LIFETIME TRANSFERS:

INSTALLMENT SALES TO GRANTOR TRUSTS, GRATS, AND OTHER TECHNIQUES

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I. Installment Sales to Grantor Trusts

A. General

1. Freezing techniques have long been a popular way of reducing federal transfer taxes.

2. A freezing technique is a transaction by which an asset's value is frozen for purposes of determining the transferor's transfer tax base, which is the total value of his or her adjusted taxable gifts during lifetime and his or her taxable estate at death.

    a. For example, a gift of Blackacre today, when Blackacre is worth $100,000, will freeze the value of Blackacre at $100,000 forever when determining the value of the transferor's transfer tax base, assuming Blackacre will not be brought back into the transferor's estate under I.R.C. § 2036, 2037 or 2038 because the grantor has retained some right or power over Blackacre.

        (1) The donor's adjusted taxable gifts will include the $100,000 gift, assuming the donor has already used his or her entire annual gift tax exclusion for the year in which Blackacre was gifted.

    b. Selling Blackacre for $100,000 will also freeze its value for transfer tax purposes, but the $100,000 received in exchange will ultimately increase the seller's transfer tax base if it is invested in some other type of asset that produces income or grows in value, or both.

        (1) A sale of Blackacre will also result in a capital gain for the seller to the extent the fair market value of Blackacre exceeds the transferor's basis in it.

        (2) For example, if the transferor's basis in Blackacre is $10,000, the transferor will recognize $90,000 of capital gain, resulting

in a capital gain tax of $18,000, assuming Blackacre is a capital asset and the capital gain tax rate is 20%.

3. One type of freezing technique is a sale of an asset to a grantor trust, usually on the installment basis.

    a. Installment sales to grantor trusts, sometimes referred to as "defective grantor trusts," have become a popular estate planning technique in recent years.

    b. The technique freezes the value of the transferred assets at their current fair market value, while the grantor receives the interest payments on the installment note, which are hopefully less than the growth in the value of the transferred assets.

    c. The transaction should not result in any income tax consequences because it is disregarded as a sale to oneself since the grantor is treated as owning the trust assets for income tax purposes.

    d. The installment sale method also allows the trust time to pay the principal, hopefully out of earnings produced by the trust assets, although the installment payments should bear no relationship to the earnings of the assets sold to the trust; otherwise the trust assets may still be included in the transferor's estate. I.R.C. § 2036(a)(1).

B. Grantor Trusts

1. Definition

    a. A grantor trust is a trust the assets of which are treated for income tax purposes under I.R.C. §§ 671 through 679 as owned by someone other than the trustee, and who is in most cases the person who transferred the assets to the trust.

    b. Because the grantor is treated as the owner of the assets in the trust, the grantor reports on his or her own income tax return the income generated by the trust assets.

    c. A trust will be a grantor trust only in part if someone other than the person treated as the grantor also transferred assets to the trust.

        (1) More than one person may be treated as a grantor with respect to the same trust, in which case each will be treated as owning the assets he or she transferred, or was treated as having transferred, to the trust.

d. In addition, a trust may be treated as a grantor trust with respect to the income of the trust but not the principal, if the grantor's rights or powers affect only the income of the trust.

(1) In such a case, the person transferring the assets to the trust would be taxed on the ordinary income generated by the trust assets, but would not be taxed on the capital gains generated by a sale of trust assets.

2. Historical Basis for the Grantor Trust Rules

a. Historically, taxpayers attempted to shift taxable income to family members in lower income tax brackets through the use of trusts over which the taxpayer retained certain rights or powers.

(1) However, the IRS and the courts viewed such arrangements as giving the grantor sufficient control over the assets that he or she should be treated as the owner of the assets for income tax purposes.

b. After a series of cases holding that the transferor of the assets to the trust would be taxed on the income from those assets when he or she retained certain rights or powers over them, the Treasury Department issued regulations describing in detail when a person would be treated as the owner of assets he or she had transferred to a trust, which were then codified by Congress as part of the Internal Revenue Code.

c. The grantor trust rules contained in the Internal Revenue Code and the regulations set forth the circumstances in which a grantor of a trust will be treated as the owner of some or all of the trust assets. I.R.C. §§ 671 through 679.

3. Identification of Grantor

a. A person who transfers assets to a trust and retains either rights to receive either the trust income or trust principal or the power to control the enjoyment of the income or principal will be treated as the grantor of the trust under the grantor trust rules.

(1) In some cases, the rules may treat someone other than the transferor as the grantor. I.R.C. § 678

b. While in most cases of installment sales to a grantor trust it is preferable for the transferor to be treated as the owner of the trust assets, there may be planning situations in which the person treated as owning the trust assets will be someone other than the transferor, such as the transferor's child.

c. A person other than the original transferor will be treated as the owner of the trust assets if he or she relinquished the right to withdraw the income or principal from the trust while retaining some other right that would have caused him or her to be treated as the owner of the trust assets had he or she been the transferor of the assets to begin with. See I.R.C. § 678.

4. Triggering Provisions for Grantor Trust Treatment

a. The transferor of assets to a trust will be treated as their owner if:

(1) He or she has retained a right to enjoy, or to control the enjoyment of, the income or principal of the trust assets or to revoke the trust, or if someone who is related or subordinate to the transferor has a right to control the enjoyment of the income or principal of the trust assets and the exercise or non-exercise of the right will not affect such person's interest in the trust;

(2) He or she has retained certain administrative rights or powers with respect to the transferred assets; for example, the right to vote shares of stock transferred to the trust, the right to control the investment of the trust assets, the right to substitute assets in the trust for other assets of equal value, or the right to borrow from the trust; or

(3) The trust income can be used to satisfy the transferor's support obligations or to pay premiums on life insurance on his or her life.

See I.R.C. §§ 674 through 677.

b. However, even though a person is treated as owning the assets for income tax purposes, he or she may not be treated as owning the assets for estate tax purposes.

(1) In other words, a transfer of assets to a trust may be a completed gift for transfer tax purposes, but not for income tax purposes.

(2) It is this dichotomy that allows an individual to be considered the owner of the assets for income tax purposes but not for estate tax purposes.

(3) Otherwise, the installment sale to a grantor trust would not have the desired result of excluding the transferred assets from the transferor's gross estate while avoiding recognition of income as a result of the sale.

c. Before the issuance of Rev. Rul 2008-22, 2008-16 I.R.B. 796, which is discussed below, the safest ways to ensure the grantor would be treated as the owner of the trust assets for federal income tax purposes but not for federal transfer tax purposes was to give someone other than the grantor a substitution power (discussed below) or a nonadverse party the right to add beneficiaries to the trust. I.R.C. § 674(a)(c).

(1) The right to add beneficiaries was considered a safe approach, but many clients were concerned about using such a right to obtain grantor trust status.

(2) For this purpose, a person is a nonadverse party if he or she does not have a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power to add beneficiaries to the trust. I.R.C. § 672(a).

(3) In addition, the potential beneficiaries that could be added by the nonadverse party should not be so restricted under the terms of the trust agreement that the potential beneficiaries could be treated as members of a class specified in the trust agreement.

(a) Such a restriction would prevent the trust from being treated as a grantor trust.

(4) In addition, a mechanism in the trust agreement should be included to ensure that there is always a nonadverse party with this right, so that the death of the original nonadverse party would not cause a termination of grantor trust status.

(a) For example, naming the head of the firm's trust and estate practice group or his or her designee as the person who has the right to add additional beneficiaries would avoid having a period when no one had the right.

(5) Giving a nonadverse party the right to add charitable beneficiaries has been held to cause grantor trust treatment. *Madorin v. Commissioner*, 84 T.C. 554 (1992); PLRs 971006, 9709001, and 930417.

(a) However, the potential beneficiaries should not be the same as those specified in the trust agreement as the ultimate beneficiaries if there are no named beneficiaries alive to take the trust assets, since in such a case the power would not be one to add new beneficiaries, but to accelerate the rights of beneficiaries already named in the trust agreement.

(6) The right to add spouses of beneficiaries is another possibility, and may comport with the grantor's desires that, in cases where his or her child dies survived by a spouse and children, the spouse should be provided for.

d. Although a power held by the grantor or another person to reacquire the trust assets by substituting assets having the same value will cause grantor trust status if the power is held in a nonfiduciary capacity, but presumably will not cause the trust assets to be included in the grantor's estate, the IRS has taken the position that whether the power is held in a nonfiduciary capacity is a question of fact.

e. There was also a concern that, if the grantor held the power, the assets subject to the power might be includible in the grantor's estate under either I.R.C. § 2036(a)(2) or 2038, because the grantor retained the power to affect the enjoyment of the trust property.

(1) In Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (April 21, 2008), the IRS seemingly blessed the use of this technique to obtain grantor trust treatment.

(a) That ruling indicated when retaining such a right would cause the assets subject to the right to be included in the grantor's estate.

(b) A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under I.R.C. § 2036 or 2038, provided:

(i) The trustee has a fiduciary obligation under local law or the trust instrument to ensure the grantor's compliance with the terms by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value; and

(ii) The substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

(c) A substitution power cannot be exercised in a manner that can shift benefits if:

(i) The trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or

(ii) The nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

(2) In Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (December 1, 2011), the IRS applied the same analysis to a power to substitute assets of equivalent value for life insurance policies held in the trust.

f. Other possible ways to ensure grantor trust status while still avoiding estate tax inclusion are problematic.

(1) For example, while giving the grantor's spouse certain powers or rights would cause grantor trust status, the death of the spouse would terminate grantor trust status if based solely on the spouse's rights.

(2) While the power to pay premiums on insurance on the grantor's life out of income should cause grantor trust status, the IRS has not been consistent in its position as to whether the mere existence of the power is enough.

(3) Other powers raise concerns about the assets' includibility in the grantor's estate or whether the power holder is subject to a fiduciary duty either to exercise or refrain from exercising the power, depending on the power and the facts.

g. Generally, depending upon which power or right is being used to create grantor trust status, the power may be relinquished, thereby terminating grantor trust status.

(1) However, the power holder may be subject to a fiduciary duty not to relinquish a power.

(2) This problem would not exist if the power was the power to add beneficiaries, as long as no potential beneficiary could claim to have some right or power that was being eliminated.

h. Some commentators believe you can toggle back on after toggling off of grantor trust status.

(1) It would seem that the IRS could argue in such a case that grantor trust status was not really terminated.

(2) In addition, in Notice 2007-73, 2007-36 C.B. 545, the IRS treated a transaction that could be toggled off and then back on as a transaction of interest under I.R.C. §§ 6011 and 6012, and Treas. Reg. § 1.6011-4(b)(6).

i. Although there is authority otherwise, giving a so-called *Crummey* withdrawal power to one or more beneficiaries in order to qualify for the annual exclusion could result in the trust not being treated as a wholly grantor trust, causing immediate gain recognition with respect to the sale of an appreciated asset to the trust.

(1) The beneficiary would be treated as contributing the portion over which he or she had a power of withdrawal to the trust, thereby becoming the grantor with respect to that portion of the trust.

5. "Intentionally Defective" Grantor Trust

a. Referring to the transaction as a sale to an "intentionally defective" grantor trust highlights the fact that the grantor is purposely creating a trust with terms that will cause the grantor to be treated as the owner of the assets for federal income tax purposes but not for estate tax purposes.

(1) This contrasts with a situation where an individual is transferring assets to an irrevocable trust with the dual goals of excluding the transferred assets from his or her estate and shifting the income from the assets for income tax purposes to individuals in lower income tax brackets.

b. Because the grantor of a grantor trust pays tax on the income earned by the trust that will ultimately pass to younger beneficiaries, the payment of income tax by the grantor could be viewed as an additional tax-free gift to the beneficiaries of the trust.

c. Rev. Rul. 2004-64, 2004-2 C.B. 7, clarifies the tax treatment of a grantor who pays the income tax on the income earned by the trust assets.

