
**Deciding Upon The Appropriate Estate Freeze Technique and Enhancing Its
Performance Through Careful Structuring, Investing and Monitoring**

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INTRODUCTION

Today, an almost overwhelming array of estate planning techniques are available to achieve the goal of reducing the amount subject to the Federal transfer taxes.¹ The estate techniques range from the simple, such as outright gifts using the annual exclusion, to techniques practitioners view as cutting edge, such as using financial derivatives to supercharge the traditional GRAT. The objective of today's presentation is not to provide an analysis of the legal issues with respect to the available techniques. There are literally hundreds of articles, CLE outlines and books that thoroughly analyze these techniques. Rather, the objective is to analyze the factors to be considered in deciding which of the techniques is the most appropriate for the client.²

Part I of this paper briefly lists a selection of estate planning techniques designed to achieve an estate freeze. Part II lists the typical assets the planner encounters. Part III contains a discussion on how to structure the successful GRAT, selecting the appropriate investment assets to enhance its probability of success and monitoring the GRAT. Part IV contains a discussion of the six types of commonly used intra-family deferred payment sale techniques.

The purpose of today's presentation is to enable you, as the tax advisor, to not only determine the most appropriate technique, or combination of techniques, to recommend for your client, but to look at the available financial and further legal techniques which can enhance the likelihood of that plan's success. Frequently, the ultimate tax savings can be enhanced through the subsequent management of the client's investment portfolio. It is important to remember that after a tax planning technique is implemented, the potential for maximization of the transfer tax savings is only fulfilled if the advisor oversees its operation and coordinates the investment decisions with the tax saving objectives. After applying this analysis to the GRAT, the presentation will then consider the same approach with other techniques such as installment sales to grantor trusts.

¹ The Federal transfer taxes include the gift tax, the estate tax and the generation skipping transfer tax.

² An excellent article which contains an economic matrix approach with a consideration of the personal elements in analyzing the array of estate planning techniques is: Abbin, "[S]He Loves Me, [S]He Love Me Not - Responding to Succession Planning Needs Through A Three Dimensional Analysis of Considerations To Be Applied In Selecting From The Cafeteria of Techniques, 31st Annual University of Miami Phillip E. Heckerling Institute on Estate Planning, Chapter 13 (1997).

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I. INTRODUCTION

The Grantor Retained Annuity Trust (the “GRAT”) is one of the most powerful, currently available estate planning technique. A GRAT enables a grantor to transfer, free of gift tax, that portion of a transferred asset’s future investment return that exceeds the rate of return §7520³ requires the Internal Revenue Service (“IRS”) to use to value annuity interests. Unlike outright gifts or sales, the GRAT delivers its benefits without any potential transfer tax disadvantage to the grantor or her family and the trusts she has created for them.

This outline explains how the GRAT technique works and discusses how to enhance its performance by carefully structuring its provisions, selecting its investments and monitoring its performance.

II. DEFINING THE GRAT

A. In General.

A GRAT, as the term “grantor retained annuity trust” suggests, is a trust that pays an annuity to its grantor for a specified period of time. At the end of the period, the beneficial interest in the trust shifts to another beneficiary or beneficiaries.

If the terms of the trust satisfy the governing instrument requirements set forth in Treas. Reg. 25.2702-3, the grantor’s interest is a “qualified annuity interest” the value of the gift to the remainder beneficiaries is determined under §7520.⁴

The Code permits the value of the gift to the remainder beneficiaries to be determined under §7520 because the required structure of the GRAT seems to preclude the manipulation of investment decisions for the purpose of shifting economic enjoyment between the income and remainder beneficiaries. The annuitant is entitled to receive the annuity no matter what the trust’s income is. As a result, a trustee whose object is to maximize the interest of the trust’s remainder beneficiaries would have no incentive to maximize growth opportunities at the expense of current income.⁵ So long as the total return, be it income or appreciation, is consistent with the Code § 7520 rate, a GRAT’s

³ References to “§” refer to sections of the Internal Revenue Code of 1986, as amended (the “Code”). References to “Treas. Reg. §” refer to sections of the regulations promulgated by the Treasury under the Code.

⁴ §2702(a)(2)(B). If a grantor’s retained interest in a trust for the benefit of members of her family is not a qualified interest and does not fit within one of the exceptions to the general rule of §2702, the value of her transfer for gift tax purposes is equal to the full value of the property transferred to the trust. For this purpose, the members of a grantor’s family are her spouse, her ancestors and descendants, her siblings and the spouses of her ancestors, descendants and siblings.

