SELECTED PLANNING TECHNIQUES

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By

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INTRODUCTION

This paper incorporates a number of planning ideas from my colleagues, Stacy Eastland and Jonathan Blattmachr, who joined me in presenting a program for ACTEC in March 2002 and at the University of Miami Heckerling Institute on Estate Planning in January 2003 during which we discussed various strategies that we have employed to assist clients in minimizing taxes. In order to avoid duplicating a voluminous set of written materials published for that program, I have summarized some of the ideas presented in that program.

Rather than present the ideas in a narrative form, I have used examples of situations in which these ideas would be useful. In order to give some structure to this presentation, the suggestions are categorized as strategies to minimize income tax, gift tax, estate tax and generation-skipping transfer ("GST") tax.

I presume that the reader is familiar with the basic concepts and relevant statutes.

INCOME TAX STRATEGIES

A. Basis Step Up Trust, Tax Basis Joint Revocable Trusts And The Grantor Trust Bypass Trust

1. The Facts: Adam owns partnership units that are subject to liabilities in excess of his basis -- his share of partnership liabilities is $2,000,000 and his basis is $500,000. If Adam's share of the fair market value of partnership assets is $2,100,000, upon a sale of his interest for $100,000, Adam would realize gain of $2,100,000. This is the sum of the cash plus the share of partnership liabilities that are treated as amounts realized by Adam on the disposition of Adam's interest. The tax due would exceed his cash receipts.

Upon Adam's death, the units will acquire a new basis under §1014. The basis adjustment is allowed even if the units pass to his wife, Alice, and no estate tax is due because the assets qualify for the marital deduction. However, if Alice predeceases Adam, there would be no adjustment to basis. The goal is to structure an arrangement whereby a basis adjustment is available regardless of which spouse dies first (and possibly again at the death of the surviving spouse). In addition, Adam would like depreciation deductions to be available to Adam for his lifetime, even if Alice predeceases him. This result is easily obtained if Adam and Alice live in a community property state, but the same benefits are not available to them if they live in states that do not follow community property law.

2. Proposal:

a. Alternative A: Adam transfers the partnership units to an inter-vivos trust for Alice. Alice has the right to all of the income and a general testamentary power of appointment. Alice also has the right to require that the trustee invest to produce a reasonable amount of income. Adam has the right to reacquire the assets and substitute assets of equivalent value. Adam retains the right to direct that all or any portion of the principal shall be distributed to Alice at any time. Upon complete distribution, the trust would terminate. If Alice does not exercise her power of appointment and Adam survives Alice, the principal remaining at Alice's death funds typical marital and bypass trusts for the benefit of Adam in accordance with a tax formula. Adam continues to have the right to reacquire assets of either the marital or bypass trust and substitute other assets of equivalent value.

b. Alternative B: Same as above except that the inter-vivos trust is an "estate trust" from which discretionary distributions of income may be made but at Alice's death the remaining principal is paid to Alice's estate.

(1) Income tax

Because Alice is a beneficiary, the trust is a grantor trust under §677. Therefore, there is no gain on the transfer of the partnership units to the trust.[1] Adam's power to reacquire assets and substitute other assets of equivalent value also causes the trust to be a grantor trust.[2] However, the IRS takes the position that the power to reacquire assets does not cause grantor trust status unless in practice it is exercised in a nonfiduciary capacity.[3]

(2) Gift tax

The trust in Alternative A qualifies for the gift tax marital deduction as a general power of appointment trust under §2523(e). The trust in Alternative B qualifies because it is not a terminable interest.

(3) Estate tax

Because Adam retains the right to direct that principal be distributed to Alice at any time, he has the right to alter or terminate the trust within the meaning of §2038(a)(1). Therefore, the trust is included in Adam's estate if he predeceases Alice. The power to invade principal for a beneficiary, unless limited by an ascertainable standard, causes the property to be included in the grantor's estate under §2038.[4]

However, in Alternative A, the amount includable in Adam's estate may be reduced by the actuarial value of Alice's income interest. Adam did not retain control over the timing of Alice's receipt of income in Alternative A.[5] However,

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1 *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

2 Code §675(4).

3 Reg. §1.675-1(b)(4); PLR 200010036 (whether power to reacquire assets is exercisable in a fiduciary or nonfiduciary capacity is a question of fact that depends on the terms of trust and the circumstances surrounding its creation and administration).

4 *Lober v. U.S.*, 74 S.Ct. 98 (1953) (holding that trusts giving settlor, as trustee, the power to distribute all or any part of trust principal to beneficiaries at any time mandated inclusion in settlor's estate upon his death); Rev. Rul. 73-143, 1973-1 C.B. 143.

5 *Estate of Schulthess v. U. S.*, 510 F.2d 617 (9th Cir. 1975); Rev. Rul. 70-513, 1970-2 C.B. 194.

in Alternative B, the entire value of the trust would be included in Adam's estate since he retained control over the timing of the receipt of income as well as principal.

Alice's general power of appointment does not prevent the application of §2038. Had the trust been structured as a QTIP, however, the QTIP election would have precluded the application of §2038. Code §2523(f)(5)(A) provides: "In the case of any qualified terminable interest property (i) such property shall not be includable in the gross estate of the donor spouse, and (ii) any subsequent transfer by the donor spouse of an interest in such property shall not be treated as a transfer for purposes of [chapter 12]." Code §2523(f)(5)(B) provides that subparagraph (A) does not apply "with respect to any property after the donee spouse is treated as having transferred such property under section 2519, or such property is includable in the donee spouse's gross estate under section 2044."

If Alice predeceases Adam, her general power of appointment causes the assets of the trust under Alternative A to be included in Alice's estate.[6] Under Alternative B, the assets are payable to her estate and would be included in her gross estate.

(4) Basis adjustment

The basis of a partnership interest acquired from a decedent is the fair market value of the interest at death, less §691 items, increased by the successor's share of partnership liabilities.[7] Therefore, upon the death of Adam or Alice, the basis of the property becomes $2.1 million.

However, §1014(e) bars a basis adjustment if the decedent acquired the asset within a year of death and bequeaths the asset to the person from whom the decedent acquired the asset. By its terms, §1014(e) is not applicable if Alice does not die within a year of Adam giving the partnership interest to the trust (or, even if Alice does die within that period, Code §1014(e) is not applicable unless the property returns to Adam). If the assets pass to a trust in which Adam has a non-discretionary interest, such as the right to receive all of the income currently, then the IRS takes the view that the actuarial value of Adam's income interest is not eligible for a basis adjustment.[8]

Adam's gift to the trust is complete when the transfer is made, so that the one-year period for purposes of §1014(e) begins to run when the trust is funded. Adam's power to accelerate distributions to Alice does not postpone the completion of Adam's gift to the trust. "A gift is not considered incomplete …

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6 Code §2041.

7 Reg. §1.742-1.

8 PLR 9026036.

merely because the donor reserves the right to change the manner or time of enjoyment."[9] Consequently, this trust is different from the situations in the tax basis joint revocable trust rulings, discussed at Paragraph (7) *infra*, where the gift is not complete until the donor spouse dies.

The fact that the trust under either Alternative A or B is a grantor trust should not preclude a basis adjustment under Code §1014 when Alice dies. If Adam's deemed ownership of the assets controls for purposes of Code §1014, which would be the only reason for disallowing a basis step up upon Alice's death, then the foundation would be laid for arguing that assets in a grantor trust acquire a basis adjustment under Code §1014 upon the grantor's death whether or not the assets are included in the grantor's estate for estate tax purposes.

If grantor trust status prevents a basis adjustment at the donee spouse's death, no inter-vivos QTIP trust would qualify for a basis adjustment when the assets are included in the donee spouse's estate under Code §2044. All inter vivos QTIP trusts are grantor trusts. Code §1014(b) provides that for the purposes of the basis adjustment rules, property includable in the decedent's gross estate by reason of a power of appointment and property included in the gross estate of the decedent under Code §2044 shall be considered to have been acquired from or to have passed from the decedent.[10] No exception is made for trusts that are treated for income tax purposes as owned by the surviving spouse under the grantor trust rules.

In PLR 9309023, a spouse conveyed one-half of her residence to an inter-vivos QTIP trust and made a QTIP election. Upon the death of the donee-spouse without exercising his limited testamentary power of appointment, the trust would continue for the benefit of the donor spouse for life. The ruling concluded that the trust would be a grantor trust as to the donor spouse both before and after the death of the donee spouse but would nevertheless obtain an adjustment to basis under Code §1014. Thus, the grantor's deemed ownership of trust assets for income tax purposes did not prevent an adjustment to basis on the donee spouse's death.

(5) Income tax consequences at Adam's death before Alice

The cessation of grantor trust status will not incur income tax if the §1014 basis adjustment is considered to occur immediately before the termination of

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9 Reg. §25.2511-2(d). *See also, Estate of Goelet v. Commissioner,* 51 T.C. 352 (1968) (distinguishing right to change time or manner of enjoyment, which does not postpone completion, from right to change the interests of beneficiaries between themselves, which renders gift incomplete, in case where settlor, as trustee, had power to distribute one beneficiary's share to other beneficiaries).

10 Code §§1014(b)(9); 1014(b)(10).

grantor trust status. Grantor trust status will terminate at Adam's death. This situation is no different from one where the decedent owned assets subject to debt in excess of basis either outright or in a revocable trust, and the IRS has never argued that gain is recognized at death in those situations. The general rule is that death does not cause gain to be recognized.[11] The IRS's position is confirmed in regulations under §684, which provide that gain is not recognized at the death of the grantor of a foreign grantor trust if the trust is includable in the grantor's estate.[12] However, if basis is not adjusted at death then Reg. §1.684-3(g) Example 3 says that the grantor is treated as having transferred the property of a grantor trust immediately before his death, and, in the case of a transfer to a foreign non-grantor trust, must recognize gain at that time. In this case, by analogy since the assets would be included in Adam's estate, the basis should be adjusted immediately before his death.

(6) Income tax consequences upon Alice's death before Adam (Grantor bypass trust)

The Treasury regulations define the "grantor" as the person who gratuitously funds a trust. These regulations also provide that the identity of the grantor of a trust does not change unless the principal of the trust is appointed to another trust by a person's exercise of a general power of appointment.[13] Thus, Adam remains the grantor for income tax purposes under Alternative A (general power of appointment trust) if Alice does not exercise her power. Therefore, grantor trust status may continue after Alice's death, if (a) Alice does not exercise her general power of appointment and (b) Adam survives her. If Alice does not exercise her general power of appointment, and if the provisions of the trust applicable following Alice's death include a provision that causes Adam to continue to be treated as the owner of the trust (e.g. Adam is a beneficiary), grantor trust status will continue.

Code §2036 will not apply to make the assets of the bypass trust includable in Adam's estate if he is a discretionary beneficiary because he is not considered to be the transferor for gift and estate tax purposes.[14] However, if under applicable state law, Adam is viewed as the transferor and therefore Adam's creditors can levy on the trust assets, the IRS could take the view that

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11 "The mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it." Footnote 73 H. Rep. No. 1337, 83rd Cong., reprinted in 3 U.S.C.C.A.N. 4017, 4331 (1954) and S. Rep. No. 1622, 83rd Cong. (2d Sess.), reprinted in U.S.C.C.A.N. 4621, 4981 (1954).

12 Reg. §1.684-3(c).

13 Reg. §1.671-2(e)(5).

14 PLR 200101021; *cf*. Reg. §25.2523(f)-1(f), Example 11 applicable to QTIP trusts.

Adam had a general power of appointment.[15] The definition of transferor may be different for tax law and state law purposes.

