

# **Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts**

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## 1. Introduction

A grantor retained annuity trust (GRAT) or an installment sale to a grantor trust can be useful in transmitting wealth in a tax-efficient way, and often one of these techniques is superior to other estate planning options. These are in effect estate freeze techniques that capitalize on the mismatch between interest rates used to value transfers and the actual anticipated performance of the transferred asset. Sales to grantor trusts and many GRATs also capitalize on the lack of symmetry between the income tax rules governing grantor trusts and the estate tax rules governing includability in the gross estate. Like most techniques, GRATs and sales to grantor trusts can be used conservatively, aggressively, or even recklessly, and some of the tax consequences are unclear. Moreover, like most techniques, their availability and usefulness must be evaluated on a case-by-case basis, with a view to the circumstances, and especially the arithmetic, in each case. The following is a summary of basic, conservative – that is, not overly “aggressive” or “cutting-edge” – principles and applications relating to GRATs and installment sales to grantor trusts.

## 2. Basic Concepts

### a. The Concept of Estate Freezing

(1) A gift is a freeze.

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

(2) A sale is a freeze.

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

### b. The Concept of Leveraging, or Freezing off a Discount

- (1) If what is given – or sold – has a value that is legitimately discounted, then the freeze shelters from future gift and estate tax not only the future appreciation in the intrinsic or ultimate value to the donee or buyer, but also (without regard to such future appreciation) the “appreciation” represented by the discount – that is, the difference between that intrinsic value and fair market value, the standard for estate and gift tax purposes. See Eastland, “Optimize Contribution to Grantor Retained Annuity Trust,” 39 ESTATE PLANNING 3 (April 2012).

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- (2) See Reg. §§20.2031-1(b) & 25.2512-1. Reg. §§20.2031-1(b) & 25.2512-1; *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Propstra v. United States*, 680 F.2d 1248, 1252 (9th Cir. 1982); *Estate of Andrews v. Commissioner*, 79 T.C. 938, 952-53 (1982); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999), *acq.*, AOD 99-006, 1999-35 I.R.B. 314; Rev. Rul. 93-12, 1993-1 C.B. 202.
  - (3) In the case of a GRAT, an additional “discount,” in effect, is provided by the way the present value of the remainder interest, which is the measure of the taxable gift, is calculated. In the case of an installment sale, a similar economic effect is produced by the way the note is valued.

c. **The Use of a Grantor Trust**

- (1) For this purpose, a grantor trust is a trust as to all of which the grantor is treated as the owner under section 671.
- (2) Obvious advantages of using a grantor trust.
  - (a) No taxpayer identification number or income tax returns are needed for the trust.
  - (b) No capital gain is realized on a sale. Rev. Rul. 85-13, 1985-1 C.B. 184.
  - (c) Since there is no tax, there is no concern about the additional interest on deferred tax liability under section 453A.
  - (d) No income is realized when the trust pays interest on an installment obligation to the grantor.
  - (e) No gain is realized if property is transferred to the grantor in kind in payment of any part of the annuity obligation in the case of a GRAT or the installment obligation in the case of a sale.
  - (f) The trust may be a shareholder of an S corporation, under section 1361(c)(2)(A)(i).
  - (g) The grantor, not the trust or the beneficiaries, will pay all the income taxes on income attributable to the trust.
  - (h) If a residence is held by a grantor trust, the grantor-beneficiary will be treated as the owner of the residence and the exclusion rules of section 121 will apply. See Reg. §1.121-1(c)(3)(i).

### 3. Use of Grantor Retained Annuity Trusts (GRATs)

a. **Circumstances in Which a GRAT Might Be Helpful**

- (1) To make a transfer of property expected to appreciate faster than the requirement to make the annuity payment required by a GRAT – *i.e.*, generally at a higher rate than the section 7520 discount rate.
- (2) To hedge against the possibility that even property expected to appreciate significantly might not do so or might even decline in value, by “wasting” on such a transfer only a nominal amount of the grantor’s unified credit.
- (3) To make a transfer of property expected to appreciate at a time when the transferor is cash-poor and desires to reduce the gift tax burden by any means available.
- (4) To reduce the transferor’s holdings in an entity to a minority, to qualify subsequently for a minority discount (if the grantor survives the GRAT term).
- (5) To shelter from gift tax the designation of descendants as remainder beneficiaries in a trust created to provide periodic payments to a former spouse following a divorce. Letter Ruling 9235032.

b. **Limitations of a GRAT**

- (1) Obviously, survival for the necessary period can never be assured. If the grantor dies during the GRAT term, all or part of the value of the GRAT property at that time is included in the grantor’s gross estate under section 2036(a).

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- (a) *Cf.* Rev. Rul. 82-105, 1982-1 C.B. 133 (describing the portion of a charitable remainder annuity trust that is included in the gross estate under section 2036(a) as the amount of principal required to produce the annuity payment in perpetuity at the applicable section 7520 rate).
    - i. The Service once took the position that section 2039, not Rev. Rul. 82-105, was the proper standard for this purpose, which would mean that the entire value of a GRAT would always be included in the gross estate. Letter Ruling 9345035; Technical Advice Memorandum 200210009.
    - ii. This is now addressed less harshly by regulations. See Part 4.h below.
  - (b) For an illustration of the “unwinding” (at least in part) of the gift tax treatment in the case of a “split gift,” see Rev. Rul. 82-198, 1982-2 C.B. 206. Because the relief of section 2001(e) is limited to amounts included in the spouse’s gross estate under section 2035 (not section 2036 or 2039), “gift-splitting” probably should not be used for a GRIT or GRAT, although the downside is minimal in the case of a near-zeroed-out GRAT.
  - (c) It might be possible to cover the estate tax exposure by term life insurance.
- (2) If the grantor does survive the GRAT term, the annuity will stop, and the grantor must have sufficient other assets to absorb this loss of income.
- c. **GRATs as Grantor Trusts**
- (1) Benefits of qualifying as a grantor trust. See Part 2.c(2) above.
- (a) The GRAT will be able to avoid obtaining a taxpayer identification number and filing income tax returns. Reg. §1.671-4.
  - (b) A grantor trust can hold stock of an S corporation (where the mandatory payout could be selected to approximately match the distributions that a profitable S corporation must make anyway to enable its shareholders to pay the income tax on its earnings). See section 1361(c)(2)(A)(i).
  - (c) If the GRAT distributes appreciated property in kind in satisfaction of the annuity obligation, there is no taxable gain. Rev. Rul. 85-13, 1985-1 C.B. 184. For the importance of preserving grantor trust status until all payments to the grantor have been made, see Part 4.g below.
  - (d) If the grantor repurchases the GRAT property before the end of the GRAT term (perhaps just before the end of the term), no gain would be recognized on the sale (Rev. Rul. 85-13, *supra*; see Letter Rulings 9146025 & 9239015).
- (2) Techniques for qualifying a trust as a grantor trust are discussed in Part 7.b below in the context of an installment sale.
- (a) In addition, paying income for the benefit of the grantor, within the meaning of section 677, is available to qualify a GRAT as a grantor trust. See Letter Ruling 9444033 (modified by Letter Ruling 9543049). To ensure this result, there is no reason, **for this purpose**, why a GRAT could not provide for the grantor to receive the annuity amount or the net income of the trust, whichever is greater, except that for gift tax purposes only the value of the annuity standing alone would be taken into account. Reg. §25.2702-3(b)(1)(iii) & (c)(1)(iii). (But for a possible reason not to do this, see Part 4.h(1)(d) below.)
  - (b) If the trust property consists of stock of a publicly traded corporation, before using a power in the grantor to reacquire trust corpus by substituting other property of an equivalent value (section 675(4)(C), see Part 7.b(2) below), care must be taken that this power would not be considered an option, or its exercise an insider trade, subject to securities laws restrictions. (Indeed, such stock should not be transferred **into** the GRAT without careful consideration of applicable securities law.)

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d. **Formula GRATs**

- (1) Reg. §25.2702-3(b)(1)(ii)(B) allows the annuity amount to be “[a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes.”
- (2) If this approach is used, and the gift tax value of the property transferred to the trust is changed as the result of a gift tax audit, the annuity, and therefore the value of the grantor’s retained interest, will change proportionately, ensuring that the taxable gift remains the predetermined fraction of the total value of the transferred property.
- (3) Not only does this contain the damage that might be done by a gift tax audit, but by that very fact it can serve to discourage an audit – or “audit-proof” the transaction – in the first place.
- (4) Because it is expressly allowed by the regulations, the use of such a formula cannot run afoul of the resistance to “adjustment clauses” sometimes identified with *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944). See Part 8.c below.

e. **Graduated GRATs**

- (1) Reg. §25.2702-3(b)(1)(ii) allows the annuity amount (whether expressed as a fixed dollar amount or a fraction of the initial fair market value of the trust property) to be increased by up to 20 percent each year.
- (2) By backloading the return to the grantor to the greatest extent possible, a GRAT with a 20 percent increase in the annuity payment each year will generally outperform any other GRAT.
- (3) Possible exceptions include—
  - (a) a two-year GRAT, for example, in which the appreciation in the second year is less than the section 7520 rate used to value the gift (regardless of the appreciation in the first year) – a typical scenario with a “home run” “liquidity event” in the first year followed by conservative investing thereafter, and
  - (b) a relatively long-term GRAT with an asset tied to a fixed cash flow but still appreciating, such as convertible preferred stock.

f. **Two-Life GRATs (Now Obsolete)**

- (1) Example: A transfers property to an irrevocable trust, retaining the right to a qualified annuity for 10 years. Upon expiration of the 10 years, the qualified annuity is payable to A’s spouse, if living, for another 10 years. Upon expiration of the spouse’s interest, the trust terminates and the trust corpus is payable to A’s children. A retains the right to revoke the spouse’s interest.
- (2) Reg. §25.2702-2(d)(1), Example 7, holds that the amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A’s qualified interest and the value of the qualified interest payable to A’s spouse subject to A’s power to revoke.
- (3) Some practitioners, invoking this example, once used “two-life GRATs,” continuing, in effect, for a term of years or, if earlier, the death of **the second to die** of the grantor and the grantor’s spouse. This technique was welcomed as a means to avoid the harsh and unexpected result of Reg. §25.2702-3(e), Example (5), which held that a retained unitrust payment (or an annuity) for a fixed term was valued under section 2702 as if it lasted only for the lesser of the stated term or the grantor’s life. Letter Rulings 9352017, 9416009, 9449012, and 9449013 appeared to approve of the two-life valuation technique.
- (4) Then the Service reversed itself and ruled that the contingent interest of the grantor’s spouse is analogous to a reversion in the grantor and must be given a value of zero. Technical Advice Memoranda 9707001, 9717008, 9741001 & 9848004. See *also* Letter Rulings 199937043 (modifying Letter Ruling 9352017), 199951031 (modifying Letter Ruling 9449012) & 199951032 (modifying Letter Ruling 9449013).

(5) The Tax Court has agreed with the Service's more recent view. *Cook v. Commissioner*, 115 T.C. 15 (2000); *Estate of Focardi v. Commissioner*, T.C. Memo. 2006-56. The Court of Appeals for the Ninth Circuit has not. *Schott v. Commissioner*, 319 F.3d 1203 (9th Cir. 2003), *rev'g and remanding* T.C. Memo. 2001-110.

(6) Meanwhile, the reconsideration of Example 5 in light of *Walton v. Commissioner*, 115 T.C. 589 (2000) (see Notice 2003-72, 2003-44 I.R.B. 964 (announcing IRS acquiescence in *Walton*); Reg. §25.2702-3(d)(4) & (e), Example (5) (amended February 15, 2005)), has made the two-life GRAT obsolete.

g. **Hedging GRATs**

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

h. **One-Asset GRATs**

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

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

- (3) Thus, as two separate GRATs, these assets produce an ending balance for the remainder beneficiaries of \$232.00. The grantor receives the entire “cool asset” back, but even that is not enough to pay \$9.20 of the \$43.20 annuity payment in the third year, and the GRAT simply disappears.
- (4) As a combined GRAT, these assets produce only \$222.80 for the remainder beneficiaries, but the grantor receives the full annuity payments. Thus, in the case of the combined GRAT, the remainder beneficiaries receive \$9.20 less and the grantor receives \$9.20 more – not the best estate planning result.
- (5) Despite this arithmetic, however, multiple-asset GRATs have sometimes done very well, especially when investments are concentrated (*e.g.*, in one or a few sectors) and actively monitored and managed.



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i. **Prohibition on Making Annuity Payments with a Note**

- (1) Technical Advice Memorandum 9604005 denied qualification under section 2702 to GRATs which depended on such borrowing, even while admitting that “[t]he express terms of the GRATs do satisfy the requirements of §2702 and the regulations thereunder.” It must be acknowledged that the facts of TAM 9604005 were especially bad for the taxpayer. For example, no interest was paid on the notes. As the TAM pointed out, this had no income tax effect (because the GRATs were grantor trusts), but it affected the economics of the arrangement, which was relevant for gift tax purposes.
- (2) To the same effect, however, was Technical Advice Memorandum 9717008.
- (3) Finally, amendments to the regulations, proposed on June 22, 1999, and finalized on September 5, 2000 (T.D. 8899), prohibit the use of notes, “directly or indirectly,” to pay a GRAT’s annuity obligation (Reg. §25.2702-3(b)(1)(i)) and require the governing instrument to prohibit such use of notes in any GRAT created on or after September 20, 1999 (Reg. §25.2702-3(d)(6)).
  - (a) Borrowing from others to make the annuity payments is not addressed in the regulations, and the practice is expressly acknowledged in the preamble to the regulations.
    - i. The preamble warns, however, that the step transaction doctrine will be applied where appropriate, such as when the trust borrows money from a bank but the bank agrees to make the loan only if the grantor deposits with the bank an amount equal to the amount of the loan. The preamble explains that this is the reason for the words “directly or indirectly” to the prohibition on the use of notes.
    - ii. Moreover, when borrowing from third parties is outstanding when the GRAT ceases to be a grantor trust, the Service will take the position that the grantor realizes income in the amount of the borrowing. *See* Technical Advice Memorandum 200010010.
  - (b) Borrowing from the grantor for other purposes, such as to enable the trust to make other investments or to pay expenses, is not addressed, and therefore should be viewed as permissible, subject to the “directly or indirectly” step transaction caveat. Usually it should be quite easy to trace the proceeds of the borrowing to a use by the trust other than to make an annuity payment.
  - (c) Payment of the annuity amount with trust assets in kind is not prohibited and is expressly acknowledged as a permissible option in the preamble.
  - (d) For symmetry, the regulations also apply to the use of notes to pay the obligations to the grantor of a grantor retained unitrust (GRUT). Reg. §25.2702-3(c)(1)(i).
  - (e) Effective dates.
    - i. The final regulations maintain the requirement that the use of notes or similar arrangements to meet the trust’s obligations to the grantor be prohibited in the governing instruments of trusts created on or after September 20, 1999. Reg. §25.2702-3(d)(6)(i).
    - ii. Likewise, the final regulations maintain the requirement that notes may not be so used after September 20, 1999, with respect to a pre-September 20, 1999, trust and the requirement that any such notes issued on or before September 20, 1999, must have been paid in full by December 31, 1999. Reg. §25.2702-3(d)(6)(ii).
  - (f) The final regulations also clarify that a GRAT may make its annuity payments to the grantor only on the anniversary date of the GRAT, and that the annuity payments need not be prorated to a calendar year in the case of GRATs that are not created on January 1. Reg. §25.2702-3(b)(1)(i), (3) & (4). This helpful amendment accomplishes what a 1994 amendment of the regulations was apparently intended to accomplish. *See* T.D. 8536 (May 4, 1994).

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- (4) In Letter Ruling 201652002 (Sept. 15, 2016), the IRS respected a retroactive judicial reformation of several GRATs to include the prohibition on the use of notes to pay the annuity obligation, which, by reason of what the trustees had successfully claimed was a “scrivener’s error,” had been omitted from the original trust instrument. The IRS relied on the following statements in the trust instrument:

WHEREAS, the Grantor wishes to establish an irrevocable Grantor Retained Annuity Trust, the retained interest of which is intended to constitute a qualified interest within the meaning of Section 2702(b)(1) of the Internal Revenue Code.

...

The Grantor has been fully advised concerning the legal effects of the execution of this Indenture and has been fully informed regarding the character and amount of the property transferred and conveyed hereby. The Grantor affirms her personal decision that this Trust shall be irrevocable. The Trustees shall have the power to amend the Trust Indenture in any manner that may be required for the purpose of ensuring that the Grantor’s retained interest in the Trust qualifies and continues to qualify as a “qualified interest” within the meaning of Section 2702(b)(1) of the Code.

j. **Paying the “Annuity” in Kind**

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

k. **Reimbursement of the Grantor for Income Tax**

See Parts 8.f and 8.g below.

l. **GRATs and Generation-Skipping**

- (1) Making grandchildren the remainder beneficiaries of a GRAT – or even making “descendants per stirpes” the remainder beneficiaries so that grandchildren will succeed to the interests of their deceased parents – is generally not a good idea, unless the parents are deceased when the GRAT is **created**, because section 2642(f) (the “ETIP” rule) effectively prevents allocation of GST exemption to such a trust until the expiration of the GRAT term, when presumably the property will have increased greatly in value.
- (2) One technique for dealing with that dilemma is to make only the surviving children the remainder beneficiaries of the GRAT and to “equalize” the treatment of children of a predeceased child in the grantor’s will or revocable trust, where the transfer (possibly funded by term insurance) would be exempt from GST tax under the predeceased parent rule of section 2651(e).
- (3) A variation is to make all the grantor’s children **vested** remainder beneficiaries
  - (a) In that case, a child need not survive the GRAT term to be entitled to share in the remainder and therefore may bequeath that remainder interest to his or her children, to a generation-skipping trust, or to other persons.
  - (b) It is sometimes suggested that after the creation of the GRAT the children could **sell** their vested remainders to a generation-skipping trust (or trust), possibly a trust funded by the grantor with whatever cash is needed to equip it to make the purchase and to which the grantor allocates GST exemption in the amount of such funding. When the sale is done early in the term of a “near-zeroed-out” GRAT and the value of the property in the GRAT has not appreciated greatly, the value of the remainder might be viewed as very small. **The authority for this technique is far from clear, however, and it should be regarded as very risky.**
- (4) A different use of a vested remainder interest is to create such an interest in another family member who has “extra” basic exclusion amount and GST exemption in light of the doubling achieved by the 2017 Tax Act, perhaps a parent of the grantor who is made the remainder

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beneficiary of an “upstream GRAT.” The remainder beneficiary could then bequeath that remainder interest to a generation-skipping trust. Assuming that the remainder is not assigned a nominal value for that purpose, the risk is reduced, although there would still be the dual risks of the remainder beneficiary’s bequeathing the remainder interest in a different, unplanned, way and, conversely, the Service’s viewing the ultimate generation-skipping bequest as made pursuant to an understanding or prearrangement for purposes of section 2036, so as to keep the original donor of the GRAT as the transferor for GST tax purposes.

- (5) Similarly, it is sometimes suggested that a grantor who is not expected to survive the GRAT term could purchase the remainder interest in the GRAT, perhaps with promissory notes, and thereby remove the consideration paid from the grantor’s gross estate. Chief Counsel Advice 201745012 (Aug. 4, 2017) considered the case where a donor had made such purchases of the remainder interests in two GRATs, using unsecured promissory notes, one day before he died. The Chief Counsel’s Office, relying on *Commissioner v. Wemyss*, 324 U.S. 303 (1945), and *Merrill v. Fahs*, 324 U.S. 308 (1945), concluded that the receipt of the remainder interests did not constitute adequate and full consideration in money or money’s worth for the transfer of the notes because the values of the remainder interests were already included in the donor’s gross estate under section 2036 and therefore the formal receipt of those remainder interests did not “replenish” the grantor’s gross estate.
- (6) On the other hand, a GRAT can be used to leverage a small amount of unified credit into a generation-skipping trust to which GST exemption can be allocated at the end of the ETIP period.
  - (a) For example, a two-year GRAT created in 2010 and ending in 2012 could have used part of the unified credit (presumably a small part) to shelter the initial transfer from gift tax, and then the grantor could have allocated up to \$5 million of GST exemption (\$10 million in the case of gift-splitting by spouses) in 2012 when the GRAT term ended and the ETIP ended. The GRAT could even have been structured to continue only \$5 million (or \$10 million) in a generation-skipping trust and distribute the excess outright to children.
  - (b) This technique was especially useful before the 2010 Tax Act when the GST exemption was greater than the gift tax exclusion amount. But it can also be useful going forward in any context in which the grantor wants to leave the GRAT asset to grandchildren (or a generation-skipping trust) and most of the rest of his or her estate to children.
  - (c) The 2012-2013 Treasury-IRS Priority Guidance Plan added an item most recently described as “Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.” The 2015-2016 Plan dropped this item.

m. **Collapsing an Underperforming GRAT**

- (1) Sale of the GRAT property to the grantor (unlike commutation) need not be prohibited. *Cf.* Reg. §25.2702-5(b)(1) & (c)(9) (prohibiting such sales in the case of a PRT or QPRT).
  - (a) Such a sale has no income tax consequences if the GRAT is a wholly-owned grantor trust. Rev. Rul. 85-13. 1985-1 C.B. 184.
  - (b) Such a sale may even be built into the GRAT design through a power to substitute assets within the meaning of section 675(4)(C). See Part 7.b(2) below.
  - (c) Under section 1041, a sale to the grantor’s spouse is likewise non-taxable.
  - (d) Unlike notes **from** the GRAT to make the annuity payments (discussed above), there should be no problem if such a sale is made, at least in part, for notes **to** the GRAT from the purchasing grantor (or spouse).
  - (e) But for a warning about valuating such notes, see Part 8.d(4) below.
- (2) Following such a sale, presumably at a justified depressed sale price, repurchased property may be placed in a new GRAT, with a lower annuity payment, and the original GRAT simply pays out its cash (or notes) and collapses.

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## 4. Fifteen Contemporary GRAT Questions

### a. Commencement and Duration of the Term

- (1) **Question 1:** What is the shortest possible GRAT term?
  - (a) Section 2702(b)(1) refers to “fixed amounts payable not less frequently than annually.” Reg. §25.2702-3(b)(1)(ii) refers to amounts “payable periodically, but not less frequently than annually.”
  - (b) In Letter Ruling 9239015, the Service ruled that an annuity interest was a qualified annuity interest in a GRAT with a term of two years.
  - (c) Subsequently, anecdotal evidence emerged that the Service would refuse to rule that an annuity interest was a qualified annuity interest unless the term of the GRAT is at least five years.
  - (d) In *Kerr v. Commissioner*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002), there was a GRAT with a term of 366 days, but there is no indication on the face of the Tax Court opinion that it was challenged or seriously scrutinized.
  - (e) The GRATs upheld in *Walton v. Commissioner*, 115 T.C. 589 (2000), had a term of two years, although the case focused on other aspects of the GRATs, namely the valuation of the remainder following a fixed term of years without regard to the mortality of the grantors.
  - (f) While most conservative practitioners are comfortable with a minimum term of two years, it is hard to find any restriction at all in the law.
  - (g) While some have suggested defining the term with reference to a formula that would adjust as necessary to produce a qualified interest, that would in turn entail defining the annuity amount by formula, which would strain the statutory requirement of “fixed amounts” (qualified only by the reference in Reg. §25.2702-3(b)(1)(ii)(B) to a “fixed fraction or percentage” of the initial fair market value).
  - (h) The Obama Administration’s revenue proposal to require a minimum 10-year term for GRATs and make other changes regarding GRATs is discussed in Part 12.b below.
- (2) **Question 2:** When is a GRAT “created” for purposes of measuring the due dates of the annuity payments?
  - (a) This might be an issue when some time must elapse to perfect or consummate a transfer, such as the reissuance of stock certificates.
  - (b) Does the mere signing of a trust instrument “create” a trust? Is a *res* required? (Who knows? In any event, this may vary from state to state.)
  - (c) Can the *res* problem be avoided by a nominal cash contribution when the trust instrument is signed? Presumably, this would not violate the prohibition of Reg. §25.2702-3(b)(5) on additional contributions, because it is merely part of a recited short-term series constituting a single contribution.
  - (d) When does the grantor’s “dominion and control” cease for purposes of Reg. 25.2511-2? As long as additional steps must be taken, can the transfer be “called back” – effectively revoked?
  - (e) If the date of funding is really uncertain, perhaps the trust should be left revocable until the funding occurs.
  - (f) What if the funding could be delayed until the next month and the section 7520 rate used to value the gift could be different?
    - i. A formula can be used, but a formula can be very cumbersome and can, for example, produce a result with infinite decimal places. Care must be taken to provide a rounding rule, making sure that the result is always rounded **down** and not up, and to establish a

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target gift that is not zero but is some nominal amount (assuming that a truly zeroed out GRAT is not desired).

- ii. If the technique of revocability until the trust is fully funded is used, it might be both safer and simpler for the grantor to simply reserve the right to amend the annuity formula until that time.
- (3) **Question 3:** Can the annuity be payable on the last day of the “year” that begins on the first day of the GRAT term, or must it be paid on the “anniversary” of that first day?
- (a) In other words, if a GRAT is created and funded on May 1, is the first annual payment due on the following April 30? Or May 1? Likewise (and perhaps more interestingly, because of its effect on the need for the grantor to survive), is the last day of the trust, when the last distribution to the grantor is due, the appropriate April 30? Or May 1?
  - (b) There seems little reason not to draft a GRAT using April 30 in this example. Any valuation difference would likely be very small and not worth the time of the Service to pursue, unless one believes that a “full” two years, for example, is the minimum required to constitute a qualified payment. But wouldn’t a two-year GRAT using May 1 be, in effect, a GRAT for two years and one day?
  - (c) Letter Ruling 9239015 involved a GRAT that terminated the day before the “anniversary” date.
  - (d) The preamble to the 2000 amendment of the regulations, T.D. 8899, provides the illustration of “a trust providing for an annuity interest created on May 1st ... [in which] the entire annual payment may be made by April 30th of each succeeding year of the trust term.”
  - (e) Nevertheless, it is unlikely that “April 30” GRATs are the norm, and Reg. §25.2702-3(b)(3) does refer to “the anniversary date of the creation of the trust.”
  - (f) Of course, this makes a difference in just one scenario: the grantor dies on May 1 of the last year of the GRAT.
- b. **“Zeroing Out”**
- (1) **Question 4:** Can a GRAT be “zeroed out” – that is, structured so that the value of the remainder for gift tax purposes is zero or nearly zero?
- (a) It is often assumed that this was settled in *Walton v. Commissioner*, 115 T.C. 589 (2000); Notice 2003-72, 2003-44 I.R.B. 964 (announcing IRS acquiescence in *Walton*); and Reg. §25.2702-3(d)(4) & (e), Example 5 (amended February 15, 2005).
  - (b) The Service had previously acknowledged that the gift tax value of the remainder following a GRAT term can be as small as 0.829 percent of the total value transferred into the trust. Letter Ruling 9239015.
  - (c) In dicta in Technical Advice Memorandum 200245053 (focusing primarily on the effectiveness of a defined-value clause), after *Walton* but before the acquiescence in *Walton*, the Service remarked that the value of the gift could not be very small (such as 1 percent).
  - (d) The Service will “ordinarily” not issue an advance ruling regarding a GRAT unless the value of the remainder interest is at least 10 percent. Rev. Proc. 2024-3, 2024-1 I.R.B. 143, §4.01(58). Thus, there are no GRAT letter rulings anymore.
  - (e) Trying to deal with this issue by formula would generally incur an unacceptable gift tax risk.
- (2) **Question 5: Should** a GRAT be **exactly** zeroed out – that is, designed with no gift tax value for the remainder?
- (a) Some advisers question whether there can be an effective estate planning result, or whether there can even be a valid trust, without a net “transfer.”

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- (b) Others insist on a nominal gift, so there is a reason to disclose the GRAT on a gift tax return and gain the repose of the gift tax statute of limitations.
  - (c) Generally, then, “zeroed out” has come to mean nearly-zeroed-out, with some small taxable gift.
  - (d) On the other hand, in *Grieve v. Commissioner*, T.C. Memo. 2020-28 (Judge Kerrigan), there was a two-year GRAT with annuity payments determined as stated percentages of what the opinion describes only as “the fair market value of assets transferred to the trust for Federal gift tax purposes.” And it was evidently designed with the intention of exactly zeroing-out the gift. Nevertheless, it worked. As the court noted in a footnote:

The parties stipulated that petitioner will not owe additional gift tax if we determine that he understated the initial fair market value of assets transferred to the GRAT if, within a reasonable time, the GRAT pays to petitioner, or to his personal representative in the event of his passing, an amount equal to the difference of the properly payable annuity and the annuity actually paid.

They never had the opportunity to make such a payment, however, because the taxpayer won the case on the underlying valuation issue.

- (3) **Question 6:** If a GRAT is exactly zeroed out, so that there is no gift, should it nevertheless be reported on a gift tax return?
  - (a) Some prefer disclosure on a gift tax return to gain the repose of the gift tax statute of limitations. The regulations expressly permit the disclosure of a “non-gift,” to start the statute of limitations on any assertion by the Service that that transfer or other transaction had a gift element. Reg. §301.6501(c)-1(f)(4). This is true even though there is otherwise no reason to file a gift tax return. Reg. §301.6501(c)-1(f)(7), Example 2.
  - (b) For others, the greatest source of repose is invisibility, and filing a gift tax return when there is no gift is resisted.
  - (c) If a gift tax return is not going to be filed, then it would be inappropriate to define the annuity with reference to values as finally determined for gift tax purposes.

c. **“Rolling” or “Cascading” GRATs**

- (1) **Question 7:** If it is contemplated that the grantor will create a new GRAT whenever a payment is made back to the grantor, should the same trust instrument be used?
  - (a) Generally, there should be no reason not to, and it would save both paper and headaches for the grantor.
  - (b) Best practices, however, require a new review of the document—
    - i. by the drafter, to make sure the calculation of the annuity is right (since a flexible formula can be cumbersome, as discussed above) and to ensure that there have been no material changes in the law (such as the prohibition in Reg. §25.2703-(b)(1)(i) on the payment of annuity amounts with notes in a GRAT created on or after September 20, 1999), and
    - ii. by the grantor, to make it clear that each GRAT is independent and not so much a part of a “prearrangement” as to risk that the GRATs will be collapsed into one long-term GRAT with estate tax exposure through the entire long term.
- (2) **Question 8:** In any event, can the investments of such successive GRATs be commingled?
  - (a) Subject to the above caveats, the answer seems to be clearly yes.
  - (b) The “investments” will frequently be the same asset, at least initially.
- (3) The Obama Administration’s revenue proposal to require a minimum 10-year term for GRATs and make other changes regarding GRATs is discussed in Part 12.b below.

d. **A Cap on the Remainder Beneficiaries’ Share**

- (1) **Question 9:** Can or should a cap be put on the amount of value ultimately passing to the remainder beneficiaries, with any excess being returned to the grantor?

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- (2) Since the most frequently asked question about a GRAT, after “What if it doesn’t work,” may be “What if it works too well,” consideration of such a cap is a good idea. The cap can be an absolute ceiling, or it can be reflected in a proportional sharing in the remainder by the remainder beneficiaries and the grantor, above a stated point. The cap will have no effect on the gift tax value of the remainder.
  - (3) This technique can substitute for the reimbursement of the grantor for income tax (discussed in Part 8.g below) as a protection against a higher-than-expected capital gain.

e. **Payment of a GRAT’s Expenses**

- (1) **Question 10:** How can be expenses of a GRAT be paid, without violating the prohibition of Reg. §25.2702-3(b)(5) on additional contributions?
- (2) Many GRATs require very little maintenance. The trustee does not “manage” the investment. The GRAT is a grantor trust that does not file income tax returns and is typically an unsupervised trust that does not file accountings. There may be little or no other reason to keep “books.” Because of these reasons and the short-term nature of most GRATs, the trustee is often an individual, sometimes the grantor. Thus, expenses are low, and such payments as are required for legal, accounting, or appraisal services are usually justified as looking out for the grantor’s own interests – in the calculation and payment of the annuity, in the proper gift tax treatment of the gift and estate tax treatment of the trust, in the monitoring of grantor trust status, and the like – and thus are properly paid by the grantor, who usually is the client anyway.
- (3) Difficulties arise when the asset held by the GRAT is purchased by an outsider. Such acquisitions can be very expensive, and the costs should probably be borne proportionately by all the sellers, including the GRAT, in the absence of very strict “tag-along” rights, which are not typically included in a GRAT instrument and which might in any event add more value to the gift.
- (4) In general, care should be taken to book the grantor’s payment of the GRAT’s share of expenses as loans to the GRAT, which can easily be traced to a use other than payment of the annuity in violation of Reg. §25.2703-(b)(1)(i).

f. **Timing of Annuity Payments**

- (1) **Question 11:** May payment in kind of an annuity payment be deferred beyond the due date?
- (2) Reg. §25.2702-3(b)(4) provides that “[a]n annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date.” (The reference to 105 days corresponds to April 15, the date the GRAT’s income tax return would be due if it filed one, which is the due date for payments based on a calendar year.) There is no provision for the payment of interest.
- (3) It is possible to build in safeguards against late payment, for example by providing in the GRAT instrument that if payment is not made within, say, 30 days of the due date, the GRAT terminates to that extent, and the trustee holds that amount as an agent or nominee for the grantor, not as trustee. But that is no substitute for paying attention to annuity payment due dates, and such a feature could encourage a false sense of security.
- (4) Many see deferral of the payment beyond the due date as entailing both risk and opportunity – risk that a **greater** share of the asset will be needed to discharge the annuity obligation if the asset declines in value, and the opportunity to use a **smaller** share of the asset to discharge the annuity obligation if the asset appreciates in value.
  - (a) This technique will often be most attractive in the case of marketable assets such as stock of a publicly-traded corporation, where changes in the market value are known from day to day. Since the payment may be made at any time within the 105 days, the trustee may time the payment with regard to apparent trends in the market value.

