SOPHISTICATED ESTATE PLANNING FOR HIGH WEALTH CLIENTS[1]

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A. General Tax Principles Applicable to Installment Sales to Grantor Trusts

1. Does Either or Both of IRC §§2701 or 2702 Apply to an Installment Sale to a Grantor Trust?

Essentially, under both I.R.C. §§2701 and 2702,[3] certain interests in a partnership, corporation or trust owned or retained by a transferor are treated as having no value thereby causing the entire amount involved in the transfer to or acquisition by members of the transferor's family to be treated as a gift. If either section applies to an installment sale, the result would be adverse. In the Tax Court case involving taxpayer Sharon Karmazin, Docket 2127-03, the IRS took the position that both I.R.C. §§2701 and 2702 may apply to an installment sale—essentially, because, in the IRS's view, the note received in the sale did not constitute debt for purposes of those sections. That case was settled with the IRS and, according to taxpayer's counsel, on grounds other than that either section applied. As long as the note, in fact, represents debt, it seems, as is discussed below, that neither section should apply.[4]

2. Are the Trust Assets Included in the Grantor's Estate If the Grantor Dies While the Note Is Outstanding?

It is at least strongly arguable that, in general, property sold on the installment basis is not included in the seller's gross estate because the seller has not retained an interest in the property sold, but has received only the buyer's promise to pay for the property as evidenced by the note.[5] The value of the buyer's note would be included in the seller's gross estate. However, in the case of an installment sale of property to a trust created by the seller which will continue to hold the property

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[2] Excerpted in part from J. Blattmachr & D. Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?," 41st Annual Heckerling Institute on Estate Planning, Chapter 1 (2007).

[3] All references to a section or § of the Code or IRC are to the Internal Revenue Code of 1986, as amended, and the all references to the regulations are to the Treasury Regulations promulgated thereunder.

[4] *See, generally*, R. Keebler and P. Melcher, "Structuring IDGT Sales to Avoid Section 2701, 2702, and 2036," Estate Planning Journal (Oct. 2005).

[5] *See Moss v. Comm'r*, 74 T.C. 1239 (1980); *Cain v. Comm'r*, 37 T.C. 185 (1961) (both involving so-called self-canceling installment notes). A similar rule applies in the case of a transfer of property in exchange for a private annuity. *See* Rev. Rul. 77-193, 1977-1 C.B. 273. The basic test was set forth in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), which holds that where a decedent has transferred property to another in return for a promise to make periodic payments for the decedent's lifetime, the payments are not income from the transferred property so as to cause inclusion of that property in the decedent's estate, if the payments are (i) a personal obligation of the buyer, (ii) not chargeable to the transferred property, and (iii) not measured by the income from the transferred property.

and the earnings thereon (together with any assets initially contributed by the seller), the trust's potential inability to satisfy the note other than with the property itself or the return thereon might support the argument that the seller has retained an interest in the property sold. The seller's retained interest would cause estate tax inclusion under I.R.C. §2036.

For purposes of I.R.C. § 2036, as well as I.R.C. § 2701 and 2702, the critical question would appear to be whether the debt is *bona fide*. If it is, the seller should not be viewed as having retained an interest in the transferred property, which should preclude the IRS from invoking any of those sections. Indeed, the IRS appears to concede as much in PLR 9515039.[6] That ruling focused on the resources available to the obligor with which to make payments on the note, finding no retained interest where the daughter/obligor had sufficient wealth but reaching a contrary conclusion where the trustee/obligor had no other assets. It would seem, therefore, that if the obligor (or guarantor) has sufficient independent wealth or, in the case of a trust, the trustee has other assets, the note ought to be respected as a *bona fide* one.[7] Moreover, if the asset subject to the installment sale and its anticipated total return are sufficient to satisfy the obligation on the note, the note should not fail as debt. Rather, if the trust is reasonably expected to be able to satisfy the note by making all payments when due, even if those payments must be made from the asset purchased and the total return thereon, the note obligation should be viewed as debt and not equity.[8]

The IRS has issued several private letter rulings and technical advice memoranda which, it seems, bear on this issue of possible gross estate inclusion. In the earliest such ruling, TAM 9251004, the donor transferred stock to a trust for the benefit of his grandchildren in exchange for a 15-year note bearing current interest with all principal due upon maturity. Because the value of the stock exceeded the value of the note, the donor intentionally made a part sale/part gift to the trust. The TAM states that, because the trust had no other assets, it must use the dividends on the stock to make interest payments on the note. The TAM characterizes this as a "priority right to the trust income," and also notes that although the trustee was not prohibited from disposing of the stock, "the overall plan as established by the tenor of the trust is that the trust will retain the closely held shares for family control purposes." The TAM concludes that under the circumstances the donor made a transfer with a retained life estate under I.R.C. §2036.

This TAM in the view of some is poorly reasoned and, perhaps, may be distinguished because the transfer was simultaneously donative in part.

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[6] Under IRC § 6110(k)(3) neither a private letter ruling not a technical advice memorandum may be cited or used as precedent.

[7] *Cf. Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003) (analyzing whether the note was bona fide in the gift tax context).

[8] Bootstrap sales have long been upheld by the courts, despite IRS challenges asserting that they represent another relationship. *See Commissioner v. Clay Brown*, 380 U.S. 563 (1965); *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq.* 1969-2 C.B. 23.

Moreover, subsequently, in PLR 9639012, the IRS appeared to adopt a somewhat different view. In PLR 9639012, the donors established qualified subchapter S trusts ("QSSTs")[9] for their children, and then partly sold and partly gifted nonvoting stock to the trusts. Apparently, dividends would be used first to pay interest and principal with respect to the stock purchase, with the full price to be paid within three years.[10] The IRS ruled that the agreement to use cash dividends to pay interest and principal on the note would not be considered a transfer or assignment of the income interest of the QSST beneficiaries, or cause the trusts to fail to qualify as QSSTs, and also ruled that no part of the trust would be included in the donor-sellers' estates.

In PLR 9535026, a donor contributed assets to a trust, and then sold stock to the trust in exchange for a 20-year note bearing current interest at the AFR under I.R.C. §7872, with all principal payable at maturity. The note was secured by the stock sold. The PLR does not recite that there was any request by the taxpayer for a ruling with respect to inclusion in the estate under I.R.C. §2036. However, the PLR did hold that if the fair market value of the stock equals the principal amount of the note, the sale would not result in a gift. This conclusion is stated to be "conditioned on the satisfaction of both of the following assumptions: (i) no facts are presented that would indicate that the note will not be paid according to its terms, and (ii) the [trust's] ability to pay the notes is not otherwise in doubt."[11] In addition, the PLR concludes that the note would not be an "applicable retained interest" under I.R.C. §2701 (and, therefore, the section will not apply), and that I.R.C. §2702 would not apply because the note would be debt, rather than a term interest. Although both I.R.C. §2701 and I.R.C. §2702 are gift tax provisions, these rulings (particularly the ruling under I.R.C. §2702, which section deals with valuation of transfers in trust to or for the benefit of family members when interests in the transferred property are retained) would seem analogous to any reasoning under I.R.C. §2036 for estate tax purposes. This conclusion was, however, stated to be "void if the promissory notes are subsequently determined to be equity and not debt. We express no opinion about whether the notes are debt or equity because that determination is primarily one of fact."[12] Interestingly, the trusts were self-settled, discretionary trusts. The ruling does not analyze the potential estate and gift tax consequences of that fact.

The IRS has also issued rulings involving what may be viewed as somewhat analogous situations, wherein property is transferred to a trust in exchange for

[9] IRC § 1361(d).

[10] The facts are somewhat complex, because the donors had previously purchased voting stock of the corporation from a third party and then distributed the nonvoting stock as a dividend with respect to that voting stock, and from the facts it is not clear whether the interest and principal payments referred to were being made to the donors or directly to the third party.

[11]The practitioners who submitted the ruling have advised that the IRS also required that the trust have other assets of at least 10% of the value of the assets sold as a condition to the issuance of the ruling.

[12]*Cf*. PLR 9436006, involving an installment sale of partnership units and marketable securities to a trust in exchange for a 35 year note with interest at the AFR. The IRS ruled, without further caveats, that IRC §§ 2701 and 2702 would not apply because the seller would hold debt.

payments for life (an annuity). In PLR 9644053, a husband and wife owned as community property stock of a corporation which, in turn, owned a partnership interest. As part of a property settlement incident to divorce, the wife was to receive the stock and was to make annuity payments to a trust for the husband's benefit for the husband's lifetime. The PLR states that "it appears that the amount of the annual payments to [husband] under the annuity agreement and the obligation of [wife] to make the annual payments are independent of the value of the stock or the income generated by the stock although the taxpayer agrees that the source of the annuity payments will be the payments of partnership profits to [corporation]. In order to prevent the immediate dissolution of the partnership to effect the property settlement, the payments to [husband] are secured by the guarantee of [partnership]. . . . Default by [wife] may only indirectly result in the sale of [corporation] stock by [wife]. Thus, it appears that [husband] has not retained any control over the stock . . . and that the transfer of property and property interests between [husband] and [wife] will be a *bona fide* exchange for full and adequate consideration." However, the PLR concludes that whether I.R.C. §2036 applies can best be determined upon consideration of the facts as they exist at the transferor's death, and so did not rule on that issue.

In PLR 9515039, the taxpayer entered into what purported to be a split purchase with a trust, with the taxpayer acquiring a life estate and the trust acquiring the reminder interest in a general partnership interest. The PLR first recharacterizes the transaction as a transfer of property to the trust in exchange for the right to receive a lifetime annuity. The PLR reaches this conclusion under I.R.C. § 2702 which the ruling concludes applies whenever two or more members of the same family acquire interests in the same property with respect to which there are one or more term interests. The PLR then concludes that because the trust held no assets other than the remainder interest, not only did the annuity interest retained by the taxpayer fail as a qualified annuity interest, but, "the obligation to make the payments is satisfiable solely out of the underlying property and its earnings. Thus, the interest retained by [taxpayer] under the agreement, being limited to the earnings and cash flow of Venture [the investment held by the family entity subject to the joint purchase] will cause inclusion of the value represented by the [trust's] interest to be includible in [taxpayer's] gross estate under I.R.C. § 2036 (reduced, pursuant to I.R.C. § 2043, by the amount of consideration furnished by [the trust] at the time of the purchase)."[13]

[13]This may be compared with the conclusion in PLR 9515039 that a transfer of assets by the taxpayer to her daughter in exchange for a lifetime annuity would not cause inclusion of the transferred property in the taxpayer's estate because the daughter held sufficient personal wealth to satisfy her potential liability for payments to the taxpayer, and neither the size of the payments nor the obligation to make those payments related to the performance of the underlying property. *See* Rev. Rul. 77-193, 1977-1 C.B. 273 (payments will not represent a retained interest in the transferred property causing estate tax inclusion under section 2036 so long as the obligation is a personal obligation, the obligation is not satisfiable solely out of the underlying property and its earnings, and the size of the payments is not determined by the size of the actual income from the underlying property at the time the payments are made).

There seems to be little case law addressing the gift and estate tax effects of an installment sale to a trust. However, in a series of cases which involved what might be viewed as a somewhat analogous issue under the income tax law,[14] the United States Court of Appeals for the Ninth Circuit (the "Ninth Circuit") has repeatedly taken the position that the transactions were properly characterized as sales in exchange for annuities rather than transfers with retained interests in trusts, except in one case where the annuity payments were directly tied to the trust income.[15] The Ninth Circuit relied on the fact that any trust property (not just the income) could be used to pay the annuity, the transaction was properly documented as a sale, and the taxpayer/seller did not continue to control the property after the sale to the trust.[16] In *Fabric v. Comm'r*,[17] a case which was appealable to the Ninth Circuit, the Tax Court (albeit with expressed reluctance) applied the analysis of the foregoing cases in the estate tax context under I.R.C. §2036, observing that "the rationale of these cases is fully applicable to the case at bar."

In *Moss v. Comm'r*,[18] the decedent sold his stock in his closely held company to the company in return for an installment note that would be canceled upon his death, and the note was secured by a stock pledge executed by the other shareholders. The Tax Court observed that "[e]ven should we consider the payments to decedent as an 'annuity' the value of the notes would still not be includible in his gross estate. . . . While the notes were secured by a stock pledge agreement this fact, alone, is insufficient to include the value of the notes in

[14]In those cases, taxpayers transferred property to trusts in exchange for annuity payments for life, which they claimed were taxable under the special rules of IRC § 72 relating to annuities; the Service contended that the transactions were not, in fact, sales in exchange for annuities, but rather were transfers with retained interests resulting in grantor trust status for income tax purposes.

[15]In *Lazarus v. Comm'r*, 58 T.C. 854 (1972), *aff'd*, 513 F.2d 824 (9th Cir., 1975), the court held that the taxpayer made a transfer with a retained interest based largely on the fact that the trust immediately sold the transferred stock for a note the income of which matched exactly the payments due to the grantor and, because it was non-negotiable, the income from which represented the only possible source of payment. The Ninth Circuit also cited the fact that the arrangement did not give taxpayer a down payment, interest on the deferred purchase price or security for its payment as indicative of a transfer in trust rather than a bona fide sale. However, in subsequent cases the court repeatedly distinguished *Lazarus* (and reversed the Tax Court) to reach the opposite result. *See, e.g., Stern v. Comm'r,* 747 F.2d 555 (9th Cir. 1984); *La Fargue v. Comm'r*, 689 F.2d 845 (9th Cir. 1982). For example, in *La Fargue*, the taxpayer transferred $100 to a trust and a few days later transferred property worth $335,000 to the trustees in exchange for a lifetime annuity of $16,502. While noting that, as in *Lazarus*, the transferred property constituted the "bulk" of the trust assets, the court held there was a valid sale because there was no "tie in" between the income of the trust and the amount of the annuity. *But see Melnik v. Comm'r*, T.C. Memo 2006-25 (sale of stock to foreign company owned by foreign trusts in exchange for private annuities treated as a sham lacking business purpose where taxpayers were unable to document chronology of establishing the structure and subsequently borrowed funds from the corporation and defaulted on the notes, although accuracy-related penalties under IRC § 6664 were abated based on taxpayers' reasonable reliance on the advice of counsel).

[16]The Tax Court has been particularly attentive to this control issue in applying the *La Fargue* rationale to subsequent cases. *See, e.g., Weigl v. Comm'r*, 84 T.C. 1192 (1985); *Benson v. Comm'r*, 80 T.C. 789 (1983). *See also, Samuel v. Comm'r*, 306 F.2d 682 (1st Cir. 1962).

[17] 83 T.C. 932 (1984).

[18] 74 T.C. 1239 (1980).

decedent's gross estate."[19] It seems that a sale to a trust is somewhat analogous to a sale secured by the transferred property.

One disturbing development in the jurisprudence on distinguishing debt from equity is the Tax Court's analysis of the applicable factors in *Estate of Rosen v. Comm'r.*[20] In *Rosen*, the decedent contributed substantial marketable securities to a family limited partnership in exchange for 99% of the limited partnership units. Subsequent to the formation of the partnership, the decedent received assets from the partnership that she used to continue her cash gift giving program and for her own support and health care needs. The taxpayer argued that the partnership distributions were loans, not evidence of a retained interest that would cause the partnership assets to be included in the decedent's estate under I.R.C. §2036. The Tax Court disagreed, found the payments not to be loans, but rather distributions from the partnership, and further found that because the parties had agreed that such payments would be made, they were evidence of a retained interest.

Unsettling, for purposes of determining how best to structure an installment sale to avoid recharacterization of the debt as a retained interest, is the Tax Court's application of what it determined to be the relevant factors for purposes of making the debt/equity distinction. Rather than applying the factors previously used by the Tax Court to distinguish a loan from a gift in *Miller v. Comm'r*,[21] the Tax Court embarked on an analysis applying the factors used in the income tax context to distinguish a loan from a capital contribution to an entity to determine whether distributions from the family partnership to the decedent were loans or partnership distributions that constituted evidence of a retained interest in the assets transferred to the partnership. Because the funds were flowing in the opposite direction, out of the partnership, rather than into the partnership, the Court struggled to apply the new factors in a sensible way, and even when those factors would have supported the conclusion that the arrangement was a loan, miraculously concluded the opposite.

The factors that are common to both a gift tax and an income tax analysis are: (1) the existence of a promissory note or other evidence of indebtedness; (2) the presence or absence of a fixed maturity date; (3) the presence of absence of a fixed interest rate and actual interest payments; (4) the presence or absence of

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[19] The court cited *Fidelity-Philadelphia Trust Co.*, discussed *supra* at note 49. The IRS has acquiesced only in the result in *Moss* (1981-2 C.B. 1), indicating a disagreement with at least some part of its reasoning.

[20] T.C. Memo. 2006-115.

[21] *See Miller v. Comm'r.*, 71 T.C.M. 1674 (1996), *aff'd*, 113 F.3d 1241 (9th Cir. 1997) ("The mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise would not be enforced is not afforded significance for Federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth. . . . The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances, including whether: (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual payment was made, (7) the transferee had the ability to repay, (8) records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan"). See, also, *Santa Monica Pictures, LLC v. Comm'r,* TC Memo 2005-104.

security; and (5) the borrower's ability to pay independent of the loan proceeds or the return on the asset acquired with the loan proceeds. Although factor (5) might give one pause in the case of an installment sale to a trust, which may or may not have substantial assets independent of those purchased in the installment sale, it would appear that so long as the trust is solvent from inception, and in fact is able to satisfy the obligation by its terms when payments are due, that the lack of a "sinking fund" or independent assets should not cause the installment obligation to fail as debt, consistent with the cases involving sales in exchange for a private annuity discussed above. Moreover, in *Miller*, the court's analysis of the debtor's ability to repay reveals that a finding of insufficient independent assets to repay the debt was relevant only because the court found that the taxpayer would not have demanded repayment from the assets purchased with the loan proceeds. On the other hand, in an installment sale, the assets purchased by the trust typically expressly secure the debt; thus, the grantor necessarily contemplates repayment with the assets purchased if the trust is otherwise unable to repay the loan. The foregoing is consistent with the income tax cases as well because the income tax cases support a finding of debt if the loan proceeds are used for daily operations rather than for investment.[22] Such use of the loan proceeds would require another source of funds to repay the debt, a distinguishing factor from an installment sale to a trust.

The court in *Rosen* ignored the following additional factors held applicable in the gift tax context: (1) whether there was a demand for repayment; (2) whether there was actual repayment; (3) whether the records of the transferor and transferee reflected a loan; and (4) whether the transfers were reported for tax purposes consistent with a loan. These factors certainly seem relevant to the analysis as they demonstrate the intent of the parties, and would show conduct consistent with that intent. Instead, the court in *Rosen* applied the following additional factors: (1) identity of interest between creditor and equity holders; (2) ability to obtain financing from an outside lender on similar terms; (3) extent to which repayment was subordinated to the claims of outside creditors; (4) the extent to which the loan proceeds were used to acquire capital assets; and (5) adequacy of the capitalization of the enterprise. Although the decedent was the only borrower, and the other partners borrowed nothing, the court, in complete conflict with the analysis in the income tax cases cited by the court, concluded that additional factor (1) indicated the distributions were not loans. With regard to additional factor (3), the court held it was either inapplicable or indicated the distributions were not loans because the loans were unsecured (actually a repetition of common factor (4)). Although the use of the loan proceeds for daily operating expenses weighs in favor of debt in the income tax arena, the court somehow reached the opposite conclusion in *Rosen*, and held that the decedent's use of the distributed funds for daily needs weighed against debt or that additional factor (4) was irrelevant. The court held that because an arm's length lender would not have lent to the decedent on the same terms, additional factor (2) indicated that the

[22] *See, e.g., Roth Steel Tube Co. v. Comm'r,* 800 F.2d 625 (6th Cir. 1986); *Stinnett's Pontiac Serv., Inc. v. Comm'r*, 730 F.2d 634 (11th Cir. 1984).

distributions were not debt. And the court held that additional factor (5) was irrelevant.

Thus, out of all the additional factors analyzed by the *Rosen* court, only additional factor (2) (whether the seller could have obtained independent financing on similar terms) would appear at all relevant in the installment sale context, with the potential to weigh against the installment sale obligation constituting *bona fide* debt. It is interesting that the *Rosen* court appears to imply that the parties should have agreed to a higher rate of interest to accommodate the fact that the decedent may have been viewed as a high risk creditor. Yet, an increased interest rate would appear to enhance the argument that the debt constituted a retained interest. Suppose for example that the installment obligation bears interest in excess of the applicable federal rate, the rate approved by the Tax Court in *Frazee v. Comm'r*[23] to avoid recharacterization of a loan as a gift? The taxpayer would be well advised to obtain independent verification of the rate that an arm's length lender would require if a rate in excess of the AFR is used. Given the possible risk of recharacterization of the installment obligation as a retained interest in the trust, a structure that avoids the contributor to the entity that is the subject of the installment obligation being the same person as the seller of the entity interest in the installment sale transaction would appear to be good practice. So, for example, husband could contribute assets to an entity owned by wife, and wife would engage in the installment sale transaction with her grantor trust. Wife could not be said to have retained an interest in the underlying partnership assets, because she did not transfer those assets to the partnership.

More encouraging is the Tax Court case *Dallas v. Commissioner,*[24] involving two sets of installment sales to trusts for the decedent's sons. Among the issues in *Dallas* was the value to two separate self-cancelling installment notes used in the first set of sales in 1999. The authors understand that each of the trusts was funded with cash and the proceeds of a third party note representing in the aggregate 10% of the purchase price of the stock sold to the trusts. The balance of the purchase price was funded with an installment note bearing interest at the applicable federal rate. At trial, the only issue concerning the 1999 notes was whether they should be discounted to take account of the self-cancelling feature. The Tax Court held that a discount should be applied; however, the IRS apparently did not otherwise challenge the *bona fides* of the notes, or argue that the notes constituted a retained interest in the trusts for purposes of I.R.C. § 2701 or 2702.[25] The IRS did not challenge at all the *bona fides* of the second set of notes issued in 2000 which did not have the self-cancelling feature.

In *Estate of Lockett v. Commissioner,*[26] the Tax Court considered whether transfers from a family limited partnership to family members of the decedent

[23] 98 T.C. 554 (1992).
[24] T.C. Memo 2006-212.
[25] Because the taxpayer was living, no argument could have been raised that the taxpayer had retained an interest under IRC §2036 so as to cause the trust to be included in the grantor's gross estate.
[26] T.C. Memo 2012-123.

were loans or gifts. The court relied on factors established in *Estate of Maxwell v. Commissioner*[27] to determine whether a *bona fide* debtor-creditor relationship existed. The court held that the determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances, including whether: (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or transferee reflected the transaction was a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.

In many respects the *Lockett* factors seem far more sensible in the gift tax context than the *Rosen* factors. In the case of one of the loans, even though the debtor failed to make payments, no property was given as collateral to secure the note and no maturity date was listed on the note, nor was it clear that the son had the ability to repay, nonetheless the note was respected as a debt and not a gift. The partnership made a demand for payment against the debtor's estate, and the estate stated it expected to pay the claim in full. In addition, the accountant treated the transaction as a loan, prepared a promissory note, kept an amortization schedule and reported each transaction as a loan. The loan was listed as an asset of the partnership on the decedent's estate tax return. In the case of another loan to the same son, the failure to execute a promissory note and to keep records consistent with a debt were fatal, and the loan was treated as a gift. In the case of a third loan, although no demand for payment was made, a note was executed and all records were consistent with the transfer being debt; accordingly, the debt was respected.

Although, perhaps, there may be some possibility that the assets in the trust will be included in the grantor's gross estate for Federal estate tax purposes if the grantor dies while the note received in exchange for the assets sold is still outstanding at the grantor's death, that risk, in the judgment of at least some practitioners, is remote. In fact, it seems that any such estate tax inclusion risk may be entirely eliminated if the note is paid in full before the grantor dies. Moreover, it seems the estate tax inclusion risk might be completely eliminated as a practical matter by selling or even giving the note to a trust for the grantor's spouse that the grantor has created.[28] Hence, the risk of the assets in the trust being included in the gross estate of the grantor seems considerably lower than with a GRAT.

[27] 98 T.C. 594 (1992), *aff'd*, 3 F.3d 591 (2nd Cir. 1993).

[28] The trust the grantor creates for his or her spouse may be a grantor trust with respect to the grantor, preventing any gain recognition by reason of the transfer of the note. Even the sale of the note to the grantor's spouse likely would not, on account of IRC §1041, result in gain recognition.

3. What is the Effect If the Installment Sale Is Not Administered in Accordance with its Terms?

It is at least arguable that the installment sale cannot be so "automatically" treated as "ineffectual" if there is some administration not in accordance with its terms as occurred with respect to the charitable remainder trust in *Atkinson*. Nevertheless, such "misadministration" of an installment sale might be used as evidence that the note received by the grantor should not be treated as debt for Federal gift tax purposes. That might be true particularly if the note is not paid in accordance with its terms, and is not enforced by the grantor as a valid debt. It might also be true if the terms of the note do not provide for repayment within the grantor's life expectancy. The authors understand that a condition of obtaining a favorable ruling in PLR 9535026 was that the debt be restructured for repayment within the grantor's life expectancy.

4. Is Gain Recognized by an Installment Sale of Appreciated Assets?

As indicated, a basic premise of an installment sale to a grantor trust is that the sale will not result in the recognition of gain even if the assets sold are appreciated and the interest accrued or paid on the note received by the grantor will not be included in the grantor's gross income for Federal income tax purposes.[29] It is therefore critical that the purchasing trust be treated as a wholly grantor trust for income tax purposes. Grantor trust status may be difficult to secure without risking estate tax inclusion. Although some provisions seem to require the trust be treated as a grantor trust (*e.g.*, the grantor's spouse is a beneficiary of the trust to whom the trustee may distribute the income and corpus), the court might find that the provisions are illusory (*e.g.*, the spouse is not really intended to be a beneficiary but is mentioned only for purposes of attempting to make the trust a grantor trust). Another possibility is the use of I.R.C. §675(4)(C). That section provides that if someone acting in a non-fiduciary has the power to "reacquire" the property in the trust by substituting property of equal value, the trust is a grantor trust. The IRS in private letter rulings has held that the determination of whether or not the person holding the power is acting in a fiduciary capacity is a question of fact.[30] In addition, the IRS has indicated to at least one practitioner involved in a request for ruling that if the power described in I.R.C. §675(4)(C) is held by the grantor at death, the property

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[29] *Compare* D. Dunn & D. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," Jl. of Taxn. 49 (2001) (gain will be recognized at the death of the grantor if the note received in the installment sale of appreciated property is outstanding at death) *with* J. Blattmachr, M. Gans & H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death ," Jl. of Taxn. 149 (Sept. 2002) (gain will not be recognized at the death of the grantor if the note received in the installment sale of appreciated property is outstanding at death). *See also* Aucutt, "Installment Sales to Grantor Trusts," *Business Entities* (WG&L), Mar/Apr 2002; E. Manning & J. Hesch "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," Tax Management Estates, Gifts and Trusts Journal 3 (Jan. 14, 1999).

[30] *See, e.g.*, PLR 9126015.

may be included in the grantor's gross estate for Federal estate tax purposes.[31] Other possibilities to obtain grantor trust status are the power to add to the class of beneficiaries, the power to lend to the grantor with or without adequate security and the use of related and subordinate trustees with broad discretionary distribution powers. Each of these may be viewed as creating some risk of estate tax inclusion, and may also run the risk of failing to confer grantor trust status if they are determined to be illusory powers because their exercise is inhibited by conflicting fiduciary duties.

5. Protecting an Installment Sale with a Formula Clause[32]

King v. Commissioner[33] represents an early taxpayer victory in the sale context. Taxpayer made an installment sale of stock of a closely held corporation to trusts created for his children. The purchase agreements provided for a retroactive adjustment to the purchase price ($1.25 per share).

□*Trigger*: determination of fair market value of the stock by IRS that is greater or less than stated price.

□*Adjustment*: adjustment of purchase price, up or down, to value determined by IRS.