Under Alternative B, the trust established by Adam terminates upon Alice's death. If Alice establishes a trust under her will that benefits Adam, Adam will not be the grantor of any such trust. He could be treated as the owner for income tax purposes of any trust established by Alice only if §678 applies. Section 678 prescribes the circumstances in which a beneficiary will be treated as the owner of trust income. For example, a beneficiary is treated as the owner of trust income if the beneficiary has the right to withdraw assets from the trust. However, if the trust is a bypass trust, it is important that Adam be considered the owner of the trust only for income tax purposes and not for gift and estate tax purposes. To accomplish this goal, Adam cannot have a right of withdrawal. However, if Alice's will establishes a bypass trust for the benefit of Adam that is eligible to be a qualified subchapter S trust as defined in §1361(d)(3), if the trustee transfers the trust assets (the partnership interest) to a newly formed subchapter S corporation, and if Adam makes the election under §1361(d) to be treated as the owner of that portion of the trust which consists of stock in an S corporation, then items of income and deduction accruing to the S corporation should be reported on Adam's income tax return.[16]

If the trust continues to be a grantor trust during the period following Alice's death when Adam is still living, Adam can continue to enjoy the benefits of grantor trust status, one of which is that depreciation deductions will continue to flow through to him. In addition, Adam can pay tax on income accruing to the bypass trust from other sources, and Adam can exchange the assets in the trust for other assets of equivalent value without incurring any income tax.[17] If he does this, then the assets purchased from the trust would again acquire a new basis upon his death.

If the asset Adam purchased from the trust is stock of the S corporation, then the stock owned by him at death will acquire a new basis at that time under §1014. However, the partnership interest owned by the S corporation will not be entitled to a basis adjustment since it is not owned directly by Adam. However, if the S corporation liquidates following Adam's death, the net result is almost the same as a basis adjustment to S corporation assets. The distribution of assets in liquidation of the S distribution to Adam's estate will be treated as a sale by the corporation.[18] The resulting gain flows through to the shareholder and increases

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15 *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), *acq.* 1962-2 C.B. 3; Rev. Rul. 62-13, 192-1 C.B. 180; *cf.* Rev. Rul. 77-378, 1977-2 C.B. 347; PLR 199917001.

16 Code §§678(e) and 1361(d)(1)(B).

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

18 See §§1371(a) and 336.

the shareholder's basis in the stock.[19] Because the shareholder acquires a basis in excess of the value of the assets the shareholder will receive on liquidation, the liquidation also causes the shareholder to realize a loss that offsets the gain.

(7) Comparison to Tax Basis Joint Revocable Trusts

In PLRs 200210051, 200101021 and 9308002, the IRS applied 1014(e) to tax basis joint revocable trusts to disallow a basis adjustment. In those rulings, spouses contributed joint and separate property to a single trust that was revocable by either of them unilaterally. The spouses also retained broad powers of appointment that did not exclude themselves as possible appointees. The IRS held that the trust assets were includable in the estate of whichever spouse died first under §§2038 and 2041. However, the IRS found that, because each spouse had the right to revoke the trust until death, no completed transfer to the other occurred until the power of revocation expired at his or her death. Consequently, even though the assets were includable in the estate of the first to die, a basis adjustment was not allowed for assets contributed by the surviving spouse **if** the assets passed back to the surviving spouse.

As the applicable credit amount increases, the application of §1014(e) is less of an issue. If the surviving spouse's interest in the bypass trust is wholly discretionary, the basis adjustment should not be disallowed for assets passing to the bypass trust.

These PLRs also concluded that (i) the gift from one spouse to the other that occurred on death when the decedent's power of revocation expired qualified for the gift tax marital deduction; (ii) the surviving spouse would not be treated as making a gift to the bypass trust; and (iii) the assets contributed by the surviving spouse that were allocated to the bypass trust fbo the surviving spouse and children would be excluded from the surviving spouse's estate upon his or her subsequent death.

These rulings are questionable. The ruling that each spouse had a general power of appointment seems erroneous. A general power of appointment does not include a power exercisable only in conjunction with the creator of the power. Since each spouse had a unilateral right of revocation, the power of appointment was not exercisable without the implicit consent of the creator of the power. Thus the power would not be a general power, at least until after one of the spouses died.

The rulings ignore whether the amount includable in the estate of the spouse who dies first should be reduced by the consideration furnished by the surviving spouse, who also contributed assets to the trust.[20]

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19 See §§1366 and 1367.

The conclusion that the marital deduction is available for the deemed gift that occurs upon a spouse's death is questionable because the gift could be viewed as made not to the spouse but to the spouse's estate.[21] Only gifts to a spouse, not to a spouse's estate, qualify for the marital deduction.

Although the rulings held that the surviving spouse would not be treated as the transferor to the bypass trust for gift and estate tax purposes, a private ruling has no reliance value. Factually, it would not be difficult to conclude that the surviving spouse was the deemed transferor for gift and estate tax purposes since his or her ownership was transitory.

If state law treated the surviving spouse as the transferor, then creditors might be able to reach the bypass trust assets. See note 16 *supra.* In that case, the bypass trust would be includable in the estate of the surviving spouse under §2041.

These rulings are attractive plans for modest estates, particularly as the applicable credit amount increases. It would be a service to the public if the IRS would issue a published ruling on tax basis joint revocable trusts so that taxpayers could rely on the rulings.

B. Fixed Term NIMCRUT

1. Facts: Sam wishes to diversify out of a concentrated stock position, to defer income and benefit charity.

2. Proposal: You advise Sam to transfer an asset with a value of $100 million to a family limited partnership in exchange for three classes of interests, Classes A, B and C. Class A will be owned by Sam's LLC. It will be entitled to 1% of income and losses and will be a general partnership interest. It has an initial value and capital account of $1 million. Class B will be a preferred limited partnership interest. It will have a liquidation preference of $90 million and will be entitled to a cumulative preferred return on that liquidation preference of 10% ($9,000,000 per year) payable only to the extent of partnership profits. However, the preferred return is not due until the partnership term expires. The partnership term expires in 19½ years. The Class B interest is valued at par - $90 million – which is the amount of its capital account. Class C is a "common" limited partnership interest. It is entitled to 99% of income after the Class B cumulative preference is paid. It has an initial value (and capital account) of $9 million.

Sam contributes the Class B preferred limited partnership interest to a "net income with make up charitable remainder unitrust" ("NIMCRUT"). The unitrust rate is set to produce a 10%

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[20] See §2043.

[21] But see PLR 200403094 in which the Service ruled that a husband's grant of a testamentary general power of appointment to his spouse would result in a gift that qualifies for the marital deduction if the wife predeceases the husband and exercises the power.

remainder. Assume that the unitrust rate is 10%. Sam has a $9 million income tax deduction for the present value of the remainder interest given to charity. (The remainder interest has a value of 10% of $90 million.)

The partnership sells the asset contributed by Sam and reinvests in a diversified portfolio. The gain accruing to the partnership must be allocated in accordance with §704(c)(1)(A) of the Code. When a partner contributing an appreciated asset to a partnership transfers his or her partnership interest, the §704(c) adjustments ("built-in gain") are transferred to the transferee partner.[22] If a portion of a partner's interest is transferred, the share of built-in gain proportionate to the interest transferred must be allocated to the transferee partner.[23] There is little guidance as to what "proportionate to the interest transferred means".[24] A reasonable method of allocating the built-in gain would be in proportion to the capital account transferred to the transferee partner. Using this method, 90% of the gain would be allocated pursuant to §704(c) to the Class B interest conveyed to the NIMCRUT. 10% of the §704(c) gain would be allocated to Sam as the owner of the Class A and Class C interests in the partnership. That 10% gain would be offset by Sam's charitable deduction allowed on Sam's gift to the NIMCRUT.

99% of income (other than built-in gain) will be allocated to Class B interests until the amount allocated equals the Class B cumulative preference. After the Class B interests have been allocated income equal to the cumulative preference, 99% of income is allocated to Class C interests. 1% of income always will be allocated to the Class A interests.

The allocations of income under the partnership agreement will be respected as long as the "substantial economic effect" standard in Reg. §1.704-1(b)(2)(i) is satisfied. Generally, an allocation has substantial economic effect if capital accounts are maintained properly and liquidating distributions to partners are made in accordance with capital accounts. Apart from the §704(c) allocation of built-in gains, the allocation of taxable income is in accordance with the partners' distribution rights.

The Class B interests should be viewed as equity rather than as debt because the preference is paid only to the extent of profits and the liquidation preference is paid only if the partnership has sufficient assets to pay the preference. "Debt" is an unqualified right to receive a sum certain at a fixed maturity date regardless of the debtor's income.[25]

The IRS could assert that the arrangement violates the anti-abuse regulations in Reg. §1.701-2. These regulations grant the IRS broad authority to attack partnerships the IRS asserts were formed or availed of with the principal purpose to reduce substantially the partners' tax liability inconsistent with the intent of subchapter K. Due to the breadth of these regulations, there never can be complete certainty that the IRS will not assert its authority to attack the

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22 Reg. §1.704-3(a)(7).

23 *Id.*

24 *See* T.D. 8902, 65 Fed. Reg. 57,092, 57,094 (September 21, 2000)(preamble to Reg. §1.1(h)-1) acknowledging a lack of guidance in this area.

25 *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).

partnership. However, the income tax reduction in this case is a result of the ownership of an interest by a charitable remainder trust, the trust must be recognized as a partner under §704(e) (because capital is a material income-producing factor) and the allocation of income to the NIMCRUT is in accordance with §704(c) and Reg. §1.704-1(b)(2). Therefore, it is hard to see how the IRS would prevail in any assertion that the partnership was abusive.

For 19½ years, the NIMCRUT has no fiduciary accounting income because no distribution is made from the partnership to the NIMCRUT. Therefore, the NIMCRUT is not required to make a distribution to Sam. The NIMCRUT defines fiduciary accounting income in accordance with state law except that under no circumstances may pre-contribution gain be allocated to income.[26] Fiduciary accounting income under state law is income received by the trust, and not income allocated to the trust for federal income tax purposes. Therefore, for 19½ years, 99% of all taxable income accruing to the partnership is "taxable" to the NIMCRUT. This income is not taxed because the NIMCRUT is tax exempt (provided that it has no unrelated business income).

Sam receives no distributions from the NIMCRUT for 19½ years. However, a make up account is maintained for Sam equal to the unitrust percentage. Sam's make up account grows because the unitrust percentage is applied to the value of the trust's assets each year. The value of the trust assets is increased by the yield on partnership assets that is reinvested at the partnership level.

At the end of the term of the partnership, the NIMCRUT receives the accrued preferred return. Under the terms of the instrument, that return is allocated to fiduciary income. Under the make-up provisions of the NIMCRUT, the make up amount is paid to Sam. Sam has deferred income for almost 20 years.

In 1997, the IRS announced that it was studying "whether a trust that will calculate the unitrust amount under §664(d)(3) [a NIMCRUT] qualifies as a §664 charitable remainder trust when a grantor, a trustee or a beneficiary can control the timing of the trust's receipt of income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under §643(b) and income for federal income tax purposes for the benefit of the unitrust recipient."[27] The IRS will not issue rulings with respect to charitable remainder trusts that own partnership interests.[28] However, the issuance of further guidance on this subject is not on the IRS business plan.

The grantor does not control the timing of receipt of income where the timing of the payment of the preference is mandated by the terms of the instrument. Therefore, the arrangement falls outside of the suspect category of NIMCRUTs.

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26 *See*, Reg. §1.664-3(a)(1)(i)(b)(4) providing that post-contribution gain but not pre-contribution gain may be allocated to income.

27 Rev. Proc. 97-23.

28 Rev. Proc. 2003-3.

The arrangement described above should be valid because it does not compromise the policy that underlies §664. The NIMCRUT in the example does not diminish the value of the charity's remainder interest, which cannot be less than the original value of the trust principal. The preference will be paid only to the extent of partnership income, which cannot include gains representing pre-contribution value. The fact that the grantor also benefits from the arrangement is permitted because the grantor is a beneficiary and permitted to benefit. For example, in PLR 9825001, the IRS ruled that a NIMCRUT funded with a deferred annuity contract did not adversely affect the trust's qualification as a charitable remainder unitrust and was not an act of self-dealing under §4941 even though the annuity arrangement allowed the beneficiary to defer income.

If Sam made a gift of the Class C interest to his descendants, the value of the interest given may be subject to Chapter 14 special valuation rules because Sam has retained indirectly the right to receive a preferred return from the NIMCRUT.[29]

C. Selecting a Situs

1. Facts: Jonathan is a resident of New York but he has a relative who is a resident of Alaska. Jonathan would like his estate and the trusts under his will to escape paying income taxes in New York. Alaska would not impose an income tax on Jonathan's estate or any trust under Jonathan's will.

2. Proposal: Jonathan names his brother, a resident of Alaska, as his executor and as trustee of the trusts under his will. Jonathan's will specifies that his estate will be probated in Alaska and that the situs of his testamentary trusts is Alaska. Alaska will take jurisdiction of Jonathan's estate and will not impose income tax on Jonathan's estate or trust. New York income taxes will be avoided.