(1) The grantor's payment of the income tax is not treated as a gift to the trust beneficiaries. In essence, the payment of the income tax is a tax-free transfer to the trust beneficiaries.

(2) If the trust agreement or state law requires the trust to reimburse the grantor for paying the income tax, the trust assets will be included in the grantor's estate under I.R.C. § 2036(a)(1).

(3) If the trust agreement prohibits reimbursement, there will be no inclusion.

(4) If the trust agreement and state law are silent on the issue or give the trustee discretion to reimburse the grantor for payment of the income tax on the trust's income, then whether the trust assets are included in the grantor's estate depends on the facts and circumstances.

(a) In this case, the trust assets are likely to be included in the grantor's estate if:

(i) The grantor can remove the trustee and appoint himself or herself as trustee;

(ii) There is an implied agreement that the trustee would always reimburse the grantor for the income taxes the grantor pays on the trust's income;

(iii) The grantor's creditors can reach the trust assets under local law; or,

(iv) Perhaps, the grantor can remove the trustee and appoint a related party, as defined in I.R.C. § 672 (c), as the trustee.

6. Trustee

a. While the grantor could be the trustee of the trust if the grantor does not retain any rights as trustee that would cause the assets in the trust to be includible in the grantor's estate, such a restriction on the trustee's discretion would reduce flexibility during the grantor's lifetime.

(1) In addition, it would be more probative of an arms-length transaction between the trust and the grantor if a person other than the grantor was serving as trustee at the time of the sale

of the assets to the trust and that person made the decision to purchase the assets and agreed to the purchase price.

b. A beneficiary could be the trustee, but the beneficiary must not hold any powers as trustee that would cause some or all of the assets in the trust to be included in the beneficiary's estate for federal estate tax purposes if one of the goals is to bypass the beneficiary's estate.

c. In some cases, a trust company may be the most appropriate candidate to serve as trustee or at least as a co-trustee.

(1) Not only would this give more credence to the arms-length nature of the transaction, but also would allow the trustee more flexibility with respect to distributions of income and principal, both during the grantor's lifetime and after the grantor's death.

C. Sale to a Grantor Trust

1. Tax Benefits

a. If the grantor of a grantor trust later sells appreciated assets to the same trust, he or she will not recognize any taxable income as a result of the sale, since for income tax purposes he or she is treated as selling the assets to himself or herself. See, e.g., Rev. Rul. 85-13, 1985-1 C.B. 184, which rejected the holding in *Rothstein v. United States*, 735 F.2d. 704 (2d. Cir. 1984), that a sale between a grantor and a trust treated as a grantor trust under I.R.C. § 675 was a taxable event.

b. If the seller takes back an installment note in exchange for the transferred assets, the trust can pay for the assets over a period of time rather than at the time of the sale.

c. From an estate planning perspective, unless the grantor has retained certain rights that would cause the trust assets to be included in his or her estate after death, the sale will remove the appreciating or income-producing assets from his or her estate, thereby resulting in a gift tax-free transfer of the appreciation or income to the trust beneficiaries.

d. Furthermore, the grantor will further reduce his or her taxable estate by paying income tax on the earnings from the trust's investments, even though the earnings inure to the benefit of the trust beneficiaries and not the grantor.

e. Finally, the ability to allocate the grantor's generation-skipping transfer (GST) exemption to the gift of the seed money to the trust means that the trust will have a zero inclusion ratio as long as no additional gifts are made to the same trust to which additional GST exemption is not allocated.

2. Disadvantages

a. While the desired tax consequences of an installment sale to a grantor trust are based on existing statutes, regulations, and case law, there is no authoritative statement by the Treasury Department or IRS approving all the desired income and transfer tax consequences.

b. Although the IRS has ruled favorably on some of the issues, there are a number of issues still unresolved, such as the income tax consequences if the grantor dies before the note is satisfied in full and how much property needs to be in the trust before the sale takes place to ensure that the assets sold to the trust will not be included in the grantor's estate under a retained right-to-income theory. See the discussion of the *Karmazin* and *Woelbing* cases below, where the IRS raised a number of issues, including I.R.C. §§ 2701 and 2702.

3. Funding of a Grantor Trust

a. Many commentators feel that the trust should hold assets having a value equal to at least 10% of the value of the installment note that will be given in exchange for the assets to be sold to the trust by the grantor.

b. The same person who intends to sell assets to the trust should give these assets to the trust so that the seller will be treated as the owner of all the trust assets.

c. Some commentators have suggested that the trust beneficiaries could guarantee the installment note, thereby avoiding the necessity of making a taxable gift to the trust.

(1) While it could be argued that a beneficiary's guarantee of the note should not be treated as a gift by the beneficiary to anyone unless the beneficiary actually has to pay off the note pursuant to the guarantee, the IRS could argue that the guarantee is a gift to other beneficiaries of the trust or, instead, to the grantor.

(a) If the IRS were successful, the trust would no longer be treated as a wholly grantor trust, thus possibly triggering gain to the extent the balance of the outstanding principal exceeds the grantor's remaining basis in the transferred assets.

(2) A guarantee may have a better chance of not being treated as a gift if the beneficiary or beneficiaries guaranteeing the payments were paid a fee.

(a) The value of the guarantee for gift tax purposes would be uncertain.

(b) The guarantee could be for only a portion of the note so that the fee would be lower.

(3) A taxable gift of seed money by the grantor to the trust avoids the uncertainties involved in using a guarantee.

(a) Note that, while not an issue in the case, 10% seed money was used in *Petter v. Commissioner*, T.C. Memo 2009-280, which involved two installment sale-to-grantor-trust transactions, and where the taxpayer prevailed in a challenge to a defined value allocation formula.

4. Role of Life Insurance

a. If the grantor trust owns life insurance on the grantor's life, the proceeds could be used to pay off the loan at the grantor's death.

b. Life insurance proceeds also could be used to buy assets from the grantor's estate or loan money to the grantor's estate to provide cash to pay estate taxes.

c. Life insurance proceeds could also be used to equalize the amount the grantor's other children are receiving at the grantor's death, when the assets that have been sold to the trust are business assets that will eventually pass at the termination of the trust only to those children who are active in the business.

d. It may be advisable to have a separate irrevocable life insurance trust hold the life insurance policies so that the proceeds would not be subject to any liabilities that might arise from the assets held in the trust, particularly if assets in the trust are used in a business or consist of real estate that could become contaminated by toxic waste.

5. Non-Tax Benefits

a. An installment sale to a grantor trust can be used to deal with a situation where an individual owns a business and wishes to transfer most, if not all, of the business to one or more, but fewer than all, of his or her children and still treat all the children equally.

b. By using the installment sale technique, the individual receives back a note that can then be left to the other children if the individual dies before the note is paid, and the proceeds of which can be invested in another asset that can be left to the other children, without incurring any income tax on the unrealized appreciation in the business.

(1) While the value of the business will be frozen at the time of the sale for purposes of determining the individual's wealth, any interest payable on the note and earnings on principal payments that are invested will increase the individual's wealth, although perhaps at a different rate than the growth of the business.

(2) It could be argued that if the children receiving the business are actively participating in the business, any increase in the value of the business after the sale is attributable to their efforts.

c. Example:

Mr. Entrepreneur owns 100 shares of the stock of an S Corporation having a fair market value of $20,000,000. He also owns commercial real estate having a fair market value of $20,000,000. He has four children, two active in the business and two not active in the business. He wants to treat the children equally, but does not want the children who are inactive in the business to have any ownership in the business.

To carry out his desires, Mr. Entrepreneur could do the following:

(1) Recapitalize the corporation to create 10 shares of voting stock and 90 shares of nonvoting stock.

(2) Sell 90 shares of nonvoting stock to a grantor trust having as its beneficiaries the two children who are active in the business.

(a) Assuming a 50% combined discount for lack of control and marketability, the value of the stock sold to the trust would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).

(3) Transfer the commercial real estate to a limited liability company (LLC) in exchange for a 90% nonvoting membership interest and a 10% voting membership interest.

(4) Sell the 90% nonvoting membership interest in the LLC to a grantor trust having as its beneficiaries the other two children.

(a) Assuming a 50% combined discount for lack of control and marketability, the value of the LLC interests sold to the trust would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).

(5) To avoid a number of potential tax problems, Mr. Entrepreneur should contribute $1,000,000 to each of the trusts, using some of the combined gift tax applicable exclusion amounts of him and his wife ($1,2060,000 each in 2022).

(6) At his death or the death of the survivor of him and his wife, Mr. Entrepreneur would leave the voting stock in the corporation to the two children active in the business and the remaining membership interests in the LLC to the other two children.

6. Appropriate Assets to Be Sold to a Grantor Trust

a. As with any freezing technique, assets that are expected to increase in value should be sold to a grantor trust.

b. However, if the assets transferred to the trust do not appreciate at a rate faster than the interest rate the trust is required to pay on the note to avoid a deemed gift under the below-market interest rate rules under I.R.C. § 7872, the transfer tax benefit will be limited to the income tax paid by the transferor on the income accumulated in the trust.

c. Because a grantor trust qualifies as an eligible shareholder of an S corporation, a grantor can sell S corporation stock to a grantor trust without jeopardizing the S corporation election. I.R.C. § 1361(c)(2)(A)(i).

7. Other Issues

a. It is important to establish separate trusts for each donor/seller (e.g., a husband and wife), so that the trusts will be treated as grantor trusts with respect to only one grantor.

(1) Otherwise, when one of the donors dies, the trust would no longer be treated as a wholly grantor trust with respect to the surviving grantor.

b. In a community property state, the husband and wife should be careful to transfer separate property to the trust to ensure it is a wholly grantor trust with respect to the transferring spouse.

(1) This may require a community property agreement whereby the spouses agree that what was community property is now the separate property of each spouse.

c. If the value of the trust assets declines to the extent the trust can no longer pay off the installment note, the grantor will have wasted any gift tax applicable exclusion amount.

(1) However, there should be no income from discharge of indebtedness because of the grantor trust status of the trust; the grantor is on both sides of the debt.

D. Tax Consequences

1. Income Tax

a. Because the grantor is treated as owning the assets in the trust for income tax purposes, a sale to the trust will be treated as a sale to the grantor, and, therefore, the grantor will not recognize any taxable income as a result of the sale. See Rev. Rul. 85-13, *supra*.

b. If grantor trust status terminates before the grantor's death while the installment note received in exchange for the assets is still outstanding, the grantor presumably recognizes taxable income equal to the amount of gain represented by the unpaid portion of the note. See *Madorin v. Commissioner*, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), *Example (5)*; and Rev. Rul. 77-402, l977-2 C.B. 222.

For example, if in the earlier example Blackacre is sold to the trust and the seller receives in exchange an installment note providing for a balloon payment of principal at the end of ten years and grantor trust status is terminated after five years, the seller would recognize taxable gain of $90,000, resulting in an $18,000 capital gain tax, assuming the asset was a capital asset in the hands of the seller. Presumably, if the trust had paid half of the principal before the grantor trust status terminated, the seller would recognize only 50% of the unrealized appreciation of Blackacre, or $45,000, and the capital gain tax would be $9,000.

c. A trust's status as a grantor trust terminates upon the grantor or other person treated as the grantor relinquishing whatever rights or powers he or she held that caused the trust to be treated as a grantor trust.

(1) Although it would be inadvisable for the grantor (or other person whose rights or powers over the trust assets cause the grantor to be treated as the owner of the trust assets) to give up such rights or powers while the note was outstanding,

grantor trust status will terminate at the grantor's death in any event.