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- (b) If this an advantage in the case of a GRAT providing for annual payments, it might be even more of an advantage if annuity amounts are made payable more frequently than annually.
- i. Reg. §25.2702-3(b)(3) states that “the annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly.” While this does not preclude an even more frequent interval, monthly payments are the most frequent payments with specific sanction in the regulations and will be the most frequent payments used by conservative estate planners.
  - ii. It appears that even a semi-annual, quarterly, or monthly payment is “[a]n annuity amount payable based on the anniversary date of the creation of the trust” if it measured from the date of the creation of the GRAT and not based on the calendar year. That is the only way to give meaning to the word “based,” which is presumably included in the regulation for a purpose. Therefore, under the regulation, even a monthly payment “must be paid no later than 105 days after the anniversary date.” Here, however, “the anniversary date” can only refer to the date **one year** after the creation of the trust (and each year thereafter).
  - iii. In other words, if a GRAT providing for monthly payments is created and funded on May 1, the first payment is due June 1 [or maybe May 31?], but apparently may be made any time through August 14 of the following year (105 days after the “anniversary date” – that is, 105 days after May 1 of the following year). The same thing is true of the other eleven payments, due on the first day of each month [or maybe the last day of the previous month] from July through the following May.
  - iv. Annuity amounts payable more frequently than annually are rarely considered, because they complicate both the valuation of the gift and the administration of the trust. But if the fair market value of an asset is reasonably easy to determine and is expected to be very volatile, monthly payments can maximize the flexibility to exploit market highs in the timing of payments in kind. This can be especially welcome to someone who is concerned that the prohibition on “commutation (prepayment) of the [grantor’s] interest” in Reg. §25.2702-3(d)(5) prohibits prepayment of any annuity amount due.
- (5) On the other hand, it may be that the right to specific assets – typically a specific fraction of the assets of the GRAT – becomes fixed at the payment due date, especially if the GRAT holds just one asset, such as an interest in a limited partnership or LLC. In that case, deferring the payment serves no strategic purpose.
- (6) The 105-day grace period of Reg. §25.2702-3(b)(3) is not a governing instrument requirement. If a governing instrument explicitly allows a 105-day delay in payment, must valuation of the remainder for gift tax purposes be based on the later permissible payment dates? If the answer is uncertain, that uncertainty must be balanced against the advantage (described above) of using the 105-day grace period, especially in a GRAT providing for monthly payments, to effectively permit the equivalent of prepayment. But that did not appear to be a problem in *Grieve v. Commissioner*, T.C. Memo. 2020-28, discussed in Part 4.b(2)(d) above, where the annuity payments determined by formula were, as the court put it, “to be paid within 105 days of [the respective anniversaries of the funding of the GRAT].”
- (7) If immediate payment of the annuity amount on its due date is not possible because it must be paid in kind with an asset or assets that must be appraised, such as an interest in a limited partnership or LLC, then it should be possible to make the payment by means of an assignment referring to the specific target value. **Such a formula assignment should require that the number of shares or units or fraction of interest in the entity be rounded up to a stated number of significant digits, to eliminate any possibility that the annuity will be underpaid.** If such an assignment is used, the actual quantity of the interest assigned should be clarified by an appraisal and documented (as on the books of the entity) as soon as possible. **This is not a case where the quantity will depend on a value “as finally determined for gift tax purposes,” and ordinarily this payment will not be reported on a gift tax return.**



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

g. **Grantor Trust Status After the GRAT Term**

- (1) **Question 12:** When does the grantor trust status of a GRAT terminate?
- (2) Some GRATs include a grantor trust feature, such as the power in the grantor to reacquire trust corpus by substituting other property of an equivalent value (section 675(4)(C)), "for as long as the grantor is living during the GRAT term" – that is, for two years or three years (or whatever term is selected) from the creation of the GRAT. But grantor trust status is needed when the final annuity payment is made to the grantor, if it is made in kind with appreciated assets, which will often be the case. This type of drafting, then, risks exposing the final annuity payment to income tax. Moreover, this tax will be imposed on the trust, not the grantor, frustrating the estate planning objective of the GRAT to move assets in a tax-efficient manner to the next generation.
- (3) Usually, as long as there is still a substantial payment to be made to the grantor, it is reasonable to assume that section 677(a)(1) confers the necessary grantor trust status.
- (4) In some cases, the GRAT continues as a grantor trust after the GRAT term for other reasons anyway.
- (5) The best approach is to provide the grantor trust feature itself "for as long as the grantor is living during the GRAT term and thereafter until all payments due the grantor have been made."

h. **Measuring the Amount That Is Included in the Gross Estate**

- (1) **Question 13:** What is the estate tax exposure if the grantor dies during the GRAT term?
- (a) Item 8 on the 2007-08 Priority Guidance Plan was titled "Final regulations under sections 2036 and 2039 regarding the portion of a split-interest trust that is includible in a grantor's gross estate in certain circumstances in which the grantor retains an annuity or other payment for life."
- i. Although a reference to "split-interest" trusts typically brings to mind a charitable remainder trust, the estate tax charitable deduction usually diminishes the importance of estate inclusion in the case of a CRT.
- ii. The more interesting question, of course, is presented by a grantor retained annuity trust (GRAT), where there can be a large difference, for example, between the present value of the unpaid annuity amounts, the amount needed to generate the prescribed annuity without depleting the principal (*cf.* Rev. Rul. 82-105, 1982-1 C.B. 133, describing the portion of a CRT that is included in the gross estate), and the entire value of the trust assets that the Service has viewed as included in the gross estate under section 2039 (Letter Ruling 9345035; Technical Advice Memorandum 200210009).
- (b) Proposed regulations (REG-119097-05) were published in the Federal Register on June 7, 2007, taking the relatively welcome position that the Service will apply section 2036 and will refrain from applying section 2039. Final regulations, Reg. §§20.2036-1(c) & 20.2039-1(e), T.D. 9414, published on July 11, 2008 (corrected July 30, 2008), took the same view.
- (c) Under the regulations, the amount includible in the gross estate with respect to a retained interest in trust is the amount needed to generate the retained interest without invasion of principal – that is, in perpetuity – up to the date-of-death value of the trust assets. Reg. §20.2036-1(c)(2)(i). In the case of a GRAT, this will usually result in inclusion of the entire value of the assets, unless the assets have increased enormously in value.
- (d) The preamble to the 2008 final regulations revealed that Treasury and the Service considered and rejected the argument that section 2036 is not applicable to a retained annuity interest in a GRAT to the extent the annuity is not payable from trust income. This argument was made in Whitty, "Repercussions of *Walton*: Estate Tax Inclusion of GRAT Remainders," *PROBATE & PROPERTY*, May/June 2005, at 13; and Whitty, "Heresy or Prophecy: The Case for Limiting Estate Tax Inclusion of GRATs to the Annuity Payment Right," 41 *REAL PROP., PROBATE & TR.*

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J. 381 (Summer 2006). Although the argument was viewed as aggressive by some estate planners, it resulted in the deletion from many GRAT forms of directions such as to pay the annuity amounts “from income and, to the extent that income is not sufficient, from principal,” in order to preserve the opportunity to make the argument if the occasion arises. Under the regulations, it is likely that the result is the same whether the annuity is paid from income or principal, because the regulation looks only to the generic amount of the annuity. See Reg. §20.2036-1(c)(2)(i) & (iii), *Example 2*. Nevertheless, it is unlikely that such directions (which do not have much substantive effect either) will be reinstated in GRAT forms.

- (e) The proposed regulations offered one GRAT example, which is retained in the final regulations. Reg. §20.2036-1(c)(2)(iii), *Example 2*. But unlike most GRATs, the GRAT in the example
- i. runs for the shorter of the stated term or the grantor’s life, not as a *Walton* style GRAT, running for a fixed term with annuity payments directed to the grantor’s estate if the grantor dies before the expiration of the term;
  - ii. is not graduated (that is, does not include an annual increase in the annuity, which, if paid in perpetuity, will always exhaust the GRAT if the graduation rate – usually 20 percent – exceeds the 7520 rate);
  - iii. provides for monthly, not annual, GRAT payments;
  - iv. continues for 10 years, relatively long as GRATs go; and
  - v. produces a relatively high taxable gift, equal to about 10.3 percent of the initial value transferred to the GRAT (for a 60-year-old grantor in July 2008).

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

- (f) New regulations were published in the Federal Register in proposed form (REG-119532-08) on April 30, 2009, and in final form (T.D. 9555) on November 7, 2011.
- i. New Reg. §20.2036-1(c)(2)(iii) provides that, in the case of a graduated GRAT, the amount includible with respect to the amount payable for the year of the decedent’s death (called the “base amount”) is the amount required to make that payment in perpetuity. (This is the same as the rule under the 2008 regulations.) The additional amount includible with respect to each annual increment in future years (called the “periodic addition” for each year) is the amount required to make **that** incremental payment in perpetuity, discounted for the passage of time before that increment takes effect. The total amount includible in the gross estate is the sum of the base amount and all the periodic additions, but not to exceed the total fair market value of the trust property on the date of the decedent’s death.
  - ii. In addition, new Reg. §20.2036-1(c)(2)(ii) provides rules for valuing the annuity payments when those payments are paid for the joint lives of the decedent and another recipient, or to the decedent following the life of another recipient.
- (g) The seriousness of the grantor’s mortality was dramatically illustrated in *Badgley v. United States*, 121 AFTR 2d 2018-1816 (N.D. Cal. 2018), *aff’d*, 9th Cir. Dkt. No. 18-16053 (2020), involving a GRAT created on February 1, 1998. The GRAT was to run for the shorter of 15 years or the grantor’s life and was to pay the grantor an annuity in quarterly installments. The grantor died November 2, 2012, after 177 months of the anticipated 180 months of the GRAT term. Analysis of the facts stated in the opinion in light of known interest rates and tax rates indicates that the GRAT was “working,” having achieved 350 percent growth after paying the annuity amounts. But ultimately the GRAT did not “work,” because the grantor lived for only 98 percent of the 15-year GRAT term. The courts rejected her executor’s argument that an annuity is not “enjoyment” for purposes of section 2036(a)(1).

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- (h) The risk of estate tax if the grantor dies during the GRAT term could be covered with term life insurance.
- (2) **Question 14:** If the grantor retains a testamentary power to direct the disposition of the GRAT assets included in the grantor's gross estate death if the grantor dies during the GRAT term, is the transfer to the GRAT still a completed gift?
- (a) Most estate planners see little risk, because the downside appears to be inclusion in the grantor's gross estate, but the power of disposition applies to the portion of the GRAT included in the grantor's gross estate anyway.
- (b) In any event, the grantor would have no power of disposition unless he or she died during the GRAT term, a condition over which the grantor has no legal control, and therefore the power does not prevent the gift from being complete. See Rev. Rul. 54-537, 1954-2 C.B. 316; Letter Ruling 8727031 (April 3, 1987).
- i. **Qualifying the GRAT for the Estate Tax Marital Deduction**
- (1) **Question 15:** If the grantor dies during the GRAT term, what is the best way to ensure that whatever value is included in the grantor's gross estate with respect to the GRAT qualifies for the marital deduction?
- (2) Before *Walton*, this was fairly easy to accomplish with a simple reversion to the grantor's estate, where normal marital deduction planning would work.
- (3) Since *Walton*, and before *Walton* for those who provided for an annuity payable to the grantor or his or her estate for a complete term of years in the hope that Example 5 of Reg. §25.2702-3(e) would be held invalid, this is more complicated. The focus is on both the remaining annuity payments (which could look like a terminable interest) and the remainder at the end of the GRAT (which is not immediately possessory). Simply combining these interests by making both payable to the surviving spouse would violate the prohibition of Reg. §25.2702-3(d)(3) on payments to anyone other than the grantor (or, by implication, the grantor's estate) during the GRAT term.
- (4) A number of approaches have been discussed. The following is an example of what seems to work:
- (a) In the GRAT instrument, provide that if, after the grantor's death survived by a spouse, income exceeds the annuity amount, that excess income is also paid to the grantor's estate. Alternatively, this could be provided throughout the GRAT term; it would ordinarily make no difference, because the annuity amount alone would probably exceed the income. (But there could be an estate tax benefit in not doing it that way. See Part 4.h(1) above.)
- (b) In the GRAT instrument, repudiate the 105-day grace period for payment of the annuity, especially if the instrument otherwise recognizes it.
- (c) In the GRAT instrument, provide that the grantor's executor can require the trustee to make the trust property productive of income or convert it into productive property within a reasonable time (within the meaning of Reg. §20.2056(b)-5(f)(4)), and provide in the grantor's will that the surviving spouse can require the executor to exercise this right. Alternatively, the GRAT instrument could give the right directly to the surviving spouse, although it is a bit awkward to do this when the spouse as such is not a beneficiary of the GRAT.
- (d) In the GRAT instrument, provide that at the end of the GRAT term, if the grantor has died during the term survived by a spouse who survives the GRAT term, the GRAT (although no longer a GRAT) continues for the spouse's life, with all income (not an annuity amount) paid to the grantor's estate.
- (e) In the grantor's will (or more typically a codicil executed at the same time as the GRAT), bequeath the grantor's entire interest in the GRAT to the spouse.
- (f) Also in the grantor's will (or codicil), as a reminder if for no other reason, specifically encourage the executor to consider a QTIP election with respect to the GRAT.

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- (g) In the grantor's will (or codicil), expressly exonerate the GRAT from section 2207B or any comparable state apportionment rule during the GRAT term. This should permit the GRAT to comply with the prohibition of Reg. §25.2702-3(d)(3) on payments to anyone other than the grantor (or, by implication, the grantor's estate) during the GRAT term, without relying on the grantor's executor's QTIP election. Reimbursement can be allowed after the end of the GRAT term. (If this is a problem, it is a potential problem with all GRATs, not just where the marital deduction is sought.)
  - (h) In the grantor's **spouse's** will (or codicil executed at the same time as the GRAT), expressly exonerate the GRAT from section 2207A or any comparable state apportionment rule during the GRAT term, again to comply with Reg. §25.2702-3(d)(3). Again, reimbursement can be allowed after the end of the GRAT term.
  - (i) In the GRAT instrument, specifically ratify reimbursement of taxes consistently with the above provisions. It might also be prudent to consider an indemnity from the grantor for any estate tax that must be paid notwithstanding the above provisions (if, for example, either the grantor or the grantor's spouse revokes or modifies the waiver of section 2207B or 2207A). (But it is not clear whether such an indemnity would make the grantor's retained annuity interest only the stated annuity interest less the value of the indemnity.)
  - (j) In the GRAT instrument, provide for the appropriate division of the trust into two shares if the grantor's executor makes only a partial QTIP election with respect to the GRAT.
  - (k) Because of the potential duration of the GRAT for the spouse's life, if state law does not clearly permit the grantor's executor to assign all GRAT payments to the spouse and close the estate, authorize such assignment in the will, and provide in the GRAT instrument that the trustee of the GRAT must honor such an assignment. This could make it unnecessary to keep the grantor's estate open as long as the surviving spouse lives.
- (5) This is a tedious list of steps that probably is not in common use. The most important steps are a, c, d, e, and k.

## 5. Installment Sales: Fundamental Authorities

### a. Background of Grantor Trust Treatment

The treatment of "grantor trusts" as owned by the grantor can be traced to regulations in the 1930s **to curb attempts to shift income between spouses** before the Revenue Act of 1948 added sections 51(b) and 12(d) of the Internal Revenue Code of 1939 to allow income-splitting through the filing of joint returns. (The 1948 Act also added section 1000(f) of the 1939 Code (now section 2513) to allow gift-splitting.) Those income-shifting attempts through the use of trusts were illustrated and analyzed in *Helvering v. Clifford*, 309 U.S. 331 (1940), *rev'g* 105 F.2d 586 (8th Cir.1939) and *aff'g* B.T.A. Memo. 1938-335. The so-called "Clifford regulations" were expanded, modified, and codified in sections 671-678 in the enactment of the Internal Revenue Code of 1954.

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

- (1) Bottom line: **For income tax purposes**, a grantor trust is disregarded. There can be no transactions between a grantor and the trust. The trust is simply a pocket of the grantor.
- (2) Rev. Rul. 85-13 essentially involved a grantor's 1981 installment **purchase** (for a note) of closely-held stock from a *Clifford*-type trust. The income beneficiary of the trust was the grantor's son for 15 years, which, prior to the replacement of the 10-year standard by a 5-percent standard in section 673, did not render the trust a grantor trust. Neither was there any other feature of the trust that would render it a grantor trust.
  - (a) Nevertheless, the Service treated the trust as a grantor trust, because the installment purchase itself was the economic equivalent of the grantor's purchase of the trust's property for cash followed by the grantor's borrowing the cash from the trust in exchange for the note,

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and the grantor's borrowing from the trust, until repayment, rendered it a grantor trust under section 675(3).

(b) Since the trust was a grantor trust, the grantor was treated as the owner of the trust and therefore the owner of the note. Therefore, the transaction could not be a sale, because the grantor was both the maker and owner of the note, and a transaction cannot be a sale if the same person is treated as owning the purported consideration both before and after the transaction.

(c) Since the transaction was not a sale, the grantor did not obtain a new cost basis in the stock.

(3) The Service acknowledged that *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), had reached the opposite result on essentially identical facts, but the Service announced that it would not follow *Rothstein* (without even an exception for the Second Circuit).

(4) The Service has consistently cited Rev. Rul. 85-13 for the proposition that a grantor and a grantor trust cannot have transactions of income tax significance with each other. For example, see Letter Rulings 200247006 (Aug. 9, 2002) and 200228019 (July 12, 2002) (transfer for consideration of a life insurance policy from a grantor trust to another grantor trust treated as owned by the same person ruled not a transfer for value for purposes of section 101).

c. **Letter Ruling 9535026 (May 31, 1995)**

(1) Bottom line: An installment sale to a grantor trust works!

(2) Letter Ruling 9535026 involved installment sales of stock to trusts that were grantor trusts under section 677(a)(1) because the trustees (the grantors' mother and a bank), who had no interest in the trusts, could pay income or principal to the respective grantors for any reason. Citing Rev. Rul. 85-13, the Service held that the sales were therefore nontaxable, and the trusts took the respective sellers' basis in the stock.

(3) The Service went on to give three other rulings.

(a) There would be no imputed gift if the value of the stock equaled the face amount of the note in each case, because the notes bore interest at the rate prescribed under section 7872. In ruling, in effect, that the notes would be valued at face if they bore interest at the section 7872 rate, the Service cited the Tax Court's holding to that effect, in favor of the Service, in *Frazer v. Commissioner*, 98 T.C. 554 (1992).

(b) Section 2701 did not apply to the transaction, because debt is not an "applicable retained interest."

(c) Section 2702 did not apply to the transaction, because the notes were not "term interests" in the trusts.

These three rulings were all conditioned on the status of the notes as debt and not equity, which the Service viewed as primarily a question of fact as to which, citing section 4.02(1) of Rev. Proc. 95-3, 1995-1 C.B. 385, the Service refused to rule. (Section 4.02(1) of Rev. Proc. 2024-3, 2024-1 I.R.B. 143, is the same.)

(4) Although Letter Ruling 9535026 does not refer to any "equity" in the trusts, such as other property to secure the debts or property with which to make a down payment, it is well known that the Service required the applicants for the ruling to commit to such an equity of at least 10 percent of the purchase price. *See generally* Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 EST. PLAN. 3, 8 (Jan. 1996). In Letter Ruling 9251004 (Sept. 4, 1992), the Service had held that a transfer of stock to a trust with no other assets, in exchange for the trust's installment note, "must be considered a retention of the right to receive trust income" for purposes of section 2036.

(5) In addition, in Letter Ruling 9535026 the Service specifically stated that "we are expressing no opinion regarding the application of section 2036 to the transaction."

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- (6) Thus, the “defective” grantor trust became the effective briar patch into which everyone wants to be thrown!
  - (7) In the settlement of a widely discussed Tax Court case, *Karmazin v. Commissioner*, Dkt. No. 2127-03 (stipulated decision entered Oct. 15, 2003), the parties agreed (i) that the sale of partnership units to a grantor trust was a bona fide sale and not the gratuitous transfer of partnership units with the reservation of an annuity, as the Service had originally argued, (ii) that the interest payments made by the trust were interest and not an annuity, (iii) that neither section 2701 nor section 2702 applied to the transaction, (iv) that for purposes of determining the sale price the discount applied in valuing the partnership units was 37 percent and not 42 percent as the transaction originally contemplated (based on an appraisal), and (v) that the defined-value clause (“that number of units equal to a value of \$\_\_\_\_\_”) was invalid for purposes of the settlement.

## 6. Structuring the Trust

### a. Drafting for Long-Term Non-Tax Dispositive Objectives

- (1) If the subject of the installment sale is going to be something like the family business, then the drafting of this trust is the occasion for making decisions about the ultimate disposition of both the control of and the economic benefit from the business.
- (2) In all cases, this is the occasion for making decisions about beneficiaries, standards for distributions, incentives and rewards, control by younger generations, and the like.
- (3) This is also the time to consider and apply to this family situation the pros and cons of locating the trust in a jurisdiction with a relaxed rule against perpetuities and maximum protection from potential creditors.
- (4) Obviously, flexibility is important, particularly with respect to issues such as the succession of trustees and the situs of the trust.

### b. Allocating GST Exemption

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

### c. Finding an Existing Grantor Trust

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

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

## 7. Ensuring Grantor Trust Treatment

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

### a. Objectives

- (1) Achieve grantor trust status for the entire trust, including income and principal (such as capital gains), until the note is paid, the grantor dies, or grantor trust status is intentionally terminated.
  - (a) Under the grantor trust rules, a grantor may be treated as the owner of "any portion" (including the entire portion) of a trust for income tax purposes. Section 671 provides that any "remaining portion" of the trust (*i.e.*, any portion of which the grantor is not treated as the owner) is subject to the generally applicable trust income tax rules of subchapter J (section 641 *et seq.*).
  - (b) A grantor may be treated as owner of only a portion of the trust if the grantor trust power applies to only a portion of the trust assets. For example, a grantor may be treated as the owner of only (i) income, (ii) corpus, (iii) a fractional or pecuniary share, or (iv) a specific asset. Reg. §1.671-3(a)(3).
  - (c) In addition, different persons may be treated as owners of different portions of the same trust. For example, if someone other than the initial grantor contributes assets to the trust, the initial grantor generally will not be treated as the owner of those assets. A power of withdrawal (such as a *Crummey* power or a "5 & 5" power) or the lapse thereof may cause the powerholder to be treated as the owner of the assets subject to the lapsed power.
- (2) Avoid inclusion of the trust assets in the grantor's gross estate.
- (3) Avoid potential conflict of interest or breach of fiduciary duty.
  - (a) If exercise of the power may constitute a breach of fiduciary duty by the powerholder (for example, a trustee), the power might be challenged, with the result that grantor trust treatment is not achieved.
  - (b) Apart from tax consequences, exercise or termination of the power in an alleged breach of fiduciary duty could expose the powerholder to liability and risk depletion of trust assets in litigation.

### b. Alternatives

- (1) Power to use trust income to pay premiums on insurance on the life of the grantor or grantor's spouse. Section 677(a)(3).
  - (a) A few ancient cases questioned whether the power to pay premiums is enough, if the power is not exercised. *See generally Rand v. Helvering*, 116 F.2d 929 (8th Cir.), *cert. denied*, 313 U.S. 594 (1941); *Schoellkopf v. McGowan*, 43 F. Supp. 568 (W.D.N.Y. 1942); *Weil v. Commissioner*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29; *Moore v. Commissioner*, 39 B.T.A. 808 (1939), *acq.*, 1939-2 C.B. 25.
  - (b) More recently, the Service ruled that it is. Letter Ruling 8852003 (Aug. 31, 1988). *Cf.* Letter Ruling 8103074 (Oct. 23, 1980) (entire trust treated as a grantor trust where only a part of the income was to be used to pay premiums).
  - (c) Reliance on the power to use trust income to pay life insurance premiums is risky in any event.
    - i. Sometimes it is hard to tell whether payments are made from "income" rather than principal (to the extent that even makes a difference anyway).

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- ii. The trust law of some jurisdictions grants this power to all trustees. *See, e.g.*, CODE OF VA. §64.2-105.B.19 (which is routinely incorporated by reference into Virginia trust instruments). The result that **every** inter vivos trust is therefore a grantor trust just seems too far-fetched.
  - iii. Despite the broad language of section 677(a), an “income” interest under section 677(a) will apparently make the grantor the owner of only the trust income, not the trust corpus. *See* Reg. §§1.671-3(b)(1); 1.677(a)-1(g), *Example 1*.
- (2) Power to reacquire the trust corpus by substituting other property of an equivalent value. Section 675(4)(C).
- (a) This power has often been favored, because it does not affect the interests of the beneficiaries.
  - (b) Nevertheless, it has been said that “[t]he Section 675(4)(C) power of substitution is one of the most historically contentious powers in the grantor trust pantheon.” Janes & Kelly, “When Using a Power of Substitution – Take Nothing for Granted,” 34 ESTATE PLANNING 3 (Aug. 2007) (a sober analysis of both the risks that the power is insufficient for income tax purposes and that it goes too far for estate tax purposes).
  - (c) In 1994, the Service adopted the view for advance ruling purposes that this power will be **reviewed on audit** to determine if it is held in a nonfiduciary capacity and therefore makes the trust a grantor trust. *See, e.g.*, Letter Rulings 9504024 (Oct. 28, 1994) and 200434012 (April 23, 2004). *Cf.* Letter Ruling 9442017 (July 19, 1994) (same as to investment power).
  - (d) It seems unlikely that a grantor who is not a trustee or cotrustee of the trust would be treated as holding this power in a fiduciary capacity.
  - (e) The apparent power to reacquire the trust assets by foreclosing on the security for the loan might be merely the right of a creditor, not a power of trust administration, and not exercisable unconditionally in any event. Moreover, such a power might have less substance if the trust has ample other assets or when the note has been paid down significantly. Therefore, if this power is to be relied on to confer grantor trust status, it is important that it be expressly granted in the trust instrument.
  - (f) Both the power that qualifies the trust as a grantor trust and the sale of assets to that trust presumably must be “real.” If an apparent “sale” is in substance only a financing arrangement, it should not be expected to transfer future appreciation from the “seller’s” gross estate.
  - (g) Income tax cases addressing this concern are hard to find.
    - i. The typical income tax case, usually arising in a tax shelter context, is a search for a “sham,” for which claimed income tax benefits are denied. Such cases are not very apt in the use of grantor trusts, which, while not “shams,” are in a sense **intended to lack** independent “reality.”
    - ii. Compare AM 2006-001 (Sept. 7, 2006), in which, in a cross-border context where one party to the transactions was a disregarded entity, a promissory note and a forward purchase agreement were considered together in reaching the conclusion that they constituted an equity instrument. Relying on several court cases, the IRS Chief Counsel’s office stated that the intention of the parties to create a debtor-creditor relationship is a significant factor in determining whether an instrument is debt, particularly when the parties are related. Citing Rev. Rul. 2002-69, 2002-2 C.B. 760, the Chief Counsel’s office said that the presence of offsetting obligations in two transactions between the same parties can show that the substance of the transactions differs from their form. The Chief Counsel’s office discussed *Blue Flame Gas Co. v. Commissioner*, 54 T.C. 584 (1970). It also cited *Helvering v. Le Gierse*, 312 U.S. 531 (1941), which found that, when two contracts between the same parties are in existence, the second contract can cause the



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first to be treated as different from its form. The Chief Counsel's office concluded that the forward purchase agreement and the promissory note should be treated as a single instrument, with the result that they constituted equity, not debt.

- (h) Later tax shelter opinions, however, applied analyses of economic substance and of the "benefits and burdens" of ownership. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983); *Saba Partnership v. Commissioner*, T.C. Memo. 1999-359. Even in the absence of express authority, those analyses suggest that there is little reason to fear that a sale to a grantor trust subject to a section 675(4)(C) power of substitution would be viewed as a sham, where typically all or most of the following factors are present:
- i. The substitution must be at the then fair market value, not the initial sale price.
  - ii. The seller retains no control over the trust or the sold property, leaving the trustee, for example, free to transfer the property. (Where, to make the terms of the sale commercially reasonable, the seller retains a security interest in the sold property, this factor is not as strong, but most of the other factors in this list will typically still be present.)
  - iii. The power of substitution applies to all trust property, not just the sold property. (Where the trust holds no other property, this factor is not as strong, but most of the other factors in this list will typically still be present.)
  - iv. There is no prearrangement or expectation at the time of the sale that the property will be reacquired by an exercise of this power.
  - v. The property in fact is not reacquired, at least not soon.
- (i) The exclusion of the property from the grantor's gross estate was generally viewed as secure under *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq.*, 1977-1 C.B. 1 (power to reacquire an insurance policy from a trust and substitute other property of equal value held not to be the retention of incidents of ownership in the policy and therefore held not to bring the insurance proceeds into the insured's gross estate under section 2038 or 2042).
- i. In *Jordahl*, the grantor, his wife, and a corporate trustee were the three trustees of a trust he created in 1931. His wife died in 1967 and thereafter he and the corporate trustee were the only trustees. In the trust agreement, the decedent retained the powers to substitute insurance policies of equal value for insurance policies held by the trust and to substitute "securities or property" of equal value for other "securities and/or property" held by the trust. The Tax Court cited 10 cases (including *United States v. Byrum*, 408 U.S. 125 (1972)) in which the decedent had reserved certain powers over investments, but in only three of those 10 cases was the decedent a cotrustee. The court when on to say:

Decedent's power to substitute property "of equal value" would modify or alter the trust no more than those powers to direct investments involved in the cases cited above. Moreover, like the settlors involved in those cases, decedent was bound by fiduciary standards. Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of "equal value" indicates that the power was held in trust.

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

- ii. The grantor's status as trustee was not emphasized by the Service in the earliest rulings that followed *Jordahl*. *See* Letter Rulings 9413045 (Jan. 4, 1994) (power of substitution held in a nonfiduciary capacity does not result in inclusion in the gross estate under section 2036, 2038, or 2042) and 9227013 (March 30, 1992) (power of substitution that is

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a “general power of administration” under section 675(4)(C) does not result in inclusion in the gross estate under section 2038).

- iii. Then in Letter Ruling 200603040 (Oct. 24, 2005), the Service considered a trust that was a grantor trust because the trustee had discretion to distribute income and principal to the grantor’s spouse. The grantor retained the power to acquire trust property by substituting property of equivalent value, a power the ruling recited “may only be exercised in a fiduciary capacity ... defined as action that is undertaken in good faith, in the best interests of the Trust and its beneficiaries, and subject to fiduciary standards imposed under applicable state law.” The ruling described *Jordahl* as follows:

The court concluded that the requirement that the substitute property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift benefits among the beneficiaries.

The ruling continued:

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

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

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

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

- a. In the facts of Rev. Rul. 2008-22, the grantor was prohibited from serving as trustee. There does not seem to be any significance to that, other than to accent the fact that the grantor’s fiduciary duty as in *Jordahl* cannot be relied on.
- b. Rev. Rul. 2008-22 did not state an “effective date.” In the case of existing trusts that do not qualify for either of the “shift benefits” safe harbors – trusts, for example, in which the trustee is required to hold the originally contributed asset and distributions are limited to simple income interests – the foregoing *Jordahl* analysis should still be available.

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- c. Rev. Rul. 2011-28, 2011-49 I.R.B. 830, used virtually identical language, while specifically referring to insurance policies and referring to section 2042 rather than sections 2036 and 2038.
- d. In light of Rev. Ruls. 2008-22 and 2011-28, it is customary to accompany a section 675(4)(C) power of substitution in a grantor trust instrument with the requirement that the trustee be satisfied “that the properties acquired and substituted by the grantor are in fact of equivalent value.” For a sobering application of this requirement when the substituted property is the grantor’s promissory note, see Part 8.d(4) below.
- (j) If the property of the trust includes voting stock of a “controlled corporation” within the meaning of section 2036(b)(2) – generally, a corporation more than 20-percent-owned by the grantor and the grantor’s family – the retention of the right to vote the stock would bring the value of the stock back into the grantor’s gross estate under section 2036(b)(1). Under sections 2036(b)(3) and 2035(a), this estate tax exposure could continue for three years **after** cessation of the right.
- i. But because Rev. Rul. 2008-22 held that a section 675(4)(C) substitution “will not, by itself, cause the value of the trust corpus to be includible in the grantor’s gross estate under §2036,” **without specifying section 2036(a)(1) or (2) or any other provision**, such a substitution power involving voting stock of a closely-held corporation should present no problem under section 2036(b).
- ii. Confirmation of this reading was found in item 10 under the heading of “Gifts and Estates and Trusts” in the 2011-2012 Treasury-IRS Priority Guidance Plan, released on September 2, 2011, which was described as “Revenue ruling on whether a grantor’s retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor’s gross estate under §2042.” This project first appeared in the 2009-10 Priority Guidance Plan, released on November 24, 2009, the year after Rev. Rul. 2008-22 was published, and is the project that produced Rev. Rul. 2011-28, *supra*. A guidance project for section 2042 without a corresponding guidance project for section 2036(b) implies that voting stock subject to section 2036(b) was already covered by Rev. Rul. 2008-22.
- iii. Section 2036(b)(1) refers to “the **retention** of the right to vote.” The last sentence of Proposed Reg. §20.2036-2(c) states: “If the decedent has the power to obtain the right to vote, such as where he may appoint himself as a trustee of a trust holding the stock, the decedent has retained the right to vote for purposes of section 2036.” But that proposed regulation was published in 1983, has never been finalized (or withdrawn), and was not cited in Letter Ruling 200603040. Thus, that concept likely has not survived the reconsideration that led to the publication of Rev. Rul. 2008-22. (In fact, this focus on the word “retention” might even suggest that a substitution power does not create a problem under section 2036(b) even if the power is exercised and the grantor at that time reacquires the right to vote. Reg. §20.2036-1(c)(1)(i) states: “An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.” But Reg. §20.2036-1(c)(1)(i) was not cited in Rev. Rul. 2008-22 either.)
- iv. And, of course, in the case of a **sale** the parenthetical “bona fide sale for an adequate and full consideration in money or money’s worth” exception in section 2036(a) might also be cited.
- v. In any event, if the trust property consists of stock of a publicly traded corporation, before using a power in the grantor to reacquire trust corpus by substituting other property of an equivalent value (section 675(4)(C), care must be taken that this power would not be considered an option, or its exercise an insider trade, subject to securities laws restrictions. (Indeed, such stock should not be transferred **into** the trust without careful consideration of applicable securities law.)

