whether the client is savvy, or perhaps another word is comfortable, enough to use the concept. The use of grantor trusts in estate tax reduction strategies is premised on the comfort level of the client.

Specifically, the grantor must be okay with the concept that he or she will pay income tax on assets that may, or may not, be available for use by the grantor. Planners should pay attention to this concern -- even if it is flawed on a cash flow basis -- because it is perceived as important to most grantors.

For example, a grantor who has a \$30,000,000 taxable estate still may not feel that he or she is able to bear the "burden" of income taxes on income not received by the grantor. This bizarre conclusion is nevertheless real to the client, and planners need to plan for this reaction. A discussion of cash flow, perhaps accompanied by spreadsheet analysis as to cash flow (to demonstrate the real impact of the burden of paying the income taxes without the accompanying cash flow), may be enough to convince otherwise reluctant clients that the grantor trust is a viable estate tax reduction strategy.

##### **A. Unified Credit, Applicable Credit Amount, Gifting Trust**

In a straight gifting situation, in which the grantor gifts property equal to or in excess of the applicable credit amount (\$1,000,000 in 2006), a gift to a grantor trust is preferable to a gift outright. If the gift is of appreciated assets, the donees will realize the capital gain in the future when the assets are sold. However, if the gift is to a grantor trust, in which the grantor retains no interest other than that necessary to make it a grantor trust, then future capital gains can be reallocated from the trust -- the donees -- to the grantor. In addition, ordinary income and other taxable income incurred annually can be allocable to the grantor of the trust. This has the effect of increasing the estate tax free property in the hands of the donees while decreasing the estate includible property in the hands of the donor.

This strategy, straightforward as it may seem, was viewed as so egregious by the Service that it tried to stop it by issuing PLRs 94-44033 and 95-04021. In those rulings, the Service ominously hinted that in a GRAT, the grantor must be reimbursed for any income tax allocable to the grantor (because of the grantor trust status) but attributable to trust corpus (e.g., capital gains).

The reasoning of the rulings was too contrary to the well established grantor trust rules of the Code. After much criticism of its approach, the Service within twelve months

repealed the rulings and in effect indicated that the payment of income taxes by the grantor of a grantor trust would not be treated as a taxable gift.<sup>9</sup>

## **B. Grantor Trust Status of a Qualified Personal Residence Trust**

### **1. The Creation of the Qualified Personal Residence Trust**

The qualified personal residence retained interest trust (often referred to as "a QPRT"<sup>10</sup>) is a retained interest trust funded with a personal residence. It has substantial grantor trust implications, all generating from the reason for its creation and implementation.

Because a QPRT is irrevocable and the grantor retains no right to alter the terms of the trust, the transfer of funds to the trust is a completed gift.<sup>11</sup> The value of this gift for gift tax purposes is the value of the property transferred less the value of the grantor's retained interests.<sup>12</sup> The grantor's retained interests are the right to receive the use of the property for a certain number of years, or for a period ending on the first to occur of the grantor's death or the expiration of the term of years. The grantor may also retain a reversion in or general power of appointment over the property if the grantor dies prior to the expiration of that certain number of years. The greater the value for gift tax purposes of these retained interests, the lower the value of the taxable gift.

If the grantor survives the term of years during which she has the retained interests, the remaining property in the trust passes to the beneficiaries, free of additional gift or estate tax. The only estate or gift tax cost associated with the transfer is the gift tax imposed at the time the trust was established.<sup>13</sup> If the grantor dies prior to the expiration of his or her retained property interest, then all of the then value of the trust is included in the grantor's gross estate pursuant to section 2036(a)(1) if the retained property interest was an income or use interest.<sup>14</sup>

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<sup>9</sup> 95-43049 (The Service actually withdrew the ominous paragraph in PLR 94-44033.)

<sup>10</sup> Treas. Reg. §25.2702-5(b). If the trust holds both a personal residence and cash, or the document allows for the sale of the personal residence during the retained interest term or conversion of the trust to a grantor retained annuity trust, this is formally referred to as a "qualified personal residence trust," Treas. Reg. §25.2702-5(c).

<sup>11</sup> Treas. Reg. §25.2511-2.

<sup>12</sup> For gift tax purposes, a gift is technically incomplete as to the value of that portion of the interest transferred which is retained by the grantor. Id.; See also Treas. Reg. §§ 25.2511-1(e), 25.2511-1(h)(7).

<sup>13</sup> Technically the gift is of the remainder interest, which is a future interest. Therefore, the gift does not qualify for the gift tax annual exclusion. I.R.C. §2503(b).

<sup>14</sup> I.R.C. §2036(a)(1). Section 2036(a)(1) includes in the value of a decedent's gross estate the value of all property which the decedent has transferred for less than full and adequate consideration under which the decedent has retained the enjoyment of or income from the property. Inclusion in the gross estate may also be mandated by section 2037(a). Generally, section 2037(a)(2) includes in the value of a decedent's gross estate the value of all property which the decedent has transferred for less than full and adequate consideration, under which the decedent retained a reversionary interest in the property which exceeded 5 percent of the value of the property immediately before the decedent's death. There is no three year rule pursuant to section 2035 of the Code when the grantor's

## 2. Valuation Rules Under Section 2702

Importantly, the valuation rules set forth in Section 2702 do not apply to certain transfers of interests in a personal residence.<sup>15</sup> A QPRT could be created and valued under pre-Section 2702 law if funded solely with a personal residence.<sup>16</sup> The grantor could retain both the right to use of the trust property for a fixed term and the right to receive the trust property (or direct where the trust property goes) if the grantor died during that term. In that situation, these retained interests would be valued pursuant to treasury regulation section 25.2512-5 and section 7520 of the Code.

This exception to section 2702 is narrow in scope; it applies only to personal residences. A personal residence must be either a principal residence of the term holder, as defined in old section 1034 of the Code, any other residence of the term holder, as intended by section 280A(d)(1) of the Code (but without regard to section 280A(d)(2)), or an undivided fractional interest in either of the above.<sup>17</sup>

Additions of cash to the trust are allowed, and the trust is permitted to hold cash but not in excess of the amount required for expenses already incurred or reasonably expected to be incurred within any six month period, for improvements to the residence to be paid for in six months and, generally, for purchase of a personal residence within three months.<sup>18</sup> As a result, a personal residence subject to a mortgage can be contributed to a GRIT.<sup>19</sup> (Difficult planning occurs with regard to mortgaged property. One strategy is to provide that the Grantor remains liable on the mortgage and that the value of the contributed property is net of the mortgage.)

An individual may not be the holder of a term interest in more than two personal residence trusts nor may a personal residence trust include household furnishings or other personal property.<sup>20</sup> A personal residence must be used exclusively as the term holder's

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income or reversionary interest expires. This is because there is no "transfer" at that time; it is merely treated as a "lapse."

<sup>15</sup> I.R.C. §2701(a)(3)(A)(ii); Treas. Reg. § 25.2702-5(a).

<sup>16</sup> Additions of cash are permitted under certain circumstances, such as for "improvements to the residence to be paid by the trust within six months." Treas. Reg. §25.2702-5(c)(5)(ii)(A).

<sup>17</sup> Treas. Reg. §§ 25.2702-5(b)(2), 25.2702-5(c)(2). See also PLR 9151046 (form of ownership of the residence in a cooperative housing corporation does not preclude qualification as a personal residence).

<sup>18</sup> Treas. Reg. §25.2702-5(c)(5)(ii)(A). If additions of cash are made to purchase the initial or a replacement residence, the trustee must have entered into a contract to purchase the residence prior to the addition. Id. An addition of cash would be treated as an additional taxable gift.