IRS determined the *value* of the stock to be $16 per share and imposed tax on the excess over $1.25. The court held that the savings clause was effective to insulate the transaction from gift tax.

The Court rejected the government's argument, based on the holding in *Procter* 30 years earlier, that the adjustment clause violated public policy because there was no attempt to rescind the transfer if it was *determined* to be a taxable gift. This view of the scope of the public policy holding in *Procter* is in accord with the view of the Tax Court, albeit in dicta, in a case involving the efficacy of a savings clause in determining the amount of the estate tax marital deduction: "In *Procter*, application of the savings clause would nullify the whole transaction and the Court would have nothing to decide."[34]

Also notable is the Court's reasoning that the adjustment clause did not violate public policy because it would not have the effect of diminishing taxpayer's

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[31] In *Jordahl v. Comm'r*, 65 T.C. 92, *acq.*, 1977-1 C.B. *1*, the Tax Court held that a power of substitution held by the grantor would not cause the trust assets to be included in the grantor's estate for Federal estate tax purposes. The IRS, in several private rulings, has cited *Jordahl* as authority for the conclusion that the assets held in a trust over which the grantor holds a power described in IRC §675(4)(C) are not included in the grantor's gross estate. Not analyzed in the subsequent rulings is the fact that the power held in *Jordahl* was held in a fiduciary capacity—under IRC §675(4)(C), to obtain grantor trust status, the power must be held in a non-fiduciary capacity.

[32] Excerpted from D. Zeydel and N. Benford, "A Walk Through the Authorities on Formula Clauses," *Estate Planning*, December 2010.

[33] *King v. U.S.*, 545 F.2d 700 (10th Cir. 1976).

[34] *Estate of Alexander v. Comm'r*, 82 T.C. 34 (1984), at 45, n. 11.

estate, thereby escaping death tax.[35] And in practice is does seem that the IRS is satisfied with a purchase price adjustment in the case of a pure intra-family sale that would increase the value of the taxable estate, and appears to prefer that result, at least in the case of an estate tax challenge, to assessing gift tax, the computation of which would be tax exclusive and would produce an offsetting deduction. The Tenth Circuit in *King* concurred with the District Court's findings of fact that there was an absence of donative intent evidenced by the existence of the valuation clause and that the parties intended that the trusts pay full and adequate consideration. The transaction was found to have been made in the ordinary course of business and thereby was excepted from gift tax by Reg. § 25.2512-8.

6. Purchase Price Adjustment *Fails*

In *McLendon*,[36] the taxpayer, a famous Texas broadcaster, entered into a private annuity agreement with his son and the trustee of trusts for his daughters. Under the agreement, which contained a tax savings *clause*, the son and trustee, as obligors, agreed to purchase a remainder interest in certain of taxpayer's assets, including two general partnership interests.

□ *Trigger*: changes in the value assigned to the elements of the transaction by the agreement resulting from a settlement with IRS or a final decision of the Tax Court.

□ *Adjustment*: up or down, in the purchase price for the remainder interest and the annuity payments, plus 10% interest on any adjustment, based on any change in valuation.

The Tax Court found that the parties understated the value of the assets in which the remainder interest was sold and held the savings clause ineffective to avoid gift tax. The court distinguished *King* because of the specific findings in that case of an arm's length transaction, free of donative intent, and repeated the prior reservations expressed by the Tax Court in *Harwood* as to the accuracy of those findings. The court chose instead to apply the public policy notions in *Procter* and *Ward* (*notwithstanding* they both involved gifts rather than a sale), noting that, if the clause was effective, its determination that a gift was made would render that issue moot and there would be no assurance that the obligors, who were not parties to the litigation, would respect the terms of the savings clause and pay the additional consideration required.

7. Defined Value Sale Succeeds

King was for many years the lone taxpayer victory and consistently distinguished based upon the specific finding of fact that the parties intended an arm's length

[35] *Id.* at 706.
[36] *Estate of McLendon v. Comm'r*, T.C. Memo 1993-459, *rev'd on other grounds,* 77 F.3d 477 (5th Cir. 1995), *on remand to*, T.C. Memo. 1996-307, *judgment rev'd by*, 135 F.3d 1017 (5th Cir. 1998).

transaction. But recently, taxpayers achieved another victory in the sale context in the *Petter* case.[37] Anne Petter's uncle was one of the first investors in what became United Parcel Service of America, Inc. (UPS). UPS was privately *owned* for most of its existence, and its stock was mostly passed within the families of its employees. Anne inherited her stock in 1982. Anne formed Petter Family LLC with two of her children and contributed stock worth $22,633,545 to the LLC. She received three classes of membership units, Class A, Class D and Class T. Anne became the manager of Class A and her daughter Donna became the manager of Class D and son Terry became the manager of Class T. The LLC was managed by majority vote of the managers, but no vote could pass without the approval of the manager of Class A units. A majority vote within each Class of members permitted that Class to name its manager. Transfers outside the Petter family required manager approval, and a transferee took an Assignee interest.

Anne created two grantor trusts which apparently were grantor solely by reason of the power to purchase a life insurance policy on Anne's life within the meaning of I.R.C. § 677(a)(3). Donna was the trustee of her trust, and Terry was the trustee of his trust. In a two-part transaction, on March 22, 2002, Anne gave each trust units intended to make up 10% of the trusts' assets and then, on March 25, she sold units worth 90% of the trusts' assets. As part of the transfers, Anne also gave units to two public charities that were community foundations offering donor advised funds.

□*Trigger*: formula gift to divide units between the trust and the charities to avoid gift tax essentially as follows:

1.1.1. Assigns to the Trust as a gift the number of units described in Recital C above that equals one-half the maximum dollar amount that can pass free of federal gift tax by reason of the Transferor's applicable exclusion amount allowed by Code section 2010(c); and

1.1.2 Assigns to the charity as a gift the difference between the total number of units described in Recital C above and the number of units assigned to the trust under the preceding section.

□*Adjustment*: Trust agrees that if the value of the units is finally determined for federal gift tax purposes to exceed the amount described in section 1.1.1, the trustee will on behalf of the trust transfer the excess units to the charity as soon as is practicable. Charity similarly agreed to return excess units to the trust.

Anne also engaged in a defined value sale. Recital C of the sale documents read "Transferor wished to assign 8,459 Class [D or T] membership units in the company (the "Units") including all of the *Transferor's* right, title and interest in the economic, management and voting right in the Units by sale to the trust and as a gift to the [charity]."

[37] *Petter v. Comm'r,* T.C. Memo 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

Trigger: formula sale to divide units between the trust and the charities essentially as follows:

1.1.1. Assigns and sells to the Trust the number of units described in Recital C above that equals $4,085,190 as finally determined for federal gift tax purposes; and

1.1.2 Assigns to the charity as a gift the difference between the total number of units described in Recital C above and the number of units assigned and sold to the trust under the preceding section.

Adjustment: Trust agrees that if the value of the units is finally determined to exceed the $4,085,190, the trustee will on behalf of the trust and as a condition of the sale to it, transfer the excess units to the charity as soon as is practicable. Charity similarly agreed to return excess units to the trust.

The trustees of the trusts *executed* installment notes and signed pledge agreements giving Anne a security interest in the LLC shares transferred. The pledge agreements specified:

It is the understanding of the Pledgor and the Security Party [sic] that the fair market value of the Pledged Units is equal to the amount of the loan – i.e., $4,085,190. If this net fair market value has been incorrectly determined, then within a reasonable period after the fair market value is finally determined for federal gift tax purpose, the number of Pledged Units will be adjusted so as to equal the value of the loan as so determined.

The IRS and the taxpayer agreed that the trusts made regular quarterly payments on the loans since July 2002. The trusts were able to make payments because the LLC paid quarterly distributions to *all* members, crafted so the amounts paid to the trusts covered their quarterly payment obligations.

Good Facts. Charities were represented by outside counsel. They conducted arm's length negotiations, won changes to the transfer documents and were successful in insisting on becoming substituted members with the same voting rights as other members. Formal letters were sent to the charities describing the gifts and the formula was reflected in all correspondence. The deal was done based upon the attorney's estimates of value using a 40% discount, then a well known appraisal firm was hired to prepare a formal appraisal. Anne hid nothing on her gift tax return and even attached a disclosure statement that included the formula clauses in the transfer documents and a spreadsheet showing the allocations of units, the organizational documents, trust agreements, transfer documents, letters of intent sent to the charities, the appraisal report, annual statements of account for UPS, and Forms 8283 reflecting Noncash charitable contributions.

Public Policy Victory. Court states "We have no doubt that behind these complex transactions lay Anne's simple intent to pass on as much as she could to her

children and grandchildren without having to pay gift tax, and to give the rest to charities in her community." "The distinction is *between* a donor who gives away a fixed set of rights with uncertain value – that's *Christiansen*[38] – and a donor who tries to take property back – that's *Procter*.[39] A shorthand distinction is that savings clauses are void, but formula clauses are fine." Anne did not give away a specific number of shares, but an ascertainable dollar value of stock. The managers of the LLC owed fiduciary obligations to the charities to avoid shady dealings by the trusts and there would be fewer disincentives to sue the trusts, versus the donor herself, for an adjustment. In addition, a number of sections of the Code expressly sanction formula clauses.

The court agreed that the assignment was not of an open ended amount, but of a fraction of certain dollar value, to be evaluated at the time she made them. The court further agreed that the gifts to charity occurred on the date of transfer, not on the date the need for readjustment or the actual readjustment occurred. Accordingly Anne was entitled to a charitable deduction as of that date.

8. *Wandry v.* Commissioner[40]

Joanne and Albert Wandry formed Norseman Capital, LLC, a Colorado limited liability company with their children to engage in business. It appears the assets of Norseman consisted primarily of cash and marketable securities. The Wandrys made gifts of fixed dollar amounts of the Units to their children and grandchildren as annual exclusion gifts and gifts using their unified credit. The assignments and memorandums of gift set forth the intent to make defined value gifts equal to a sufficient number of units so that the fair market value of the Units for federal gift tax purposes would be a stated dollar amount.

- *Trigger*: IRS challenge to the valuation and a final determination of different value by the IRS or a court.
- *Adjustment*: number of gifted Units adjusted to equal the value gifted as follows:

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

[38] *Estate of Christiansen v. Comm'r*, 130 T.C. No. 1 (2008), *aff'd,* 586 F.3d 1061 (8th Cir. 2009).
[39] *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944).
[40] *Wandry v. Comm'r*, T.C.Memo. 2012-88.

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.

The IRS advanced three arguments. first that the description of the gift on the gift tax returns setting forth a specific number of Units constituted an admission by the taxpayers to a gift of specified numbers of Units, rather than defined value gifts; second, that the capital accounts controlled the nature of the gifts; and third, that the gift documents themselves transferred a fixed percentage. Last the government argued a violation of public policy under *Procter*. The Tax Court found that the totality of the gift tax returns evidenced an intent to make defined value gifts, notwithstanding the gift descriptions, and that the capital accounts were not controlling but were tentative. The court addressed the *Procter* challenge by analogizing the gifts to the transfers in *Petter*, stating that so long as the amount of Units gifted can be computed by mathematical formula once the value of the Units is known, the formula was effective to define the amount the gifts. The court also found it inconsequential that the formula reallocated Units between the donors and the donees, rather that between the family member donees and charity, as in *Petter*. Some experts have suggested that perhaps the gift instrument should confer a right on the donees to participate in the reporting of the gift so that the donees have the ability to enforce their right to receive the formula amount, in the same way that a formula allocation gift allows the donees to enforce their rights to receive the proper percentage among themselves.

In Action on Decision 2012-04, the IRS announced its nonacquiescence in *Wandry*. The IRS relies on Treas. Reg. §25.2511-2(b) for the proposition that a completed gift occurs when the donor parts with dominion and control in a manner that leaves the donor no power to change the disposition. The IRS concludes that because a final determination for Federal gift tax purposes is an occurrence beyond the donor's control, any adjustment based upon a final gift tax determination has no effect on the number of units transferred as a completed gift. Instead, the IRS concludes that the adjustment cannot render any portion of the original gift incomplete. The IRS relies on a number of cases for the proposition that gift completeness occurs when the donor has so parted with dominion and control as to be unable to retrieve the gifted property.[41] However, none of those cases involves a defined value formula of the type used in *Wandry*. The aspect of *Wandry* that the IRS appears reluctant to accept is that the formula operates never to transfer the units that exceed the defined value. Instead, the IRS interprets the *Wandry* clause as initially transferring all the Units, followed by a return of a portion of the units to the taxpayer upon a final gift tax determination.

Nevertheless, the AOD provides some comfort to those concerned that because the number of units transferred is unknown at the time of the intended gift, perhaps the entire gift is incomplete. The IRS takes the opposite position and

[41] *Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943); *Robinette v. Helvering*, 318 U.S. 184, 187 (1943); *Estate of Kolb v. Comm'r*, 5 T.C. 588, 593 (1945); *Macky v. Comm'r*, 39 B.T.A. 220, 229 (1939).

concludes that the gift of all the units is complete at inception, the defined value formula having no tax savings effect. The IRS distinguishes the *Petter* type formula, referred to by some as a "formula allocation clause" because in the case of a formula allocation clause there is no doubt that all the units are transferred, the only issue for determination is how the donees will share the property. The IRS emphasized that a *Petter* style formula does not allow the taxpayer to "take property back" which the IRS apparently considers too similar to a *Procter* formula.

Conclusion

Recent cases confirm that the use of formula clauses is garnering support from the courts. *Petter* and *Christiansen* weigh strongly in favor of a defined value formula that results in the allocation of property among different transferees, rather than a return of property to the transferor. Whether the transferee who is the beneficiary of an adverse valuation adjustment must be a public charity to avoid the public policy arguments advanced by the Commissioner remains perhaps an open question. Certainly any formula that involves an allocation of property among beneficiaries, rather than a return of property to the donor, does not involve "undoing the gift" or "require the court to opine on a moot case," factors held in *Procter* to violate public policy, particularly where the measure of the charitable deduction must be decided.

The Commissioner has attempted to distinguish formulas expressly permitted under the Code (and therefore the only types of formulas that should be recognized for tax purposes) as being ones that ultimately resulted in taxation, such as a marital deduction formula. Fortunately, the Commissioner has been unable to persuade the Courts of this distinction in view of structures such as charitable remainder trusts which would not produce additional tax. Nevertheless, the argument might indicate that a taxable default beneficiary is preferable. For example, if the excess gift were contributed to a grantor retained annuity trust,[42] the gift tax matter would require decision in order to determine the measure of the annuity payable to the grantor as well as the gift tax due on the remainder value. But the permitted adjustment to a GRAT annuity based upon a final determination of the fair market value of the property contributed under the regulations would limit the gift tax exposure. This would avoid a court ruling on a moot issue. A marital deduction trust as default beneficiary would also ultimately result in a transfer tax due.

Formula clauses continue to be necessary to capture the benefits of available tax shelters while avoiding unanticipated transfer taxes. It seems the courts are sympathetic to the need for formula clauses, particularly with hard to value assets. It seems that if a formula permits the collection of current gift tax, at least to a degree, the strongest public policy arguments would be neutralized, while permitting the taxpayer, nonetheless, to limit the exposure to tax when

[42] A grantor retained annuity trust is one described in Treas. Reg. 25.2702-3(b).

transferring difficult to value assets. A formula allocation clause appears least susceptible of successful challenge. And if the taxpayer can demonstrate an arm's length business transaction free from donative intent, then a purchase price adjustment clause based upon a third party appraisal should still be viable.[43]

B. Can We Learn Something From Trombetta?[44]

The decedent in *Trombetta* sold rental real estate properties to a trust in exchange for a private annuity. The present value of the private annuity was actuarially less than the value of the properties transferred to the trust, and the excess was reported as a taxable gift. The Tax Court concluded that the transaction was a transfer with a retained interest within the meaning of I.R.C. §2036. The court's analysis is also relevant for purposes of determining whether I.R.C. §2702 might apply. The form of the transaction, being in effect a part sale and part gift, proved to be adverse to the taxpayer. One reason is that the bona fide sale exception under I.R.C. §2036 was not available. This suggests that it would be far better if the initial funding of the trust occurs as a separate transaction that is not tied to the sale. The court also looked to *Fidelity-Philadelphia Trust Co. v. Smith*[45] to analyze whether I.R.C. §2036 applies. In *Fidelity Philadelphia*, the Court sought to establish factors that would distinguish between a sale or exchange (on the one hand) and a transfer with a retained interest on the other.[46] Gans and Blattmachr, in their recent article analyzing the *Trombetta* case point out that *Fidelity Philadelphia* established three conditions, which is satisfied, should avoid the application of I.R.C. §2036. Those factors are: (1) the obligation to make payments to the decedent is not chargeable to the transferred property, (2) the obligation is the transferee's personal obligation, and (3) the amount of the payments to be made to the decedent is not dependent on the actual amount of income generated by the transferred property. Gans and Blattmachr conclude that the presence of independent equity in the purchasing trust, equity contributed separately from the sale transaction, is an important factor in allowing the taxpayer to satisfy the foregoing three criteria. If independent equity is present, then the installment sale obligation is not chargeable solely to the transferred property, the trust is personally obligated, having independent assets to satisfy the obligation, and the installment sale obligation would have its own requirements for payment which are independent from, and not tied to, the income received from the transferred assets. The point is that the form of the transaction is critical to falling within the safe harbor of *Fidelity Philadelphia*. There were additional adverse facts in *Trombetta* as well. Although the taxpayer's children provided guarantees, they were never called upon to make good on those guarantees. The annuity obligation was not consistently paid in accordance with its terms. And the trust paid the principal and interest on mortgages on the properties sold on which the decedent remained personally liable. This suggests that in structuring an installment sale, the appropriate form can be critical to success. Gans and Blattmachr

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[43] For an excellent and very creative discussion of the potential applications of formula clauses, *see* C. McCaffrey, "Formula Valuation -- Shield Against Gift Tax Risk or Invitation to Audit?," 42nd Annual Heckerling Institute on Estate Planning (2008).

[44] *Estate of Trombetta v. Commissioner*, T.C. Memo. 2013-234.

[45] 356 U.S. 274 (1958).

[46] *See* M. Gans and J. Blattmachr, "Private Annuities and Installment Sales: Trombetta and Section 2036." Journal of Taxation, May 2014 (hereinafter referred to as "Gans and Blattmachr").

also suggest that the *Fidelity Philadelphia* test is to be applied at the inception of the transaction, and subsequent reversals in the creditworthiness of the trust should not alter the outcome if the factors are satisfied at inception.

C. Estates of Donald and Marion Woelbing[47]

In these related cases, Mr. Woelbing sold non-voting stock in Carma Laboratories (a closely held company) to a grantor irrevocable life insurance trust that owned policies on the lives of Mr. and Mrs. Woelbing in exchange for a $59 million promissory note bearing interest at the applicable federal rate. The cash surrender value on the policies was in excess of $12 million, and the policies were subject to split dollar arrangements. The two sons guaranteed 10% of the face amount of the note. The agent has asserted that I.R.C. §2702 applies without stating a basis for that assertion. The transaction was closed in 2006 and by 2009 $20 million had been paid down on the note. The agent discussed with the taxpayers whether the appropriate interest rate on the note was the AFR versus the I.R.C. §7520 rate, which would apply if I.R.C. §2702 were applicable. The taxpayers valued the note at face for estate tax purposes and the IRS asserted that the note was disallowed as debt and should not be included in the gross estate. By asserting that I.R.C. §2702 applies, such that the note does not constitute a qualified retained interest, the note would be assigned a zero value. Alternatively, the IRS asserts that the stock should be included in the gross estate under I.R.C. §§ 2036 and 2038.

The transaction appears to have been carefully and properly planned. Nevertheless, in view of the opposition to installment sales using guarantees, one should consider the added protection offered by the Gans and Blattmachr analysis of the *Trombetta* case and provide for adequate, and independent, equity in the trust. It appears that a defined value sale was employed in Woelbing. And it may well be that the IRS's assertion of a value more than double the taxpayers' value is at the heart of the dispute.

D. Is it Possible to Make the Installment Sale to Trust Created by the Spouse?[48]

One way to avoid the possibility that a taxable gift has occurred when making an installment sale to a trust would be to make the sale to a trust created by the seller's spouse in which the seller has sufficient beneficial interests so that any gift by the seller to the trust is treated as an incomplete gift, and therefore not subject to gift tax. To ensure an incomplete gift, it would seem prudent, if the husband will be the seller and the wife will be the settlor of the purchasing trust, to make the husband a discretionary beneficiary of income and principal with the power to veto distributions to any other discretionary beneficiary and also to grant to the husband a testamentary special power of appointment.[49] An additional question raised when the sale is not made to the seller's

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[47] Estate of Donald Woelbing v. Comm'r, Docket No. 30261-13; Estate of Marion Woelbing v. Comm'r, Docket No. 30260-13.

[48] Carlyn McCaffrey discussed this idea in one of her Heckerling Institute presentations, although it was not mentioned in the written materials. The author wishes to thank Elizabeth Glasgow, Yoram Keinan and Charles Stiver for their contributions to the analysis in this and the following section of this outline.

[49] *See* D. Zeydel, "When is a Gift to a Trust Complete -- Did CCA 201208026 Get It Right?," forthcoming Journal of Taxation, September 2012.

own grantor trust is what would be the effect of the transaction if grantor trust status terminates while the note remains outstanding.

Facts: Suppose husband sells property to a grantor trust of which the husband is a beneficiary created by his wife in exchange for a promissory note issued by the wife's grantor trust. Prior to the wife's death, no payments of principal are made under the note. The wife dies thus terminating the status of the trust as a grantor trust while the promissory note remains outstanding and is held by the husband.

1. Basis of the Promissory Note Held By Wife's Grantor Trust

In general, a taxpayer's basis in property is determined under the Code based on how the property was acquired.[50] In the case of a promissory note issued by a taxpayer, the position of the IRS is that the taxpayer's basis in a "self-made" promissory note is $0 until payment under the note is made.[51]

In *Peracchi v. Commissioner,*[52] however, the court held that for purposes of calculating whether liabilities exceeded basis in an I.R.C. § 351 transaction, triggering gain under I.R.C. § 357(c), the contributing shareholder was treated as having a basis in his own note contributed to the corporation equal to the face amount of the note. Although the court emphasized that it limited its holding to the case of a note contributed to a C corporation, it did so to distinguish the case of a contribution to a partnership, which could enable a taxpayer to deduct pass-through losses attributable to nonrecourse debt, *i.e.*, the case of a tax shelter. Several aspects of the court's analysis might apply. For example, if the transferee of a note took the zero basis of the obligor on the note, the transferee would recognize gain on a sale of the note in an amount equal to the full amount of the sales proceeds, which "can't be the right result." Second, even if the transferor controls the transferee, which would not be the case on the facts, the issuance of the note has real economic consequences for the obligor on the note if creditors of the transferee might require payment of the note, for example, in a bankruptcy proceeding of the transferee, assuming bankruptcy is not a remote possibility. Finally, the same end result could be achieved if the obligor on the note issued the note to a bank in exchange for cash, transferred the cash instead of the note, and the transferee purchased the note from the bank. The cash clearly would have had basis, and the only difference in the transaction would be the avoidance of the transaction costs with the bank. The court's analysis in *Peracchi*, therefore, constitutes at least some support for the position that a note issued from a trust could have basis in the hands of the transferor.

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[50] *See* generally IRC §§1001; 1014; 1015; 1041.

[51] *See Gemini Twin Fund III v. Commissioner*, 62 T.C.M. 104 (1991), *aff'd*, 8 F.3d 26 (9th Cir. 1993) ("Even assuming . . . that a note is property under state law and for other purposes, a taxpayer has no adjusted basis in his or her own note. Until the note is paid, it is only a contractual obligation . . . ."); see also Milton T. Raynor, 50 T.C. 762 (1968).

[52] 143 F.3d 487 (9th Cir. 1998).

Lessinger v. Commissioner,[53] involved the same issue as *Peracchi* of liabilities in excess of basis under I.R.C. § 357(c) and a promissory note issued by the shareholder/transferor to the corporation/transferee. The court states that the concept of basis refers to assets and not liabilities and that therefore the corporation/transferee could have a basis in the promissory note even if the shareholder does not. The court found that to be the case on the facts before it. The transferee would have a cost associated with the shareholder/transferor's note because it took assets with liabilities in excess of basis and because it would have to recognize income on payment of the note if it had no basis in the note. As in *Peracchi*, the court noted that the shareholder/transferor could have borrowed cash from a bank and transferred the cash to the corporation/transferee, which could have purchased the shareholder/transferor's note from the bank. The court concluded there was no reason to recognize gain when assets are transferred to a controlled corporation and the transferor undertakes a genuine personal liability for a promissory note issued to the corporation for an amount equal to the excess liabilities. The court's reliance on the fact that the transferee should not have to recognize full gain on a disposition of the note, and on the fact there would be no zero basis problem if an equivalent alternative transaction were undertaken, could also apply in the context of a trust issuing debt to purchase an asset so that the holder of the note issued by a trust could have basis in the note even if the trust does not have basis in the note..

2. Basis of the Promissory Note Held by Husband After Sale of Property

Notwithstanding the foregoing analysis, in any lifetime transfer of property between a husband and wife, whether a gift or an arm's length sale transaction, the basis of the property transferred is determined under I.R.C. § 1041. Pursuant to I.R.C. § 1041(b), the transfer for income tax purposes is treated as a gift, regardless of the parties' intent to engage in a sale, and the basis of the property transferred in the hands of the transferee is the adjusted basis of the transferor. In addition, for the purposes of the deemed gift and transferee basis rules for transfers between spouses, the use of a grantor trust in the transaction will not avoid the application of I.R.C. § 1041(b) because the grantor trust is disregarded as to the grantor under Revenue Ruling 85-13. Accordingly, if a transfer of a "self-made" promissory note occurs between a husband and a wife's grantor trust, the IRS's position will be that the husband's basis in the promissory note will be $0, unless payments under the note have been made.

3. Rules for Gain Recognition of a Promissory Note under IRC Section 1001

Except as otherwise provided in the income tax provisions, a taxpayer recognizes gain or loss upon the sale or other disposition of property. Treasury Regulation § 1.1001-1(a) provides that gain or loss is realized from a disposition of property within the meaning of I.R.C. § 1001 if the property is exchanged for other

[53] 872 F.2d 519 (2d Cir. 1989).

property differing materially either in kind or in extent. A debt instrument, such as a promissory note, differs materially in kind or in extent if it has undergone a "significant modification." Reg. § 1.1001-3(b). In essence, a significant modification of a debt instrument results in a "new" debt instrument that is deemed to be exchanged for the original unmodified debt instrument.[54]

4. Significant Modification Occurs if Promissory Note Has New Obligor

Regulation § 1.1001-3 provides rules for determining whether a change in the legal rights or obligations of a debt instrument is a "significant modification" so as to be treated as an exchange triggering gain or loss realization, including rules for when a change in obligor is a significant modification. The substitution of a new obligor on a nonrecourse debt instrument, without more, is not a significant modification to trigger a gain realizing exchange under I.R.C. § 1001. Reg. 1.1001-3(e)(4)(ii). Therefore, the optimal solution to putting the structure in place would be to use a nonrecourse obligation. If that is done, it might be wise to introduce guarantees in order to ensure the *bona fides* of the debt. The presence of guarantees should not defeat treatment of the obligation as nonrecourse.

Generally, the substitution of a new obligor on a recourse debt instrument is a significant modification. Reg. § 1.1001-3(e)(4). There does not appear to be any direct authority that the death of an individual obligor, and the resulting transfer to the individual obligor's estate would constitute a substitution of a new obligor on the promissory note for the purposes of Regulation § 1.1001-3(e)(4). Similarly, there appears to be no direct authority that a trust, characterized for income tax purposes initially as a grantor trust during the grantor's lifetime and then as a non-grantor trust upon the grantor's death, would constitute two distinct entities such that the non-grantor trust would be treated as a "new obligor" on the self-made promissory note issued by the trust.