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- (k) A power in **another** to “reacquire” trust property by substituting property of an equivalent value has been held to support grantor trust status (again subject to review on audit to determine if the power is held in a nonfiduciary capacity).
- i. Letter Ruling 200434012 (power of “reacquisition” in the grantor’s **father** sufficient to make trust a grantor trust). *Accord*, Letter Rulings 199908002 (Nov. 5, 1998) (power in grantor’s **brother**); 9810019 (Dec. 5, 1997) (the *Karmazin* ruling, with a power in a “**disinterested party**”); 9037011 (June 14, 1990) (power in **cotrustee**); 9026036 (March 28, 1990) (power in grantor’s **spouse**).
  - ii. On July 25, 2008, when the Service promulgated sample inter vivos charitable lead unitrust forms, including forms for both nongrantor and grantor CLUTs, the feature used to confer grantor trust status was a right during the donor’s life, in **an individual other than the donor**, the trustee, or a disqualified person as defined in section 4946(a)(1), exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value. Rev. Proc. 2008-45, 2008-30 I.R.B. 224.
  - iii. Although section 675(4)(C) uses the word “reacquire,” it uses that word in reference to a power held “by any person.”
  - iv. Such a power gives no protection, however, if the power holder dies, unless a successor power holder is specified.
  - v. Such a power avoids a 2036 or 2038 problem.
- (3) Other administrative powers. Section 675.
- (a) The powers of the grantor (or the grantor’s spouse) to deal with the trust for less than adequate and full consideration (section 675(1)) and to borrow without adequate interest (section 675(2)) have always raised concerns about includibility of the trust assets in the grantor’s gross estate under section 2036 or 2038 (or in the grantor’s spouse’s gross estate under section 2041).
  - (b) The grantor’s power to borrow from the trust without adequate security (section 675(2); *see* Letter Ruling 199942017 (July 22, 1999)) is a similar problem, but perhaps not to the same degree, and may even be addressed by compensating for the lack of security with a premium interest rate, which actually enhances the estate planning utility of the trust by increasing the transfers to younger generations. But if that means that the premium interest rate renders the security “adequate,” then this technique can’t work. And it is hard to tell what rate of interest, if any, would avoid the estate tax risk created by a lack of security which by statute (section 675(2)) is not “adequate.”
  - (c) Actual borrowing of trust funds by the grantor (section 675(3)) is hard to reconcile with the installment sale. Borrowing by the grantor would presumably be nominal compared to the amount of the trust’s installment sale note, and might simply be an offset against that note. Often the trust will have no other assets to lend.
  - (d) The powers to vote stock (section 675(4)(A)) and control investments (section 675(4)(B)) are limited to certain control situations, and in any event they raise issues under sections 2036 and 2038, especially section 2036(b).
- (4) Certain spousal rights or powers. Sections 672(e) & 677(a).
- (a) The ability to qualify a trust as a grantor trust by making the income (or even a reversion) payable to the grantor’s spouse (section 677(a)(1) & (2)) is intriguing. The gift tax marital deduction is not a consideration, because it is not desirable to subject the trust corpus to estate tax when the spouse dies.

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- (b) Grantor trust status achieved through the grantor's spouse evidently survives divorce (section 672(e)(1)(A)), but it does not survive the spouse's death (and other scenarios such as annulment are unclear). For that reason, and because it is not available to single people at all, this technique is unreliable.
- (5) Power of an independent trustee or other independent person to add beneficiaries and cause a distribution to be made to them, under section 674, which states in part:
- (a) General rule. The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.
- ...
- (c) Exception for certain powers of independent trustees. Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—
- (1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or
- (2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).
- A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.
- (a) This is the feature most frequently used by those who are concerned about the 2036/2038 implication of a section 675(4)(C) substitution power.
- (b) The reason for specifying an "independent" trustee (or other person) is to avoid an "adverse party," whose consent would prevent the power from rendering the trust a grantor trust. Section 674(a). An "adverse party" is a person with a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power. Section 672(a). Nearly any beneficiary's interest would be adversely affected by the addition of new beneficiaries and a distribution to them.
- (c) The reason for specifying the **addition** of beneficiaries is that it is essential to **fail** to "qualify" for any of the exceptions in section 674(b) and (c).
- i. In general, section 674(a), by its terms, will not be triggered by a "sprinkle" or "spray" power held only by an adverse party, and section 674(c) will prevent section 674(a) from being triggered if such a power is held by a nonadverse party.
- ii. Section 674(c) does not apply when the grantor or the grantor's spouse is a trustee or when more than half of the trustees are "related or subordinate parties who are subservient to the wishes of the grantor." But it is awkward to rely on the identity of trustees for grantor trust status, because the grantor's service as trustee can create or aggravate estate tax problems, and other trustees can die or become incompetent (while corporate trustees are generally not related or subordinate or subservient) or can simply resign. It can also artificially limit the recruitment of capable trustees.
- iii. On the other hand, the flush language in section 674(c) provides that the exceptions in that subsection do not apply when someone has the power to **add** to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, other than to provide for after-born or after-adopted children.

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- (d) The reason for specifying that the power to add beneficiaries include the power to cause a **distribution** to be made to them is that section 674(a) is triggered only by a “power of disposition.”
- i. If an independent trustee has the power to add beneficiaries to a discretionary trust, but the consent of a cotrustee, who might be an adverse party, is required to actually make a distribution, the power might not go far enough to ensure grantor trust status. **It is important not only to fail to qualify for the exceptions in sections 674(b) and 674(c), which often get most of the attention, but also to trigger the general rule of section 674(a) itself.**
  - ii. On the other hand, if an independent trustee or other nonadverse party has the power to add beneficiaries other than to provide for after-born or after-adopted children, section 674(a) might still be triggered if other trustees, without the consent of an adverse party, hold a power of disposition over trust corpus or income that is not covered by one of the exceptions in section 674(b) (powers subject to a standard, exercisable only by will or after an event, limited to charities, affecting only timing of distributions, and so forth). **But, as stated above, grantor trust status that depends on the identity of trustees from time to time can be fragile and unpredictable.**
- (e) The beneficiaries that might appropriately be added by an independent trustee or other independent person in “violation” of section 674(c) are spouses (or companions) of descendants, their ancestors or siblings (*i.e.*, a descendant’s in-laws), their siblings’ descendants (*i.e.*, a descendant’s “nieces” and “nephews” by marriage), their descendants (*i.e.*, a descendant’s stepchildren), and charitable organizations.
- i. In the case of a power to add spouses or in-laws, such a power can permit the trustee to avoid the hardship that might otherwise result when a descendant who is dependent largely on the trust for support dies, perhaps at a relatively young age, leaving a spouse without support. This result is aggravated when there are no descendants who could otherwise become successive beneficiaries. In the case of a power to add charities, such a power can have significance, when, for example, it is contemplated that the trustee will shift the beneficial interest away from a descendant or other beneficiary who engages in some conduct that the grantor presumably would want to discourage.
  - ii. In drafting any standards for adding beneficiaries, though, care must be taken to avoid simply designating the class in the instrument and, in effect, taking away the trustee’s discretion to “add” beneficiaries that is relied on under section 674. In addition, the power to “add” beneficiaries might create too many “potential current beneficiaries” under section 1361(c)(2)(B)(v) and thereby prevent the trust from electing to be an electing small business trust (“ESBT”), if necessary, after the grantor’s death. *Cf.* section 1361(e)(2), under which unexercised powers of appointment are ignored in counting the “potential current beneficiaries” of an electing small business trust (ESBT).
  - iii. On the other hand, in Letter Ruling 201709020 (Sept. 12, 2016), the Service considered a trust in which the trustee (the grantor’s wife) had “absolute discretion” to distribute income and principal to a “Family Trust” and to any of the grantor’s descendants and also had the power to add as beneficiaries any descendant of the grantor’s parents other than the grantor. The Service ruled that the trust was an eligible S corporation shareholder “because Grantor will be treated as the owner of the Trust.”
  - iv. Presumably, the pressure is lessened when the power is held by another person, not the trustee. The power of such a person even to add after-born children would seem sufficient to make the trust a grantor trust, because the exception for a power to add after-born children in section 674(c) applies only to independent **trustees**.

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- v. Under section 674(a) itself, however, it is not enough that a person merely have the power to add beneficiaries to a discretionary trust. That person must also have the power, without the approval or consent of an adverse party, to direct a distribution to such added beneficiaries. Some estate planners, however, do not share this concern and regard this precaution as unnecessarily conservative.
  - vi. Care is needed in drafting “bomb clauses” to dispose of the trust property if there ever are no living descendants. A clause giving the trustee the power to distribute the trust property at that time to charities of the trustee’s choice might be construed as making all potential charitable distributees contingent beneficiaries of the trust already, thereby making the power to “add” charitable beneficiaries meaningless. This problem **might** be avoided by making the power to add beneficiaries clearly applicable **during** the life of the trust, not just at termination. A better approach might be to limit the charities specified in the “bomb clause” to certain purposes (which could be very broadly expressed, so long as **some** charities are left out), and giving the trustee the power to add **any** charity.
  - vii. Similarly, if the power to add beneficiaries is given to a person who is not a trustee (*e.g.*, a sibling of the grantor), care must be taken that **that person** is not in the class of persons (*e.g.*, the grantor’s heirs-at-law) who would succeed to the trust property under a “bomb clause.”
  - viii. If the power is limited to periods after the death of the grantor, then a hypothetical reversion in the grantor must exceed 5 percent of the value of the trust. Sections 674(b)(2) & 673(a). This rule, however, does not necessarily solve the problem of “bomb clauses” discussed in the preceding paragraph. Even though the likelihood that a bomb clause will take effect is probably much smaller than 5 percent, the concern persists that the trustee’s power to add charitable beneficiaries during the grantor’s life does not really allow the “addition” of beneficiaries. The 5-percent rule addresses, in effect, the present value of the trustee’s power, not the determination of who or what are already “beneficiaries.”
  - ix. The power to add charitable beneficiaries was acknowledged to render a trust a grantor trust in *Madorin v. Commissioner*, 84 T.C. 667 (1985) (holding that the trustee’s **renunciation** of that power was a deemed disposition of trust assets and a realizing event). The Service has followed *Madorin*. See, *e.g.*, Letter Rulings 9710006 (Nov. 8, 1996), 9709001 (Nov. 8, 1996), and 9304017 (Oct. 30, 1992).
- (f) Because sections 674(a) and 674(c) explicitly refer to both income and corpus, they leave no doubt that under those provisions a grantor would be treated as the owner of the **entire** trust.

c. **“Toggling” Grantor Trust Status Off and On**

- (1) The easiest type of toggle is to provide that the power that makes the trust a grantor trust terminates at the grantor’s death, if desired. Grantor trust status is no longer relevant, and there seem to be no tax issues with such a provision.
- (2) Enabling the powerholder to renounce or terminate a grantor trust power may be desirable to permit reaction to unknown financial or personal circumstances or changes in trust or tax law.
- (3) It helps if there is specific authority for the relinquishment of the power – either in the instrument or in applicable trust law.
- (4) One must face the dilemma that a trustee ordinarily would have no reason consistent with fiduciary duty to voluntarily relinquish powers that might be exercised in the future in the best interests of the trust beneficiaries. This is particularly true when an obvious result of such relinquishment would be to subject the trust or its beneficiaries to an income tax that they otherwise would avoid. Broad discretion in the trust instrument might not be sufficient to authorize the trustee to relinquish a power when there is no **reason** to do so. **Mere accommodation of the grantor does not appear to ever be a proper reason. Recent family limited partnership cases under section 2036(a) should give us pause.**

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- (5) One solution may be to provide that the trustee **acquires** a desirable power by relinquishing the power that makes the trust a grantor trust. For example—
- (a) A trust instrument with an independent trustee might provide that during the grantor's life the trustee, in general, does not have the power to vary the shares of the grantor's children (or other living descendants), perhaps on the theory that the grantor, who knows those beneficiaries, has adequately determined their shares and that the grantor, while alive, is able personally to make any necessary adjustments by other inter vivos arrangements. To allow a response to subsequent changes (for example, in a beneficiary's lifestyle), the trust instrument might give the trustee the power to divert any beneficiary's share to charity (but not to siblings or other family members), thereby rendering the trust a grantor trust by failing to qualify for the section 674(c) exception. In that way, while the grantor is alive, the trustee will escape possible badgering by family members to increase their shares.
  - (b) The trust instrument could also provide that during the grantor's life the trustee could acquire the power to vary the shares of family members, but only if the trustee irrevocably relinquishes the power to add charitable beneficiaries during the grantor's life. In that way, while the trustee would then be exposed to possible badgering by family members, at least the family members would have the assurance that the entire pot available to them would not be depleted by a diversion to charity.
  - (c) A variation, not so dependent on the provision of mandatory distributions, would be to simply allow an independent trustee, by relinquishing the power to add charitable beneficiaries, to expand the standard of distributions to family members from an "ascertainable" standard to a broader standard including such objectives as "welfare" or "happiness." **To make such a relinquishment "real," it might be desirable for such a distribution to actually be contemplated and actually be made.**
- (6) A simpler solution might be to give the power in the first place to a person who is not a trustee. It is in this light that that a power (for example, a power of substitution) held **by the grantor** can be most convenient.
- (7) Of course, if grantor trust status is terminated during the grantor's life while any part of the installment note is still unpaid, the capital gain is accelerated and taxed to the grantor at that time. *Madorin v. Commissioner, supra*; Reg. §1.1001-2(c), *Example (5)*; Rev. Rul. 77-402, 1977-2 C.B. 222. The trust would then presumably receive an adjustment to basis equal to the amount of gain recognized.
- (8) It is not completely clear whether grantor trust status is determined year-by-year in some cases, meaning that grantor trust status would continue until the end of the year in which a terminating event occurs. See, for example, the reference to "taxable year" in Reg. §1.677(a)-1(b)(2).
- (9) Toggling grantor trust status back on is more difficult.
- (a) The ability to reacquire the power may be viewed as tantamount to having the power itself. Even if the power is held by someone other than the trustee (such as a "protector"), that probably only means that the trustee and the protector together still have the power. It is tempting to provide that the relinquished power will be reinstated after the grantor's death, when grantor trust status is no longer relevant. But, in that case, the interrelationship of section 674(b)(2) and section 673 might cause grantor trust status to continue, if the value of a remainder following the grantor's death is at least 5 percent, as it almost always is.
  - (b) On the other hand, some estate planners are more comfortable with toggling off and on, for example by using the grantor's spouse as a trustee with a section 674(a) distribution power (the spouse could suspend grantor trust status by resigning and in the future could reinstate grantor trust status by being reappointed (by someone other than the grantor)) or by relying on actual borrowing of trust funds by the grantor under section 675(3).
  - (c) Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the replacement of an independent trustee with a related or subordinate party] results in taxable



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income to the grantor.” Because of the interrelationship with certain partnership transactions and section 754 basis elections, the Chief Counsel’s office viewed the overall transaction as “abusive” and wanted to explore other ways to challenge it. But it nevertheless believed that “asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.”

d. **Beneficiary Withdrawal Powers**

- (1) A holder of a *Crummey* power or other withdrawal power might be the owner of a part of a trust under section 678(a)(1). This was the result in Letter Rulings 199935046 & 199942037 (June 7, 1999) and 200011054-056 & 200011058 (Dec. 15, 1999) (the holder of a 30-day *Crummey* power treated as the owner of the trust under section 678(a)(2) after the *Crummey* power lapsed, and therefore the trust was an eligible shareholder of an S corporation under section 1361(c)(2)(A)(i)). See also Letter Ruling 200747002 (June 21, 2007) (*Crummey* power-holders treated as owners of trusts, “assuming no additional contributions are made”).
  - (a) It is sometimes thought that section 678(b) avoids this result as to **income** when the grantor is the owner of the trust, but section 678(b) does not clearly apply when a beneficiary holds a power to withdraw **corpus**.
  - (b) Moreover, the challenge facing estate planners in such cases is to determine who the “grantor” is. Specifically, when a holder of a withdrawal power has had the right to acquire trust property outright, and the original grantor holds only the power to substitute assets or even holds no power at all but is treated as the owner only by reason of a power held by an independent trustee, is the original grantor’s status as an owner robust enough to survive the intervening power of withdrawal, for purposes of determining grantor trust status?
  - (c) Section 678(a)(2) continues the powerholder’s status as owner of the trust in certain circumstances following a **release** or **modification** of a withdrawal power, but not necessarily following a mere **lapse** of a withdrawal power, as typically occurs after a short period of time in the case of a *Crummey* power. The Service reached the opposite result, however, in Letter Rulings 8142061 (July 21, 1981) and 8521060 (Feb. 26, 1985), which essentially treated a lapse the same as a release, and, in the 1999 rulings, apparently confirmed that result. The same assumption appeared in early “beneficiary defective inheritor’s trust” (“BDIT”) rulings, Letter Rulings 200949012 (Aug. 17, 2009), and 201216034 (Jan. 11, 2012). The implicit reasoning is apparently that the lapse of an unlimited power of withdrawal while a withdrawal power subject to a standard continues is in effect a downgrading of the unlimited power to a limited power and hence tantamount to a partial release.
  - (d) In addition, there has been concern that even if the powerholder is no longer treated as the **owner**, the powerholder may still have become the new “grantor” as to part of the trust, with the result that the trust is not a grantor trust at all to that extent. The most recent regulations provide that a person other than the original grantor with a withdrawal right may not become a new “grantor” of the trust, but may still be treated as the **owner** of the trust under section 678(a)(1). Reg. §1.671-2(e)(6), *Example 4*.
  - (e) In contrast, Letter Rulings 200730011 (April 25, 2007) and 200732010 (Aug. 10, 2007), citing section 678(b), viewed a *Crummey* power as having no effect on the grantor’s status as owner.
  - (f) Thus, many no longer view a *Crummey* power as a serious barrier to grantor trust status. For others, it is still impossible to be sure that the original grantor’s “owner” status revives following the lapse of the withdrawal power.
- (2) **As a result, the conservative approach is still to avoid *Crummey* powers in trusts intended to be wholly grantor trusts.**

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## 8. Structuring the Sale

### a. Assets

- (1) There are generally two types of assets that will be sold to a grantor trust in an installment sale.
  - (a) Income-producing assets which the client hopes can remain in the family. The estate planning objective is to protect those assets from erosion and jeopardy of a forced sale, caused by a large estate tax obligation. A typical example is a family-owned business.
  - (b) Any other kind of asset that is expected to outperform the interest rate on the installment note, so the buildup of value in the trust (which the sale allows the seller to avoid) exceeds the buildup in value in the seller's estate by reason of the payment or accrual of interest on the note.
- (2) Typical examples include real estate in the path of development and a business that is expected to rapidly increase in value and/or might soon go public or be acquired by a public company.
- (3) A life insurance policy can be the subject of a sale to a grantor trust, whether or not it is an installment sale. Because a purchase by the insured's grantor trust is treated as a purchase by the insured, it would avoid transfer-for-value treatment under section 101(a)(2)(B). See Letter Rulings 200247006 (Aug. 9, 2002) and 200228019 (July 12, 2002).
- (4) If the asset itself is leveraged, such as closely-held stock or a limited partnership interest, that is so much the better.
- (5) A remainder interest may sometimes be sold for its actuarially determined value. See *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996), *rev'g* 105 T.C. 252 (1995), *cert. denied*, 520 U.S. 1230 (1997); *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997); *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999), *rev'g* T.C. Memo. 1996-25. *But see* *Gradow v. United States*, 897 F.2d 516 (Fed. Cir. 1990), *aff'g* 11 Ct. Cl. 807 (Cl. Ct. 1987). See generally *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). On remand in *Magnin*, the Tax Court seemed to accept the principle of valuing the remainder at its actuarial value, but it still found that the seller had gotten the valuation wrong. *Estate of Magnin v. Commissioner*, T.C. Memo. 2001-31. Under section 2702, such remainder sales would ordinarily be limited to personal residences (where the terms of the sale are patterned after a qualified personal residence trust) and sales to non-family members such as nieces and nephews.
- (6) As in the case of a GRAT, S corporation stock is well suited to an installment sale to a grantor trust, because a wholly-owned grantor trust can be an S corporation shareholder under section 1361(c)(2)(A)(i), and because the distributions from the S corporation needed to enable the shareholders to pay income tax on the corporation's income are generally available to make payments on the note. For example, if the grantor owns 100 percent of the stock of an S corporation and sells 10 percent of it to a grantor trust, and the income tax on the corporate earnings is \$100,000, then the grantor (now a 90-percent owner) might receive \$90,000, and the trust would receive \$10,000, which it could use to make a payment on the installment note, giving the grantor \$100,000 to pay the income tax.
- (7) But a purchase of stock **from** an S corporation is not the same as a purchase from the grantor/shareholder. An S corporation is a pass-through entity for income tax purposes, but it is not disregarded, as a grantor trust is under Rev. Rul. 85-13.
- (8) If the grantor's estate may be eligible for special tax treatment under sections 303, 2032A, or 6166, attention should be paid to the effect of the sale on that eligibility, as with any major transfer.

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b. **Documentation**

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

c. **Use of a "Defined Value Clause"**

- (1) Just as in the days when one could drive into a gas station and ask for "five dollars' worth of regular," without specifying the number of gallons, there is an intuitive notion that a donor ought to be able to make a gift of any stated amount expressed in the form of "such interest in X Partnership ... as has a fair market value of \$13,000." In fact, the IRS explicitly approved that very formulation in Technical Advice Memorandum 8611004 (Nov. 15, 1985). Citing Reg. §25.2512-3, the technical advice memorandum made the common-sense observation that "the fractional portion of the partnership that is attributable to each gift is determined by the relation of the stated fair market value of each gift to the fair market value of the entire partnership (valued at the time of each gift), the fair market value of the entire partnership being determined according to recognized valuation principles." See McCaffrey & Kalik, "Using Valuation Clauses to Avoid Gift Taxes," 125 Tr. & Est. 47 (1986); Peterson, "Savings Clauses in Wills and Trusts," 13 Tax Mgt. Est., Gifts & Tr. J. 83 (1988).
- (2) A drawback of such clauses is frequently the fact that the entitlement to and taxation of future distributions is left ambiguous. This is arguably less of a concern in a grantor trust, where all of the income from both the transferred property and the retained property is going to be taxed to the grantor anyway, probably for a term that extends beyond the gift tax statute of limitations.
- (3) A more serious concern is that since 1985 the IRS has discovered (or decided) that a "defined value clause" might run afoul of the "public policies" articulated by the Court of Appeals for the Fourth Circuit in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944).
- (4) In *Knight v. Commissioner*, 115 T.C. 506 (2000), the Tax Court disregarded the use of such a technique to transfer "that number of limited partnership units in [the partnership] which is equal in value, on the effective date of this transfer, to \$600,000." It was generally believed, however, that that result in *Knight* could have been avoided if the taxpayers had acted more consistently and carefully. Despite the apparent attempt to make a defined-value gift, the gifts shown on the gift tax return were stated merely as percentage interests in the partnership (two 22.3 percent interests on each return). Moreover, the taxpayers contended in court that such interests were actually worth **less** than the "defined value."

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- (5) Field Service Advice 200122011 (Feb. 20, 2001) addressed the facts generally known to be those at issue in *McCord v. Commissioner*.
- (a) Facts as stated in the Field Service Advice.
- i. The taxpayers had created a partnership with their sons, receiving limited partnership interests in exchange for their contributions. The taxpayers then gifted the limited partnership interests to GST tax-exempt trusts for their sons, their sons directly, and two charities.
  - ii. The partnership interest received by each donee was determined by formula: The trusts received partnership interests equal to the donors' remaining GST exemption. The sons received, directly, partnership interests equal to a fixed dollar value above the amount passing to the trusts. One charity received a fixed dollar amount above the amount transferred to the sons' trusts. All remaining value (if any) was allocated to the other charity. Thus, if the Service increased the value of the transferred partnership interests on audit, the increase would automatically pass only to this charity.
  - iii. The sons agreed to assume any gift tax liability imposed on the donors as a result of the transfer.
  - iv. The partnership interests were subject to a call provision. Approximately six months after the transfers, the partnership redeemed the charities' interests at fair market value, determined by a subsequent appraisal. Upon redemption, the charities executed releases acknowledging payment in full and releasing the partnership from "any and all obligations, including, but not limited to (1) any and all obligations pursuant to the call agreement and (2) any and all obligations pursuant to the [partnership agreement]."
- (b) Arguments.
- i. On examination, the Service increased the value of the partnership interests.
  - ii. The taxpayers argued that if the increase was sustained, an offsetting charitable deduction should be allowable because the formula clause would allocate that increase to charity. The Service disallowed any offsetting charitable deduction, noting that nothing in the partnership agreement or the releases provided a mechanism for the charity to obtain any additional consideration for its redeemed interest in the event the value of the transferred partnership interest was redetermined. As a result, the charity had no right to anything other than the cash it actually received. Any increase in value accrued to the benefit of the sons alone.
  - iii. The Service also refused to respect the valuation clause, citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The Service acknowledged that the valuation clause in question was not identical to the valuation clause in *Procter*, because it was a "formula" clause that defined how much was gifted to each donee, while *Procter* involved a so-called "savings" clause which provided that a gift would be "unwound" in the event it was found to be taxable. Nevertheless, the Service believed the principles of *Procter* were applicable, because both types of clause would recharacterize the transaction in a manner that would render any adjustment nontaxable.
- (c) Clearly, FSA 200122011 demonstrated that the Service has little use for the distinction between "formula" valuation clauses and *Procter*-like "savings" clauses that "unwind" the gift. If the valuation clause results in no additional gift tax, under the reasoning of FSA 200122011 the Service will ignore it.
- (d) When *McCord* itself was decided by the Tax Court, the court essentially avoided the formula issue by seizing on the fact that the assignment document had used only the term "fair market value" not "fair market value as determined for federal gift tax purposes." *McCord v. Commissioner*, 120 T.C. 358 (2003). See the discussion of the Fifth Circuit's reversal of the Tax Court in paragraph (9) below.

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(6) Technical Advice Memorandum 200245053 took the dialogue over defined-value clauses to the next level.

(a) Facts.

- i. The taxpayer, as trustee of an irrevocable trust, and her three children formed a family limited partnership. The trust received a 0.85 percent general partnership interest and a 99 percent limited partnership interest. Each of the three children received a 0.05 percent general partnership interest. The trust contributed cash, publicly traded securities, and real estate in exchange for its interests, and the children contributed cash in exchange for general partnership interests.
- ii. At the same time as the limited partnership was created, the taxpayer created another irrevocable trust for the benefit of her descendants with herself as trustee. To make it a grantor trust, the children were given rights to acquire trust property by substituting assets of equivalent value.
- iii. Finally, as trustee of the first irrevocable trust, the taxpayer made a gift of a 0.1 percent limited partnership interest to the new irrevocable trust. In addition, the taxpayer sold a **fractional share** of the first trust's remaining 98.9 percent limited partnership interest to the second trust. The sales agreement defined the term "Purchase Price" as the value determined by an appraisal of the 98.9 percent limited partnership interest made as soon as practical after date of the sale. The sales agreement defined **the fractional share** sold as follows:

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

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

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

(b) Arguments.

- i. The taxpayer argued that *Procter* and similar precedents were distinguishable because in this case some small tax could result if the Service successfully contested the value of the 0.1 percent gift. The taxpayer also argued that the Service has sanctioned the use of "valuation formula clauses" in other situations, such as testamentary marital deduction formula clauses and retained annuity formulas in GRATs.

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- ii. The Service concluded that the gift and the sale were part of an integrated transaction, with only an insignificant portion of the transaction placed at issue (meaning subject to gift tax) in an effort to circumvent the case law. In addition, the Service stated that marital deduction formula clauses are necessary to take advantage of “Congressionally authorized” benefits, and that formulas to define retained annuities in GRATs, which are authorized in Reg. §25.2702-3(b)(1)(ii)(B), are also a practical method to enable a donor to take advantage of a “Congressionally approved” mechanism for transferring a remainder interest in trust property. (It seemed not to occur to the Service to regard the gift tax annual exclusion, the gift tax unified credit, or the adequate consideration exception as “Congressionally authorized.”)
- (7) Next came Technical Advice Memorandum 200337012 (May 6, 2003).
- (a) This TAM considered an assignment, which said: “Assignor desires to transfer as a gift to Assignee that fraction of Assignor’s Limited Partnership Interest in Partnership which has a fair market value on the date hereof of \$a.”
- (b) The TAM goes on to say that on the gift tax return the taxpayer reported the gift as an “e% interest,” valued at “\$b, an amount equal to \$5,000 less than \$a.”
- (c) The Service, citing *Procter*, rejected this attempted use of a value definition. The Service concluded:
- Taxpayer argues that Paragraph B is distinguishable from the clauses in *Proctor* [sic] because Paragraph B is purportedly a “definitional clause,” not a “formula clause.” A different label does not nullify the effect Paragraph B would have on the gift. The Taxpayer argues that “the donor gets nothing “back” as he never intended to transfer any interest beyond that having a value of \$a.” However, pursuant to the assignment, Trust received an e% interest in Partnership from Taxpayer. If Paragraph B is given effect and the value of the e% interest, as finally determined by the Service, is greater than \$a, a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in *Proctor* [sic] and *Ward* conclude are void as contrary to public policy. Accordingly, in conclusion, Paragraph B is void as contrary to public policy and the Service will make adjustments to the gift tax on the Year 1 return to reflect the value of the e% interest, as finally determined by the Service.
- (8) In the settlement of the widely discussed Tax Court case of *Karmazin v. Commissioner*, Dkt. No. 2127-03 (stipulated decision entered Oct. 15, 2003), the parties agreed that the defined-value clause (“that number of units equal to a value of \$\_\_\_\_\_”) was invalid for purposes of the settlement.
- (9) *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev’g* 120 T.C. 358 (2003).
- (a) This well-known case involved Charles T. McCord, Jr. (then deceased) and his wife Mary S. McCord, of Shreveport, Louisiana. On June 30, 1995, the McCords created a partnership with their sons, McCord Interests, Ltd., L.L.P. (“MIL”), receiving Class A and Class B limited partnership interests in exchange for their contributions. The Class B interests held a “put right” to withdraw from MIL prior to MIL’s stated termination date of December 31, 2025, and upon withdrawal would receive the fair market value of that Class B interest, determined without regard for the put right itself. All MIL interests transferred to a charity were subject to a “call right” in MIL to repurchase the interest at fair market value. The MIL partnership agreement was amended and restated in mid-October 1995, effective November 1, 1995. On November 20, 1995, the McCords gave their Class A MIL interests to a school foundation, and all partners joined an agreement providing that the foundation would become a Class A limited partner.
- (b) On January 12, 1996, the McCords made gifts of their Class B interests in MIL, accomplished by means of an “Assignment Agreement” that used what the Fifth Circuit later described as a “sequentially structured ‘defined value clause’”:
- i. to four generation-skipping trusts, the dollar amount of fair market value in interest in MIL equal to the donors’ remaining GST exemption, on a net gift basis,

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- ii. to the donors' four sons, \$6,910,932.52 of fair market value in interest in MIL, less the amount given to the generation-skipping trusts, on a net gift basis,
  - iii. to the Shreveport Symphony, \$134,000 of fair market value in interest in MIL, and
  - iv. to the Community Foundation of Texas, the remaining dollar amount of interests in MIL.
- (c) In March 1996, on the basis of an appraisal by Will Frazier of Howard Frazier Barker Elliott (now Stout), all the donees of the January gifts executed a "Confirmation Agreement" that translated their gifts into percentage interests in MIL. The percentage interest of the Community Foundation of Texas, which was represented by its own counsel, was confirmed to be 3.62376573 percent, meaning that every step in the Assignment Agreement had been given effect. The McCords each reported taxable gifts of about \$2.2 million..
- (d) On examination, the Service roughly doubled the value of the partnership interests. In Field Service Advice 200122011 (Feb. 20, 2001), the Service acknowledged the taxpayers' argument that if that increase in value were sustained, an offsetting charitable deduction should be allowable because the formula clause would allocate that increase to charity. The Service disallowed any offsetting charitable deduction, noting that nothing in the partnership agreement or the Confirmation Agreement provided a mechanism for the charity to obtain any additional consideration for its redeemed interest in the event the value of the transferred partnership interest was redetermined. As a result, the charity had no right to anything other than the cash it actually received. Any increase in value accrued to the benefit of the sons alone.
- (e) The Service also refused to respect the valuation clause, citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The Service acknowledged that the valuation clause in question was not identical to the valuation clause in *Procter*, because it was a "formula" clause that defined how much was gifted to each donee, while *Procter* involved a so-called "savings" clause that provided for a gift to be "unwound" in the event it was found to be taxable. Nevertheless, the Service believed the principles of *Procter* were applicable because both types of clauses would recharacterize the transaction in a manner that would render any adjustment nontaxable. (See also TAMs 200245053 and 200337012.)
- (f) When *McCord* was decided by the Tax Court, a majority of the court sided largely with the IRS, finding that the taxable gifts by each of the McCords was about \$4.7 million. The majority came to this result, after determining the fair market value of the transferred interests, by applying the percentages in the Confirmation Agreement, even though they had been agreed to about two months after the actual gifts. The court avoided the formula issue, stating: "Had petitioners provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes, we might have reached a different result. However, that is not what the assignment agreement provides." 120 T.C. at 397.
- (g) In a widely discussed and debated decision, the Fifth Circuit reversed totally, scolded the Tax Court majority soundly, and remanded the case to the Tax Court to enter judgment for the taxpayers. The court said [footnotes omitted]:

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

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

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

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

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

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

At the outset, we reiterate that, although the Commissioner relied on several theories before the Tax Court, including doctrines of form-over-substance, violation-of-public policy [the *Procter* attack], and, possibly, reasonable-probability-of-receipt, he has not advanced any of those theories on appeal. Accordingly, the Commissioner has waived them.