<sup>19</sup> See Treas. Reg. § 25.2702-5(c)(2)(ii). See also PLR 9340009. A personal residence encumbered prior to transfer does not maximize transfer tax gain. The objective is to transfer as much net value as possible to the GRIT. Accordingly, debts and liens associated with the property should be paid prior to transfer. If mortgage payments are made on behalf of or by the trust, that amount of the payment which reduces principal logically should be treated as an additional gift to the trust. See COVEY, "Recent Developments Concerning Estate, Gift and Income Taxation," 26 UNIV. MIAMI INST. EST. PLANN & 129.4(F).

<sup>20</sup> Treas. Reg. § 25.2702-5(c)(2)(ii).

residence "when occupied by the term holder."<sup>21</sup> However, the residence may be rented provided the requirements of Section 280A (d)(1) are satisfied.<sup>22</sup> Further, a personal residence may include appurtenant structures used for residential purposes and adjacent land "not in excess of that which is reasonably appropriate for residential purposes."<sup>23</sup>

The drafting of a QPRT must be done with care. Provisions that must be included in the governing instrument of a QPRT depend on whether the trust (1) is intended to hold only a personal residence with no sales possibility during the retained interest term or (2) will be permitted to sell the residence or otherwise hold cash.<sup>24</sup> For example, the governing instrument should either prohibit sale during the retained use term<sup>25</sup> or if sale is permitted, should provide that if the personal residence is sold, then either (i) the proceeds be held in a separate account and used within two years from the date of sale (or prior to the expiration of the retained interest term, if earlier) to purchase another residence to be used by the term holder as a personal residence, or (ii) the proceeds not used to purchase another residence within two years of the date of sale or expiration of the retained interest term either be distributed to the term holder or (if the retained interest term has not expired) be converted into an annuity interest.<sup>26</sup> Analogously, the trust should either prohibit use for a purpose other than as a personal residence of the term holder (during the retained interest term) or, if such use is permitted, should provide that within thirty days after the personal residence is not used or held for use as such by

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<sup>21</sup> Treas. Reg. §§ 25.2702-5(b)(2)(iii), 25.2702-5(c)(2)(iii).

<sup>22</sup> Id. See also Treas. Reg. § 25.2702-5(d) (Example 2). The regulations allow a portion of the residence to be used for Section 280A(c)(1) or (4) activities if such use is secondary to use as a residence. Use of a residence as a "bed and breakfast" is prohibited. Id.

<sup>23</sup> Treas. Reg. §25.2702-5(b)(2)(ii). In recent private letter rulings, this requirement has been clarified. For example, in PLR 9328040, the Service ruled that a vacation home that had on its property a "small ranch style structure" was permissible, primarily because no rent or other consideration was to be paid by the users of the ranch. See also PLR49014 (two penthouse apartments and the hall space between them constitute one qualified residence), and PLR 9343034 (distinct parcels of land can constitute "adjacent land").

<sup>24</sup> Generally, the regulations distinguish between governing instrument requirements for a basic personal residence trust, Treas. Reg. §25.2702-5(b), and a more sophisticated one designed to hold cash or allow for the sale of the personal residence or conversion to a qualified annuity interest during the retained interest term. Treas. Reg. §25.2702-5(c).

<sup>25</sup> See Treas. Reg. §25.2702-5(b).

<sup>26</sup> Treas. Reg. §§ 25.2702-5(c)(7-8). See also PLR 9151046. Similar provisions need to be included to permit the trust to hold insurance proceeds received as a result of damage to or destruction of the residence. Treas. Reg. §25.2702-5(c)(7)(B). If conversion to a qualified annuity interest is permitted, then the trust must also contain all provisions relating to a grantor retained annuity trust and required by Treas. Reg. Section 25.2702-3, must provide that right to receive annuity amount begins on date of sale (or damage or destruction rendering the residence incapable of use) or when the residence ceases to be used or held for use as a personal residence, and must require that the annuity amount equal or exceed that amount determined by the formula in the regulations. Treas. Reg. §25.2702-5(c)(8).

the term holder,<sup>27</sup> the assets be distributed outright to the term holder or be converted to a retained annuity interest.<sup>28</sup>

Further, if the trust is intended to hold cash as permitted by the regulations, the instrument must prohibit distributions of corpus to any beneficiary other than the term holder during the period of the term interest, must require that income be distributed to the term holder at least annually, and should prohibit commutation of the term holder's interest.<sup>29</sup> It must require that the cash held by the trust in excess of permissible amounts be distributed at least quarterly to the term holder and, upon termination of the term holder's interest in the trust, any cash held for the payment of expenses be distributed outright to the term holder.<sup>30</sup> The instrument must provide that the trust estate consist of only one personal residence used or held for use by the grantor (except for cash and sale and insurance proceeds if the above-discussed provisions are included).<sup>31</sup> The grantor must be prohibited from repurchasing the residence.

### 3. Grantor Trust Implications

During the retained interest term, the trust is automatically a grantor trust. This is important should the residence be sold and there is a capital gain. In that event, the exclusion under section 121 would apply to eliminate the first \$250,000 (or \$500,000 if the grantor is married) of the gain because of the grantor trust status.

After the retained term, the grantor of the trust will often desire to retain use of the trust. This is almost an automatic assumption in the case of personal residences transferred to a QPRT. In that event, the grantor must pay fair market value rent, to avoid adverse estate tax consequences with residing there.<sup>58</sup>

The payment of rent will be another means to transfer property to the beneficiaries without additional gift tax concerns. Ordinarily, however, the payment of rent results in taxable income to the lessor, the children.

If the trust is structured as a grantor trust after the retained term expires, the payment of rent will be between the grantor and the grantor trust. Under the reasoning of revenue

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<sup>27</sup> See Treas. Reg. §§ 25.2702-5(d) (Example 5), for an explanation of the phrase "held for use" and an example in the context of the grantor having to move into a nursing home during the retained interest term.

<sup>28</sup> Treas. Reg. §25.2702-5(c)(7-8).

<sup>29</sup> Treas. Reg. §§ 25.2702-5(c)(3), 25.2702-5(c)(4), 25.2702-5(c)(6). For a generic personal residence trust structured under Treas. Reg. § 25.2702-5(b), which is not permitted to hold cash, the regulations are silent on commutation. Adhering to the statutory objective would preclude its availability.

<sup>30</sup> Treas. Reg. §§ 25.2702-5(c)(5)(ii)(A)(2). Accrued expenses can be paid out of cash.

<sup>31</sup> Treas. Reg. §§ 25.2702-5(b)(1), 25.2702-5(c)(5)(i).

<sup>58</sup> See, e.g., PLRS 98-29002 and 98-27037. See also Rev. Rul. 70-155 and *Estate of McNichol*, 265 F.2d 667 (1959).

ruling 85-13,<sup>59</sup> this is a non recognition event for income tax purposes. As a result, the grantor will pay rent -- a tax free transfer to the remainderpeople of the QPRT -- without having that rent treated as taxable income.

### C. Post Mortem Use of Grantor Trusts in the Credit Shelter Trust Context

The grantor trust strategy should be considered in credit shelter trusts. This provides tremendous and important planning opportunities. The concept behind the credit shelter trust is to allow the \$1,000,000 amount (reduced by any lifetime use) to pass free of estate tax at both the passing of the first spouse and the subsequent passing of the surviving spouse. The \$650,000 amount will pass to the credit shelter trust free of estate tax at the first spouse's death because of the unified credit. Upon the death of the surviving spouse the credit shelter trust will pass free of estate tax because it is not part of the surviving spouse's estate. In fact, as long as the credit shelter trust remains in existence, it will not be subject to estate taxes.