Alaska has adopted a statute that allows non-residents to probate their estates using Alaska probate courts provided that there is an individual or corporation resident in Alaska serving as an executor. Alaska Stat. §13.06.068. Alaska also does not tax the income of trusts established by nonresidents.

State income taxes also may be avoided by establishing irrevocable inter-vivos trusts having a situs in states that do not impose income tax on the undistributed trust income. The same result may be obtained, following the grantor's death, from using a revocable trust. The chance of avoiding income tax in the grantor's state of domicile is increased if the trust does not receive additions from the probate estate administered in the decedent's state of residence.

Some jurisdictions, such as the District of Columbia and Connecticut, by statute assert the right to tax inter-vivos and testamentary trusts established by persons who are residents regardless of whether the jurisdiction has any other contact with the trust. This assertion of taxing jurisdiction survives the grantor-resident's death. Both laws were recently challenged on

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[29] *See* §2701(e)(3) attributing ownership through trusts.

constitutional grounds.[30] The trustees argued that there was not a sufficient connection with the jurisdiction of the grantor's residence to justify taxing the income of the trusts under either the due process or commerce clauses of the Constitution. The Constitutional arguments failed.[31] However, in both cases, each of the trusts had a connection to the taxing jurisdiction in addition to the residence of the grantor that supported the right of the District of Columbia and Connecticut to tax the income of the trusts. Importantly, the District of Columbia case, in footnote 11, reserves judgment on the constitutionality of the assertion of jurisdiction to levy tax where the trust had not availed itself of the right to resort to local courts.

> We express no opinion as to the constitutionality of taxing the entire net income of inter vivos trusts based solely on the fact that the settlor was domiciled in the District when she died and the trust therefore became irrevocable. In such cases, the nexus between the trust and the District is arguably more attenuated, since the trust was not created by probate of the decedent's will in the District's courts. An irrevocable inter vivos trust does not owe its existence to the laws and courts of the District in the same way that the testamentary trust at issue in the present case does, and thus it does not have the same permanent tie to the District. In some cases the District courts may not even have principal supervisory authority over such an inter vivos trust. The idea of fundamental fairness, which undergirds our due process analysis, therefore may or may not compel a different result in an inter vivos trust context.[32]

Therefore, there remains the possibility that residents of high tax jurisdictions may be able to move the situs of their trusts and of their estates to friendlier jurisdictions.

D. Avoiding §684

1. Facts: Hal is the grantor of a foreign trust. Although the trust is administered in the U.S. by a U.S. trustee, it is classified as foreign under the "hair trigger" rules of §7701(a)(31) because a non-U.S. person has the right to remove and appoint trustees. The trust is a grantor trust for income tax purposes while Hal is alive because Hal is a U.S. grantor and the trust has U.S. beneficiaries. §679 makes a foreign trust a grantor trust if the trust has a U.S. grantor and U.S. beneficiaries. However, the trust is not includable in Hal's estate for federal estate tax purposes. Therefore, upon Hal's death, when the trust ceases to be a grantor trust, §684 would apply.

§684 causes gain to be realized when the U.S. grantor of a foreign grantor trust ceases to be treated as the owner of the trust at his/her death unless the assets acquire a new basis under

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30 *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. App. 1997); *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), *cert. denied*, 528 U.S. 965 (1999).

31 *See Gavin*, at 205, 206.

32 *District of Columbia v. Chase*, at 547, n11.

§1014.[33] If the assets do not acquire a basis under §1014, then the grantor is treated as having sold the assets immediately prior to death.[34]

2. Proposal: Hal creates a second irrevocable trust that is a U.S. trust and gives the trustees of the U.S. trust the unrestricted right to withdraw assets from the foreign trust. This right of withdrawal makes the U.S. trust the owner of the foreign trust assets under §678, but only after Hal's death. A trust will be treated as the owner of another trust to the extent it has the power to withdraw that trust's assets.[35] For so long as Hal is alive, §678(b) provides that the grantor, and not the beneficiary who has powers of withdrawal, shall be treated as the owner of the income of the trust. For purposes of subpart E of Subchapter J, "income" not otherwise defined means taxable income and not fiduciary income.[36] Therefore, fiduciary accounting income as well as income allocable to corpus is deemed to be owned by Hal. However, upon Hal's death, §684 should not apply because a U.S. trust, rather than a foreign trust, is now deemed to own the trust assets.

Following Hal's death, if the trustees of the U.S. trust are directed to sell the assets and distribute the proceeds to a foreign person (which may include a foreign trust), the income realized by the U.S. trust is deductible under §661. As long as the income is not the sort of income that is taxable to non U.S. persons, the income realized by the U.S. trust is not taxable to the foreign beneficiaries of the U.S. trust. The character of the income realized by a foreign beneficiary determines whether it is subject to U.S. income tax.[37] Therefore, in some circumstances, the unrealized appreciation would not be taxed.

E. Springing Charitable Remainder Trusts

1. Facts: Earl, a young single computer entrepreneur, funded a highly successful GRAT for the benefit of his parents. The annuity term has expired. The trust holds a concentrated position in the stock of Earl's company which stock has a very low basis. Earl also has a significant number of shares of the same low basis stock. Earl would like to diversify his holdings and the holdings of the trust but is concerned about the tax cost.

2. Proposal: The GRAT remainder trust is a grantor trust. A selector has the power to add charities as beneficiaries and the trustee has the power to create and fund a charitable remainder trust for the benefit of any of the beneficiaries.

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33 Reg. §1.684-3(c).

34 Reg. §1.684-3(g) Example 3.

35 Reg. §1.671-2(e)(6) Example 8.

36 *See* Reg. 1.671-2(b)("[W]hen it is stated in the regulations under subpart E that 'income' is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes.")

37 *Martin-Montis Trust v. Commissioner*, 75 T.C. 381 (1980), *acq*. 1981-2 C.B. 2 (1981).

The trustee exercises the power to fund a charitable remainder trust. Earl benefits from a charitable contribution deduction for the value of the remainder interest. The charitable remainder trust is tax exempt. The annuity payments to Earl's parents are taxable to them rather than to Earl, but not until payments are made.

The grantor trust may establish a split interest trust because the assets are deemed owned by the grantor until conveyed to the transferee trust. Although a charitable remainder trust must be qualified under §664 from inception, the trust's inception occurs when it ceases to be a grantor trust.[38] A deduction is allowed to the grantor under §170 for the value of the interest given to charity. A grantor is allowed a deduction for charitable gifts made by a grantor trust.[39]

A charitable remainder trust could not be funded from a non-grantor trust. Although a non-grantor trust is allowed a deduction for amounts distributed to charity in accordance with §642(c), Reg. §1.664-1(a)(iii)(a) provides that a trust is not a charitable remainder trust unless a deduction under §§170, 2055 or 2522 was allowed for the transfer.

If Earl's trust were not a grantor trust, it might be changed to become a grantor trust to facilitate funding a charitable remainder trust, provided that the trustee's powers were broad enough to permit it.

F. Assets Subject to Liabilities in Excess of Basis in Trust

1. Facts: John is the primary beneficiary of a trust which upon his death will continue for the benefit of his descendants. John has a limited power of appointment, and the assets will pass to his descendants free of federal estate tax. The primary asset held by the trust is an interest in an office building which has a basis and a value of $100 million but is subject to a liability of $120 million. Therefore, the net value is zero and the "negative basis" is $20 million. John is concerned that upon his death, his children will inherit an asset with a potential income tax liability of $5 million or more.

2. Proposal: If John can exercise the limited power of appointment to spring the so-called "Delaware tax trap" under §2041(a)(3), then the assets will be included in John's estate and acquire a new basis, thereby relieving his descendants of this potential income tax burden. §2041(a)(3) applies if a power of appointment created after October 21, 1942 is exercised to create another power of appointment which, under the applicable law, can be validly exercised so as to postpone the vesting of any estate for a period without regard to the date of the creation of the first power. The exercise of a limited power of appointment to create an immediately exercisable general power of appointment may spring the trap. The exercise of a general power of appointment usually starts the running of a new perpetuities period.

Suppose, however, that John's trust expressly prohibits the exercise of the power of appointment to expose the trust to estate tax under §2041(a)(3). Is there another solution? Assume that the trustee has the power to invade principal in favor of John. If the interest in the

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38 Reg. §1.664-1(a)(4).

39 Reg. §1.671-2(c).

building is distributed outright to John (so that it will be taxable in his estate), what are the tax consequences?

The general rule is that gain is not recognized when assets are distributed to a beneficiary of a trust unless the trustee elects to do so.[40] There is another general rule, however, that gain is realized when a partnership interest is transferred and the transferor's share of partnership liabilities is reduced.[41] There is no express exception for trust distributions. If §643(e) did not exist, a distribution of a partnership interest could trigger gain as a result of the partnership provisions. Authorities disagree on which statute prevails. One author states, "[N]ote the significance of the lack of cross reference to subchapter K and the absence of pertinent regulations or rulings as in §§752 and 1001 to suggest that §643(e) is not predominate for distributions by a fiduciary, resulting in no 'triggering' of income from debt relief on such a distribution."[42] Another author states, "[I]t seems that an otherwise tax-free distribution by an estate or trust of a partnership interest constitutes a sale or exchange to the extent that the estate is treated as having realized partnership liabilities under §752(d)."[43] Further complicating the policy issue is the fact that depreciation is allocated under §167(d) and not in accordance with Subchapter J rules. In the absence of any overriding trust provision, depreciation is allocated in accordance with trust income. The reduction of the trust's basis in the building may have been due to depreciation allocated to John or another income beneficiary, rather than to the trust.

Assuming that gain is recognized on the distribution, the tax liability belongs to the transferor – the trust. If the trust has assets of nominal value apart from its investment in the office building, there are no assets from which the tax authorities can collect the tax. The transferee liability of the beneficiaries would be limited to the value of what the beneficiaries receive.[44] Since the value of what the beneficiaries would receive is "negative", there should be no transferee liability.

The trustee is liable if distributions are made from a trust before satisfying tax liabilities.[45] However, there is no liability until a distribution is made, even assuming that the distribution triggers tax. Also, the liability of a fiduciary cannot exceed the value of the assets distributed.[46]

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40 §643(e).

41 Reg. §1.1001-2(a).

42 Byrle Abbin, *Income Taxation of Fiduciaries and Beneficiaries* at 248 (1998 Edition).

43 William S. McKee, *Federal Taxation of Partnerships and Partners*, ¶ 23.06[2][a] (3d ed. 1997).

44 *See*, *Yagoda v. Commissioner*, 39 T.C. 170 (1962), *acq*. 1963-2 C.B. 3 (1963), *aff'd*, 331 F.2d 485 (1964), *cert. denied*, 379 U.S. 842 (1964) (holding that a trust beneficiary is liable for trust debts only to the extent of trust assets distributed to such beneficiary.)

45 31 U.S.C. §3713(b).

46 *See*, *U.S. v. Coppola*, 85 F. 3d 1015 (2nd Cir. 1996)(holding that an executor who distributed assets to beneficiaries before paying estate taxes and in such manner as to

If John acquires the building before death, the basis will be adjusted under §1014.

However, only limited basis adjustments will be allowed when the federal estate tax is no longer in effect.[47] Although gain generally will not be recognized when assets subject to liabilities in excess of basis pass from the decedent to a decedent's estate or to any beneficiary, certain exceptions will apply.[48] For example, if assets pass to a "tax exempt beneficiary," gain is realized to the extent the liabilities exceed basis. A "tax exempt" beneficiary includes not only tax exempt organizations and governments, but also "to the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance." It is possible that the segregation of assets subject to liabilities in excess of basis in separate trusts will be treated as passing to a tax exempt beneficiary on the theory that the arrangement interferes with the ability of the tax authorities to collect tax that may be due upon a gain realization event.

GIFT TAX STRATEGIES

A. Formula Gifts

1. Facts: Susan has a 60% limited partnership interest in a family limited partnership that owns an apartment building worth $10 million. Susan would like to transfer her interest to a trust for her children and more remote descendants. Susan also wishes to benefit charities. Susan has an appraisal that values her 60% limited partnership interest at $3 million. Thus the appraiser is applying a 50% discount to the net asset value of Susan's partnership interest. This discount is attributed to the lack of marketability and lack of control of Susan's interest. Susan has limited resources to pay gift tax deficiencies and asks you what protection you can give her that her appraisal will be respected.