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

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

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

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

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

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



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- iii. Even if the court did not explicitly “bless” defined value clauses, it effectively took away, at least in the Fifth Circuit, an important tool (but not necessarily the only tool) for attacking them – namely, the ability to look at “what really happened” down the road.
- (10) So what were the planning implications of *McCord*? [The following section was written just after *McCord* was decided.]
- (a) Will the IRS agree that the Fifth Circuit has implicitly addressed defined value clauses, or will it be emboldened by the fact that the Fifth Circuit refused to explicitly bless them? The latter is almost certain.
- (b) Will *McCord* give a boost to the use of defined value clauses? In the Fifth Circuit, this seems likely. Elsewhere, it is hard to say.
- (c) If so, will donors use words like “as finally determined for federal tax purposes”?
- i. To do so might seem to increase the odds of favorable treatment in the Tax Court. But it might be most likely to annoy the IRS and provoke a court to look closely at the public policy issues largely avoided by both the Tax Court and the Fifth Circuit in *McCord*.
- ii. To “play it straight” and avoid such words would make the case most like *McCord*, improve the value of *McCord* as a precedent, further distance the transaction from the “trifling with the judicial process” that seemed to be the last straw in *Procter*, and perhaps reduce the chance of provoking a confrontation.
- iii. “Activists” who like to see things resolved will like the *McCord* model. Clients more nervous about getting a tax bill will prefer an “as finally determined” approach. The somewhat unusual fact pattern in *McCord* – especially the donors’ disengagement from the ultimate outcome and the participation of an independent charity – lends itself to the “activist” approach.
- (d) Will variations such as the use of formula disclaimers, or sales rather than gifts, be more popular or more effective? It is hard to tell.
- (e) In any event, has the Fifth Circuit delivered what clients want? If clients want a guarantee that they will not have a hassle with the IRS, *McCord* comes up short.
- (f) How can clients cope with the uncertainty of not knowing exactly what they have transferred?
- i. More than one trust with the same trustee, with joint investments authorized, might help.
- ii. In any event, grantor trusts should be used whenever possible, where all of the income from all the transferred property and even any retained property will be taxed to the grantor anyway, ideally for a term that extends beyond the gift tax statute of limitations.
- iii. Issues of GST exemption allocation need to be considered also.
- (g) Who or what should be the “pourover” recipient of any transferred property in excess of the defined value?
- i. A public charity, as in *McCord*, is ideal, but the *McCord* fact pattern might be a luxury that many clients cannot emulate.
- ii. A private foundation can be convenient, if the self-dealing shoals can be navigated.
- iii. A “zeroed-out” charitable lead annuity trust presents opportunities and challenges similar to those with a private foundation.
- iv. The donor’s spouse is a possibility, although this might just shift the gift tax exposure to the spouse. And obviously that is not much help to unmarried clients.
- v. Depending on a charitable or marital deduction always faces some risk that the very uncertainty will jeopardize the deduction. See Technical Advice Memoranda 9050004 & 9403005 (all stock owned by decedent valued as a control block for purposes of the gross

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estate, but marital bequest valued separately for purposes of the marital deduction), relying on *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (estate of a decedent who owned all the stock of a corporation entitled to prove a control premium for a 51-percent block of stock bequeathed to spouse), and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

- vi. A formula GRAT is easy to use, so long as the prohibition of Reg. §25.2702-3(b)(5) on additional contributions is not violated.
  - vii. An “incomplete gift trust” – for example, where the grantor retains a power of appointment treated as retained “dominion and control” for purposes of Reg. 25.2511-2 – is a possibility.
  - viii. The donor himself or herself is the easiest of all, and this is the default result of a simple defined value transfer – “I give/sell \_\_\_\_\_ so much of \_\_\_\_\_ as has a value of \$\_\_\_\_\_.” But then the donor can never step out of the transaction and let other parties sort out value in arm’s-length discussions, which seemed so important in *McCord*. (A CLAT, GRAT, or incomplete gift trust may present similar risks, because ultimately the limitation on the gift tax exposure depends on what comes back to the donor.)
- (h) There will be more attention to the technique of “backing into” a defined value transfer by the use of defined value disclaimers.
- i. There is support for this in Reg. §25.2518-3(d), Examples 18 & 19.
  - ii. The Service has ruled favorably in the estate tax context. See Letter Ruling 200420007.
  - iii. But at other times, the Service seems reluctant to “bless” the use of disclaimers beyond the strict terms of the examples in the regulations – and sometimes even that is difficult. [That reluctance set up the next case, *Christiansen*.]
- (11) *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff’d*, 586 F.3d 1061 (8th Cir. 2009).
- (a) In *Christiansen*, the decedent’s will left everything to her daughter (her only child), who was also her executor, with the proviso that anything her daughter disclaimed would pass three-fourths to a charitable lead trust and one-fourth to a charitable foundation the decedent had established. Her daughter disclaimed a portion of the estate, using the following language:
- Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 Dollars (\$6,350,000.00) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 (“the Disclaimed Portion”). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes.
- (b) After quoting that language of the disclaimer, the court stated: “But note especially the final phrase: ‘as such value is finally determined for federal estate tax purposes.’” In other words, the court emphasized the presence of the language the absence of which it had found significant in *McCord*.
- (c) A divided court (11-2) held the disclaimer to be disqualified to the extent of the three-fourths that passed to the charitable lead trust, because the disclaimant had not also explicitly disclaimed her contingent remainder interest in the charitable lead trust.
- (d) But the court, without dissent, upheld the disclaimer to the extent of the one-fourth that passed to the foundation. The court rejected the Service’s argument, based on *Procter*, that the valuation formula clause in the disclaimer violated public policy. The court said:

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

- (e) The Tax Court majority did not cite any of the examples in Reg. §25.2518-3(d). A dissent (on the issue of the charitable lead trust) cited Examples (8), (10), and (11) dealing with severability. No opinion cited Example (20), which states, rather on point:

A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B's disclaimer is a qualified disclaimer.

- (f) The Court of Appeals for the Eighth Circuit affirmed.
- i. The only issue before the Eighth Circuit was the validity of the disclaimer of 25 percent of the property over \$6,350,000 as adjusted for federal estate tax purposes to the private foundation. The IRS made the same two legal arguments that it had made at the Tax Court level. First, the IRS argued that because the overall value of Mother's estate was not finally determined until after the conclusion of the IRS's successful challenge of the valuation of the family limited partnerships, a transfer based upon the value "as finally determined for federal estate tax purposes" was dependent upon a "precedent event" contrary to the provisions of Reg. §20.2055-2(b)(1). Second, the IRS contended that permitting partial disclaimers of property over a fixed amount would act as a disincentive for the IRS to audit estates in which the formula disclaimers were made since no additional tax revenue would be realized if such estates were audited. Because of this disincentivizing effect, the IRS said that such disclaimers were contrary to public policy.
  - ii. In a pithy eight-page opinion, the Eighth Circuit rejected the first argument by noting that there is a difference between those post-death events that actually change the value of an asset or estate after the death of a decedent and those post-death events that are "merely part of the legal or accounting process of determining value at the time of death." The court looked at cases in which, for example, the gift to charity was dependent upon the testator's daughter dying without descendants, *Commissioner v. Sternberger's Estate*, 348 U.S. 187 (1955), or where the gift to the charity was one of the remainder of the trust and the trust's primary beneficiary could invade the principal, *Henslee v. Union Planters*, 335 U.S. 595 (1949). The Eighth Circuit also cited Reg. §20.2055-2(e)(2)(vi)(a) in which the IRS recognized that references to values as finally determined for federal estate tax purposes are sufficient for the value of a guaranteed annuity interest to be determinable as of the date of death or creation.
  - iii. The court also rejected the IRS's second argument that the Court should interpret the statutes and regulations to maximize the incentive of the IRS to challenge and audit returns. First, the role of the IRS is to enforce the tax laws, not to increase the amount of revenue. Second, there was no evidence of a clear congressional policy to maximize the incentives for the IRS to audit returns. Instead, the purpose of the charitable deduction is to encourage taxpayers to make charitable gifts. Third, the IRS was wrong in its belief that a policy of not encouraging audits would encourage executors and administrators to understate the value of assets. Instead, they are bound by state law to perform their responsibilities or otherwise face criminal or civil penalties. Moreover, charitable beneficiaries in a situation such as this would want to see the values maintained since that would give them more. The court believed that there are sufficient mechanisms in place to ensure the accurate valuation of assets.

(12) *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

- (a) Anne Petter had inherited stock of United Parcel Service of America, Inc. (UPS) from her uncle, who was one of the first investors in UPS. Her holdings in the traditionally closely-held

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UPS were ample enough that she was restricted from transferring stock during a “lock-up period” associated with an IPO. She created the Petter Family LLC (“PFLLC”), which initially was a single-member LLC “disregarded” for income tax purposes, and contributed UPS stock to it. She and her advisors then undertook to finalize the PFLLC operating agreement (including class voting, restrictions on transfer, and other refinements), and involved two of her three adult children in the process. (The other child was disabled, and she provided for him in other ways.) As the court summarizes, “[t]his was undoubtedly the most complex transaction any of the Petters had been a part of. Donna [Anne’s daughter] struggled to understand it and even hired an attorney to help her.”

- (b) Then Anne created grantor trusts for those two children and their descendants. She gave to each trust PFLLC interests defined by a formula referring to “one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor’s applicable exclusion amount allowed by Code Section 2010(c).” Three days later, in sale documents, she assigned to each trust PFLLC interests defined as “the number of Units ... that equals a value of \$4,085,190 as finally determined for federal gift tax purposes.” (That dollar amount was 9 times half of her remaining applicable exclusion amount for gift tax purposes – in other words, 9 times the amount of the gift to each trust, so that the “equity” portion represented by the gift to each trust would be 10 percent.) In exchange, she received 20-year interest-bearing notes. On each occasion – gift and sale – the documents identified a specific total number of units Anne was transferring and directed that the excess over the amount the formula assigned to the trusts would pass to two charitable community foundations. One of the community foundations was assisted by a lawyer, who participated in negotiating the terms of the transfer; among other things, she negotiated terms to assure both community foundations that they would bear no legal costs and would become members of the PFLLC rather than mere assignees, and to assure her client that safeguards would be put in place to prevent it from being exposed to unrelated business taxable income.
- (c) Although the transactions were structured on the basis of estimates of the value of the PFLLC interests, they were completed, shares were allocated, and Anne’s gift tax return was prepared, all on the basis of a professional appraisal that compared the PFLLC to closed-end mutual funds and applied an aggregate valuation discount of about 53 percent. On Anne’s gift tax return, the court said, “[s]he hid nothing.”
- (d) As the court put it, “[t]he Commissioner had several quarrels.” The IRS originally contended that the value of the LLC interests was about half again the value Anne had reported on her gift tax return, although the IRS and Anne ultimately agreed on a compromise value. While the formula clauses would have self-adjusted to prevent an increase in the gifts to the trusts in either case, the IRS of course denied the validity and effectiveness of those clauses as “contrary to public policy.”
- (e) Judge Holmes, who also wrote the majority Tax Court opinion in *Christiansen*, wrote an opinion seasoned with savvy descriptions of grantor trusts, donor advised funds, valuation discounts, and estate planning in general. The opinion begins with *Commissioner v. Procter*, 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944), *rev’g & rem’g* 2 TCM [CCH] 429 (1943), which the opinion says “became the cornerstone of a body of law regarding ‘savings clauses,’” built on the propositions that such savings clauses are invalid “conditions subsequent” and are “contrary to public policy” because they discourage collection of tax, obstruct the administration of justice, and would require courts to render unauthorized declaratory judgments. The opinion traces the case history in the Tax Court and other courts. It cites *McCord v. Commissioner*, 120 T.C. 358 (2003), *rev’d*, 461 F.3d 614 (5th Cir. 2006), where, because the formula in question operated only on the parties’ current estimates of value (*i.e.*, not values finally determined for gift or estate tax purposes), the Tax Court “did not find it necessary to consider Procter.”
- (f) Judge Holmes recalls that in *Christiansen* the Tax Court had “found that the public-policy arguments were undermined by *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966), where

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the Supreme Court warned against invoking public-policy exceptions to the Code too freely." He emphasizes that "[a]lthough *Christiansen* was a split decision on other issues [relating to the validity of the disclaimer], we were unanimous in concluding that 'This case is not *Procter*.'" *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009). Thus armed with the encouragement of the Supreme Court and the authority of a unanimous Tax Court, but faced with the IRS's determined pitched stand on the public policy issue, Judge Holmes elaborates, in a section captioned "Drawing the Line" (footnote omitted):

In *Christiansen*, we also found that the later audit did not change what the donor had given, but instead triggered final allocation of the shares that the donees received. 130 T.C. at 15. The distinction is between a donor who gives away a fixed set of rights with uncertain value – that's *Christiansen* – and a donor who tries to take property back – that's *Procter*. The *Christiansen* formula was sufficiently different from the *Procter* formula that we held it did not raise the same policy problems.

A shorthand for this distinction is that savings clauses are void, but formula clauses are fine. But figuring out what kind of clause is involved in this case depends on understanding just what it was that Anne was giving away. She claims that she gave stock to her children equal in value to her unified credit and gave all the rest to charity. The Commissioner claims that she actually gave a particular number of shares to her children and should be taxed on the basis of their now-agreed value.

Recital C of the gift transfer documents specifies that Anne wanted to transfer "940 Class T [or Class D] Membership Units" in the aggregate; she would not transfer more or fewer regardless of the appraisal value. The gift documents specify that the trusts will take "the number of Units described in Recital C above that equals one-half the \* \* \* applicable exclusion amount allowed by Code Section 2010(c)." The sale documents are more succinct, stating the trusts would take "the number of Units described in Recital C above that equals a value of \$4,085,190." The plain language of the documents shows that Anne was giving gifts of an ascertainable dollar value of stock; she did not give a specific number of shares or a specific percentage interest in the PFLLC. Much as in *Christiansen*, the number of shares given to the trusts was set by an appraisal occurring after the date of the gift. This makes the Petter gift more like a *Christiansen* formula clause than a *Procter* savings clause.

(g) In a section captioned "Public Policy Again," the opinion continues:

Because this formula clause is not sufficiently similar to that in *Procter*, we must first ask whether to apply policy arguments at all. As we noted in *Christiansen*, there is a general public policy in favor of encouraging gifts to charities. See *United States v. Benedict*, 338 U.S. 692, 696-97 (1950). And the facts in this case show charities sticking up for their interests, and not just passively helping a putative donor reduce her tax bill. The foundations here conducted arm's-length negotiations, retained their own counsel, and won changes to the transfer documents to protect their interests. Perhaps the most important of these was their successful insistence on becoming substituted members in the PFLLC with the same voting rights as all the other members. By ensuring that they became substituted members, rather than mere assignees, the charities made sure that the PFLLC managers owed them fiduciary duties....

As in *Christiansen*, we find that this gift is not as susceptible to abuse as the Commissioner would have us believe. Although, unlike *Christiansen*, there is no executor to act as a fiduciary, the terms of this gift made the PFLLC managers themselves fiduciaries for the foundations, meaning that they could effectively police the trusts for shady dealing such as purposely low-ball appraisals leading to misallocated gifts....

We could envision a situation in which a charity would hesitate to sue a living donor, and thus risk losing future donations or the donor's goodwill. However, gifts are irrevocable once completed, and the charities' cause of action most likely would have been against the trusts, rather than against Anne, since the trusts held the additional shares to which the charities laid claim.

The Commissioner himself could revoke the foundations' 501(c)(3) exemptions if he found they were acting in cahoots with a tax-dodging donor. See, e.g., sec. 503(b). And Washington's attorney general is also charged with enforcing charities' rights. See Wash. Rev. Code Ann. secs. 11.110.010, 11.110.120 (West 2006). We simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax....

Applying the Supreme Court's admonition to the second and third policy concerns in *Procter*, we find a similar lack of "severe and immediate" threat to public policy. We do not fear that we are passing on a moot case; because of the potential sources of enforcement, we have little doubt that a judgment adjusting the value of each unit will actually trigger a reallocation of the number of units between the

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trusts and the foundation under the formula clause. So we are not issuing a merely declaratory judgment.

- (h) The court noted that the Code and Regulations explicitly allow valuation formula clauses, for example to define the payout from a charitable remainder annuity trust (CRAT) or a grantor retained annuity trust (GRAT), to define marital deduction or credit shelter bequests, and to allocate GST exemption. The court expressed disbelief that Congress and Treasury would allow such valuation formulas if there were a well-established public policy against them.
  - (i) The court thus approved in all respects Anne's use of the defined value clauses. The court went on to hold that the date on which Anne was entitled to deduct the finally determined charitable contribution for income tax purposes was the date of the initial gift.
  - (j) There are several "good facts" in *Petter*, including:
    - i. a family "legacy" investment (UPS stock) which centralized holding could preserve (although the court did not stress this point);
    - ii. active participation in finalizing the PFLLC operating agreement, including the engagement of an attorney by Anne's daughter;
    - iii. active involvement of counsel for one of the charities, resulting in changes in the charity's favor that the court found material in clarifying the fiduciary duties owed to the charities;
    - iv. the involvement of trustees and LLC managers to assume those fiduciary duties;
    - v. Anne's unequivocal aggregate transfer of a specified amount of LLC, with no attempt on her part to "get anything back";
    - vi. the reliance on a professional appraisal; and
    - vii. Anne's full disclosure on her gift tax return.
  - (k) But there are questions about the scope of the ruling, including the following:
    - i. What does it mean when the court says "[w]e do not fear that we are passing on a moot case" when there is no possibility of finding a deficiency on these facts? Is it because the decision results in an increased charitable income tax deduction – which is not a deficiency but it is something?
    - ii. What if a charity were not the recipient of the gift over? Would the absence of an income tax deduction affect the "moot case" analysis? Would it reduce the importance of fiduciary duties? Would it decrease the likelihood of the vigilance residing in a third party that the court seemed to find material?
    - iii. How comfortable will estate planners be in relying on the principles reflected in *Christiansen* and *Petter* to continue to recommend transfers where not just the allocation of the aggregate transfer, but the aggregate transfer itself, is defined by a value formula?
    - iv. Curiously, in the Ninth Circuit, the Government did not argue the "public policy" element of *Procter* but relied on the argument "that part of the gifts to the charitable foundations were subject to a condition precedent – an IRS audit – in violation of Treasury Regulations 25.2522(c)-3(b)(1)," which provides that no gift tax charitable deduction is allowed for a transfer to charity that is dependent on a future act or "a precedent event" for the transfer to be effective. The Ninth Circuit rejected that argument.
- (13) *Hendrix v. Commissioner*, T.C. Memo. 2011-133, was the fourth case, after *McCord*, *Christiansen*, and *Petter*, to approve the use of a defined value clause, with the excess going to charity.
- (a) But in so doing, Judge Paris emphasized the size and sophistication of the charity, the early participation of the charity and its counsel in crafting the transaction, the charity's engagement of its own independent appraiser, the charity's fiduciary obligation to ensure that it received the number of shares to which it was entitled, and the fundamental public policy

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of encouraging gifts to charity. As a result, the opinion was a reminder that all of the defined value formula cases prior to *Hendrix* involved charity (not a return of property to the grantor or redirection of the assets elsewhere) and a warning that arm's-length negotiations with the charity might be required, or at least would be given substantial weight.

- (b) In other words, *Hendrix* warned that the use of defined value formulas affirmed in the recent cases might be narrower than first meets the eye.

(14) Then came *Wandry v. Commissioner*, T.C. Memo. 2012-88.

- (a) The donors, husband and wife, each defined their gifts as follows:

I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

[Here each donor listed their four children and five grandchildren with corresponding dollar amounts calculated to use the then \$11,000 annual gift tax exclusion for each of the nine donees and one-fourth of the then \$1 million lifetime gift tax exclusion amount for each of the four children.]

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

- (b) The donors filed gift tax returns reporting gifts of the prescribed dollar amounts, but ("[h]owever," as the court said) described the gifts as the percentage Norseman membership interests determined by an independent appraiser to correspond to those prescribed dollar amounts. On audit, the IRS held the donors to those percentage interests, revalued at higher values (which values, for purposes of the litigation, the donors agreed to).
- (c) The Tax Court (Judge Haines) rejected the Service's contention that the donors' gift tax returns were admissions of the percentage interests transferred, distinguishing *Knight* on the grounds that the gift tax returns in *Knight* had not stated dollar amounts and that the taxpayers in *Knight*, by claiming at trial that their gifts were actually worth less than the dollar amounts, had "opened the door" to the Service's argument that they were worth more, while the *Wandrys* had been consistent.
- (d) The court also rejected the Service's contention that the contemporaneous accounting entries to Norseman's capital accounts determined the amount of the gifts. The court stated that "[t]he facts and circumstances determine Norseman's capital accounts, not the other way around," and pointed out that "the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect previous years."
- (e) The court then turned to the "old issue" of public policy based on *Procter*. The court cited *Christiansen*, *Petter*, and *McCord* (but not *Hendrix*), as well as *King v. United States*, 545 F.2d 700 (10th Cir. 1976) (in which a purchase price adjustment clause was upheld by the court of appeals to which *Wandry* would be appealed, but which, because the adjustment was to the price paid in a sale, not the quantity of interest transferred, the court said was not "squarely on point"). The court stressed the now familiar "distinction between a 'savings clause', which a taxpayer may not use to avoid the tax imposed by section 2501, and a 'formula clause', which is valid. ... A savings clause is void because it creates a donor that tries 'to take property back'. ... On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value'."

(f) The court offered the following important analysis:

Respondent argues that the cases at hand are distinguishable from Estate of Petter. Rather than transferring a fixed set of rights with an uncertain value, respondent argues that petitioners transferred an uncertain set of rights the value of which exceeded their Federal gift tax exclusions. Respondent further argues that the clauses at issue are void as savings clauses because they operate to “take property back” upon a condition subsequent.

Respondent does not interpret Estate of Petter properly. The Court of Appeals described the nature of the transfers and the reallocation provision of the clause at issue in Estate of Petter as follows:

Under the terms of the transfer documents, the foundations were always entitled to receive a predefined number of units, which the documents essentially expressed as a mathematical formula. This formula had one unknown: the value of a LLC unit at the time the transfer documents were executed. But though unknown, that value was a constant, which means that both before and after the IRS audit, the foundations were entitled to receive the same number of units. Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer’s transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive.

(g) The Tax Court then applied each part of the Court of Appeals’ description in *Petter* and determined that the Wandrys’ gifts complied. Most interesting, the court said this in reference to what it analyzed as Part IV of the Ninth Circuit’s description:

Absent the audit, the foundations may never have received all the units they were entitled to, but that does not mean that part of the Taxpayer’s transfer was dependent upon an IRS audit. Rather, the audit merely ensured the foundations would receive those units they were always entitled to receive” [quoting the Ninth Circuit in *Petter*]. Absent the audit, the donees might never have received the proper Norseman percentage interests they were entitled to, but that does not mean that parts of petitioners’ transfers were dependent upon an IRS audit. Rather, the audit merely ensured that petitioners’ children and grandchildren would receive the 1.98% and .083% Norseman percentage interests they were always entitled to receive, respectively [in contrast to the 2.39% and 0.101% interest, respectively, that had been shown on the gift tax returns].

It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to “take property back”. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the [appraisal] report understated Norseman’s value. The clauses at issue are valid formula clauses.

(h) This is a fascinating comparison, because it equates the rights of the charitable foundations in *Petter* that were the “pourover” recipients of any value in excess of the stated values with the rights of the children and grandchildren in *Wandry* who were the primary recipients of the stated values themselves. In a way, the facts of *Wandry* were the reverse of the facts in *Petter*.

- i. The effect of the increased value in *Petter* was an **increase** in what the charitable foundations received, whereas the effect of the increased value in *Wandry* was a **decrease** in what the donees received. The analogs in *Wandry* to the charitable foundations in *Petter* were the donors themselves, who experienced an **increase** in what they **retained** as a result of the increases in value on audit.
- ii. Judge Haines did not explicitly acknowledge that economic equivalence, which might mean either that he overlooked it or that he viewed it as immaterial. It does not appear that he overlooked it, however, because he stated that absent the audit “the foundations [in *Petter*] may never have received **all the units** they were entitled to” (meaning the audit showed that they were entitled to **more**) but “the donees [in *Wandry*] might never have received **the proper Norseman percentage interests they were entitled to**” (meaning the audit showed that they were entitled merely to a **different** percentage, namely **less**). But that is pretty subtle.



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- iii. It is also telling that in the court's words the effect of the language in the gift documents was to "correct the **allocation** of Norseman membership units among petitioners and the donees because the [appraisal] report understated Norseman's value." Until *Wandry*, many observers had believed that the courts had approved not "formula transfers" but "formula allocations" of a clearly fixed transfer. In fact, the *Wandry* court used a variation of the word "allocate" five times to describe the determination of what was transferred and what was retained. But the "allocation" was between the donees and the original donors. "Allocation" to the donors looks a lot like **retention** by the donors, if not a way to "take property back," and thus the court might be suggesting that the time-honored distinction between "formula transfers" and "formula allocations" might not be so crucial after all. But it is a cause for concern that the court did not acknowledge that tension, but continued to use "allocation" language to justify what in economic effect defined what was **transferred** by the donors, not merely how the transferred property was allocated among donees. Again, though, the overall context and thrust of the court's analysis was that the donors had not sought "to take property back," but had merely defined what was given on the date of the gift. But that too is pretty subtle.
- (i) Nevertheless, it is hugely significant that there is now a taxpayer victory in a case that does not involve a "pourover" to charity of any excess value.
- i. As in *Christiansen* and *Petter*, the court cited *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966), for the proposition that "the Supreme Court has warned against invoking public policy exceptions to the Code too freely, holding that the frustration caused must be 'severe and immediate.'"
- ii. The court concluded by again acknowledging the absence of a charity and saying that "[i]n *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern."
- iii. Thus, *Wandry* appears to bless a simpler fact pattern that more closely conforms to the common sense "five dollars' worth of regular" approach that many observers, apparently even the IRS in 1985, have thought should work.
- (j) The IRS issued a nonacquiescence in *Wandry* on November 9, 2012. AOD 2012-004, 2012-46 I.R.B.
- i. The Action on Decision took the view that "on the date of the gift the taxpayers relinquished all dominion and control over the fixed percentage interests" because "[t]he final determination of value for federal gift tax purposes is an occurrence beyond the taxpayers' control." It went on to say that "[i]n *Petter*, there was no possibility that the transferred property would return to the donor, and thus, the court had no need to consider the extent to which the gift was complete."
- ii. Although the nonacquiescence could signal that the IRS is waiting for cases with "better" facts ("better" for the IRS, "bad" facts for taxpayers), *Wandry* itself included some facts that could have been viewed that way, including a 19-month delay for obtaining the appraisal, a description of the gifts on the gift tax returns as straightforward percentage interests without reference to the defined-value formulas, and adjustments to capital accounts rather than percentage interests as the prescribed response to changes in valuation.
- (k) The fairest summary of *Wandry* is that it was undeniably significant for extending the scope of the decided cases beyond the context of a charitable pourover. Unlike the charitable cases, where the weight of case law has now accumulated behind defined value clauses with a "pourover" to a charity that has actively monitored and participated in the transaction, *Wandry* does not represent a consistent body of Tax Court and appellate court jurisprudence, and, as even the charitable cases show, the IRS does not approve of the defined-value

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technique. Because it is also fair to speculate that many year-end 2012 gifts followed the pattern of a “*Wandry* formula,” we should not have been surprised to see subsequent cases involving *Wandry* types of defined-value transfers. But no such surge of cases materialized.

- (l) For an important analysis of limitations on the effectiveness of *Wandry* clauses, see Bramwell & Dillon, “Not Another *Wandry* Article: Real Issue With *Wandry* Formulas,” 41 Est. Plan. 3 (May 2014).

(15)A Fourth Circuit Comment on *Procter*.

- (a) In *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014), *aff’g* 140 T.C. 1 (2013), *supplemented* by T.C. Memo. 2013-154, Mr. and Mrs. Belk had claimed a charitable deduction for a conservation easement on a golf course they had constructed for use in a housing development they had built. The donors had retained the right to substitute other property to be subject to the easement, with the charity’s consent. The IRS, the Tax Court, and the Court of Appeals for the Fourth Circuit all disallowed the deduction because section 170(h)(2)(C) requires that the restriction be “granted in perpetuity” on the real property transferred.

- (b) The Fourth Circuit also considered a savings clause in the conservation easement that provided in pertinent part that the charity

shall have no right or power to agree to any amendments ... that would result in this Conservation Easement failing to qualify ... as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations.

- (c) The court noted:

The Belks properly acknowledge that “the IRS and the courts have rejected ‘condition subsequent’ savings clauses, which revoke or alter a gift following an adverse determination by the IRS or a court.” Appellants’ Br. 39 (citing *Commissioner v. Procter*, 142 F.2d 824, 827-28 (4th Cir. 1944)). They maintain, however, that the savings clause here is not a “condition subsequent” savings clause, but simply “an interpretive clause meant to insure that [the Trust] makes no amendment to the Conservation Easement ... that would be inconsistent with the overriding intention of the parties.” *Id.* The Belks are wrong.

- (d) Discussing *Procter* (“which,” the court stated, “the Belks do not suggest was incorrectly decided”) and the treatment of savings clauses in the analogous context of testamentary instruments, the court concluded that an “interpretive clause” could be useful to “help illustrate the decedent’s intent,” to “interpret ambiguous ... language,” or to “help ... indicate the testator’s intent not to give ... a disqualifying power.” But, because “the Belks’ intent to retain ‘a disqualifying power’ [of substitution] is clear from the face of the Easement[,] [t]here is no open interpretive question for the savings clause to ‘help’ clarify.” The court concluded:

Indeed, we note that were we to apply the savings clause as the Belks suggest, we would be providing an opinion sanctioning the very same “trifling with the judicial process” we condemned in *Procter*. 142 F.2d at 827. Moreover, providing such an opinion would dramatically hamper the Commissioner’s enforcement power. If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying deduction (or credit), enforcement of the Internal Revenue Code would grind to a halt.

- (e) There has understandably been a lot of curiosity about how the Fourth Circuit, which decided *Procter* in 1944, would view the issues today. *Belk* does not answer that question. In a case in which the holding of *Procter* appears not to have been challenged, the court simply found that the donors’ effort to distinguish *Procter* did not work. And, notably, the issue in *Belk* was a substantive requirement of the conservation easement statute, not valuation.
- (f) The Tax Court and other courts have cited *Belk*, and sometimes *Procter* with it, in considering substantive limitations on conservation easements, but not in the context of the valuation of gifts. See, e.g., *Wachter v. Commissioner*, 142 T.C. 140 (2014); *Balsam Mountain Investments, LLC v. Commissioner*, T.C. Memo. 2015-43; *Bosque Canyon Ranch, L.P. v. Commissioner*, T.C. Memo. 2015-130, *aff’d*, 867 F.3d 547 (5th Cir. 2017); *Carroll v. Commissioner*, 146 T.C. 196 (2016); *Ten Twenty Six Investors v. Commissioner*, T.C. Memo. 2017-115; *Palmolive Building Investors, LLC v. Commissioner*, 149 T.C. 380 (2017); *PBBM-*

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*Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (2018); *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019); *Carter v. Commissioner*, T.C. Memo. 2020-21; *Railroad Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22; *Hoffman Properties II, LP v. Commissioner*, 956 F.3d 832 (6th Cir. 2020); *Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54; *Hewitt v. Commissioner*, T.C. Memo. 2020-89; *Plateau Holdings, LLC v. Commissioner*, T.C. Memo. 2020-93; *Pine Mountain Preserve, LLLP v. Commissioner*, 978 F.3d 1200, 126 AFTR 2d 2020-6617 (11th Cir. 2020); *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354, 127 AFTR 2d 2021-2420 (11th Cir. 2021).

(16) In *Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013) (stipulated decisions entered on March 25 and 28, 2016), the Tax Court was asked to consider a sale by Donald Woelbing, who owned the majority of the voting and nonvoting stock of Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products.

(a) In 2006 Mr. Woelbing sold all his nonvoting stock for a \$59 million interest-bearing promissory note to a trust that owned insurance policies under a split-dollar arrangement with the company. Mr. Woelbing died in 2009, and the IRS challenged the 2006 sale in connection with its audit of Mr. Woelbing's estate tax return. In their Tax Court petition, Mr. Woelbing's executors described the sale as follows:

(d) In the 2006 stock sale transaction, Decedent sold all of his nonvoting stock of Carma Laboratories, Inc. to the Trust in exchange for an interest-bearing promissory note in the amount of \$59,004,508.05. The purchase price was determined by an appraisal of the nonvoting stock's fair market value by an independent appraiser, Brownstone Associates.

(e) The sale of the nonvoting stock was made pursuant to an Installment Sale Agreement, which provided that the Decedent sold stock to the Trust worth \$59,004,508.05. The Installment Sale Agreement further provided that both the number of shares of stock sold and the purchase price of \$59,004,508.05 were determined on February 28, 2006, but that Decedent and the Trust acknowledge that the exact number of shares of stock purchased by the Trust depends on the fair market value of each share of stock. The Installment Sale Agreement further provided that based on a recent appraisal of the stock, this results in 1,092,271.53 shares of stock being purchased but that in the event that the value of a share of stock is determined to be higher or lower than that set forth in the Appraisal, whether by the Internal Revenue Service or a court, then the \$59,004,508.05 purchase price shall remain the same but the number of shares of stock purchased shall automatically adjust so that the fair market value of the stock purchased equals \$59,004,508.05.

(f) At the time of the 2006 stock sale transaction and subsequently, the Trust had significant financial capability to repay the promissory note for the nonvoting stock of Carma Laboratories, Inc. without using the nonvoting stock of Carma Laboratories, Inc. or its proceeds. This substantial financial capability exceeded 10% of the face value of the promissory note.

(g) At the time of the 2006 stock sale transaction, the Trust owned three life insurance policies on Decedent's and Mrs. Woelbing's lives with an aggregate cash surrender value of \$12,635,722. All of this cash value could be pledged to a financial institution as collateral for a loan which could be used to make payments on the promissory note to Mr. Woelbing. Since Carma Laboratories, Inc. was required to continue making payments during Mr. and Mrs. Woelbing's lifetimes under the Split-Dollar Insurance Agreement, the amount of cash surrender value available for this purpose would continue to grow.

(h) At the time of the 2006 stock sale transaction, the Trust owned three life insurance policies on the Decedent's and Mrs. Woelbing's lives with an aggregate cash value of \$12,635,722, a portion of which could be accessed via policy loan or via the surrender of paid-up additions to the insurance policies that could be used to make payments on the promissory note to the Decedent. Since Carma Laboratories, Inc. was required to continue making payments during Decedent's and Mrs. Woelbing's lifetimes under the Split-Dollar Insurance Agreement, the amount of cash surrender value available for this purpose would continue to grow.

(i) At the time of the 2006 stock sale transaction, Petitioners, Paul Woelbing and Eric Woelbing, beneficiaries of the Trust, executed personal guarantees in the amount of ten percent of the purchase price of the stock.

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- (b) The IRS basically ignored the note, doubled the value of the stock on the date of the gift to \$117 million, again increased the value on the date of Mr. Woelbing's death to \$162 million and included that value in his gross estate, and asserted gift and estate tax negligence and substantial underpayment penalties. Here, in part, is what the Notice of Deficiency said:

**FEDERAL GIFT TAX (FORM 709): 2006**

...

It is determined that IRC Section 2702 requires inclusion of the entire value of non voting shares of Carma Laboratories, Inc. stock, determined under IRC Section 2512, as gifts when they were sold in 2006 to the Woelbing 1999 Irrevocable Insurance Trust in exchange for a note.

If it is determined that IRC Section 2702 does not apply, then alternatively it is determined that under IRC Sections 2511 and 2512 the donor made a taxable gift equal to the difference between the fair market value of the Carma Laboratories, Inc. shares transferred to the Woelbing 1999 Insurance Trust [\$117 million in 2006], and the note received in exchange [zero].

...

**FEDERAL ESTATE TAX (FORM 706 DATE OF DEATH: 07/06/2009**

...