If the spouse is a beneficiary of the credit shelter trust this does not preclude the spouse from acting as trustee. However, if the spouse acts as trustee, the standard of principal distributions needs to be limited to an ascertainable one relating to health, support, maintenance or education. Further, the spouse should be given no express general power of appointment, nor should the spouse have the possibility of using the funds to discharge a legal obligation of support or other creditor obligation.

Ideally, the goal of a credit shelter trust after the first spouse has passed away and the trust has been created is to accumulate wealth in the trust that will be passed on free of estate tax at the surviving spouse's passing. To the extent the trust generates income, and the income taxes are paid out of non trust assets -- e.g., by the surviving spouse out of his or her assets -- this increases the estate tax free amount in the credit shelter trust, at the cost of decreasing the estate taxable amount held by the surviving spouse. This is an excellent result from an estate tax reduction perspective.

The strategy involves the surviving spouse acting as trustee of this type of trust. If the surviving spouse is the trustee and a beneficiary, the question is whether the literal language of Code section 678 is met:

AA person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."

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<sup>59</sup> The importance of revenue ruling 85-13 is to the grantor trust strategy in much the same way as section 2056 is to the marital deduction. It is the pivotal authority underpinning the planning strategies. The ruling, in essence, reflects the Service's view that transactions between a grantor, individually, and that person's grantor trust, are to be ignored. Revenue Ruling 85-13 did not accept *Rothstein v. United States*, 735 F.2d 704 (1984), which had held to the contrary.

Treasury regulation section 1.678(b) provides that "[s]ection 678 treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations" (emphasis added).

The issue arises in the typical language in the credit shelter trust providing the surviving spouse, as trustee, with the right to distribute income or principal to the surviving spouse if needed for that spouse's "health, support, or maintenance." The power to pay pursuant to this standard would encompass that spouse's creditors, and fall within the language of the above cited regulation. Further, the right to distribute income or principal to oneself is perhaps the power to vest the corpus or income in that person.

The argument to the contrary is that the power is not exercisable unless the standard of distribution is met, e.g., the spouse is in need of the funds pursuant to that standard. In that event, although the trust would be a grantor trust, it would also arguably be included in the gross estate under section 2041.<sup>60</sup>

The case law is not enlightening on this area. The result in light of this uncertainty is to develop the position most favorable to the surviving spouse based on facts at that time, but to take a consistent position in each case. Going back and forth between grantor and non grantor trust status as to a credit shelter trust on returns post-mortem is likely to give rise to an audit and an undefensible position.

D. **Grantor Retained Annuity Trust and Unitrusts: Illustration with a Closely-Held Business**

A grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT) are grantor trusts masquerading as pure transfer tax strategies. As an example, the owner will put a portion or all of the business (such as the stock) into an irrevocable trust and retain the right to a fixed annuity for a period of years. Often this period of years will be short-term, such as five, with the idea that the stock put in the trust will increase substantially in value and that this increase will pass to the benefit of the remainder beneficiaries of the GRAT. After the fixed years, any property remaining in the GRAT passes to the remainder beneficiaries. There is initially a gift equal to the discounted present value of the remainder interest.

With a closely held business, even in the S corporation context, the value of the interest contributed to the GRAT, initially, can arguably be discounted to take into account marketability and minority restrictions. Further, the discount rate used in valuing the grantor's retained right to the annuity, as well as the remainder beneficiary's interest, is the section 7520 rate. This rate is 6.4% for April, 1999. The lower the rate, the lower the

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<sup>60</sup> Although the surviving spouse can act as trustee of a credit shelter trust with an ascertainable standard relating to health, support or maintenance (or related standard), without running afoul of the section 2041 power of appointment rules, there is one important caveat. If the standard of distribution is met, and the trust is drafted in a way that would mandate the distribution of funds if the standard is met, arguably the funds are de facto distributable to the spouse and included in that spouse's gross estate under either sections 2041 or 2033. Not to worry, the Service has not yet made this argument.

amount of the annuity that must be retained in order to reduce the remainder beneficiary's value and therefore the value of the gift.

Consider a S corporation valued at \$3,000,00. If fifty percent is contributed to a three year GRAT, its normative value is \$1,500,000. At a discount of 33%, the contributed value is \$1,000,000. If a \$388,485 annuity is retained, and the business grows at a 20% value, before income tax, the following chart indicates the value transferred with a minimal taxable gift of \$20,323. (Ignoring Example 5 of the regulations and revenue ruling 77-454 would result in a gift equal to zero.)

| Year | Annuity   | Amount Remaining |
|------|-----------|------------------|
| 1    | \$388,485 | \$1,411,515      |
| 2    | \$388,485 | \$1,305,333      |
| 3    | \$388,485 | \$1,177,915      |

The grantor determines what the retained annuity amount should be. The greater the annuity, the lower the remainder beneficiary's value, and therefore the lower the gift. The goal of the retained annuity is to absorb as much of the value of the stock contributed to the GRAT as possible. Accordingly, the remainder beneficiary's interest should be close to zero, subject to applicable revenue rulings and regulations.

To the extent the value of the business grows in excess of the value of the retained annuity amount that increased value inures to the benefit of the remainder beneficiaries of the trust.

E. **Sale to a Grantor Trust**

1. **Versus a GRAT**

The sale to a grantor trust has become an increasingly popular substitute for the GRAT. If it works (more on this later), it has in most circumstances features that are more attractive than a GRAT:

- a. estate tax inclusion if the grantor dies before the note is paid off less than the estate tax inclusion if the grantor dies before the retained annuity term,
- b. an interest rate that is lower than the section 7520 rate,

- c. superior generation skipping planning because unlike a GRAT there is no estate tax inclusion period (GRATs should not be used for generation skipping planning),
- d. the possibility of creative structuring as to the annual repayment amounts, and
- e. the possibility of no gift tax and no required gift tax reporting.

## 2. How is It Set Up?

The sale is structured by the owner of the asset, such as the business interest. He or she initially establishes a trust that is effective as a "grantor trust" for income tax purposes, but which is not controlled by the business owner or otherwise subject to an estate tax taint.

The fabric of the transaction is a sale between the grantor and a third party. *Be.g.*, the Grantor's Family Irrevocable Trust. This trust will benefit the grantor's beneficiaries. The adult children are often designated as the original trustees of the trust.

The trust will be structured as "grantor trust" for income tax purposes. This means that there will be no recognition of gain on the sale of the asset to the trust. Thus, the difference between the grantor's basis in the asset, and the sales price to the trust, will not currently be taxed as a capital gain.

More importantly from a transfer tax gain perspective, the grantor will pay income taxes on the dividends received by the trust because of the assets the trust owns. In this regard, it is as if for income tax purposes the grantor still owns the assets sold to the trust. Importantly, the payment by the grantor of those taxes will not, under current law, constitute a gift to the trust.

After the grantor trust is established, it should be funded with a certain amount of cash. The cash is often contributed to the trust, via a taxable gift, by the grantor.

Thereafter, the business interest is sold to the grantor trust; and the owner takes back cash as a down payment and a promissory note for the difference. Depending on the length of the promissory note, it will carry interest at the prescribed federal rate for short, mid-term or long term loans. I.R.C. 1274. Interest at substantially greater than AFR causes, interestingly enough, section 2036(a)(1) concerns.<sup>166</sup>

After the loan is paid off, the business interest is owned by the trust, at essentially a carryover basis, and the interest is no longer in the grantor's gross estate. If the grantor dies prior to the full repayment of the loan, arguably only the unpaid portion of the loan that remains at the grantor's passing is included in the grantor's estate.

Alternatively, if the grantor has sufficient cash, the grantor can loan those funds to the trust. And the trust can then pay for the business interest with cash.

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<sup>166</sup> See PLR 92-51004.