(2) Whether death causes an income recognition event if the note is then outstanding is discussed below.

d. Interest paid to the grantor while the trust is a grantor trust will not be taxable income to the grantor or deductible by the trust.

e. Since the grantor is treated as owning the assets in the trust, the trust will have the same basis in the assets it purchases from the grantor as the grantor had.

f. If the grantor has gifted other assets to the trust in an effort to avoid inclusion of the sold assets in the grantor's estate, the trust's basis in the gifted assets will be the grantor's basis plus any gift and generation-skipping transfer (GST) tax paid on any unrealized appreciation in the assets (but not in excess of the gifted asset's fair market value at the time of the transfer). I.R.C. § 1015.

g. Finally, neither the trust nor the grantor will recognize taxable income if appreciated assets are used to satisfy the note.

2. Gift Tax

a. If the sale of the assets to the trust is considered made for full and adequate consideration in money or money's worth, the seller should not be treated as making a taxable gift as a result.

(1) The Internal Revenue Service (IRS) will treat the installment note received in exchange for the assets as full and adequate consideration if the face amount of the note is equal to the fair market value of the assets sold to the trust and the interest paid on the outstanding balance of the note is equal to the applicable federal rate (AFR) under I.R.C. § 1274. See *Frazee v. Commissioner,* 98 T.C. 554 (1992).

b. The AFR depends upon the term of the note.

(1) If the term of the note is three years or less, the AFR is the short-term rate, which was .44% (compounded annually) for January 2022.

(2) If the term of the note is more than three years but no more than nine years, the AFR is the mid-term federal rate, which was 1.30% (compounded annually) for January 2022.

(3) If the term of the note is over nine years, the AFR is the long-term federal rate, which was 1.82% (compounded annually) for January 2022.

c. The AFR in most cases will be less than the I.R.C. § 7520 rate that must be used when valuing a retained interest in a grantor retained annuity trust (GRAT). I.R.C. § 2702(a)(2)(B).

(1) The § 7520 rate is 120% of the federal mid-term rate, and for January 2022 was 1.6%.

(2) If the term of the note is over three years but no more than nine years, the AFR will always be less than 120% of the mid-term federal rate.

(3) Furthermore, generally the short-term AFR and, occasionally, the long-term AFR have been less than 120% of the mid-term federal rate.

d. Consequently, one of the benefits a sale to a grantor trust has over a GRAT is that the minimum required interest rate for determining the amount that must be payable to the grantor (as interest pursuant to the installment sale or the value of the retained annuity interest in the case of the GRAT) is generally lower in the installment sale than in the GRAT.

(1) In a GRAT, the property must appreciate in value by more than 120% of the federal mid-term rate before there has been a tax-free transfer of value to the remainder beneficiaries of the GRAT, while in the case of an installment sale to a grantor trust, the property needs only to appreciate in value by more than the AFR.

e. In a supplemental memorandum opinion, Judge Kroupa held that the step transaction doctrine applied to treat the gifts and sales of LLC membership interests as one transfer so that the transfers were treated as transfers of 50% interests. *Pierre v. Commissioner*, T.C. Memo 2010-106.

(1) According to Judge Kroupa, nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions.

(2) In addition, they were planned as a single transaction and that the multiple steps were used solely for tax purposes.

(3) However, because the IRS did not offer an expert on the valuation of the interests, relying on its position that the

transfers were of the underlying assets, the Court accepted the taxpayer's expert's opinion that the lack of control discount should be reduced from 10% to 8%.

(a) The Court also accepted the taxpayer's original 30% discount for lack of marketability.

(b) The taxpayer's expert at trial increased the lack of marketability discount to 35%, but the taxpayer did not advocate the increase.

(4) Consequently, the only effect of the application of the step transaction doctrine in this case was a slight reduction in the lack of control discount.

(a) However, it is not likely that the IRS would fail to offer expert testimony in future cases involving the collapsing of related gifts and sales to reduce the lack of control discount, or, in some cases, to advocate a premium when the two transactions result in the transfer of a majority or controlling interest.

f. An installment sale to a grantor trust should not be subject to the special valuation rules under I.R.C. § 2701 if the installment note is not treated as an equity interest, and should not be treated as a retained interest under I.R.C. § 2702 if the installment note is not treated as a retained interest in the trust. See PLRs 9535026 and 9436006. But see the discussion of the *Karmazin* and *Woelbing* cases below.

3. Estate Tax

a. Unless the transferor has retained rights over the assets in the trust that would cause the assets to be included in his or her estate, the assets in the trust, including the assets sold in exchange for an installment note, should be excluded from the transferor's estate at his or her death, regardless of whether he or she dies before or after the note has been paid in full.

(1) The fact that the assets sold to the trust will not be included in the transferor's estate regardless of when the transferor dies is a second advantage the installment sale to a grantor trust has over a GRAT, since in the case of a GRAT, the value of some or all of the transferred assets will be included in the transferor's estate if he or she dies before his or her annuity interest terminates.

b. In this regard, many commentators advise that before the sale the trust should already hold assets having a value equal to at least 10% of the amount of the installment note so as to prevent an argument that the grantor has retained an interest in the sold assets that would cause the assets to be included in the grantor's estate under I.R.C. § 2036(a)(1) because there are no other assets available to pay off the note.

(1) The IRS in at least one private letter ruling dealing with the installment sale technique apparently accepted the 10% amount. PLR 9535026.

(2) In addition, 10% of a corporation or partnership's value is the minimum value that can be assigned to the residual interest in such entity when applying the special valuation rules under I.R.C. § 2701(a)(4).

(3) *Petter v. Commissioner*, T.C. Memo 2009-280, involved installment sales of LLC units to grantor trusts, where the donor gave the trusts gifts of LLC units before the sales equal to 10% of the value of the total units held in the trusts after the sales.

(a) However, the sales to the grantor trusts were not at issue in the case.

c. Finally, principal and interest payments on the note should not be related to the income produced by the assets sold to the trust and all trust assets should be liable to pay the note, again to avoid an argument that the transferor has retained an interest in the assets sold to the trust. See, e.g., *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958).

4. GST Tax

a. Because the assets initially given to a trust to establish it as a grantor trust will not be included in the grantor's estate, the estate tax inclusion period (ETIP) rules will not prevent the grantor from immediately allocating his or her GST tax exemption ($12,060,000 for transfers in 2022) to the gift.

(1) An ETIP is a period during which assets transferred to a trust will be included in the transferor's estate, other than because of the transferor's death within three years of the transfer. I.R.C. § 2642(f)(3).

(2) Under I.R.C. § 2642(f), a transferor's GST tax exemption may not be allocated to a transfer during an ETIP.

(a) For example, if the transferor retains the right to the income from the assets transferred to a trust, he or she will not be able to allocate his or her GST exemption to the transfer until the first to occur of the termination of his or her right to the income or his or her death.

(3) Note that because some or all of the assets in a GRAT will be includible in the transferor's estate if the transferor dies before the transferor's interest in the GRAT terminates, the transferor will not be able to allocate his or her GST exemption to the transfer until the termination of his or her interest in the GRAT.

b. The ability to allocate the GST exemption at the time of the initial gift is a third advantage of the installment sale technique over a GRAT.

c. Additionally, the subsequent installment sale of assets to the trust will not be a generation-skipping transfer if it is for full and adequate consideration in money or money's worth.

E. Death of Grantor Before Satisfaction of Note

1. Introduction

a. The tax consequences are not entirely clear if the grantor dies before the installment note has been satisfied.

b. Regardless of whether the installment note has been paid in full before the grantor dies, nothing in the trust should be included in the grantor's estate, provided the grantor retained no powers or rights over the trust assets that would cause the trust assets to be included in his or her gross estate.

2. The note, of course, will be included in the grantor's estate for estate tax purposes.

a. It is arguable that the note could be valued at less than its face value under Treas. Reg. § 20.2031-4, which reads:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate,

date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

b. Note that proposed Treas. Reg. § 20.7872-1 prohibits the discounting, at other than the applicable federal rate, for estate tax purposes, of any gift term loan made by a decedent with donative intent after June 6, 1984.

(1) However, this is only a proposed regulation issued in 1985.

(2) In addition, because the proposed regulation applies to gift term loans made with donative intent, it should not apply to an installment note received in a sale transaction designed to avoid any taxable gift.

3. Termination of Grantor Trust Status at the Grantor's Death

a. Because the grantor trust status of the trust terminates when the grantor dies, some commentators argue that the estate will recognize taxable income if some or all of the note remains unpaid at the grantor's death.

(1) Presumably, such income will be in the form of capital gain equal to the unpaid portion of the note less a portion of the grantor's basis (assuming that the assets sold to the grantor trust were capital assets).

(2) The gain may be treated as recognized by the grantor before his or her death, and will be reported in the grantor's final income tax return unless the sale qualified for installment sale treatment for income tax purposes, in which case the gain will be recognized by the recipient, usually the grantor's estate or beneficiary, as the note is paid off and the recipient will be entitled to a deduction for the federal, but not state, estate tax attributable to the inclusion of the unpaid balance of the note in the grantor's estate.

(3) If the gain is treated as recognized after the grantor's death, it could be argued that there is no taxable gain because the installment note receives a step-up in basis equal to the value of the assets sold to the trust at the date of the sale.

b. Some commentators contend that the payments on the note after the death of the grantor are not items of income in respect of a decedent because they would not have been taxable to the decedent had the decedent received the payments during his or her lifetime on account of the grantor trust rules.

(1) Although there are precedents for treating the termination of grantor trust status during the grantor's lifetime as an income recognition event for income tax purposes, including the authorities cited earlier, the better reasoned view is that these precedents do not apply in the case of an installment sale to a grantor trust if the grantor dies with the note outstanding and, therefore, there should be no taxable income to the grantor or the grantor's estate at the grantor's death.

(2) For a discussion of this issue, in which the authors take the position that gain should not be realized at death, see Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 TAX MGMT. EST., Gifts & TR. J. 3 (1999).

c. A second issue that arises if the grantor dies before the note is satisfied is whether there is any increase in the basis of the assets that were sold to the trust pursuant to the installment sale.

(1) While a convincing argument can be made that the basis of such assets should be stepped up to the outstanding balance of the installment note, such a result seems inconsistent with the income tax consequences to the grantor.

(a) However, if income is recognized by the estate or beneficiary receiving the note, the trust's basis in the property should be increased by the amount of gain recognized.

(2) Certainly, the basis of the assets would not be increased under I.R.C. § 1014(a) to their fair market value at the grantor's death, because they are not includible in the grantor's estate.

(a) I.R.C. § 1014(a) provides that an asset includible in the gross estate of the decedent, other than items of income in respect of a decedent described in I.R.C. § 691(a), obtains a new basis for income tax purposes equal to the fair market value of the asset at the date of death, or the alternate valuation date if elected.

F. Using Formulas to Define Transfers

1. Introduction

a. Because interests in limited partnerships and LLCs are difficult to value, taxpayers are often hesitant to make gifts of such interests for fear of incurring gift tax, or more gift tax than they would otherwise want to incur.

b. One way of dealing with this problem is to use a defined value formula, which would limit transfers, whether by gift or sale, to a specific amount, with any excess passing in such a way that there will be no additional taxable transfer in excess of the stated dollar amount, because the excess value:

(1) Passes to a charity;

(2) Passes to a spouse or a trust for the benefit of a spouse that qualifies for the marital deduction;

(3) Passes to a zeroed out GRAT (so there is no present value of the remainder);

(4) Reverts to the transferor; or

(5) Is not a completed gift because it passes to a trust over which the grantor has retained some power that makes it an incomplete gift.

c. Five recent cases have blessed the use of defined value formulas, although the facts in each case, including the type of formula and the identity of the recipients of the excess value, are important to keep in mind when considering the effectiveness of using such a formula.