It is determined that the decedent retained for a period that did not in fact end before his death, the possession or enjoyment of, or right to the income from, or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income from the Carma Laboratories, Inc. shares transferred to the Woelbing 1999 Insurance Trust, within the meaning of IRC Section 2036. Further, it has not been established that the transfer of the property to the trust was a bona fide sale for adequate and full consideration. Consequently, the fair market value of the transferred shares, at \$162,191,400 being included in the value of the gross estate in lieu of the note reported on Schedule C, item 10. IRC Section 2031.

It is determined that the decedent's transfer of Carma Laboratories, Inc. shares transferred to the Woelbing 1999 Insurance Trust constituted a transfer pursuant to which the enjoyment of the property was subject, at the time of decedent's death, to the decedent's right to alter, amend, revoke, or terminate, within the meaning of IRC Section 2038. Further, it has not been established that the transfer of the property to the trust was a bona fide sale for adequate and full consideration. Consequently, the fair market value of the assets transferred to the trust is being included in the value of the gross estate. Accordingly, the taxable estate at Schedule G is being increased by a total of \$162,191,400. IRC Section 2031.

- (c) There were other issues too, including unreported gifts in the form of checks to Mr. Woelbing's sons in 2006, totaling \$216,900, which the executors apparently conceded.
- (d) The total amount of gift tax, estate tax, and penalties at issue for both estates is \$152 million, about \$10 million less than the IRS asserted the transferred nonvoting stock was worth.
- (e) The case was settled, and stipulated decisions were entered on March 25 and 28, 2016, finding no additional gift taxes due with respect to either Mr. or Mrs. Woelbing and no additional estate tax due with respect to Mr. Woelbing's estate. It was informally reported that an agreed upward valuation adjustment in the settlement was reflected in an agreed downward adjustment in the number of shares Mr. Woelbing transferred in the 2006 sale, much as the defined value clause contemplated. In that case, the value of those shares would have been included in his gross estate, would have qualified for a marital deduction, and thus presumably would increase the size of Mrs. Woelbing's gross estate and increase the amount of estate tax owed by her estate. The settlement with the IRS probably included her executors' agreement to make or accept those changes to her estate tax return.
- (17) Tax Court petitions in another pair of "defined value" cases, *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16), were filed October 11, 2016. H.A. True III is the son of the late H.A. True Jr. and, as his father's executor, he had been the petitioner in *Estate of True v. Commissioner*, T.C. Memo. 2001-167, which involved buy-sell agreements, promissory notes, and interest rates.

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- (a) In the 2016 case, Mr. True made gifts of interests in a family business to one of his daughters and made sales of the business interests to all of his children and a trust. The transfers were valued on the basis of an appraisal from a recognized reputable national appraisal firm. The transfers to his children were subject to a “transfer agreement” with a defined value/price adjustment provision. He and his wife made the split-gift election, so any gift was treated as made one-half by each of them, which accounted for their separate Tax Court petitions.
- (b) A gift of units in the family business was made to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests is determined for federal gift tax purposes to be worth more than the anticipated \$34,044,838 amount of the gift, “(i) the ownership interest gifted would be adjusted so that the value of the gift remained at \$34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift.”
- (c) Sales of business interests were made to that daughter, the other two children, and a trust. According to the petition, the transfer agreement for the sales to his children “provided that if it is determined for federal gift tax purposes that the interests sold were undervalued . . . , the purchase price would be increased to reflect the finally-determined fair market values.”
- (d) The IRS asserted a gift tax deficiency of \$16,591,418 for each of the taxpayers. The taxpayers argued that their valuations were correct, but if the transferred interests were determined to have a higher value, no gift should result because of the price adjustment provisions in the transfer agreement.
- (e) The cases were settled in July 2018. According to the stipulated decisions filed July 9 and 6, 2018, the agreed gift tax deficiencies totaled \$4,008,643, less than one-eighth of the deficiencies the IRS had asserted. This probably means that either
- i. the IRS on reflection found the appraisal to be much more persuasive after all,
  - ii. the IRS agreed to allow the taxpayers to increase the purchase prices as the transfer agreements provided and exacted corresponding side-agreements from the taxpayers as it probably did in *Woelbing*, which would ultimately increase the taxpayers’ gross estates, or
  - iii. some combination of those two.
- (f) Another example of the IRS and the taxpayer agreeing to give effect to a formula – in this case in a GRAT – is the stipulation in *Grieve v. Commissioner*, T.C. Memo. 2020-28, discussed in Part 4.b(2)(d) above.

(18) *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40.

- (a) In *Moore*, one of the many issues involved a formula bequest in the decedent’s revocable trust to a charitable lead trust in an amount to “result in the least possible federal estate tax payable as a result of my death.” In addition, an irrevocable trust created by the decedent directed its trustee to “distribute an amount equal to the value of any asset of this trust which is includible in my gross estate for federal estate tax purposes” to that revocable trust to be distributed in accordance with its terms (which included the formula transfer to the charitable lead trust). Following the decedent’s death, the charitable lead trust apparently was funded with a substantial amount under the revocable trust’s formula transfer.
- (b) The IRS did not contest at least some of the charitable deduction claimed on the estate tax return for the formula amount left to the charitable lead trust based on values reported on the return. Thus, the initial funding of the formula charitable transfer based on values of assets and deductions reported on the return was respected, at least in part.
- (c) The issue addressed by the Tax Court was whether an **additional** charitable deduction should be allowed as a result of any increase in the value of the decedent’s estate resulting from the estate tax examination and litigation. The Tax Court (Judge Holmes) denied any

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additional charitable deduction for funds that might be transferred to the charitable lead trust pursuant to the formula clause. One basis for this result was the particular wording of the irrevocable trust transferring to the revocable trust “an amount equal to the value of any asset *of this trust* which is includible in my gross estate” (emphasis in court opinion). Noting that the dispute in the case involved mainly the taxation under section 2036 of assets not owned by the irrevocable trust, the court found that the literal language of the irrevocable trust did not transfer any additional amount to the revocable trust.

- (d) But what the court described as a “**much more general problem**” was that “[w]e have repeatedly denied charitable deductions where the donation turned upon the actions of the decedent’s beneficiary or an estate’s executor or administrator” and that “[c]haritable deductions must be ascertainable at a decedent’s date of death.” In the court’s view, whether the revocable trust would get additional funds from the irrevocable trust to transfer to the charitable lead trust was not determinable at the decedent’s death, but only after an audit that ultimately resulted in additional value being included in the gross estate. The court stated that “[f]or the exception to apply, it would have to have been almost certain that the Commissioner would not only challenge, but also successfully challenge the value of the estate.”
- (e) In *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff’d*, 586 F.3d 1061 (8th Cir. 2009) (discussed in paragraph (11) above), a sole beneficiary disclaimed all of the estate (under a fractional formula) in excess of a stated dollar amount, with the disclaimed assets passing to a charitable lead trust and foundation. The Tax Court in *Christiansen*, in an opinion also written by Judge Holmes, reasoned as follows regarding the estate tax examination contingency argument (emphasis added):

The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen’s death (other than the execution of the disclaimer [which is recognized in charitable deduction regulations])—it remains 25 percent of the total estate in excess of \$6,350,000. **That the estate and the IRS bickered about the value** of the property being transferred doesn’t mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a **settlement or final adjudication of a dispute about the past, not the happening of some event in the future**. Our Court is routinely called upon to decide the fair market value of property donated to charity—for gift, income, or estate tax purposes. And the result can be an increase, a decrease, or no change in the IRS’s initial determination.

The Eighth Circuit affirmance in *Christiansen* also emphasized that a regulation about charitable lead trusts recognizes that references to values “as finally determined for Federal estate tax purposes” are sufficiently certain to be considered “determinable” for purposes of qualifying as a guaranteed annuity interest. Reg. §20.2055-2(e)(2)(vi)(a).

- (f) But in *Moore* Judge Holmes distinguished *Christiansen* and also *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff’d*, 653 F.3d 1012 (9th Cir. 2011) (in which he also wrote the Tax Court opinion), where a gift was made of LLC units, with units up to a stated dollar value passing to trusts for the donor’s children and the excess units over that stated value passing to charity. Although both of those cases recognized formula-based transfers to charity, in *Moore* Judge Holmes wrote that in those cases “the transfer itself was not contingent on the happening of some event... [V]alue was at issue, but not whether there would be a transfer to the donee at all.” He contrasted those situations with the *Moore* facts, which he described this way (emphasis in original):

Article 5, section 2 of Moore’s Irrevocable Trust does not say that the Living Trust will receive a transfer of assets of unknown value. It says that whether the Living Trust will even receive a transfer of assets is unknown—contingent on an examination by the Commissioner. This is unlike *Estate of Christiansen*, where we *knew* the charity would get a transfer of assets, just not the value, or *Estate of Petter*, where we *knew* the charity would get some transfer of value, just not how much. Here, we *don’t know* if the charity would get any additional assets at all.

- (g) Judge Holmes’s *Moore* opinion thus draws a distinction between estate tax examinations and court determinations regarding **value** and those involving all other issues, such as what

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assets are in the gross estate or the amount of allowable deductions. In contrast, for example, classic testamentary marital deduction formula clauses traditionally take into account a wide variety of factors, not just valuation issues, to leave enough assets to a surviving spouse in order to avoid or minimize federal estate tax (analogous to the “least possible federal estate tax” formula charitable clause in *Moore*). Adjustments in estate tax examinations or litigation are taken into consideration in applying the formula marital bequest. If the formula transfer in the *Moore* case had been to a surviving spouse or marital trust, presumably the formula bequest would have been respected, assuming sufficient estate assets were available to satisfy the formula bequest. *E.g., Estate of Turner v. Commissioner*, 138 T.C. 306 (March 29, 2012) (“*Turner II*”).

- (h) Judge Holmes’s reason for making that distinction in *Moore* might lie somewhere in the facts or posture of the case that is not made clear in the opinion, which is hard to understand in some places. But in any event, he made no effort to discredit or limit the *Christiansen* and *Petter* decisions, only to distinguish them. Thus it cannot be assumed that *Moore* somehow weakens those precedents.
- (i) And the *Moore* opinion does not mention *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944), or the public policy arguments that have made *Procter* famous.
- (j) If *Moore* is appealed, the appeal would be heard by the Ninth Circuit Court of Appeals (which also approved the *Petter* defined value clause involving a formula charitable transfer).

(19) *Nelson v. Commissioner*, T.C. Memo. 2020-18

- (a) On October 1, 2008, Mrs. Nelson transferred to a family limited partnership her shares (about 27% of the common stock) of a holding company that held eight subsidiaries operating in the oil and gas business. She and her husband were the sole general partners of the FLP (collectively owning the 1% general partner interest), and she owned most of the limited partner interests (93.88%), with the balance of the limited partner interests being owned by custodianships and trusts for family members. About three months later, on December 31, 2008, Mrs. Nelson made a gift of an interest in the FLP to a trust (what has come to be referred to as a “spousal lifetime access trust,” or “SLAT”) for her husband and her four daughters. Her husband was the trustee. The gift assignment provided:

[Mrs. Nelson] desires to make a gift and to assign to \* \* \* [the trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS (\$2,096,000.00) as of December 31, 2008 \* \* \*, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

Two days later, on January 2, 2009, she sold additional limited partner interests in the FLP to the trust in return for a \$20 million note. The note provided for 2.06% interest on unpaid principal, was secured by the limited partner interest that was sold, and required annual interest payments through the end of 2017 (suggesting that it was a 9-year note – the interest rate was the mid-term AFR for January 2009, applicable for a debt instrument with a term over 3 years but not over 9 years). The sale assignment provided:

[Mrs. Nelson] desires to sell and assign to \* \* \* [the trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS (\$20,000,000.00) as of January 2, 2009 \* \* \*, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment \* \* \*.

After appraisals determined that the gift and sale equated to transfers of about a 65% limited partner interest, the partnership agreement was amended to reflect that percentage, which was then used for reporting on the FLP’s Schedules K-1 and for determining proportional cash distributions to the partners.

- (b) The IRS and the Tax Court both valued the transferred interests higher than the Nelsons’ appraisers had and rejected the Nelsons’ attempt to adjust the transfer downward in light of those higher values. The court cited the plain language of the assignments, which transferred

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interests worth specified dollar amounts “as determined by a qualified appraiser within ninety (90) days” (180 days for the sale). The court specifically distinguished the defined value precedents discussed above (*Christiansen, Petter, Hendrix, Wandry*) that had addressed transfers of property worth specified dollar amounts based on values as finally determined for gift or estate tax purposes. Thus, *Nelson* does not reject or even weaken those precedents.

- (c) The *Nelson* case, decided by the Tax Court over 11 years after the transfers, illustrates the importance of using grantor trusts for defined value transfers. In the case of a gift or sale to a grantor trust, even if the ownership percentage were to change as a result of a gift tax audit, all of the income and deductions will have been reported on the grantor’s income tax return in any event, and no corrective returns should be necessary (unless the parties wish to file corrected entity level returns to make clear the appropriate sharing of profits and losses of the entity’s owners).
- (d) But *Nelson* also illustrates a potential disadvantage of using defined value clauses. This case did not involve a defined value clause dependent on values as finally determined for gift tax purposes, so the percentage interests transferred did not have to be adjusted to reflect the values determined by the court. Instead, the court found that the Nelsons had made additional taxable gifts of about \$4.5 million. Even if they had previously used all of their unified credit, at the 2008-2009 45% gift tax rate the additional gift taxes would have been about \$2 million (plus interest). But the facts stated in the opinion indicate that an adjustment to the amounts transferred to reflect finally determined values would have reduced the value of the trust’s assets (as of the beginning of 2009) by over \$15 million. The Nelson family in hindsight may be relieved that they “lost” their argument that the assignments were defined value transfers. They may be happy to pay an additional \$2 million of gift tax in order to keep in the trust an additional \$15 million, plus subsequent appreciation and income (unreduced by income tax, which the grantor pays).

d. **Interest Rate**

- (1) The interest rate on an installment sale to a grantor trust should be the rate prescribed by section 7872(f)(2)(A) for term loans.
  - (a) The Tax Court has held that section 7872 is the applicable provision. *Frazee v. Commissioner*, 98 T.C. 554 (1992). See also *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff’d on other grounds*, 390 F.3d 1210 (10th Cir. 2004).
  - (b) But Judge Hamblen concluded his opinion in *Frazee* by stating: “We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept.” 98 T.C. at 590.
  - (c) And at times the Service has seemed to embrace a market interest rate standard. See, e.g., Letter Ruling 200147028 (issued Aug. 9, 2001; released Nov. 23, 2001).
  - (d) In the *Nelson* case discussed in paragraph c(19) above, the IRS respected a nine-year note that used the mid-term AFR, secured by the limited partner interest that was sold. The IRS did not attempt to argue that the note’s value should be discounted because the interest rate was less than a market interest rate.
  - (e) Section 7872(d)(2) provides that in a gift context (which includes a transfer to a grantor trust) the gift tax consequences of a term loan are analyzed under section 7872(b)(1). Section 7872(b)(1) treats as a transfer from the lender (the grantor/seller) to the borrower (the trust) an amount equal to the excess of the amount lent (the value of the property transferred, less any down payment) over the present value of the payments to be made under the terms of the loan. Section 7872(f)(1) defines “present value” with reference to the “applicable Federal rate” (AFR). Section 7872(f)(2)(A) defines the AFR for a term loan.
- (2) The rate prescribed by section 7872(f)(2)(A) for a term loan is “the applicable Federal rate in effect under section 1274(d) (as of the day on which the loan was made), compounded



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semiannually.” Since installment sales most often involve annual payment of interest with annual compounding, the rates under section 1274(d) for annual compounding are often used, but they will never be lower than the rates for semiannual compounding, and therefore the rates for semiannual compounding might produce a better result in some cases.

- (a) Section 1274(d)(1) divides loans into “short-term” (not over three years), “mid-term” (over three years but not over nine years), and “long-term” (over nine years). The rates to be used for such loans under various compounding assumptions for each month are published by the IRS in a Revenue Ruling released during the last half of the preceding month. The same Revenue Ruling announces the rate to be used under section 7520 for valuing annuities, life interests, term interests, remainders, and reversions.
- (b) In the case of a “sale or exchange,” section 1274(d)(2) allows the use of the rate for either of the two preceding months, if it is lower.

- i. The specific wording of section 1274(d)(2) is:

- (2) Lowest 3-month rate applicable to any sale or exchange.—

- (A) In general—In the case of any sale or exchange, the applicable Federal rate shall be the lowest 3-month rate.

- (B) Lowest 3-month rate—For purposes of subparagraph (A), the term “lowest 3-month rate” means the lowest of the applicable Federal rates in effect for any month in the 3-calendar-month period ending with the 1st calendar month in which there is a binding contract in writing for such sale or exchange.

- ii. It might seem that this “lowest 3-month rate” is available for purposes of section 7872 as well. Section 7872(f)(2)(A) incorporates section 1274(d), and section 1274(d) includes section 1274(d)(2). But the use of a lower rate for one of the two preceding months might be risky. Observe that section 7872(f)(2)(A)’s incorporation of section 1274(d)(2) refers to “the applicable Federal rate **in effect** under section 1274(d) (**as of the day on which the loan was made**),” while section 1274(d)(2)(B) defines the “lowest 3-month rate” as “the lowest of the applicable Federal rates **in effect for any month** in the 3-calendar-month period.” It appears that, for any transaction to which it applies, section 1274(d)(2) allows the use of the AFR “in effect” for any one of three months. But for each of those three months there is only one AFR “in effect.” Therefore, the AFR “in effect” referred to in section 7872(f)(2)(A) may be just one AFR, not an AFR that was “in effect” in another month. And this is even further reinforced by the uniquely specific limitation in section 7872(f)(2)(A) to “the **day** on which **the loan was made**.”

- iii. When both section 1274 (dealing with the timing and character of income recognized for income tax purposes with respect to “original issue discount” for certain debt instruments) and section 7872 were first enacted in the Deficit Reduction Act of 1984 (Public Law 98-369), this provision for using the rate from one of the previous two months was not included, and section 1274(d)(2) originally read simply:

- (2) Rate applicable to any sale or exchange.—In the case of any sale or exchange, the determination of the applicable Federal rate shall be made as of the first day on which there is a binding contract in writing for such sale or exchange.

Therefore, there was no occasion for either section 7872 or the 1984 legislative history to comment on the three-month option.

- iv. In 1985, section 1274(d)(2) was amended to read as it does now by Public Law 99-121, “An Act To amend the Internal Revenue Code of 1954 to simplify the imputed interest rates of section 1274 and 483, and for other purposes.” The 1985 act eliminated from section 1274 what had been alternative semiannual and monthly imputed interest rates, leaving only the monthly rates, a change that affected the operation of both section 1274 and 7872 because of the references to section 1274(d) in section 7872(f)(2). The conference report (Conf. Rep. 99-250, 99th Cong., 1st Sess. (Aug. 1, 1985)) described this change as follows (emphasis added):

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Under the House bill, the sole mechanism for determining the AFR will be the one currently prescribed by the temporary Treasury regulations. The alternative mechanism under present law for determining the six-month rate prescribed by the 1984 Act will be eliminated.

Under these revised rules, the AFR will be computed using the same methodology as under present law, except that the rates will be determined on a monthly basis and the rate will reflect the average yields for one-month periods. **In addition**, the AFR for a particular month may be used as the imputed interest rate for **contracts** for sales or exchanges entered into in that month and **the next two succeeding months**.

... The conference agreement generally follows the House bill.

- v. Public Law 99-121 did not amend section 7872(f)(2), although it did add a new section 7872(f)(11), relating to employee relocation loans, and a new section 7872(g), relating to loans to qualified continuing care facilities. Significantly, as enacted in 1985, section 7872(f)(11) read as follows (emphasis added):

(11) Time for determining rate applicable to employee relocation loans.—

(A) In general.—In the case of any term loan made by an employer to an employee the proceeds of which are used by the employee to purchase a principal residence (within the meaning of section 1034 [later changed to section 121 by the Taxpayer Relief Act of 1997]), the determination of the applicable Federal rate shall be made **as of the date the written contract to purchase such residence was entered into**.

(B) Paragraph only to apply to cases to which section 217 applies.—Subparagraph (A) shall only apply to the purchase of a principal residence in connection with the commencement of work by an employee or a change in the principal place of work of an employee to which section 217 applies.

- vi. This legislative history suggests the following inferences:

- Sections 7872(f)(2)(A) and 1274(d)(2) were different from the beginning, with section 7872(f)(2)(A) looking to “the day on which the loan was made” and 1274(d)(2) looking to “the first day on which there is a binding contract in writing for such sale or exchange,” a dichotomy that continues to the present day. In other words, even before the 1985 amendment, section 1274(d)(2) allowed for the use of AFRs for months **before** the transaction (if under contract), but section 7872(f)(2)(A) did not.
- The difference was not changed by the 1985 amendment, in which the reference to the AFR “in effect” for one single month in section 7872(f)(2)(A) was actually duplicated in section 1274(d)(2)(B) with reference individually to each of three single months.
- Indeed, in the 1985 amendment Congress added “the date the written contract to purchase such residence was entered into” in new section 7872(f)(11)(A), resembling section 1274(d)(2), but still left unchanged the very different reference to “the day on which the loan was made” in section 7872(f)(2)(A). In other words, Congress not only perpetuated the date-of-transaction/date-of-contract dichotomy between the wording of sections 7872(f)(2)(A) and 1274(d)(2), it introduced the same dichotomy between the wording of sections 7872(f)(2)(A) and 7872(f)(11).
- This difference might reflect the fact that in looking at section 1274 in 1985 Congress had in view arm’s-length negotiations that might have extended over several months (not the typical sale to a grantor trust by the very grantor who created it for that purpose).
- Such a contemplation of arm’s-length negotiations can be discerned in the 1985 conference report, where the writers describe the three-month option not as a two-month lookback from the formation of the contract but as a two-month look-**ahead** from “the AFR for a particular month” to “the next two succeeding months,” possibly contemplating the paradigm of settling on financial terms like interest rates while the negotiations are still ongoing. Compare Chief Counsel Advice 201939002 (issued May 28, 2019; released Sept. 27, 2019; discussed in Part 12.e(1) below), in

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which the IRS considered a “merger [that] was the culmination of ... negotiations with multiple parties,” which apparently had focused on a price or price range at some point in the negotiations before the “culmination.”

- vii. The regulations are no help. Proposed Reg. §1.7872-3(b)(4), addressing term loans, was published on August 20, 1985, before Public Law 99-121 was enacted on October 11, 1985. It merely tracks section 7872(f)(2)(A) (including the phrase “in effect on the day the loan is made”) and does not mention sales. Like most of the section 7872 proposed regulations, it has not been finalized.
- viii. The IRS has applied AFRs under section 7872(f)(2) to term loans in Letter Rulings 9408018 (Nov. 29, 1993) and 9535026 (May 31, 1995). Neither ruling mentioned the three-month option of section 1274(d)(2). One of them, Letter Ruling 9535026, signed by Branch 4 Chief George Masnik, actually discussed the 1985 legislation that created the three-month option, but still without mentioning the three-month option:

Section 7872(f)(1) provides that the present value of any payment is determined by using a discount rate equal to the applicable federal rate as of the date of the loan. In the case of term loans, the applicable federal rate is the applicable federal rate in effect under section 1274(d), compounded semiannually, as of the date the loan is made. Section 7872(f)(2)(A). Following the amendment of section 1274(d) by section 101(b)(1) of the 1985 Imputed Interest Simplification Act, Pub. L. No. 99-121, 1985-2 C.B. 367, the Commissioner prescribes equivalent rates based on compounding periods other than semiannual compounding (for example, annual compounding, quarterly compounding, and monthly compounding), to facilitate application of section 7872 to loans other than those involving semiannual payments or compounding. See Rev. Rul. 86-17, 1986-1 C.B. 377. Section 7872 generally does not apply to any loan to which section 483 or 1274 applies. Section 7872(f)(8).

- ix. Silence, of course, does not prove that the three-month option would not be allowed. It might mean only that the issue wasn’t raised. Indeed, it could also be significant that on some occasions (unlike section 7872(f)(2)(A)) Congress has **explicitly disclaimed the applicability of section 1274(d)(2)** when it has applied the section 1274 AFR for various income tax purposes. For example:
  - Section 382(f)(2) (relating to limitations on operating loss carryforwards, added by the Tax Reform Act of 1986 (Public Law 99-514)).
  - Section 453(l)(3)(B)(i)(III) (relating to installment obligations with respect to timeshares and residential lots, added as then section 453C(e)(4)(B) by the Tax Reform Act of 1986).
  - Sections 860B(c)(1) and 860E(c)(2)(C) (relating to the income taxation of an interest in a real estate mortgage investment conduit (REMIC), added by the Tax Reform Act of 1986).
  - Section 1298(d)(2)(B)(ii) (relating to the calculation of the amount of taxable income resulting from treating certain property leased by a foreign corporation as owned by that corporation, added as then section 1297(d)(2)(B)(ii) by the Revenue Reconciliation Act of 1993 (Public Law 103-66)).

All five of those Code provisions, however, may have needed such clarification, because they incorporate section 1274(d) by very general wording (“under,” “determined under,” or “as defined in”), and, unlike section 7872(f)(2)(A), do not use the phrase “in effect” or include a specific limitation such as “as of the day on which the loan was made.”

- x. Similar explicit exceptions can also be found in regulations, including the recent regulations addressing the valuation of property for purposes of the standards an eligible entity must satisfy to be a qualified opportunity fund (QOF) or a qualified opportunity zone business under section 1400Z-2, enacted in 2017. Reg. §1.1400Z2(d)-1(b)(4)(iii)(B) states (emphasis added):

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For purposes of calculating present value under paragraph (b)(4)(iii) of this section, the discount rate is the short-term applicable Federal rate under section 1274(d)(1), based on semiannual compounding, for the month in which the eligible entity enters into the lease. For purposes of the preceding sentence, the three month rule in section 1274(d)(2) **does not apply** to determine the applicable Federal rate.

In other contexts, a regulation may explicitly **affirm** the three-year option. An example is Reg. §1.482-2(a)(2)(iii)(C), which provides a safe haven interest rate for loans or advances between members of a group of controlled entities.

- xi. But if silence does not prove that the three-month option would not be allowed, neither does it provide any reassurance that the three-month option **would** be allowed. And the 1274(f)(2)/1274(d)(1) rate **for the current month** seems to best fit the precedent of *Frazer*, where, by the way, Judge Hamblen's opinion did not mention the three-year option, even though the AFRs for August 1985 were slightly **lower** than the AFRs two months later when the transfer in question occurred on October 7, 1985. Compare Rev. Rul. 85-117, 1985-2 C.B. 187 (long-term AFR with semiannual compounding of 10.45 percent for August 1985) with Rev. Rul. 85-154, 1985-2 C.B. 188 (10.55 percent for October 1985).
  - xii. In addition, some planners might simply be reluctant to rely on the existence of a "sale" as that word is used in section 1274(d)(2) (in the income tax subtitle) in the context of a transaction that is intended not to be a "sale" for income tax purposes.
  - xiii. In any event, under section 7872(d)(2) and (b)(1), the consequence (disregarding audit hassles, costs, and risks) of using an interest rate somewhat lower than the AFR that is ultimately determined to be correct is simply that an incremental taxable gift is deemed to have been made at the time of the sale. The long-term estate freeze and grantor trust benefits should not be affected.
  - xiv. For a thoughtfully articulated opposite view, concluding that the three-month option in section 1274(d)(2) is available for sales to grantor trusts, see Hesch, Gassman & Denicolo, "Interesting Questions: Interest Rates for Intra-Family Transactions," 36 Tax Mgmt. Est., Gifts & Tr. J., No. 2 (March 10, 2011).
- (c) Under section 7872(f)(2)(B), the rate for demand loans is the floating short-term rate in effect from time to time. There is also an optional "blended" rate, announced each year with the July monthly rates.
- (3) In periods of low interest rates, consideration is often given to "refinancing," or "renegotiating" a note to a lower interest rate.
- (a) The technique is generally supported in Blattmachr, Crawford & Madden, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109 JOURNAL OF TAXATION 22 (July 2008).
  - (b) Caution is advised in Feder, "The Promissory Note Problem," 142 TRUSTS & ESTATES 10 (Jan. 2003), and Hayes, "Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners," 13 CALIF. TRUSTS & ESTATES QUARTERLY 5 (2007).
  - (c) Proposed Reg. §1.7872-11(e) is labeled "Treatment of renegotiations" but is only "Reserved." The proposed regulations have been outstanding since August 1985.
- (4) Occasionally, a grantor with a power of substitution under section 675(4)(C) (described in Part VII.B.2 above) will want to reacquire a trust asset by giving the trustee a promissory note. In such cases, it is likely, in light of Rev. Ruls. 2008-22 and 2011-28, that the trust instrument requires the trustee to be satisfied "that the properties acquired and substituted by the grantor are in fact of equivalent value." (See Part 7.b(2)(i)vi above.) **This is arguably a higher standard than section 7872.** (See Judge Hamblen's comment in *Frazer* in paragraph (1)(b) above.) Thus, in such a substitution transaction, the section 7872 rate should not be taken for granted. The grantor's note should probably be appraised, which is likely to result in a higher interest rate.

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e. **Payment**

- (1) There is no requirement for a particular term for the note, but to ensure treatment as debt, conventional wisdom suggests a term no longer than 15-20 years.
- (2) Likewise, there is no requirement for any particular payment schedule. Payment of principal may balloon at the end. While there is no requirement to pay interest currently, and therefore interest may be added to principal and paid at the end, it may be most commercially reasonable to require the payment of interest at least annually (but compounded semiannually), even if all principal balloons at the end.
- (3) Attention must be paid to the fact that the grantor will be paying income tax on all the income realized by the trust (since it is, after all, a grantor trust). If the trust has extraordinary income, such as by reselling the asset, the grantor may owe a lot of income tax. A “due-on-sale” clause in the note might help, if the note is not a demand note, but neither a due-on-sale clause nor a demand note will necessarily cover tax on the appreciation that accrues after the grantor’s sale to the trust. **Generally, grantor trusts are not for those who can’t afford them.**
- (4) The sale can be structured to provide asset-protection benefits, by providing that if the trustee determines that any creditor of the grantor has obtained or is attempting to obtain a judgment that could jeopardize the grantor’s ability to benefit from the note payments, then the trustee can divert those payments to a discretionary trust for the grantor’s benefit, over which the grantor has a testamentary power of appointment, perhaps in a protective jurisdiction.

f. **Reimbursement for the Payment of Income Tax – Historically**

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

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

- (2) This paragraph was immediately controversial. One year later, the ruling was reissued with this paragraph deleted. Letter Ruling 9543049 (Aug. 3, 1995).
- (3) Nevertheless, questions remained.
  - (a) Was the italicized dictum about the result without reimbursement right?
  - (b) Did the dictum apply only to trust accounting income – *i.e.*, “income **received** by the trustee” – and not to passthrough income for income tax purposes such as a trust’s undistributed share of the income of an S corporation?
  - (c) Was such a doctrine effectively limited to GRATs, where the right to receive “fixed amounts” arguably means fixed **net** amounts and where the addition of assets to the trust is prohibited? (The Service continued to insist on reimbursement as a condition for issuing a ruling with respect to a GRAT, but has not extended this policy to other types of grantor trusts.)
- (4) Generally, it was not thought by estate planners to be necessary, and was often thought not even to be appropriate, to include this type of reimbursement language in grantor trusts in

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general, including grantor trusts to which installment sales are intended – subject, of course, to the foregoing observation about the grantor’s ability to pay income tax.

- (5) Inclusion of a reimbursement clause was thought to risk inclusion of the trust assets in the grantor’s estate. Although Reg. §20.2036-1(b)(2) provides that property is included in the transferor’s estate if its income may be applied toward the discharge of the transferor’s legal obligation (in this case, the grantor’s income tax liability), the Service occasionally ruled that such a clause did not cause inclusion under section 2036. See Letter Rulings 9413045 (Jan. 4, 1994), 9709001 (Nov. 8, 1996), 1999919039 (Feb. 26, 1999) & 199922062 (Feb. 26, 1999).
- (6) The Service likewise ruled that **permissible** reimbursement, in the discretion of someone who is independent, did not present a section 2036 problem. Letter Ruling 200120021 (Feb. 13, 2001). If such a power is held by an independent **trustee**, it would present the question of when it would ever be consistent with the trustee’s fiduciary duty to make this reimbursement to someone (the grantor) who is not a beneficiary of the trust.
- (7) The grantor’s **relinquishment** of a right of reimbursement, to toggle off grantor trust status, would arguably be an additional gift to the trust.

g. **Reimbursement for Income Tax – Currently**

- (1) Just before the Fourth of July weekend in 2004, the Service promulgated Rev. Rul. 2004-64, 2004-2 C.B. 7. The Revenue Ruling poses three situations involving “defective” grantor trusts, with a trustee who the ruling recites is required by the trust instrument not to be related or subordinate to the grantor within the meaning of section 672(c). Because the trusts are grantor trusts, the grantor is liable for the income tax on the trust income.
  - (a) In Situation 1, neither state law nor the governing instrument requires or permits the trustee to reimburse the grantor for the income tax, and the grantor pays the tax. The ruling holds that the value of the trust assets is not includible in the grantor’s gross estate.
  - (b) In Situation 2, the governing instrument **requires** the trustee to reimburse the grantor for the income tax. The ruling holds that the value of the trust assets **is** includible in the grantor’s gross estate in this case, because the grantor has retained the right to have trust assets used to pay the grantor’s obligations. The ruling states that the result would be the same if the reimbursement right flowed from state law, rather than from the governing instrument. The ruling goes on, however, to provide that it will not apply the holding of Situation 2 to trusts created before October 4, 2004.
  - (c) In Situation 3, the trustee has the **discretion** to reimburse the grantor for the income tax. The ruling holds that the value of the trust assets is not includible in the grantor’s gross estate in this case, unless the discretion is accompanied by other bad facts, which the ruling describes as “including but not limited to: an understanding or pre-existing arrangement between [the grantor] and the trustee regarding the trustee’s exercise of this discretion; a power retained by [the grantor] to remove the trustee and name [the grantor] as successor trustee; or applicable local law subjecting the trust assets to the claims of [the grantor’s] creditors.”
- (2) In all three situations, the ruling holds that the grantor’s payment of the income tax is not a gift to the trust beneficiaries, because the grantor is liable for the tax. In Situations 2 and 3, the ruling holds that the trustee’s reimbursement of the income tax is not a gift to the grantor by the trust beneficiaries, because it is made pursuant to the terms of the trust instrument.
- (3) The clarifications provided by Rev. Rul. 2004-64 were generally welcomed by the estate planning community, and the ruling seemed to reach the right results, given the historical disconnect between the income tax and estate tax rules. The grace period until October 4, 2004, was also welcomed.
- (4) Moreover, the October 2004 effective date was generally viewed as applicable for purposes of implied retained rights to reimbursement (Scenario 3) as well as explicitly retained rights to reimbursement (Scenario 2). It would be quite odd for rights that are only arguably implied to be

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treated more harshly than rights that are overtly retained, especially in light of the historical ruling positions described above. Contemporaneous reactions from Treasury and Service personnel seemed to confirm this view.