### 3. Conversion from Grantor Trust to Non-Grantor Trust

Because the trust is a grantor trust, transactions between the grantor and the trust are not recognized for income tax purposes. Accordingly, the grantor's sale of appreciated property to the grantor trust does not change the income tax basis of the property.

The income tax consequences at death if the note has not been repaid, or if the trust shifts to non-grantor trust status, are concerns. If something were to happen to Grantor during the term of the Note, the then *unpaid portion* of the principal amount of the Note would be included in the Grantor's estate for estate tax purposes. This is not a surprising result.

The income tax side is more uncertain. One position is that gain is recognized any time a trust shifts from grantor trust status to non grantor status. For example, when the grantor passes away, a grantor trust automatically becomes a non grantor trust. Under that argument, the capital gain would be recognized equal to the difference between the current basis of the stock and either the original sales price or the then fair market value. There is also the possibility that no gain need then be reported.

According to at least one commentator, Dick Covey, the change of the grantor owned status of the trust results in a realization of gain by the grantor, citing *Madorin v. Comm'r*, 84 T.C. 667 (1985). It is still far from certain. However, *Madorin* was based on Treas. Reg. 1.1001-2(c) (Example 5). That is a discharge-of-liabilities provision, not a grantor trust regulation. Further, *Madorin* involves a negative basis partnership issue. It is not a garden variety grantor trust type issue. Its application to recognition of income in most grantor trust planning is debatable.

### 4. The Service's Arsenal Explored More Fully: Capitalization and Section 2036(a)(1)

Possibly the most concerning argument by the Service would be under section 2036(a)(1) of the Code. The Service would argue that the sale was no more than a property transfer with a retained interest. If that argument is successful, the entire sold asset would be included in the estate under 2036(a)(1) at date of death values.

One has to close one's eyes to conceptualize the argument. The property transferred is the equity interest in the sold asset. The retention is the payments made to the trust because of the asset, such as dividends; thereafter transferred to the grantor because of the trust's obligation to repay the note. And, importantly, the full and adequate consideration exception to section 2036(a)(1) does not apply because the debt does not constitute consideration. All in all, the 2036(a)(1) argument is a bit difficult to even formulate, let alone accept.

But the reason that it causes practitioners problems is because it is enough of a theory for a court to use -- assuming the court does not like the smell of the transaction. In this regard, it bears resemblance to the step transaction doctrine, sort of coming out of nowhere to invalidate a transaction that looks too good. An editorial comment: the sale is not a transaction that looks too good to be true. First, it is no more than truly a sale. So that is not abusive. Second, even if it might have some resemblance to a 2036(a)(1)

transaction, one still has to believe that 2036(a)(1) transactions are transfer tax abusive. They are not.<sup>168</sup>

As can be expected, the Service may get more tough in its published rulings. Rulings which, by the way, are not law and do not have the force of law, but which often scare practitioners (this one included).

Letter ruling 94-36006 evidences facts similar to the sale to a grantor trust. In that ruling, the stock was sold to a trust in exchange for a 25 year note. The 25 year note carried with it interest at the AFR. Other assets were also included in the trust. No 2036 argument or discussion was made by the Service.<sup>169</sup>

Conversely, letter ruling 92-51004 held that 2036 was applicable to a sale/note transaction. The Service reasoned that because the annual repayments on the note soaked up a large amount of the income flowing into the trust, that the sale was no more than a retention of the right to the income from the assets in the trust.

Importantly, substantial assets can be placed into the trust in addition to the asset sold, but often additional assets cannot just make their way to the trust. They must be gifted, which causes its own concerns.<sup>170</sup>

## **XV. DRAFTING A GRANTOR TRUST**

The practitioner should carefully consider which power to give to the grantor or other individual in order to make the trust a grantor trust. This consideration is particularly important to avoid adverse estate tax treatment of the trust.

For example a parent may wish to give \$12,000 worth of S corporation stock to a 2503(c) trust for her son, and may further wish to pay all of the income taxes generated by the gifted assets until his son reaches age 21. In short, the parent wants to create an effective grantor trust. The parent also desires to transfer the stock free of gift tax through use of the Code Section 2503(b) gift tax exclusion, avoid having the trust subject to federal estate tax at the parent's death, and ensure that the gift will not jeopardize the subchapter S status of the corporation. The parent's retention of the right to revoke the entire trust would accomplish the parent's goal of causing the trust to be a grantor trust

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<sup>168</sup> There is an excellent discussion of the 2036(a)(1) issue by Fred Nicholson, in an article in the February 22, 1996 Tax Management Memorandum. In that article, three cases are cited for the proposition that when there is no required relationship between the property transferred and the payment on the note, Code Section 2036 should not as a result be applicable. Importantly, two of the three cases are not technically Section 2036 cases. Stern v. Comm'r., 747 F.2d 555 (9th Cir. 1984); La Fargue v. Comm'r., 689 F.2d 845 (9th Cir. 1982); Estate of Becklenberg v. Comm'r., 273 F.2d 297 (7th Cir. 1960); Estate of Fabric, 83 TC 934 (1984).

<sup>169</sup> See also PLR 95-35026 (no gain or loss on sale of stock to grantor trusts in exchange for notes).

<sup>170</sup> As Nicholson said in his article, "The point here ... is only to suggest that there is an element of uncertainty in this strategy that may be difficult to quantify." Essentially, the concern boils down to, can the client withstand the uncertainty in the transaction? If the note has been repaid before death, and the decedent's equity interest in the asset disappears, then arguably the risk of an audit -- and therefore a challenge to the transaction -- have been greatly diminished.

(under Code Section 676) but also would cause the trust to be includible in the parent's estate for federal estate tax purposes under Code Sections 2036 and 2038.

Conversely, if the trust included a provision that allowed a third party, nonadverse trustee to use trust income to pay premiums on policies of life insurance on the grantor or allowed the grantor to substitute trust property, the trust technically would be a grantor trust under Code Section 677 or Section 675 (neither of which cause inclusion of the trust assets in the grantor's estate), thereby allowing the trust to be a permitted S corporation shareholder with all income taxes paid by the parent, and yet not be includible in the taxable estate of parent.<sup>171</sup>

The issue is what power to use to make it a grantor trust. No one power is better than another. Either the trust has a power that causes it to be a grantor trust, or it does not have that power. Having more than one grantor trust power does not make it more of a grantor trust. However, as planners, we tend to over-intellectualize all planning areas and this is one that has been so tortured.

The provision most favored as a grantor trust provision, until recently, was the section 675 (4)(c) power: "a power to reacquire the trust corpus by substituting other property of an equivalent value." There are rulings that support the conclusion that this power, alone, is sufficient to create a grantor trust.<sup>172</sup>

Recently, there has been propounded the argument that this power may create a retained interest subject to estate tax inclusion under Code sections 2036(a)(1) or 2038. Specifically, because the power is retained in a non fiduciary capacity, it looks like a retained power to alter or designate the beneficial interests under those sections.

However, that argument looks tenuous at best. The more it is propounded as a reasonable argument, the more likely the Service is to use it (ala the revenue ruling 79-353 disaster). Accordingly, it should not be given serious discussion.

If it becomes a concern, that section allows for the power to be exercisable "in a nonfiduciary capacity by any person without the approval of any person in a fiduciary capacity." Arguably, the power can be vested in one other than the grantor to put the property back in the grantor by having other property held by the grantor substituted into the trust.

That power cannot be used be in a qualified personal residence trust (QPRT). In a QPRT, the regulations provide that the residence cannot be reacquired by the grantor.<sup>173</sup> A different grantor trust power must be used.

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<sup>171</sup> See Pvt.Ltr.Ruls. 8852003, 8823112, and 8926019.