2. Proposal: Susan will use a formula defined value clause to transfer her limited partnership interest to a trust and to a community foundation. Susan will create a grantor trust with an independent trustee and fund the trust with marketable securities and cash having an aggregate value of $300,000. Susan will assign her interest in the family partnership as follows: (i) Susan will make a gift to the trust of 5% of her limited partnership interest (a 3% partnership interest); (ii) Susan will assign to the trust that fraction of her remaining limited partnership interest the numerator of which is $2,500,000 (which is the face amount of a promissory note issued by the trust and payable to Susan) and the denominator of which is the fair market value of her remaining limited partnership interest *as finally determined for Federal gift tax purposes,* and (iii) the balance of her interest (the "residual gift") 90% to the foundation and 10% to the trust. Based on Susan's appraiser's values, her entire limited partnership interest is worth $3 million, the 3% limited partnership interest is worth $150,000, the amount sold to the trust is $2,500,000, the residual gift to the foundation is $315,000 and the residual gift to the trust is

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render the estate unable to pay taxes was personally liable up to the value of assets distributed.)

47 See §1022.

48 See §1022(g).

worth $35,000. The total taxable gifts is $485,000 (including the marketable securities and cash used to fund the trust).

Susan also makes a cash gift to the foundation which the foundation is required to use to obtain an independent appraisal of her gift and negotiate with the trustee to fix their shares in the partnership. The foundation's interest is not subject to any restrictions on transfer or call rights. The foundation is admitted as a partner and therefore acquires all of the rights in the partnership that Susan had (and not an assignee interest). The partnership agreement provides for the resolution of any valuation disputes by averaging the values determined by qualified appraisers retained by the parties to the dispute. Subsequently, the foundation obtains an appraisal which employs a lower discount than the discount used by Susan's appraiser. The foundation and the trust negotiate the valuation differences using the partnership agreement's dispute resolution mechanism, even though that is not binding upon the issue presented in the instrument of assignment that Susan signed. More than a year later, the trust purchases the foundation's interest based on the value of the foundation's interest as determined by qualified appraisers retained by the trust and the foundation and using the same valuation dispute resolution procedure.

Susan's formula defined value transfer should be effective to avoid a gift tax deficiency (except with respect to the residual gift to the trust) even if the IRS disputes the valuation reported on her return.

"Formula defined value" clauses should be distinguished from "price adjustment" clauses like the ones discussed in Revenue Ruling 86-41, 1986-1 C.B. 300, *Commissioner v. Procter*, 142 F. 2d 824 (4th Cir. 1944) and *Ward v. Commissioner*, 87 T.C. 78 (1986). In Rev. Rul. 86-41, the IRS said that a clause that increased the consideration to be paid for the transferred property or that caused a portion of the transferred property to revert to the transferor were conditions subsequent that are not effective to avoid a taxable gift from being made on the transfer of the property.

The IRS has considered formula defined value clauses in two private letter rulings. In each case, the IRS treated the formula defined value clause as conditions subsequent, indistinguishable from those used in *Proctor*, *Ward* and Rev. Rul. 86-41. The rulings recite facts that compromise the taxpayers' position that the transfer was a formula defined value transfer. In each case, the taxpayers executed instruments fixing the amount of the transfer in a manner that was inconsistent with a formula defined value transfer. For example, in PLR 200245053, a transfer that began as a defined value transfer became an agreement to revert property to the transferor when the parties signed an Agreement stating:

> [T]he parties hereto agree that the Assignment effected a transfer of a Ninety-eight and nine tenths percent (98.9%) limited partnership interest . . . . The parties acknowledge that this Agreement is subject to modification if within the statute of limitations applicable to the Assignment it shall be determined that the Assignment actually conveyed a different percentage than that set forth above. The parties agree that if there shall be such a determination, the ownership interests in the Partnership and distributions previously made from the Partnership shall be adjusted.

The ruling concluded that there was no difference between the adjustment clause in Rev. Rul. 86-41 and the adjustment provision in PLR 200245053.

Similarly, in PLR 200337012, the taxpayer's gift tax return reported a gift of a stated percentage interest in the partnership without reference to the formula defined value clause.

In *McCord v. Commissioner*, 120 T.C. 358 (2003), the Commissioner argued that a formula defined value clause was void as against public policy. Although the Tax Court held that the particular formula defined value clause used by the petitioners in that case was ineffectual to avoid gift tax, importantly, the majority did not hold that the clause was void as against public policy. In fact, the Tax Court decision creates an inference that a properly drafted formula defined value clause is not against public policy and will be effective to avoid gift tax.

In *McCord*, the petitioners assigned all of their Class B limited partnership interest pursuant to an "assignment agreement" dated January 12, 1996 to a number of assignees, whose relative interests in and rights to the Class B interests were defined by a formula. The petitioners' children and four trusts for the children collectively were to receive a fraction having a fair market value of $6,910,933. The Shreveport Symphony was to receive the next $134,000 of value and a community foundation ("CFT") was to receive any value in excess of $7,044,933. The assignment agreement left it to the assignees to determine their interests but mandated that the determination was to be based on values using federal gift tax valuation principles. Any dispute concerning value was to be submitted to arbitration. Two months after the gift, the assignees executed a "Confirmation Agreement" which determined each person's share of the Class B interests. The partnership had the right to call any interest in the partnership that was held by a charity and the partnership exercised this right and redeemed the charities' interests in June, 1997, for fair market value as determined by a subsequent appraisal. Representatives of the charities accepted the appraisals prepared by the petitioners' children both for the Confirmation Agreement and the redemption, without independent inquiry.

The Commissioner argued that the formula clause in the assignment agreement was against public policy because it was designed to neutralize the tax effect of any upward adjustment to value on audit of the gift tax return. The petitioners argued that the formula defined value clause was effective so that any increase in value inures to the benefit of CFT under the formula. Side-stepping the public policy argument, the majority states:

> Because the assignment agreement does not equate the term "fair market value" with the term "fair market value as finally determined for Federal gift tax purposes," petitioners' argument must fail.
>
> * * *
>
> The formula clause is not self-effectuating, and the assignment agreement leaves to the assignees the task of (1) determining the fair market value of the gifted interest and (2) plugging that value into the formula clause to determine the fraction of the gifted interest passing to CFT. * * * Had the petitioners provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest **as finally**

determined for Federal gift tax purposes, we might have reached a different result. However, that is not what the assignment agreement provides.[Emphasis added.]

As the dissent by Judge Foley points out, "Inexplicably, the majority ignore respondent's primary contentions, (i.e., that the substance over form, and violations of public policy doctrines are applicable) and base their holding on an interpretation of the assignment agreement that the parties never raised. Judge Foley finds that the formula defined value clause is distinguishable from the condition subsequent clauses in *Proctor* and *Ward*. He would hold that the petitioners' formula clause was not against public policy.

Because the majority notes that formula defined value clauses are specifically allowed by regulations and rulings in the case of split interest trusts, GRATs and marital deduction clauses in wills, it is likely that the majority would not find such clauses to be void. Formula defined value clauses are specifically allowed in Reg. §25.2518-3(c) (allowing defined value formula for disclaimer of pecuniary amount); Reg. §25.2702-3(b)(2) (allowing value of grantor retained annuity trust annuity to be stated in terms of a fraction or percentage of fair market value); Reg. §25.2702-39(c)(2) (requiring the annuity of a grantor retained annuity trust to be increased if an incorrect determination of the fair market value of the trust assets is made); Rev. Proc. 64-19, 1964-1 C.B. 682 (relating to defined value formula for funding the marital deduction); Reg. §1.664-2(a)(1)(iii) (allowing defined value dollar amount of charitable remainder annuity trust to be expressed as a fraction or percentage of the initial net fair market value of the property passing in trust as finally determined for federal tax purposes); Rev. Rul. 72-395, 1972-2 C.B. 340, modified by Rev. Rul. 88-81, 1988-2 C.B. 127, modified by Rev. Rul. 82-128, 1982-2 C.B. 71, modified by Rev. Rul. 80-123, 1980-1 C.B. 205, clarified by Rev. Rul. 82-165, 8 1982-2 C.B. 117, 1982-40 I.R.B. (allowing valuation definition clauses in charitable remainder trusts; and Reg. §1.664-3(a)(1)(iii) (requiring adjustments in annuity amounts if an incorrect determination of the fair market value of the charitable remainder trust has been made).

If an adjustment occurs in a formula defined value clause, a change in the identity of the transferee may occur (*e.g.*, the credit shelter trust owns less of the asset and the marital trust owns more of the asset). If an adjustment occurs in a price adjustment clause, the initial transfer is partially unwound and the identity of the transferee does not change (*e.g.*, the transferee pays an additional amount for the asset). Price adjustment clauses were found to be against public policy in *Procter* because, if such clauses were effective, the result of an audit of the gift tax return could never result in a deficiency. Although the same public policy argument applies to formula defined value clauses, they are so commonly used that an argument that they violate public policy is not persuasive.[49] Moreover, as explained below, the public policy argument

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[49] In TAM 200245053, the IRS asserts that defined value clauses are valid only where specifically allowed to implement "Congressionally sanctioned tax benefits," such as in testamentary marital and credit shelter formula clauses and GRATs. Moreover, the IRS asserts that the GRAT regulations "should not be viewed as sanctioning the utilization of the formula to 'zero out' a gift, as is the case in the situation presented here." In view of the Tax Court's decision in *Walton v. Commissioner*, 115 TC 589 (2000) the IRS' position on GRATs is not persuasive.

could be addressed by deliberately structuring the formula to produce a small deficiency on audit. [50]

A formula defined value transfer may increase the retained interest of the donor (as in the case of a grantor retained annuity trust); may define the portion of the property interest that is transferred or may provide that a defined portion of the property transferred passes to a "tax sheltered recipient." For example, a transfer may provide that an undivided part of a "hard-to-value" asset, which exceeds a defined value of the transferred entity interest, will pass (a) to a grantor retained annuity trust ("GRAT") in which the remainder interest is de minimis, (b) to the transferor's spouse or to a marital deduction trust, (c) to a charity, or (d) to a trust in which the grantor has retained an interest that makes the gift incomplete such as a retained power of appointment.

Any formula defined value clause needs a mechanism to bring finality to the question of who owns what. Where the transfer involves a gift, finality can be achieved by filing a gift tax return that adequately discloses the formula transfer. When the statute of limitations expires on assessing a gift tax deficiency and none has been asserted, the ownership fractions will have been determined. However, if a gift tax return is not filed that adequately discloses the transfer, finality cannot be achieved unless there is another mechanism that does not involve any action by the transferor that can be viewed as donative.

In *McCord*, *supra*, finality was achieved by the assignees entering into a Confirmation Agreement in which they determined their shares. The charities did not obtain their own appraisal of the interests given to them but simply accepted the children's appraisal. A few months later, the charities' interests were redeemed by the partnership pursuant to a call option also at a value determined by the children's appraiser. In that case, in addition to the public policy argument, the Commissioner also argued that the "integrated transaction doctrine" applied to make the formula defined value transfer ineffectual. It is advisable to avoid the integrated transaction argument by assuring that the charities engage in conduct evidencing arms' length price negotiations. At a minimum, the charities should obtain their own appraisals. A call option is unnecessary in most cases because it is highly likely that the charities will agree to redeem their partnership interests even if there is no call option. A prompt redemption of the charities' interests in the partnership is not helpful to the taxpayers' defense against the Commissioner's assertion of the integrated transaction doctrine.

Susan's formula defined value clause includes the "magic language" "as finally determined for Federal gift tax purposes." The foundation hired an appraiser and engaged in arms' length negotiations to determine values. The purchase of the foundation's interest is not pursuant to a call option. The purchase occurs more than a year later. An audit of Susan's return may produce a gift tax deficiency because some of the residual gift belongs to the trust. These distinctions from *McCord* may be sufficient to uphold the valuation clause.

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[50] In TAM 200245053 the IRS rejected the formula clause even though the gift tax audit would produce a small deficiency on the transfer of a 0.1% interest in the partnership transferred as a gift at the same time a 98.9% interest in the partnership was sold.