(1) *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006) *rev'g* 120 T.C. 358 (2003), involved a defined value allocation formula with the excess passing to a charitable organization.

(2) *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd.* 104 AFTR 2d 2009-7352 (8th Cir. 2009), involved a formula disclaimer, with the excess passing to a charitable foundation.

(3) *Petter v. Commissioner*, T.C. Memo 2009-280, *aff'd,* 108 AFTR 2d 2011-5593 (9th Cir. 2011), involved gifts and sales of LLC units to grantor trusts where the number of units gifted and sold were determined pursuant to a defined value formula, with the excess units passing to two charitable organizations.

(4) *Hendrix v. Commissioner*, T.C. Memo 2011-133, involved a defined value allocation formula in connection with sales and gifts with the excess passing to a charitable organization.

(5) In *Wandry v. Commissioner*, T.C. Memo 2012-88, the Tax Court approved a defined value transfer formula that decreased the amount passing by gift to avoid any gift tax.

(a) The court actually treated the formula as a defined value allocation formula, although it was really a defined value transfer formula.

(b) Although the government dropped its appeal of *Wandry*, it has stated it does not acquiesce in the decision. AOD 2012-004, 2012-46 I.R.B., 11/13/2012.

(i) IRS believes that Tax Court erred in determining that the property transferred for gift tax purposes was anything other than fixed percentage membership interests transferred on the date of the gift to each donee, which was how the gifts were reported on the gift tax returns.

(ii) Presumably it is looking for a case with better (worse) facts to challenge such a formula.

(iii) Actually, the facts in *Wandry* were not great for the taxpayer: the gift tax returns described the gifts as gifts of a percentage membership interest and the appraisal was not done until nineteen months after the gifts.

2. The IRS's Position

a. Based on *Proctor v. Commissioner*, 142 F.2d 824 (4th Cir. 1944), the IRS has challenged defined value formulas, regardless of the type, based on two arguments:

(1) The defined value formula was a condition subsequent because the gift was contingent on an event occurring after the transfer; i.e., the determination of the value of the transferred assets; and

(2) The defined value formula was against public policy, because:

(a) The formula clause had a tendency to discourage the collection of the tax because efforts to collect would simply undo the gift;

(b) The effect of the clause would be to obstruct the administration of justice by requiring the courts to pass upon a moot case; and

(c) A judicial proclamation on the value of the gift would be a declaratory judgment, because the condition is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment.

b. The Courts in *McCord*, *Christiansen, Petter, Hendrix,* and *Wandry* held that the defined value formula in those cases was not a condition subsequent, because it did not affect the amount transferred, but just reallocated the transferred assets based on the value at the time of the transfer, even though the value was not finally determined until a later date.

c. The same courts also held that the defined value formula clauses under the facts in those cases did not violate public policy.

(1) There is a public policy in favor of encouraging gifts to charities, although this was not a factor in *Wandry*.

(2) The court in *Petter* was not passing on a moot case; because of the potential sources of enforcement, it had little doubt that a judgment adjusting the value of each unit would actually trigger a reallocation of the number of units between the trusts and the foundations under the formula clause.

(3) For the same reason, the court was not issuing merely a declaratory judgment.

3. Designing the Formula

a. Based on *McCord, Christiansen, Petter,* and *Hendrix,* a defined value allocation formula, rather than defined value transfer formula, stands a better chance of being accepted by the courts.

b. A defined value transfer formula defines the dollar amount of a transfer that the transferor intends to make, and if the value of the assets is determined to be higher, then a portion of the assets reverts to the transferor.

(1) Such a formula could read as follows: I give 50 shares of XYZ Company to my child, provided that if the value of the shares exceeds $1,000,000, then the number of shares

transferred shall be reduced so that the value of gifted shares does not exceed $1,000,000.

(2) This was the type of formula used in *Proctor*, and a number of other cases in which the taxpayer was not successful. See, e.g., *Knight v* Commissioner, 115 T.C. 506 (2001), *Ward v. Commissioner*, 87 T.C. 78 (1986), and *Harwood v. Commissioner*, 82 T.C. 239 (1984).

(3) However, if the formula states that that the transfer is the number of shares having a value, as determined for federal transfer tax purposes, equal to $1,000,000, then it is arguable that a transfer has only been made of the number of shares having such a value.

(4) This is the language that was used in the *Wandry* case.

(a) As one commentator said, such a formula is similar to asking the gas station attendant to give you $5.00 worth of gas.

(b) The key to such a formula being effective is to ensure that the actual transfer under contract law is the amount of interests in the entity (shares, LLC membership interests, limited partnership interests) equal to a specific dollar amount, based on the value of such interests as finally determined for federal gift tax purposes.

(c) The amount of interests initially treated as being transferred may be based on an appraisal, but it should be clear that the actual amount of interests transferred will be adjusted if the value is later adjusted by the IRS.

(5) One problem with using this technique is that if the amount of equity interests transferred turns out to be different than the amount originally thought to be transferred, adjustments to the taxable income recognized by the donor and the donee may require amended tax returns.

(a) However, if the transfers are to trusts that are treated as grantor trusts, no such returns would be required, because all the income would be taxed to the grantor in any event.

c. A defined value allocation formula allocates the transferred assets among various transferees, usually defining the dollar amount of the transfers subject to gift tax, and the balance passing in some way that will not result in any gift tax liability.

(1) Such a formula could read as follows: I give 50 shares of XYZ Company to my child, provided that if it is determined that the value of the shares exceeds $1,000,000, then shares having a value in excess of $1,000,000 shall pass instead to the Community Foundation.

(2) This is the type of formula used in *McCord, Christiansen*, *Petter*, and *Hendrix*, all cases where the taxpayer was successful.

d. Although not used in the McCord and Hendrix cases, it may be better to have the value tied to the value as finally determined for federal transfer tax purposes, which was the case in *Christiansen, Petter,* and *Wandry*.

(1) The Tax Court in *McCord* indicated that tying the value for purposes of allocating the transferred assets pursuant to the formula to the value as determined for federal gift tax purposes might have resulted in a holding in favor of the taxpayer.

(2) However, on appeal, the taxpayer was successful in having the formula apply to avoid any additional gift tax, without the Fifth Circuit dealing with the manner in which value was determined for purposes of applying the formula.

e. Because the facts in all four cases before *Wandry* where the court has upheld the validity of the defined value allocation formula involved transfers of the excess value to a charitable organization, the jury is still out whether such a formula would work where the recipient was a spouse, a trust for the benefit of the spouse that qualifies for the marital deduction, or a zeroed-out GRAT, or the excess value passes to a trust where the grantor has retained a right or power that prevents the transfer from being a completed gift.

(1) However, in *Wandry v. Commissioner*, the Tax Court approved a defined value transfer formula that decreased the amount passing by gift to avoid any gift tax.

(2) Note that there are a number of transactions where the IRS or the regulations accept the use of defined value transfer formulas where there is no real adversity between the parties involved.

(a) These include optimum marital deduction formulas, formulas with GRATs, formula disclaimers, and formula inter vivos QTIP elections.

4. It is imperative that the gift be reported on the gift tax return as a gift of a dollar amount and not a percentage interest or a number of units, although it can be stated that, based on an appraisal, the initial percentage is X% or number of units is X, but the actual percentage may be adjusted based on the value of the gift as finally determined for federal gift and estate tax purposes.

a. In *Nelson v. Commissioner*, T.C. Memo 2020-81, *aff'd* 128 AFTR2d 2021-6532 (5^{th} Cir, 2021), the Tax Court rejected the petitioners' argument that transfers by gift and by sale to an irrevocable trust were of specific dollar amounts, not fixed percentages, because the value of the transfers was to be determined by an appraiser within a fixed period and were not qualified by a subsequent determination of value for federal gift and estate tax purposes, distinguishing the cases where the formula provided that the actual percentage of interests transferred would be adjusted based on values as finally determined for federal gift and estate tax purposes, even though the initial percentage was based on an appraisal done after the initial transfers.

b. In *Nelson*, the gift and the sale assignments referred to the gift or sale as the donor's or seller's right, title, and interest in a limited partnership interest having a fair market value of a dollar amount as determined by a qualified appraisal within 90 (180 in the case of the sale) days of the effective date of the agreement.

G. Potential IRS Challenges

1. Introduction

a. One of the disadvantages of the installment sale to a grantor trust technique is the uncertainty of the tax consequences.

b. Although most of the expected tax consequences are based on existing case law, the Code, regulations and rulings, the IRS has not blessed the technique in any published ruling.

2. The *Karmazin* Case.

a. Against this background, a docketed Tax Court Case, *Karmazin v. Commissioner*, Docket #2127-03, which was settled on October 15, 2003 before it went to trial, demonstrates the potential issues the IRS would likely raise in challenging the technique.

b. Summary of the Facts

(1) Taxpayer gifted limited partnership units to two grantor trusts, which had a value of 10% of the trust assets after the subsequent sale of additional units.

(2) Next, the taxpayer sold units to the trusts in exchange for promissory notes bearing interest at the applicable federal rate (AFR) and secured by a pledge agreement pledging both the purchased and gifted units.

(3) A defined value formula was used to determine the number of units sold, based on an overall discount of 44.22%.

(4) Annual exclusion gifts were made in the year of the sale and the following year.

(5) Following an audit of the gift tax returns for both years, the agent issued a determination letter disallowing the entire transaction.

c. Issues Relating to the Installment Sale Transaction

(1) The partnership was a sham because there was no business purpose.

(2) I.R.C. § 2703 applied to disregard the partnership.

(3) The defined value clause, incorrectly categorized as an adjustment clause by the IRS, was invalid, based on *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

(4) The promissory note was equity and not debt, based on the following factors:

(a) The debt to equity ratio was too high;

(b) The only assets in the trusts were partnership units;

(c) The debt was non-recourse and therefore note-holders and equity-holders would be affected proportionately (ignoring the secured nature of the promissory notes); and

(d) Commercial lenders would require personal guarantees or a larger down payment

(5) If the debt were recharacterized as equity, either I.R.C. § 2701 or 2702 or both would apply.

(a) The notes would not be treated as qualified payment rights under I.R.C. § 2701 and would be valued at zero under the subtraction method.

(b) The right to interest payments under the notes would not be qualified interests under I.R.C. § 2702 because the trusts did not satisfy the requirements of a GRAT.

d. Settlement of the case

(1) The case was settled, resulting in a 95% reduction in the deficiency asserted by the agent.

(2) The settlement was based on respecting the sales of the partnership units to the trusts as bona fide sales.

(a) The sales were not recharacterized as transfers with the retention of an annuity.

(b) The interest payments were not recharacterized as annuity payments.

(c) Neither I.R.C. § 2701 nor 2702 applied.

(d) The defined value clause was ignored.

3. The *Woelbing* Case

a. In *Estate of Woelbing v. Commissioner*, T.C. No. 030261-13, the IRS argued that I.R.C. §§ 2702, 2036 and 3038 applied.

b. The involved a sale of nonvoting stock in a closely held corporation to a grantor trust in exchange for an installment note in the amount of $59 million.

(1) The IRS claimed that the value of the note was zero.

(2) The rate of interest was the AFR rate, the sales price was determined by an independent appraiser, and the sons, who were beneficiaries of the trust guaranteed 10% of the debt and the trust already held life insurance policies with a cash value of $12 million.

(3) The case settled without any resolution of issues raised by the IRS.

H. Conclusion

1. An installment sale to a grantor trust may be a very effective way to transfer assets to younger family members at their current value, as opposed to their presumably appreciated date-of-death value, without incurring any gift or income tax on the transfer.

2. The value of the principal and interest payments received on the note will remain in the grantor's transfer tax base.

3. The disadvantage to the beneficiaries is that they will end up with the same carryover basis that the trust will have in the assets sold to the trust.