<sup>172</sup> See PLRs 93-52017, 92-39015.

<sup>173</sup> Treas. Reg. §25.2702-5(c)(a) (However, a distribution upon expiration of the retained term to another grantor trust pursuant to the provisions of the instrument is permissible.)

One possibility is to use the power to borrow the corpus without adequate security (and make sure that the trustee does not have the power to lend the property without adequate security).<sup>174</sup>

Another grantor trust power that is currently used by practitioners is the power in the trustee (who is a non adverse party)<sup>175</sup> to add charitable beneficiaries. Under section 674(b)(5), the ability to expand the class of beneficiaries is a grantor trust power.

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<sup>174</sup> I.R.C. §675 (4).

<sup>175</sup> Code §672(a) defines "adverse party" as:

any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

A "nonadverse party" is simply defined as a "person who is not an adverse party." Code 672(b). In those situations in which the grantor has retained a fiduciary or administrative power over the trust property, an adverse party, such as a beneficiary of the trust, typically will not share the power with the grantor. However, the practitioner should understand the planning possibilities with this rule; most importantly, at the outset when planning to qualify the trust for grantor or nongrantor status.

## Attachment 1

### [CLIENT] GRANTOR RETAINED ANNUITY TRUST

I, [CLIENT], have transferred the assets listed in the attached schedule to \_\_\_\_\_ as trustee. Those assets shall be held in trust subject to the provisions of this instrument.

#### Article 1 Introduction

1.1 *Family*. My "spouse" is \_\_\_\_\_. I have \_\_\_\_\_ children now living, namely \_\_\_\_\_.

1.2 *Name of Trust*. The name of this trust shall be the [CLIENT] GRANTOR RETAINED ANNUITY TRUST.

#### Article 2 Trusts Irrevocable

This instrument and the trusts established hereunder are irrevocable.

#### Article 3 Annuity Trust

The initial trust shall be the Annuity Trust and shall be administered as follows:

3.1 *Annuity Payments*. On each anniversary of the date of the receipt of property, the trustee shall pay to me or, if I am not then living, to my estate an amount equal to \_\_\_\_\_ percent of the fair market value of the trust property ("the annuity amount") determined as of the date of the receipt of property. No payment shall be made to any person other than me (or my estate).

3.2 *Termination*. This trust shall terminate on the \_\_\_\_\_ anniversary of the date of the receipt of property.

3.3 *Distribution on Termination*. On termination the trustee, after paying a final annuity payment for the period ending on the date of termination, shall allocate the remaining Annuity Trust in shares of equal value to my children who are then living and to the estates of my children who are not then living. No distribution shall be made to any descendant other than a child of mine.

**Article 4**  
**Distribution to Beneficiaries Under Prescribed Age**

Any property to be distributed to a beneficiary under age \_\_\_\_\_ at the time of distribution shall immediately vest in the beneficiary, but the trustee shall retain the property as a separate trust for the beneficiary on the following terms. The trustee may pay to the beneficiary as much of the income and principal as the trustee deems advisable for the beneficiary's health, maintenance in reasonable comfort, education, or best interests. Any income not so paid in each tax year shall be added to principal at the end of each tax year. The trustee shall distribute the remaining trust assets to the beneficiary when the beneficiary attains age \_\_\_\_\_ or to the beneficiary's estate if the beneficiary dies prior to receiving the assets. If at the time the trust is created or during the administration of the trust the beneficiary is under age 21, the trustee may terminate the trust and distribute the property to a custodian for the beneficiary under a Uniform Transfers or Gifts to Minors Act.

**Article 5**  
**Contingent Gift Provision**

On the death of the last to die of all beneficiaries of any trust (the "termination date"), any of the trust not otherwise distributable shall be distributed to my heirs. Heirs and their respective shares shall be determined under the laws of descent and distribution of Illinois on my death for property located in Illinois as if I had died on the termination date unmarried and domiciled in Illinois.

**Article 6**  
**Trustee Succession**

6.1 **Resignation.** A trustee may resign at any time by signed notice to the co-trustees, if any, and to me or, if I am not then living, to the income beneficiaries.

6.2 **Individual Trustee Succession.** Each acting individual trustee (unless limited in the instrument in which the trustee was designated) may, by signed instrument filed with the trust records, (a) designate one or more individuals (other than me) or qualified corporations to act with or to succeed the trustee consecutively or concurrently, in any stated combination and on any stated contingency, and (b) amend or revoke the designation before the designated trustee begins to act.

6.3 **Default of Designation.** If at any time no trustee is acting and no designated trustee is able and willing to act, then the first of the following who is able and willing to act shall be trustee:

- (a) \_\_\_\_\_;
- (b) \_\_\_\_\_;
- (c) \_\_\_\_\_;

(d) Any individual or qualified corporation appointed in an instrument signed by me or, if I am not then living, by a majority of the income beneficiaries.

6.4 **Corporate Trustee Substitution.** A corporate trustee may be removed at any time by an instrument signed by a majority of the income beneficiaries but only if, on or before the effective date of removal, a qualified corporation has been appointed corporate trustee in the same manner.

## **Article 7 Trustee Actions**

7.1 **Control.** Except as otherwise provided, whenever more than one trustee is acting, the “trustee” means all trustees collectively, and a majority of the trustees qualified to participate in an action or decision of the trustees shall control. Any trustee who is not qualified to participate in or dissents from such action or decision shall not be liable therefore.

7.2 **Accountings.** Upon written request, the trustee shall send a written account of all trust receipts, disbursements, and transactions and the property comprising the trust to each income beneficiary and, at the option of the trustee, to the future beneficiaries of the trust. A future beneficiary of a trust is a person to whom the assets of the trust would be distributed or distributable if the trust then terminated. Unless court proceedings on the account are commenced within three months after the account is sent, the account shall bind and be deemed approved by all of the following beneficiaries who have not filed written objections to the account with the trustee within three months after the account is sent, and the trustee shall be deemed released by all such beneficiaries from liability for all matters covered by the account as though such account was approved by a court of competent jurisdiction: (a) each beneficiary to whom the account was sent and (b) if the account was sent to all income and future beneficiaries of the trust, then all beneficiaries of the trust who have any past, present, or future interest in the matters covered by the account.

7.3 **Trustee’s Right to Account Settlement Before Distribution.** Before distribution of any trust principal, the trustee shall have the right to require settlement of any open accounts of the trust from which the distribution is being made, either by the written approval and release of all beneficiaries having an interest in the distribution or, if the releases cannot be obtained, by court settlement of the open accounts. All the trustee’s reasonable fees and expenses (including attorneys’ fees) attributable to approval of the trustee’s accounts shall be paid by the trust involved.

7.4 **Acceptance of Predecessor’s Accounts.** On the signed direction of the income beneficiaries, the trustee shall accept without examination the accounts rendered and property delivered by or for a predecessor trustee or my executor. Such acceptance shall fully discharge the predecessor trustee or my executor and shall bind all beneficiaries.

7.5 **Notice.** If a beneficiary is under legal disability, the trustee shall give any notice or accounting to the beneficiary’s personal representative, if any, and if none, to a parent of the beneficiary, if any, and if none, to any person who the trustee believes has demonstrated concern for the interest of the beneficiary. That person may sign any instrument for the beneficiary.

7.6 **Special Trustees.** If the trustee (the “principal trustee”) is unable or unwilling to act as trustee as to any property, such person or qualified corporation as the principal trustee shall designate by signed instrument shall act as special trustee as to that property. Any special trustee may resign at any time by giving written notice to the principal trustee. The special trustee shall have the powers granted to the principal trustee under this instrument, to be exercised with the approval of the principal trustee. Net income and any proceeds of sale shall be paid to the principal trustee, to be administered under this instrument. The principal trustee may remove and replace the special trustee at any time.