5. Significant Modification Exception -- Substantially Transferring All Assets

The unresolved question of whether the single trust's change in status for income tax purposes from a grantor trust to a non-grantor trust upon the wife's death would constitute a "new obligor" may be avoided if the change in the trust's status is regarded as a transaction to which an exception to the "new obligor" rule applies.

Regulation § 1.1001-3(e)(4)(i)(C) states that the substitution of a new obligor on a recourse debt instrument is not a significant modification if (i) the new obligor acquires substantially all of the assets of the original obligor, (ii) the transaction does not result in a change in payment expectations (defined in Regulation § 1.1001-3(e)(4)(iii) as a substantial enhancement or impairment of

[54] *See* PLR 200315002.

the obligor's capacity to meet its payment obligations) and (iii) the transaction does not result in a significant alteration (defined in Regulation § 1.1001-3(e)(4)(i)(E) as an alternation that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument). This exception is rarely used, but the IRS has held that these three conditions were satisfied and the exception applied in a corporate restructuring under which the transferor corporation transferred its three primary businesses, the liabilities for two of its three business and all of the promissory notes at issue to a subsidiary.[55]

This "substantially all assets" exception has not been applied in the context of trusts; however, there is an argument that upon the wife's death, the resulting non-grantor trust has acquired substantially all of the assets and liabilities (including the note) of the wife's grantor trust.[56] This argument is weakened by the lack of any actual transfer between two distinct entities, as occurred in PLR 9711024. The argument that this exception should apply would be strengthened by increasing the similarity to PLR 9711024. This might be achieved if under the terms of the trust agreement upon the death of the wife the original grantor trust were to terminate and pour its assets and liabilities into a new non-grantor trust with slightly different terms (rather than allowing the original trust to continue as a non-grantor trust upon the wife's death). Although this proposal under which a new trust is created would have the benefit of increasing the likelihood that the "substantially all" exception would apply, by adding a new distinct entity to the scenario it would also increase the likelihood that the general rule that a gain realization event is triggered upon the substitution of a new obligor of the note would also apply.

6. Significant Modification Exception -- State Law

In contrast, a separate argument exists that relies on the continuation of the original trust. An alternative argument to avoid the application of the substantial modification rules based on the substitution of a new obligor could be made based on the IRS's holding in PLR 200315002.

In PLR 200315002, the IRS held that no substitution of obligors had occurred when, pursuant to the applicable state law, a corporation converted into a domestic limited liability company. The IRS relied on the fact that, under the applicable state law, "the conversion of any other entity into a domestic limited liability company shall not be deemed to affect any obligations or liabilities of the other entity incurred prior to its conversion to a domestic limited liability company . . . and for all purposes of [state] law, all rights of creditors and all liens upon any property of the other entity that has converted shall be preserved unimpaired, and all debts, liabilities and duties of the other entity that has converted shall thenceforth attach to the domestic limited liability company and

[55] *See* PLR 9711024.

[56] Under stated assumption three, we have assumed that no other conditions have changed that would cause the exception to fail due to a change in payment expectations or a significant alteration.

may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it." PLR 200315002. The IRS reached its conclusion regardless of the fact that the new domestic limited liability company was a single member limited liability company and a disregarded entity in relation to another corporation. The IRS concluded that applying Regulation § 1.1001-3 requires a corresponding application of state law and under the applicable state law the rights of the holder of debt instruments issued by the obligor did not change and therefore the obligors did not change for the purposes of determining if a significant modification had occurred.

Assuming the applicable state law governing the wife's grantor trust would treat the single trust obligor that undergoes a change in grantor trust status for income tax purposes upon the wife's death as the same legal entity as the grantor trust, subject to the same debts, liabilities and duties, an argument could be made that no change in obligor has occurred within the meaning of Regulation § 1.1001-3(e)(4), even though the issuing grantor trust was a disregarded entity.

7. Analogous Argument For No Gain Realization Based on Installment Sale Rules

Further support for an argument that no gain should be recognized upon the obligor trust's change in status from grantor trust to non-grantor trust is found in the installment sale rules of I.R.C. § 453. An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.[57] The transaction between the husband and the wife's grantor trust would qualify as an installment sale,[58] but for the application of I.R.C. § 1041(b), which requires that a transfer between a husband and wife (or, in this case, the wife's grantor trust) be treated as a gift for income tax purposes.[59] Although the installment sale rules will not apply in this scenario the income tax consequences of the transaction if I.R.C. § 1041 did not apply remain persuasive.

Under I.R.C. § 453B, the disposition of an installment sale debt obligation occurs if the debt is satisfied at other than face value or distributed, transmitted, sold, or otherwise disposed of.[60] The general rules for determining whether a gain realizing disposition has occurred under I.R.C. § 1001 do not apply when determining whether a disposition of an installment obligation has occurred under I.R.C. § 453B.[61] Specifically, a modification that triggers a deemed exchange

[57] IRC § 453(b)(1).

[58] In concluding that installment sale treatment would apply if IRC 1041(b) did not apply, we assume that the property sold by the husband to the wife's grantor trust is not depreciable property that would prevent the application of the installment sale method under section 453(g), which excludes the sale of depreciable property to a controlled entity, which includes a trust of which the seller is a beneficiary.

[59] There appears to be no authority that expressly prohibits the application of the installment sale rules to a transfer of property between husband and wife due to the application of section 1041; however, it seems that the Service's position is that section 1041 trumps other income tax provisions.

[60] IRC § 453B(a).

[61] T.D. 8675.

under I.R.C. § 1001 does not automatically trigger a disposition within the meaning of I.R.C. § 453B because I.R.C. § 1001 does not override installment sale treatment.[62] Instead, the degree of change necessary to trigger a disposition for I.R.C. § 453B purposes is typically greater than that for I.R.C. § 1001 purposes.[63]

In contrast to the authorities under I.R.C. § 1001, the IRS's position is that a gain realizing disposition under I.R.C. § 453B occurs only when the rights of the holder under the installment obligation disappear, are materially disposed of, or are altered so that the need for postponing recognition of gain otherwise realized ceases. Under this standard, the IRS has held that a substitution of obligors on the installment obligation is not a gain realizing disposition.[64]

The fact that a change in obligors on an installment sale obligation would not trigger a deemed disposition for the purposes of gain realization to the holder is significant in analyzing the gain realization under I.R.C. § 1001, since the only basis for the exclusion of this transaction from the application of the more favorable installment sale rules is I.R.C. § 1041, a statute that was enacted because Congress believed it was "inappropriate to tax transfers between spouses" but whose application in fact increases the possibility that taxation will occur in what is in essence an intra-spouse installment sale.[65]

8. Tax Consequences of Interest Payments Made Pursuant to the Promissory Note

A separate consideration in the transaction will be the income tax consequences to the holder/husband and the wife via her obligor/grantor trust of the interest payments made pursuant to the promissory note. The analysis of the income tax payments is distinct from the issue of whether gain realization will occur under I.R.C. § 1001 upon the wife's death.

The nonrecognition rule under I.R.C. § 1041 for a transfer of property between spouses does not apply to the interest portion of the transaction.[66] In FSA 200203061, the IRS held that a wife had to include in income any interest payments she received from an interest-bearing promissory note she received pursuant to her divorce that represented her marital rights in her ex-husband's wholly-owned business because, although the promissory note was transferred incident to the divorce, only the portions of the payments that represented principal qualified for nonrecognition treatment under I.R.C. § 1041. In a similar

[62] IRC §1001(d).
[63] Keyes, "Federal Taxation of Financial Instruments & Transactions" at Section 3.05.
[64] Rev. Rul. 75-457; Rev. Rul. 82-122.
[65] Committee Report, PL 98-369, 7/18/1984.
[66] See generally RS Field Service Advice 200203061; *Yankwich v. Commissioner*, T.C. Memo 2002-37; *Gibbs v. Commissioner*, T.C. Memo 1997-196. Although all of the authorities that conclude that IRC 1041 does not apply to the payment of interest have occurred in the context of interest incurred on a principal payment to a former spouse incident to divorce, we do not find any authority that would distinguish an interest payment between current spouses so as to reach a different income tax consequence.

case, the Tax Court reached the same conclusion noting that the interest paid to a wife on an ex-husband's obligation to pay to the wife her share in the former couple's business and the gain the wife might have realized on the transfer of her interest in her ex-husband were two distinct items, each having its own tax consequences.[67] The Tax Court held that because interest is not "gain" subject to nonrecognition under I.R.C. § 1041, the interest payments were includible in the wife's income.[68] Based on the foregoing, the holder/husband will have includible income due to the interest payments on the promissory note.

The character of the interest paid by the grantor trust and the deductibility of the interest payments by the wife via her grantor trust is based on the property transferred by the husband in the transaction. The Tax Court has rejected the IRS's argument that any interest paid under a debt between spouses is to be characterized automatically as "personal" because it relates to a transfer between spouses.[69] Instead, to the extent the interest is allocated to a residence, it can be deductible qualified residence interest, and to the extent the interest is allocated to investment property, it can be characterized as investment interest.[70]

E. Using Nonrecourse Debt to Avoid the Potential Gain Realization Issues[71]

A number of sections of the Code determine tax consequences based on whether debt is "recourse" or "nonrecourse" to the taxpayer, although these terms are not really defined in the Code. The predominant Code sections that are relevant (and helpful) to the analysis are: (1) Code § 1001 and the Regulations thereunder that define the terms "amount realized" and "material modification," and (2) Code § 752 and Regulations thereunder, concerning allocation of liabilities among partners in a partnership. If nonrecourse debt is used, it appears the concern about a potential modification upon the death of the wife disappears because a change in obligors of nonrecourse debt does not constitute a significant modification of the debt instrument.

1. General Case Law

In the seminal case of *Commissioner v. Tufts*, the Supreme Court distinguished recourse from nonrecourse debt by focusing on the *economic position of the lender*: The only difference between [a nonrecourse] mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any

[67] *Gibbs v. Commissioner*, T.C. Memo 1997-196.
[68] Id.; *Cipriano v. Commissioner*, T.C. Memo 2001-157, aff'd 91 AFTR 2d 2003-608 (3rd Cir. 2003).
[69] As with the issue of whether the interest payments are subject to nonrecognition under section 1041, all of the authorities that address the character of the interest have occurred in the context of interest payments incident to divorce, and again we do not find any authority that would distinguish an interest payment between current spouses so as to reach a different characterization of the interest.
[70] *Seymour v. Commissioner*, 109 T.C. 279 (1997) (qualified residence interest); *Armacost v. Commissioner*, T.C. Memo 1998-150 (investment interest).
[71] The analysis in this section of the outline was contributed by the author's partner, Yoram Keinan.

potential loss caused by devaluation of the property. If the [fair market value] of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property and be relieved of his obligation.[72]

The focus in this case (as well as in *Crane v. Commissioner*) was whether the debt instrument secured by a collateral should be respected at all as debt if the value of the collateral is significantly lower than the outstanding balance of the debt.

In *Raphan v. U.S.*,[73] the Federal District distinguished between recourse and nonrecourse debt, stating:

> Personal liability for a debt ('recourse indebtedness') means all of the debtor's assets may be reached by creditors if the debt is not paid. Personal liability is normally contrasted with limited liability ('nonrecourse indebtedness'), against which a creditor's remedies are limited to particular collateral for the debt.[74]

As the above cases suggest, the general concept of "nonrecourse debt" (as opposed to "recourse debt") is debt, pursuant to which: (i) the creditors remedies are limited to certain assets of the borrower (i.e., the assets that were used as collateral for the loan), and (ii) the creditor does not have the right to go against the debtor personally.

2. Authorities Under Code § 1001

<u>Reg. § 1.1001-2</u>

Reg. § 1.1001-1(a) define the term "amount realized" for purposes of determining gain or loss realized by a taxpayer on a sale or exchange. An "amount realized" includes, for this purpose, the amount of liabilities from which a taxpayer is discharged as a result of a sale or disposition.[75] If debt is nonrecourse debt and is discharged in connection with the sale or other disposition of the property, the full amount of debt is treated as part of the amount realized and the transaction is treated as a capital gain or loss under Code §§ 61(a)(3) and 1001.[76] Accordingly, no part of such a transaction represents cancellation of debt ("COD") income

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[72] *See Commissioner v. Tufts*, 461 U.S. 300 (1983). *Crane v. Commissioner*, 331 U.S. 1 (1947) and *Tufts v. Commissioner* supra, provide that with respect to the sale or disposition of an asset subject to a nonrecourse obligation, the amount realized includes the amount of the nonrecourse obligation. See also IRC § 7701(g) ("For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.").

[73] 759 F.2d 879 (Fed. Cir. 1985).

[74] *Id. See also Dakotah Hills Offices Limited Partnership v. Commissioner*, T.C. Memo 1998-134, citing *Raphan* in footnote 5.

[75] Reg. § 1.1001-2(a)(1).

[76] Reg. §§ 1.1001-2(a)(1) and (4).

taxable under Code § 61(a)(12) and the exclusions under Code § 108 do not apply to the transaction.

Without defining the terms "recourse" or "nonrecourse" liability, Reg. § 1.1001-2(a)(4) provides among other things, that: (i) the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from liability, but (ii) the sale or other disposition of property that secures a recourse liability discharges the transferor from the liability only if another person agrees to pay the liability (whether or not the transferor is in fact released from liability (notwithstanding the fact that the seller remains secondarily liable for the debt).[77]

Thus, a critical aspect of the distinction between nonrecourse and recourse debt for this purpose is whether the creditor can look for a third party (other than the borrower) for payment of the debt. Stated differently, for purposes of Reg. § 1.1001-2, a nonrecourse debt, where the collateral is the only source of payment, should be treated similarly to a recourse debt on which a third party is fully obligated.

For this purpose, the IRS has ruled that debt instruments denominated as "limited recourse notes" are generally treated as "nonrecourse."[78] In FSA 200135002, the debtor, a parent of an affiliated group of corporations, formed a subsidiary to construct hydroelectric plants. The subsidiary borrowed to finance the project and offered the land and the plants as collateral. In addition, the parent guaranteed the loan and later made capital contributions when the subsidiary encountered financial difficulty. The subsidiary defaulted on the loan and negotiated a resolution agreement with the lender. The subsidiary sold the plants to a third party and gave the lender the proceeds of the sale to satisfy the debt. On its consolidated return, the parent reduced its basis in the assets it transferred to the subsidiary, and the subsidiary excluded that amount from its income, claiming it was insolvent at the time of the contribution. Furthermore, the parent claimed that the discharge did not require it to recognize the sub's excess loss account and that the sub's loan was recourse.

The IRS concluded that the entire transaction should be treated as a sale or exchange rather than two transactions consisting of a reduction of debt and then a sale. Furthermore, the IRS noted that the loan agreement was titled "limited recourse," and citing California and Federal case law, concluded that the loan was nonrecourse:

> Our review of California case law suggests that the term 'limited recourse loan' is the same as the term 'nonrecourse loan' within

[77] Reg. § 1.1001-2(a)(4).

[78] *Santulli v. Commissioner*, 70 TCM (CCH) 801 (a note entitled "recourse note" that contained a limitation on the creditor's rights to certain revenue streams that the borrower assigned under a security agreement was held to be nonrecourse loan); FSA 200135002 (the IRS ruled that a corporation's grant of a limited recourse security interest in almost all of its current assets and income therefrom constituted a nonrecourse obligation for purposes of Reg. § 1.1001-1).

> the meaning of Reg. §1.1001-2. [citations omitted] Moreover, numerous federal tax cases have treated loans denominated as 'limited recourse' as being the same as 'nonrecourse.' [citations omitted]. In summary, the rights of a creditor with respect to a limited recourse loan are not as great as the rights of a creditor with respect to a recourse loan. In this case, we conclude that B could not have, for example, attached assets of S that were not specifically mentioned in the Loan Agreement. Accordingly, the loan was nonrecourse for purposes of Reg. § 1.1001-2.[79]

Reg. § 1.1001-3

Reg. § 1.1001-3 define a "significant modification" of a debt instrument for the purposes of determining if an exchange occurs under Code § 1001. The predominant relevant categories of debt instruments for this purpose are "recourse" and "nonrecourse" debt instruments, and different types of modifications of debt instruments are assessed taking into account the existence of these two categories, because these two categories reflect fundamental differences in aspects of a debt instrument that are most important to the lender and borrower. The term "nonrecourse" is also not defined in Reg. § 1.1001-3.

Under the particular Regulation, a change in collateral, guarantee, or credit enhancement of a nonrecourse debt is generally treated as a significant modification because the lender can only look to the value of the collateral, guarantee or credit enhancement in case of the borrower's default.[80] In other words, because the collateral, guarantee or credit enhancement are fundamental for the debt repayment in a nonrecourse debt, any change in such collateral, guarantee, or credit enhancement will result in significant modification. It is very clear that the regulations do not distinguish for this purpose, between an asset used as a collateral, a third party guarantee, or another form of credit enhancement (e.g., letter of credit).

Under the same rationale, a change of the obligor of a nonrecourse debt is not a significant modification, because the lender still has recourse to the same collateral, guarantee, or credit enhancement (whichever is applicable) to secure

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[79] In addition to the California cases, the IRS listed for this purpose several Federal cases that dealt with Code § 465, pursuant to which an individual taxpayer engaged in an activity to which Code § 465 applies may only deduct losses from the activity to the extent that the taxpayer is "at risk" with respect to the activity at the close of the taxable year. Code § 465(a). An individual taxpayer generally is "at risk" with respect to amounts including "the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity" (Code § 465(b)(1)) and with respect amounts borrowed for use in the activity to the extent the taxpayer is personally liable for repayment of such amounts, or has pledged property, other than property used in the activity, as security for the borrowed amounts. Code § 465(b)(2). A taxpayer is considered not to be at risk "with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." Code § 465(b)(4). *See e.g., Abramson v. Commissioner*, 86 T.C. 360 (1986); *Peters v. Commissioner, 89 T.C. 423 (1987); Investment Research Associates v. Commissioner, T.C. memo. 1999-407; Santulli v. Commissioner*, T.C. Memo 1995-458; *Wimpie v. Commissioner*, T.C. Memo 1994-411.

[80] Reg. § 1.1001-3(e)(4)(iv).

the repayment of the debt.[81] On the other hand, a change in obligor of a recourse debt is generally a significant modification, subject to certain exceptions.[82]

Summary of Authorities under Code §1001.

While there is no definition for the term "nonrecourse debt" under Code §1001 or the Regulations thereunder, it appears that under both sets of Regulations described above and the IRS's interpretation of these Regulations, "nonrecourse debt" is simply a debt instrument under which the borrower is not primary liable for the debt. It is clear that if the creditor can look to either an asset used as collateral, a third party, or other form of credit enhancement, for repayment of the debt before it looks to the borrower, then the debt should constitute nonrecourse to the borrower. In addition, even if the borrower still remains secondary liable, and/or can be called to pay the debt in some limited circumstances, it should not change the nature of the debt as "nonrecourse debt."

3. Other Authorities (Regulations §1.752-1(a)(1))

While not directly applicable to debt modifications, the Regulations under Code § 752 provide another indirect authority for the definition of the term "nonrecourse debt." The Regulations under Code §752 allocate a partnership liability among partners for purposes of determining their tax basis in their partnership interest. Code § 752 provides a definition of "recourse" and "nonrecourse" debt for the purposes of the allocation rules, and such definitions focus on whether a partner has an economic risk of loss, which is solely for the purposes of Code § 752.[83] Reg. § 1.752-1(a)(1) provides that "[a] partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2." On the other hand, a nonrecourse partnership liability is simply a partnership liability for which no partner or related person bears the economic risk of loss.[84] Thus, to the extent that partners do not have any personal liability for the partnership's debt, the partnership's debt should be treated as "nonrecourse debt." The creditors will have no claim against the partners in the partnership or any related person (as defined in § 1.752-4(b)) or any such persons' assets if the partnership defaults on a nonrecourse loan.

The Treasury regulations under Code §§704 and 707 also determine tax consequences related to partnership allocations or transactions with a partnership respectively, in part, based on the character of the partnership indebtedness, which in each instance is determined under the Treasury regulations under Code §752.[85]

[81] Reg. § 1.1001-3(e)(4)(ii).
[82] Reg. § 1.1001-3(e)(4)(i).
[83] Reg. § 1.752-1(a).
[84] Reg. § 1.752-1(a)(2).
[85] Reg. §§ 1.707-5(a)(2)(i),(ii), 1.704-2(b)(3), (4).

Under these Regulations, it is also clear that in determining if a partnership's debt instrument is "nonrecourse," the focus is on whether the partner has any personal liability for the partnership's debt. In other words, again, as long as the creditor must look to another source of payment, other than the partner, the debt should be treated as "nonrecourse debt."

4. Summary of Authorities

While there is no direct authority for the defining the meaning of the term "nonrecourse debt" for purposes of Treasury regulations § 1.1001-3, it appears that using the closest analogies, a nonrecourse debt instrument is essentially a debt instrument pursuant to which the borrower does not have primary personal liability for the debt and the creditor can get recourse from a source other than the borrower (e.g., collateral or third party guarantee), whether the borrower becomes secondarily liable or not liable at all.[86] Furthermore, even if the borrower, under some limited circumstances, can be called to pay the debt (i.e., the debt is "limited recourse loan"), the debt can still be treated as non-recourse debt for purposes of Reg. § 1.1001-3.

The following factors, therefore, must exist, for the debt to be treated as nonrecourse debt:

1. The debt must be secured by a collateral, third party guarantee or other credit enhancement (e.g., letter of credit).

2. At all times, the value of collateral or amount of guarantee or letter of credit must be at least as much (and preferably more) than the outstanding balance of the debt.

3. The terms of the debt must specifically provide that the creditor has no or very limited recourse to the borrower. The borrower can become secondary liable as long as there is a primary obligor other than the borrower

4. If the nonrecourse feature is in the form of a third party guarantee, it must be very clear that the guarantor takes primary responsibility for repayment, and the borrower is only secondarily liable. This would essentially treat the guarantor as the primary obligor on the debt.

Application to a Note

Although there is no direct authority, it seems that the following elements of the note could result in the note being treated as nonrecourse debt, a critical factor being that at no time would the creditor be looking to the borrower personally for repayment:

[86] *See Briarpark, Ltd. v. Commissioner*, 73 TCM (CCH) 3218 (1997), citing *Zappo v. Commissioner*, 81 T.C. 77, 87 (1983) for the view that a guarantee agreement, pursuant to which the original obligor becomes secondary liable for the debt, transforms the debt into nonrecourse debt.

1. If the note will be guaranteed by third party guarantee (which must be unrelated to the Husband), such a guaranty should be a nonrecourse guaranty for the guarantor, secured by designated property of the guarantor. If such guarantee is the only nonrecourse feature of the note, the guarantee must apply to at least 100% of the principal of the note.

2. If the note will be secured by property (whether the borrower's property or the guarantor's property) on a nonrecourse basis, the value of the collateral must be equal to or greater than the value of outstanding debt. The size of the down payment that is made initially should not affect the analysis of whether the note is nonrecourse; it is the comparison between the outstanding balance of the note and the collateral securing the note that will dictate if the note is nonrecourse or not.

3. A combination of a third party nonrecourse guarantee and collateral (and any other form of credit enhancement) can also result in treating the note as nonrecourse debt, as long as the combined value of the guarantee and collateral (and any other form of credit enhancement) is at least 100% of the outstanding balance of the note and the borrower does not have personal liability for the note.

F. Other Possible Ways to Avoid a Retained Interest.

Gans and Blattmachr suggest that another possible way to avoid a retained interest is to structure the sale to a grantor trust for cash rather than a promissory note. How can this be accomplished? Gans and Blattmachr suggest that the grantor's spouse could lend money to the purchasing trust in order to permit the sale to occur for cash. Perhaps this only shifts the potential transfer with a retained interest from the grantor to the grantor's spouse, although compliance with the authorities cited above to ensure the obligation is treated as debt rather than equity should assist. It might also be possible for the grantor to fund a marital trust with the cash and have the marital trust lend that cash to the purchasing trust so that the sale would be for cash, rather than a note. The one difficulty with this approach is that a method to settle a valuation dispute in connection with an installment sale to a grantor trust is to increase the face value of the promissory note given in exchange. If there is no promissory note at the outset, then the purchase and sale agreement should contemplate one. Providing for additional consideration in the event of a valuation adjustment should support the bona fides of the arrangement as a sale for which the grantor intends to receive full and adequate consideration.

II. 99-Year GRAT[87]

A. Basic Structure of a GRAT.[88]

In a grantor retained annuity trust ("GRAT"), the grantor of the trust retains the right to receive an annuity for a fixed term of years, following which the remainder will pass to

[87] Idea contributed by Turney Berry.

[88] The GRAT discussion is excerpted in part from J. Blattmachr & D. Zeydel, "GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?," 41st Annual Heckerling Institute on Estate Planning, Chapter 1 (2007).

the specified successor beneficiaries. The greater the value of the annuity interest, the smaller the taxable gift involved in the creation of a GRAT. A lower interest rate increases the actuarial value of the retained annuity. Thus, the same annuity payments will produce a lower taxable gift at a lower interest rate.

It would seem that a low interest rate environment (that is, a low I.R.C. § 7520 rate) would increase the probability of success for a GRAT. However, GRATs are not as interest rate sensitive as one might assume because it is the relative performance of a GRAT that matters, not absolute performance. In general, a GRAT is successful if the assets outperform the I.R.C. § 7520 rate, and that rate fluctuates based upon the economic climate. In high interest rate environments, the I.R.C. § 7520 rate will be relatively higher as well. Nonetheless, it does appear that in particularly low, or particularly high, interest rate environments, assets selection may be important because outperformance in a low interest rate environment may be correlated with certain asset classes, and not others. Financial projections by the client's investment advisors will be important to maximize the potential of a successful GRAT.

Although short term so-called "rolling" GRATs has been a favored strategy, a risk of using a rolling GRAT approach is that GRATs may not survive potential changes to the estate and gift tax law. Accordingly, one might reconsider using a longer term GRAT with the following variation. One difficulty with a longer term GRAT is that early success may be offset by future failure in asset performance. One might overcome that risk in part by using a power of substitution under I.R.C. § 675(4)(C) to capture the volatility in a GRAT.[89] The strategy would be for the taxpayer to exercise the power of substitution when the assets have reached what in the taxpayer's view is a peak value in order to preserve that enhanced value for the benefit of the GRAT remainder beneficiaries. The grantor would substitute a less volatile asset or one that is perceived to have a depressed value.

Another negative of a longer term GRAT is that death within the term of the GRAT will likely cause a substantial portion, if not all, of the assets of the GRAT to be included in the grantor's gross estate for Federal estate tax purposes.[90] The probability of death within the term of a GRAT can be estimated using the 90CM mortality tables which are based upon the 1990 census.

B. Important Questions About GRATs Remain.

1. How Small Can the Remainder in a GRAT Be?

Although Treasury Regulations have adopted the holding in Walton, at least in the view of the National Office of the IRS at one time, that does not mean the

[89] PLR 200846001 allowed the taxpayer to exercise a power of substitution over a GRAT without negative gift tax effects. The power of substitution in the private letter ruling was held in a fiduciary capacity, but a power of substitution that complies with the requirements of Revenue Ruling 2008-22, 2008-16 I.R.B. 796, should have the same effect because it requires that the trustee have a fiduciary duty to ensure that the property substituted for the trust property be of equivalent value.

[90] *See* Reg. §20.2036-1(c).

value of the (taxable) remainder in the GRAT may be structured to be zero or even "too" small. In Technical Advice Memorandum 200245053, issued after Walton was decided but before the IRS announced its "acquiescence" in the case, the IRS indicated that a GRAT with a "zeroed out" remainder may violate public policy under the Procter case (which held a formula clause that attempted to return gifted property in excess of the annual exclusion to the donor void) because a valuation adjustment would not cause the taxpayer to owe any additional gift tax. Although many practitioners may conclude that the risk is remote that a GRAT is not a "qualified interest" under I.R.C. §2702(b) by reason of the value of the remainder being very small (if not zero), some advisors or taxpayers may conclude that the possibility that the courts might agree with the conclusion in the TAM should not be ignored.