- (5) Where Rev. Rul. 2004-64 has raised eyebrows among estate planners is the requirement in its facts that the trustee must not be related or subordinate to the grantor within the meaning of section 672(c) and its somewhat expansive articulation of fact patterns that could cause estate inclusion when coupled with a trustee's discretion to reimburse the grantor for income taxes (Situation 3).
  - (a) Attempts by the Service to engraft the income tax concept of "related or subordinate" on the transfer tax originate at least from Rev. Rul. 95-58, 1995-2 C.B. 191, which revoked the extremely unpopular holding of Rev. Rul. 79-353, 1979-2 C.B. 325, that a trust would be included in the gross estate of a grantor who retained the right to remove and replace a corporate trustee with unlimited discretion over distributions with another corporate trustee. Rev. Rul. 95-58 expressly overrode the holding of Rev. Rul. 79-353 only in cases where the successor trustee could not be related or subordinate to the grantor. For the most part, the estate planning community has not accepted that restriction as a defensible gloss on the substantive law, believing instead that the only legitimate restriction of substantive law (as alluded to in the portion of Rev. Rul. 2004-64 quoted above) applies if the decedent had "the unrestricted power to remove or discharge a trustee at any time and appoint **himself**" as trustee. Reg. §§20.2036-1(b)(3) & 20.2038-1(a)(3) (emphasis added). Nevertheless, there is very little that can be done about the Service's disposition to draft Revenue Rulings narrowly in this way. It is generally recognized that Revenue Rulings like this provide only a safe harbor, and a client is free to take a more aggressive position, although many clients will prefer to avoid the risk and hassle.
  - (b) Because of concerns about includibility where an independent trustee (or another independent person) has discretion to reimburse the grantor for income tax, it is possible that after October 3, 2004, such discretion will be granted only sparingly, and will perhaps be limited to direct payments to tax authorities, not to the grantor so as to risk placing the discretion within the reach of the grantor's creditors.
- (6) Whether or not reimbursement discretion is desired, it will become more common, as a precaution, to include in trust instruments specific language negating or limiting any right of reimbursement that might be implied from applicable state law. The following are some samples:
  - (a) **Total negation of reimbursement (a good default provision):** "My Trustee may not pay, or reimburse me or my estate for the payment of, any income taxes imposed with respect to income or gains of the trust, notwithstanding any contrary rule of law."
    - i. In Letter Ruling 200944002 (July 15, 2009), the Service reasoned that "[i]n this case, under the terms of Article Twelfth, paragraph D, the trustee is prohibited from paying Grantor or Grantor's executors any income or principal of Trust in discharge of Grantor's income tax liability. Although Rev. Rul. 2004-64 does not consider this situation, it is clear from the analysis, that because the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, that Grantor has not retained a reimbursement right that would cause Trust corpus to be includible in Grantor's gross estate under § 2036. See Rev. Rul. 2004-64."
    - ii. It is surprising that Letter Ruling 200944002 would say that "Rev. Rul. 2004-64 does not consider" a prohibition on reimbursement, when Situation 1 of Rev. Rul. 2004-64 is described by stating that "[n]either State law nor the governing instrument of Trust contains any provision requiring or permitting the trustee to distribute to [the grantor] amounts sufficient to satisfy [the grantor's] income tax liability attributable to the inclusion of Trust's income in [the grantor's] taxable income." It is hard to see the difference between **prohibited** and **not permitted**. But the confirmation of Letter Ruling 200944002 is welcome.

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- (b) **Negation after a prescribed term in which estate tax is conceded:** “At no time after the expiration of the GRAT Term shall my Trustee pay, or reimburse me or my estate for the payment of, any income taxes imposed with respect to income or gains of the trust, notwithstanding any contrary rule of law.”
- (c) **Discretion in trustee:** “My Trustee [not related or subordinate under section 672(c)], in his/her/its sole discretion, may pay to the appropriate tax authorities, **or reimburse me or my estate for the payment of,** any incremental income taxes imposed with respect to income or gains of the trust. This discretion shall govern such payments or reimbursements notwithstanding any contrary rule of law.” [When there is more than one cotrustee, limiting this discretion to only one of the cotrustees is of course appropriate. If there is concern about exposing the trust assets to the grantor’s creditors, deletion of the words in bold font, and the inconvenience that such deletion would create, should be considered.]
- (d) **Discretion in someone else:** “At any time, \_\_\_\_\_ [not related or subordinate under section 672(c)], in his/her/its sole discretion, may direct my Trustee to pay to the appropriate tax authorities, **or reimburse me or my estate for the payment of,** any incremental income taxes imposed with respect to income or gains of the trust. This discretion shall govern such payments or reimbursements notwithstanding any contrary rule of law.” [If there is concern about exposing the trust assets to the grantor’s creditors, deletion of the words in bold font, and the inconvenience that such deletion would create, should be considered.]
- (7) For an ominous indication that the IRS might be trying to limit the application of Rev. Rul. 2004-64, see the discussion of Chief Counsel Advice 202352018 in Part 12.f below.
- h. **Use of a Self-Canceling Installment Note (“SCIN”)?**
- (1) There is no reason not to use an installment note that is payable until the expiration of a stated term or the death of the holder, whichever occurs first – that is, a note that “self-cancels” at the holder’s death. *See Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003) (upholding the use of a SCIN).
- (a) If such a note is used, it is important that there be a commercially reasonable interest or principal premium for that feature, bearing a reasonable relationship to the age and probably the health of the holder. (Section 7520 probably does not apply in determining the value of such contingencies.)
- (b) In addition, if such a note is used, it is important that principal and interest both be paid in level payments or in some equivalent manner.
- (2) The holding of *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992) (reviewed by the Court), *aff’d*, 998 F.2d 567 (8th Cir. 1993), that the holder’s death constitutes a disposition of the SCIN for purposes of section 453B should not be particularly important in the case of a grantor trust.
- i. **Use of a Private Annuity Instead of an Installment Note?**
- (1) The most common objection to the use of a private annuity – that it converts capital gain to ordinary income under section 72 – is not applicable to a transaction between a grantor and a grantor trust.
- (2) Nevertheless, the payments would probably have to reflect the generally higher section 7520 rates, rather than the generally lower 7872/1274 rates.
- j. **Features Advisable for Estate Tax Purposes**
- (1) The Supreme Court has held that the irrevocable assignment of rights in life insurance policies coupled with retention of annuity contracts did not subject the insurance policies to estate tax under the predecessor to section 2036. *Fidelity-Philadelphia Trust v. Smith*, 356 U.S. 274, 277 (1958). The Court based this holding on two significant observations:
- (a) The annuity payments were not linked to income produced by the transferred insurance policies.



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

k. **Equity/Down Payment/Capitalization**

- (1) As previously stated, it is well known that the Service required the applicants for Letter Ruling 9535026 to commit to trust equity of at least 10 percent of the installment purchase price.
- (2) More recently, the Service has refused to rule on proposed installment sales to “dry” trusts – *i.e.*, trusts with no other assets.
- (3) “Equity,” in the form of either a down payment or other assets to secure the loan, is usually considered a good idea. Ten percent is usually regarded as safe, although lower percentages are often considered acceptable and higher percentages are often viewed as prudent.
- (4) In the *Nelson* case discussed in paragraph c(19) above, a gift to a trust believed to be \$2,096,000 was followed by a sale of property believed to have a value of \$20,000,000. That would have resulted in “equity” of only about 9.5%. No mention was made of that in the opinion, and it cannot be determined whether that was a part of the IRS’s concerns about the transactions. Of course, after the gift component had been adjusted upward by the Tax Court, this issue disappeared.
- (5) The need for equity is very thoughtfully challenged in Hesch & Manning, “Beyond the Basic Freeze: Further Uses of Deferred Payment Sales,” 34 UNIV. MIAMI INST. EST. PLANNING ch. 16 (2000), which concludes, however: “Nevertheless, the issue is an intensely factual one, requiring a careful exercise of judgment by the estate planner, including sound advice to the client concerning the degree of risk involved, with our advice remaining that only those who are willing to take substantial risks should use a trust with no other significant assets.” *Id.* at ¶1601.1G.

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- (6) Guarantees by beneficiaries are sometimes viewed as ways to provide “equity” without a substantial taxable gift.
- (a) If the trust does not pay a fee for such guarantees, or the fee is not adequate, the guarantor might become a contributor and thus a grantor, with the result that the trust is not wholly owned by the original grantor as desired.
  - (b) A credible argument can be made, however, that the mere giving of a guarantee is not a gift, particularly by remainder beneficiaries (who otherwise would appear to just be making gifts to themselves). See Hatcher & Manigault, “Using Beneficiary Guarantees in Defective Grantor Trusts,” 92 J. TAXATION 152 (2000). Cf. Shenkman, “Role of Guarantees and Seed Gifts in Family Installment Sales,” 37 ESTATE PLANNING 3, 16-17 (Nov. 2010).
  - (c) Guarantees by the grantor’s spouse are sometimes used, relying on section 1041 to prevent the realization of gain even if there are two owners (both spouses). But section 1041 does not apply to the payment or accrual of **interest**, and the gift tax marital deduction is never assured when the gift in effect goes into a trust.
  - (d) If the *Woelbing* cases (see paragraph c(16) above) had gone to trial, the Tax Court, among other things, might have been obliged to address the possible reliance on guarantees, as well as “split-dollar” life insurance policies, to provide “equity” in the trust to support the purchase.
- (7) The intriguing alternative of making the “equity” portion of the trust an incomplete gift through retention of a limited power of appointment was outlined in Dunn, Such & Park, “The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts,” 34 ESTATE PLANNING 39 (2007). Others critique that approach and conclude that it “should be considered risky.” Mulligan, “Fifteen Years of Sales to IDITs—Where Are We Now?” 35 ACTEC JOURNAL 227, 231 (2009) (a thoughtful and important retrospective by the lawyer who obtained Letter Ruling 9535026).
- (8) For some, the surge of gift-giving in generation-skipping grantor trusts in 2012 produced a pool of “equity” in those trusts. If an advisor followed the convention of providing at least 10 percent “equity” in the structure, gifts by a married couple totaling \$10.24 million (in 2012) would have provided a fund that could support a purchase of property with a value of \$92.16 million, for a total transfer of \$102.4 million.
- (9) The risks created by “thin capitalization” are
- (a) includibility in the gross estate under section 2036,
  - (b) a gift upon the cessation of section 2036 exposure,
  - (c) applicability of section 2702 to such a gift,
  - (d) the creation of a second class of equity in the underlying property with possible consequences under section 2701,
  - (e) possible loss of eligibility of the trust to be a shareholder of an S corporation,
  - (f) treatment of the trust as a partnership (or possibly even an association taxable as a corporation),
  - (g) continued estate tax exposure under section 2035(a) for three years after cessation of section 2036 exposure, and
  - (h) inability to allocate GST exemption during the ensuing ETIP.

The section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but, because of the ETIP problem, the trust still might not be fully GST tax-exempt.

- (10) If the grantor’s gift to the trust to equip it to pay the down payment is followed too closely (for example, at the same time!) by the installment purchase, there might be some concern that the

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transaction would be collapsed and recharacterized as a part-sale and part-gift, although that might not make an overall difference.

- (11) On the other hand, in *Estate of Malkin v. Commissioner*, T.C. Memo. 2009-212, the court found that a “purported installment sale of ... limited partnership interests [to a trust created by the seller] was a sham,” when at the time the sale contract was signed the grantor (who was terminally ill, by the way) had not transferred any assets to the trust to empower it to pay the contemplated down payment.
- (12) While the Step Transaction Doctrine is often mentioned as a concern, a close look at the judicial roots of the Step Transaction Doctrine suggests that it is probably being misapplied in most estate planning contexts. For example:
- (a) “The step transaction doctrine is in effect another rule of substance over form....” *Penrod v. Commissioner*, 88 T.C. 1415, 1328 (1987).
  - (b) “A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit. The controlling principle will be found in *Gregory v. Helvering*, 293 U.S. 465, 469, 470, 55 S. Ct. 266, 267, 79 L. Ed. 596, 97 A.L.R. 1355; and applying that principle here, the judgment of the court below is affirmed.” *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 19 AFTR 1258, 1260, 58 S. Ct. 393, 82 L. Ed. 474 1260 (1938).

## 9. Advanced Installment Sale Applications

- (1) After a grantor trust has purchased property from the grantor, there is no reason, if done in a commercially reasonable manner, that the grantor cannot **lease** the property back from the trust, thereby minimizing the disruption in the grantor’s use of the property while still removing the appreciation in the property from the grantor’s gross estate.
- (2) When a grantor trust that has made an installment purchase becomes “in the money” – *i.e.*, when the cash flow from the investment exceeds the debt service and/or permits the debt to be paid off – the trust can use that cash as the down payment in buying more of the asset on an installment basis, without additional funding by the grantor. Such purchases may, of course, be at a higher price reflecting the growth in value of the investment.
- (3) If a grantor trust purchases the grantor’s right to the retained annuity in a GRAT, the appreciation represented by assets that the GRAT distributes in kind in satisfaction of its annuity obligation will not accumulate in the grantor’s estate, and the payback at the 7520 rate will, in effect, be converted to a lower payback at the 7872 rate.

## 10. Tax Treatment of the Installment Note at the Grantor’s Death

### a. Income Tax Treatment

- (1) If the grantor/seller/note-holder dies before the note is fully paid off, the Service may argue that that causes a realization of the grantor’s gain, to the extent the note is unpaid.
  - (a) That would arguably be similar to the realization that occurs when a grantor cures the defect or renounces the power that causes the trust to be a grantor trust. *Madorin v. Commissioner*, *supra*; Reg. §1.1001-2(c), Example (5); Rev. Rul. 77-402, 1977-2 C.B. 222. It would be no more aggressive than the Service’s argument that the death of the holder of a SCIN causes a realization. *Estate of Frane v. Commissioner*, *supra*. (Both the Service’s argument and the courts’ holdings are open to serious question; this writer believes that *Frane* was wrongly decided.)

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- (b) Cf. Technical Advice Memoranda 200010010 (Nov. 23, 1999) and 200011005 (Nov. 23, 1999), where the Service took the position that the grantor of a GRAT realized income in the amount of the GRAT's borrowing (from third parties) outstanding when the GRAT ceased to be a grantor trust. (This result could apparently have been avoided if the grantor had bought the assets from the GRAT before the end of the term, or in any event if the GRAT had continued as a grantor trust for income tax purposes after the end of the GRAT term.)
- (c) In Letter Ruling 200434012 (April 23, 2004), involving a sale from one grantor trust to another, the Service included the caveat that "when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 by reason of A's death or the waiver or release of any power under § 675, no opinion is expressed or implied concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), a change in the basis of any property under § 1012 or § 1014, or any deductible administration expense under § 2053."
- (2) At first it might have been assumed, without much analysis, that this would be the result – perhaps on some type of IRD theory.
- (3) But in 1999, a thoughtful and rigorous article, reflecting considerable peer review, plowed new ground in articulating the argument that there should **not** be such realization at death. Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999).
- (a) The argument is that **for income tax purposes**, under Rev. Rul. 85-13, there is no transfer of the underlying property to the trust while the trust is a grantor trust. Therefore, **for income tax purposes**, the transfer to the trust occurs at the grantor's death. But there is no rule that treats a transfer at death as a realization event for income tax purposes, even if the transferred property is subject to an encumbrance, as the property here is subject to the unpaid installment note. See Rev. Rul. 73-183, 1973-1 C.B. 364 (transfer of stock of a decedent to the decedent's executor held not to be a disposition within the meaning of section 1001(a)). Thus, there is no gain realized on the property in the trust. Because, **for estate tax purposes**, the property is not included in the decedent's gross estate, it does not receive a new basis under section 1014.
- (b) Since the note is included in the decedent's gross estate, it receives a new basis – presumably a stepped-up basis – under section 1014, unless it is an item of income in respect of a decedent ("IRD") under section 691, which is excluded from the operation of section 1014 by section 1014(c). Since the fact, amount, and character of IRD are all determined in the same manner as if "the decedent had lived and received such amount" (section 691(a)(3); cf. section 691(a)(1)), and since the decedent would not have realized any income in that case (Rev. Rul. 85-13), there is no IRD associated with the note. Thus, the note receives a stepped-up basis, and the subsequent payments on the note are not taxed.
- (c) Confirmation of this treatment is seen in sections 691(a)(4) & (5), which set forth rules specifically for installment obligations "reportable by the decedent on the installment method under section 453." In the case of installment sales to grantor trusts, of course, there was no sale at all for income tax purposes, and therefore nothing to report under section 453.
- (d) This is not unreasonable, since the income tax result is exactly the same as if the note had been paid before the grantor's death – no realization – which fulfills the policy behind section 691.
- (e) Moreover, if the unpaid portion of the note were subject to income tax on the grantor's death, the result would be double taxation, because the sold property, being excluded from the grantor's estate, does not receive a stepped-up basis.
- (4) Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the

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replacement of an independent trustee with a related or subordinate party] results in taxable income to the grantor.”

- (a) After citing and discussing *Madorin* and Rev. Rul. 77-402 (which addressed the reverse conversion to nongrantor trust status), the Chief Counsel’s office noted (emphasis added) that “the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner **which is generally not treated as an income tax event.**”
  - (b) Because of the interrelationship with certain partnership transactions and section 754 basis elections, however, the Chief Counsel’s office viewed the overall transaction as “abusive” and wanted to explore other ways to challenge it. But it nevertheless believed that “asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.”
- (5) The debate continued. *See, e.g.*, Cantrell, “Gain Is Realized at Death,” TRUSTS & ESTATES at 20 (Feb. 2010); Gans & Blattmachr, “No Gain at Death,” TRUSTS & ESTATES at 34 (Feb. 2010).
  - (6) Some reinforcement of the “death of the owner ... is generally not treated as an income tax event” statement in Chief Counsel Advice 200923024 may be seen in Reg. §1.1400Z2(b)-1(c)(4)(i), which specifies that a transfer of a qualifying investment in a qualified opportunity fund (QOF) (a corporation or partnership that has at least 90 percent of its assets invested in qualified opportunity zone property) by reason of the investor’s death is **not an “inclusion event”** that accelerates the gain deferred under section 1400Z-2 (which was added to the Code by the 2017 Tax Act). The QOF, context however, is different (including an explicit incorporation of the rules of section 691 governing income in respect of a decedent into section 1400Z-2(e)(3)).

b. **Estate Tax Treatment**

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

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see no reason why the estate tax value should not be fair market value, which, after all, is the general rule, subject to Reg. §20.2031-4.

- (c) Reg. §20.2031-4 states that “[t]he fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.”
- (5) Judge Tannenwald distinguished between “how” regulations and “whether” regulations in *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996). Section 2663(2) provides that “[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this chapter, including ... regulations (consistent with the principles of chapters 11 and 12) providing for the application of this chapter [the GST tax] in the case of transferors who are nonresidents not citizens of the United States.” This, Judge Tannenwald held, refers to a “how” regulation that is not a necessary condition to the imposition of the GST tax on transfers by nonresident aliens. A similar result with reference to the phrase “under regulations” was reached in *Francisco v. Commissioner*, 119 T.C. 317 (2002), and *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (2000). Compare section 465(c)(3)(D), which provides that a special rule “shall apply only to the extent provided in regulations prescribed by the Secretary.” *Alexander v. Commissioner*, 95 T.C. 467 (1990).
- (6) Also compare *Frazer v. Commissioner*, 98 T.C. 554 (1992), and *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff’d on other grounds*, 390 F.3d 1210 (10th Cir. 2004), discussing other proposed regulations under section 7872.
- (7) The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015, released on July 31, 2015 (see [http://www.irs.gov/pub/irs-utl/2015-2016\\_pgp\\_initial.pdf](http://www.irs.gov/pub/irs-utl/2015-2016_pgp_initial.pdf)), included a project, new that year, titled “Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872.” It was retained in the 2016-2017 Priority Guidance Plan but dropped from the slimmed-down 2017-2018 Priority Guidance Plan published October 20, 2017, by the Trump Administration.
- (a) It is not clear that this guidance project was related to Proposed Reg. §20.7872-1, which it does not cite.
- (b) It is clear that there has been a lot of interest in the valuation of promissory notes, especially after the docketing of *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13, in which the IRS asserted \$2.8 billion in estate, gift and generation-skipping taxes owed. On July 6, 2015, the case was settled for just over \$550 million. Addressing Mr. Davidson’s sales both in Chief Counsel Advice 201330033 (Feb. 24, 2012) and in its answer in the Tax Court, the IRS argued the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson’s health. See also *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43.

## 11. Comparing Techniques

### a. Comparison

Grantor retained annuity trusts (GRATs) and installment sales to grantor trusts are frequently compared. Another – “classic” – freeze technique is the entity capital freeze, using preferred stock or

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a preferred partnership interest, generally policed by section 2701. The following discussion compares these three techniques:

- (1) Is it necessary to make payments?
  - (a) "Qualified payments" are required in a capital freeze, a GRAT must pay the annuity, and the purchase price plus interest must be paid in an installment sale. In an installment sale, however, the payments can balloon at the end.
  - (b) Advantage: Installment sale.
- (2) Can the grantor count on payments for cash flow? For example, could the transferor receive payments for life?
  - (a) Preferred payments from an entity freeze can be, and ordinarily are, payable in perpetuity. GRAT payments and installment sale payments are generally limited to the prescribed term.
  - (b) Advantage: Capital freeze.
- (3) Is it **necessary** for the transferor to receive payments for life (which increase the transferor's estate)?
  - (a) In a capital freeze, yes, unless the preferred interest is sold or redeemed, which also increases the transferor's estate. Not in a GRAT or installment sale.
  - (b) Advantage: GRAT and installment sale.
- (4) Are payments easy to value?
  - (a) In a capital freeze, an appraisal – often a costly appraisal – is generally needed. In a GRAT, the statute and regulations insist upon the use of section 7520, which is very simple. In an installment sale, Frazee and True indicate that section 7872 can be used, which is also relatively simple, except for questions about ability to pay (coverage).
  - (b) Advantage: GRAT. Runner-up: Installment sale.
- (5) Can the rate of return be low, to minimize the return that builds up the transferor's estate?
  - (a) In a capital freeze, the rate of return, often determined by the appraiser, will generally be greater than the 7520 rate. A GRAT, of course, uses the 7520 rate, which is 120 percent of the "federal midterm rate." Depending on the term, the 7872 rate used for an installment sale, especially the short-term or mid-term rate, is often (but not always) less than the 7520 rate, because it avoids the 120-percent factor.
  - (b) Advantage: Usually an installment sale. Sometimes a GRAT.
- (6) Can other features be used to prop up the value of what the transferor retains or receives for gift tax purposes, to reduce the need to make monetary payments?
  - (a) In a capital freeze, within limits, such features as voting rights and preemptive rights associated with a preferred interest might be given value under section 2701. This cannot be done in a GRAT and probably not in an installment sale.
  - (b) Advantage: Capital freeze.
- (7) Is it possible to "zero out" the transaction and have no taxable gift at all?
  - (a) In a capital freeze, this is effectively limited by the 10-percent equity floor of section 2701(a)(1). A GRAT can be "zeroed out" (or nearly "zeroed out") because old Reg. §25.2702-3(e), Example 5 has been acknowledged to be invalid. *Walton v. Commissioner*, 115 T.C. 589 (2000)); Notice 2003-72, 2003-2 C.B. 964 (announcing IRS acquiescence in *Walton*); Reg. §25.2702-3(d)(4) & (e), Example 5 (amended February 15, 2005). (Nevertheless, to ensure the validity of the trust and to provide the occasion for gift tax disclosure, most GRATs are designed to produce a relatively small amount of reported gift.) A sale is, by definition, a

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value-for-value – i.e., “zeroed-out” – transaction. Nevertheless, the initial funding of the trust to equip it to pay the desired down payment is usually a gift, which a GRAT avoids.

(b) Advantage: GRAT.

(8) Is an equity floor needed?

(a) In a capital freeze, 10 percent, under section 2701(a)(1). In a GRAT, no. In an installment sale, probably enough to avoid “dry trust” characterization, perhaps 10 percent, but this can be supplied from other assets.

(b) Advantage: GRAT. Runner-up: Installment sale.

(9) Can one attempt to “audit-proof” by formula?

(a) In a capital freeze, this is difficult or impossible. In a GRAT, such a formula is explicitly permitted by Reg. §25.2702-3(b)(1)(ii)(B). An installment sale can use either a price adjustment clause of the sort addressed in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), or a “value definition clause” of the sort addressed in Technical Advice Memorandum 8611004 (Nov. 15, 1985) and *Wandry*, but each of these techniques has its complications and drawbacks. See Part 8.c above.

(b) Advantage: GRAT.

(10) Is it necessary to obtain cooperative actions from other family members?

(a) In a capital freeze, “elections” by other “applicable family members” are often needed under Reg. §25.2701-2(c)(4). There is no such requirement in the case of a GRAT or installment sale.

(b) Advantage: GRAT and installment sale.

(11) Is there a gift if the payments are not made?

(a) Maybe not in the case of a capital freeze, under the principles of *Snyder v. Commissioner*, 93 T.C. 529 (1989). Probably so in the case of a GRAT or installment sale.

(b) Advantage: Capital freeze.

(12) Is there a grace period, without tax consequences, for making the required payments back to the transferor?

(a) For making “qualified payments” in a capital freeze, a four-year grace period under section 2701(d)(2)(C). For a GRAT, maybe 105 days under Reg. §25.2702-3(b)(4). There is no such provision in the case of an installment sale.

(b) Advantage: Capital freeze.

(13) Is there an adverse result if payments are not made?

(a) In the case of a capital freeze, the compounding provisions of section 2701(d) are very harsh. In the case of a GRAT or installment sale, the penalty is probably the normal gift tax consequences.

(b) Advantage: GRAT and installment sale.

(14) Must payments be made if the underlying investment does not work out?

(a) Under section 2701(d)(2)(B), there is no penalty for not making “qualified payments” if the entity does not increase in value. In a GRAT or installment sale, payments are absolute obligations that must be made until the trust is exhausted.

(b) If the grantor trust has other assets, it can be a disaster if the property that was the subject of an installment sale declines in value, but the promissory note is included in the grantor’s gross estate at face value. And even a grantor trust designed and used solely for the sale



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may have assets representing the "equity" that is conservatively required, or possibly has already made a payment to the grantor in the form of a down payment.

(c) Advantage: Capital freeze (slightly).

(15) Is there a double income tax on the arrangement?

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

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

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

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

(b) Advantage: Capital freeze (slightly).

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

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

(b) Advantage: Capital freeze and installment sale.

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

(a) Not at all in a capital freeze. Perhaps not in the case of an installment sale either; it could be complicated if the grantor/holder dies before the note is fully paid, but the only question in such a case would be whether gain is recognized for income tax purposes, not whether the future appreciation escapes estate tax. The grantor of a GRAT must survive the GRAT term for the GRAT to work.

(b) Advantage: Capital freeze and installment sale.

(19) Can GST exemption be allocated to the arrangement?

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

(b) Advantage: Capital freeze and installment sale.

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

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

(b) Advantage: Capital freeze.

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

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

(b) Advantage: GRAT and installment sale.

b. **Summary**

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

	<b>Capital Freeze</b>	<b>GRAT</b>	<b>Installment Sale to a Grantor Trust</b>
1. Payments required?	Yes	Yes	<b>Can balloon at end</b>
2. <i>Permitted</i> payout	<b>Can be perpetuity</b>	Limited to GRAT term	Limited to note term
3. Payments <i>required</i> for life?	Yes	<b>No</b>	<b>No</b>
4. Payments easy to value?	No (appraisal needed)	<b>Yes (section 7520)</b>	Somewhat (section 7872)
5. Rate of return	Market rate, presumably higher	<b>Section 7520 rate [sometimes lower]</b>	<b>AFR under section 7872 [usually lower]</b>
6. Able to use other valuable features?	<b>Within limits</b>	No	Probably not
7. Able to nearly "zero out"?	Limited by 10% floor	<b>Yes</b>	<b>Yes, except for down payment, if any</b>
8. Need equity floor?	Yes (10%)	<b>No</b>	Probably
9. Can "audit-proof" by formula?	Difficult or impossible	<b>Yes</b>	Difficult
10. Need elections?	Sometimes	<b>No</b>	<b>No</b>
11. Gifts if payments not made?	<b>Probably not (Snyder)</b>	Probably	Probably
12. Grace period?	<b>Four years</b>	Maybe 105 days	None
13. Section 2701(d) applies?	Yes	<b>No</b>	<b>No</b>
14. Must pay if losing money?	<b>No (section 2701(d)(2)(B))</b>	Yes	Yes
15. Double income tax?	Only in a corporation	<b>No</b>	<b>No</b>
16. Can make future transfers?	<b>Yes</b>	No	No
17. Able to "unwind"?	<b>Yes, by amendment</b>	No	Yes, can prepay
18. Survival required for future growth to escape tax?	<b>No</b>	Yes	<b>No</b>
19. Immediate GST exemption?	<b>Yes</b>	No	<b>Yes</b>
20. Rules apply when family interest is a minority interest?	<b>Generally not</b>	Yes	Yes
21. Available for an S corporation?	No	<b>Yes</b>	<b>Yes</b>

(2) Recapitulation:

(a) Capital freeze: 10.

(b) GRAT: 10.

(c) Installment sale to a grantor trust: 10.

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c. **Significance**

- (1) Absolutely none! Each case is different.
- (2) The factors must be weighed, not merely counted. Generally, the most important factors are thought to be the required rate of return (#5), the ability to zero-out (#7), the mortality risk (#18), and the ability to allocate GST exemption (#19). All those factors (except #7) generally favor an installment sale, while a GRAT is predictable under section 2702 and the regulations thereunder and a capital freeze is a traditional technique obviously contemplated by section 2701 and the regulations thereunder.
- (3) Depending on the assets used, and the client's ability and willingness to pay gift taxes, a taxable gift almost always outperforms any other freeze technique (provided the donor survives for three years).

## 12. The Future of These Techniques

a. **Grantor Trusts in General**

- (1) The benefits of an installment sale to a grantor trust, including the tax-free treatment at death addressed in the foregoing discussion, depend principally on the historical mismatch of the rules for grantor trust treatment in subpart E of part I of subchapter J of chapter 1 of the Code and the rules for inclusion in the gross estate under chapter 11. This mismatch, and the fact that Rev. Rul. 85-13 is being invoked in applications well beyond what was contemplated in 1985, are no secret.
- (2) It is hard to argue that the grantor's payment of income tax on someone else's income is not economically equivalent to a gift, but, because the tax is the grantor's own obligation under the grantor trust rules, it escapes gift tax. And sales to grantor trusts are often viewed as economically equivalent – or superior – to GRATs, but without the policing of sections 2702 and 2036 or the "ETIP" restrictions of section 2642(f) on allocating GST exemption.
- (3) Nevertheless, various developments in the last two decades have seemed to actually ratify and validate the widespread use of grantor trusts in estate planning, including the following:
  - (a) Rev. Rul. 2004-64, 2004-2 C.B. 7, addressing the estate tax consequences of provisions regarding the reimbursement of the grantor for income tax on the grantor trust's income. See Part 8.g above.
  - (b) Rev. Rul. 2007-13, 2007-11 I.R.B. 684, holding that the transfer of life insurance contracts between two grantor trusts treated as owned by the same grantor is not a transfer for valuable consideration for purposes of section 101.
  - (c) Rev. Rul. 2008-22, 2008-16 I.R.B. 796, providing reassurance regarding the estate tax consequences under sections 2036 and 2038 of the grantor's retention of a section 675(4)(C) power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value. See Part 7.b(2)(i)vi above.
  - (d) Rev. Rul. 2011-28, 2011-49 I.R.B. 830, extending that reassurance to section 2042 and cases where the trust property includes policies of insurance on the grantor's life.
  - (e) Rev. Proc. 2008-45, 2008-30 I.R.B. 224, promulgating sample inter vivos charitable lead unitrust forms, including forms for both nongrantor and grantor CLUTs, where the feature used to confer grantor trust status is such a substitution power in a person other than the grantor.
- (4) Moreover, it could be argued that the present state of affairs causes no harm. The value of the asset transferred does come back to the grantor/seller in the form of the installment note and is subject to estate tax to the extent it is not paid before death. Thus, the transfer tax base is preserved. To the extent that additional advantages flow from valuation, these advantages are not unique to grantor trusts.

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(5) Any change would entail tremendously complex effective date and transitional rules. Changing an entire regime like this usually is not justified unless the reasons are compelling.

b. **The Obama Administration's Revenue Proposals**

(1) **The GRAT Proposal, 2009-2014**

- (a) After reciting the history of section 2702 and the use of GRATs, the "General Explanations" of the Obama Administration's revenue proposals (popularly called "Greenbooks"), prior to 2015 (for example, page 162 in the 2014 Greenbook) noted that "[t]axpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability."
- (b) While rumors had occasionally been heard of congressional plans to limit the attractiveness of GRATs by imposing a minimum gift tax value for the remainder (such as 10 percent), the Greenbooks instead proposed to increase the mortality risk of GRATs by requiring a minimum 10-year term.
- i. Both the Greenbooks and a September 8, 2009, publication of the staff of the Joint Committee on Taxation titled "Description of Revenue Provisions in President's Fiscal Year 2010 Budget Proposal, Part One: Individual Income Tax, Estate and Gift Tax Provisions" (JCS-2-09), focused on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.
- ii. The JCT staff publication noted that even a 10-year GRAT could be used "as a gift tax avoidance tool" and that a 10-year minimum term might encourage the use of GRATs by younger taxpayers. As an alternative way of achieving more accurate valuation, the JCT staff publication suggested valuation of the remainder interest for gift tax purposes at the end of the GRAT term when the remainder is distributed – embracing the "hard to complete" approach floated by "Tax Reform for Fairness, Simplicity, and Economic Growth" published by the Treasury Department on November 27, 1984 (the Reagan Administration's "Treasury I").
- (c) Before 2015, the Greenbook discussions actually ratified the use of "zeroed-out" GRATs, within the constraint of a minimum 10-year term.
- i. In the single substantive change from the 2009 Greenbook, the 2010 and 2011 Greenbooks added that "[t]he proposal would also include a requirement that the remainder interest have a value greater than zero and would prohibit any decrease in the annuity during the GRAT term." The 2012 Greenbook clarified that the requirement is "that the remainder interest have a value greater than zero **at the time the interest is created**" (emphasis added).
- ii. Nevertheless, the 2010, 2011, 2012, 2013, and 2014 Greenbooks went on to say, like the 2009 Greenbook, that "a minimum term would not prevent 'zeroing-out' the gift tax value of the remainder interest." Obviously **near-zeroing-out** is what is meant.
- (d) The 2012 Greenbook added an additional requirement of a **maximum** term equal to the life expectancy of the annuitant plus 10 years. That would limit the use of very long-term "Walton-style" GRATs with a low annual payout that would result in a reduced inclusion in the gross estate under Reg. §20.2036-1(c)(2)(i).
- (e) The 2013 and 2014 Greenbooks made no change from the 2012 Greenbook.
- (f) The proposal would apply to GRATs created after the date of enactment.
- (g) The proposal was estimated to raise revenue over 10 years by \$3¼ billion in the 2009 Greenbook, \$2.959 billion in the 2010 and 2011 Greenbooks, \$3½ billion in the 2012

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Greenbook, \$3.894 in the 2013 Greenbook, and \$5.711 in the 2014 Greenbook. (The June 11, 2009, Joint Committee on Taxation estimates scored the 10-year revenue gain from the Administration proposal at \$2.28 billion.)