Note, however, that even though Susan's formula defined value clause is self-effectuating, as the majority found to be critical, the assignees are not precluded from negotiating their shares of the partnership in any manner they choose. Since Susan had no role in determining the arrangements between the trust and the charity, how can it be that Susan has made a gift? If the Service believes the discount should be 25%, but the foundation believes it should be 40% and the independent trustee believes it should be 50%, has the foundation made a taxable gift to Susan's trust if they settle on a discount of 45%? No gift tax should result, if the foundation did not enforce its "I.R.S. right" to recover the excess partnership interest allocated to Susan's grantor trust, even if that failure to recover results in a deemed "bargain" transfer to the trust, because the gift tax is only imposed upon transfers by individuals.[51] Secondly, and perhaps more importantly, the foundation did not make a transfer to anyone when it determined its rights, because the foundation believed in good faith that it received adequate and full consideration.[52] The charity is not a "transferor" for purposes of §2512. The "private inurement" and "excess benefit" rules under IRC §§501(c)(3) and 4958 should also not be applicable, assuming the parties were not in collusion, Susan is not an insider of the foundation, the foundation had independent counsel, and the foundation used independent appraisers.[53]

The trust and the foundation will have to negotiate in a reasonable and arms length manner to determine the appropriate ownership percentages and purchase. If they do, then the price determined by that negotiation satisfies the tax law definition of fair market value – the willing buyer and willing seller test. If the foundation does not negotiate with the trust in a reasonable and arms' length manner, the price they fix will not be probative of value.

In FSA 200122011, which was based on *McCord*, the IRS said the following about the formula defined value clause:

> Though *Proctor* involved a savings clause as opposed to a formula clause, the principles of *Proctor* are applicable to this case. If formula clauses like the one at issue are effective to require payment of any increased value to the charitable donee, these clauses would be similar in effect to savings clauses in that they recharacterize the transaction in a manner that would render any adjustment nontaxable. A valuation increase resulting from an examination would serve only to increase the charitable deduction, but would not otherwise generate any gift tax deficiency. Moreover, the adjustment would substantiate a claim for an increase in the income tax charitable deduction claimed by the donor. The sole justification for the Commissioner's examination would be to insure that charity received all that it was entitled to under the transfer documents. This would place federal tax administrators in the position of policing charitable transactions, a role more appropriately performed by the states' attorneys general.

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51 *See* I.R.C. §2501(a)(1); Reg. §25.2501-1(a).

52 *See* Reg. §25.2512-8.

53 *See* Reg. §53.4958.

The IRS analysis misses several key points, including: (i) the IRS does have a "revenue incentive" to examine a charity's actions in agreeing to the amount of a formula gift, because the charity and the "offending" individual will be subject to IRS sanctions (which potentially increases Treasury revenue), if there is any excess benefit to that individual; (ii) state attorney generals *do* have a duty to enforce the formula; (iii) the charity has a fiduciary duty under state property law to enforce the formula (and, as noted above, it is clear law that federal gift tax consequences follow state property law); (iv) assuming the charity does engage in arms length negotiations, it is irrelevant whether the formula clause "works," because under gift tax valuation cases and the IRS's own regulations, it is clear arms length negotiations are the best evidence of value;[54] (v) as noted above, the IRS itself mandates formula clauses for charitable split interest trusts and grantor retained annuity trusts, both of which involve the same public policy considerations; (vi) as noted above, the IRS has long accepted formula marital deduction clauses, which have the same public policy considerations as formula gifts to charity; and (vii) there is a key distinction between price adjustment clauses such as the one discussed in *Procter* and defined value formula clauses (*e.g.* marital deduction clauses). One distinction is that the price adjustment clause involves a condition subsequent. In addition, in some defined value formula clauses, the identity of the recipient could change (which is clearly not in the donor's best interest).

Moreover, the objection that <u>no</u> deficiency will result upon an audit can be easily defeated, as it is in Susan's case. Instead of Susan transferring to the foundation all of the residual interests having a value in excess of $2,500,000 (the defined amount), Susan transferred only 90 percent of such excess. In that case, 10 percent of any valuation adjustment would increase her taxable gifts and potentially produce a deficiency. Thus, the audit would not be without any consequence, just without much consequence.

Suppose that Susan does not want to benefit charity, but still wants the protection of a formula clause. Instead of the above example, suppose that Susan makes a gift to a trust that directs the independent trustee to divide the amount received into separate portions, one equal to Susan's remaining gift tax exemption and the other any excess. The excess will be allocated to a marital deduction trust or to a trust over which Susan retains a limited power of appointment. Alternatively, Susan may fund the trust with the gift of $300,000 in January and make the sale in March. The trust may say that any gifts made after February are allocated to a trust over which Susan retains a power of appointment. Or Susan may make a gift of the limited partnership interest to her husband with the provision that any amount he disclaims passes to Susan's irrevocable grantor trust. If Susan's husband makes a qualified disclaimer of a pecuniary formula amount equal to Susan's remaining gift tax exemption, there should be no risk of a gift tax deficiency. In all of these cases, however, a gift tax return will have to be filed adequately disclosing the transaction in order to bring finality to the determination of who owns what portion of the property held by the trustee.

PLR 8611004 illustrates the importance of bringing finality to the application of the formula. Under the facts in PLR 8611004, the donor transferred a sole proprietorship to a partnership in exchange for a 99.9982% interest in the partnership. The other .0018% interest in

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54 *See Morrissey v. Comm.*, 243 F.3d 1145 (9th Circuit, 2001.

the partnership was owned by trusts for the donor's children. The donor transferred a portion of his partnership interest having a value equal to a stated dollar amount to the trusts for his children each year from 1971 through 1982. The donor and trustees agreed on the capital ownership attributable to the gifts, and partnership income was allocated accordingly. The Service concluded that the donor's formula transfer was effective. The donor would be treated as having transferred interests having a value equal to the stated amounts of the gifts. However, the donor would be treated as retaining the right to recover "excess interests;" to the extent that the gifted fractional interests reflected in the partnership agreement and income tax returns exceeded the fractional interests actually conveyed in the gift assignments, no completed gift occurred. If, however, the donor were ever barred from enforcing his ownership right to the excess interest, he would be treated as having made an additional gift to the trusts.

B. GRAT Sales

Another defined value strategy is to use a GRAT. The use of formula clauses in a GRAT to provide protection against a valuation dispute is beyond question. However, the problem with a GRAT is that the annuity must be paid at least as often as annually. If Susan conveyed her partnership interest to a GRAT, cash flow from the building would not be sufficient to timely pay the projected annuity. The alternative of annually appraising her limited partnership interest to pay the annuity in kind is expensive and inconvenient. In addition, the partnership interest paid in kind to Susan will suffer the same discount used on funding the GRAT. Susan's sale of a portion of her annuity to an irrevocable grantor trust may alleviate the cash flow problem.

For example, assume that under the formula as computed by Susan's advisors, Susan retains the right under a GRAT to receive $675,000 for five years. That right has a present value (hypothetically) of $3 million which is the estimated fair market value of her interest in the limited partnership. Susan sells the right to receive $675,000 per year for five years to an irrevocable grantor trust, taking back a long term note for $3 million with interest at the applicable federal rate. There is no valuation issue as to the present value of the right to receive fixed payments. Each year, the trustee of the GRAT makes the annuity payments to the assignee trust, using cash and, if necessary, partnership interests. The assignee trust uses the cash received from the trustee of the GRAT to pay interest on the note owed to the grantor. Since Susan has only sold the assignee trust the right to receive $675,000 per year, if on audit of her gift tax return, the IRS says that the proper amount of the annuity is $775,000, Susan has the right to receive $100,000 per year because she did not sell that right. The GRAT's cash flow from the partnership is sufficient to cover a $100,000 annual cash payment to Susan. In this manner, partnership interests may be transferred to the assignee trust rather than to Susan in satisfaction of annuity payments. Susan protects her right to the valuation protection of a GRAT and does not receive discounted partnership interests in payment of her annuity.

C. Sales to §678 Trust

1. Facts: Susan is looking for ways to transfer her 60% limited partnership interest at its appraised value of $3 million without the risk of incurring gift tax and avoid a valuation controversy over whether any defined value formula clause is void as against public policy.

2. Proposal: Susan's mother transfers $50,000 to a trust which is not a grantor trust and which gives Susan a right of withdrawal. The right of withdrawal lapses to the extent of the greater of $5,000 or 5% of the trust at the end of each year. Despite the nontaxable lapse of withdrawal rights, Susan is the owner of the trust for income tax purposes under §678. Susan has a limited testamentary power of appointment.

If Susan sells her 60% limited partnership interest to the trust for a promissory note for $3 million based on her appraiser's value, there should be no gain recognized because the sale is to a trust deemed to be owned by Susan under §678. The principles of Revenue Ruling 85-13, which ignore for income tax purposes transactions between a grantor and a grantor trust, should apply equally to transactions between a beneficiary and a trust which the beneficiary is deemed to own. However, if the IRS determines that the sale from Susan to the trust was a bargain sale, the bargain element is not a completed gift because Susan has retained a limited power of appointment.

Assuming that Susan's rights of withdrawal lapse before her death, and assuming that she is not treated as making a gratuitous transfer to the trust, the assets in the trust should not be included in her estate at her death. However, if and to the extent that Susan is treated as making a bargain sale to the trust, the assets will be taxed at her death under §2036. Therefore, it is necessary that Susan file a gift tax return fully disclosing the transaction and allow the IRS the opportunity to evaluate the sale. If the statute of limitations closes on the assertion of a gift tax deficiency, then the argument that §2036 applies should be foreclosed.

D. Sale of Preferred Partnership Interests to a Grantor Trust

1. Facts: Mary is a real estate developer with a very illiquid estate. She carries a large amount of insurance to pay premiums on policies intended to provide liquidity for estate taxes. She has used all of her gift tax exemption to pay premiums owed by an irrevocable life insurance trust ("ILIT") but the policies are not paid up and substantial additional amounts are due. She wants to know how she may finance the policies without incurring gift tax costs. At current interest rates, low interest loans are attractive, but the interest compounding over Mary's remaining life expectancy is formidable.

2. Proposal: Mary creates a high-yield asset as follows. Mary contributes her portfolio of cash and marketable securities worth $4 million that has an annual total return of 6% (approximately $240,000) into a family limited partnership that has three classes of interest. Class A is a general partnership interest representing 1% of the equity that is entitled to a guaranteed payment of $40,000 a year, Class B is a cumulated preferred interest that is entitled to a liquidation preference of $2 million and has a 8% cumulative preference (that is, it is entitled to receive the first $160,000 of annual income as earned) and Class C a common limited partnership that is entitled to the balance of the income after paying the Class A and Class B interests. An appraiser values the Class B interests at par.

Mary sells the Class B interests to her ILIT in exchange for a note with a face amount of $2 million and interest at the AFR. Assume that the AFR for the note is 4%. Mary has created arbitrage profit of 4% (the excess of the 8% preferred return over the 4% interest rate on the note) which should make approximately $80,000 available to pay premiums on her life insurance. If there is sufficient cash flow, the excess can be used to pay down the note or prepay premiums.

When the premiums are paid up, the partnership is liquidated and the ILIT uses the liquidation preference to pay the principal on the note.

E. Gift of Preferred Partnership Interest to a Charitable Lead Trust

1. Facts: Mary also is charitably inclined. Mary regularly makes gifts to charity of $200,000 a year. Mary is looking for ways to transfer wealth to her children without incurring gift tax.

2. Proposal: Mary creates the same family limited partnership described above – Class A, B and C interests. Mary gives the Class B preferred interest having a fair market value of $2 million and a preference of 8% to an 18 year charitable lead annuity trust ("CLAT") paying an annuity of 8 percent per year. The remainder value is almost $70,000. The preference is sufficient to cover the amount due to charity. Treasury tables assume a yield of 4.6% rather than 8%, and therefore expect that the principal will be diminished by the lead payments. If the preference is paid, the principal will not be diminished. Since there are assets worth $4 million supporting the preferred return, it is realistic to expect that the preference will be returned. However, it is not appropriate to value the interest at a premium because the interest is not marketable and the owner of the interest has no assurance that the preference will be timely paid.