2. Minimum Remainder Value?

It also should be noted that the IRS will not issue a private letter ruling on the qualification of a GRAT where the value of the remainder interest is less than ten percent of the value of the contributed property. That, also, may indicate that the IRS may challenge any GRAT the remainder of which is "too small".

In any case, if the grantor's retained annuity in a GRAT is not a "qualified interest" under I.R.C. §2702(b) by reason of the value of the remainder being very small, the consequences of making it that small are uncertain. One possibility is that the gift would be deemed to be equal to the minimum value permitted for a remainder in a GRAT (such as ten percent). Another possibility is that making the value of the remainder in the GRAT too small causes the annuity to fail to constitute a qualified interest under I.R.C. § 2702(b). That could mean the value of the entire property contributed to the GRAT is subject to gift tax. That possibility may seem exceptionally remote to many practitioners, but some taxpayers might find the risk to be unacceptable and may only create a GRAT if the value of the remainder is at least ten percent of the value of the property contributed to the trust, which, as indicated, is the minimum size of a remainder in a GRAT upon which the IRS will issue a private letter ruling that the annuity interest in a GRAT is a qualified interest under I.R.C. §2702(b).

3. How Short a Term May a GRAT Last?

Another uncertainty with respect to a GRAT, at least in the view of some practitioners, is how short the annuity term can be. At one time, the IRS would not issue a ruling that the retained annuity interest in a GRAT would be a qualified interest under I.R.C. §2702(b) unless the annuity term were at least five years long. Some practitioners are confident a GRAT of at least two years may be a qualified interest. This view is likely supported in no small measure by the fact that the GRATs in the Walton case were two year GRATs, even though the sole issue for decision in Walton was the valuation of the gifts. Others are not so certain. If the GRAT must be of a minimum term to be a qualified interest, the

entire amount transferred to the trust might be subject to gift tax if the annuity term is shorter than that minimum.

4. Possible Language to Avoid Adverse Effect of Minimum Value and/or Minimum Term.

As explained, some practitioners and their clients may believe that the minimum value of the remainder interest in a GRAT and the minimum term of a GRAT are legally uncertain. Strong arguments can be made, it seems, that a qualified annuity interest exists even where the value of the remainder is relatively small (such as one one-hundredth of one percent), and the annuity will be paid for a relatively short term (such as two years). However, to avoid an unanticipated technical disqualification, it may be prudent to provide formula language that would adjust the retained annuity to produce whatever remainder value may be legally required, and likewise to adjust the fixed term to whatever duration is necessary in order to have a tax qualified GRAT. The following provision may accomplish those two goals:

> a. The "Annuity Amount" shall be determined as provided below, and shall be paid to the Grantor [specify payment terms, such as annually during the Fixed Term on the date immediately preceding the anniversary of the Funding Date]:
>
> > i) In the first year of the Trust, the Annuity Amount shall be a Fixed Percentage of the Gift Tax Value of the assets contributed to the Trust on the Funding Date; and
> >
> > ii) In each subsequent year of the Trust during the Fixed Term, the Annuity Amount shall be one hundred twenty percent (120%) of the Annuity Amount payable in the preceding year.
>
> b. The "Fixed Percentage" shall be that percentage that will cause the Gift Tax Value of the taxable gift to the Trust (taking into account the determination of the Fixed Term as provided in Paragraph (D)) to equal the greater of:
>
> > i) [specify the percentage of the fair market value of the assets contributed to the GRAT that the value of the remainder will represent, such as one one-hundredth of one percent (.01%)] of the Gift Tax Value of the assets contributed to the Trust on the Funding Date rounded up to the nearest whole dollar; and
> >
> > ii) The smallest amount such that Annuity Amount will constitute a qualified annuity interest within the meaning of Internal Revenue Code §2702(b)(1) and Reg. §25.2702-3(b)(1).

c. The "Funding Date" shall be the date of the initial assignment, conveyance transfer or delivery of property to the Trustee.

d. The "Fixed Term" shall commence on the Funding Date and end on:

i) [specify the date upon which the annuity payments to the Grantor will end as an anniversary of the Funding Date, such as the second anniversary of the Funding Date]; or

ii) such later anniversary of the Funding Date as shall be necessary in order that the Annuity Amount shall constitute a qualified annuity interest within the meaning of Internal Revenue Code §2702(b)(1) and Reg. §25.2702-3(b)(1).

e. The "Gift Tax Value" of any property shall be the fair market value of such property as finally determined for Federal gift tax purposes.

5. What Is the Effect of Improper Administration of a GRAT?

A third uncertainty is the consequence, if any, if the GRAT is not administered in accordance with its terms that are required by the Regulations. For example, suppose the annuity for the year is not paid within 105 days of the close of the year (or the anniversary of the commencement of the GRAT), as appears to be required by the Regulations. In *Atkinson v. Comm'r*, the court stated that a lifetime charitable remainder annuity trust includible in the decedent's estate was not a "qualified" charitable remainder annuity trust under I.R.C. §664, and thus, no charitable deduction would be available to the decedent's estate, where the trust was found not to have made any annuity payments to the decedent-annuitant during her lifetime. The Tax Court found that the CRAT was drafted in complete compliance with the Code and Regulations, and thus, was ineligible for a statutory reformation under I.R.C. §2055(e)(3). The Tax Court also found the CRAT disqualified because estate tax was ultimately paid from the trust in respect of a successor beneficiary's annuity interest. However, the Eleventh Circuit affirmed solely on the first issue, that the CRAT was disqualified from inception for failure to make annuity payments to the decedent. The Eleventh Circuit stated, "Accordingly, since the CRAT regulations were not scrupulously followed through the life of the trust, a charitable deduction is not appropriate." This is indeed a very high standard, and failure to comply has dramatic results. Given the holding in Atkinson, it may be difficult for practitioners and taxpayers to conclude that there is no risk of an adverse effect if a GRAT is found not to have been administered in accordance with its terms as required by the Regulations (e.g., an annuity payment is made more than 105 days after its payment due date) or that there is no risk that such a mistake in administration may occur.

6. Possible Language to Avoid Disqualification of a GRAT for Improper Administration.

As explained, improper administration of a GRAT notwithstanding proper drafting of its terms, has the potential to disqualify the annuity as a "qualified interest," with the consequence that one hundred percent of the property contributed to the GRAT would be treated as a taxable gift under I.R.C. §2702. To avoid the risk of retroactive disqualification of the annuity interest, it might be prudent to vest in the grantor that portion of the GRAT necessary to satisfy the annuity due to the grantor upon its payment due date, and, by express language in the GRAT, terminate the trust relationship as to that portion of the trust as of that time. This concept has a basis in the doctrine of "dry trusts" under the Statute of Uses applicable to interests in real property. Under the Statute of Uses, when property held in trust is no longer subject to administration because all duties of the trustee have terminated, that property immediately vests in the beneficiary by operation of law. The language offered below attempts to incorporate the concept of immediate vesting, in addition to changing the trustee's relationship to the portion of the trust needed to satisfy the annuity from one of trustee to one of agent for the grantor. In that manner, the annuity would be de facto distributed to the grantor from the trust, and thus, included in the grantor's estate for all property law purposes. Language such as the following might be considered:

If any portion of the annuity payable to the grantor or the grantor's estate, as the case may be, on a particular date is not distributed in its entirety by the trustee to the grantor or the grantor's estate, as the case may be (both referred to as the "Annuity Payee"), by the end of the last day (the "annuity due date") on which it must be paid in order for the annuity to be treated as a qualified annuity for purposes of I.R.C. § 2702, including any applicable grace period (such unpaid portion of the annuity being hereinafter sometimes referred to as the "undistributed annuity amount"), then, at the end of the annuity due date, the Annuity Property (as hereinafter defined) held by the trustee shall vest absolutely in the Annuity Payee. The trust shall immediately terminate as to the Annuity Property, and the trustee, in the trustee's capacity as trustee, shall have no further duties, power, authority or discretion to administer the Annuity Property notwithstanding any provision of applicable law or this agreement to the contrary. If the Annuity Property shall remain in the hands of the trustee after the annuity due date, the trustee shall hold such property exclusively as nominee and agent for the Annuity Payee. The grantor hereby authorizes the trustee, but only as nominee and agent for the Annuity Payee to invest the Annuity Property on the Annuity Payee's behalf with the same authority as the Annuity Payee could individually. The trustee, both as trustee and as such nominee and agent, is hereby relieved of any liability for commingling assets that have vested absolutely in the Annuity Payee with assets that remain part of the trust estate under this Article. Any Annuity Property that shall have vested in the grantor as hereinbefore provided shall, upon the grantor's subsequent death, vest in the grantor's estate. For purposes of this Article, the term "Annuity Property" shall mean that portion of the trust estate (i) having a fair market value as finally

determined for Federal gift tax purposes equal to the lesser of (x) all property held by the trustee, in the trustee's capacity as trustee, at the end of the annuity due date or (y) the undistributed annuity amount, and (ii) if the fair market value as finally determined for Federal gift tax purposes of the property then held by the trustee is greater than the undistributed annuity amount at the end of the annuity due date, consisting of those assets having the lowest income tax basis as finally determined for Federal income tax purposes compared to their current fair market values as finally determined for Federal income tax purposes, and (iii) if more than one asset has the lowest basis for Federal income tax purpose, consisting of a proportionate share of each such asset, and (iv) shall include all income, appreciation and depreciation on such assets and all other incidents of ownership attributed thereto.

C. Declining Payment GRATs

It is well established that short term GRATs succeed if the assets contributed are volatile. And they fail for the same reason. A spike in value can cause a GRAT to succeed; and a sharp decline can cause a GRAT to fail. However, a GRAT structured so that there is no, or virtually no, taxable gift upon formation reduces the cost of forming an unsuccessful GRAT to the fees incurred, and the opportunity cost of having foregone another, potentially more successful, strategy. If capturing volatility in the name of the game, then as long as rolling GRATs are possible, the shortest possible term will have the greatest possibility of producing a positive GRAT remainder. This is true because a short term GRAT is most likely to avoid periods of appreciation being offset by period of depreciation. Assuming that most are comfortable with a 2-year GRAT under the *Walton*[91] case, even though *Walton* did not bless (but also did not challenge) a 2-year term, but are not comfortable with a 1-year term, can the equivalent of a 1-year term be achieved. The answer appears to be "yes", not by shortening the term, but instead by steeply declining the payments. Treasury Regulation §25.2702-3(e) *Example 3* appears to permit declining payments. The Example posits that annuity payment of $50,000 will be made in years one to three and $10,000 in years four to ten and concludes the annuity is a qualified annuity interest. Therefore, it seems that a two year GRAT with a very, very large payment (99%, for example) in year 1 with a payment in year 2 that will actuarially nearly zero out the contribution to the GRAT would capture volatility better than a straightline GRAT or even a 20% increasing GRAT. It appears from one study that nearly 12% of the remainder value of a steeply declining rolling GRAT strategy can attributed to the declining payments, a significant added benefit.[92] The Obama administration's proposals would eliminate the ability to create a GRAT with declining payments.

[91] In *Walton v. Comm'r,* 115 T.C. 589 (2000), *acq*. IRS Notice 2003-72, 2003-44 I.R.B. 964, the Tax Court held that the value of the interest retained by the grantor for purposes of IRC §2702 could include the value of the annuity payable for a specified term if the annuity was payable to the grantor for the term or to the grantor's estate for the balance of the term if the grantor died during the term.

[92] *See* D. Zeydel and R. Weiss, "Overcoming Planning Procrastination in Turbulent Times", Boston Estate Planning Counsel, December 1, 2011.

D. Enter the 99-Year GRAT[93]

Interest rates that are extremely low facilitate an alternative strategy: the very long-term GRAT. The longer the term the lower will be the annuity required to zero-out the GRAT, that is to produce no gift. Reg. §20.2036-1(c)(2) provides that where a grantor retained an interest in an annuity the value of the property included in the grantor's estate will be the amount required to produce the annuity using the I.R.C. § 7520 rate in effect at the grantor's death. See Examples 1 and 2 of the referenced Regulation.

Example: A 99 year GRAT funded with $1,000,000 in a month when the I.R.C. § 7520 rate is 2.2% will require annual payments of $24,866 per year to produce a zero gift. Suppose that when the grantor dies the I.R.C. § 7520 rate has increased. Merely by the increase, assets will be excluded from the grantor's estate. If the I.R.C. § 7520 rate increases to 6%, more than 55% of the original value of the assets would escape estate tax, merely by virtue of the actuarial computation. ($24,866/.06=$414,433). If the I.R.C. § 7520 rate increases to only 4%, more than 35% of the original value of the assets would escape estate tax. ($24,866/.04=$621,650). In each case, the balance of the property escapes estate tax.

The beauty of the 99-year GRAT is that it is purely a numbers game. The annuity payment divided by the applicable I.R.C. § 7520 rate provides the amount of property needed to sustain the annuity payments as if they were an income interest in property in perpetuity. The higher the I.R.C. § 7520 rate, the less property is needed to produce a given income interest. This principal allows one to create a GRAT with a relatively lower annuity payment in a low interest rate environment and still make the remainder interest very small.

Because it seems likely that the grantor will die prior to the end of the 99 year term, estate tax inclusion seems inevitable. In order to preserve the treatment of the GRAT as having a term interest, that interest should be required to continue for the entire term -- to children, for example, or trusts for their benefit. As with more traditional GRATs, care must to taken not to merge the annuity and remainder interests, as that might defeat treatment of the annuity as one that lasts for the entire term of the GRAT.

It may be possible to merge the interests at a later time by a post death transaction, but a transaction that might constitute the transfer of the term interest without a simultaneous transfer of the remainder interest to a third party may have adverse income tax consequences. For example, in PLR 200648016 (December 1, 2006), the IRS took the position that terminating a trust according to the actuarial interests of the beneficiaries caused the income beneficiary to experience 100% capital gain on the actuarial value of the income interest with no allocation of basis under the uniform basis rules.[94]

[93]Idea contributed by Turney Berry.
[94] See Reg. §1.1001-1(f).

III. Leveraged GRATs[95]

A. Use of Family Partnership and GRAT, But Inverted

1. Obtaining the Benefit of a Discount With a GRAT

Obtaining a valuation discount for assets contributed to a GRAT can be a challenging undertaking. If a short term GRAT is used, the annuity payments will be very large. If discountable assets are used to satisfy the payments, the benefit of the discount would be diluted. If significant distributions are made from the partnership, the IRS will likely be able successfully to challenge the valuation discount asserted for the contribution of the partnership interest to the GRAT. So how can we obtain a discount, but still the valuation protection offered by the self-adjustment rules permitted for GRATs?

Suppose instead of selling limited partnership units to a dynasty trust, the following structure is used. An individual creates a family limited partnership and a single member LLC that holds assets worth ten percent of the anticipated discounted value of the limited partnership units of the family partnership. The limited partnership interests are contributed and/or sold for a promissory note to the LLC. Following these steps the individual still owns 100% of the LLC and the balance of the partnership units, so no taxable gift has occurred.

After all assignments have been completed, suppose most of the LLC membership interests are contributed to a 10 year near "zeroed out" GRAT. The LLC membership interest will not have a very significant value because although it will own all the limited partnership units of the family partnership, it will also owe a promissory note back to the grantor equal to the appraised value of the units. The GRAT annuity payment will be based upon the net value.

2. Improved Financial Results

When an LLC that is leveraged is owned by a GRAT, it seems possible with minimal cash flow coming out of the partnership to the LLC and on to the GRAT, that the GRAT the annuity amounts during the Annuity Period could be satisfied in cash. This eliminates the problems associated with satisfying the GRAT annuity with hard to value assets.

The note associated with the sale before the GRATs are created could be satisfied by the remainderman (the Grantor Trust) with hard to value assets after the GRAT terminates. However, the use of payments in kind to satisfy the loan after the GRAT terminates does not run the "deemed contribution" danger that may be inherent in satisfying GRAT annuity payments with hard to value assets.

Another advantage of the technique is that because of the relatively modest annuity payment in comparison to value of the partnership interest passing to the

[95] Idea contributed by Stacy Eastland.

remainder beneficiary, if a death of the grantor of the GRAT occurs before the Annuity Period ends, there is a much greater chance that some of the assets of the GRAT will not be included in the grantor's estate under I.R.C. § 2036.

Not only is the technique more structurally conservative, as far as preserving qualified interest status of a GRAT, the technique of using a leveraged LLC with a GRAT also has the desirable effect of significantly increasing the "estate planning" success of the GRAT by more than twice. The reason for the substantial improvement is twofold: (i) the annuity amount is always paid with undiscounted cash and (ii) the average hurdle rate "cost" of that leverage is at the applicable federal rate under I.R.C. § 1274, instead of the I.R.C. § 7520 rate.

B. Risks in the Strategy?

It seems that valuation risk is well protected in the strategy. The question is will the strategy be protected from attack under general tax doctrines such as step transaction or sham transaction. It does seems a little peculiar to be selling an asset to an entity that you own 100%. Perhaps the structure could be improved by interposing an incomplete gift trust to engage in the sale with the LLC. Suppose the family limited partnership units are first contributed to a self-settled asset protection trust that is not a completed gift, but is nevertheless independent from the settlor, with an independent trustee. The trust would give the settlor sufficient control to cause the gift to the trust to be incomplete. Thereafter, the settlor would not engage in any transaction involving the partnership interest personally. Rather, the trustee of the incomplete gift trust would engage in the transaction with the LLC. It seems that structure would improve the *bona fides* of the sale; and the *bona fides* of the debt owed by the LLC to the trust, thereby improving the potential to sustain the value of the LLC interest as reduced by the face value of the arm's length debt. The sale itself might also be protected from valuation risk by the methods described above for installment sales to grantor trusts.

IV. Supercharged Credit Shelter Trust[SM 96]

A. Testamentary Credit Shelter Trusts.

Under Subchapter J of the income tax provisions of the Code, unless the trust is a grantor trust under Subpart E of Part 1 of Subchapter J, the income taxation of trust's income is based on the concept of distributable net income (DNI). Under those DNI rules, the trust's income is taxable to the beneficiaries or the trust depending on the amount of distributions made each year. See section 651-662. Thus, if income distributions to the surviving spouse are mandated or made in the discretion of the trustee, they will be taxed under the DNI rules to the spouse, as a general rule. If, on the other hand, the trust's income is either accumulated or distributed to descendants, it will, of course, not be taxed to the spouse. Suppose, however, the DNI rules could be displaced with the grantor trust rules so that the trust's income, therefore, would be made taxable to the spouse even if no

[96] Excerpted from M. Gans, J. Blattmachr & D. Zeydel, "Supercharged Credit Shelter Trust," *21 Probate and Property 4*, July, August 2007.

distributions are made to the spouse. (Under the grantor trust rules, the income, deductions and credits against tax of the trust are attributed directly to the grantor as though the trust does not exist and the trust assets were owned directly by the grantor.) If this could be accomplished, the trust would grow income tax free and thus, in effect, would be enhanced by the spouse's income-tax payments. And, assuming an allocation of GST (generation-skipping tax) exemption were made to the trust, the enhancement attributable to the spouse's payment of the income tax could inure to the benefit of lower-generation beneficiaries on a completely transfer-tax-free basis. The credit shelter trust would thus become "supercharged."

B. Making the Credit Shelter Trust a Grantor Trust

1. Using 678?

How might one structure a credit shelter trust in order to supercharge it? At bottom, the concept rests on Rev. Rul. 2004-64, 2004-2 C.B. 7. In the ruling, the IRS considered the gift tax implications of a grantor trust. In the case of a Grantor Trust, the DNI rules do not apply. Instead, the trust is ignored for income tax purposes and its income is taxed to the grantor.[97] In Rev. Rul. 2004-64, the IRS concluded that the grantor's payment of the tax on the income of a grantor trust does not constitute a taxable gift.[98] Thus, if a credit shelter trust could be structured so that it was the surviving spouse's grantor trust for income tax purposes while still functioning as a credit shelter trust for transfer-tax purposes (no inclusion in the surviving spouse's estate), it would be supercharged.

The difficulty, however, is that, under conventional planning, the surviving spouse is not the grantor of the credit shelter trust. The trust is created by bequest under the will (or revocable trust) of the first spouse to die and, therefore, cannot be viewed as the surviving spouse's grantor trust. Nonetheless, under I.R.C. § 678, the trust could qualify as the surviving spouse's grantor trust if he or she were given the right to withdraw the trust principal. While this would be effective in terms of making the trust's income taxable to the spouse, it would be ineffective in terms of the estate tax: such a withdrawal power is a general power of appointment that would cause the trust's assets to be included in the surviving spouse's gross estate under I.R.C. § 2041 (and a release or lapse of the power during the surviving spouse's life would trigger a taxable gift under I.R.C. § 2514 to the extent not saved by the "five-and-five" exception in I.R.C. § 2514(e)). The critical question, therefore, is how to make the credit shelter trust the surviving spouse's grantor trust without relying on I.R.C. § 678.

[97] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[98] For a discussion of the ruling, *see* M. Gans, S. Heilborn & J. Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," Estate Planning, Vol. 31 No. 10, at 467 (October 2004).

2. Using a Lifetime QTIP Trust for the Spouse Dying First

This can be achieved through the use of a lifetime QTIP trust. To illustrate, assume the wife creates a lifetime QTIP trust for her husband with sufficient assets to use his entire estate tax exemption when he dies. She elects QTIP treatment for the trust on her United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). (Note that it will not qualify for the marital deduction if the spouse for whom the QTIP is created is not a U.S. citizen.[99] Thus, no gift tax is payable when the trust is created, and the entire trust will be included in the gross estate of the husband when he dies under I.R.C. § 2044. While both spouses are alive, the trust is the wife's grantor trust (assuming her husband is a beneficiary with respect to both trust income and principal, the trust is deemed wholly owned by the wife).[100] Therefore, all of the trust's income (whether allocated to accounting income or to principal) would be taxed to the wife without regard to the DNI rules.

Upon the husband's death, as indicated, the assets in the lifetime QTIP trust created by the wife for the husband are included in his gross estate under I.R.C. § 2044. But estate tax will be avoided to the extent of his remaining Federal estate tax exemption (and as to the entire trust if any assets in excess of the husband's remaining exemption pass in a form that qualifies for the marital deduction for estate tax purposes in his estate). And, assuming the trust is properly drafted, its assets (to the extent of the husband's estate tax exemption) should not be included in the wife's gross estate at her later death. Even though she may be a permissible (or even mandatory) beneficiary of the credit shelter trust created from the lifetime QTIP trust, it will not be included in her gross estate as long as she does not have a general power of appointment and as long as the husband's executor does not make a QTIP election. While, under I.R.C. § 2036, trust assets may ordinarily be included in the grantor's gross estate where the grantor is a beneficiary, the QTIP regulations explicitly preclude the IRS from invoking I.R.C. § 2036 or I.R.C. § 2038 in the surviving spouse's estate in the case of such a lifetime QTIP.[101] Thus, even if the credit shelter trust is drafted to permit distributions to the wife, it will not be included in her gross estate. In effect, the trust functions exactly as would a credit shelter trust formed from assets in the husband's own estate: A trust using his exemption would be excluded from the wife's gross estate at her later death.

Nonetheless, for income tax purposes, the trust can continue to be treated as the wife's grantor trust after the husband's death, provided the trustee has discretion to make distributions of income and principal to the wife. Regardless of the way in which the trustee in fact exercises this discretion, the trust's taxable income will continue to be attributed to the wife under the grantor trust rules by reason of the wife's discretionary interest in trust income and principal. See section 676,

[99] *See* IRC § 2523(i).
[100] *See* IRC §§ 676, 677.
[101] *See* Reg. § 25.2523(f)-1(f), Example 11.

677. Most critically, the wife is viewed as remaining the grantor of the trust for income tax purposes – thus triggering I.R.C. § 676 and/or 677 -- even though, at her husband's death, it was included in his gross estate under I.R.C. § 2044.[102] As a result, the wife's payment of the tax on the trust's income does not constitute a taxable gift. Thus, even assuming the trustee accumulates the income or distributes it to the descendants, the wife is required to pay the income tax and is not treated as making a taxable gift when she does so. In short, the credit shelter trust is supercharged. And if GST exemption is allocated to the lifetime QTIP trust, the transfer tax savings will be further enhanced (although Rev. Rul. 2004-64 does not make explicit reference to the GST, its conclusion that no taxable gift occurs by reason of the grantor's payment of the income tax should likewise apply for GST purposes).[103]

It is appropriate parenthetically to discuss the allocation of GST exemption in a bit more detail here. The spouse who creates the lifetime QTIP trust may make the so-called "reverse QTIP" election under I.R.C. § 2652(a)(3) when the lifetime QTIP trust is created. In other words, the GST exemption of the first spouse to die will not be allocated to the credit shelter trust formed from that lifetime QTIP trust. Rather, the GST exemption of the spouse who created it will be allocated and allocated earlier in time than will estate tax exemption of the spouse dying first. An example may help illustrate this concept. Suppose it is quite certain the husband will die before the wife will. She creates a $5 million lifetime QTIP trust for him. Although she makes the QTIP election to make the trust qualify for the gift tax marital deduction under I.R.C. § 2523(f), she "reverses" that election under I.R.C. § 2652(a)(3) for GST tax purposes. Hence, her GST exemption begins to "work" as soon as she creates the trust. Assume that when the husband dies, the lifetime QTIP trust is worth $6 million. The first $5 million (indexed for inflation) goes into a credit shelter trust for the surviving spouse and is GST exempt by reason of *her* allocation of *her* GST exemption to the trust. The balance of the assets in the lifetime QTIP trust the wife created for the husband goes into a QTIP trust for her which the husband's executor will elect to qualify for the estate tax marital deduction under I.R.C. § 2056(b)(7). And it too will be GST exempt, again by reason of the wife's allocation of GST exemption to the lifetime QTIP trust when she created it. The husband's GST exemption will be allocated to other assets in his estate—these other assets presumably will pass into a so-called "reverse" QTIP trust for the wife. Hence, this strategy not only supercharges the estate tax exemption of the spouse who dies first, but also supercharges the GST exemption of the surviving spouse. Of course, as with all lifetime uses of tax exemptions, there is a risk that exemption is wasted if the assets decline in value.

[102] *See* Reg. §1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust).

[103] *See* Reg. §26.2632-1(c)(2)(ii)(C) and Reg. .§26.2652-1 and J. Blattmachr, "Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation," The Chase Review (Spring 1996).

3. Creditors' Rights Doctrine

Under the law of most, but not all, states, a grantor's creditors may attach assets in a trust the grantor has created and from which he or she is entitled or eligible in the discretion of a trustee to receive distributions.[104] The question becomes whether estate tax inclusion in the estate of the spouse who created the QTIP that becomes a credit shelter trust for that spouse might result if, under state law, her creditors could reach the trust's assets.

Because the wife in the above example is the grantor of the lifetime QTIP trust and will also be a permissible beneficiary of the resulting credit shelter trust, it is at least arguable that, under state law, her creditors could attach the trust's assets. Ordinarily, the ability of a grantor's creditors to reach trust assets triggers inclusion in the gross estate under I.R.C. § 2036.[105] As indicated, however, the QTIP regulations explicitly preclude the IRS from invoking I.R.C. § 2036 and 2038 in this context.[106]

Is it nonetheless possible that the IRS could successfully argue that, because of the right of the wife's creditors to reach the trust's assets, she has a general power of appointment triggering inclusion in her estate under I.R.C. § 2041? While the QTIP regulations render I.R.C. § 2036 and 2038 inapplicable in the wife's estate, they do not rule out the possible application of I.R.C. § 2041. Although Reg. § 20.2041-1(b)(2) may be read to say that the transferor of property cannot be deemed to hold a general power of appointment under I.R.C. § 2041, it is appropriate to mention that the QTIP rules make the spouse who is the beneficiary of a lifetime QTIP trust the transferor of the trust property for estate and gift tax purposes once the trust is created. Example 11 to Reg. § 25.2523(f)-1(f) says "S [the spouse for whom the lifetime QTIP trust was created] is treated as the transferor of the property." In addition, that is consistent with I.R.C. § 2044(c) ("For purposes of this chapter…, property included in the gross estate under subsection (a) shall be treated as property passing from the decedent").