- (h) These limitations on GRATs were included in section 307 of the “Small Business and Infrastructure Jobs Tax Act of 2010” (H.R. 4849), which the Democratically-controlled House of Representatives passed by a vote of 246-178 on March 25, 2010. The vote was partisan; only four Republicans voted for the bill and only seven Democrats voted against it. Reminiscent both of the Greenbooks’ explanations and of the 1990 legislative history of section 2702 itself, the House Ways and Means Committee offered the following “Reasons for Change”:

The valuation rates and tables prescribed by section 7520 often produce relative values of the annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, taxpayers can use GRATs to make gifts of property with little or no transfer tax consequences, so long as the investment return on assets in the trust is greater than the rate of return assumed under section 7520 for purposes of valuing the lead and remainder interests. The Committee believes that such uses of GRATs for gift tax avoidance are inappropriate.

In some cases, for example, taxpayers “zero out” a GRAT by structuring the trust so that the assumed value of the annuity interest under the actuarial tables equals (or nearly equals) the entire value of the property transferred to the trust. Under this strategy, the value of the remainder interest is deemed to be equal to or near zero, and little or no gift tax is paid. In reality, however, a remainder interest in a GRAT often has real and substantial value, because taxpayers may achieve returns on trust assets substantially in excess of the returns assumed under section 7520. Any such excess appreciation passes to the remainder beneficiaries without further transfer tax consequences.

In addition, grantors often structure GRATs with relatively short terms, such as two years, to minimize the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor’s estate for estate tax purposes. Because GRATs carry little down-side risk, grantors frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the grantor’s odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the grantor to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.

The provision is designed to introduce additional downside risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two-year) GRATs, a GRAT with a 10-year term carries greater risk that the grantor will die during the trust term and that the trust assets will be included in the grantor’s estate for estate tax purposes. The provision limits opportunities to inappropriately achieve gift tax-free transfers to family members in situations where gifts of remainder interests in fact have substantial value.

H.R. Rep. No. 111-447, 111th Cong., 2d Sess. 55-56. (2010) (footnote omitted).

- (i) The GRAT limitations contained in H.R. 4849, like the Administration’s recommendations, were to apply to transfers made after the date of the enactment – that is, after the date the President signs it into law.
- (j) The same provisions appeared in
- i. section 531 of the “Small Business Jobs Tax Relief Act of 2010” (H.R. 5486), which the House of Representatives passed by a vote of 247-170 (with five Republicans in favor and eight Democrats against) on June 15, 2010,
  - ii. the supplemental appropriations bill (H.R. 4899) that the House approved on July 1, 2010,
  - iii. section 8 of the “Responsible Estate Tax Act” (S. 3533 and H.R. 5764), introduced by Senator Sanders on June 24, 2010, and Rep. Linda Sanchez on July 15, 2010, and
  - iv. section 308 of the December 2010 “Baucus Bill.”
- (k) These provisions appeared again in section 301 of the “Trade Adjustment Assistance Extension Act of 2011,” (S. 1286), introduced on June 28, 2011, by Senators Casey (D-PA) and Brown (D-OH), neither of whom was a member of the Finance Committee. Unlike the

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other bills, this provision, as introduced, would have applied to GRATs funded after December 31, 2010. Even if Congress passed such legislation, there seems to be little or no chance that Congress would make it retroactive.

- (l) If a minimum 10-year term for GRATs were required, it would be harder to realize one of the chief benefits of a GRAT, which is capturing upside volatility in the GRAT for the benefit of the next generation. (The Greenbooks and the JCT staff publication focused on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.)
  - i. With depressed values in some industries, difficulty in predicting the timing of recovery, and relatively low interest rates under section 7520, some clients have opted for GRATs with terms longer than the typical two years anyway.
  - ii. But **requiring** a minimum 10-year term (**at least before the 2015 proposal**) would encourage more customizing of the terms of a GRAT, including greater use of level GRATs or GRATs in which the annuity increases in some years but not others or increases at different rates in different years. For example, the typical 20 percent increase in the annuity payment each year would produce a payment in the tenth year equal to about 5.16 times the payment in the first year.
  - iii. A 10-year GRAT might also demand greater monitoring and active management. For example, if the asset originally contributed to the GRAT achieves its anticipated upside early in the 10-year term (maybe in the first year or two as is hoped for with a two-year GRAT), the grantor can withdraw that asset and substitute another asset of equivalent value with upside potential. If the grantor holds that withdrawn appreciated asset until death, this will also permit the asset to receive a stepped-up basis.
  - iv. A longer term for the GRAT will also permit a lower payout rate, which could make it easier to fund the annuity payments with cash (as with S corporation stock where the corporation distributes cash to equip its shareholders to pay income tax) and thereby avoid an annual appraisal.
  - v. A lower payout rate could result in a smaller amount includible in the grantor's gross estate under section 2036 if the grantor dies during the 10-year term. Under Reg. §20.2036-1(c)(2)(i) (promulgated in April 2008) that includible amount is the amount needed to sustain the retained annuity interest without invasion of principal – that is, in perpetuity. Thus, for example, a 10-year GRAT with a level payout created when the section 7520 rate is 2.0 percent (as it is in November 2019) will require a payout equal to about 11.1 percent of the initial value. If the section 7520 rate when the grantor dies is 5.0 percent (as it was in December 2007), the amount included in the grantor's gross estate will be 222 percent of the initial value. That would represent a lot of appreciation, but often that is exactly what is hoped for when a GRAT is created. In that case, any appreciation in excess of 122 percent will pass **tax-free** to the next generation, even if the grantor dies during the 10-year term (**unless** the GRAT instrument provides for a reversion to the grantor, a general power of appointment, or a similar feature that would result in total inclusion of the date-of-death value in the gross estate).
- (m) Planners who don't mind monitoring the requirements of two sets of tax rules in the same transaction will be intrigued by the possibility of placing a preferred (frozen) interest in a partnership (or LLC) that meets the requirements of section 2701 into a GRAT that meets the requirements of section 2702.
  - i. This technique is described in Angkatavanich & Yates, "The Preferred Partnership GRAT—A Way Around the ETIP Issue," 35 ACTEC JOURNAL 289 (2009). In the paradigm addressed in this thoughtful article, the partnership (or LLC) is formed by the prospective grantor's capital contribution in exchange for the preferred interest and a capital contribution by a GST tax-exempt generation-skipping trust in exchange for the growth

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interest in the partnership. The payouts on the preferred interest are structured to be “qualified payments” within the meaning of section 2701(c)(3).

- ii. Even if the grantor dies during the GRAT term, the underlying appreciation in the partnership growth interest will still escape estate tax.
- iii. Moreover, all the appreciation in the partnership growth interest will be captured in a generation-skipping trust, unlike the typical GRAT.

## (2) **The Grantor Trust Proposal, 2012-2014**

- (a) The 2012 Greenbook proposed including the date-of-death value of all grantor trusts in the grantor’s gross estate and thus subjecting that value to estate tax. Specifically, the 2012 Greenbook (page 83) stated:

To the extent that the income tax rules treat a grantor of a trust as an owner of the trust, the proposal would (1) include the assets of that trust in the gross estate of that grantor for estate tax purposes, (2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor’s life, and (3) subject to gift tax the remaining trust assets at any time during the grantor’s life if the grantor ceases to be treated as an owner of the trust for income tax purposes. In addition, the proposal would apply to any non-grantor who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would have been subject to capital gains tax if the person had not been a deemed owner of the trust. In such a case, the proposal would subject to transfer tax the portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction. The proposal would reduce the amount subject to transfer tax by the value of any taxable gift made to the trust by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

- (b) That proposal was very broad and vague, and many observers assumed that it would be revised. Sure enough, in the 2013 Greenbook (page 145) and the 2014 Greenbook (page 166), the proposal was reworded as follows:

If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person’s treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner’s life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner’s obligation to the distributee) during the life of the deemed owner. The proposal would reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

- (c) In comparison to the 2012 Greenbook, the 2013 and 2014 Greenbooks referred more to “a deemed owner” and less to “the grantor.”
  - i. The classic paradigm trust deemed owned by a beneficiary for income tax purposes under section 678(a) would likely be included in the beneficiary’s gross estate anyway, because the power described in section 678(a) would essentially be a general power of appointment. Therefore, the changes in this Greenbook from references to “the grantor” to “a deemed owner” may indicate that more sophisticated beneficiary-owned trusts are in view.
  - ii. It is no secret that the Service is concerned about such trusts and is watching the developments that might affect such trusts. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01(48) included “[w]hether trust assets are includible in a trust beneficiary’s gross estate under §§ 2035, 2036, 2037, 2038, or 2042 if the beneficiary sells property (including insurance policies) to the trust or dies within 3 years of selling such property to the trust, and (i) the beneficiary has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that

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person to be the owner if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, (ii) the trust purchases the property with a note, and (iii) the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased” among what Rev. Proc. 2013-3 described as “areas in which rulings or determination letters will not ordinarily be issued.” That fact pattern was also included as a no-rule area for purposes of deemed owner status (§4.01(43)), completed gift treatment (§4.01(55)), and the application of section 2702 (§4.01(63)). That IRS position is maintained in Rev. Proc. 2024-3, 2024-1 I.R.B. 143, §4.01(41) (deemed owner status), (49) (estate inclusion), (52) (completed gift treatment) and (60) (application of section 2702).

(d) Like the 2012 Greenbook, the 2013 Greenbook also stated:

The proposal would not change the treatment of any trust that is already includable in the grantor’s gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts; grantor retained annuity trusts; personal residence trusts; and qualified personal residence trusts.

That is an odd concession.

- i. The implication is that the treatment of GRATs, for example, does not have to be changed because GRATs already are treated consistently with the Greenbook proposal. In fact, while it is assumed that all or most GRATs are grantor trusts (which can facilitate payment of the annuity in kind without capital gain), the value of the assets in a long-term GRAT might not be fully included in the grantor’s gross estate, and the termination of a GRAT’s grantor trust status, which may or may not occur at the end of the GRAT term, is not treated as a taxable gift.
  - ii. In any event, the trusts cited in the Greenbook – GRITs, GRATs, PRTs, and QPRTs – ordinarily do not acquire assets from the grantor by purchase, so there is no reason to think that they would be affected by this proposal anyway.
- (e) The Greenbooks said nothing about adjustments to basis, under either section 1015(d)(6) with respect to gift tax or section 1014(b)(9) with respect to estate tax.
- (f) The reference to GRITs, GRATs, PRTs, and QPRTs was followed in the 2012 Greenbook by a description of the proposed effective date, accompanied by a reference to “[r]egulatory authority . . ., including the ability to create transition relief for certain types of automatic, periodic contributions to existing grantor trusts,” fueling the speculation that the proposal was aimed, at least in part, at life insurance trusts, where the periodic payment of premiums, while not exactly “automatic,” is typically done under the terms of a preexisting insurance contract.
- (g) In contrast, the reference to GRITs, GRATs, PRTs, and QPRTs in the 2013 Greenbook was followed by disclaimers that the proposal “would not apply to any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor” (possibly a reference to a “rabbi trust”) or “to any trust that is a grantor trust solely by reason of section 677(a)(3)” (evidently a reference to life insurance trusts).
- i. The passes given to these trusts were no doubt meant to be helpful, and they were helpful, but they only highlighted the tension that remains inherent in the proposal.
  - ii. For example, life insurance trusts sometimes can and do acquire assets from the grantor by purchase, including life insurance policies, and those policies are certainly expected to increase in value. The fact that they nevertheless are not covered by the clarified proposal still leaves us wondering what policy lies behind the proposal or what characteristics of estate planning techniques actually offend that policy.
  - iii. And the implication that a life insurance trust that purchases a policy from the grantor is covered by the proposal if it has some other grantor trust feature, like a substitution



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power under section 675(4)(C), even though the economics might be identical, was just as baffling. Probably in response to that, the 2014 Greenbook revises this reference to state: "The proposal ... would not apply to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor's spouse."

- iv. The staff of the Joint Committee on Taxation has expressed some of the same concerns. See Staff of the Joint Comm. on Taxation, "Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal" 104-05 (Dec. 2013).
- (h) Moreover, while the last sentence of the 2013 and 2014 Greenbook descriptions, like the 2012 Greenbook, proposed regulatory authority, the stated example was "the ability to create exceptions to this provision."
  - i. This may be the most important feature of the proposal, because, without it, while narrower than the 2012 Greenbook's proposal, the proposal was still very broad.
  - ii. In particular, the proposal appears to apply to all sales, no matter how leveraged, no matter what the interest rate is on any promissory note, no matter what the other terms of the note are, and no matter whether the note is still outstanding at the seller's death. A GRAT, for example, has clear regulatory safe harbors for all those features and "works" for estate tax purposes if it falls within those safe harbors. It would be odd if a simple installment sale to a grantor trust, which is a sale and not a gift, is subjected to harsher gift (and estate) tax treatment than the funding of a GRAT, which actually is a gift.
  - iii. But these are complex issues. And for that reason, it may be best, or even crucial, that they be addressed in regulations. So viewed, the changes to this proposal reflected in the 2013 Greenbook, and particularly the implicit promise of workable regulations, should be welcomed.
  - iv. Nevertheless, except in the extraordinary event that Treasury and the IRS release an indication of what will be in such regulations before the legislation is enacted, there might still be a gap between enactment and such a release in which a popular and effective estate planning technique will have been chilled.
- (i) The proposal would apply with respect to transactions (possibly including even the substitution of assets by the grantor, whether under a section 675(4)(C) reserved power or otherwise) engaged in on or after the date of enactment.
- (j) In the 2012 Greenbook, the almost unlimited proposal was estimated to raise revenues by \$910 million over 10 years. In the 2013 Greenbook, the ostensibly narrower proposal was estimated by Treasury to raise revenues by \$1.087 billion over 10 years. In 2014, an essentially unchanged proposal was estimated by Treasury to raise revenues by \$1.644 billion over 10 years. The staff of the Joint Committee on Taxation estimated that the 2013 proposal would raise revenues by \$3.227 billion over 10 years. Staff of the Joint Comm. On Taxation, "Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal" 206 (Dec. 2013).

### (3) **The 2015 and 2016 Combined GRAT and Grantor Trust Proposal**

- (a) The "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals" was released on February 2, 2015 (see <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf>). The 2015 Greenbook combined the GRAT and grantor trust proposals into one proposal, titled "Modify Transfer Tax Rules for Grantor Retained Annuity Trusts (GRATs) and Other Grantor Trusts."
- (b) The GRAT proposal added "a requirement that the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or \$500,000 (but not more than the value of the assets contributed)."

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- i. While a minimum gift tax value as such is not a surprise, the 25 percent level is surprisingly high. For example, 10 percent is the minimum remainder value required for the IRS to consider ruling that an interest in a GRAT is a qualified annuity interest under section 2702. Rev. Proc. 2024-3, 2024-1 I.R.B. 143, §4.01(58). In the context of an installment sale to a grantor trust, it is well known that the IRS required the applicants for Letter Ruling 9535026 (May 31, 1995) to commit to “equity” of at least 10 percent of the purchase price. And 10 percent is the equity floor, the minimum value of the common stock of a corporation or “junior equity interest” in a partnership, under section 2701(a)(4), which was enacted at the same time as section 2702.
  - ii. The alternative minimum remainder value of \$500,000 means that 25 percent is not enough for GRATs funded with less than \$2 million. It is possible that one of the targets of that provision is a \$100,000 GRAT that appreciates miraculously before the first annuity payment is due. In any event, this rule would require an invasion of the grantor’s lifetime gift tax exemption, or even the payment of gift tax, to create a qualified GRAT.
- (c) The 2015 Greenbook also added that “the proposal ... would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust.” That would diminish the availability of some of the proactive techniques described in paragraphs (1)(l) and (1)(m) above.
  - (d) The 2015 grantor trust proposal was substantively the same as in 2013 and 2014.
  - (e) The combined and revised proposal in the 2015 Greenbook was estimated to raise revenue by \$18.354 billion over 10 years, compared to a total of \$7.355 billion for both proposals in the 2014 Greenbook.
  - (f) The proposal in the 2016 Greenbook, released on February 9, 2016 (see <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>), was the same as the 2015 proposal, with a 10-year revenue estimate of \$19.149 billion.

### c. **The Biden Administration’s Budget Proposals**

The Treasury Department released its Fiscal Year 2025 Greenbook on March 11, 2024 (see <https://home.treasury.gov/system/files/131/General-Explanations-FY2025.pdf>). With a sharply divided Congress, it is possible – if not likely – that **none** of the Greenbook proposals will be acted on. Even so, whenever we see legislative proposals articulated like this, it is important to pay attention, because they are constantly evolving and could be pulled from the shelf and enacted, if not this year then in the future when the political climate is different. Such proposals never completely go away. And each time they are refined and updated, we can learn more about what to watch for and how to react.

#### (1) **Deemed Realization of Capital Gains**

In terms almost identical to the Fiscal Year 2022, 2023, and 2024 Greenbooks, the Fiscal Year 2025 Greenbook (at pages 80-82) again advocates the “deemed realization” of capital gains upon transfers by gift and at death.

- (a) **Effective Date.** The proposal would take effect on January 1, 2025. But it would apply to previous appreciation; there would be no “fresh start” as, for example, in the 1976 carryover basis legislation.
- (b) **Realization Events.** Gain would be explicitly recognized on transfers by gift or at death, equal to the excess of an asset’s fair market value on the date of the gift or death over the donor’s or decedent’s basis in that asset. The Greenbook does not mention holding periods or distinguish short-term and long-term gain. The Greenbook also does not specifically incorporate the alternate valuation date for transfers at death, although it does state generally that a transfer “would be valued at the value used for gift or estate tax purposes.”
- (c) **Taxpayer, Return, and Deductibility.** The Greenbook states that the gain would be reported “on the Federal gift or estate tax return or on a separate capital gains return.” Reassuringly,

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however, the Greenbook confirms that “the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent’s estate (if any).” That means that, after all exclusions are used, the 39.6 percent capital gains rate the Greenbook also proposes and the current 40 percent estate tax rate would produce a combined tax rate on appreciation of 63.76 percent ( $0.396 + 0.4 \times (1 - 0.396)$ ).

- (d) **Exclusion for Tangible Personal Property.** The Greenbook would exclude “gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles).”
- (e) **Exclusion for Transfers to Spouses.** The Greenbook would exclude “[t]ransfers to a U.S. spouse.” There is no elaboration of the term “U.S. spouse” (for example, citizen or resident), and there are no special provisions targeted to spousal trusts. Transfers to a spouse would carry over the transferor’s basis. Thus, the effect of excluding transfers to spouses would be simply to defer the application of the deemed realization rules until the spouse’s disposition of the asset or the spouse’s death.
- (f) **Exclusion for Transfers to Charity.** The Greenbook would exclude “[t]ransfers ... to charity.” It adds that “[t]he transfer of appreciated assets to a split-interest trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity’s share of the gain based on the charity’s share of the value transferred as determined for gift or estate tax purposes.” Thus, for many purposes, the exclusion would correspond to the allowable gift or estate tax charitable deduction. Like transfers to a spouse, transfers to charity would carry over the transferor’s basis.
- (g) **Other Exclusions.** The Greenbook proposes a unified exclusion of capital gains for transfers both by gift and at death of \$5 million per person (up from \$1 million in the Fiscal Year 2022 Greenbook), indexed for inflation and “portable to the decedent’s surviving spouse under the same rules that apply to portability for estate and gift tax purposes.” The Greenbook adds that this would “result ... in a married couple having an aggregate \$10 million exclusion,” but it does not explain exactly how that would be accomplished for lifetime gifts when there has been no “decedent” or “surviving spouse.” The Greenbook does not address whether the use of the exclusion for lifetime gifts is mandatory or elective. But it adds, quixotically and without further elaboration, that the \$5 million exclusion “would apply only to unrealized appreciation on gifts to the extent that the donor’s cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift.” Thus, in effect, a lifetime gift must actually generate a gift tax liability for the donor to use this \$5 million exclusion of gain during life. So the first \$12 million or so of gifts would trigger recognition of gain, and after that gifts with \$5 million of appreciation would escape deemed realization, and after that gifts would trigger gain again. This could significantly influence the selection of assets to use for lifetime gifts.

The Greenbook adds that “[t]he recipient’s basis in property, whether received by gift or by reason of the decedent’s death, would be the property’s fair market value at the time of the gift or the decedent’s death” (except, presumably, for excluded transfers to spouses and to charity discussed above). Could it be that the Greenbook would increase that proposed \$1 million exclusion to \$5 million and at the same time allow a stepped-up basis even if the gain is excluded? Although surprising, that would be a significant simplification.

But in an apparent reversal of the Fiscal Year 2022 Greenbook, the three most recent Greenbooks state that “[t]he recipient’s basis in property, whether received by gift or by reason of the decedent’s death, would be the property’s fair market value at the time of the gift or the decedent’s death” (except, presumably, for excluded transfers to spouses and to charity discussed above). The Fiscal Year 2022 Greenbook, not surprisingly, included the caveat that “the donee’s basis in property received by gift during the donor’s life would be the donor’s basis in that property at the time of the gift to the extent the unrealized gain on that property counted against the donor’s \$1 million exclusion from recognition.” Thus, the recent Greenbooks would increase that proposed \$1 million exclusion to \$5 million and at the

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same time allow a stepped-up basis even if the gain is excluded. Although surprising, that would be a significant simplification.

In addition, the Greenbook confirms that the exclusion of \$250,000 per person of gain from the sale or exchange of a taxpayer's principal residence under section 121 would apply to the gain realized under this proposal with respect to all residences, and it adds that that exclusion would be made "portable to the decedent's surviving spouse." In this case the application of the portability model to lifetime gifts may be less of an issue because section 121(b)(2) itself doubles the exclusion to \$500,000 for joint returns involving jointly used property.

The Greenbook also confirms that the exclusion under current law for capital gain on certain small business stock under section 1202 would apply.

- (h) **Netting of Gains and Losses.** For transfers at death, capital losses and carry-forwards would be allowed as offsets against capital gains and up to \$3,000 of ordinary income, mirroring the current income tax rules for lifetime realization events in sections 1211 and 1212. There is no mention of relaxing the rules of section 267 prohibiting the deduction of losses from sales or exchanges between related persons, but it seems almost certain that those rules would be relaxed in any provision for taking losses into account at death, where transfers to related persons are the norm.
- (i) **Valuation.** As noted above, the Greenbook contemplates that a transfer generally "would be valued at the value used for gift or estate tax purposes." The Greenbook adds that "a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property." In other words, no entity-level discounts. But, elaborating the word "generally," which was new in the Fiscal Year 2023 Greenbook, the Greenbook also helpfully adds that "this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business."
- (j) **Special Rules for Trusts and Entities.** The Greenbook provides that transfers into, and distributions in kind from, a trust would be recognition events, unless the trust is a grantor trust deemed wholly owned and revocable by what the Greenbook calls "the donor." Again there is no exclusion or exemption for pre-enactment gain, and indeed the Greenbook explicitly states that the proposal would apply to "certain property owned by trusts ... on January 1, 2025." In other words, this proposed recognition treatment would apply to distributions of appreciated assets to both current and successive or remainder beneficiaries of preexisting trusts, including, for example, both the grantor (or grantor's spouse) and the remainder beneficiaries of a pre-2025 GRAT. With regard to revocable trusts, the deemed owner would recognize gain on the unrealized appreciation in any asset distributed (unless in discharge of the deemed owner's obligation) to anyone other than the deemed owner or the deemed owner's "U.S. spouse" (again undefined), and on the unrealized appreciation in all the assets in the trust when the deemed owner dies or the trust otherwise becomes irrevocable.

The Fiscal Year 2022 Greenbook went a lot farther and, surprisingly, provided that the rules about transfers into and distributions in kind from a trust would also apply to a "partnership" or "other non-corporate entity," without further explanation. The current Greenbook clarifies that this extension to such entities applies "if the transfers have the effect of a gift to the transferee."

The Greenbook also proposes, in effect, a 90-year mark-to-market rule:

Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. For this purpose, a tacking rule would apply to property received in a nonrecognition event from another such entity. This provision would apply to property held on or after January 1, 1944, that is not subject to a recognition event since December 31, 1943, so that the first recognition event would be deemed to occur on December 31, 2033.

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Again assets of partnerships and other entities are included, in this case without a gift-equivalent requirement or other explanation. The Fiscal Year 2025 Greenbook adjusts an anomaly in the previous Greenbooks, in which the cited dates seemed to provide for a period of 91 years, not 90 years, and it adds the clarification of “a tacking rule.” But, because the 90-year mark-to-market rule does not depend on any arguable recognition “event” like a gift, death, or other transfer, that rule is probably the feature of this proposal that would most likely attract a constitutional challenge.

- (k) **Deferral of Tax.** The Greenbook also provides that “[t]axpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated.” This is a helpful clarification of the Fiscal Year 2022 Greenbook, which provided only that the “[p]ayment of tax ... would not be due.” Deferral could increase the amount of tax if there is more appreciation, but it could also prevent the payment of tax to the extent the value of the business declines (which sometimes happens after the death of a key owner). That approach would apparently also tax the realization event at whatever the tax rates happen to be at the time, which might sometimes be a vexing consideration in the executor’s decision to make this election.

If that election is made, would it still be true, as the Greenbook states in the context of exclusions immediately before its discussion of deferral, that “[t]he recipient’s basis in property, whether received by gift or by reason of the decedent’s death, would be the property’s fair market value at the time of the gift or the decedent’s death”? Probably not, because mere deferral of deemed realization (regardless of the amount of gain deferred) is much different from the total escape from realization provided by the limited exclusion. Thus, the loss of a stepped-up basis at intervening deaths could make this ultimate income tax liability much more severe than under current law.

And of course the statutory language implementing this Greenbook proposal should be expected to include definitions of a “business,” “family-owned,” and “family-operated” and possibly rules for the identification of assets that should be excluded from the deferral because they are not used in the business, and such definitions and rules might also create or aggravate challenges over a long-term deferral. The IRS would also be authorized to require reasonable security at any time from any person and in any form acceptable to the IRS, which could be another complication for the family business, for example in raising capital, over a long-term deferral.

In addition, the Greenbook would allow “a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made.” Details about start dates and interest rates are not provided, but the proposal appears much broader and more robust than, for example, section 6166 with its multiple qualification tests.

- (l) **Administrative Provisions.** The Greenbook envisions (but without details) a number of other legislative features, covering topics such as a deduction for the full cost of related appraisals, the imposition of liens, the waiver of penalties for underpayment of estimated tax attributable to deemed realization of gains at death (which, of course, would not have been foreseeable), a right of recovery of the tax on unrealized gains, rules to determine who selects the return to be filed, consistency in valuation for transfer and income tax purposes, and coordination of the changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed.
- (m) **Regulations.** Treasury would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including reporting requirements that could permit reporting on the decedent’s final income tax return, which would be especially useful if an estate tax return is not otherwise required to be filed. In a tacit acknowledgment of the harshness of enacting such a proposal without a “fresh start” for basis as in 1976, the

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Greenbook explicitly contemplates that the regulations will include “rules and safe harbors for determining the basis of assets in cases where complete records are unavailable.”

## (2) **GRATs and Other Grantor Trusts**

The Fiscal Year 2023 Greenbook (at page 40) lamented that “[i]ndividuals who own assets expected to appreciate in value use two common techniques for reducing estate taxes that exploit the gift and income tax features of grantor trusts to remove value from their gross estates.” Those two exploitative techniques turned out to be GRATs (which many would point out were created by Congress in section 2702(b)(1)) and sales of appreciating assets to grantor trusts (which, likewise, many would point out are facilitated by Congress’s use of the phrase “treated as the owner” in sections 673 through 677 and its treatment of income tax as a liability of that owner under section 671). Be that as it may, the Fiscal Year 2023 Greenbook invited Congress to blaze a new trail with the first three ((a) through (c)) of the following proposals. The Fiscal Year 2024 Greenbook and the Fiscal Year 2025 Greenbook (at pages 127-133) follow suit, and go even farther with other proposals, including the following proposals (d) and (e).

(a) **Limitations on GRATs.** Like the Obama Administration Greenbooks, the Greenbook would impose on GRATs

- a minimum term of 10 years,
- a maximum term of the life expectancy of the annuitant plus 10 years,
- a prohibition on any decrease in the annuity during the GRAT term (which otherwise might be used to reduce the amount includable in the grantor’s gross estate if the grantor dies before the end of the GRAT term),
- a minimum remainder value equal to the greater of 25 percent of the assets contributed to the GRAT or \$500,000 (but not more than the value of assets contributed to the GRAT), which would put an end to the very common and effective technique of nearly-zeroed-out GRATs, and
- a prohibition on the grantor’s acquisition of any asset from the GRAT in an exchange without recognizing gain or loss on the exchange.

This proposal would apply to GRATs created on or after the date of enactment. If this proposal gained traction and was given a reasonable chance of being enacted, that might encourage the creation and funding of GRATs before enactment, which would avoid the first four limitations, particularly the huge fourth limitation of a minimum 25 percent remainder value. But merely creating a GRAT before enactment would not necessarily avoid the fifth limitation, because the proposals discussed in paragraph (1)(j) above and paragraph (b) below would apparently also require a GRAT to recognize gain if the annuity payments were made with appreciated assets. (The gain recognition risk might be minimized, if feasible, by using a longer term GRAT in which the annuity amounts were low enough that they could be satisfied out of income, not with in-kind distributions.)

(b) **Recognition of Gain on Sales Transactions with Grantor Trusts.** “For trusts that are not fully revocable by the deemed owner,” “the transfer of an asset for consideration between a grantor trust and its deemed owner” would result in the recognition of gain (thus overruling Rev. Rul. 85-13, 1985-1 C.B. 184), and the basis of the asset would become the amount paid. The proposal uses without elaboration the term “deemed owner” (which implies that it includes a person other than the grantor under section 678) and also the term “grantor trust” (which sometimes implies that a trust treated as owned by a person other than the grantor is not included). The proposal would apply to transactions on or after the date of enactment. It would require the recognition of gain both on sales and on transfers in satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. But, in a refinement of the Fiscal Year 2023 Greenbook proposal, the Fiscal Year 2024 and 2025 Greenbooks propose an addition to section 267(b) that would disallow recognition of losses in

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such transactions. The recognition proposal significantly overlaps with the deemed realization proposals for trusts discussed in paragraph (1)(j) above.

- (c) **Payment of Income Tax by Deemed Owner as Gift.** The payment of income tax on the income of a “grantor trust” (other than a trust that is fully revocable by the grantor, as the Fiscal Year 2024 Greenbook clarified) would be a gift “unless the deemed owner is reimbursed by the trust during that same year” in which the tax is paid. Again, the proposal uses the clashing terms “deemed owner” and “grantor trust.”

The Greenbook states that the gift would generally occur “on December 31 of the year in which the income tax is paid.” Acknowledging the need for some exceptions to that rule, the Greenbook adds “if earlier, immediately before the owner’s death, or on the owner’s renunciation of any reimbursement right for that year.” But even with that addition the Greenbook does not specifically provide for cases where the reimbursement is made only in the trustee’s discretion and not as the deemed owner’s “right,” or where the “reimbursement right” terminates other than by the owner’s renunciation, or when grantor trust (or “deemed owned”) status itself terminates other than by the owner’s death. Likewise, the Greenbook does not address how to determine the year in which the deemed owner pays the income tax on the trust’s income when some of the deemed owner’s income tax liability is paid by quarterly estimated payments, three of which have been made in the year before the income tax return is filed, or by overpayments applied from the previous year’s return. It is almost certain, however, that all such payments would be treated as made in the year the tax is due, because otherwise the notion of being “reimbursed by the trust during that same year” would make no sense.

And of course the annual reimbursement of such taxes pursuant to either a requirement or an exercise of discretion pursuant to an understanding or prearrangement would create a risk of including the value of the trust assets in the grantor’s gross estate under section 2036 as applied in Rev. Rul. 2004-64, 2004-2 C.B. 7 (discussed in Part 8.g above).

The Fiscal Year 2024 Greenbook added that “the amount of the gift cannot be reduced by a marital or charitable deduction or by the exclusion for present interest gifts or gifts made for the donee’s tuition or medical care,” presumably meaning that the deemed owner’s payment of income tax on a trust’s income would be a gift even if the trust’s assets or income are used or could be used to make distributions that would not be taxable gifts if made directly by the deemed owner. But the Fiscal Year 2024 Greenbook clarified that the gift would be an adjusted taxable gift for estate tax purposes. The Fiscal Year 2025 Greenbook retains those refinements.

This proposal would apply to all trusts created on or after the date of enactment (which, if the proposal gains any traction, could provide an incentive to create and fund grantor trusts before the date of enactment).

- (d) **Adjustment of a Trust’s GST Inclusion Ratio on Transactions with Other Trusts.** Like the Fiscal Year 2024 Greenbook, the Fiscal Year 2025 Greenbook notes that a purchase by a GST tax-exempt trust of assets from, or a remainder interest in, another trust (particularly citing a purchase from a GRAT) is “[a] popular technique for leveraging the benefit of the GST exemption.” (A sale of assets by one grantor trust to another grantor trust is generally thought to be exempt from recognition of gain under Rev. Rul. 85-13, 1985-1 C.B. 184, as applied, for example, in Letter Ruling 202022002 (issued Feb. 25, 2020; released May 29, 2020).) The Greenbook would limit that leveraging opportunity by requiring a readjustment of the purchasing trust’s inclusion ratio for all such transactions occurring after the date of enactment. Specifically, the value of the purchased assets would be included in the total value of the trust in the denominator of the applicable fraction, and the value of only the portion of those assets excluded from GST tax immediately before the purchase would be added to the numerator of the fraction. A similar readjustment would be required following a decanting.