4. However, if the technique is to be used, the formalities should be followed to the letter, including a properly drafted trust agreement, installment note, and any other documents required under state law to transfer ownership of the assets to the trust and to support the grantor's status as a bona fide creditor of the trust.

5. Finally, the installment sale to a grantor trust should be compared with other techniques, such as a preferred equity interest transaction, a GRAT, or a financed net gift, and the use of a self-cancelling installment note (SCIN) or a private annuity should be considered if the grantor is in poor health but not terminally ill.

6. Note the Built Back Better Act would have eliminated the advantages of the sale to a grantor trust by including in the grantor's estate the grantor trust portion of the trust and treating distributions during the grantor's as taxable gifts and sales between the grantor trust and the grantor as taxable events.

II. Alternatives to Installment Sales

A. Preferred Equity Interests

1. Similar benefits to those achieved with an installment sale to a grantor trust may be derived through the use of either a preferred equity interest transaction, a GRAT, or a financed net gift.

   a. In a preferred equity interest transaction, the older family member will receive pursuant to the creation or recapitalization of a partnership or corporation a preferred interest in the entity that will not increase in value, even though the entity's assets, including intangible assets, do increase in value after the recapitalization.

   b. The holder of the preferred interest will be entitled to receive a preferred distribution on an annual basis.

(1) Because a preferred equity interest involves the creation of two classes of equity interests, an S corporation cannot be the subject of a preferred equity interest transaction.

(2) In addition, because the preferred payment by a C corporation will be a dividend that will be includible in the recipient's taxable income and not deductible by the corporation, resulting in a double tax (once on the income earned by the corporation to pay the dividend and once to the recipient when he or she receives the dividend), a C corporation is usually not a good candidate for a preferred equity interest transaction.

c. Consequently, today most preferred equity interest transactions involve limited partnerships and limited liability companies (LLCs), which, because they are pass-through entities for federal income tax purposes, avoid two layers of tax.

2. I.R.C. § 2701 ignores the value of applicable retained interests in a partnership or LLC for purposes of determining the value of subordinate equity interests transferred to the transferor's spouse and descendants and spouses of descendants of the transferor and the transferor's spouse. I.R.C. § 2701(a)(1), (a)(3)(A), and (e)(1).

a. "Applicable retained interests" are certain senior equity interests (*i.e.*, equity interests that carry a preferred right to income or capital distributions) retained by the transferor and the transferor's spouse and ancestors and spouses of ancestors of the transferor or the transferor's spouse. I.R.C. § 2701(a), (b), and (e)(2); Treas. Reg. § 25.2701-3(a)(2)(ii).

b. A "senior equity interest" is an applicable retained interest to the extent it gives the holder (1) an extraordinary payment right or (2) a distribution right (the right to receive distributions from the entity) if the transferor and members of the transferor's family control the entity. I.R.C. § 2701(b)(1).

(1) An extraordinary payment right is the right to put or call the interest (*i.e.*, to force the entity to purchase the interest from the holder or to require the entity to sell an interest in the entity to the holder), to convert the interest into a subordinate equity interest, or to compel the liquidation of the interest (essentially a put right). I.R.C. § 2701(b)(1)(B); Treas. Reg. § 25.2701-2(b)(2).

(2) The transferor and members of the transferor's family (defined for this purpose as including descendants of the

parents of the transferor or the transferor's spouse, as well as ancestors and spouses of ancestors of the transferor and his or her spouse) control an entity if any of them is a general partner in a limited partnership (or presumably a member-manager in a manager-managed LLC) or together they own 50% or more of the equity interests in the entity. I.R.C. § 2701(b)(1), (b)(2).

(3) A distribution right does not include (i) a right to distributions with respect to any interest that is junior to the rights of the transferred interest, (ii) any liquidation, put, call, or conversion right, or (iii) any right to receive any I.R.C. § 707(c) guaranteed payment of a fixed amount. I.R.C. § 2701(c)(1)(B).

c. However, the value of distribution rights which are qualified payment rights is not ignored. I.R.C. § 2701(a)(3).

(1) A qualified payment right is the right to receive a fixed amount or an amount based on a fixed interest rate from the entity at least annually, or, if the amount is not paid in the current year, to receive the accumulated unpaid amounts in subsequent years before other equity interest holders receive distributions from the entity. I.R.C. § 2701(c)(3), Treas. Reg. § 25.2701-2(b)(6).

(a) For example, a holder of cumulative preferred stock has a qualified payment right.

(2) Although a qualified payment right is valued at fair market value for purposes of determining the value of the initial transfer unless it is combined with an extraordinary payment right, the entity's subsequent failure to pay the qualified payment on a timely basis may result in an increase in the holder's taxable gifts if he or she transfers a qualified payment right during life or in the holder's taxable estate if the right is held at death. Treas. Reg. §§ 25.2701-2(a)(4), 25.2701-4(a), and (c).

3. Certain payment rights fall outside the definition of distribution rights completely and thus are not ignored in valuing a retained interest.

a. These rights include mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under I.R.C. § 707(c), and nonlapsing conversion rights. Treas. Reg. § 25.2701-2(a)(4).

b. A guaranteed payment right, which entitles the holder to receive a fixed amount at a specified time, is also valued at fair market value when determining the value of a transferred subordinate equity interest. Treas. Reg. § 25.2701-2(b)(4)(iii).

(1) For example, an individual has a guaranteed payment right if he or she is entitled to receive $2,000 a year from the entity for his or her lifetime.

4. The effect of I.R.C. § 2701 is to reduce the value of interests older family members continue to hold and increase the value of interests transferred to younger family members by applying the subtraction method of determining the value of a transferred interest when I.R.C. § 2701 applies.

a. Under this method, the value of any equity interests retained by the older family members, disregarding extraordinary payment rights and distribution rights that are not qualified payment rights, is subtracted from the value of all family-held interests in the entity.

b. The remainder is the value assigned to the subordinate equity interests and other equity interests held by the family in the entity. Treas. Reg. § 25.2701-1(a)(2); s*ee also* Treas. Reg. § 25.2701-3 for the specific method.

c. Because in most cases it is the subordinate equity interests that have been transferred to younger family members, the amount of taxable gifts by the older transferring family members is increased by the same amount that the value of their retained equity interests is reduced.

5. Transfer tax savings may be obtained by transferring to younger family members equity interests that will absorb the future growth in the entity's value.

a. For example, an older family member starting a new business with little initial value will incur a small taxable gift if he or she gives all the residual interests to younger family members and retains a senior equity interest that is valued at zero because it is not a qualified payment right.

(1) Any subsequent increase in value will inure to the younger family members without further gift tax consequences.

b. Likewise, a tax-free shift in value occurs if the value of a business increases at a rate that exceeds the discount rate used in determining the value of a qualified payment right or guaranteed payment right retained by the older family member.

(1) Although the value of the qualified payment right or guaranteed payment right will reduce the value of the taxable gift, any payments actually made will be included in the older family member's estate unless consumed.

(2) In addition, any unpaid or late payments, compounded at the discount rate used to value the qualified payment right, will be included in the transferor's taxable gifts, subject to the cap discussed below.

6. Nonetheless, in most situations the family can best achieve its tax and nontax goals by avoiding the application of I.R.C. § 2701 altogether.

a. I.R.C. § 2701 is not operative if there is only one class of equity interest in the entity, despite differences in voting rights, rights to manage the entity, or exposure to liability. Treas. Reg. § 25.2701-1(c)(3).

b. Only one class of entity will exist if distributions of operating revenue and liquidating proceeds are based on capital accounts and the capital accounts are maintained in a manner that reflects the financial investment of the owners in the enterprise from time to time, taking into account profits retained in the entity and losses allocated to the owners. Treas. Reg. § 25.2701-1(c)(3).

(1) For example, if Smith's capital account has a balance of $10,000 and the capital account balances of all the owners is $100,000, Smith would receive ten percent of all distributions and would be allocated ten percent of all tax items.

(2) To reflect the owner's financial investment in the entity, an owner's initial capital account should:

(a) Equal the fair market value of the owner's initial capital contribution;

(b) Be increased by any additional capital contributions, the owner's distributive share of the entity's profits, and the amount of any of the entity's liabilities that are assumed by the owner or that are secured by property distributed to the owner by the entity; and

(c) Be decreased by the amount of cash and the fair market value of any property distributed to the owner, the owner's distributive share of the entity's losses, and the amount of any liabilities of the owner that are assumed by the entity or that are secured by any property contributed by the owner to the entity.

Treas. Reg. § 1.704-1(b)(2)(iv).

(3) If there are any gifts to the entity by a person who is not an owner, the capital accounts of the owners should be increased on a pro rata basis to reflect the fair market value of the property.

(4) Finally, if an owner makes a non-pro rata capital contribution to the entity or the entity makes a non-pro rata distribution to an owner, the capital accounts of the owners should be adjusted to reflect the then fair market value of the assets held by the entity immediately before the capital contribution or distribution. Treas. Reg. § 1.704-1(b)(2) (iv)(d)-(f).

(a) The capital account of the contributor or the distributee should be adjusted to reflect the fair market value of the property contributed or distributed. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

7. If capital accounts are properly maintained, basing distributions on relative capital account balances of the owners will ensure that only one class of equity exists.

a. In this regard, the regulations under I.R.C. § 2701 state that special allocations to satisfy specific requirements in subchapter K (the partnership taxation rules), such as the special allocation rules of I.R.C. §§ 704(b) and 704(c)(1)(A), will not create a second class of equity. Treas. Reg. § 25.2701-1(c)(3).

b. In addition, such allocation of income, gain, loss, deduction and credit items will eliminate several other potential tax problems.

(1) Allocation of tax items according to relative capital account balances will avoid the complex rules under I.R.C. § 704(b) dealing with the substantial economic effect of special allocations of tax items.

(2) Also, the family partnership rules under I.R.C. § 704(e) require that the allocation of a partnership's income must be proportional to the capital interests, after allocating to a donor partner reasonable compensation for services he or she rendered to the partnership. Treas. Reg. § 1.704-1(e)(3).

(3) Finally, maintaining one class of equity interest will avoid the possible triggering of a gift by an inadvertent lapse under I.R.C. § 2704(a), which can occur if an older family member loses the right to liquidate his or her retained subordinate

equity interest because of a transfer of a senior equity interest to a younger family member.

8. A typical preferred equity interest transaction might work as follows: an older family member owns an office building that has a current fair market value of $1,000,000 and a tax basis of $100,000.

   a. The older family member transfers the office building to an LLC and takes back both a preferred interest that has a value of $900,000, based on the present value of the preferred return on the preferred interest, and a residual interest worth $100,000, determined by subtracting from the $1 million the $900,000 value of the preferred interest.

      (1) Note that the $100,000, which is 10% of the value of the office building, satisfies the 10% minimum residual value requirement under I.R.C. § 2701(a)(4).

   b. The older family member then sells or gives the $100,000 residual interest to a younger family member.

   c. Any future growth in the value of the office building will inure to the benefit of the owner of the residual interest, and not to the older family member.

   d. To be treated as a partner for income tax purposes the older family member may need to retain some minimal interest in the growth in the value of the office building, but the small growth interest will only reduce the transfer tax benefits slightly.

   e. However, if the preferred payment is not actually made, I.R.C. § 2701(d) will require the value of the retained preferred interest to be increased when the older family member dies or transfers the preferred interest.

      (1) The increase, which is designed to reflect the amount of increase in the transferor's estate the unpaid payments would have caused had they been timely made, is determined by adding to the transferor's estate or taxable gifts the amount of each unpaid payment, compounded annually from the due date of the unpaid payment, using the same rate of return that was used in determining the value of the retained interest for purposes of valuing the transferred residual interest at the time of the recapitalization.

      (2) Consequently, it is imperative the required payment be made on a timely basis.