7.7 **Delegation to Co-Trustee.** Any individual trustee may delegate any or all of that trustee’s powers and duties to a co-trustee, except that no trustee shall be permitted to delegate any discretion with respect to the distribution of income or principal to a beneficiary. Any delegation may be for a definite or indefinite period and may be revoked by the delegating trustee. Any delegation or revocation shall be in writing, signed by the delegating trustee, and delivered to the co-trustee to whom the delegation is made. Any person or institution may rely on the written certification of a co-trustee that the co-trustee has the power to act without concurrence of any other trustee, provided, however, that the co-trustee shall attach to the written certification a copy of the instrument by which the powers and duties have been delegated.

7.8 **Compensation.** The trustee shall be entitled to reimbursement for expenses and to reasonable compensation.

7.9 **Determinations by Trustee.** The trustee’s reasonable determination of any question of fact shall bind all persons.

7.10 **Third-Party Dealings.** The trustee’s certification that the trustee is acting according to this instrument shall protect anyone dealing with the trustee. No one need see to the application of money paid or property delivered to the trustee.

7.11 **Exoneration of Trustee.** Any individual trustee acting in good faith shall not be liable for any act or omission. No trustee shall be liable for any act or omission of another trustee.

7.12 **Bond.** No trustee need give bond to, qualify before, or account to any court.

7.13 **Powers of Successor Trustee.** Unless expressly limited, each successor trustee shall have all the titles, powers, duties, discretions, and immunities of the original trustee.

## **Article 8 Trustee Powers**

In addition to all powers granted by law, the trustee shall have the following powers, to be exercised in a fiduciary capacity:

8.1 **Retention.** To retain any property transferred to the trustee, regardless of diversification and regardless of whether the property would be considered a proper trust investment;

8.2 ***Sale.*** To sell at public or private sale, contract to sell, grant options to buy, convey, transfer, exchange, or partition any real or personal property of the trust for such price and on such terms as the trustee sees fit;

8.3 ***Real and Tangible Personal Property.*** To make leases and subleases and grant options to lease, although the terms thereof commence in the future or extend beyond the termination of any trust; to purchase, operate, maintain, improve, rehabilitate, alter, demolish, abandon, release, or dedicate any real or tangible personal property; and to develop or subdivide real property, grant easements, and take any other action with respect to real or tangible personal property that an individual owner thereof could take;

8.4 ***Borrowing.*** To borrow money from any lender, extend or renew any existing indebtedness, and mortgage or pledge any property in the trust;

8.5 ***Investing.*** To invest in bonds, common or preferred stocks, notes, options, common trust funds, mutual funds, shares of any investment company or trust, or other securities, life insurance, partnership interests, general or limited, limited liability company interests, joint ventures, real estate, or other property of any kind, regardless of diversification and regardless of whether the property would be considered a proper trust investment;

8.6 ***Joint Investments; Distribution; Determination of Value.*** To make joint investments for two or more trusts held by the same trustee; to distribute property in cash or in kind, or partly in each; and to allocate or distribute undivided interests, different property, or disproportionate interests to the beneficiaries, and to determine the value of any property so allocated or distributed; but no adjustment shall be made to compensate for a disproportionate allocation of unrealized gain for federal income tax purposes, and no action taken by the trustee pursuant to this paragraph shall be subject to question by any beneficiary;

8.7 ***Rights as to Securities.*** To have all the rights, powers, and privileges of an owner of the securities held in trust, including, but not limited to, the powers to vote, give proxies, and pay assessments and to participate in voting trusts, pooling agreements, foreclosures, reorganizations, consolidations, mergers, and liquidations and, incident to such participation, to exercise or sell stock subscription or conversion rights;

8.8 ***Conservation of Assets.*** To take any action that an individual owner of an asset could take to conserve or realize the value of the asset and with respect to any foreclosure, reorganization, or other change with respect to the asset;

8.9 ***Delegation.*** To employ agents, attorneys, and proxies of all types (including any firm in which a relative of mine or his or her spouse is a partner, associate, or employee or is otherwise affiliated) and to delegate to them any powers the trustee considers advisable;

8.10 ***Payment of Expenses and Taxes.*** To pay all expenses incurred in the administration of the trust and to pay all taxes imposed on the trust;

8.11 ***Determination of Principal and Income.*** To determine in cases not covered by statute the allocation of receipts and disbursements between income and principal, except that (a) reasonable reserves for depreciation, depletion, and obsolescence may be established out of

income and credited to principal only to the extent that the trustee determines that readily marketable assets in the principal of the trust will be insufficient for any renovation, major repair, improvement, or replacement of trust property that the trustee deems advisable and (b) any premium paid for interest-bearing debt obligations shall be amortized out of income;

8.12 ***Dealings with Fiduciaries.*** To deal with, purchase assets from, or make loans to the fiduciary of any trust made by me or a trust or estate in which any beneficiary under this trust has an interest, even though a trustee under this instrument is the fiduciary, and to retain any assets or loans so acquired, regardless of diversification and regardless of whether the property would be considered a proper trust investment; to deal with a corporate trustee under this instrument individually or a parent or affiliate company; and to deal with the fiduciary of any other estate, trust, or custodial account even though the fiduciary is a trustee under this instrument;

8.13 ***Compromising Claims.*** To litigate, compromise, settle, or abandon any claim or demand in favor of or against the trust;

8.14 ***Nominee Arrangements.*** To hold any asset in the name of a nominee, in bearer form or otherwise, without disclosure of any fiduciary relationship;

8.15 ***Liability Insurance.*** To purchase liability and casualty insurance of any kind for the protection of the trust estate, including comprehensive liability insurance;

8.16 ***Environmental Matters.*** To inspect and monitor businesses and real property (whether held directly or through a partnership, corporation, trust, or other entity) for environmental conditions or possible violations of environmental laws; to remediate environmentally damaged property or to take steps to prevent environmental damage in the future, even if no action by public or private parties is currently pending or threatened; to abandon or refuse to accept property that may have environmental damage; and to expend trust property to do the foregoing; and no action or failure to act by the trustee pursuant to this paragraph shall be subject to question by any beneficiary;

8.17 ***Ability To Take Other Actions.*** To do all other acts to accomplish the proper management, investment, and distribution of the trust.

## **Article 9 Administrative Provisions**

9.1 ***Income Payments.*** After the last annuity payment to me, mandatory income payments shall be made at least quarterly.

9.2 ***Standard for Discretionary Payments.*** In the exercise of discretion to make a payment to a beneficiary, the trustee may consider all income and resources known to the trustee to be available to the beneficiary and the standard of living of the beneficiary.

9.3 ***No Advancements.*** No payment made to any beneficiary under this instrument shall be treated as an advancement.

**9.4 *Exercise of Power of Appointment.*** A lifetime power of appointment granted under this instrument may be exercised only by written instrument specifically referring to the power of appointment. A testamentary power of appointment granted under this instrument may be exercised only by a will specifically referring to the power. The appointment may be either outright or subject to such trusts and conditions as the holder of the power designates. The holder of the power may grant to any person to whom principal may be appointed further powers of appointment. In determining whether a testamentary power of appointment has been exercised, the trustee may rely on an instrument admitted to probate in any jurisdiction as the will of the holder of the power or may assume the power of appointment was not exercised in the absence of actual notice of the holder's will within three months after the holder's death.