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(e) **Modifying the Tax Treatment of Loans from a Trust.** The Fiscal Year 2025 Greenbook notes that “[l]oans to trust beneficiaries are being used to avoid the income and GST tax consequences of trust distributions.” In support of that assumption, it states the obvious fact that “the borrower ... is receiving property from the trust,” and then offers the possibly debatable and in any event situational views that “the borrower is unlikely to have been able to otherwise obtain” such a loan and “these loans are often forgiven or otherwise remain unpaid.”

- i. **Loans to Beneficiaries.** Loans to trust beneficiaries would be treated as distributions, carrying out distributable net income for income tax purposes and constituting, as appropriate, either a direct skip or a taxable distribution for GST tax purposes.
- ii. **Repayment of Loans Made to Beneficiaries.** If a trust beneficiary repays a loan, the payor of any GST tax on the making of the loan could request a refund from the IRS within one year after the final payment on the loan.
- iii. **Repayment of Loans Made to Deemed Owners.** The repayment of a loan made by a trust to a person who is not a trust beneficiary but is a deemed owner of the trust under the grantor trust rules would be treated as a new contribution to the trust, which, like any other contribution, would utilize GST exemption of the borrower, generate a GST tax liability in the case of a direct skip on the borrower or the borrower’s estate, or increase the trust’s inclusion ratio, depending on the borrower’s elections and the generation assignments of the trust’s beneficiaries at the time of the repayment. This is proposed, as the Greenbook puts it, “[t]o discourage borrowing from a trust by [such] a person.” The Greenbook adds:

Any GST tax payable on such a deemed direct skip that could not be collected from a deemed owner or a deceased deemed owner’s estate (such as, if the time for collecting such a debt from a decedent has expired), would be payable by the trust itself.

The proposal includes a grant of regulatory authority to identify certain types of loans that would be excepted from the application of the proposal. This authority could be used to exempt short-term loans, which do not raise the same concerns. Similarly, other exceptions might be the use of real or tangible property for a minimal number of days.

This proposal would apply to loans made, renegotiated, or renewed by trusts after the year of enactment.

d. **Senator Sanders’ “For the 99.8 Percent” and “For the 99.5 Percent” Acts**

- (1) On January 31, 2019, following the surge of Democratic victories in the 2018 House elections, Senator Bernie Sanders (I-Vermont) introduced S. 309, titled “For the 99.8 Percent Act,” an updated compilation of legislative proposals he and other Democrats have been offering for many years regarding the estate, gift, and GST taxes and related grantor trust income tax issues. Senator Sanders has introduced a bill like this in every Congress since 2010, when he named it the “Responsible Estate Tax Act” (S. 3533, 111th Cong., June 24, 2010). The “For the 99.8 Percent Act” included revivals of the GRAT and grantor trust proposals of the Obama Administration Greenbooks discussed above. An identical bill, H.R. 4857, was introduced in the House of Representatives by Rep. Jimmy Gomez (D-California) on October 24, 2019.
- (2) On March 25, 2021, Senator Sanders introduced S. 994, titled “For the 99.5 Percent Act,” which also includes adaptations of proposals from the Greenbooks of the Obama Administration and even the Clinton Administration. A companion bill (H.R. 2576) was introduced in the House of Representatives on April 15, 2021, by Representative Jimmy Gomez (D-California).
- (3) On April 18, 2023, Senator Sanders introduced S. 1178, again titled “For the 99.5 Percent Act.” On the same day, Representative Gomez introduced a companion bill (H.R. 2676) in the House of Representatives.



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- (4) Section 7 of all three bills revives the proposals of the Obama Administration's Greenbooks regarding GRATs, generally in the form in which those proposals solidified in the 2015 and 2016 Greenbooks.
- (a) Like the 2015 and 2016 Greenbooks, the bill would require any GRAT to
    - i. have a term no shorter than 10 years (the proposal in the original 2009 Obama Administration Greenbook),
    - ii. prohibit any decrease in the annuity during the GRAT term (a proposal added in the 2010 Greenbook),
    - iii. have a term no longer than the life expectancy of the grantor plus 10 years (a proposal added in the 2012 Greenbook), and
    - iv. have a remainder interest with a value for gift tax purposes when the GRAT is created equal to at least 25 percent of the value of the assets contributed to the GRAT or \$500,000, whichever is greater (but not greater than the value of the assets contributed) (a proposal added in the 2015 Greenbook).
  - (b) Section 8 of Senator Sanders' 2010 "Responsible Estate Tax Act" had included only the minimum 10-year term and the prohibition on decreases in the annuity, reflecting only the 2009 and 2010 Greenbooks that had been published before then.
  - (c) The 2015 Greenbook had also added that "the proposal ... would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust." That would diminish the availability of some of the proactive techniques that might be used to manage a long-term GRAT. The 2019, 2021, and 2023 bills omit that proposal.
- (5) Similarly, section 8 of all three bills revives the proposals of the Obama Administration's Greenbooks regarding grantor trusts and provides proposed statutory language for those proposals, generally following the 2013 and 2014 Greenbooks.
- (a) The bills would add to the Code a new chapter 16 (titled "Special Rules for Grantor Trusts"), containing a single section 2901 (titled "Application of Transfer Taxes").
  - (b) Section 2901 would apply to any portion of a trust if
    - i. the grantor is the deemed owner of that portion under subchapter J, or
    - ii. a person other than the grantor is the deemed owner of that portion under subchapter J, if that person "engages in a sale, exchange, or comparable transaction with the trust that is disregarded for purposes of subtitle A [the federal income tax subtitle]," to the extent of "the portion of the trust attributable to the property received by the trust in such transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction." (This second category appears to target the techniques known as "BDITs" and perhaps some "BDOTs," whether as a matter of tax policy or simply to crack down on techniques known to be in use.)
  - (c) Tracking the Obama Administration Greenbooks, section 2901 would
    - i. include the assets of such portion in the gross estate of the deemed owner for estate tax purposes,
    - ii. subject to gift tax any distribution from such portion to one or more beneficiaries [presumably beneficiaries other than the deemed owner] during the deemed owner's life, and
    - iii. treat as a gift subject to gift tax the assets of such portion at any time during the deemed owner's life that the deemed owner ceases to be treated as an owner of such portion for income tax purposes.

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- (d) Section 2901 would reduce the amount thereby subject to estate or gift tax by “the value of any transfer by gift by the deemed owner to the trust previously taken into account by the deemed owner under chapter 12.” This is not an exception for the **portion** of the trust attributable to such a taxable gift; it is a “reduction” by the **amount** reported as a gift. In other words, section 2901 would “freeze” the amount excluded from its reach at its initial gift tax value (thus targeting “leveraged” transfers).
  - (e) Section 2901 provides that it “shall not apply to any trust that is includible in the gross estate of the deemed owner (without regard to [section 2901]).” (An additional exception in Senator Sanders’ 2019 bill for “any other type of trust that the Secretary determines by regulations or other guidance does not have as a significant purpose the avoidance of transfer taxes” is omitted from his 2021 bill and again from his 2023 bill.
  - (f) Section 2901 would provide that “[a]ny tax imposed by [section 2901] shall be a liability of the trust.” It does not specify whether any such tax, especially estate tax, would be calculated at the average or marginal tax rate, or in some other way.
  - (g) Section 2901 would apply to
    - i. trusts created on or after the date of enactment,
    - ii. any portion of a trust attributable to a contribution on or after the date of enactment to a trust created before the date of enactment, and
    - iii. any portion of a trust created before the date of enactment if a transaction referred to in paragraph (b)ii above occurs on or after the date of enactment.

e. **Ominous Challenges to GRATs by the IRS**

- (1) **Chief Counsel Advice (CCA) 201939002** (issued May 28, 2019; released Sept. 27, 2019) concluded that stock on a listed exchange transferred to a GRAT by the co-founder and chairman of the board of the corporation had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock.

On his gift tax return, the donor had valued the shares under Reg. §25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift. Reg. §25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value. The CCA reasoned:

The principle that the hypothetical willing buyer and seller are presumed to have “reasonable knowledge of relevant facts” affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property. Estate of Kollsman v. Commissioner, T.C. Memo. 2017-40, [aff’d, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019)]. Moreover, both parties are presumed to have made a reasonable investigation of the relevant facts. Id. Thus, in addition to facts that are publicly available, reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during the course of negotiations over the purchase price of the property. Id. Moreover, a hypothetical willing buyer is presumed to be “reasonably informed” and “prudent” and to have asked the hypothetical willing seller for information that is not publicly available. Estate of Kollsman, supra.

...

... Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of [the date the GRAT was funded], would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

The CCA failed to even mention that because the donor was the chairman of the board of the publicly traded corporation, federal securities laws may have prohibited him from disclosing confidential information regarding the merger.

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The case addressed by the CCA was *Baty v. Commissioner* (Tax Court Docket No. 12216-21, petition filed June 23, 2021). On June 15, 2022, after the petitioner had filed a motion for summary judgment and a memorandum in support (arguing, among other things, the application of the restrictive securities laws) and 12 days before the IRS's response was due, the parties filed a proposed stipulated decision. On June 17, the court entered the stipulated decision and denied the motion for summary judgment as moot.

- (2) **Chief Counsel Advice 202152018** (issued Oct. 4, 2021; released Dec. 30, 2021) involved the founder of what the CCA described as a "very successful company, Company," who transferred shares of the Company to a two-year GRAT. The required annuity payments, as the CCA described them, were "a fixed percentage of the initial fair market value of the trust property." The CCA did not specifically state that that was the fair market value **as finally determined for federal tax purposes**, as described in Reg. §25.2702-3(b)(1)(ii)(B), but it is hard to believe that it wasn't, when that description of the annuity payments in the CCA immediately follows the description of the GRAT (emphasis added) as "a two-year grantor retained annuity trust (GRAT), **the terms of which appeared to satisfy the requirements for a qualified interest under § 2702 and the corresponding regulations.**"

The value used for the transferred shares was based on an appraisal as of a date about seven months earlier that had been obtained to report the value of a nonqualified deferred compensation plan under section 409A. Prior to the transfer to the GRAT, however, the donor had been negotiating with several corporations about a possible merger and had received offers from five different corporations within two and a half weeks before the transfer to the GRAT. Within three months after the initial offers, four of the corporations had submitted higher offers, and, three months after that, the donor accepted one of the offers, an initial cash tender offer for some of the outstanding shares at an amount that was nearly three times greater than the value used for the GRAT, with an option to purchase the remaining shares under a formula valuation.

Several weeks prior to closing the tender-offer purchase, the donor had given shares to a charitable remainder trust and valued the shares pursuant to a qualified appraisal (under section 170(f)(11)) at an amount equal to the tender-offer value. The charitable remainder trust also took advantage of the tender offer.

About six months after the end of the GRAT's two-year term, the purchasing corporation purchased the balance of the Company's shares at a price per share almost four times the value used for the GRAT valuation.

CCA 202152018 has analysis very similar to the reasoning in CCA 201939002. Indeed, the following conclusion in CCA 202152018 is almost word for word the same as the corresponding conclusion in CCA 201939002 quoted above, **except for the additional 17 words (emphasis added) at the end:**

Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of [the date the GRAT was funded], would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation, **and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT.**

That addition is a big further step, which treats the GRAT annuity as not being a qualified interest because of the undervalued appraisal used to determine the annuity amounts that were payable by the GRAT over its two-year term. Accordingly, the donor would be treated as making a gift equal to **the full finally determined value of the shares transferred to the GRAT, without any offset for the value of the retained annuity payments.**

The CCA reasoned by analogy to *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002). In *Atkinson*, no annuity payments were actually made from a charitable remainder annuity trust during the two years from the creation of the CRAT until the donor's death. Although the trust met the statutory requirements for five percent annual distributions, the trust did not operate in accordance with those terms, and the court denied an income tax

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charitable deduction. On appeal, the taxpayer argued that the deduction was denied because of a “foot fault,” or a minor mistake, but the appellate court concluded that the trust had failed to comply with the rules governing CRATs throughout its existence and denied the deduction. The deduction was denied because of the manner in which the trust was operated, even though the agreement itself met the technical requirements for CRATs.

Similarly, CCA 202152018 reasoned that basing the annuity payments on an undervalued appraisal was an “operational failure” that prevents the donor’s interest in the GRAT from being a qualified annuity interest under section 2702, apparently even if the GRAT document included a formula, specifically authorized by Reg. §25.2702-3(b)(1)(ii)(B), to adjust the annuity payments to a specified percentage of the initial fair market value of assets contributed to the GRAT, as finally determined for federal tax purposes. Immediately following the conclusion quoted above, which echoes CCA 201939002, the CCA added (emphasis added):

In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, **intentionally** basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee’s failure to satisfy the “fixed amount” requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and **misleading** appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.

The operational effect of **deliberately** using an undervalued appraisal is to **artificially** depress the required annual annuity. Thus, in the present case, the **artificial** annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See Atkinson.

The nature of a CCA, and a frequent challenge in understanding a CCA, is that it arises from a specific audit of a specific case, and therefore possibly with a specific back-story, not revealed in the CCA itself. Perhaps the IRS concern in this CCA was not so much with the appraised **value** but with the **process**. The donor appears to have used a valuation that the donor knew was seven months out of date, prepared for another purpose, and which substantially undervalued the shares because of intervening events (obviously unknown to the appraiser), even though the same donor showed the necessary initiative and diligence to obtain a qualified appraisal for the subsequent gift to a charitable remainder trust when the higher value would be beneficial. In fairness to the donor and the appraiser, however, it should be noted, as the CCA noted, that, when asked to explain, the company that conducted the appraisal stated:

The appraisal used for the GRAT transfer was only six months old, and business operations had not materially changed during the 6-month period ... For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than \$5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations ... to various charities.

Although there are anecdotal reports of increasingly aggressive IRS audits of GRATs (see Jonathan Curry, “Estate Planners Ponder IRS’s ‘Overaggressive’ GRAT Slapdown,” TAX NOTES, Feb. 15, 2022), the IRS’s extreme reaction in this case, seemingly ignoring even its own regulations about adjusting annuity payments to match redetermined values, may be explained by the perceived lack of any good faith effort whatsoever to determine the initial value, and perhaps by other facts in the case as well.

f. **Gift by Adding Reimbursement of Income Tax to a Grantor Trust: CCA 202352018**

- (1) **Summary.** Reversing the position taken in a 2016 letter ruling, the IRS rules that trust beneficiaries have made a taxable gift, in an undetermined amount, by consenting to add to the terms of an irrevocable grantor trust a discretionary power in the independent trustee to reimburse the grantor for income tax the grantor pays on the trust’s income. Chief Counsel Advice 202352018 (issued Nov. 28, 2023; released Dec. 29, 2023).

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(2) **Facts**

- (a) CCA 202352018 deals with an irrevocable trust that authorizes the independent (not “related or subordinate” to the grantor within the meaning of section 672(c)) trustee to distribute trust principal or income to the grantor’s child “in the trustee’s absolute discretion” and directs that at the child’s death the trust remainder is to be distributed to the child’s issue, per stirpes.
- (b) The grantor retained a power with respect to the trust that causes the grantor to be taxed on all the trust income under section 671 but would not cause the value of the trust assets to be subject to estate tax at the grantor’s death – in other words, making the trust a “grantor trust,” often referred to as a “defective grantor trust.” The CCA does not reveal what power the grantor held, but an example would be a power to reacquire trust assets by substituting property of equivalent value, under section 675(4)(C). Neither the governing state law nor the trust instrument required or authorized the trustee to reimburse the grantor for income tax the grantor pays on the trust’s income.
- (c) At a time when the grantor’s child had living children but no grandchildren or more remote descendants, the trustee petitioned a state court to modify the terms of the trust to give the trustee the discretionary power to reimburse the grantor for the income tax the grantor pays on the trust’s income. Pursuant to a state statute, the grantor’s child and that child’s children consented to the modification. The court granted the petition and issued an order modifying the trust to allow such reimbursements in the trustee’s discretion.

- (3) **Conclusion.** The Chief Counsel’s Office concluded that, as a result of the modification to which they had consented, the beneficiaries “each have made a gift of a portion of their respective interest in income and/or principal” of the trust. Ominously, it added without elaboration that “[t]he result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.”

(4) **Application of Rev. Rul. 2004-64**

- (a) As discussed in Part 8.g above, Rev. Rul. 2004-64, 2004-2 C.B. 7, has been the guide regarding the payment of income tax on the income of a grantor trust for almost 20 years. The Revenue Ruling confirmed that the grantor’s payment of income tax is not a gift by the grantor to the trust’s beneficiaries because it is paid in discharge of the grantor’s own liability, imposed by section 671. It also clarified that if the terms of the trust require the trust to reimburse the grantor for those income tax payments, the grantor has “retained the right to have trust property expended in discharge of [the grantor’s] legal obligation” that would cause the full value of the trust assets to be included in the grantor’s gross estate under section 2036(a)(1). In contrast, it held (emphasis added) that if that reimbursement is only discretionary with the trustee under the terms of the trust or applicable state law and the trustee is not “related or subordinate” to the grantor, that discretion, whether or not exercised,

would not **alone** cause the inclusion of the trust in [the grantor’s] gross estate for federal estate tax purposes. ... However, such discretion **combined with other facts** (including but not limited to: an understanding or pre-existing arrangement between [the grantor] and the trustee regarding the trustee’s exercise of this discretion; a power retained by [the grantor] to remove the trustee and name [the grantor] as successor trustee; or applicable local law subjecting the trust assets to the claims of [the grantor’s] creditors) may cause inclusion of [the trust’s] assets in [the grantor’s] gross estate for federal estate tax purposes.

- (b) Rev. Rul. 2004-64 also held that reimbursement of the grantor for payment of income tax on the trust’s income pursuant to a discretionary reimbursement authority held by an independent trustee “is not a gift by the trust beneficiaries,” apparently even if there is an understanding or pre-arrangement or similar bad facts that are relevant under the Revenue Ruling to the grantor’s own estate tax consequences.

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With regard to the reimbursement discretion, CCA 202352018 distinguishes Rev. Rul. 2004-64 on the ground that the discretionary authority in the Revenue Ruling was granted under the terms of the original governing instrument, not under a modification consented to by the beneficiaries as in the CCA.

**(5) Reversal of a Previous Letter Ruling**

- (a) The CCA acknowledges in a footnote that Letter Ruling 201647001 (issued Aug. 8, 2016; released Nov. 18, 2016) “concludes that the modification of a trust to add a discretionary trustee power to reimburse the grantor for the income tax paid attributable to the trust income is administrative in nature and does not result in a change of beneficial interests in the trust.” But the CCA adds that “[t]hese conclusions no longer reflect the position of this office.” Like the CCA, the 2016 ruling does not offer much insight into the actual context, other than the statement (not mirrored by the CCA) that “[d]ue to unforeseen and unanticipated circumstances, payment by the Grantors of the income taxes on Trust’s income has become unduly burdensome.”
- (b) A similar IRS reversal of position, allowing neither a charitable deduction nor a marital deduction for a charitable remainder unitrust interest that the trustee may “sprinkle” between the grantor’s spouse and charity, was seen in Chief Counsel Advice 202233014 (issued July 12, 2022; released Aug. 19, 2022). CCA 202233014 acknowledged in a footnote that four previous PLRs had allowed an estate tax or gift tax marital deduction for a unitrust interest that could be distributed between charity and the decedent’s or grantor’s spouse in the trustee’s discretion, but (like CCA 202352018) stated in a footnote that “[t]he position in these earlier rulings no longer reflects the position of this office.”
- (c) Significantly, the issuance of a Chief Counsel Advice repudiating a position taken in a letter ruling does not revoke the letter ruling, in the absence of further action specific to the recipient of that letter ruling. Under section 11.04 of Rev. Proc. 2024-1, 2024-1 I.R.B. 1, 65-66, automatic revocation of a letter ruling is limited to the enactment of legislation, the ratification of a tax treaty, a decision of the United States Supreme Court, the issuance of temporary or final regulations, or the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin. That does not include a Chief Counsel Advice.

**(6) Valuation**

- (a) The CCA does not say how to value the purported gifts, stating in another footnote that “[a]lthough the determination of the values of the gifts requires complex calculations, Child and Child’s issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate.” Earlier, in the section titled “Law,” the CCA includes this paragraph:

Section 25.2511-2(a) [of the Gift Tax Regulations] provides that the gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer. Rather, it is a tax upon the donor’s act of making the transfer. The measure of the gift is the value of the interest passing from the donor with respect to which they have relinquished their rights without full and adequate consideration in money or money’s worth.
- (b) Like most CCAs and letter rulings, the CCA makes no immediate or specific application of that paragraph and therefore offers little help with valuation – basically just redundantly reciting that the value “is the value.”
- (c) Still earlier in the “Law” section, the CCA quotes Reg. §25.2511-1(e) for the proposition that “if the donor’s retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.” Again, there is no elaboration and the statement is not very helpful. The context of Reg. §25.2511-1(e) is a transfer by gift of “less than [the donor’s] entire interest in property,” which is awkward to apply to a case in which the purported gift is actually a purported transfer by the donees back to the donor. In any event, taxing the beneficiaries on

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the entire value of the trust property in this case is an outcome that seems simply too extreme to be entertained, even under the surprising aggressiveness of the CCA.

- (d) There are provisions of the Internal Revenue Code, such as sections 2701 and 2702, that are intended and presumably designed to target gifts of less than the transferor's entire interest in the property, but they may not offer much help. For one thing, section 2701 applies to gifts to "a member of the transferor's family," which seems quite inclusive, except that under section 2701(e)(1) it is limited to the transferor's spouse, descendants of the transferor or the transferor's spouse, and spouses of such descendants. It would not apply to the purported transfer here by the child and grandchildren of the grantor to their parent or grandparent. Section 2702 does apply to transfers to ancestors, under section 2704(c)(2)(B) (incorporated by section 2702(e)), but its focus under section 2701(e)(2) (incorporated by section 2702(a)(1)) on the **retention** of interests only by the transferor, the transferor's spouse, or their **ancestors** or ancestors' spouses reflects the focus on transfers to younger generations with interests retained by older generations.
- i. That is confirmed by the fact that every example in the section 2702 regulations that identifies a transferee mentions only children, or in a couple instances the spouse, of the transferor. See Reg. §§25.2702-2(d), 25.2702-3(e), 25.2702-4(d), 25.2702-5(d), and 25.2702-6(c). To be fair, those examples may simply reflect the types of transfers that are most common. But they are consistent with the traditional focus on transfers to **younger** generations illustrated, for example, in Rev. Rul. 81-264, 1981-2 C.B. 185, which held that the running of a state statute of limitations on recovery of a demand loan and accrued interest resulted in a taxable gift by "D" (the lender) to "A" (D's child). The ruling showed its preoccupation with transfers to lower generations by reasoning (emphasis added):
- Here, as in all such familial transactions, there is a presumption that the transfer of wealth from D to A without consideration is not entirely free of donative intent. ... A had the resources to pay the debt, and, **as D's child**, was **the natural object of D's bounty**. **On these facts**, D's failing to enforce the debt obligation and permitting it to be barred by the statute has not been shown to be free of donative intent.
- ii. Moreover, except under section 2702(a)(3)(ii) and (b) where an interest in a personal residence or an annuity or unitrust interest is involved (which don't appear to be applicable to the reimbursement of income tax paid), the result under section 2702(a)(2)(A) is apparently that the beneficiaries could be treated as making taxable gifts equal to the entire value of the trust assets (an outcome, as stated above, that seems simply too extreme to be entertained), or perhaps only the value of their particular interests at the time, which seems very difficult to determine.

#### (7) **A Radical Alternative: Section 2519**

- (a) Section 2519 is another Code section that in effect could impose gift tax on the entire value of the assets in a trust – in this case a QTIP trust if the surviving spouse disposes of only the spouse's life interest, which is only a **part** of the trust. In fact, section 2519 would treat even the "disposition of ... **part** of a qualifying income interest for life" as a disposition of the **entire** interest in the trust apart from that income interest.
- (b) The potential mischief of such a rule is illustrated in Chief Counsel Advice 202118008 (issued Feb. 1, 2021; released May 7, 2021), in which the IRS ruled that the agreement of the surviving spouse and the deceased spouse's children (as remainder beneficiaries and as virtual representatives of the contingent and unborn beneficiaries) to distribute all the assets of a QTIP trust to the spouse (in what the CCA called a "commutation") resulted in both (1) a disposition of the surviving spouse's qualifying income interest under section 2519(a), and thus, the surviving spouse's gift of all of the interests in the trust other than the qualifying income interest, and (2) a gift by the remainder beneficiaries of their remainder back to the spouse.
- (c) By not permitting any offset of those two opposite or circular gifts, CCA 202118008 attracted considerable attention from estate planners, as imposing unnecessary double taxation.

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Indeed, on the same day as the commutation, the spouse transferred assets, some by gift and some (including assets received from the QTIP trust in the commutation) in exchange for promissory notes, to irrevocable dynasty trusts that the spouse had created for the benefit of the children and their descendants. Those transfers, plus the observation that other assets received in the commutation and retained by the spouse would be subject to estate tax at the spouse's death, escalated some of the reactions to a perception of **triple** taxation.

- (d) Nevertheless, the Chief Counsel's Office seemed to have no problem concluding in CCA 202118008 that "the QTIP statutory scheme and legislative history support the view that ... the separate transfers by Spouse and Children cannot be offset by consideration for tax purposes."
- (e) There is, however, no similar "statutory scheme" applicable in CCA 202352018, which cites nothing but generally applicable gift tax regulations.

#### (8) **The Challenge of Gift Tax Valuation**

- (a) One way to deal with the valuation challenge might be to treat any reimbursement pursuant to the modified trust terms as a gift by the beneficiaries when that reimbursement is made. But that is just not the way the gift tax works (unless the "gift" is treated as "incomplete" until a reimbursement, if any, is made, for which the CCA offers no grounds for optimism). The gift tax depends on projections, maybe actuarial factors, and math – "complex calculations," as the footnote in the CCA puts it. Perhaps appraisals, although an appraisal would undoubtedly raise issues of extraordinary assumptions, hypothetical conditions, and limiting conditions (purportedly imposed by the CCA itself) that at a minimum would require disclosure in any appraisal report under the Uniform Standards of Professional Appraisal Practice (USPAP), and, together with the absence of any "comparable sale" data, might also discourage a qualified appraiser from undertaking the engagement.
- (b) And even if the creation of the discretionary reimbursement authority can be credibly viewed as a gift and credibly valued for gift tax purposes, the apportionment of that value among the current, future, contingent, and even unborn beneficiaries would pose still another challenge – not to mention how an unborn beneficiary could be required to file a gift tax return or be liable for gift tax. Ironically, and perhaps unintentionally, the CCA itself seems to envision gift tax liability for unborn beneficiaries by asserting in its footnote that "Child and Child's **issue** cannot escape gift tax on the basis that the value of the gift is difficult to calculate," when in the facts of the CCA "Child's issue" currently include only Child's **children**.

In fairness, the CCA does not **explicitly** state any intention to treat unborn contingent beneficiaries as donors, and the use of "issue" may be just an inclusive drafting convention that estate planners often use as well. Besides, unborn beneficiaries could never personally give their consent anyway. But does that mean that no loss of value attributable to the reimbursement authority is attributed to them? Or that the loss of value attributed to them is deemed to be part of the gift by their parent or other ancestor? Or that the loss of value attributed to them is just not treated as a gift. Of course if no value is attributed to unborn beneficiaries – taking a more or less "qualified beneficiary" approach – valuation might be a bit simpler, because it could bypass very speculative steps such as estimates of fertility.

#### (9) **Reflections and Comments**

##### (a) **The Role and Backstory of a CCA**

- i. A Chief Counsel Advice typically arises from a specific audit or audits of a specific case or cases that are probably headed to litigation if they are not settled. For that reason, it is always possible that there is a backstory, not revealed in the CCA itself, that would explain the IRS's seemingly excessive reaction. It is also reasonable to assume that a CCA is written to support the strongest possible litigation position, either to reinforce the litigation itself or to encourage the taxpayer to agree to a settlement that is favorable to



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the IRS, which in this case might be an agreed higher value for the beneficiaries' purported gifts.

- ii. The backstory of CCA 202352018 also includes that fact that it is addressed to two IRS Associate Area Counsels – Janice B. Geier in Portland, Oregon, and Sheila R. Pattison in Austin, Texas – who have been among the IRS counsel of record in a number of Tax Court cases, including cases well-known to estate planners. Ms. Pattison was counsel in the Texas cases of *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd in part, and rev'd and rem'd in part*, 293 F.3d 279 (5th Cir. 2000), involving the includability in a decedent's gross estate of the value of property that the decedent had transferred to a limited partnership, and *Nelson v. Commissioner*, T.C. Memo. 2020-81, *aff'd*, 17 F.4th 556 (5th Cir. 2021), involving a defined value clause limited to appraisals obtained shortly after the dates of the transactions. Ms. Geier was counsel in the *Strangi* case on remand, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), and the Oregon case of *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, involving "tax-affecting" in the valuation of interests in timber businesses. Thus, it is hard to view the CCA as a request by inexperienced lawyers for education from the National Office and perhaps more likely that it should be viewed as a more strategic step in the context of anticipated litigation.

**(b) The Frustrating Dilemma of the CCA**

- i. Even so, CCA 202352018 will seem troubling to many. And rightly so. There does not appear to be any reason for the IRS to be concerned about the potential for placing more money in the hands of a grandparent where it could be subject to transfer tax in the near future, rather than continuing to accumulate it free of transfer tax to pass to the grandchildren or potentially even great-grandchildren. The CCA does not say a word to indicate why the IRS would or should be concerned about that.
- ii. As noted above, Rev. Rul. 2004-64 confirmed that the grantor's payment of income tax on the income of a grantor trust is not a gift by the grantor to the trust's beneficiaries because it is paid in discharge of the grantor's own liability, imposed by section 671. In other words, when the trust was created as a grantor trust, the grantor gave the beneficiaries the value transferred to the trust, which was a taxable gift, and also gave the beneficiaries a framework within which the grantor would in effect pay the future income tax on **their** income, but that was **not** a taxable gift. If the benefit of the arrangement to pay that income tax is not a transfer to the beneficiaries for gift tax purposes, how, it might be asked, can what amounts to a diminution of that benefit or even the return of that benefit to the grantor, in whole or in part, be a transfer for gift tax purposes?

**(c) What About Simply Relinquishing the Grantor Trust Feature?**

- i. Or suppose the grantor's retained power or other feature of the trust that makes it a grantor trust can be relinquished or renounced by the grantor. Whether, when, and how it can be relinquished or renounced might be difficult to determine and might vary widely, depending on the particular grantor trust power or feature involved, the other specific terms of the trust, the applicable state law, and sometimes the experience and perspective of the observer. The CCA does not clarify whether relinquishment or renunciation was an option in the case or cases it addresses. Of course such relinquishment or renunciation could not possibly be a gift by the grantor – it leaves the grantor better off, not worse off. But neither can it be a gift by the beneficiaries – even though they are left worse off, they didn't do anything. So what if the beneficiaries consent to giving the trustee a discretionary reimbursement authority in order to **deter** the grantor from taking the more decisive action of relinquishment or renunciation? How could that be a gift by the beneficiaries, when they gain, not lose, from avoiding the grantor's more decisive action of relinquishment or renunciation?

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- ii. Often (although not necessarily always), the grantor's consideration of relinquishment or renunciation of grantor trust status may be prompted by the anticipation of an extraordinary gain, perhaps from the sale of an asset that has been the trust's sole or principal asset, has performed very well, but in the view of the trustee has reached the point where it would be prudent to replace it with other assets, possibly more diversified, that the trustee believes have better income and/or appreciation potential for the future. There might be serious doubt about the grantor's ability under the terms of the trust to suspend the grantor trust feature for only one taxable year. The presence of a discretionary reimbursement authority that would permit reimbursement, perhaps even partial reimbursement, only for the taxable year of that extraordinary transaction (in the trustee's discretion if the trustee finds that to be in the best interests of the beneficiaries to whom the trustee owes a fiduciary duty), would both meet the grantor's concerns and serve the beneficiaries' interests, and would leave in place the beneficiaries' right to expect the grantor, again, to effectively pay the income tax on those beneficiaries' income in the future.

(d) **The Importance of Fiduciary Duty.** In fact, wouldn't the strong principle of **fiduciary duty** that governs all the trustee's actions always govern **any** discretionary reimbursement by the trustee of the grantor pursuant to the type of discretion added to the terms of the trust in the facts of CCA 202352018? (And wouldn't that also include a fiduciary duty to ensure that the value of the trust assets is not included in the grantor's gross estate, especially if that would expose the trust to apportionment of estate tax?) If so, shouldn't that lead to the conclusion that **any** exercise by the trustee of a discretionary power to reimburse the grantor for income tax paid would occur only if the trustee determined it to be in the beneficiaries' best interests? Therefore, isn't it true that in fact the beneficiaries are not **hurt** but **benefited** – that is, they **will not lose** and they **may gain** – by the presence of such a power? So how can the creation of such a power be a gift by beneficiaries? Again, the CCA does not say a word to indicate that the IRS has considered such obvious facts of life.

(10) **So What's Next?** As noted above, CCA 202352018 is probably a step in the audit of an actual case or cases headed to settlement or to litigation. If settled, there will be no public release of any kind, as there was of the CCA itself, which did not identify names, dates, amounts, or other details. Sometimes advisors involved in such settlements receive permission from the taxpayers to discuss the cases publicly, but that is rather rare.

If the case or cases go to litigation, there will probably be unredacted public documents that shed more light on the case, including possibly a court opinion or, alternatively, a stipulated decision to reflect a settlement reached after the litigation is commenced. And we might learn more about the "backstory" from such documents, especially an opinion. More interestingly, if the outcome is anything but a complete taxpayer victory, we could learn more about how such an outcome could possibly be explained and justified.

(a) **The Examples of CCA 201939002 and CCA 202152018.** This waiting game recalls the waiting game of Chief Counsel Advice 201939002 and the possibly ongoing waiting game of Chief Counsel Advice, both discussed in Part 12.e above.

(b) **Application to CCA 202352018**

- i. So, in the case of CCA 202352018, we might hear rumors about a settlement at the IRS. Or we might see some court documents that suggest that litigation had commenced but the case was settled and a stipulated decision entered. Or we might be treated to a full-blown court opinion, in which, as stated above, it would be very interesting to see how anything but a complete taxpayer victory is justified. Or we might hear nothing more.
- ii. Meanwhile, and regardless of the outcome, the CCA has created a lot of turmoil.