(3) However, there is a cap on the amount included in the transferor's estate or taxable gifts equal to the amount of increase in the value of the residual interest after the initial transfer.

(4) Under I.R.C. § 2701(d)(2)(C), the first payment can be delayed for up to four years, but subsequent payments will then have to be made on an annual basis to avoid compounding.

f. As in the case of an unpaid note pursuant to an installment sale to a grantor trust where the interest has been paid on an annual basis, only the value of the preferred interest will be included in the transferor's estate if the preferred payments have been made on a timely basis.

g. Also, the transferred residual interest will have the same basis in the hands of the transferee as the transferor had, plus any gift or GST tax paid on the unrealized appreciation, unless the transferee purchases the residual interest, in which case his or her basis would be equal to the consideration paid.

9. The disadvantage of a preferred equity interest transaction is that a qualified business appraiser must determine the preferred interest's value using a rate of return based on market conditions.

a. This rate may be considerably higher than the applicable federal rate that would be used for determining the interest rate in an installment sale to a grantor trust or the rate that would be used for valuing the retained annuity interest in a GRAT.

10. In addition, if the qualified payments are not actually made to the transferor, the transferor's estate will be increased by the amount of the unpaid payments plus interest, compounded annually from the due date of each unpaid payment, subject to the cap discussed above.

a. Presumably in the case of an installment sale to a grantor trust, if a payment is not made, the grantor will simply be treated as making a gift of the unpaid amount to the trust, with no additional gift or estate tax consequences, unless the trust has no assets to make the payment, in which case there may be no income or gift tax consequences.

(1) There should be no discharge-of-indebtedness income because the trust is a grantor trust.

(2) There should be no gift because the trust has no assets to use to pay the remaining principal.

B. GRATs

1. In General

a. In a GRAT, an older family member transfers an asset to a trust and retains the right to receive a fixed dollar amount for a period of time, after which the transferor's interest terminates and either the asset is distributed to the beneficiaries, usually younger family members, or the trust continues on for some period.

b. Under I.R.C. § 2702, the value of the gift is the value of the transferred asset less the value of the retained annuity interest, provided the requirements contained in I.R.C. § 2702 and the regulations thereunder relating to a qualified annuity interest are satisfied.

(1) The present value of the retained interest in a GRAT for transfer tax purposes is determined using 120% of the federal mid-term rate under I.R.C. § 2702(a)(2)(B).

(2) Consequently, if the value of the asset transferred to the GRAT does not increase in value by more than 120% of the federal mid-term rate, there is no tax-free shifting of value to the remainder beneficiaries of the trust.

c. A qualified annuity interest is an irrevocable right to receive a fixed amount, which must be payable to or for the benefit of the term holder for each taxable year of the term.

(1) A right of withdrawal, whether or not cumulative, is not a qualified annuity interest.

(2) The annuity payment may be made after the close of the taxable year, provided that the payment is made no later than the date by which the trustee is required to file the income tax return of the trust for the taxable year (without regard to extensions), or, in the case of a payment date other than the end of the trust's taxable year, 105 days after such date. Treas. Reg. § 25.2702-3(b)(1)(i).

(3) The fixed amount must be either a stated dollar amount payable periodically, but not less frequently than annually, or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually. Treas. Reg. § 25 .2702-3(b)(1)(ii).

(a) However, the stated dollar amount payable in subsequent years is a qualified interest only to the extent it does not exceed 120% of the stated dollar amount payable in the preceding year. Treas. Reg. § 25 .2702-3(b)(1)(ii).

(b) Any excess will not be taken into account in determining the value of the retained interest. Treas. Reg. § 25.2702-3(b)(1)(iii).

(c) Although income of the trust in excess of the annuity amount may be paid to or for the benefit of the holder of the qualified annuity interest, the right to the excess income will not be taken into account in valuing the qualified annuity interest. Treas. Reg. § 25.2702-3(b)(1)(iii).

(4) If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Treas. Reg. § 1.664-2(a)(1)(ii) and (iv), relating to adjustments for any incorrect determinations of the fair market value of the property in the trust, and the computation of the annuity interest in the case of short taxable years and the last taxable year of the term. Treas. Reg. § 25.2702-3(b)(2) and 25.2702-3(b)(3).

(5) A modification made to the final regulations eliminates the necessity of making a payment of a pro rata portion of the fixed amount for the first taxable year when the trust is created on a date other than January 1.

(a) Of course, a pro rata payment is required for the final year if it is a short year. T.D. 8536 (May 4, 1994), amending Treas. Reg. § 25.2702-3(b)(3).

2. Governing Instrument Requirements

a. The governing instrument must prohibit additional contributions to the trust. Treas. Reg. § 25.2702-3(b)(5).

b. The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the annuity interest. Treas. Reg. § 25.2702-3(d)(3).

c. The governing instrument must also fix the term of the annuity interest.

(1) The term chosen must be one of the following: the life of the term holder, a specified term of years, or the shorter of those periods.

(2) Successive term interests for the benefit of the same individual are treated as the same term interest.

Treas. Reg. § 25.2702-3(d)(3).

d. The governing instrument must prohibit commutation of the interest of the holder of the qualified interest. Treas. Reg. § 25.2702-3(d)(4).

e. The governing instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation. Treas. Reg. § 25.2702-3(d)(6).

3. Structuring the GRAT

a. The so-called two-year rolling zeroed-out GRAT has been suggested as a means of transferring substantial amounts of future appreciation to children of the grantor.

(1) Two years is the minimum term of a GRAT under the regulations because the regulations refer to an annual payment.

(2) If the amount of the annuity payment is set high enough to establish a value for the retained interest almost equal to the value of the property transferred, there will be a very small taxable gift.

b. Under this technique, the grantor transfers any assets distributed to him or her to satisfy the annuity payment obligation of the GRAT to another two-year zeroed-out GRAT.

(1) At the end of the term, any remaining assets (presumably equal to the sum of the income from the assets and any increase in the value of the assets, less the 7520 rate) pass transfer tax-free to the remainder beneficiaries.

(2) The two-year period avoids the dilution of high-growth years by low-growth years.

(3) However, the use of a short-term GRAT risks the possibility that Congress may eliminate the tax advantages of the GRAT prospectively.

(4) In addition, the short term GRAT does not lock in what may be a very low 7520 rate.

(5) Note that the Obama administration tax proposals for 2016 included a provision requiring a minimum term for a GRAT of ten years, a maximum term limited to the annuitant's life expectancy and ten years, and a minimum value of the remainder interest equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000, and prohibiting any decrease in the amount of the annuity during the term.

c. Using a separate GRAT for each type or class of asset will prevent the failure of some of the assets to appreciate in value from affecting those assets that do appreciate in value.

(1) If the asset in a separate GRAT becomes exhausted because the annuity payment requirement exceeds the amount of assets in the trust, the trust will simply terminate.

(2) If the asset were included as part of a trust containing other assets, the appreciation on other assets would have to be used to make the required payment.

4. If the transferor dies before the end of the annuity term, some or all of the assets in the GRAT will be included in the transferor's estate under I.R.C. § 2036(a) because he or she has retained the right to enjoy the income from the transferred assets. Treas. Reg. § 20.2036-1(c)(2).

5. Benefits of a GRAT

a. The benefit of a GRAT is the potential shift of value to younger beneficiaries free of transfer tax.

(1) This objective may be accomplished with minimal gift tax liability if the value of the donor's retained annuity interest is close to the value of the asset transferred to the trust.

(2) Because the retained qualified annuity interest in a GRAT may be valued as an annuity for a specified term of years, rather than as an annuity for the shorter of a term certain or the period ending upon the grantor's death, it is possible to fix the value of the donor's retained annuity interest at the same value as the value of the transferred asset (hence the zeroed-out GRAT), although many commentators suggest that there be at least a small gift element. *Walton v. Commissioner*, 115 T.C. No. 41 (2000). Treas. Reg. § 25.2702-3(e), example 5.

b. It is also possible to fix the value of the remainder interest for gift tax purposes with relative certainty by tying the amount of the annuity payment to a percentage of the transferred asset's value as finally determined for gift tax purposes, because any increase in value on audit would cause a corresponding increase in the amount of the annuity payment, resulting in a very small increase in the value of the remainder interest, which is the measure of the gift.

c. Unlike a sale to a grantor trust in exchange for an installment note, there is no need to make a gift to the trust of so-called "seed money."

d. Finally, because the requirements of a GRAT are spelled out in the Code and the regulations, there is greater certainty that the desired tax consequences will be achieved.

6. Disadvantages of a GRAT

a. If the grantor dies during the term of the GRAT, the value of some or all of the assets in the GRAT will be includible in the grantor's estate.

b. In addition, the value of the retained interest is based on 120% of the federal mid-term rate, which in most cases will be higher than the applicable federal rate used for determining the minimum interest to be paid on the installment note in the case of an installment sale to a grantor trust to avoid any taxable gift in connection with the sale.

c. Also, the grantor cannot allocate his or her GST tax exemption to the transfer of assets into a GRAT until his or her interest terminates.

d. Finally, distributions from a GRAT may only be made to the holder of the annuity interest during the term of the interest, while in the case of an installment sale to a grantor trust there are no restrictions on who may receive distributions from the trust before or after the note has been satisfied, although the grantor should not be a beneficiary to avoid inclusion of the trust assets in the grantor's estate.

7. Example

a. The use of a GRAT may be beneficial if the value of the property transferred to the trust will increase at a rate in excess of the 7520 rate.

b. The transfer of a minority interest in an S corporation or a limited partnership interest to a GRAT may allow the initial annuity payment to be lower than the actual pro rata portion of the expected income attributable to the stock or partnership interest due to the minority discount that would apply to the value of the stock or partnership interest when transferred to the trust.

c. For example, assume the owner of an S corporation having a fair market value of $1,000,000 transfers 49% of the stock (which can be nonvoting) to a trust, retaining the right to an annuity equal to 1.6% of the initial value of the assets of the trust, payable for 20 years. Assume that the appropriate interest rate for valuation purposes under I.R.C. § 7520 is 1.6% (the 7520 rate for January 2022). Assume also that the value of the minority interest held by the trust is $294,000, based on a 40% minority discount (60% times $490,000). The annual payment would be $4,704, which is 1.6% of the discounted value of the minority interest, but only .96% of the undiscounted value of the interest ($490,000). If the corporation increases in value (including retained earnings) at a rate greater than .96%, a shift in value to the remainder beneficiary will be achieved transfer-tax free. By contrast, if no minority discount were applicable to the interest held in trust, the corporation would have to increase in value at a rate greater than 1.6% to achieve a similar transfer-tax free shift in value. Thus, contributing property that is subject to a minority discount allows the grantor of the trust to leverage the benefits of a GRAT.

d. Note, however, that in PLR 9707027, involving the funding of a GRAT with cash, marketable securities, and certain limited partnership interests, the facts state that the value of any gifts of non-publicly traded partnership interests made to the GRAT will be determined without regard to any discounts for the grantor's lack of control. Presumably, the IRS required the grantor to agree to such a method of valuing the limited partnership interest.

C. Self-Canceling Installment Notes (SCINs)

1. Generally

a. In some cases, the grantor may be willing to take back a SCIN in connection with a taxable sale to a younger family member or a sale to a grantor trust.

b. Under such a note, the principal amount outstanding at the time of the grantor’s death is extinguished.

(1) Because this feature will depress the value of the note, either the principal amount or the interest rate, or both, may have to be increased in order to avoid a taxable gift upon the date of the initial transfer.

(2) Furthermore, if the term of the note extends beyond the grantor’s life expectancy, the transaction will be treated as a

private annuity rather than an installment note. GCM 39503 (1986) 1986 IRS GCM LEXIS 42.