So if the spouse for whom the QTIP trust was created is the transferor for estate and gift tax purposes, it seems completely logical that that spouse could "create" a general power of appointment for the grantor spouse. For example, a wife creates a lifetime QTIP trust for her husband and gives him a testamentary special power of appointment. When he dies, the trust is included in his estate under I.R.C. § 2044 and he exercises his special power of appointment to grant his wife a general power of appointment. It seems virtually certain the trust will be in the wife's estate under I.R.C. § 2041 even though she was the creator of the QTIP.

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[104] *See, e.g.*, New York Estates, Powers & Trusts Law 7-3.1; Restatement (3d) Trusts, sections 57-60.

[105] *See, e.g.*, *Outwin v. Commissioner*, 76 T.C. 153 (1981), acq., 1981-2 C.B. 1; *Palozzi v. Commissioner*, 23 T.C. 182 (1954), acq. 1962-1 C.B, 4; *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986); Rev. Rul. 77-378, 1977-2 C.B. 348.

[106] *See* Reg. § 25.2523(f)-1(f), example 11 (foreclosing the application of sections 2036 and 2038 in the surviving spouse's gross estate with respect to a QTIP trust previously included in the other spouse's gross estate under section 2044).

The same result should obtain (that is, inclusion in the wife's gross estate) if she structured the lifetime QTIP trust to grant herself a general power of appointment upon her husband's death because the husband would nevertheless, by reason of the application of I.R.C. § 2044, have become the transferor prior to the existence of the wife's general power of appointment. Hence, if under applicable state law, the wife's creditors could reach the assets of the credit shelter trust, I.R.C. § 2041 could apply in her estate and would make this strategy unworkable because it would cause the credit shelter trust to be included in her gross estate. It is critical, in other words, that the plan be structured so that I.R.C. § 2041 cannot apply in the wife's estate with respect to the credit shelter trust for her benefit formed out of the lifetime QTIP trust she created for her husband.

This can be accomplished in one of two ways. First, I.R.C. § 2041 can be negated through the use of an ascertainable standard relating to health, education, maintenance or support. For example, if distributions from the credit shelter trust to the wife were limited by such a standard, I.R.C. § 2041 could not apply in her estate even if her creditors could access the trust's assets under state law. In those states permitting creditors access, creditors will typically only be able to reach the amount that the trustee could distribute to the grantor under a maximum exercise of discretion.[107] Thus, in such jurisdictions, if the trustee may make distributions only to the extent necessary for the grantor's health, education, maintenance and support, the grantor's creditors are similarly limited. They can only reach the trust's assets to the extent the trustee could properly make payments to the grantor for such purposes. And since I.R.C. § 2041 excludes from the definition of a general power of appointment a right to property circumscribed by such a standard, including an appropriate standard in the instrument would preclude the IRS from invoking I.R.C. § 2041 even if the trust were located in a state permitting creditors access. (Further limitations might also be incorporated, such as requiring the trustee to consider other resources prior to making distributions.) Practitioners should carefully check applicable state law to ensure creditors of the grantor would be so limited in their access to the trust property.

Second, the trust could be formed under the laws of a state that does not permit the grantor's creditors to access trust assets. Where the law of such a state controls (Alaska and Nevada appear to have the strongest statutes), it will be respected for Federal estate tax purposes. In addition, Florida and Arizona have enacted special statutes that do not permit creditors to reach the assets of a QTIP trust even if that trust becomes a trust for the benefit of its settlor upon the death of the spouse for whose lifetime benefit the trust was created.[108]

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[107] *See, e.g., Vanderbilt Creditor Corp. v. Chase*, 100 AD 2d 544, 437 NYS 2d 242 (2d Dept. 1984); comment f to Restatement (3d) Trusts, section 60.

[108] *See, e.g., Estate of German v. United States*, 7 Ct. Cl. 641 (1985) (no estate tax inclusion in estate of grantor who was eligible to receive income and corpus from the trust because her creditors could not attach the trust property under the law under which the trust was created); see also Rev. Rul. 2004-64 and PLR 200944002, in which the IRS concluded that the right of the settlor to receive distributions in the discretion of an independent trustee would not, by itself, invoke section 2036). *See, e.g.,* Florida Statutes §735.050005(3).

In sum, when using a Supercharged Credit Shelter Trust[sm], it is critical to (a) include an appropriate standard in the instrument and/or (b) locate the trust in a state where the grantor's creditors cannot reach trust assets. Failure to do so could potentially result in inclusion of the trust in the surviving spouse's estate. If the suggested approach is used, the lifetime QTIP trust becomes a credit shelter trust with respect to the first spouse to die for transfer tax purposes while remaining the surviving spouse's grantor trust for income tax purposes, thereby permitting the credit shelter trust to appreciate on an income tax free basis. Given the substantial amount of additional wealth that can be transferred tax-free with the supercharged version of the credit shelter trust (see the accompanying illustration), practitioners should give the approach serious consideration in all cases in which the spouses are willing to consider committing assets to a lifetime trust arrangement.

C. Simulating a Step-Up in Basis

Because the credit shelter trust formed from the lifetime QTIP trust will remain a grantor trust for Federal income tax purposes with respect to the spouse who created it (and who is the beneficiary of the credit shelter trust), it will grow free of income tax without the spouse who created the lifetime QTIP trust being treated as making a gift.[109] In addition, even though the credit shelter trust will not be included in the gross estate of the surviving spouse and, therefore, the basis of its assets may not be "stepped up" pursuant to Section 1014(a) when he or she dies, he or she may substitute assets with higher bases than those in the trust at any time even just before death, free of income tax by reason of Rev. Rul. 85-13.[110] This substitution may simulate the effect of the tax free step up in basis at death for assets included in the gross estate and, in fact, at least for purposes of gain, may have bases in excess of their values when the surviving spouse dies.

D. Uncertainty of Sequence of Deaths

One benefit of the relying on portability is that there is no need to guess which spouse will die first to obtain the benefits. So long as each spouse has sufficient assets to use his or her GST exemption, the survivor will be able, either with his or her own assets or with inherited assets, to create an immediate grantor trust with the first spouse's DSUE amount. A way to replicate this advantage with the Supercharged Credit Shelter Trust[sm] is to have each spouse create a lifetime QTIP. This would provide the additional advantage of leveraging both spouses' GST exemptions as discussed below.

E. GST Exemption Issues

The GST exemption of the first spouse to die portable. Of course, the survivor could use his or her own GST exemption by allocating it to the grantor trust created under the protection of the inherited DSUE amount. But, still, the GST exemption of the first spouse could be lost. The loss of the GST exemption of the first spouse to die may well eliminate any benefit of making the trust to which the survivor will transfer assets under

[109] *See* Rev. Rul. 2004-64.
[110] 1985-1 CB 184.

the protection of the DSUE amount a grantor trust so it can compound free of income tax. For example, if that trust grows to 180 percent of what otherwise would be in a traditional Credit Shelter Trust (which is not a grantor trust), this extra eighty percent in value would be lost by the imposition of a 40% GST tax when the couple's children die.

To attempt to avoid the loss of the use of the GST exemption of the first spouse, it has been suggested that if the couple will rely on portability, the first spouse create a QTIP trust for the surviving spouse equal to the first spouse's unused GST exemption making a so-called reverse QTIP election made under I.R.C. §2652(c)(3) so the GST exemption of the first spouse could be allocated to it. One difficulty, if such a QTIP trust is created, it is possible that the survivor will not have enough property to use the entire inherited DSUE amount. The reason is that the use of the first spouse's estate tax shelter and GST exemption have become de-coupled. Therefore, to use the DSUE and avoid the possibility of losing the opportunity to use it, the surviving spouse must consider putting the survivor's own assets in trust shortly after the first death which would create double the assets that would be held in trust if a traditional credit shelter trust were used.

Because the first spouse's QTIP trust that is GST exempt will be reduced by the payment of income to the surviving spouse, a part of the leverage that can occur by reason of the GST exemption allocation will be eroded. It seems that the erosion of GST tax benefits may be offset to a degree by the DSUE amount gift trust which can grow income tax free. Nevertheless, the surviving spouse will not have the same flexibility with respect to the DSUE amount trust as with a traditional credit shelter trust.

The bottom line is that it likely would be best if the GST exemption of the spouse dying first could be allocated to a trust that has been supercharged (that is, to a trust that is a grantor trust with respect to the surviving spouse) and does not leak out income. That cannot be done with relying on portability unless the surviving spouse allocates the surviving spouse's own GST exemption to the DSUE amount trust. It can be done with a Supercharged Credit Shelter Trust[sm] because the spouse dying first and not the surviving spouse will be treated as creating the trust. In fact, the Supercharged Credit Shelter Trust[sm] provides the option of using the GST exemption of either spouse.

F. More on GST Exemptions and the Supercharged Credit Shelter Trust[sm]

If the spouse who created the lifetime QTIP trust (that will become a Supercharged Credit Shelter Trusts[sm] for him or her when the first spouse dies) makes the reverse QTIP election under Section 2652(c)(3) and allocates his or her GST exemption to that trust when it is created, the GST exemption will increase, if the trust grows in value, during the balance of the spouse's lifetime as well as after the death of the spouse dying first. The amount of GST exemption available to the spouse who created the lifetime QTIP trust will continue to grow by the inflation adjustment provided under I.R.C. §§ 2010(c)(3)(B) and 2631(c).

To the extent, if any, that the value of the lifetime QTIP trust exceeds the remaining unused estate tax exemption of the spouse who was the beneficiary of the lifetime QTIP trust and who dies first, this excess can be transferred to a separate QTIP trust which also

will be GST exempt by reason of the original allocation of GST exemption of and by the spouse who created that trust and who is the surviving spouse.

Furthermore, as noted above, such a plan likely will enhance the amount of property protected from estate and GST tax sometimes by a significant amount (possibly, a multiple) compared to having a credit shelter trust created when the first spouse dies because both the unified credit and the GST exemption of the first spouse have been supercharged by reason of being in a grantor trust with respect to that spouse (and also by the early use of the GST exemption). Having the GST exemption of the first spouse allocated to the Supercharged Credit Shelter Trust[sm] upon his or her death probably can do no better than having the GST exemption of the surviving spouse applied to the lifetime QTIP trust (and which will become a Supercharged Credit Shelter Trust[sm] when the first spouse dies) upon the death of the first spouse, and typically will do worse because the exemption will not have grown between the time the lifetime QTIP trust was created.

However, if the spouse who created the lifetime QTIP trust and is the survivor does not allocate his or her GST exemption to that trust when created, then the first spouse to die presumably will allocate his or her GST to the QTIP trust at death. This would make the GST effects somewhat similar to a credit shelter trust in that there would be no leverage of GST exemption during the lifetime of the first spouse, but the first spouse's entire inflation adjusted estate tax shelter and GST exemption could be allocated to the credit shelter trust formed from the lifetime QTIP trust. The important difference is that the credit shelter trust for the surviving spouse created from the lifetime QTIP would be a grantor trust with respect to the survivor, permitting tax-free growth. On the other hand, if the GST exemption of the surviving spouse has been allocated to the lifetime trust, there will be no risk of excess wealth in the lifetime QTIP that is not GST exempt. If there is wealth in excess of the first spouse's estate tax shelter, that excess would pass to a new QTIP trust for the survivor which would also be a grantor trust and also be GST exempt. The survivor would also continue as a beneficiary of the QTIP trust created for the survivor's benefit, if both spouses create a lifetime QTIP. But as QTIP trusts, both will leak as income is paid to the surviving spouse as it must be. Nevertheless, when compared to relying on portability, because of the difficulty of providing benefits to the surviving spouse in the DSUE amount trust, the Supercharged Credit Shelter Trust[sm] would appear to provide greater security for the surviving spouse and greater leverage of the couple's GST exemptions.

As indicated, it may or may not be more efficient for the surviving spouse to allocate his or her GST exemption to the lifetime QTIP trust (at the time it is created) rather than having the first spouse to die allocate his or her GST exemption to it when he or she dies. If the surviving spouse has allocated his or her GST exemption at the time the lifetime QTIP is formed, it may grow (and free of income tax) from the time the surviving spouse created the lifetime QTIP trust and when the other spouse dies. However, there will be leakage from this trust up until the first spouse dies, when the "must pay the income" QTIP trust may convert into a discretionary credit shelter trust.

The increase in value of the lifetime QTIP trust might exceed the amount of income that must be paid from it to the first spouse to die until the time the survivor dies. And, if so, it likely will be "better" if the spouse who created the lifetime QTIP allocates his or her GST exemption to the lifetime QTIP trust rather than having the first spouse allocate his or hers to the Supercharged Credit Shelter Trust[sm] when he or she dies. Whether the couple can count on an increase in the lifetime QTIP trust in excess of the income payable each year to the first spouse to die depends on many factors including how long before the death of the first spouse to die.

With the Supercharged Credit Shelter Trust[sm], it probably is best if each spouse creates a lifetime QTIP trust for the other with each making the reverse QTIP election and allocating his or her GST exemption to it. That way, the GST exemption of each spouse will increase in value while both are living if each trust grows in excess of the annual payout to each spouse, which by selecting one of the many jurisdictions that permit the conversion of a QTIP trust to a 3% unitrust, should occur over a relatively long period of time especially because there will be no income tax "drag" on the trusts as they will remain grantor trusts (and, therefore, will not owe any income tax) until the first spouse dies. Upon the death of the first spouse, the lifetime QTIP trust he or she has created for the survivor will cease being a grantor trust although it will continue to be a QTIP trust for the survivor until death.

G. Supercharged Credit Shelter Trust[sm] and State Death Tax

Many states have an independent state death tax system with a state death tax exemption smaller than that allowed under Federal law. If the first spouse uses the full Federal exemption by, for example, making a gift to a traditional credit shelter trust, state death tax will be due at his or her death because the state death tax exemption is smaller than the Federal exemption. Alternatively, if he or she limits the use of the exemption to the state death tax exemption, there would be no state death tax when the first spouse dies but more will be included in the gross estate of the surviving spouse because a larger marital deduction was used than would have been used had the entire Federal exemption been transferred to the credit shelter trust.

Portability provided a solution. If no bequest is made to a credit shelter trust or the bequest to it is limited to no more than the state death tax exemption amount, there will be no state death tax due when the first spouse dies, the survivor can inherit the unused Federal exemption and the survivor can immediately make a gift equal to the DSUE amount which replicate the use of a credit shelter trust for the full Federal exemption. Unless the surviving spouse is domiciled in or the property used to make the gift is located in Connecticut or Minnesota, the only states that currently impose a gift tax, state death (and gift) tax is permanently avoided with no increase in Federal estate tax when the surviving spouse dies..

However, the surviving spouse must be willing to give away an amount equal to the inherited DSUE amount. Not only may a surviving spouse be hesitant to do that, but he or she, as explained above, would not be able to enjoy the same level of benefit and

control he or she may have with a traditional credit shelter trust equal to the Federal exemption.

It seems, however, that the state death tax exemption problem can be avoided and, in fact, planning may be enhanced for the family by having the estate of the surviving spouse trigger the application of Rev. Proc. 2001-38.[111] In fact, it even seems to "work" to avoid gift tax in Connecticut and Minnesota.

Under Rev. Proc. 2001-38, the Internal Revenue Service ruled that the estate of the surviving spouse is permitted to "undo" or "reverse" any QTIP election made in the estate of the first spouse to die that was unnecessary to reduce the Federal estate tax, which means the to the extent it is undone, the QTIP trust would not be included in the survivor's gross estate under Section 2044. Note that even if the revenue procedure is invoked, it seems that any GST exemption allocated to the QTIP Trust would be preserved although, as discussed in the Quadpartite Will article cited below, it seems likely that it would be first allocated to the credit shelter trust, which in this case would be equal to the state estate tax exemption, and then to any so-called "reverse" QTIP trust (equal to the excess of the Federal GST exemption amount over the value of the credit shelter trust).

Nevertheless, if the spouse dying first directed the amount by which his or her Federal estate tax exemption exceeded the state exemption to pass into a separate QTIP trust (called the "Excess Exemption QTIP Trust") and elected for it to qualify for the Federal estate tax marital deduction, it would also presumably qualify for the state estate tax marital deduction or exemption.[112] In that case, neither Federal nor state estate tax would be due upon the death of the first spouse to die. Although that would seem to cause the excess Federal exemption (plus any growth on it) to be included in the gross estate of the surviving spouse, the revenue procedure allows a reversal of the election so that no part of the Excess Exemption QTIP Trust would be included in the gross estate of the surviving spouse either for Federal or probably state estate tax purposes.

In fact, the estate of the surviving spouse now has a choice: (1) do not invoke Rev. Proc. 2001-38, which will mean that the assets will to be included in his or her estate at death but allow the assets (subject to the usual exceptions, for example, for the right to IRD) to receive an automatic change in basis under Section 1014, or (2) invoke the revenue procedure so that assets will be excluded from the gross estate of the survivor.

An advantage portability may have over relying on Rev. Proc. 2001-38 is the trust created by the surviving spouse to use the DSUE amount could be grantor trust with respect to the surviving spouse so that it is supercharged, and it need not "leak" by distributions of income to the surviving spouse. Ordinarily, a QTIP used to absorb any excess Federal estate tax exemption over the state estate tax shelter would not be a grantor trust with respect to the surviving spouse but it could well be made one under a Supercharged Credit Shelter Trust[sm] by having the surviving spouse create a lifetime QTIP trust that

[111] 2001-1 CB 1335.

[112] *See* Gans & Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 Estate Planning 3 (Apr 2005).

would pass upon the death of the first spouse into a credit shelter trust equal to the state death tax exemption and an amount equal to the excess of the Federal exemption over the state exemption pass into an "Excess Exemption QTIP Trust". However, income would have to leak out of that trust to the surviving spouse, eroding the amount that could pass free of estate tax when the survivor dies if Rev. Proc. 2001-38 is invoked by his or her estate. Nonetheless, the Quadpartite will (or revocable trust) structure employing an Excess Exemption QTIP Trust allows a "wait and see" strategy: if it is determined that having the surviving spouse make a gift of the DSUE amount to a grantor trust is preferable that can be done by porting the exemption over to the surviving spouse and transferring all the assets in the Excess Exemption QTIP Trust to him or her; if it is determined that the surviving spouse will not or should not make such a gift or if retaining the Excess Exemption QTIP Trust structure is best, then it can be kept in place.

H. Both Portability and Rev. Proc. 2001-38 Likely Not Available

It should be noted that, although on the face of things, it seems both portability and Rev. Proc. 2001-38 may be used, it would result in a whipsawing of the IRS: the survivor could, for example, immediately make a gift of the DSUE amount which would be available if the QTIP election is made with respect to the Excess Exemption QTIP Trust and invoke Rev. Proc. 2001-38 at death.[113] However, the members of the Real Property Probate & Trust Law Section of the ABA have advised the IRS of this possibility and have recommended that the revenue procedure be amended to deny invoking it if the estate of the spouse dying first has elected portability.

V. Split Purchase Trusts[SM] [114]

A. Basic Structure

Section 2702 also applies to joint purchases by family members. A joint purchase occurs when a property owner purchases a temporary interest in an asset (such as a term of years or life estate) and a family member purchases the remainder.[115] Although §2702(a)(1) applies to any "transfer of an interest in trust," §2702(c)(1) and (2) provide that, for purposes of §2702, a joint purchase is treated as property held in trust.

If an individual acquires a term interest in property and, in the same transaction or a series of related transactions, one or more members of the individual's family acquire a nonterm interest in the same property, the individual is treated as acquiring the entire property, and transferring to each of those family members the interest acquired by that family member in exchange for any consideration paid by that family member.[116] The

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[113] *See* Gans & Blattmachr, "Decoupling, Portability and Rev. Proc. 2001-38," LISI Estate Planning Newsletter #1965 (5/21/12).

[114] Excerpted from Blattmachr, Slade and Zeydel, BNA Tax Management Portfolio 836-2nd: Partial Interests -- GRATs, GRUTS, QPRTs (Section 2702).

[115] Section 2702 also can apply to a circumstance where one family member buys one temporary interest in an asset (such as an income interest for life) and another family member buys another temporary interest in it (such as a secondary life income interest). See generally Blattmachr, "Split Purchase Trusts[sm] v. Qualified Personal Residence Trusts," 138 Tr. & Est. 56 (Feb. 1999).

[116] §2702(c)(2); Regs. §25.2702-4(c).

amount of the individual's gift in such a transaction may not, however, exceed the amount of consideration furnished by that individual for all interests in the property.[117]

Example: P purchases a life estate in property from P's parent for $100, and P's child purchases the remainder for $50. The value of the property purchased is $300, the value of the life estate determined under §7520 is $250, and the value of the remainder interest is $50. P is treated as acquiring the entire property and transferring the remainder interest to P's child. However, the amount of P's gift is limited to $100, the amount of consideration furnished by P for P's interest.[118]

A personal residence trust, a GRAT, and a GRUT are exceptions[119] to the rule under §2702 that the value of any interest in a trust retained by the transferor or any applicable family member is zero. Because a joint purchase is treated as property held in trust and, thus, falls within the purview of §2702(a)(1), the exceptions for personal residence trusts, GRATs, and GRUTs contained in §2702(a)(2) should be applicable to a joint purchase.[120] However, neither §2702 nor the regulations issued thereunder specifically state that the value of a term interest in a joint purchase that is a qualified interest is determined under §7520. Nevertheless, under a strict interpretation of §2702 and the regulations, the retention of a qualified interest in a joint purchase will fall under the exception in §2702(a)(2)(B).

B. Joint Purchase Through Personal Residence Trust

The joint purchase of a personal residence should fall under the §2702(a)(3)(A)(ii) exception.[121] In that case, normal valuation principles determined under §7520 should apply. That is, the value of the remainder in the personal residence will be determined by subtracting from the value of the residence the fair market value of the temporary interest, determined by standard income forecast and longevity (mortality) tables promulgated by the IRS under §7520. As a consequence, neither family member who makes a joint purchase of a personal residence, subject to the terms of a personal residence trust, should be deemed to have made a gift to the other where each pays the actuarial value, determined under §7520, of the interest that he or she purchases.

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[117] Regs. §25.2702-4(c).

[118] See Regs. §25.2702-4(d), Ex. 4. Note that P's parent made a gift with a value of $150 to P.

[119] Although technically GRATs and GRUTs are not exceptions to §2702, the special rule in §2702(a)(2)(B) causes them to function as exceptions.

[120] See 136 Cong. Rec. S15682 (10/18/90) (acknowledging that a joint purchase of art may fall under the special rule of §2702(c)(4) for certain tangible personal property).

[121] See PLR 9841017. See also PLR 200112023. Cf. PLRs 200919002, 200840038, 200728018 (ruling favorably on §2702 aspects of sale of remainder interest in personal residence trust). It is unclear whether such a joint purchase would be required to be effected through a personal residence trust or could be effected through an agreement between the purchaser of the temporary interest (i.e., the life estate) and the purchaser of the remainder that contained the mandatory provisions of a personal residence trust. See generally Blattmachr, "Split-Purchase Trusts[sm] vs. Qualified Personal Resistence Trusts," 138 Tr. & Est. 56 (Feb. 1999) (discussing that a split purchase of a personal residence seems to fall within the personal residence exception under §2702(a)(3)(A)).

C. Tax and Administrative Considerations

1. Estate Tax Considerations

Section 2036(a)(1)

It appears that the estate tax inclusion issue may be avoided by a joint purchase of a personal residence, unless the death of the individual is clearly imminent.[122] Unlike a personal residence trust, a true joint purchase does not involve a transfer from one taxpayer to another, because one taxpayer acquires a life estate (or term interest) from a third party and the other acquires the remainder. As a consequence, §2036(a)(1) should not apply, as it applies only if there is a transfer and a retention of an interest by the transferor.

Nonetheless, the IRS has indicated that the purchaser of the remainder interest must not have acquired the funds to buy the remainder from the purchaser of the life estate.[123] The IRS's position does not appear to be supported by the law. In only one circumstance do the estate tax rules have "clean consideration" provisions.[124] However, it probably is best to arrange, where possible, for the purchaser of the remainder in a joint purchase to acquire the funds for the purchase of the remainder interest from a source other than the person who acquires the term or life estate interest or, at least, for those funds to have been acquired in a totally unrelated transaction. TAM 9206006 also suggests that the IRS will not deem a transfer to have occurred (causing estate tax inclusion under §2036(a)(1)) if no gift is involved (i.e., funds are loaned to the prospective purchaser of the remainder interest and interest is payable at the applicable federal rate under §7872 on a *bona fide* loan).

Moreover, it is the view of the IRS, upheld in *Gradow v. U.S.*,[125] that if an owner of property sells the remainder interest, the entire property will be includible in the seller's estate under §2036(a)(1) if the seller holds an income (or use) interest in the property at death and the purchase price of the remainder interest was for less than the full value of the *entire* property (that is, not just for the actuarial value of the remainder).[126] Although

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[122] Regs. §25.7520-3(b)(3), effective for gifts made after Dec. 13, 1995, provides that a special actuarial factor taking into account actual life expectancy, rather than the standard actuarial factor, must be used when the person who is the measuring life is terminally ill.

[123] TAM 9206006 (child's remainder interest in real estate is includible in parent's estate to extent that parent provided funds to child for split purchase with parent). See also PLR 9841017 (refusing to rule on whether §2036(a)(1) would apply in the case of a joint purchase).

[124] See §2040(a) (relating to certain joint property). See also former §2036(c)(2)(B) (repealed by the Revenue Reconciliation Act of 1990, P.L. 101-508, §11601).

[125] 897 F.2d 516 (Fed. Cir. 1990).

[126] See TAM 9133001. See also PLRs 200840038, 200728018 (although ruling that sale of remainder interest in personal residence trust for consideration equal to actuarial value of remainder interest determined under §7520 was sale for adequate and full consideration for gift tax purposes, IRS expressed no opinion on application of §2036).

§2036(a)(1) does not apply to a transfer for full and adequate consideration in money or money's worth, the IRS's view, affirmed in *Gradow*, is that a transfer of a remainder in an asset will be deemed to be for a full and adequate consideration in money or money's worth and, therefore, outside of §2036(a)(1), only if the transfer is for the full value of the property. Such a gross estate inclusion rule, however, should not apply to a joint purchase because the term holder will not have made a transfer of the remainder by gift, sale, or otherwise. In any event, the precedential effect of *Gradow* may have been significantly eroded by later decisions.[127]

Note that although the IRS has had success with the *Gradow* reasoning,[128] the Third Circuit found *Gradow* unpersuasive in *D'Ambrosio.* The Third Circuit held that the decedent's sale of her remainder interest in closely held stock fell within the §2036(a)(1) exception for adequate consideration. Rather than requiring the consideration to equal the fee simple value of the property, the court held that consideration equal to the fair market value of the remainder interest (determined under the IRS actuarial tables) was adequate for §2036 purposes. The Fifth Circuit agreed in *Wheeler*. Because the IRS's position rested principally on an analogy to the widow's election mechanism addressed in *Gradow*, the Fifth Circuit in *Wheeler* analyzed *Gradow* in detail, concluding that the widow's election cases present factually distinct circumstances that preclude the wholesale importation of the *Gradow* rationale into cases involving sales of remainder interests. The Ninth Circuit's decision in *Magnin* is consistent with *D'Ambrosio* and *Wheeler*.

Moreover, the regulations under §2702 appear to foreclose any such inclusion. For instance, in Regs. §25.2702-6(c), *Ex. 8*, an individual purchases a term (income) interest in property at the same time as his or her child purchases the remainder. The example states that if the term holder dies before his or her 10-year term ends, *the remaining term interest* is includible in the term holder's gross estate under §2033, with no mention of the inclusion of the remainder. The regulation further provides that the term holder's estate is entitled to the double tax mitigation relief in Regs. §25.2702-6(b) (which provides for a reduction in adjusted taxable gifts). Such relief is available, according to Regs. §25.2702-6(a)(2), *only* if the term interest in trust is includible in the individual's gross estate *solely* by reason of §2033. The regulations, therefore, appear to imply that, with respect to a joint purchase, the entire value of the property is not includible in the term holder's estate under §2036(a)(1) under an extension of the *Gradow* doctrine or otherwise.