Mary could reduce the remainder factor to zero by using a formula. Such a formula might read as follows:

> "In each taxable year of the trust (pro rated for any short year as hereinafter provided) the Trustees shall pay to XYZ CHARITY such sum as shall be equal to a percentage (rounded to the nearest one-thousandths of one percent) so that the value of the remainder of this trust, as finally determined for federal gift tax purposes with respect to the transfers by the grantor to this trust is zero (or as close to but not less than zero as is mathematically possible, if it is not mathematically possible to make the remainder value zero) of the initial fair market value of the trust assets."

Formula clauses to define the annuity percentage are advisable. The formula assures that there will not be a transfer tax surprise if the annuity is not computed correctly. When the CLAT commences other than at the beginning of the calendar year, the commercial programs used to value term and remainder interests are not correct. Formula clauses also are useful when a testamentary CLAT is desired. The optimum annuity rate cannot be determined in advance of knowing the §7520 rate in effect at the time of the testator's death.

Although Mary will not be entitled to a charitable contribution deduction for the $2 million gift to the CLAT, Mary will have the equivalent of a deduction each year of the trust as the first $160,000 of income from her investment portfolio is used to make payments to charity. At the end of the term of the lead trust, the $2 million should remain for transfer to her children.

A disadvantage of a CLAT is that assignment of Mary's GST exemption cannot be made at the time the trust is funded in a manner that assures that the property will have a zero inclusion ratio. §2642(e) allows Mary to assign $70,000 of her GST exemption to the trust. However, the applicable fraction is not determined until the lead interest ends. The fraction will have a numerator of $70,000 increased at the §7520 rate for 18 years and a denominator equal to the value of the assets at that time. If the CLAT's investments perform at a rate better than the §7520 rate, the inclusion ratio will exceed zero. If the investments perform less well, GST exemption will have been wasted (the trust will have an inclusion ratio of less than zero).

If Mary funds a charitable lead unitrust ("CLUT") instead of a CLAT, she can assign just the amount of GST exemption necessary to produce an inclusion ratio of zero for the remainder. §2642(a)(2)(B)(ii)(II) allows the inclusion ratio to be fixed when a CLUT is funded. (The special rule in §2642(e) applies only to CLATs.) However, CLUTs are not interest rate sensitive. For example, the remainder in an 8% 18 year CLUT funded with $2 million would be worth $453,782 rather than $70,000 in the case of a comparable CLAT. Therefore, when interest rates are low, a CLAT is a more tax efficient strategy.

Mary may be able to use the strategy to pass wealth to her grandchildren without incurring GST tax. Because the Class C interests are subordinated to the Class B interests, the Class C interest should be deeply discounted. Mary may wish to sell this discounted interest to the ILIT for a note bearing interest at the applicable federal rate. When the lead interest ends, the partnership may be liquidated. $2 million would pass to Mary's children as the remainder beneficiaries of the CLAT and 99% of the balance would pass to the ILIT.

F. Dynasty Trusts

1. Facts: Bernie has read about the phasing out of the estate tax and its repeal in 2010. Bernie understands that the generation-skipping transfer tax is also being phased out and repealed in 2010. He asks whether his estate planning documents cannot be simplified to eliminate trusts. What do you tell Bernie?

2. Proposal: You advise Bernie that trusts are as important as ever, and even more useful.

There are many reasons not related to taxes why use of a trust may be advisable. Sometimes a beneficiary is too young or unsophisticated in financial management to take responsibility for the management of assets. Even if a beneficiary is adult and able, as he or she becomes aged and infirm, trust management may be necessary. Trusts also are useful to protect beneficiaries from the claims of creditors, including a spouse or former spouse. However, the tax benefits of using trusts are not diminished by changes in the transfer tax laws.

The principal reason why trusts will be as important as ever they were when the estate tax was in full force is that gift taxes are not being phased out or repealed. In a world without estate or generation-skipping transfer tax, gift tax can be avoided only by leaving assets to a trust that will allow a trustee to spread the income and principal among the family members as their needs require. Without a trust, there would be a $1 million limit on the amount by which an individual could benefit his or her descendents until his or her death. Moreover, the risk that estate and generation-skipping taxes will not be repealed, or permanently repealed, is significant.

Income tax also can be avoided by making charities discretionary beneficiaries of multi-generational trusts. When there is no estate tax, the split interest rules will no longer be relevant to estate tax planning. Discretionary trust distributions to charity can shield trust income from tax.

It may be possible to establish a trust in a state that does not tax the accumulated income of the trust. Over a long period of time, the reduction of tax at the state level produces significant benefits.

Even income that is distributed to a beneficiary may avoid being taxed in the beneficiary's state of residence. If the trust is an electing small business trust having a situs in a state that does not impose an income tax, distributions do not carry out trust income to the beneficiary.[55] If the state of the beneficiary's residence defines income based on federal adjusted gross income, the income will not be taxed in the state of the beneficiary's residence.

During the grantor's lifetime, §679 prevents avoidance of U.S. income tax by funding foreign trusts. However, after the grantor's death, §679 is no longer applicable. Therefore, it is possible to establish a foreign trust and avoid federal income tax on accumulated income. Moreover, a trust can be established and managed in the U.S. and be classified as foreign for federal income tax purposes by giving a foreign person even a relatively minor power, such as the power to terminate the trust. While the accumulated income will be subject to the accumulation distribution ("throwback") tax when it is deemed distributed to U.S. beneficiaries, the accumulation distribution rules treat distributions from foreign trusts as coming out of current income first. Therefore, as long as distributions never exceed the current income of the trust, there is no throwback tax.

In addition, a distribution of a fixed dollar amount does not carry out accumulated income. So, for example, suppose that Bernie funded his foreign trust from his will with $2 million to accumulate income for the benefit of his grandchildren for 20 years. At the end of 20 years, the trustee is directed to distribute $2 million to Bernie's grandchildren or to another trust for their benefit which is a U.S. trust. That distribution does not carry out any income. §663(a)(1) provides that a specific sum of money which under the terms of the governing instrument is payable in not more than 3 installments does not carry out income to a trust beneficiary. After 20 years, the trustees begin making distributions of current income to the trust beneficiaries. If the principal, as distinguished from the income earned on the principal, is <u>never</u> distributed to a U.S. beneficiary, then there will never be any throwback tax.

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55 §641(c). Credit for this idea belongs to Carlyn McCaffrey.

ESTATE PLANNING IDEAS

A. Avoiding §2035 on Transfers of Life Insurance

1. Facts: Adam shows you an ILIT set up by his former attorney. You see that the ILIT is flawed because Adam has incidents of ownership under §2042 or a general power of appointment under §2041. The policies owned by the ILIT have a cash value of about $70,000. Adam is 65 years old and his wife, Alice, is 64. Both are in reasonably good health.

2. Proposal: There are three options. Option one is to cancel the policy and buy a new policy in a new ILIT. Option one may be too costly. Option two is to distribute the policy to Alice (Adam is not a beneficiary), transfer the policy from Alice to Adam and then from Adam to a new ILIT. Option two runs the risk that if Adam dies within 3 years, §2035 will include the policies in his estate. Option three is for Adam's ILIT to sell the policy for cash to a new ILIT funded by Adam. §2035 does not apply to transfers for full and adequate consideration.

The sale technique will not work if Adam is terminally ill at the time of purchase. That is because the policy will have a fair market value close to the death benefit.[56] However, if Adam is in reasonably good health, the value of the policy is its interpolated terminal reserve value plus the unearned premium.[57]

The IRS could argue, as it did successfully in *U.S. v. Allen*, 293 F. 2d 916 (10th Cir. 1961) that "full and adequate consideration" means something different from "fair market value." In Allen, the court said that §2035 applied to a sale of a decedent's retained interest in a trust that was includable in the decedent's estate under §2036 because the purchase price did not equal the value of the entire trust. Full and adequate consideration was determined to be more than fair market value of the decedent's interest in the trust, in order to avoid the depletion of the estate subject to tax if §2035 were applicable. In that case, the decedent died within 3 years of the purchase.

More recent cases hold that full and adequate consideration does mean fair market value.[58] Generally, the substitution of fair market value for the transferred interest means that the estate is not depleted by the transfer. However, that is not true when §2035 would otherwise be applicable.

The theory in Allen could be applied to the sale of a life insurance policy within 3 years of death, but to date this has not occurred. In PLR 9413045, the IRS ruled that a sale of an insurance policy from a trust in which the insured had an incident of ownership to another in

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56 *Pritchard v. Commissioner*, 4 T.C. 204 (1944).

57 Reg. §20.2031-8(a)(2).

58 *E.g. Estate of D'Ambrosio v. U.S.*, 101 F.3d 309 (3rd Cir. 1996); *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997); *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999), remanded 81 TCM (CCH) 1126 (Feb. 12, 2001).

which the insured had no incidents of ownership for a purchase price equal to the policy's fair market value would not be included in the insured's estate under §2035 even if the insured died within 3 years of the sale.

The sale of the policy is not as likely to be respected as a bona fide sale if the insured makes a gift to the purchaser shortly before the sale in order to finance the purchase of the policy. Therefore, it may be preferable to purchase the policy for a note. Since both ILITs will be grantor trusts, no income tax consequences should result from the interest payments. For the same reason, the transfer for value rule in §101 should not subject the proceeds of insurance to income tax. There has been no sale for income tax purposes, or if there has been a sale, it is made to the insured, which is an exception to the transfer for value rule.[59] If you want a "belts and suspenders" approach, the ILITs could become partners in a partnership in order to support a third reason why the transfer for value rule would not cause the proceeds to become taxable.[60] §101(a)(2)(B) provides that a policy transferred for value to the insured or to a partner of the insured will not make the proceeds taxable.

If Alice owned a policy on the life of Adam and wants to remove the policy from her estate without losing the right to benefit from the policy, Alice could sell the policy to an ILIT of which Alice is a beneficiary. Alice could not make a gift of the policy to the ILIT because §2036 would apply. §2036 will not apply if she sells the policy to the ILIT.

The transfer for value rule should not present a problem because the sale from Alice to Adam's ILIT should be treated for income tax purposes as within the sale to the insured exception to the transfer for value rule. However, if the ILIT pays Alice with a note, the interest payments will incur income tax. There is no exclusion for interest paid between spouses, or between a spouse and a grantor trust of the other spouse.[61] However, interest must be paid or the foregone interest will be a gift, and any gift from Alice to the trust will cause §2036 to be applicable.

B. EPTL §10-6.6

1. Facts: Carol is the beneficiary of a trust established by her grandfather that has a substantial corpus. Carol is entitled to all of the income. In addition, the independent trustee has the power to invade principal for Carol without limit. The trust terminates when Carol attains the age of 40. Carol is 39. Carol would like the trust to continue to benefit her and her children during her lifetime and to pass to trusts for her children upon her death.

2. Proposal: Carol's trust is governed by New York law because the independent trustee has the power to change the governing law and does so. New York law allows a trustee to exercise a power of invasion in favor of a beneficiary to appoint assets to a new trust with very

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[59] See PLR 200228019 (sale from one insurance trust to another is not a transfer for value if both are grantor trusts).

[60] *Id.*

[61] *Seymour v. Commissioner*, 109 T.C. 279 (1997).

different provisions. The trustee appoints Carol's trust to a new trust that also pays all of the income to Carol, but continues until her death and then benefits Carol's descendants until the rule against perpetuities requires the termination of the trust. All of the principal of the trust upon Carol's death will pass to Carol's descendants free of estate tax because as of the date of her death, Carol's interest was only a life estate.

EPTL §10-6.6 says that a trustee who has absolute discretion under the terms of a will or irrevocable trust to invade principal for the benefit of a beneficiary or beneficiaries, the trustee may exercise the discretion to appoint any part of the principal to a new trust. The power may be exercised without the court's consent and without the consent of any beneficiary. The only restrictions are that the power cannot reduce the fixed income interest of a beneficiary, it cannot be exercised to violate the rule against perpetuities and cannot violate the provisions of EPTL §11-1.7 which prohibits granting certain powers and immunities to testamentary trustees.