(3) See CCA 201330033 where the IRS held that the installment notes in a SCIN transaction should be valued based on a method that takes into account the willing-buyer willing seller standard of I.R.C. § 25.2512-8 and should also account for the decedent's medical history on the date of the initial transfer.

c. The income tax consequences of a SCIN were unclear before the Installment Sales Revision Act of 1980 extended installment sale treatment to contingent sales. I.R.C. § 453(j)(2); Temp. Treas. Reg. § 15A.453-1(c).

2. Tax Consequences

a. If the grantor dies before the entire principal has been paid, the remaining balance, although not includible in the grantor's estate, will be treated as a disposition by the estate for income tax purposes, resulting in recognition of any remaining gain to the estate. *Estate of Frane*, 93-2 USTC ¶ 50,386, 72 AFTR 2d ¶ 93-5067 (1993), reversing the Tax Court 98 T.C. 341 (1992), and affirming the Internal Revenue Service's position as expressed in GCM 39503 and Rev. Rul. 86-72, 1986-1 C.B. 253.

(1) Note that the Internal Revenue Service had already agreed that the balance of the note was not includible in the transferor's estate. See GCM 39503, which agreed with the holding in *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980) *acq. in result*, 1981-1 C.B. 2.

(2) The Tax Court's position, that the gain should have been recognized by the decedent, would have resulted in a deduction to the estate of the income tax liability on the gain, while the IRS and the Eighth Circuit's position, that the gain is recognized by the estate, results in no income in respect of a decedent deduction under I.R.C. 691(c) because the balance of the note is not included in the estate.

b. If the note had not been self-canceling at death, the balance of the gain would have been taxed either to the estate or to the recipient of the payments, since the unrecognized gain is an item of income in respect of a decedent. I.R.C. § 691(a)(4).

(1) A deduction for the estate tax attributable to the gain would be available. I.R.C. § 691(c).

(2) The recognition of gain and concomitant tax liability may expose the estate to an unexpected liquidity problem.

c. The purchaser's basis is the full purchase price, including any cash paid as a down payment and the principal of the note, even if the grantor dies before the full amount is paid.

3. Planning

a. One of the problems with using a SCIN is valuing the property and the note.

(1) The face amount of the note, the interest rate, or both, should be increased to take into account the risk that the transferor will die before all the payments have been made.

(2) In addition to the transferor's life expectancy, the transferor's health condition should also be taken into account.

(3) Whether to increase the principal of the note or the rate of interest depends on the relative tax situations of the seller and purchaser.

(a) Interest payments may be deductible to the purchaser, but will be ordinary income to the seller, while principal payments will not be deductible to the purchaser and will be capital gain, in most cases, to the seller.

(b) The purchaser may have larger depreciation deductions if the principal is increased.

b. In drafting the note, it may be possible to avoid the result in *Frane*, where the estate of the transferor recognized the remaining gain. The language dealing with the purchase price could read as follows:

For value received, the undersigned promises to pay to the order of Payee the contingent principal sum of $_______ together with interest on the unpaid balance thereof at the rate of _____ percent per annum in equal installments of $_______ each to be applied first to interest on the unpaid principal if, and only if, Payee is living on the due date of such installment. The condition to the obligation to make such payment has been bargained for and taken into account in determining the rate of interest hereunder in accordance with applicable actuarial tables so that the actuarial value of this note is equal to the value of the assets being contemporaneously sold by Payee to the undersigned. The first such conditional installment shall be due one year from the date hereof and each subsequent conditional installment shall be due on the same date each year thereafter until the earlier of the death of Payee or _____ years from the date hereof. (Additional desired provisions, including reference to security instruments, should be added.) [The foregoing was suggested by Dave Cornfeld of St. Louis, MO.]

4. Estate of Costanza v. Commissioner, 320 F 3d 595 (6th Cir. 2003), *rev'g* T C Memo 2001-128

Duilio Costanza owned two properties in Flint, Michigan that he sold to his son, Michael, in late 1992 or early 1993, in exchange for a SCIN. One of the properties was a restaurant that Duilio had owned and operated since his retirement from General Motors in 1966. Although Duilio was suffering from heart disease, his life expectancy was estimated to be between 5 and 13.9 years. At the time of the sale, he contemplated retiring to Italy, where he was born in 1919. He died on May 12, 1993 from a toxic reaction to bypass surgery he had the day before. Although the SCIN called for monthly payments, according to Michael's testimony his father had requested the payments be made quarterly to limit the number of bank transactions. Consequently, Michael did not make the first payment until March 8, 1993, in the form of three checks, each in the monthly amount and each of which Michael had inserted another date indicating the month for which the payment was being made. No additional payments were made before Duilio died, consistent with his request that quarterly payments be made.

The Tax Court ruled that the sale was not a bona fide transaction and that Duilio had made a gift of the value of the two properties, less the amount of the three checks, to Michael. Its ruling was based on its belief that there was no intent to enforce the payment provisions of the SCIN. However, the Sixth Circuit, accepting the veracity of the testimony of Michael and Duilio's attorney concerning the reasons for the failure to adhere to the technical provisions of the SCIN, held that the estate had rebutted the presumption that a SCIN signed by family members is presumed to be a gift. The presumption may be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The Court rejected the IRS' argument that the SCIN was not a bona fide transaction because Michael and Duilio would not have entered into it unless they thought Duilio would die before the note was paid. Such an argument would question the validity of a SCIN, which had been upheld by the Tax Court in *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1981).

While *Costanza* confirms the validity of a SCIN among family members, it also emphasizes the importance of ensuring that the transaction will be treated as bona fide. True, Michael and Duilio did not dot all the "I's" and cross all the "T's," however, there was enough credible evidence that they both intended to enforce the SCIN.

D. Private Annuities

1. Generally

a. In certain cases the transfer of property to a grantor trust in exchange for a private annuity may result in a significant reduction in the size of the annuitant's gross estate, with no increase in the annuitant's adjusted taxable gifts.

b. The term "private annuity" generally refers to an annuity (a payment in cash of a sum certain at least annually) for the lifetime of the annuitant by a purchaser of the property who does not otherwise issue annuities.

c. Although a private annuity may consist of payments for a certain period of years or over the lives of more than one annuitant, the typical private annuity is a lifetime annuity only.

d. The principal estate tax savings in connection with a private annuity is the immediate exclusion of the value of the transferred property from the transferor's transfer tax base, subject to an increase in adjusted taxable gifts if the present value of the annuity is less than the fair market value of the transferred property.

e. Proposed regulations require the recognition of income on any unrealized appreciation in the assets transferred in exchange for the private annuity. Prop. Treas. Reg. § 1.1001-1(j), generally effective for exchanges of property for an annuity contract after October 18, 2006.

2. Income Tax Consequences to Annuitant

a. The annuitant will recognize taxable income as each payment is received to the extent the amount of the payment exceeds the amount of the annuitant's adjusted basis in the transferred property allocated to the payment. Rev. Rul. 69-74 (1969) 1969-1 C.B. 43; GCM 39503.

(1) The amount of the annuitant's adjusted basis allocated to each payment is determined by dividing the annuitant's adjusted basis in the transferred property by the number of expected payments. I.R.C. § 72(b), (c)(3).

(a) In the case of a life annuity, the number of expected payments will be determined by the annuitant's life expectancy. I.R.C. § 72(b), (c) (3) (A).

(2) Before the issuance of the proposed regulations, the annuitant realized capital gain on the exchange to the extent the fair market value of the transferred property exceeds the annuitant's adjusted basis.

(a) A pro rata portion of the gain was recognized as each payment was received.

(b) Any depreciation recapture was recognized before the capital gain.

See Treas. Reg. § 1.1245-6(d).

(3) However, for exchanges after October 18, 2006 (and in some cases, after April 18, 2007), gain will be recognized at the time of the transfer, and the annuitant's basis will equal the fair market value of the annuity contract determined under I.R.C. § 7520.

(4) The balance of the payment will be ordinary income.

(5) With respect to an annuity starting date before the effective date of the proposed regulations, once all of the capital gain has bean recognized (which should occur at the same time the adjusted basis has been recovered), the entire payment will be taxed as ordinary income.

(a) If the annuitant dies before he or she has recovered the adjusted basis in the property, the balance will be deductible on the annuitant's final income tax return as a net operating loss.

(b) Any remaining unrecognized gain will disappear.

b. Example: Assume that the annuitant is age 79, and transfers property with a fair market value of $200,000 and an adjusted basis of $100,000 for an annuity paying $25,000 per year, which is also valued at $200,000. The annuitant's life expectancy is ten years. The amount of each of the annual payments excludible from income for the first ten years will be $10,000 ($100,000 ÷ 10). $10,000 of each payment for the first ten years will be taxable as capital gain ($200,000 - $100,000/10). The balance of the annual payment, $5,000, will be taxed as ordinary income. After ten years, the entire payment will be taxed as ordinary income.

c. Before the effective date of the proposed regulations requiring the recognition of gain at the time of the exchange, unlike the installment sale, the annuitant did not have to recognize the deferred gain if the obligor disposed of the transferred property before the annuitant recognized all the gain, since the IRS had taken the position that I.R.C. § 453(e) did not apply to private annuities. GCM 39503.

(1) While not relevant to a sale to a grantor trust, because the trust's basis in the asset would be the same as the grantor's basis and the grantor would recognize gain on the unrealized appreciation upon the resale, in other settings the resale by the trust would result in no gain recognition because its basis in the asset would be the fair market value of the annuity, presumably the same amount as the fair market value of the asset.

(2) Consequently, the gain would be deferred pursuant to the private annuity arrangement, although the family unit has realized the full fair market value of the asset.

(3) This favorable income treatment was the reason for the issuance of the proposed regulations requiring immediate income recognition.

d. If the annuitant's right to payments is secured by the transferred property, the taxable gain was recognized in the year of the transfer, even before the proposed regulations requiring recognition in any event. *Estate of Bell v. Commissioner,* 60 T.C. 469 (1973); 212 *Corp. v. Commissioner* 70 T.C. 788 (1978).

(1) In the example above, if all the gain was recognized in the year of the transfer, $20,000 would be excludible from adjusted gross income each year for the first ten years. Rev. Rul. 62-137 (1962) 1962-2 C.B. 28, supplemented Rev. Rul. 62-216 (1962) 1962-2 C.B. 30, clarified Rev. Rul. 67-39 (1967) 1967-1 C.B. 18, and amplified Rev. Rul. 72-438 (1972) 1972-2 C.B. 38, amplified Rev. Rul. 84-162 (1984) 1984-2 C.B. 200.

3. Income Tax Consequences to Purchaser

a. The purchaser is not entitled to deduct any of the payments made to the annuitant, although a portion of each payment is in reality economic interest.

b. The purchaser obtains a basis in the property equal to the sum of the expected payments for purposes of determining gain on a subsequent disposition of the property and for calculating depreciation deductions if the property is used in a trade or business. Rev. Rul. 55-119 (1955) 1955 1 C.B. 352.

(1) The number of expected payments is determined in the same manner as for determining the annuitant's tax consequences.

(a) In the case of a life annuity, the number of annual payments is the annuitant's life expectancy.

(2) If the annuitant lives past his or her life expectancy, each additional payment will increase the purchaser's basis.

(3) If the property is sold before the annuitant's death, payments made in excess of the expected number of payments after the sale will be treated as a loss.

(4) If the annuitant dies before the amount of payments equals the purchase price, the purchaser will recognize gain equal to the excess of the purchase price over the amount of payments made to the annuitant.

(5) If the property is being depreciated, once the annuitant reaches his or her life expectancy, the adjusted basis for depreciation will be recalculated each year as the additional payments are made.

c. For purposes of determining loss, the purchaser's basis is limited to the payments actually made at the date of the sale or exchange.

(1) Additional payments thereafter will be reported as a loss in the year the payments are made.