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[127] See Magnin Est. v. Comr., 184 F.3d 1074 (9th Cir. 1999); Wheeler v. U.S., 116 F.3d 749 (5th Cir. 1997); D'Ambrosio Est. v. Comr., 101 F.3d 309 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997).

[128] See, e.g., *Pittman v. U.S.*, 878 F. Supp. 833 (E.D.N.C. 1994).

In addition, in Regs. §25.2702-4(d), *Ex. 1*, in which an individual purchases a 20-year term interest in an apartment building and his or her child purchases the remainder, it is stated that *"[s]olely for purposes of section 2702*, [the term holder] is treated as acquiring the entire property and transferring the remainder interest to [the] child in exchange for the portion of the purchase price provided by [the] child." (Emphasis added.) Because the term holder is treated as acquiring the whole property in the joint purchase and selling the remainder *only* for purposes of §2702, the term holder should not be treated as selling (or transferring) the remainder for purposes of §2036(a)(1), which would appear necessary for *Gradow* to apply.

Although the foregoing analysis suggests that the *Gradow* doctrine should not apply to a joint purchase of a personal residence where each joint purchaser provides the consideration, based upon standard actuarial principles, for his or her interest, the IRS may conclude otherwise.

If a *direct* joint purchase is made (not in connection with a trust), however, there is no basis for concluding that there was a transfer from one joint purchaser to another. TAM 9206006 may support that conclusion. Although the National Office concluded in this technical advice memorandum that the entire value of the home was included in the estate of the person who purchased the life estate, the National Office did so on a finding that the life tenant supplied the consideration (i.e., made a transfer) to the persons who bought the remainder. Although it may be necessary, in order for the joint purchase to fall under the personal residence exception, for all of the regulatory requirements for a personal residence trust to be satisfied, it does not seem that a transfer is being made by one joint purchaser to the other, so as to trigger the application of the *Gradow* doctrine. Accordingly, it appears reasonable to conclude that the *Gradow* doctrine should not apply to a true joint purchase of a personal residence, whether effected through a trust or not.[129]

2. Interest of Term Holder

In a joint purchase of a personal residence, the term holder may acquire a life interest rather than an interest for a term of years. Thus, the term holder will not have to lose possession of the property during his or her lifetime.[130] Furthermore, a purchase in which the term holder acquires the use of the residence for life probably will reduce the amount that the

[129] In PLR 9841017, the Service concluded that the joint purchase of a personal residence fell under the §2702(a)(3)(A) personal residence trust exception but did not rule on whether §2036 could apply. See generally Blattmachr, "Split-Purchase Trusts[sm] vs. Qualified Personal Residence Trusts," 138 Tr. & Est. 56 (Feb. 1999).

[130] Even though a term holder in a personal residence trust might be able to rent the property after the term interest ends, that may not be appropriate under all circumstances. Under Rev. Rul. 85-13, 1985-1 C.B. 184, the grantor of a personal residence trust can rent the residence without taxable income to the beneficiaries or the trust if the trust is a wholly grantor trust under §§671–679.

purchaser of the remainder has to invest in the residence[131] (compared to the size of the taxable gift of the remainder made through a personal residence trust) and, depending upon other factors, may involve other effective estate planning.[132]

3. Income Tax Considerations

A joint purchase trust, formed by the family members to purchase the temporary and remainder interests in a personal residence, probably will not be a wholly grantor trust with respect to the purchaser of the temporary interest (e.g., the life estate) because the temporary interest holder will have contributed only a portion of the assets to the trust.[133] Hence, the existence of the trust will not be entirely ignored with respect to that person. However, it appears that the entitlement to income tax deductions for certain home mortgage interest under §163(h)(3) and for real property taxes under §164(a) should apply to the person who holds a life estate interest in the residence through the joint purchase trust.[134]

If the joint purchase trust is a grantor trust with respect to the purchaser of the term or life interest, the home will be treated in its entirety as belonging to that purchaser for income tax purposes.[135] The IRS, as suggested by TAM 9206006, might contend that the purchaser of the term or life interest provided the consideration for the purchase of the remainder causing I.R.C. §2036(a)(1) to apply if the purchaser still holds the temporary interest at death. One way, perhaps, to avoid that result is to use only a grantor trust created long before the split purchase is effected.

4. Payments of Expenses

It appears that expenses incurred in maintaining a jointly purchased residence are allocable to and should be paid by the term holder or the remainder holder in accordance with state law.[136] If there is mortgage indebtedness on the residence, that probably will mean that the interest

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[131] Because it generally will be desirable to avoid having all or any part of the personal residence included in the estate of the term holder, usually any term retained by the term holder in a personal residence trust will be shorter than the anticipated life span of the term holder. Normally, the value of the life interest will be greater than the value of the term interest for a term expected to be less than the life span; hence, the value of the remainder following the life estate may be less than the remainder following the term of years.

[132] There is, however, at least one valuation factor in favor of a personal residence trust as opposed to a joint purchase of a residence. The value of the interests retained by the grantor in the personal residence trust apparently may include any contingent reversion. However, a contingent reversion would not in all likelihood be acquired in a joint purchase and, therefore, would not be taken into consideration in valuing the interests in a joint purchase.

[133] Sections 671–679 provide that a grantor may be taxed as the owner of any portion of a trust.

[134] See PLR 9448035.

[135] Rev. Rul. 85-13, 1985-1 C.B. 184.

[136] See PLRs 200919002, 200840038, 200728018 (expenses were split between individuals holding life interests in personal residence trust and trust that purchased remainder interest). Cf. PLR 9249014.

portion of a cash mortgage payment should be paid by the term holder and the principal portion by the remainder holder, unless a different allocation is required by state law.[137] It should be noted, however, that the potential wealth transfer "leveraging" of a joint purchase (or a personal residence trust) may be diminished if there is debt on the property.

VI. Testamentary CLATs[138]

A. The Transaction

If a client has an interest both in charity and in transferring wealth to family members, a so-called split-interest trust such as a charitable remainder trust or a charitable lead trust might be considered. A charitable lead annuity trust ("CLAT") benefits from a low interest rate environment for the same reason that GRATs do, because the annuity will have a higher actuarial value. A CLAT is usually is a longer term strategy than is a GRAT. One reason for that is the GRAT will "fail" if the grantor dies during the annuity term; a CLAT generally will not.[139] A CLAT, therefore**,** has the potential to benefit from **"**locking in**"** a long-term low interest rate at inception.

Assume, for example, that a 20-year zeroed-out CLAT created every month from January 1926 to May 1988 were invested in an S&P 500 index fund. Assume also for this purpose (because we do not have I.R.C. § 7520 rates for that period) that the I.R.C. § 7520 rate is 6% for each CLAT and the annuity payment to charity were escalated annually by 50% (meaning each subsequent year's annuity payment would be one and half times the amount of the payment for the prior year). In simulations run by one financial institution,[140] 92% of the CLATs would be successful, meaning at least $1 would be delivered to the remainder beneficiary. Indeed**,** the median remainder value would have been 557% of the starting value of the CLAT -- a very impressive result.

It also appears that if the path of annuity payments from a CLAT escalates significantly, the likelihood of a successful outcome, that is delivery of tax free dollars to the remainder beneficiaries, improves. There does not appear to be any prohibition on escalating CLAT payments.[141] In PLR 201216045 (April 20, 2012), the IRS approved the modification of a testamentary CLAT to permit increasing annuity payment.

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[137] Cf. Rev. Rul. 90-82, 1990-2 C.B. 44.

[138] Donald Tescher appears to have been the first to advocate this technique. The author wishes to thank Parker Taylor and Brandon Ross for their contributions to this portion of the outline.

[139] *See* Reg. §20.2036-1(c)(1).

[140] Courtesy of J.P. Morgan Private Bank.

[141] *See* Rev. Proc. 2007-45, 2007-25 I.R.B. 89 *Annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4*. ("CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer may be ascertained at the time of the transfer to the trust"). *See* Regs. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(*a*), and 25.2522(c)-3(c)(2)(vi)(*a*).

Most do not expect future market performance to be as robust as in the past. Suppose that we assume a hypothetical portfolio with an expected return of 8.6% with 15% volatility. In computations performed by one financial institution, a 25 year zeroed out grantor CLAT with 100% escalation (meaning the CLAT annuity payment doubles each year) commenced when the section 7520 rate is 3% is expected to deliver a tax free benefit to the remainder beneficiaries that is 468% of the original value contributed to the CLAT in the median case, still a very attractive result.[142]

A CLAT might be used in a testamentary context as follows. Suppose an individual has an interest in a closely held business or family partnership that he or she wishes to leave to his or her family. Suppose the client has created a long duration dynasty trust for his or her descendants and allocated GST exemption to the trust so that the trust has an inclusion ratio of zero. On possibility is for the client to engage in a lifetime sale of the interest to the dynasty trust. But the individual may not wish to part with the interest currently, or there may be income tax reasons causing the individual to wish to preserve the possibility of a basis step up at death under I.R.C. § 1014. Assume at least 50% of the trustees of the dynasty trust are independent trustees within the meaning of I.R.C. § 674(c) with respect to the dynasty trust's settlor and all its beneficiaries. Suppose the individual's testamentary estate plan provides that a substantial portion of the client's estate will pass to a "zeroed out" CLAT, thereby reducing or potentially eliminating estate tax upon the individual's death. It is possible to put in place currently an option permitting the dynasty trust to purchase an interest in the business or a family partnership at death at its fair market value as finally determined for Federal estate tax purposes. Alternatively, , if no option is in place, the dynasty trust might sell the interest to the dynasty trust after death. The dynasty trust would purchase the interest for cash and/or marketable securities and/or promissory notes at its fair market value at the time of sale as determined by the independent appraisal of a qualified independent appraiser. The promissory note would provide for interest payments for a specified term at the appropriate applicable federal interest rate with a balloon principal payment due at the end of the term.[143]

The question is whether the safe harbor from indirect self-dealing set forth in Treasury Regulation §53.4941(d)-1(b)(3) would be available with respect to (i) the sale of the interest to the dynasty trust for cash and/or marketable securities and/or promissory notes, (ii) the CLATs' receipt and retention of the promissory notes issued pursuant to such sale, and (iii) the dynasty trust's payment of principal and interest on the promissory notes?

1. Self-Dealing under the Private Foundation Rules

Section 4941 imposes an excise tax on each act of direct or indirect self-dealing between a disqualified person and a private foundation. Self-dealing is defined in the code to include any direct or indirect (i) sale or exchange of property between

[142] Courtesy of J.P. Morgan Private Bank.

[143] If the term of any of the promissory notes exceeds the term of the CLAT, at the end of the CLAT term, the applicable promissory note would be distributed to the respective dynasty trust and would extinguish as a result of the merger.

a private foundation and a disqualified person as well as (ii) lending of money or other extension of credit between a private foundation and a disqualified person.[144] For purposes of the private foundation rules, the code defines a "disqualified person" to include a substantial contributor to the foundation, a member of a substantial contributor's family, as well as a trust in which a substantial contributor or a member of a substantial contributor's family holds more than thirty-five percent (35%) of the beneficial interest.[145] An individual is a substantial contributor to a foundation if she contributed or bequeathed an aggregate amount of more than Five Thousand Dollars ($5,000) to the private foundation, if such amount is more than two percent (2%) of the total contributions and bequests received by the foundation before the close of the taxable year.[146]

While the self-dealing rules are stated in the context of private foundations, these rules also apply to charitable lead annuity trusts.[147] Accordingly, the excise taxes on self-dealing under §4941(d) generally would be applicable to any direct or indirect loans between a charitable lead trust and a disqualified person or to a disqualified person's direct or indirect purchase of assets owned by a charitable lead trust.[148]

The dynasty trust would be considered disqualified persons in relation to the CLAT. By virtue of the decedent's testamentary gift to the CLAT, the decedent is a substantial contributor to the CLAT, and, as such, she is a disqualified person in relation to the CLAT.[149] The likely beneficiaries of the dynasty trust, as family members of the decedent, are disqualified persons in relation to the CLAT as well. If descendants will hold greater than thirty-five percent (35%) beneficial interests in the dynasty trust, the trust is a disqualified person in relation to the CLAT as well.

The dynasty trust would not purchase the interest directly from the CLAT (*i.e.*, direct self-dealing). Rather, the dynasty trust would purchase the LLLP interest at its fair market value from the decedent's estate in exchange for cash and/or marketable securities and/or promissory notes. However, due to the fact that the CLAT would have an expectancy in the LLLP interest, the dynasty trust's purchase of the interest from the estate in exchange for cash and/or marketable securities and/or notes would likely be characterized as acts of indirect self-dealing.

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[144] IRC § 4941(d)(1)
[145] IRC § 4946(a)(1)
[146] IRC § 4946(a)(2)
[147] IRC § 4947(a)(2)
[148] While the self-dealing rules are stated in the context of private foundations, these rules also apply to CLATs. 26 U.S.C. § 4947(a)(2).
[149] PLR 200207029

2. Safe Harbor Under The Regulations

An exception to "indirect self-dealing" applies to transactions occurring during the course of an estate or revocable trust administration.[150] Section 53.4941(d)-1(b)(3) of the Treasury Regulations provides that "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if—

a. The administrator or executor of an estate or trustee of a revocable trust either—

i) Possesses a power of sale with respect to the property,

ii) Has the power to reallocate the property to another beneficiary, or

b. Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

c. Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

d. Such transaction occurs before the estate is considered terminated for Federal income tax purposes pursuant to paragraph (a) of §1.641(b)-3 (or in the case of a revocable trust, before it is considered subject to sec. 4947);

e. The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

f. With respect to transactions occurring after April 16, 1973, the transaction either—

i) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,

[150] Reg. § 53.4941(d)-1(b)(3)

ii) Results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or

iii) Is required under the terms of any option which is binding on the estate (or trust).

A revocable trust that becomes irrevocable upon the death of the decedent-grantor under the terms of the governing instrument of which the trustee is required to hold some or all of its net assets in trust after becoming irrevocable for both charitable and noncharitable beneficiaries is not considered a split interest trust under I.R.C. § 4947(a)(2) for a reasonable period of settlement after becoming irrevocable.[151] For such purpose, the term "reasonable period of settlement" means that period reasonably required (or, if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust.[152] These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of rights of the subsequent beneficiaries.[153]

Unfortunately, the IRS will not rule whether the period of administration or settlement of a trust (other than a trust described in section 664) is reasonable or unduly prolonged, as this determination is dependent on the facts and circumstances involved in the particular settlement.[154] However, in PLR 200024052, the IRS stated that a trustee who is charged with determining the estate tax and obtaining the approval of the probate court to sell assets to a disqualified person would be taking reasonable steps towards the settlement of the trust. Additionally, the IRS has found that administering a revocable trust for three years after the grantor's death was reasonable.[155]

Although Treasury Regulations § 53.4941(d)-1(b)(3)(iii) specifically provides that the proposed transaction would not be considered self-dealing if the transaction is completed before the revocable trust is considered subject to section 4947, further guidance may be obtained by reviewing the provisions applicable in determining when an estate is considered terminated for Federal income tax purposes.

Like Treasury Regulations § 53.4947-1(c)(6)(iii) (applicable in determining when a revocable trust becomes subject to section 4947), Treasury Regulations § 1.641(b)-3(a) provides that the estate administration period is the time actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law. The estate administration period cannot be unduly prolonged, and, if it is, it is considered terminated for Federal

[151] Reg. § 53.4947-1(c)(6)(iii)
[152] PLR 200024052
[153] *Id*.
[154] Rev. Proc. 2011-3, section 3.01(51)
[155] PLR 200224035

income tax purposes after the expiration of the reasonable time for the executor's performance of all the duties of administration. Further, an estate will be considered terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

Note, however, that if the executors make a valid election under I.R.C. § 645 to treat a qualified revocable trust as part of the estate for Federal income tax purposes, the estate cannot terminate for Federal income tax purposes prior to the termination of the I.R.C. § 645 election.

Treasury Regulation § 1.645-1(f)(1) provides that a 645 election terminates on the earlier of the day on which both the electing trust and related estate, if any, have distributed all of their assets, or the day before the applicable date. The "applicable date" is defined as the later of the day that is two years after the date of the decedent's death, or the day that is six months after the date of final determination of liability of estate tax. Treasury Regulation § 1.645-1(f)(2)(ii) defines the date of final determination of liability as the earliest of the following: (a) the date that is six (6) months from the issuance of an estate tax closing letter, (b) the date of a final disposition of a claim for refund that resolves the liability for the estate tax, (c) the date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for estate tax, (d) the date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for estate tax, or (e) the date of expiration of the period of limitations for assessment of the estate tax.

Although a 645 election has terminated, the estate may still be opened for Federal income tax purposes. Similar to the analysis for when a revocable trust becomes a split-interest trust pursuant to section 4947, determining when an estate terminates for Federal income tax purposes is dependent on the facts and circumstances involved in the particular settlement. For example, in *Brown, Jr. v. United States*, the Fifth Circuit Court of Appeals held that an estate administration lasting twelve (12) years was unduly prolonged, especially in light of the fact that all of the executor's ordinary duties had been completed except for the transfer of the corpus to the beneficiaries.[156] As a general prospect, for tax purposes the administration period ends when the estate is in a condition to be closed.[157]

3. Survey of Applicable Revenue Rulings[158]

The IRS has privately ruled on similar transactions several times in the past. For example, in PLR 200207029, a trust for the benefit of a substantial contributor's

[156] 890 F.2d 1329 (5th Cir. Ct. App. 1989)
[157] *Marin Caratan*, 14 TC 934 (1950)
[158] Under section 6110(k)(3) of the code, a private letter ruling cannot be cited or relied upon as precedent. Nevertheless, a private letter ruling provides insight into the view of the IRS with the respect to the applicable law at the time of its issuance.

descendants proposed to purchase two limited liability company interests held by a second trust, the remainder of which was to pass to charitable split-interest trusts. The purchase price would be equal to the limited liability company's fair market value. The transaction was to be financed with an installment note. Additionally, the transaction was approved by a court of competent jurisdiction, and it was represented that the notes passing to the charitable split-interest trusts were as liquid as the limited liability company interests being purchased. The transaction occurred during the administration period before the trust was considered terminated for federal income tax purposes. The IRS held that since the proposed transaction satisfied the requirements of Treasury Regulation § 53.4941(d)-1(b)(3), the proposed transaction would not constitute an act of indirect self-dealing and therefore would not be subject to excise taxes.

Similarly, in PLR 9434042, the IRS prospectively ruled that a transaction similar to the current facts would not constitute an act of indirect self-dealing provided that all of the requirements of Treasury Regulation § 53.4941(d)-1(b)(3) were satisfied. In the contemplated transaction, the residuary trust estate ultimately would pass to a family foundation upon the death of the survivor of the settlor and the settlor's spouse. The IRS held that a disqualified person's purchase of assets from the settlor's revocable trust for an installment note would not constitute an act of indirect self-dealing provided that all the requirements of Treasury Regulation § 53.4941(d)-1(b)(3) were satisfied. Additionally, the distribution of the note to the private foundation as well as the foundation's receipt of payments under such note also would not constitute self-dealing.

Further, in PLR 9042030, the IRS held that funding a pecuniary gift to a private foundation with a note, the debtor of which is a disqualified person's estate, and the subsequent payment of principal and interest due on the note would not constitute an act of indirect self-dealing provided that the note was paid off prior to the estate terminating for federal income tax purposes. According to the facts presented, the decedent's estate, after paying taxes, debts, and expenses, had a small amount of cash to satisfy the bequest to the private foundation. Although the estate had interests in illiquid assets, those assets were largely unsuitable for funding the gift to the foundation. In order to overcome the cash shortfall, the estate proposed to distribute cash and a note to the foundation. The PLR states that the note passing to the foundation was as liquid (if not more liquid) than the illiquid assets which otherwise would have been distributed. Finding that the transaction satisfied Treasury Regulation § 53.4941(d)-1(b)(3), the IRS held that the distribution of the note to the foundation and the foundation's retention of the note would not be self-dealing provided that the note was paid off prior to the estate terminating for federal income tax purposes. Note that in this ruling the foundation was entitled to an immediate distribution in satisfaction of its bequest.

In PLR 9818063, disqualified persons were granted options to purchase partnership interests from a revocable trust in exchange for installment notes. A private foundation held a substantial remainder interest in the revocable trust. It was represented that the proposed transaction met the requirements propounded in

Treasury Regulations § 53.4941(d)-1(b)(3). Based on the foregoing, the IRS held that the exercise of the option to purchase the assets from the revocable trust in exchange for a note prior to the revocable trust becoming subject to section 4947 as well as the private foundation's receipt and holding of the notes pursuant to the exercise of the option was not self-dealing.

In PLR 200024052, the IRS held that a disqualified person's purchase of a charitable lead annuity trust's expectancy in assets in exchange for a note would not constitute self-dealing provided that the transaction satisfied the requirements of Treasury Regulation § 53.4941(d)-1(b)(3). Specifically, a decedent's children and closely held entities owned by such individuals proposed to purchase investment company stock from the decedent's revocable trust in exchange for promissory notes. Upon obtaining court approval, the trustee of the revocable trust had the power to sell trust property at fair market value prior to the revocable trust becoming subject to section 4947 provided that the consideration was as liquid as the expected interest. The IRS found that Treasury Regulation § 53.4941(d)-1(b)(3) was satisfied, and, as such, the sale of the stock in an investment company to disqualified persons in exchange for notes and a charitable lead trust's subsequent retention of the notes would not constitute an act of self-dealing.

Consistent with its rulings since 1990, the IRS, in PLR 200722029, again approved a disqualified person's purchase of assets from an estate or revocable trust in which a private foundation had an expectancy. The purchase was to be financed with a promissory note. The IRS found that the proposed transaction as well as the foundation's subsequent receipt and retention of the promissory note satisfied Treasury Regulations Treasury Regulations § 53.4941(d)-1(b)(3).[159]

Most recently, on July 22, 2011, the IRS issued PLR 201129049 which held that a private foundation's retention of a disqualified person's note and its receipt of payments pursuant to such note would not be deemed acts of self-dealing. In PLR 201129049, a closely held corporation characterized as a disqualified person as to a private foundation, purchased stock from a revocable trust during the administration of a decedent's estate pursuant to the terms of a shareholders' agreement. But for the purchase, the stock was to otherwise pass to the private foundation. The IRS held that the foundation's holding of the promissory note and the receipt of payments made pursuant to the promissory met the requirements of Treasury Regulation § 53.4941(d)-1(b)(3) and therefore would not be deemed acts of self-dealing subject to excise tax.

It is worth noting, however, that in PLR 8521122 (issued in 1985, five years prior to PLR 9042030), the IRS ruled that (i) the distribution of a note, the debtor of which is a disqualified person, to a private foundation, (ii) the foundation's

[159] *See also*, PLR 200232033 in which the IRS also held that charitable lead trusts' receipt of notes, the debtors of which were disqualified persons, and the subsequent distribution of such notes to the charitable lead trusts' charitable beneficiary, a private foundation, were not acts of self-dealing because the provisions of Treasury Regulations § 53.4941(d)-1(b)(3) were satisfied.

retention of said note, and (iii) payments made to the foundation pursuant to the note would constitute direct acts of self dealing subject to excise taxes. PLR 8521122 does not appear to represent the IRS's current position with regard to self-dealing and transactions during the administration of an estate or trust.

Since 1990, the IRS has consistently ruled that a private foundation's receipt of a disqualified person's note as well as subsequent payments made pursuant to the note would not be self-dealing if all the requirements of Treasury Regulations § 53.4941(d)-1(b)(3) are met. Based on the foregoing, it may be argued that PLR 8521122 is no longer applicable when analyzing indirect self-dealing transactions.

B. The Results

It seems the results of the transaction, particularly if the interest sold has sufficient cash flow to amortize the purchase price over the term of the CLAT, appear to be substantial reduction or even elimination of the estate tax on the business interest. Certainly, if interest rates are low at the time of death, it seems possible that a long duration CLAT (20 or 30 years) may allow the family the flexibility to defer immediate decisions on whether to sell the business, retain the business or bring in outside investors. Substantial value will inure the charity; therefore, it seems the transaction would not be appropriate for an individual with no charitable intent. But the lead payee of the CLAT annuity could be the decedent's private foundation, which will obtain the same estate tax deduction as a contribution to a public charity under I.R.C. § 2055.

VII. *Turner* and Protecting FLPs from Estate Tax Inclusion[160]

A. The Turner Estate Tax Inclusion Problem

In *Estate of Clyde W. Turner, Sr. v. Commissioner,* 138 T.C. No. 14 (2012) ("*Turner II*"), the United States Tax Court refused to change its conclusion made in *Estate of Clyde W. Turner, Sr. v. Commissioner,* T.C. Memo. 2011-209 (*"Turner I*") that the underlying assets of the partnership that the decedent had contributed to it were included in his gross estate, for Federal estate tax purposes, even with respect to partnership interests he had transferred by gift to persons other than his wife prior to his death. More important, perhaps, it also held that no marital deduction would be permitted for value of the partnership interests that were the subject of those lifetime gifts. The court indicated that there could be a further reason for at least a partial disallowance of the marital deduction where the underlying assets of the partnership are included in the estate and are worth more than the partnership interests which the decedent owned at death.

Turner II raises significant issues in representing a married person who holds a substantial partnership interest at death and who wishes a portion of the estate to qualify for the estate tax marital deduction to avoid the imposition of estate tax upon his or her death.

[160] Excerpted from J. Blattmachr, M. Gans & D. Zeydel, "Turner II and Family Partnerships: Avoiding Problems and Securing Opportunity," *Journal of Taxation*, July 2012.

B. Attempt to Qualify for a Marital Deduction

In *Turner*, the decedent, pursuant to his will, had bequeathed his estate by a disposition called an "optimum" marital deduction provision. Such a disposition essentially directs that all property pass in a form qualifying for the estate tax marital deduction except for any unused estate tax exemption.[161] The structure is intended, by using the unused estate tax exemption and the marital deduction, to avoid the imposition of any Federal estate tax when the married person dies and to avoid having the unused estate tax exemption amount of the spouse dying first, unlike the marital deduction amount, be included in the gross estate of the surviving spouse upon his or her later death. That seems to be what Mr. Turner intended. His estate, in its request for reconsideration of *Turner I*, contended that no estate tax should be payable because Mr. Turner had so structured his will. According to the Court, "The estate argues that even if I.R.C. § 2036 applies, the will requires the estate to increase the value of the marital gift." The Court rejected that contention essentially because the partnership interests that were given away before death could not be transferred to the surviving spouse and would not be included in the gross estate at her death (or subject to consumption by her during her remaining lifetime or could be made the subject of gifts by her). The Court refers to a situation where assets are included in the decedent's gross estate which cannot pass to the surviving spouse (because they have passed to someone else) as a type of "mismatch" because the optimum marital deduction cannot include such assets—essentially, a "not available for the spouse" mismatch. However, it seems that the estate may have made the argument that such assets should be allowed to qualify for the estate tax marital deduction on account of another or, perhaps, what may be viewed as a more fundamental type of "mismatch" that the IRS had not apparently made in *Turner I*—a "valuation" mismatch.