EPTL §10-6.6 apparently can be exercised to cut off a testamentary general power of appointment. If the power were exercised to change the terms of a marital general power of appointment trust, it may result in the marital trust assets escaping estate tax upon the death of the surviving spouse. Unlike the case of a QTIP trust, where an election was made to expose the remainder to estate tax under §2044, a general power of appointment marital trust qualifies for a marital deduction without an election being made. The trustee's exercise of the appointment power cannot be deemed a gift by the surviving spouse who has no voice in the exercise of the trustee's power.

However, the exercise of the powers in EPTL §10-6.6 could cause grandfathered GST status to be lost. Reg. §26.2601-1(b)(4)(i)(A) protects powers of appointment granted by statute that were in effect when the trust became irrevocable. Since EPTL §10-6.6 is a new statute, the exercise of the powers to shift beneficial interests to lower generations could cause the trust to become subject to the GST tax.

C. Family Limited Partnership for Estate Planning

1. Facts: Lois, age 72, is a widow. She has four adult children who have successfully taken over management and ownership of the family business. Lois is in good health but is interested in shifting responsibility for her investments to her children. Her assets are cash, bonds and marketable securities. The children are interested in ways to diminish estate tax.

2. Proposal: Lois and the children form a family limited partnership in which the children take general partnership interests and Lois becomes a limited partner. Lois contributes \$5 million and the children collectively contribute \$1 million. All partners are contributing a diversified portfolio so that no gain is recognized under §721(b). According to an appraiser, even though Lois contributed \$5 million to the partnership, Lois' limited partnership interest is only worth \$4 million. The arrangement assures Lois that her children will actively manage the family investments and enables the family to take advantage of certain private equity opportunities. Therefore, you argue that there has not been a gift on formation of the partnership.

The extent to which §2036 may be applicable to cause the assets of the partnership to be included Lois' estate is uncertain. The IRS has applied §2036 where partnership formalities are not followed and where the decedent retained voting rights.[62] In this case, it is assume that none of these reasons for applying §2036 are applicable. For example, Lois will not retain voting rights in the partnership.

D. "Graegin Notes"

1. Facts: Upon Lois' death, her limited partnership interest is still worth $4 million. The taxes due in Lois' estate are $2 million. To pay Lois' estate tax, the general partners could liquidate Lois' interest in the partnership by buying her interest for $4 million. Assuming a 50% estate tax rate, the limited partnership saved the family $500,000 because the fair market value of Lois' interest is less than the net asset value of her interest.

2. Proposal: More estate tax savings are possible if, instead of liquidating Lois' interest, the partnership loans the estate the funds to pay taxes. If the loan is a balloon note and there is no right of prepayment, the interest for the entire term of the loan may be accrued and deducted as an administration expense. There is no present value concept with respect to the deductibility of administration expenses for estate tax purposes. Therefore, even though the interest on the loan will not be paid for many years, the estate may deduct it at full value. In addition, the interest income to the partnership will not accrue immediately, but only as the loan matures. Finally, because the estate tax rate is higher than the income tax rate, it is preferable to use a high interest rate to reduce estate tax. The consequence is that the estate tax may be reduced by as much as 50% and possibly more, depending upon the interest rate and the term of the loan.

The IRS argued unsuccessfully in *Graegin v. Commissioner*, T.C. Memo 1988-477, that the deduction was not appropriate in the family context because the prepayment prohibition was not meaningful. If the family partnership has some non-family members, as was also true in Graegin, that argument should not be successful. Even if the prohibition on prepayment is not respected by the IRS, if the time for finally determining the estate tax is extended by audit and litigation proceedings, the interest actually paid by the time the tax is finally determined should be deductible, and the deduction will relate back to the due date of the taxes without diminution for the time value of money.

E. Defined Value Strategies for Estate Tax Planning

1. Facts: George owns an 80% limited partnership interest in a family limited partnership that owns a family business. The appraisers have issued a report that shows that his limited partnership interest is worth $8 million, which equals 50% of the net value of his share of the partnership. George is happy about the estate tax savings potential of the appraiser's report, but he is concerned that the IRS would engage his estate in protracted litigation concerning the discounts. He would like to avoid this dispute.

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62 *Strangi v. Commissioner*, T. C. Memo 2003-145; *Kimbell v. United States*, 371 F.3d 257 (2004).

2. Proposal: George's will leaves his residuary estate to his adult children and provides that to the extent the children disclaim all or any portion of his estate, the disclaimed amount passes to a charity. George's children collectively disclaim all but $7,800,000 of George's residuary estate, which consists solely of his limited partnership interests. Assuming that the appraisal is not challenged, the charity would receive a 2% limited partnership interest. (200,000/8,000,000) multiplied by the Estate's 80% limited partnership interest is a 2% interest.

If the formula disclaimer is effective, the IRS has no incentive to argue about the size of the discount because it does not affect the amount of estate tax that will be due at the time of George's death. For example, if the estate's interest is valued at $10 million, the charity will be entitled to an interest worth $2.2 million ($10 million less the $7.8 million the children did not disclaim). The $2.2 million would be satisfied by distributing to charity a 17.6% limited partnership interest.

Of course, the charity has a fiduciary obligation to diligently assert its claim to the appropriate share of the limited partnership interests. On the other hand, the charity's interest is not marketable and the most likely purchasers are George's children. It is not realistic to think that this leverage will not make price negotiations easier for George's estate. That being said, the fair market value of the interest properly reflects its lack of marketability.

But will the formula be effective to prevent an estate tax deficiency? Formula disclaimers of a fraction of a decedent's residuary estate are specifically allowed by the disclaimer regulations. Reg. 25.2518-3(d) example (20) provides as follows:

> EXAMPLE (20). A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A's estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B's disclaimer is a qualified disclaimer.

This case is similar to example 20. Here, a fraction of the residuary estate also is being disclaimed. The numerator of the fraction equals the excess of the value of the residuary estate over a stated dollar amount rather than, as in example 20, "the smallest amount which will allow the estate to pass free of Federal estate tax." The two examples would be even more similar if the numerator were expressed as the smallest amount which will allow the estate tax not to exceed a stated dollar amount. Such a formula would provide the same audit adjustment.

Despite the authority supporting formula disclaimers and the ubiquitous use of formula clauses in testamentary documents (e.g., formula marital deduction and credit shelter formulas) the IRS has challenged a formula disclaimer of a portion of a decedent's estate. There is a case currently docketed in the Tax Court, Estate of Morfeld, Tax Court Docket #012750-03, in which the IRS is challenging a formula disclaimer of the portion of the residuary estate exceeding a stated dollar amount on the grounds that the disclaimer violates public policy. The residuary estate consisted of interests in a limited partnership that the estate valued using a 45% discount. The IRS has taken the position that no discount should be applied to value the estate's interest. If the formula disclaimer is effective, then the valuation adjustments would increase the amount passing pursuant to the disclaimer and not result in an estate tax deficiency. However, if the disclaimer is effective for state law purposes and not for tax purposes, the children will both receive less value and owe more tax. This result will not occur if the children have previously negotiated a purchase of the charity's partnership interest.

In determining the value for gift and estate tax purposes of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). Assuming that state law recognizes the formula disclaimer as legally binding on the beneficiaries, the taxation of their interests should be based on their property interests. After their property interests are determined, the federal tax law then takes over to determine how such rights and interests will be taxed.[63] The federal estate tax consequences should be consistent with that definition.

The same result as a formula disclaimer could be achieved if George bequeathed a dollar amount to the children and the residue of his estate to charity. The estate tax liability will be based on the dollar amount of the bequest regardless of how the limited partnership interests are valued.

F. Deathbed Gifts to Avoid State Death Taxes

1. Facts: Carl is terminally ill and has an estate of $10 million consisting of marketable securities and real estate both of which have unrealized appreciation. He lives in a state that has not phasing out its estate tax, has limited the estate tax exemption to $1,000,000 and does not impose gift tax. If Carl dies in 2004, the top combined effective federal and state estate tax rate is 60% (48% federal and 12% state, which reflects the state death tax credit allowed for 25% of the state estate tax). Carl has made gifts using all of his gift tax exemption.

2. Proposal: You recommend that Carl borrow against his assets and make a cash gift to his children. Assume that the most that Carl can borrow and gift is $4,000,000. Carl's estate will pay $417,600 less in total transfer taxes than if no gift is made because state death tax is avoided on the gift. The federal transfer tax will not be reduced. By borrowing funds to make the gift, the basis step up is not lost. Some of the savings will be offset by the cost of borrowing, but because Carl's life expectancy is short, the interest expense is not likely to be very great.

GENERATION-SKIPPING TRANSFER TAX STRATEGIES

A. Inter-Vivos Reverse QTIP Trust

1. Facts: Tommy has exhausted his gift tax exemption, does not want to incur gift tax but wants to take advantage of projected increases in the GST exemption enacted by EGTRRA. You have explained to Tommy that the GST exemption will peak at $3.5 million in 2009.

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63 *Morgan v. Commissioner*, 309 U.S. 78 (1940).

2. Proposal: You suggest that Tommy fund an inter-vivos QTIP for his wife, Martha, with an amount equal to his GST exemption. Tommy will elect the marital deduction but also will elect to continue to be treated as the transferor for GST purposes.

§2652(a)(3) and Reg. §26.2552-2 permit the grantor of a QTIP trust for which a marital deduction is elected under §2523(f) to elect to be treated as the transferor for GST purposes. This is called a "reverse QTIP election."

Reg. §26.2632-1(c)(2)(ii)(C) provides that the ETIP rule does not apply to a reverse QTIP. But for that rule, Tommy would not be able to effectively assign GST exemption to the trust and determine its inclusion ratio since it is includable in Martha's estate. Because the ETIP rule does not apply, Tommy may immediately put his GST exemption to work without incurring any gift tax. Even if Tommy retains an income interest to take effect upon Martha's death, there is no ETIP.[64]

Of course, the QTIP will be taxable in Martha's estate at full fair market value at the time of her death. However, Martha may avoid depleting the GST exempt trust by directing that the estate tax imposed by reason of §2044 be paid from other assets. Reg. §26.2652-1(a)(5) <u>Example 7</u> provides that there is no constructive addition to a QTIP trust for which a reverse QTIP election has been made when estate tax imposed by §2044 is paid from other sources. This is true even where the right of recovery of tax granted by §2207A has not been waived.

The inter-vivos QTIP will be a grantor trust for income tax purposes because §677 will apply. To assure that capital gains as well as ordinary income is taxable to Tommy, the trustee (other than Martha) should have the right to invade principal for the benefit of Martha. Because the QTIP trust will not bear income or estate tax costs, its value should appreciate substantially.

To further augment the value of the trust, the investments made by the QTIP could be structured to generate little fiduciary net income, all of which must be distributed to Martha. Of course, Martha must have the right to require that the trust be invested to produce income, but she does not have to exercise that right.[65] One way to reduce fiduciary net income and allow reinvestment of growth is to invest the QTIP assets in a family limited partnership that reinvests income rather than making distributions to partners.

If Martha survives Tommy, further GST savings could be achieved by making the QTIP trust a grantor trust as to Martha. This must be done without making Martha the deemed transferor for GST tax purposes. The trust could become a grantor trust if the trustee of the QTIP contributed the assets in the QTIP to a subchapter S trust and Martha made an election for the trust to be taxed as a qualified subchapter S trust. This makes Martha the owner of the income of the subchapter S corporation under Code §678. Any QTIP will necessarily satisfy the requirements for being a qualified subchapter S trust. Martha's payment of income taxes on the undistributed income accruing to the subchapter S corporation will further augment the growth of the QTIP trust assets.

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64 *See* Reg. §25.2523(f)-1(f), Example 11.

65 Reg. §25.2523(e)-1(f)(4).

B. Cascading Crummey Powers

1. Facts: Jean has two children and four grandchildren. Jean has used almost all of her GST exemption and wishes to primarily benefit her grandchildren. She has funded an ILIT. The premiums are $30,000 a year. Jean wants ideas to minimize GST tax.

2. Proposal: If an ILIT benefits both children and grandchildren of the grantor, crummey powers may be granted to children first, up to the annual exclusion amount, and then to grandchildren. This avoids using any GST exemption (or incurring GST tax) if the contributions do not exceed the amount subject to withdrawal by the children.