**9.5 *No Rule Against Perpetuities.*** I intend that each trust established under this instrument shall be a Qualified Perpetual Trust under Illinois law and shall not be subject to the Rule Against Perpetuities. The power of the trustee to sell, lease, or mortgage assets shall be construed as enabling the trustee to sell, lease, or mortgage trust property for any period beyond the Rule Against Perpetuities. If assets that would not qualify as a part of a Qualified Perpetual Trust would otherwise be added to any trust established under this instrument, the trustee shall segregate those assets and administer them as a separate trust identical to the one to which the assets would have been added, except that, despite any other provision, 21 years after the death of the last to die of all of the beneficiaries living at my death, each such separate trust then held under this instrument shall be distributed to the income beneficiaries in the proportions in which they are entitled to share the income or, if their interests are indefinite, to the income beneficiaries in equal shares.

**9.6 *Facility of Payment.*** The trustee may make any payments (other than distributions on termination) to a beneficiary under legal disability or whom the trustee determines to be unable to properly manage his or her affairs in any of the following ways: (a) to the legally appointed guardian of the beneficiary, (b) to an adult relative or friend of the beneficiary in reimbursement for proper expenditures on behalf of the beneficiary, (c) to a custodian for the beneficiary under a Uniform Transfers or Gifts to Minors Act, (d) by making direct expenditures for the benefit of the beneficiary, or (e) to the beneficiary directly. The trustee may make distributions of tangible personal property to a beneficiary under legal disability or whom the trustee determines to be unable to properly manage his or her affairs in any of the ways listed in (a), (c), or (e) above.

**9.7 *No Spendthrift.*** Any interest under this instrument shall be assignable.

**9.8 *Consolidation and Division of Trusts.*** At any time after the last annuity payment to me, the trustee may consolidate any trust held under this instrument with any other trust if the beneficiaries of the trusts are the same and the terms of the trusts are substantially similar. Further, the trustee, in the trustee's absolute discretion, may divide a trust (the "initial trust") into two or more separate trusts and may segregate an addition to a trust (the "initial trust") as a separate trust.

(a) ***Funding.*** In dividing the initial trust, if the division is to be effective as of my death or as of the death of any other person, the trustee shall fund each separate trust with property having an aggregate fair market value fairly representative of the appreciation or

depreciation in value from the date of such death to the date of division of all property subject to the division.

(b) **Terms.** A trust created pursuant to this paragraph shall have the same terms and conditions as the initial trust, and any reference to the initial trust in this instrument shall refer to that trust. The rights of beneficiaries shall be determined as if that trust and the initial trust were aggregated, but (1) different tax elections may be made as to the trusts, (2) disproportionate discretionary distributions may be made from the trusts, (3) taxes may be paid disproportionately from the trusts, (4) upon termination the share of a remainder beneficiary (including any recipient trust) may be satisfied with disproportionate distributions from the trusts, and (5) a beneficiary of the trusts may disclaim an interest in one of the trusts without having to disclaim an interest in another trust. In administering, investing, and distributing the assets of the trusts and in making tax elections, the trustee may consider differences in federal tax attributes and all other factors the trustee believes pertinent.

9.9 **Accrued and Unpaid Income.** On the death of any beneficiary, any accrued or unpaid income shall be paid as income to the next beneficiary succeeding in interest.

9.10 **Controlling Law.** The validity and effect of each trust and the construction of this instrument and of each trust shall be determined in accordance with the laws of Illinois. The original situs and original place of administration of each trust shall also be Illinois, but the situs and place of administration of any trust may be transferred at any time to any place the trustee determines to be for the best interests of the trust.

9.11 **Qualification Under Code §2702(b).** I intend to create an annuity trust in which I retain a qualified interest, as defined in Code §2702(b), and this instrument shall be so interpreted. The trustee shall perform all acts necessary to ensure compliance with said Code section and any applicable regulation issued thereunder. No trustee or other person shall have any power that would disqualify this trust under Code §2702 or any applicable regulation issued thereunder. This instrument and the trusts established hereunder are unamendable, except that the trustee shall have the power to amend this trust by signed instrument solely to ensure that the trust qualifies and continues to qualify as an annuity trust within the meaning of Code §2702 and any such amendment shall apply retroactively to the inception of this trust.

9.12 **Annuity Prorations.** If the number of days included in the year of my death, if applicable, is less than 365 days (366 days if the taxable year includes February 29), the annuity amount payable for such year shall be prorated on a daily basis.

9.13 **Payments for Tax Liability.** Notwithstanding any other provision hereunder, and notwithstanding any rights I might have under applicable law, the trustee shall not make any distributions to me (or after my death to the personal representative of my estate or the successor in interest thereto, as the case may be) to discharge any income tax liability (whether federal, state, or otherwise). To the extent any provision of state law requires the trustee to make such distributions or permits me to require the trustee to make such distributions, I expressly waive the benefit of that provision of state law.

9.14 **No Additional Contributions.** No contributions may be made to the trust after the initial contribution to the trust estate.

9.15 **No Commutation.** My interest shall not be subject to commutation.

9.16 **Payment Correction.** If an incorrect payment of the annuity amount is made, the trustee, after the error is discovered, promptly shall pay to the beneficiary (in the case of an underpayment) or collect from the beneficiary (in the case of an overpayment) an amount equal to the difference between the amount the trustee should have paid and the amount the trustee paid.

9.17 **No Debt Obligation.** The trustee may not issue a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity obligation.

9.18 **Source and Timing of Annuity Payments.** The annuity amount shall be paid from income and, to the extent income is not sufficient, from principal. Any excess income shall be added to principal. The annuity amount shall be paid no later than 105 days after each anniversary of the date of receipt of property.

9.19 **Substitution of Assets.** Until the last annuity payment is made to me, I retain the power in a nonfiduciary capacity without the consent of the trustee to reacquire the trust assets by substituting other assets of equal value.

## **Article 10 Definitions**

### **10.1 Child and Descendant.**

(a) **Child.** A “child” of a person means only (1) a child born to the person or to the person’s spouse while they are lawfully married; (2) a natural child of the person born while the parents are not lawfully married if the parents subsequently become lawfully married, but only for purposes of any allocation or distribution made after that marriage; (3) a child lawfully adopted by the person prior to that child’s attaining age 21; or (4) a natural child of that person if that person is a female.

(b) **Descendant.** A child of a person is a “descendant” of that person and of all ancestors of that person. A person’s descendants include all such descendants whenever born. Except when distribution or allocation is directed to descendants *per stirpes*, the word “descendants” includes descendants of every degree whether or not a parent or more remote ancestor of a descendant is also living.

(c) **Child in Gestation.** A child in gestation on the date any allocation or distribution is to be made shall be deemed to be living on the date if the child is subsequently born alive and lives for at least 90 days.

10.2 **Code.** References to sections of the “Code” refer to the Internal Revenue Code of 1986, as amended from time to time, and include corresponding provisions of subsequent federal tax laws.

10.3 **Regulation.** “Applicable regulation” or “regulation” means any regulation issued under Code §2702.

10.4 **Qualified Interest.** “Qualified interest” shall have the same meaning as determined for purposes of Code §2702.

10.5 **Incapacity.** A person shall be considered incapacitated if under a legal disability or unable to give prompt and intelligent consideration to financial affairs. The existence of the inability may be determined by a physician, and any person may rely on written notice of the determination. A person already acting as trustee shall cease to act on incapacity.

10.6 **Income Beneficiary.** An “income beneficiary” means a person to whom or for whose benefit income (including annuity payments) of any trust is or may be currently distributed.

10.7 **Per Stirpes.** Whenever assets are to be allocated for or distributed to the descendants of a person in shares “*per stirpes*,” those assets shall be divided into equal shares, one such share for each then living child of that person and one such share for each deceased child of that person who has a descendant then living. Any such deceased child’s share shall then be allocated for or distributed to that child’s descendants *per stirpes* in accordance with the preceding sentence and this sentence.