(2) If the property is sold at a price in excess of the amount of payments already made but below the sum of the amount of payments already made plus the amount of the expected payments to be made after the sale, no gain or loss is recognized at the time of the transaction.

(a) Once the amount of payments exceeds the purchase price, the purchaser will begin to recognize losses.

4. Transfer Tax Consequences

a. The transfer of property in exchange for a private annuity will result in a taxable gift to the extent that the fair market value of the property exceeds the present value of the annuity.

(1) Fortunately, for purposes of determining the present value of the annuity, the valuation tables issued under the Internal Revenue Code are used. I.R.C. § 7520.

(a) Because these tables ignore the annuitant's health (unless the annuitant is terminally ill) and are based on an interest rate that may not reflect the current market interest rate under the circumstances, the annuity may be overvalued, resulting in a tax-free transfer if the annuitant dies before his or her life expectancy or the return on the transferred asset exceeds the I.R.C. § 7520 rate.

(b) This risk element is not reflected in the determination of the value of the annuity.

(c) If the annuitant is terminally ill, the actuarial tables may not be used. Treas. Reg. § 20.7520-3(b) (3).

(i) An individual who is known to have an incurable illness or other deteriorating physical condition is terminally ill if there is at least a 50% probability that the individual will die within one year.

(ii) However, if the individual survives for 18 months, the individual will be presumed to not have been terminally ill unless the contrary is established by clear and convincing evidence.

(2) Consequently, if the proposed annuitant is in poor health but is not terminally ill, the use of a private annuity may significantly reduce the annuitant's estate.

b. The entire value of the property exchanged for the private annuity should be excluded from the annuitant's estate and if the annuitant dies soon after the transfer, only a small number of annuity payments will have been paid.

c. However, the IRS has been successful in having the value of the transferred property included in the annuitant's estate in the following situations:

(1) The annuity payments are substantially the same as the income generated by the property transferred. *Greene v. United States*, 237 F.2d 848 (7th Cir. 1956); *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq*. 1973-2 C.B. 2, *aff'd* 513 F.2d 824 (9th Cir. 1975); Rev. Rul. 79-74, 1979-1 C.B. 296).

(2) The transferee is not personally liable for the annuity payments. Rev. Rul. 68-183, 1968-1 C.B. 308).

(3) The transferee has no possible economic means to make the annuity payments. *La Fargue v. Commissioner*, 73 T.C. 40 (1980), *rev'd*, 689 F.2d 845 (9th Cir. 1982); *Estate of Schwartz v. Commissioner*, 9 T.C. 229 (1947), *acq*. 1947-2 C.B. 4.

(4) The transferor retains control over the property transferred and its disposition by the transferee. *Estate of Holland v. Commissioner*, 47 B.T.A. 807 (1942).

5. Planning Considerations

a. From the annuitant's standpoint, the purchaser should have the financial ability to make the annuity payments, particularly if the annuitant will be dependent upon the annuity payments for his or her continuing needs.

b. If the purchaser is a trust, it is likely that the annuitant will be treated as the grantor of a grantor trust and will be taxed on all the income in the trust.

(1) The trust assets also may be includible in the annuitant's estate under I.R.C. § 2036(a)(1) because he or she has retained an income interest in the property.

(2) In addition, I.R.C. § 2702 may apply if the transfer is to a trust.

(a) However, the right to the annuity payments should qualify as a qualified interest.

c. Before the issuance of the proposed regulations requiring immediate recognition of gain, if the purchaser was a corporation, the Internal Revenue Service might have determined that the annuitant had sufficient security to treat the transaction as closed at the time of the transfer, causing immediate recognition of all the gain inherent in the transferred property, the same result as if the property were sold to a commercial annuity company for an annuity contract.

d. With respect to the type of property that should be transferred, it must be recognized that the property will not receive a step-up in basis under the Internal Revenue Code provision regarding the basis of property acquired from a decedent. I.R.C. § 1014.

(1) Instead, the purchaser obtains a basis equal to the payments made to the annuitant.

(2) Consequently, the more the purchaser pays to the annuitant, the higher the purchaser's basis will be.

(3) The advantage of an increased basis probably does not offset the disadvantages of the drain on the purchaser's cash flow and the increase in the annuitant's gross estate.

e. Property that has an adjusted basis in excess of its fair market value should not be used for purchasing a private annuity because no loss will be recognized to the annuitant in most cases because the obligor will be a related party under I.R.C. § 267.

f. Note the surviving spouse should consider transferring in exchange for a private annuity property that the surviving spouse has inherited from the deceased spouse, which will receive an adjusted basis equal to its fair market value under I.R.C. § 1014, thereby eliminating any taxable capital gain.

(1) The surviving spouse in a community property state should also consider transferring the surviving spouse's share of community property, because it will also receive an adjusted basis equal to it fair market value.

E. Financed Net Gifts[1]

1. The Concept

a. An older family member makes a net gift to a trust for the benefit of a younger family member and lends the trust the money to pay the gift tax on the net gift.

b. A net gift is a gift where the donee has assumed the obligation to pay the tax on the gift.

c. As a result of the assumption of this obligation, the amount of the gift is reduced by the amount of gift tax the donee has to pay.

d. The amount of the gift is determined by a formula, where the amount of the gift is equal to the tentative tax divided by 1 + the rate of the tax. Rev. Rul 75-72, 1975-1 CB 310.

(1) For example, if the amount originally gifted to the donee is $1,000,000, and the gift tax rate is 40%, the amount of the

[1] With permission, this part of the outline is based on an outline and presentation by David A. Handler, a partner with Kirkland & Ellis LLP, Chicago, Illinois, given at the 44th Annual Heckerling Institute on Estate Planning in Orlando, FL, in January 2010. However, any mistakes are mine.

gift tax is $285,714 [$400,000 ($1,000,000 times 40%) divided by 1.40 (1 plus the gift tax rate of 40%) = $285,714] and the net gift is $714,286 ($1,000,000-$285,714).

2. Benefits

a. The gift tax is tax exclusive, because if the donor lives for more than three years after the gift, the gift tax is out of the donor's estate.

b. Because the amount borrowed to pay the gift tax is approximately two-thirds less than the amount of loan required in the case of an installment sale to a grantor trust, there is less cash flow required to pay interest and principal payments to the grantor.

(1) This is the case because the loan is equal to the gift tax on the net gift rather than the value of the property being sold to the grantor trust.

c. Because the face amount of note given in exchange for the money to pay the gift tax is approximately one-third of the value of the assets transferred to the trust, there is no need for seed money and the likelihood of a challenge by the IRS that there is a retained interest under I.R.C. § 2701, 2702, or 2036(a) is greatly diminished, if not avoided altogether.

(1) In addition, the loan will not be required until the gift tax is paid, which could be as long as 15 ½ months after the net gift is made.

d. Because the amount financed is less than the amount in an installment sale to a grantor trust, there is less of an investment risk that the value of the assets will decline in value below the amount of the outstanding loan.

e. If the IRS successfully challenges the value of the transferred assets, the additional gift would be reduced (presumably) by the additional gift tax the trust would have to pay on the increased value.

(1) There is authority that, if the donee's obligation is speculative, the potential payment of additional gift tax on audit will not reduce the value of the gift if it is actually paid. Compare *Harrison v. Commissioner*, 17 T.C. 1350 (1952) with *Frank J. Armstrong, Jr. Trust v. United States*, 132 F. Supp. 2d 421 (W.D. VA), aff'd. 277 F.3d 490 (4th Cir. 2002) and *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006) (holding that the donees' agreement to pay any gift tax if the donor died within three years of the date of the gift was not too speculative).

f. David Handler's outline also has an illustration showing that the financed net gift has a benefit of $16,531,982 compared to a benefit of $6,110,765 in the case of an installment sale to a grantor trust, assuming either a net gift or a sale of $9,000,000 of assets, and using a nine year note, a 10% return, and a 5% interest rate on the note.

3. Disadvantages of the Financed Net Gift

a. The assets of the family are immediately reduced by the payment of the gift tax by the donee trust.

b. If the gift tax liability assumed by the trust exceeds the basis the donor has in the property, gain will be recognized unless the trust is a grantor trust. *Diedrich v. Commissioner*, 102 S.Ct. 2414 (1982).

c. When compared to a transfer at death, the loss of a full step up in basis needs to be taken into account (although the basis in the case of a gift will be increased by the amount of gift tax and GST tax attributable to the unrealized appreciation in the gifted asset, but not in excess of the fair market value of the asset).

(1) Although the gift tax is paid sooner in the case of a net gift, the donee has the property to enjoy now and the future appreciation is out of the donor's estate.

4. Conclusion

a. The financed net gift technique should be one of the techniques considered when the client desires to make transfers during his or her lifetime for estate planning purposes.

b. However, the client must not mind paying transfer taxes sooner than required and must have the liquid funds to lend to the donee trust to pay the gift tax.

III. Basis Considerations

A. Introduction

1. As a result of the decrease in the transfer tax rate and the increase in the income tax rate, as well as the increase in the transfer tax exemption, the transfer tax benefits of lifetime gifts will often be out-weighed by the income tax cost of a loss of a step up in basis at the death of the donor.

2. The donee's basis in a gifted asset, for purposes of determining gain on a disposition of the gifted asset, is the same of the donor's basis plus any gift and GST tax attributed to the unrealized appreciation at the time of the gift, but not in excess of the asset's fair market value. I.R.C. § 1015.

3. For purposes of determining loss, the donee's basis is the lesser of the basis determined for gain or the fair market value of the asset at the time of the gift. I.R.C. § 1015(a).

4. A beneficiary's basis in an asset acquired from a decedent is the fair market value of the asset at the date of death or the alternate valuation date, if elected, except for items of income in respect of a decedent. I.R.C. § 2014(a) and (c).

B. Planning Considerations

1. In general, distinguish between techniques that will cause gifted assets to be included in the donor's estate and techniques that will cause the gifted assets to be included in the donee/beneficiary's estate.

2. Consider the nature of the assets, whether a sale of the asset will result in ordinary income or capital gain, which will determine the tax rate that will apply to a sale of the asset.

3. Consider in what state the donor or donee/beneficiary will reside when he or she dies; some states, like California, have no estate tax, but a high income tax rate, while other states, like Washington, have no income tax, but a high estate tax rate.

4. Consider whether it is likely that the asset will be sold during the donee/beneficiary's lifetime.

C. Techniques to Increase Basis

1. Using a formula general power of appointment (very difficult to fine tune).

2. Give a third party the right to grant a general power of appointment.

3. Reverse estate planning: giving assets to parents (won't work with wealthier families).

4. Asset swapping with grantor trusts (works if there are grantor trusts with appreciated assets).

5. Using partnerships to change the basis of non-depreciable property without death or a taxable event, by distributing loss property in kind to a parent having a basis in excess of the basis of the distributed property so that a section 754 election increases the basis of remaining assets in the partnership.

6. Broad distribution powers held by a trustee or trust protector.

7. Delaware tax trap.

8. If trust formed in an asset protection state, move to a state that doesn't provide such protection to trigger I.R.C. § 2036(a)(1).

9. Preferred equity interest transaction with a qualified payment right under I.R.C. § 2701.

10. Preferred equity interest transaction that does not involve a qualified payment right.

11. Allocation of partnership debt under I.R.C. § 704 (allocate debt to older individual, so that at death, his or her interest obtains a basis equal to the fair market value of the partnership interest plus the debt).

12. Arguing there was an implied agreement that triggers I.R.C. § 2036(a)(1).

13. Undoing discounts by dissolving a partnership or LLC or amending the partnership or operating agreement to give the owners a right to cause a liquidation of his or her interest or the entity, so that there would be little or no discount from the owner's pro rata share of the fair market value of the underlying assets.