When a crummey power lapses, the power holder is treated as making a gift to the trust to the extent that the lapse exceeds the greater of $5,000 or 5% of the value of the property over which the power could have been exercised.[66] For example, Jean's $30,000 gift to the trust, which her husband elects to gift split with her (§2513), gives each child the right to withdraw $15,000. 30 days later, each child's right of withdrawal lapses. Because each child's right to withdraw $15,000 exceeds the $5,000 threshold in §2514(e) (ignoring the 5% alternative test) by $10,000, each child is treated as the transferor of $10,000. Together, both children have become the transferors of $20,000. However, each of Jean's four grandchildren has the right to withdraw ¼ of the $20,000, or $5,000 each. The grandchildren's rights also lapse after 30 days. Jean is the transferor for GST purposes of $10,000 (for which Jean may assign GST exemption) and her children are the transferors for GST purposes of $20,000.

If different persons contribute to the same trust, the contributed amounts are treated as held in separate trusts for GST purposes.[67] Therefore, distributions to the grantor's grandchildren from the portion of the assets deemed to have been contributed by the grantor's children are not generation-skipping transfers. The grandchildren are not "skip persons" with respect to their parents.

Because the children of the grantor are treated as contributing assets to the trust and they are beneficiaries of the trust, there is a risk that §2036 will apply to include the assets in their estates upon their deaths, which would defeat Jean's purposes. This is less of a problem where: (1) an independent trustee and not the children control distributions to beneficiaries; and (2) the trust is governed by the laws of a state that does not allow the grantor's creditors to levy on the assets of the trust. Note, however, that a §2041 problem with respect to crummey powers theoretically could apply regardless of whether the withdrawal rights that lapse exceeded the "5 and 5" limit in §2514(e). After all, §2514(e) is a transfer tax concept and has nothing to do with defining whether a person is or is not a grantor for purposes of state law governing the rights of creditors. A beneficiary who is not a "transferor" for gift tax purposes may be deemed to hold a general power of appointment over a trust. By contrast, §§2036-2038 are not applicable except for "transferors" for gift tax purposes.

If cascading crummy powers are used, it is advisable to:

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66 §2514(e).

67 Reg. §§26.2654-1(a)(2)(i) and 26.2654-1(a)(3).

- Make the beneficial interests wholly discretionary so that no power holder has the "right" to any amount from the trust;
- Use independent trustees so that no power holder has the right to control beneficial enjoyment;
- Establish the trust in a jurisdiction that prevents creditors from reaching trust assets to satisfy the power holder's debts.

C. Generation Jumping

1. Facts: Maxine, age 84, is the beneficiary of an irrevocable trust established by her deceased husband that is not exempt from GST tax and not grandfathered from GST tax. Maxine has a limited testamentary power of appointment. Maxine has children, grandchildren and great-grandchildren. Her children are wealthy, and she wants the trust to primarily benefit her grandchildren and more remote descendants. Maxine has used all of her GST exemption. She does not expect to live to 2010 and Maxine is skeptical that the estate and GST tax will be repealed. Maxine consults you about minimizing GST tax.

2. Proposal: You suggest that Maxine exercise her limited testamentary power of appointment to appoint the remaining principal to a trust that benefits only her great-grandchildren for a period of five years. After five years, Maxine's children and grandchildren will become additional discretionary beneficiaries.

GST tax will be due upon Maxine's death when the interest is treated as passing to her great-grandchildren. However, only one GST tax will be due whether the trust passes to Maxine's grandchildren or her great-grandchildren. The determination of which generation is treated as receiving the property depends upon who has a current interest in the trust.[68] But for this maneuver, GST tax would have been due upon the death of Maxine's children and a second time upon the death of Maxine's grandchildren.

D. Assignments of Remainder Interests

1. Facts: Bob has founders stock in a new enterprise that is scheduled to have an initial public offering in about nine months. He has two adult children, Charles and Catherine, and six grandchildren. He would like to benefit his children and grandchildren, avoid generation-skipping transfer tax and avoid valuation disputes with the IRS. Therefore, Bob is more comfortable with a GRAT than a sale to a grantor trust.

2. Proposal: Bob funds a nearly zeroed out GRAT for each child giving each child a vested and transferable remainder interest. Bob cannot assign any of his GST exemption to the trust until the end of the estate tax inclusion period - the end of the term of the GRAT.[69] Charles and Catherine each create and fund a trust for their spouses and children (Bob's grandchildren),

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68 Reg. §26.2612-1(e) and see Reg. §26.2653-1.

69 §2642(f)

make gifts of their GRAT remainder interests to each of their trusts and assign their GST exemption to the trusts in an amount sufficient to produce a zero inclusion ratio. Each grantor retains the right to reacquire assets and substitute assets of equivalent value. Shortly before the end of the GRAT term, Charles and Catherine exercise their right to reacquire the remainder interest from their trusts and substitute other assets of equivalent value. At the end of the term, the GRATs distribute the remainders to Charles and Catherine.

The IRS has taken the view that if a beneficiary transfers his or her vested remainder in a charitable lead annuity trust ("CLAT") to another trust ("trust 2"), both the beneficiary and the grantor of the CLAT are treated as the grantors of trust 2 for generation skipping transfer ("GST") tax purposes in the same proportion as the value of the lead and remainder interest at the time of the gift to trust 2. *See* PLR 200107015 (ruling that to avoid circumvention of §2642(e), the grantor of a CLAT and the remainder beneficiary who assigns his or her interest in the CLAT to his or her children, will both be deemed transferors for GST purposes. The remainder beneficiary will be considered the transferor with respect to the present value of his or her interest in the trust on the date of the assignment and the grantor will be considered the transferor with respect to the balance of the trust). This ruling is highly questionable. Although the policy argument that allowing this sort of transfer would undermine the specific rules of §2642(e) is sound, the Code and applicable regulations specifically define the transferor for GST purposes as the person who was most recently subject to gift tax on the transfer, which would be the remaindermen and not the grantor of the CLAT.[70]

The policy argument that underlies the IRS position on CLATs in PLR 200107015 may not be applicable to GRATs. Although the suggested strategy does evade the ETIP rule, it is not clear that the ETIP rule was designed to prevent leveraging of the GST exemption, as was the case with CLATs and the rule of §2642(e). For example, the ETIP rule would apply where a donor made a gift to a trust retaining only a §2038 power to terminate the trust in favor of the trust beneficiaries. The power does not make the gift incomplete or reduce the value of the taxable gift. That is, the ETIP rule applies when there is no leveraging if the principal is includable in the transferor's estate for estate tax purposes.

When the GRAT term ends, GST tax will not apply if the donor of the GRAT (Bob) is treated as the transferor for GST purposes and Charles and Catherine are treated as the transferees. Bob is the transferor and his children are remainder beneficiaries both when the GRAT was created and when the GRAT term expires. The grandchildren receive nothing directly from Bob or as a consequence of any action of Bob's. Charles and Catherine make gifts and then purchases.

Even if Bob is considered to be an indirect grantor of the grandchildren's trusts, because the spouses of Charles and Catherine are beneficiaries, there is no generation skipping transfer when the GRAT term expires. The trust is not a skip person. §2613(a)(2) defines a trust as a skip person only if no non-skip person has an interest in the trust. If Bob is considered a

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70 §2652(a)(1)(B), Reg. §26.2652-1(a)(1) "[T]he individual with respect to whom property was most recently subject to Federal estate or gift tax is the transferor of that property for purposes of chapter 13."

transferor of a portion of the grandchildren's trust, a generation skipping transfer could occur when a distribution was made to grandchildren, or when the non-skip beneficiaries no longer have an interest in the trust.[71]

Under the theory of PLR 200107015, Bob would be considered to be a transferor along with Charles and Catherine at the time they assigned their remainder interests to the grandchildren's trusts in the proportion of their beneficial interests in the trust. This argument is analogous to the one the IRS lost in *D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996) and *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997). In those cases, the Service argued that "full and adequate consideration" for a sale of a remainder interest was something other than the actuarial value of the remainder interest. That argument was flawed. So is the argument that the gift of the remainder to a trust made by the remainder beneficiaries is something other than a gift solely by them. Charles and Catherine assigned GST exemption on a timely return equal to that amount necessary to produce a zero inclusion ratio. §2642(b) provides that the inclusion ratio is determined by using the value as finally determined for federal gift tax purposes. No gift was made to that trust other than by Charles and Catherine. Thus, there seems to be no plausible argument that the inclusion ratio of the grandchildren's trust is other than zero.

Charles and Catherine are the grantors of the trusts for the grandchildren. They are treated as the owners of the trusts because their spouses are discretionary beneficiaries and because they retain the right to reacquire assets and substitute other assets of equivalent value. Therefore, their purchases of the remainders from the grantor trusts will not incur gain.[72]

E. Qualified Severances

1. Facts: Don has used all of his GST exemption to fund a wholly discretionary trust for his three children and five grandchildren and their spouses. The trust divides into shares on a per stirpetal basis upon Don's death. If a child dies without issue, the deceased child's share passes to his or her spouse. One child is deceased without issue and survived by a spouse. The trust assets have declined in value from initial funding. Assets that were worth $1.5 million when Don made a late assignment of his GST exemption to the trust are now worth $600,000. The trust is not a grantor trust. Therefore, Don cannot substitute other assets with equivalent value without incurring income tax. However, Don does have some remaining gift tax credit. Don would like to make a gift of $300,000 using stock he expects to appreciate in value. Don wants to shift GST exemption to the stock.

2. Proposal: Don contributes the stock to the trust. After the contribution, the trust has an inclusion ratio of 1/3. The trustee makes a qualified severance, dividing the trust into two trusts, Trust A worth $600,000 with an inclusion ratio of zero and Trust B worth $300,000 with an inclusion ratio of one. The trustee allocates to Trust A all of the stock that Don recently contributed to the trust and the balance of the assets one-half to Trust A and one-half to Trust B. Don has shifted GST exemption from under-performing assets to the stock that he expects to

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71 §§2612(a)(1)(A); 2612(b).

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

appreciate. His deceased child's spouse is designated as the sole remainder beneficiary of Trust B and the grandchildren are the sole remainder beneficiaries of Trust A.

§2642(a)(3)(B) requires that in a qualified severance, one of the trusts must receive a "fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before severance." The statute does not require that each of the resulting trusts receive a fractional share of each asset held in the trust prior to severance.

A qualified severance must create separate trusts that have in the aggregate the same succession of beneficial interests. §2642(a)(3). The succession of interests language was drawn from Reg. §26.2654-1(b)(ii)(A). The preamble to the regulations explain what succession of beneficial interests means:

> "The final regulations provide that the trusts resulting from the severance of a single testamentary trust need not be identical. Thus, if the trust provides income to spouse, remainder to child and grandchild, the trust may be severed to create two trusts, one with income to spouse, remainder to child and a second with income to spouse remainder to grandchild. This result could be achieved through proper estate planning in any event. However, the regulations make it clear that the resulting trust must provide for the same succession of interests as provided for under the original trusts. Thus, a trust providing for an income interest to a child, with remainder to a grandchild, could not be divided into one trust for the child (equal in value to the child's income interest) and another for the grandchild." (Emphasis added.)

F. Postponing Taxable Terminations and Distributions

1. Facts: Bette is the beneficiary of an ILIT funded by her deceased husband. The trust has an inclusion ratio of one. Bette has a limited testamentary power of appointment. Upon her death without exercising the power of appointment, the remainder will pass, per stirpes, to her then living descendants. One of Bette's four children is in poor health and has five minor children.

2. Proposal: Bette exercises the power of appointment to appoint the principal remaining at her death to a discretionary trust for the benefit all of Bette's descendants. An independent trustee has the power to divide the trust at any time. A taxable termination is avoided upon Bette's death because the discretionary trust is not a "skip person" so long as any of Bette's children is a beneficiary. The trustee may make distributions for health and education that are exempt from GST tax. If the GST tax is repealed in 2010, the trustee may make distributions to Bette's grandchildren or to trusts exclusively for grandchildren in that year without incurring GST tax.

Conclusion

The ideas discussed above are a few creative ways that taxpayers may arrange their affairs to preserve wealth for their families. The challenge is particularly great in light of the scheduled phase out of the federal estate and generation skipping transfer taxes and the significant reduction in gift tax that may occur in 2010. A premium is placed on deferring taxable events and using estate freeze techniques so that deferral will not increase the tax base. Of course, these goals are defeated if tax is accelerated due to a valuation dispute. Many of the strategies seek to avoid this audit risk by incorporating defenses to audit adjustments.