10.8 **Qualified Corporation.** A “qualified corporation” means any bank, trust company, or other corporate entity that is authorized to act as a trustee and that is not a related or subordinate party under Code §672(c) as to any beneficiary under this instrument.

10.9 **Spouse.** The “spouse” of any person, other than me, means the individual legally married to, and not legally separated from, that person on the date of the distribution then in question or on the date of the prior death of that person.

## Article 11 Captions and Context of Terms

Captions shall have no impact or meaning as to the terms of this instrument. Singular and plural and masculine, feminine, and neuter shall be interchangeable as required or permitted in the context of this instrument.

Signed and agreed on \_\_\_\_\_, 20\_\_.

\_\_\_\_\_  
[CLIENT]

\_\_\_\_\_  
[TRUSTEE]

STATE OF ILLINOIS        )  
  )  
COUNTY OF \_\_\_\_\_  )        ss.

On \_\_\_\_\_, 20\_\_, [CLIENT] personally appeared before me and acknowledged that this instrument was executed as that person's free act and deed.

\_\_\_\_\_  
Notary Public



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## Endnotes

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<sup>1</sup> As a practical matter, discussion with the client of his or her mortality is a difficult, if not impractical, concept. Accordingly, the term of years will often be a number recommended by the planner as a relatively conservative term based on the grantor's age. Realistically, a client is rarely, if ever, really reflective of the determination of "how long will I live, and therefore how long does the retained annuity need to be?"

<sup>2</sup> Though rates are currently much lower, when the statute was enacted, Congress was focused on discount rates at this level. The value of qualified annuity interests is determined by taking into account 120% of the federal mid-term rate in effect for the month of the transfer. Reg. § 25.2702-2(b)(2).

<sup>3</sup> At an interest rate at 10.60%, the value of an annuity interest at a 5% of initial fair market value payout rate in a 5-year GRAT is calculated as follows. First, the value of an annuity interest in \$1 for 5 years at an assumed interest rate of 10.60% equals 3.7334. Second, because the annuity is at 5% of \$1, the value of a 5% annuity on \$1 equals  $3.7334 \times .05$ , or .18667.

<sup>4</sup> Calculated by subtracting \$186,670 from \$1,000,000

<sup>5</sup> The before tax rate of return of the GRAT, which includes the sum of all income generated plus realized and unrealized capital appreciation, is hereinafter referred to as the GRAT's "rate of return" in this article.

<sup>6</sup> Calculated by multiplying \$1,000,000 by  $(1 + .106)^5$

<sup>7</sup> Calculated by subtracting from the appreciated value, \$1,654,914, the respective values of the transferred and retained interests, \$813,330 and \$186,670.

<sup>8</sup> Calculated by subtracting from the appreciated value of the property, \$1,684,914, the value of the retained interest, \$186,670. With pre-chapter 14 GRITS, this would have been possible by the trustee investing in high growth, low yield assets.

<sup>9</sup> Calculated by subtracting from the full appreciated value, \$1,468,244, the value of the property remaining at the end of the GRAT term, \$1,345,992.

<sup>10</sup> Calculated by taking the difference between the total payments received, \$250,000, and the initial fair market value of the retained interest, \$186,670.

<sup>11</sup> Calculated by subtracting \$63,330 from \$122,252.

<sup>12</sup> For example, the \$50,000 paid at the end of the first year increases at a 10.80 percent rate for the next four years, the \$50,000 paid at the end of the second year increases at a 10.80 percent rate for the next three years, and so on. Stated algebraically, this results in the following:

$$[50,000(1 + .106)^4 + 50,000(1 + .106)^3 + 50,000(1 + .106)^2 + 50,000(1 + .106)^1] \text{ less } 200,000 = 58,992$$

<sup>13</sup> Calculated by multiplying \$186,670 by  $(1 + .106)^5$ , which equals \$308,922 (*i.e.*, \$250,000 + \$58,922).

<sup>14</sup> The discounted present value of the right to receive \$1,345,992 five years in the future, under an assumed investment return rate of 10.60 percent, equals \$813,330, which is .813330 of the interest transferred. (The formula is  $1/(1 + x)^t$ , where  $x$  equals the interest rate and  $t$  equals the term for years.) This amount is the same amount as the taxable gift made in year one.

<sup>15</sup> *Id.*

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16 Calculated by multiplying the value of the gifted interest, \$813,330, by  $(1 + .12)^5$ .

17 Calculated by multiplying the value of the retained interest, \$186,670, by  $(1 + .12)^5$ .

18 This is calculated as follows. First, \$186,670 multiplied by  $(1 + .106)^5$  equals \$308,922. Adding thereto the difference between earning 12% versus 10.6% on the received annuity amounts, \$8,720, equals \$317,642. This is \$11,334 less than what it should have been under an assumed 12% rate (\$328,976). This \$11,334 difference passes to the benefit of the remainder transferred interest.

19 Technically the retained interest has increased at a rate equal to 12% less \$11,334.

20 Technically the remainder interest has increased at a rate equal to 12% plus \$11,334.

21 "Increases" refers to the before tax increase in the value of the property in a GRAT, which includes the sum of interest, dividends, realized appreciation, and unrealized appreciation.

22 Mathematically,  $0 * \text{any rate of return}$  is still 0. And the GRAT can never be a negative number; that is, there can be no lingering obligation by the grantor to pay money over that the GRAT does not have.

23 Conversely, if the GRAT experiences a rate of return of greater than 5%, there is transfer tax gain. Assume the annual return on the GRAT, before tax, is 6%. At the end of three years, approximately \$21,000 remains to pass to the remainder beneficiaries, and no taxable gift has been made.

24 Iterations to the strategy, such as the grantor selling for a self-canceling installment note, would allow for the strategy to be effective even in the grantor did not live a long period of time after the transfer.

25 In addition to current appraisals, personal guarantees by the beneficiaries (assuming sufficient net worth) should be considered. If guarantees are made, commentators have suggested that compensation should be paid to the beneficiaries to avoid potential gift and adverse generation-skip issues. However, this seems questionable in that the grantor trust status of the matter could be adversely impacted. If feasible, a current standby letter of credit should be obtained from a commercial third-party lender.

26 The Preamble to the Treasury Regulations was consistent on this point. "The proposed regulations prohibited increases to prevent transferors from "zeroing out" a gift while still effectively transferring the appreciation on all the property during the term to the remainder beneficiary (e.g., by providing for a balloon payment in the final year of the term). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of section 2702." Preamble to T.D. 8395, 1992-1 C.B. 316, 319

27 That the interest retained by the Grantor is expressed as a fixed percentage or fixed amount, and not subject to contingencies other than as to time of retention and time of payment, then the amount retained will be a qualified interest regardless of the volatility of the asset or the potential for transfer tax savings. This is true regardless of what the GRAT invests in and regardless of the remoteness of the GRAT paying out the annuity amount because of the riskiness of the GRAT's investments.

28 A direct transfer of \$4.5 million to the trust, with no retained rights, would have triggered gift taxes of \$1,635,000 (assuming no prior taxable gifts and 2004 rates). Also, there is still a slight concern that the IRS could assert a *Procter*, 142 F.2d 824 (1944) analysis and assert that there must be some taxable gift consequences sufficient to allow the IRS to review a GRAT valuation on audit. Certain practitioners have advocated created a very small taxable gift, such as \$1,000, that could be capable of being increased slightly, but inconsequentially, on audit. *See, e.g.*, McCaffrey, Plaine and Schneider, "The Aftermath of Walton: the Rehabilitation of the Fixed-Term, Zeroed-Out GRAT, 95 J. Tax'n 325 (2001). It is not intuitively obvious that the practitioner need go this far, yet.

*See attachment 1.*