The type of mismatch that could have been raised in *Turner I* but apparently was not is a mismatch between the value of the partnership units passing to the surviving spouse in a form qualifying for a marital deduction and the value of the underlying assets of the partnership included in the decedent's gross estate under I.R.C. § 2036. The Court states, "[The IRS] allowed an increased marital deduction that [was] calculated on the basis of the value of assets transferred in exchange for the partnership interests that [the decedent] held at death, rather than on the basis of the discounted values of the general and limited partnership interests that [the decedent] owned at death, to the extent that they passed to [his wife]." Perhaps, that allowance by the IRS was inadvertent. Certainly, the IRS had raised the issued in court previously in other cases. The Court noted that the issue was raised in *Estate of Black v. Commissioner*, 133 T.C. 342 (2009); *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21, but stated it did not have to address the issue because it found in those cases that the underlying assets of the partnership were not

[161] For the structure and common language to effect such a disposition, *see, generally,* J. Blattmachr & I. Lustgarten, "The New Estate Tax Marital Deduction: Many Questions and Some Answers," 121 *Trusts & Estates* 18 (Jan. 1982); J. Blattmachr, D. Hastings & D. Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 *Trusts & Estates* 47 (Apr. 1988); and M. Gans & J. Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 *Estate Planning* 3 (Apr. 2005).

included in the decedent's estate.[162] However, if a court does find them included in the gross estate of a married person and if the IRS raises the valuation mismatch as a ground to limit the marital deduction, the question is how the courts will rule. The action of the IRS in *Turner I* may indicate the Service will not contend there is a valuation mismatch.

However, rather than inadvertence being the reason the IRS did not raise the valuation mismatch in *Turner,* it may be that the Service concluded that the Wife could unilaterally terminate the partnership (essentially as a general partner) under the terms of the partnership agreement. In other words, to the extent Mr. Turner's wife inherited partnership interests from him she could access the proportionate underlying assets, assuming she could do so under the terms of the partnership agreement. Of course, even if she had a unilateral right to terminate the partnership, she could not access the underlying partnership assets attributable to the partnership interests Mr. Turner had given away to others during his lifetime.

Based upon the reasoning the Tax Court used in *Turner II* to not allow the marital deduction for partnership units that could not pass to the surviving spouse, it may well be that no marital deduction will be allowed by a court for the excess of the estate tax value of the underlying assets of the partnership included in the gross estate over the value of the partnership interests the decedent could pass to his or her surviving spouse, at least where the surviving spouse may not unilaterally access the partnership assets attributable to the partnership interest the survivor acquires from the first spouse to die.

C. Avoiding the Application of Section 2036

There seem to be at least two ways in which I.R.C. § 2036(a) may be avoided. The first is to cause the entity to be formed in a manner so that transfers to it fall under the "*bona fide* sale for full and adequate consideration" exception to the section. Case law has established that the exception consists of two parts both of which must be met for it to apply: (1) the transfer must be "*bona fide*" and (2) it must be for full and adequate consideration in money and money's worth. The courts seem to have concluded that the transfer will be deemed to have been for full and adequate consideration in money or money's worth if the transferor receive back a proportionate interest in the income and equity of the entity (e.g., the amount contributed by a partner is fully reflected in the partner's capital account and represents a proportionate part of all contributions to the partnership and distributions are made in accordance with the partners' interests).[163]

The courts also appear to have concluded that a transfer will be regarded as "*bona fide*" if there is a significant and legitimate non-estate tax reason for the formation of the entity. The Court of Appeals or the Fifth Circuit in its famous decision in *Strangi* in 2005, cited above, suggests that there will be finding of a significant and legitimate non-tax reason only if, measured from a purely objective standard, the formation was likely to achieve

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[162] The Court states, "In some cases the IRS has taken the position that even when section 2036(a) applies, the marital deduction is measured by the value of what actually passes to the surviving spouse, which is a discounted partnership interest, and not by the value of the underlying assets," citing to *Black, supra,* and *Schutz, supra.*

[163] *See, e.g., Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005); *Estate of Strangi v. Commissioner,* 417 F.3d 468 (5th Cir. 2005).

the non-tax purpose. It seems that a legitimate concern about a real threat of a creditor may be such a reason.[164] A need to provide management for a business or investment may be sufficient.[165] A wish to avoid diversification of certain public stock holdings may be a sufficient reason.[166] It also seems that in making the objective determination the courts will look at facts after formation of the enterprise—for example, a claim that the parties pooled their assets to change investments will probably not be found if no sales and reinvestments of the contributions are made. Similarly, having the entity make large distributions to the partners may be used as evidence that the recited reason is not true. Also, failure to pool business assets may be used as evidence of a lack of a *bona fide* reason for the formation of the enterprise.[167] In any event, it seems appropriate to make a contemporaneous record of the legitimate and significant non-tax reasons for the formation of the entity and have the operation of the entity made consistent with those reasons if it is desirable to fall under *bona fide* sale exception. However, as *Turner II* illustrates, there is no assurance that I.R.C. § 2036(a) will not be found to apply.

An alternative way to avoid the application of I.R.C. § 2036(a) is to avoid having the transferor be found to have retained the right to income or the right to control the beneficial enjoyment of the transferred property or its income. Because a transferor may be found to have retained the right to income through an implied, non-legally enforceable understanding, it may be difficult to prove a lack of a retained right if significant distributions are made to the transferor from the entity. A statement in the last decision in *Estate of Strangi v. Commissioner, supra,* may suggest that pro rata distributions to the partners will not be used as evidence of such an understanding if there are other partners whose interests are significant. But the meaning and scope of the statement is uncertain. What does seem more certain is that the failure of the transferor to maintain adequate assets to maintain a reasonable lifestyle for life will be used as evidence of an implied understanding (as it may show the transferor knew that he or she would need distributions from the entity).[168] Perhaps, the strongest proof will be the fact that no distributions are made. (If a need to additional funds arises, the transferor could sell partnership units.) However, it must be emphasized that the courts may still find I.R.C. § 2036(a) to apply. The court in *Estate of Bongard v. Commissioner, supra,* applied I.R.C. § 2036(a)(1) even though no distribution had been made.

D. If All Else Fails -- Qualifying the Included Property for a Marital Deduction

One solution to the estate tax inclusion problem, and it may be the reason why the IRS did raise the valuation mismatch in *Turner*: the surviving spouse had the unilateral right to withdraw the underlying assets from the partnership to the extent she inherited partnership interests from her husband. Hence, the partnership agreement could provide for a contingent marital deduction. In other words, the partnership agreement could provide that assets of the partnership that are included in a deceased married partner's

[164] *See, e.g., Estate of Hilgren v. Commissioner*, T.C. Memo 2004-46.
[165] *See, e.g., Estate of Kimbell v. Commissioner,* 371 F.3d 257 (5th Cir. 2004).
[166] *See, e.g., Estate of Schutt v. Commissioner*, T.C. Memo 2005-126.
[167] *See, e.g., Turner (Estate of Thompson) v. Commissioner*, 382 F. 3d 367 (3rd Cir. 2004). Note that this 2004 decision is not related to *Turner I* or *Turner II.*
[168] *Cf. Estate of Stone v. Commissioner*, T.C. Memo 2003-309.

gross estate shall pass in a form qualifying for the estate tax marital deduction.[169] That should mean that there is no problem with respect to the allowance of the marital deduction: the included assets themselves are being transferred to (or for) the surviving spouse and there should be no valuation mismatch.[170]

That, nonetheless, may present some additional issues to consider. For example, assume the spouse dying first, and in whose estate underlying partnership assets are included, wishes the marital deduction share to pass into a marital deduction trust and not directly to the surviving spouse.[171] Even if the provision in the partnership agreement that requires the distribution of the assets of the partnership that are included in the deceased spouse's gross estate to be distributed to the surviving spouse or a marital deduction trust if but only if those assets would be so included in the estate of the deceased spouse without regard to that provision in the partnership agreement, the IRS might argue that the provision gave the deceased spouse additional control. For example, if the partnership agreement required that the interest transferred by the deceased spouse or a marital deduction trust must be redeemed as of the deceased spouse's death by a distribution of a pro rata portion of the partnership's underlying assets, the decedent would have the power until death to control whether the partnership assets so included would pass outright or in trust for his or her spouse. The Service might contend that this power to control that disposition causes the underlying assets of the partnership to be included in the deceased spouse's gross estate under I.R.C. § 2036(a)(2). That argument should not prevail if the redemption of the partnership interest bequeathed by the deceased spouse outright to the surviving spouse or to a marital deduction trust occurs if but only if the partnership assets with respect to the partnership interest bequeathed to the surviving spouse or marital deduction trust are included in the deceased spouse's gross estate without regard to the partnership redemption interest.

Perhaps, some will be concerned that such a provision in a partnership agreement will be used as evidence that there was no significant and legitimate non-tax reason for the formation of the partnership. But that should not be the case. The fact that the IRS has repeatedly attempted to have a partnership's underlying assets be included in the gross estate of a deceased partner is not a secret. Every planner should be aware of it and take action to avoid adverse consequences which would arise in such a case does not seem to belie the non-tax reasons for the partnership's formation.

An alternative that might be considered is to have the partnership agreement provide that, with respect to any partnership interest inherited by the surviving spouse (or a marital deduction trust), the surviving spouse (or marital deduction trust) has a unilateral right to

[169] Many practitioners use a qualified terminable interest property (QTIP) trust described in section 2056(b)(7) as the form of the contingent marital deduction because, among other advantages, it permits the decedent's estate to elect how much, if any, of the trust will qualify for the estate tax marital deduction. If the surviving spouse may not be a United States citizen, it should be in the form of a qualified domestic trust described in section 2056A.

[170] It appears that the payment of the assets to or for the surviving spouse pursuant to the terms of the partnership agreement would be considered as passing from the deceased spouse to the surviving spouse for purpose of Reg. § 20.2056(c)-2(b).

[171] If the surviving spouse is not a U.S. citizen, the estate tax marital deduction would be permitted only for assets passing into a qualified domestic trust described in section 2056A.

"put" the partnership units to the partnership in exchange for a pro rata portion of the underlying partnership assets to the extend the underlying partnership assets are included in the deceased spouse's gross estate.[172] (Of course, the surviving spouse may wish to rid himself or herself of this put right prior to death by sale, for example, of that right.[173]) As mentioned above, such a put right may be why the IRS did not raise the valuation mismatch in *Turner I*: the surviving spouse could redeem the units on account of her status as a general partner.

In any event, an automatic redemption provision in the partnership agreement or the granting of a put right to the surviving spouse (or the marital deduction trust) would not seem to salvage the marital deduction for partnership interests given away during lifetime to persons other than the surviving spouse by the deceased spouse as happened in *Turner*. Presumably, any redemption of those partnership interests would result in underlying partnership assets being transferred to the recipients of the gifts and not to the surviving spouse. Perhaps, some will consider going all the way: providing in the partnership agreement that, to the extent underlying partnership assets are included in the estate of the deceased spouse without regard to the partnership provision, those assets must pass to the surviving spouse or a marital deduction trust.[174]

E. Can the Included Partnership Assets Qualify for a Marital Deduction Without a Redemption?

There is another possible solution, which is in some respects similar to the manner in which the assets of a grantor retained annuity trust (a so-called GRAT) or a qualified plan or an individual retirement account (IRA) may be qualified for an estate tax marital deduction. In the case of a GRAT, the annuity causes estate tax inclusion of the underlying assets held in the GRAT under I.R.C. § 2036.[175] With a qualified plan or IRA, the decedent's interest causes inclusion of the underlying assets of the qualified plan or IRA. But the decedent or the decedent's estate cannot always control the administration of the trust or plan that holds the assets included in the gross estate. Nevertheless, it seems that in each of those cases, if all the income from the GRAT, plan or IRA is in fact distributed to the surviving spouse or to a marital deduction trust,

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[172] *Cf. Estate of Nowell v. Commissioner*, T.C. Memo. 1999-15 (general partnership interest inherited was valued as a full partnership interest, and not as an assignee interest, by reason of a partnership provision conferring general partnership status on the inheritor).

[173] If the right is conferred on a so-called QTIP trust described in section 2056(b)(7), consideration should be given to ensuring the transfer of this right will not trigger section 2519. Perhaps, distributing the right outright to the surviving who could dispose of it would be safer course than having the QTIP trust sell it. It should be made certain that the put right does not disappear upon the transfer to insure section 2704 does not apply. In fact, it might be a "floating" put right that would apply to the "number" of partnership units the surviving spouse inherited as opposed only to the units the survivor inherited.

[174] Using a qualified terminable interest property (QTIP) trust described in section 2056(b)(7) as the recipient of the partnership assets provides an additional measure of flexibility on estate taxation: the executor of the deceased spouse's will could determine not to elect marital deduction treatment for the trust (or elect it only in part). Another option to engage in post mortem estate tax planning may be for the surviving spouse to disclaim pursuant to section 2518 the partnership interest received by the spouse or a marital deduction trust by reason of the deceased spouse's death.

[175] *See* J. Blattmachr, M. Gans & D. Zeydel, "Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues," 109 J. Tax'n 4 (Oct. 2008).

followed by that income being distributed to the surviving spouse, with no possibility of the underlying assets being paid to anyone else, then the GRAT, plan or IRA itself may be qualified for a marital deduction.[176] This may mean that the valuation mismatch problem could be avoided if the partnership agreement requires the underlying assets included in the deceased spouse's gross estate to be administered as a marital deduction trust.

This solution might be easiest to comprehend in the context where the deceased spouse continues to own limited partnership units until the deceased spouse's death. The deceased spouse's estate believes the deceased spouse's gross estate includes the limited partnership units, but the IRS assert that under I.R.C. § 2036 the underlying assets of the partnership are included in the deceased spouse's estate. Suppose that the partnership agreement requires that if any of the assets of the partnership are included in gross estate of a deceased partner or former partner, then the partnership shall hold the included assets in a segregated fund, and shall distribute in respect of the deceased partner's partnership interest from the date of the deceased partner's death all of the income (as defined for purposes of the estate tax marital deduction) of the segregated fund to the owner of the deceased partner's partnership interest. Might that permit the included assets to qualify for a marital deduction? Perhaps, a prohibition on distributions to any other partner coupled with a mandatory distribution of all income (as defined for marital deduction purposes) to the spouse or to a marital trust for the spouse might be sufficient to obtain a marital deduction. And a conversion, essentially, to a partnership that is required to distribute all its income to its partners may be less detrimental from a valuation standpoint than a mandatory redemption clause, because with an automatic redemption, the underlying partnerships will be owned by the surviving spouse and included in his or her gross estate, barring other action, without any discount while, with the marital deduction trust arrangement, it may be that a discount would be permitted because the surviving spouse never acquired ownership of the partnership's assets. Of course, if only the partnership units are included in the gross estate of the surviving spouse (because they were in the marital deduction trust for the surviving spouse), they may be valued with a lesser discount than if the partnership was not required to distribute its income (as defined for marital deduction trust qualification purposes). In any event, the redemption provision or the mandatory payment from the partnership of income to the marital deduction trust, as the case may be, should be conditioned on the underlying partnership assets being included in the deceased partner's gross estate without regard to the provision.

The difficulty with this "mandatory partnership income distribution to a marital deduction trust" solution may be a metaphysical one. It may be that the IRS will assert that what is transferred to or in trust for the surviving spouse is a limited partnership interest, not the underlying assets that are included in the deceased spouse's gross estate. In that event, even if the partnership distributes all of its income (as defined for marital deduction purposes) to the surviving spouse or a marital deduction trust for the surviving spouse, the partnership interest commands a valuation discount, causing the valuation mismatch problem. Nevertheless, if the spouse in fact receives a qualifying income

[176] *See, e.g.*, Rev. Rul. 2006-26, 2006-1 C.B. 939.

interest in the assets included in the deceased spouse's gross estate, it seems possible for those assets to qualify for a marital deduction in the manner described above, even if the limited partnership interest is discountable for other purposes.[177]

VIII. Split Interest Trusts Created by Entities[178]

A. Introduction

Partnerships and corporations, at least occasionally, create trusts. Trusts also may be created by the trustees of other trusts.[179] Treasury regulations specify when a partnership or the corporation will be treated, for Federal income tax purposes, as the grantor[180] of the trust or when its partner or shareholder will be treated as the grantor, even though the trust "nominally" was created by the entity.[181] Unfortunately, forecasting whether the Internal Revenue Service (the "IRS" or "Service") will treat an entity or an owner of the entity as the grantor of a trust may be difficult in many situations. In contrast, the regulations dealing with the status of a trust as the grantor of another trust are reasonably certain. It does not appear that one trust can be treated for income tax purposes as the grantor (meaning a creator who has made a gratuitous transfer of property to the trust) of

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[177] Courts, including the Tax Court in *Turner I*, have indicated that the purpose of section 2036 is to bring into the gross estate inter vivos transfers that are part of a testamentary plan. They have considered the testamentary nature of the plan not only in analyzing the applicability of the bona fide exception but also in determining whether the decedent had retained the requisite "string" to cause the section to apply. *See Turner I* ("Factors indicating that a decedent retained an interest in transferred assets under section 2036(a)(1) include a transfer of most of the decedent's assets, continued use of transferred property, commingling of personal and partnership assets, disproportionate distributions to the transferor, use of entity funds for personal expenses, *and testamentary characteristics of the arrangement*."(Emphasis added.)). While it would seem that the "string" issue should not be impacted by the testamentary flavor of the transaction (for example, it is uncertain how it would affect the right to income or control of the transferred assets), it must be acknowledged that the courts nonetheless seem to be taking this approach. Thus, before using the QTIP approach suggested in text, consideration should be given to the question whether such an approach would lead the courts to view the arrangement as a testamentary one.

[178] Excerpted in part from J. Blattmachr & D. Zeydel, "Split Interest Trusts Created By Entities (and More)," 49th Annual Heckerling Institute on Estate Planning, Chapter 14 (2015).

[179] For example, in doing a "decanting" under Alaska Statutes (AS) 13.36.157-159, the trustees of one trust (the "invaded trust") may pay the corpus to another trust (the "appointed trust"), in certain cases, including, as defined in AS 13.36.215, "to a new trust created… by the trustees, in that capacity, of the invaded trust."

[180] The term "grantor" can have more than one meaning for income tax purposes. A grantor can be the person who creates a trust. A grantor can also be a person treated as the owner of the trust assets for Federal income tax purposes. It is possible to be a grantor without being an owner, and to be an owner without being a grantor. In order to be a grantor that is also treated as an owner for purposes of Section 671 of the Code, as a general matter the person must have made a gratuitous transfer of property to the trust. A person may also become an owner under Section 678, even if that person has not made a gratuitous transfer of property to the trust. Note that in this context, a gratuitous transfer need not have a transfer tax implication. In other words, a gratuitous transfer need not be a gift for gift tax purposes. A gratuitous transfer means only an uncompensated transfer of property.

[181] Although this regulation has been promulgated under Section 671 of the Code, which section is part of the so-called "grantor trust rules," which are contained in subpart E of part 1 of subchapter J of Chapter 1 of Subtitle A of the Code, the determination under the regulation of which taxpayer is the grantor for Federal income tax purposes seems to be for all purposes of the income taxation of estates, trusts and their beneficiaries, not just for purposes of the grantor trust rules. See, e.g., Treas. Reg. § 1.671-2(e)(1), which provides, in part, "For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person…." In other words, this regulations indicates that the determination of the identity of the grantor is not limited to the grantor trust provisions (Sections 671-679) but for all purposes of the income taxation of estates, trusts and their beneficiaries.

another trust although one trust may be treated as the owner of the trust, for Federal income tax purposes, of another trust, in some cases.[182] The determination of the identity of the owner for income tax purposes of a trust can be significant, in some cases.

The basic rule is set forth in Treasury Regulation § 1.671-2(e)(1) and provides that for purposes of the grantor trust rules, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of the regulation) of property to a trust. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under Sections 671 through 677 or Section 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under Sections 671 through 677 or Section 679. However, a person may be treated as an owner of a trust without being a grantor under Section 678. How this rule applies in the case of an entity or a trust that creates a trust can be difficult to analyze.

This article will discuss some of these differences, focusing specifically on charitable contributions made by certain of these entities by transfers to a so-called "split interest" trust, such as a charitable remainder trust ("CRT") described in Section 664(d)[183] or a charitable lead trust ("CLT") described in Section 170(f)(2)(B)[184], where an individual or a trust (or a decedent's estate) is a partner or shareholder. It will suggest ways of making it more certain that the partnership or corporation, rather than its partners or shareholders, will be treated as the grantor (owner) of the trust when that is beneficial. It will also discuss certain other matters relating to split-interest trusts, whether created by an entity or by an individual.

B. Some Basic Charitable Deduction Rules

1. For Individuals

Individuals are entitled, under Section 170(a), to an income tax deduction for certain contributions to charitable organizations that are described in Section

[182] "If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code." Treas. Reg. § 1.671-2(e)(5). However, as illustrated by Example 8 in Treas. Reg. § 1.671-2(e)(6), one trust may be the owner, for income tax purposes, of another trust it creates.

[183] Note that, although a charitable remainder trust is described in Section 664, the income tax deduction for the charitable interest in one is allowed under Section 170(f)(2)(A) to the individual who creates one. The gift tax and estate deductions for the charitable interest in a charitable remainder trust are provided under Sections 2522(c)(2)(A) and 2055(e)(2)(A), respectively.

[184] The income tax deduction for a transfer to a charitable lead trust is allowed under Section 170(f)(2)(B) but, as discussed later in this article, only if it is a grantor trust. The gift and estate tax charitable deductions for the creation of a charitable lead trust are under Sections 2522(c)(2)(B) and 2055(e)(2)(B), respectively.

170(c), subject to limitations relating to the individual's contribution base,[185] the type of organization to which the contribution is made[186], the nature of the asset donated[187] and other factors[188].

2. For Estates and Trusts

The taxable income of a decedent's estate and of a trust that is not a grantor trust[189] is computed in the same manner as an individual's taxable income is computed except to the extent otherwise provided in part 1 of Subchapter J of Chapter 1 of Subtitle A of the Code.[190]

One of the important differences between the manner in which the taxable income of an estate or trust is determined as opposed to that of an individual is the extent of the deduction permitted for gifts or payments to charity. An estate or a non-grantor trust is entitled to a charitable deduction, without limitation, under Section 642(c) for its gross income paid (or, for a decedent's estate, paid or set aside) pursuant to the terms of its governing instrument for a charitable purpose described in Section 170(c). However, no Section 642(c) deduction is allowed for payments from a non-grantor trust for a charitable purpose to the extent the income so paid is allocable to the trust's unrelated business income ("UBI") within the meaning of Section 681. UBI, for this purpose, consists of the trust's income from certain business activities and from certain property acquired with borrowed funds reduced by the modifications listed in Section 512(b). These modifications include a deduction for charitable contributions allowed by Section 170, subject to the percentage limitations applicable to individuals. UBI, within the meaning of Section 681, is essentially the same as unrelated business taxable income or "UBIT"[191] defined in Section 512, which includes income attributable to acquisition indebtedness[192]. Capital gain recognized on the sale of an asset is

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[185] Contribution base is defined in Section 170(b)(1)(G) as adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under Section 172).

[186] See Section 170(b)(1)(A) and (B)

[187] See Section 170(b)(1)(C).

[188] See, *e.g.*, Sections 170(a)(3) and 170(f).

[189] A grantor trust is one the income, deductions and credits against tax of which are attributed pursuant to Section 671 to the trust's grantor (or technically its "owner") or, if the trust is described in Section 678(a), to another taxpayer.

[190] Section 641(b).

[191] Although the initials are "UBIT," it is commonly pronounced as "UBIT" by practitioners.

[192] If there is no debt on the asset, there can be no acquisition indebtedness. Acquisition indebtedness is defined in Section 514(c)(7). Note that, to the extent Section 681 applies, the limitations relating to the taxpayer's contribution base attributable to individuals apply to the trust. Section 681 does not apply to a decedent's estate. It may also be noted that certain formerly revocable trusts may elect, pursuant to Section 645, to be treated as part of the decedent's estate for Federal income tax purposes, for the time limit specified in the section, which will exempt the trust during that time from Section 681. That will also permit such a trust to be entitled to an income tax deduction for its gross income set aside for a charitable purpose during the period that the Section 645 election is in effect. Note that a decedent's estate will be treated as ceasing to exist for income tax purposes when the administration of the estate is determined to have been unduly prolonged. See Treas. Reg. § 1.641-1(b)(3)(a). In any case, it may be important, in planning, to determine whether there is acquisition indebtedness. Perhaps, it also should be noted that transferring property subject to debt to a charitable remainder trust or a charitable lead trust may be an act of self-dealing exposing the transferor to tax imposed by Section 4941(a). *See* Section 4941(d)(2)(A) (an act of self-dealing occurs

not normally UBIT if there is no indebtedness against the property.[193] To the extent the trust has UBI that is paid to charity, its deduction limitations are the same as those for an individual.[194]

3. For C Corporations

Corporations (so-called "C corporations") that are not so-called "S corporations"[195] are entitled to a deduction under Section 170(a) for contributions to charity but the rules for C corporations are different from those for contributions by individuals, in some ways. For example, as a general matter, a corporation may reduce its taxable income by only ten percent (10%) for such contributions.[196]

4. For S Corporations

Charitable contributions made by an S corporation pass through to the shareholders, under Section 1366(a)(1)(A), in a manner similar to how contributions by a partnership pass through, under Section 702(a)(4), to the partners.[197]

5. For Partnerships

As just indicated, charitable contributions made by a partnership pass through, under Section 702(a)(4), to the partners. It is important to note that a decedent's estate or a trust that is not a grantor trust, which is a partner, is entitled to a deduction under Section 642(c) for a charitable contribution made by the partnership from the partnership's gross income even if the governing instrument

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if property transferred is subject to a mortgage or similar lien which the charitable remainder trust assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer).

[193] Section 512(b)(5) provides that from UBIT "There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than-- (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber."

[194] See Treas. Reg. § 1.681(a)-2(a)(second to last sentence); Section 512(b)(11)).

[195] See subchapter S of Chapter 1 of Subtitle A of the Code.

[196] Section 170(b)(2).

[197] For an electing small business trust (ESBT) defined in Section 1361(e)(1), no income or deduction is passed out to the trust that is the shareholder. *See* Section 641(c). For more on a comparison of a charitable contribution by an S corporation as opposed to one by its shareholder, see, generally, C. Hoyt, "Charitable Gifts By Subchapter S Corporations and by Shareholders of S Corporation Stock," ALI-ABA Estate Planning Course Materials Journal April 2006, at http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0604-HOYT_thumb.pdf.

of the trust or estate does not provide for the making of charitable contributions. Rev. Rul. 2004-5.[198]

C. More on Non-Grantor Trusts as Partners and S Shareholders

Rev. Rul. 2004-5 states explicitly that a charitable contribution by a partnership was from its gross income although the conclusion (that the trust that is a partner is entitled to take a deduction under Section 642(c) for its share of the partnership's charitable donation) is not expressly limited to a case where the donation is made from gross income. Nonetheless, it appears to be the position of the IRS that, for a charitable contribution by a partnership to be deductible by a trust that is a partner, the charitable contribution must have been made by the partnership from its gross income.[199] It seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset, so acquired with the trust's gross income, should be treated as a contribution of gross income for purposes of Section 642(c).[200] In other words, if gross income is used to acquire an asset, that asset itself should continue to be treated as gross income at least as long as the asset can be traced to such gross income.[201]

Rev. Rul. 2004-5 indicates that Section 681 would apply if the partnership makes the charitable contribution from it gross income that would have been UBI if received directly from the trust.[202] Although the concept of UBI (or UBIT) does not apply to a

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[198] 2004-1 CB 295.

[199] See Field Service Advice 200140080 (not precedent).

[200] See, e.g., *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), dealing with the predecessor to current Section 642(c) and in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal. See, also, Chief Counsel Advice (CCA) 201042023 (the Service ruled that a property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income. However, the charitable deduction was limited to the trust's adjusted basis in the property. (Not precedent.) Cf. *Crestar Bank v. Internal Revenue Service*, 47 F. Supp. 2d 670 (E.D. Va. 1999); *Freund's Estate v. Commissioner*, 303 F.2d 30 (2nd Cir. 1962); *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970); *Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (1944*); Estate of Joseph Esposito v. Commissioner*, 40 TC 459 (1963).

[201] *Id.*

[202] The ruling states, in part, "Because none of [the partnership]'s income for the taxable year would be considered 'unrelated business income' for purposes of § 681(a), the amount of the charitable deduction is not limited under § 681." Also, note that Box 20 of Schedule K-1 of a partnership income tax return specifically requires that the share of the partner's UBI of the partnership be disclosed. In Field Service Advice 200140080 (not precedent), which dealt with a trust's distributive share of a partnership's charitable contributions, the IRS stated that although the courts in *Lowenstein v. Commissioner*, 12 TC 694 (1949), aff'd, 183 F.2d 172 (*sub nom First National Bank of Mobile v. Commissioner*) (5th Cir. 1950), and *Estate of Bluestein v. Commissioner*, 15 TC 770 (1950), did not analyze the governing instrument requirement, "the basis for the court's allowance of the deductions appears to be the fact that the contributions were made at the partnership level and that the estate would never receive the benefit of these amounts." The IRS further stated, "Based on the Bluestein and Lowenstein cases, we believe that a trust should be allowed a deduction for its distributive share of charitable contributions made by a partnership even though the trust's governing instrument does not authorize the trustee to make charitable contributions. However, all of the other requirements of IRC § 642(c) must be met, and the limitations of IRC § 681(a) must be taken into account."

partnership, the nature of a partnership's income presumably passes through to a trust for UBI purposes.[203]

Nonetheless, when an estate or trust distributes its gross income to charity pursuant to Section 642(c) or otherwise, the gross income should not be treated as UBTI in the hands of the charity even if it would have been UBTI if received directly by the charity.[204] Of course, as mentioned above, Section 681 does not apply to an estate.

In any event, the safer course, in order to allow a non-grantor trust partner to be entitled to the charitable deduction without the limitation on contributions made by the partnership, is to have the contribution made from the partnership's gross income other than what would be UBI. [205]

Although not addressed in Rev. Rul. 2004-5, it may suggest that tracing of the source of the contribution by the partnership may be permitted—that is, because the partnership can make the charitable contribution from its gross income as opposed to any other asset it holds, its seems to follow that it can make it from gross income that would not be UBI (at least to the extent it has gross income that would not be UBI). However, an amendment to the regulations under Section 642(c) provides that, for purposes of determining the type of income deemed distributed from an estate or trust to charity for purposes of "shifting" income to charity, any such distribution will be treated as consisting proportionately of all classes of gross income unless the governing instrument of the estate or trust provides otherwise and such provision has independent economic

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[203] Section 513(b).

[204] This conclusion is based upon the absence of a provision that would cause the distribution to be treated as UBTI in the hands of the charitable recipient, the several provisions that otherwise cause a recipient of a distribution from an estate or trust to treat it as having the same income tax character as it had in the hands of the estate or trust, and the fact that there is an explicit provision requiring a charity that is a partner to treat any partnership income (without applying the rule to distributions from an estate or trust) attributed to it as UBTI if it would have been UBTI if earned directly by the charity. For example, in the case of a partnership, UBTI carries out to any partner that is a charity, as provided in Section 512(c) and as UBI to a trust partner which, to that extent, would be subject the trust's charitable distributions of the UBI to the Section 170 limitations to individuals. However, payments to charity from an estate or trust even if consisting of UBI should not be treated as UBTI in the hands of the charitable recipient. Such transfers from an estate or trust to charity do not qualify for a distribution deduction under Section 651(a) or 661(a) and do not consist of the distributable net income (DNI) of the estate or trust under Section 652(a) or 662(a) whose tax character is also passed out to the non-charitable recipient of the DNI. See Section 663(a)(2), which denies this treatment for amounts paid to charity that are deducted under Section 642(c) (and determined without regard to Section 681) by an estate or trust. This seems consistent with the private foundation rules where the net investment income of a trust or estate does not retain its character in the hands of a private foundation for purposes of Section 4940. See Notice 2004-35, 2004-19 IRB 889. So UBI should not be treated as "carried out" from an estate or trust to a charity and treated as UBIT in its hands. But, as previously mentioned in this article, Section 681(a) provides that in computing the deduction allowable under Section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under Section 642(c) shall be allowed as a deduction with respect to income of the taxable year which is allocable to "unrelated business income ." See also Section 642(c)(4), which provides that in the case of a trust (but not an estate), the deduction allowed by Section 642(c) is subject to Section 681 (related to UBI). Cf., also, discussion in J. Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," 26th Annual Heckerling Institute on Estate Planning, Chapter 10 at 1004.3 (1992).

[205] Note that Section 68(a), which provides an overall limitation on itemized deductions, does not apply to a non-grantor trust or a decedent's estate. Section 68(e). The two percent "floor" rule of Section 67(a) does not apply to Section 642(c) deductions. Section 67(b)(4).

effect.[206] This recent amendment does not, by its terms, apply to income distributed to charity by a partnership where a trust is a partner. Because a non-grantor trust and an estate under the prior regulation could specify the character of the income being distributed to charity and because the amended regulation does not, as just stated, by its terms apply to distributions of income by a partnership of which the trust is a partner, it may be that the partnership may specify the type of income being paid which would be respected for purposes of Section 681.

In any event, under Rev. Rul. 2004-5, if a non-grantor trust is a partner in a partnership, the trust will be entitled to a deduction for charitable contributions made by the partnership (at least if made from the partnership's gross income and potentially subject to Section 681 if paid or deemed paid from what would be UBI if received directly by the trust) and, usually, without the normal limitations (related to "contribution base") of an individual taxpayer.

There is developed law on whether a non-grantor trust that is a shareholder of an S corporation may take a deduction for charitable contributions made by the S corporation.[207] The Treasury regulations dealing with Electing Small Business Trusts ("ESBTs"), defined in Section 1361(e)(1), which are certain trusts that may qualify by electing to be eligible shareholders of S corporations, provide that an ESBT is entitled to a charitable deduction attributable to contributions made by the S corporation from its gross income, although "[t]he limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion."[208] If the shareholder is a grantor trust for income tax purposes (or another is treated as the owner of the trust for income tax purposes under Section 678[209]), the charitable deduction would pass through to the individual who is the income tax owner of the trust. Certain trusts are not grantor trusts but may be eligible shareholders of an S corporation. These consist of voting trusts and the beneficial owners of the trust are treated as the S shareholders (to whom any charitable contribution made by the S corporation would be attributed); certain testamentary trusts, including certain formerly revocable trusts[210], for a limited period, of which the decedent's estate will be treated as the shareholder (and to which any charitable contribution made by the S corporation would be attributed); and certain tax exempt trusts. In addition, a decedent's estate is an eligible S shareholder.[211] Hence, in circumstances where the decedent's

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[206] See Treas. Reg. §1.642(c)-3(b)(2).

[207] Although Section 1366(a)(1) provides that an S corporation shareholder may deduct on the shareholder's own income tax return a pro rata portion of the corporation's charitable contributions, Section 1366(d)(1) limits the deduction to the sum of the shareholder's basis in his or her stock and any basis in any indebtedness the corporation owes to the shareholder. For years 2006 through 2013, a somewhat different rule on the limitation for such deductions applied. This limitation does not apply to a partner on charitable contributions made by the partnership.

[208] Treas. Reg. § 1.641(c)-1(d)(2). The "S portion" of the ESBT's income is the income from the S corporation that is attributed to the trust. See, generally, Blattmachr & Boyle, Income Taxation of Estates & Trusts (PLI 2014), Chapter 7.

[209] Note that the beneficiary of a Qualified Subchapter S Trust makes an election pursuant to Section 1361(d)(2) for the trust to qualify by the beneficiary being treated as the income tax owner of the S stock pursuant to Section 678. See Blattmachr & Boyle, supra.

[210] See Section 645.

[211] For a more complete discussion of these matters, see Blattmachr & Boyle, supra.

estate is the shareholder or treated as the shareholder of the S corporation, the principles of Rev. Rul. 2004-5 should apply so the estate will obtain a Section 642(c) deduction for contributions by the S corporation (and not limited by Section 681 as that section does not apply to a decedent's estate).

D. More on Contribution Limitations

An individual may be entitled to a deduction of up to 50% of his or her contribution base for donations of cash (or non-appreciated property) to a so-called "publicly supported" charity and 30% for cash donations to a so-called "private foundation."[212] Although Section 170(c) permits a deduction for contributions "to or for the use" of charitable organizations, the Treasury Regulations impose a 30% (or with respect to any long-term capital gain property 20%) contribution base limit for contributions "for the use" of charity as opposed to a contribution "to" charity.[213] Levels of contribution are limited to 30% and 20% if the contribution is made to a charitable lead trust.[214]

As detailed below, not only may trusts make contributions to charity, they also may, in some cases, create and make contributions to charitable remainder and charitable lead trusts, and except to the extent such contributions consist of UBI, such a trust would not be subject to the special deduction limitations, computed as a percentage of the

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[212] See Section 170(b). These deduction limitations are reduced, in general, to 30% and 20%, respectively, to the extent the donation consists of property that includes inherent "long term capital gain," that is, gain that would be taxed as long-term capital gain if the contributed asset were sold by the taxpayer. See Section 170(e).

[213] This conclusion on the limits for contributions to charitable lead trusts seems challenging to reach. Treas. Reg. §1.170A-8(a)(2) provides that a contribution of an income interest (essentially, the unitrust or annuity interest in a charitable lead trust) is treated as a contribution "for the use" of charity rather than "to" charity. Treas. Reg. § 1.170A-8(b) provides, in part, "To qualify for the 50-percent limitation the contributions must be made 'to,' and not merely 'for the use of,' one of the specified organizations." Hence, if the charitable lead trust is for charities and consists of property that otherwise would entitle the individual taxpayer to a deduction of up to 50% of his or her contribution base, the taxpayer's contribution limit is 30% of the contribution base. *See* Section 170(b)(1)(B)(i). Treas. Reg. § 1.170A-8(c) indicates that the contribution limitation is 20%, not 30%. But the 20% limit was the limit the Code imposed on all contributions to or for the use of charities that were not so-called "publicly supported" ones (that is, other than the entities described in Section 170(b)(1)(A)), such as contributions to or for the use of most private foundations. However, the 20% threshold was increased to 30% by the Deficit Reduction Act of 1984. Treas. Reg. § 1.170A-8 predates the effective date of that Deficit Reduction Act of 1984 change (See T.D. 7207 (10-3-72)) and has not been amended to reflect that change. However, if the contribution to the charitable lead trust consists of long-term capital gain property for a private non-operating foundation, the limit is 20% on account of Section 170(b)(1)(D)(i). Hence, where the contribution to a charitable lead trust is for publicly supported charities the deduction limitation, as a percentage of the contribution base, is 30% whether the contribution is of cash (or other unappreciated property) or of long-term capital gain property. Other limitations on deductions and some elective rules that may raise the contribution level back to 50% or 30% —see, e.g., Sections 170(b)(1)(C)(iii) and 170(e). Note, as mentioned in the text, that an individual is entitled to an income tax deduction for the value of the annuity or unitrust interest committed to charity in a charitable lead trust only if the trust is a grantor trust. See Section 170(f)(2)(B).

[214] See Treas. Reg. §§ 1.170A-8(b)(third sentence), 1.170A-8 (a)(2)(first sentence), 1.170A-8 (c)(1)(ii) and 1.170A-8 (d). "For purposes of the income tax charitable deduction, transfers to grantor charitable lead trusts are considered gifts 'for the use of' charity rather than gifts 'to' charity. If the trust makes payments to a public charity, the deduction can be used against up to 30% of the grantor's contribution base with a five year carryover of any excess deduction. If the trust provides income to a private non-operating foundation, the percentage limitation is reduced to 20%. Any contribution exceeding the amount deductible in the year of contribution can be carried forward up to five additional years." http://www.pgdc.com/pgdc/charitable-lead-trust.

contribution base, applicable to individual taxpayers. An income tax deduction is permitted for the value of the remainder committed in a charitable remainder trust described in Section 664(d); provided the value of the remainder interest is at least 10% of the value of the property contributed to the trust.[215] An income tax charitable deduction is permitted for value of the annuity or unitrust interest committed to charity in a charitable lead trust only if it is a grantor trust under subpart E of part 1 of subchapter J of chapter 1 of subtitle A of the Code.[216] However, if the contribution to a charitable lead trust is made to a non-grantor trust, no charitable deduction is allowed to the trust's grantor but the non-grantor trust would be entitled, under Section 642(c), to an unlimited deduction for its gross income paid pursuant to its governing instrument to charity (again subject to the limitations imposed by Section 681 if made from UBI).

E. Split Interest Trusts Created by Non-Grantor Trusts

The IRS has issued a private letter ruling[217] holding that a non-grantor trust may transfer assets to a charitable remainder trust ("CRT") described in Section 664(d).[218] The trust, apparently, was not authorized to create a CRT. However, the trust beneficiary held a presently exercisable special (non-general) power of appointment by which, it seems, the beneficiary could create such a trust. Of course, a charitable remainder trust will not be "qualified" until such time that it is not a grantor trust.[219] It is interesting, perhaps, to note that the ruling does not specify whether the trust from which the charitable remainder trust was formed was entitled to an income tax deduction under Section 642(c) for the actuarial value of the remainder to the extent CRT was funded with gross income of the trust.[220] There would not appear to be any reason why it should not be entitled to such a deduction. In fact, it seems that conclusion is consistent with Rev. Rul. 2005-4, allowing a non-grantor trust that is a partner of a partnership to deduct a charitable contribution made by the partnership (at least if made from the partnership's gross income).

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[215] Note that a trust can be a charitable remainder trust under Section 664 only if it never was or when it is no longer a grantor trust. Treas. Reg. § 1.664-1(a)(4)(second sentence). Note, also, that contributions to a charitable remainder trust will be limited to the percentage of the individual's contribution base for transfers to private foundations if the remainder may pass to such a foundation.

[216] See Section 170(f)(2)(B).

[217] Under Section 6110(k)(3), neither a private letter ruling ("PLR") nor a national office technical advice memorandum ("TAM") may be cited or used as precedent.

[218] PLR 9821029 (not precedent). Treas. Reg. § 1.664-1(a)(4) provides that a charitable remainder trust will be treated as created no earlier than when no one is treated as the trust's owner for income tax purposes under the grantor trust rules.

[219] If the trust does not grant a beneficiary such a special power, it may be possible to grant one by "decanting" the trust from the current one to another that permits it. See, generally, D. Zeydel & J. Blattmachr, "Tax Effects of Decanting - Obtaining and Preserving the Benefits," 111 *Journal of Taxation 288 (*November 2009). However, it is not certain that any deduction for the payment of gross income from the "new" trust will qualify for a Section 642(c) deduction if the original grantor of the property did not "envision" charitable contributions. Cf. *Brownstone v. United States*, 465 F 3d. 525 (2d Cir. 2006).

[220] The beneficiary might have held a power not just to appoint corpus of the trust but tax income as well. In fact, it might be that corpus, for state law accounting purposes, would include capital gain for Federal tax purposes.

The reasoning set forth in the private letter ruling supports the view that a non-grantor trust also may create a charitable lead trust described in Section 170(f)(2)(B).[221] However, an income tax deduction is not permitted for the actuarial value of an interest in a charitable lead trust unless the trust is a grantor trust. It seems that a non-grantor trust may create another trust which is a grantor trust (meaning a trusts whose assets are treated as owned for income tax purposes by the another) under Section 678 as to the non-grantor trust that created it if the non-grantor trust is authorized to do so.[222] A trust may be a grantor trust with respect to the person who made a gratuitous transfer to the trust for many reasons, one of which is that someone holds a power exercisable in a non-fiduciary capacity to substitute property of equivalent value for assets in the trust.[223] In fact, the Internal Revenue Service has held that such provision will cause a charitable lead trust to be a grantor trust.[224] It seems that if, pursuant to a presently exercisable special (non-general) power of appointment held by a beneficiary of a non-grantor trust or pursuant to a power held by the trustees of such trust to do so, a charitable lead trust that is a grantor trust is created from the gross income of the non-grantor trust, the non-grantor trust should be entitled to a deduction pursuant to Section 642(c), except to any extent it is limited by Section 681.

In any case, if a beneficiary of a non-grantor trust does not hold a presently exercisable special (non-general) power of appointment, which may be exercised to create a charitable lead trust, and if the non-grantor trust is not authorized to create one[225], it likely will be preferable for any such grantor charitable lead trust to be created by a partnership of which the non-grantor trust is a partner (or a shareholder of an S corporation) as there seems more certainty that a charitable deduction would be available in such a case.

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[221] The IRS has also ruled (privately) that a corporation may create a charitable lead trust. *See* PLR 9512002 (not precedent).

[222] Treas. Reg. 1.671-2(e)(6), Example 8. It may be of interest to note that the example concludes that the trust created by the non-grantor trust is one described in Section 678. Hence, the creating trust is not the grantor for Federal income tax purposes under Sections 671 through 677 and Section 679, but would be the owner of the trust for income trust purposes. Note that Section 170(f)(2)(B) allows an income tax deduction to the "grantor" who is the owner of the trust for income tax purposes. As discussed elsewhere, one trust cannot, at least as a general rule, be treated as another trust's grantor. It seems likely that if a trust described in Section 678 creates a charitable lead trust that is treated as a grantor trust with respect to the beneficiary who is treated as the owner, the Section 678 owner should be entitled to a deduction for the value in the lead trust committed to charity. However, it may be that having a partnership of which the Section 678 trust is a partner create the lead trust that is a grantor trust with respect to the partnership produces a more certain result of the owner of the Section 678 trust obtaining the deduction.

[223] Section 675(4)(C).

[224] See Rev. Proc. 2007-45, 2007-29 IRB 89, Section 8.09 (1); and Rev. Proc. 2008-45, 2008-30 IRB 224, Section 8.09 (1).

[225] It might be possible, pursuant to a state "decanting" law, to transfer the assets of the non-grantor trust to another non-grantor trust under which a beneficiary holds a presently exercisable special power of appointment, which may be exercised to create a charitable lead trust which would be a grantor trust with respect to the trust over which the special power is held, or under which the trustees may create such a trust. There is, nonetheless, an issue whether a Section 642(c) deduction would be allowed because the original trust from which the decanting occurred did not so authorize the creation of the trust by the trustees or a beneficiary. For information about decanting (the exercise of a power of invasion by the trustee in further trust) and some of the tax effects of decanting, see D. Zeydel & J. Blattmachr, "Tax Effects of Decanting-Obtaining and Preserving the Benefits," 111 Journal of Taxation 288 (November 2009), cited in *Morse v. Kraft*, 466 Mass. 92 (2013).

The IRS has also ruled privately that a partnership and a corporation (including an S corporation) may create a charitable remainder trust.[226] Moreover, the Service has issued a private letter ruling on some of the effects of a corporation creating a charitable lead trust, indicating that the Service accepts that a corporation may create a CLT.[227]

Hence, it seems that a partnership (that is not a disregarded entity[228]) may create a charitable lead trust and, if it is a grantor trust with respect to the partnership, an income tax deduction should be passed out to the partners including, under Rev. Rul. 2004-5, to any non-grantor trust that is a partner.[229]

However, even if the partnership or corporation is not disregarded for income tax purposes, an issue is whether, under the Treasury Regulation[230], the entity will be treated as creating the trust or whether one or more of its owners will.

F. Structure of the Partnership and Corporation that Creates the Trust

A partnership may be treated as creating a trust, including a grantor trust, if it is for its benefit as opposed to the personal benefit of a partner as may a corporation if it is for its benefit as opposed to the personal benefit of a shareholder. The regulations provide:

If a gratuitous transfer is made by a partnership or corporation to a trust *and is for a business purpose of the partnership or corporation*, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, *if a partnership or corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders*, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.[231] (Emphasis added.)

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[226] PLR 9205031and PLR 8102093 (C corporation); PLR 200644013 and PLR 9340043 (S corporation); PLR 9419021 (partnership); PLR 199952071 (limited liability company, treated as a partnership for Federal tax purposes), none of which may be cited or used a precedent.
[227] PLR 9512002 (not precedent).
[228] If the partnership is disregarded for Federal tax purposes (see Treas. Reg. § 301.7701-3 and Rev. Rul. 2004-77, 2004-2 CB 119 (entity with two partners, one of which is disregarded as to the other)), it cannot be classified as a partnership but rather will be treated as a disregarded entity unless it elects to be taxed as a corporation. If the partnership is a disregarded entity, its partners would be treated as creating the trust.
[229] If the trust that is a partner is a grantor trust, then the charitable deduction would be attributed (passed out) to the grantor. See Rev. Rul. 85-13, 1985-1 CB 184.
[230] Treas. Reg. § 1.671-2(e)(4).
[231] Treas. Reg. § 1.671-2(e)(4).

As reflected by the Treasury Regulation, partnerships and corporations often create trusts for business reasons and, in such a case, presumably would be treated as the grantor of any such trust for Federal income tax purposes. The same would seem true for a charitable remainder trust ("CRT") or charitable lead trust ("CLT") created by the entity as reflected by the private letter rulings cited in this article.

Of course, partnerships (and other business entities, such as S and C corporations) often make contributions to charities. However, there does not seem to be any requirement that the charitable contribution need be for a business purpose in order to be treated as made by the entity for income tax purposes, as opposed to being treated as made its owners.

If the creation of the charitable remainder trust or the charitable lead trust will be in fulfillment of one of the entity's business purposes, it certainly would seem to fall under the foregoing regulation that provides that a partnership or corporation may be treated as the grantor of a trust (whether or not it is a grantor trust for income tax purposes).

Hence, if a partnership or corporation creates a CLT and the entity retains the right annually to choose the charitable recipients or commits the payments to a local charities or charities in the same "industry" as the company (e.g., educational institutions if the company publishes school books and provides other educational goods) and if the remainder reverts solely to the partnership or corporation, as the case may be, when the charitable term ends, it seems the contribution to the trust is for a business purpose of the partnership or corporation and not for the personal benefit of any partner or shareholder.[232] Similarly, if a partnership or a corporation creates a CRT, it may well be treated as created by the entity (as opposed to any owner of the entity) if there is a business purpose for doing so. As mentioned elsewhere, the IRS has ruled that C corporations, S corporations and partnerships may create CRTs. One reason the entity may do that is because the entity has an asset which if sold (or distributed to its owners) would cause gain recognition. In at least some cases, an appreciated asset may be contributed to a CRT without gain recognition and the CRT may sell the asset without paying any income tax because a CRT is exempt from income tax except that, to the extent it has UBTI, which may include acquisition indebtedness, an excise tax may be imposed on such income.[233]

Even though, ultimately, everything a partnership or an S corporation does is for the benefit of its owners, it seems that creating a CLT as a grantor trust to generate a deduction for the owners or creating a CRT to eliminate income tax on the sale of an appreciated asset should be treated as being done for a business purpose of the entity. However, there seems to be a more assured way of having the creation of a CLT or CRT be treated as being for a business purpose of the entity, so the trust is not treated as created by the entity's owners.

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[232] The IRS has issued private letter rulings, which although they may not be cited or used as precedent, hold that entities, such as partnerships, may create charitable remainder trusts described in Section 664. See, e.g., PLR 9419021. See, generally, Baker & Batson, Charitable Remainder Handbook. p.1, n. 3 ("A sampling of PLRs that permit non-natural person entities to be a CRT donor includes: C-Corporation – 9205031 and 8102093; S-Corporation – 200644013 and 9340043; LLC – 199952071; Partnership –9419021; and Trust – 9821029.")

[233] See 664(c).

Suppose the entity includes in its statement of purposes philanthropic ones. Although it may seem odd that a for-profit entity would be devoted, in part, to philanthropic purposes, this has been done ever since Google created Google.org almost 20 years ago. Google.org's website states that "Google.org develops technologies to help address global challenges and supports innovative partners through grants, investments and in-kind resources." In other words, Google.org is an organization that attempts to accomplish philanthropic goals (although, apparently, its goals are not limited to purely qualified charitable purposes as described in Section 501(c)(3)). Google does so without the restrictions on activities that a tax exempt charity must follow, such as the prohibition on carrying on propaganda or otherwise attempting to influence legislation.[234] For example, apparently, Google.org may and does make "grants" to other for-profit companies that may develop technologies that may benefit human kind (such as cleaner energy). The following is a description of how Google.org is intended to operate: "By choosing for-profit status, Google will have to pay taxes if company shares [that it owns] are sold at a profit — or if corporate earnings are used — to finance Google.org. Any resulting venture that shows a profit will also have to pay taxes. It could, for example, form a company to sell…converted cars [that pollute less], finance that company in partnership with venture capitalists, and even hire a lobbyist to pressure Congress to pass legislation granting a tax credit to consumers who buy the cars."[235]

In a circumstance where the purposes of the partnership or corporation include charitable ones within the meaning of Section 664 or 170(f)(2)(B), it seems that the deduction for the value of the charitable interest committed in a charitable lead trust that is a grantor trust or a charitable remainder trust created by the partnership or S corporation should pass out to its partners or shareholders, as the case may be. In fact, the governing documents of the partnership or corporation might explicitly authorize the entity to create CRTs and CLTs to carry out its philanthropic purposes. And if an S corporation or partnership, which has such purposes and powers, creates a CRT described in Section 664 or a CLT described in Section 170(f)(2)(B), which CLT is a grantor trust, the deduction allowed for the charitable component of the trust should be deductible for income tax purposes by the shareholders or partners including any non-grantor trust or a decedent's estate that is a shareholder or partner, pursuant to Rev. Rul. 2004-5, under Section 642(c). And unlike C corporations and individuals whose income tax deductions are limited to a percentage of adjusted gross income, a decedent's estate or a non-grantor trust is entitled to an unlimited charitable deduction under Section 642(c) (except to the extent Section 681 applies).

G. Other Potential Planning Enhancement of Entity Created Trusts?

It has been suggested that certain estate planning arrangements may be better accomplished by having an entity engage in them rather than having the owner or owners of them do so. For example, it has been contended that the potential estate tax planning benefits of a self-cancelling installment sale (for which the seller of property receives a

[234] See Section 501(c)(3).
[235] See http://www.nytimes.com/2006/09/14/technology/14google.html?pagewanted=all.

note that will be cancelled if the seller or some other designated person dies before the note payment date, a so-called "self-cancelling installment note" or "SCIN") to a grantor trust may be more efficiently accomplished if a corporation creates a trust that is a grantor trust with respect to the corporation and makes the sale rather than having the shareholder make a sale of the stock in the corporation.[236]

H. Summary and Conclusions

In some cases, a better result may be obtained if a partnership or a corporation creates a charitable split interest trust, such as a charitable remainder trust or charitable lead trust, than if the trust is created by the partners or shareholders. No income tax deduction for a creation and funding of a charitable lead trust is permitted unless the trust is a grantor trust. That means that all income earned during the charitable term of the trust will be taxed to the grantor without any further deduction. In addition, the amount by which an individual may reduce his or her taxable income tax by the deduction allowed is limited to 30% or 20% of the contribution base. Also, the deduction allowed may be recaptured when grantor trust status ends (which will be no later than the death of the grantor). However, a non-grantor trust that is allowed by deduction for creation of a charitable lead trust created by a partnership of which the trust is a partner may be unlimited (that is, not limited by a percentage of any contribution base) as a general rule. Furthermore, properly structured, it seems that recapture that may occur when the lead trust is a grantor trust likely can be avoided if an entity creates the trust.

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[236] S. Horwitz & J. Damicone, "BIDIT: New Twist on Trust Design Provides Superior Results," 41 Estate Planning 3 (July 2014). The comparison made in the article may not be entirely accurate. For example, it is stated, "As stated above, with a [sale to a grantor trust for a note], [the seller/grantor] would receive a series of payments pursuant to the promissory note. If [the seller/grantor] died during the term of the note, the former 'grantor' trust would no longer be treated as a grantor trust. This means that [the seller/grantor]'s estate would recognize income on the hypothetical sale of the stock to the trust. (This assumes that [seller/grantor]'s basis in his shares is less than the outstanding amount due on the note on the date of death.)" However, as discussed in detail in J. Blattmachr, M. Gans & H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 Journal of Taxation 149 (September 2002), and confirmed in CCA 200923024 (not precedent), no gain or income is recognized in such a situation. Other issues may arise when attempting to use such a structure.