⁵ The trustee might, however, have an incentive to maximize the possibility of a higher overall return by making speculative investments. If the GRAT is structured initially with a zero or relatively small remainder interest, the risk burden will be borne entirely or almost entirely by the annuitant while the remainder beneficiary will enjoy the rewards but not the risks of a successful speculative investment.

annuitant and its remainder beneficiaries will each receive their appropriate share of trust assets.

B. Governing Instrument Requirements

There are eight governing instrument requirements, each of which is described briefly below:

1. Frequency of Annuity Payments

An annuity amount must be payable at least once in every twelve-month period to the holder of the annuity or the annuitant. The trust instrument must require pro-ration of the annuity payment made for a period of less than 12 months in the same manner as is required for charitable remainder annuity trusts under Treas. Reg. § 1.664-2(a)(1)(iv). The annuity must be paid to the annuitant whether or not the trust has produced income equal to the annuity. If income is insufficient, the trustee must be required to invade principal to pay the annuity.

The regulations require that the annuity must be paid no later than 105 days after the anniversary date of the creation of the trust if the annuity is payable based on the anniversary date and no later than the date on which the trustee must file the trust's income tax return (determined without extensions) if the annuity amount is payable based on the taxable year of the trust.⁶

2. Prohibition Against Use of Notes to Fund Annuity Payments

The regulations also provide that the GRAT instrument “must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity . . . payment obligation.”⁷ This prohibition, however, does not prevent the use of notes issued by other persons to satisfy the payment obligation. In addition, it does not prevent the grantor from lending money to the GRAT for other purposes, including providing it with funds to make investments.

3. Fixed Amount Requirement

The annuity amount must be a fixed amount. By this the regulations mean an amount that is fixed in the trust instrument either in terms of a fixed dollar amount or in terms of a fixed percentage of the initial fair market value of the property transferred to the trust, as finally determined for

⁶ Treas. Reg. § 25.2702-3(b)(4). It is not clear whether express permission in the trust instrument to delay a payment nominally due on a particular date to a later date will be reflected in a lower valuation for the annuity. Arguably, such an annuity does have a lower value because of the trustee's power to deny the use of the annuity amount to the grantor for 105 days.

⁷ Treas. Reg. § 25.2702-3(d)(5).

federal tax purposes.⁸ The regulations do not require that the fixed amount be the same for each year. The only requirement imposed on variations in amounts payable from year to year is the requirement that an amount payable in one year not exceed 120% of the amount payable in the prior year.

4. Formula Adjustment Requirement

The regulations permit the annuity amount to be defined as a percentage of or as a fraction of the value of the trust's assets as finally determined for gift tax purposes. But, if the formula approach is used, the trust instrument must contain a provision requiring adjustment of annuity amounts previously paid if an error was made by the trustee in determining such value. The adjustment clause must satisfy the requirements of Treas. Reg. § 1.664-2(a)(1)(iii), which deals with a similar problem in connection with charitable remainder annuity trusts.⁹

5. Additions

The trust instrument must prohibit additional contributions to the trust.¹⁰

6. Commutation

The trust instrument must prohibit "commutation."¹¹ By this term, the regulations refer to the pre-payment by the trustee of the annuitant's annuity interest.

7. Amounts Payable to Other Persons

The trust instrument must prohibit payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.¹² The charitable lead trust regulations contain a similar provision.¹³

8. Term of the Annuity

⁸ Treas. Reg. § 25.2702-3(b)(1)(ii). The Service will not ordinarily issue rulings on whether annuity interests are qualified annuity interests under Code Sec. 2702 if the amount of the annuity payable annually is greater than 50% of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10% of the initial net fair market value transferred to the trust. Rev. Proc. 2004-1, 2004-1 I.R.B. 1 Section 4 (50) (January 5, 2004).

⁹ Treas. Reg. § 25.2702-3(b)(2).

¹⁰ Treas. Reg. § 25.2702-3(b)(4).

¹¹ Treas. Reg. § 25.2702-3(d)(4). See PLR 9412036 (December 23, 1993) in which the IRS determined that the absence of a provision prohibiting commutation would preclude treatment of an interest as a qualified interest.

¹² Treas. Reg. § 25.2702-3(d)(2).

¹³ Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(f).

The term of the qualified annuity interest must be fixed in the trust instrument and must be for (i) the life of the annuitant, (ii) a specified term of years, or (iii) the shorter of those two periods.¹⁴ Recently issued proposed regulations under §2702 make it clear that the full value of an annuity interest retained for a term of years is a qualified interest.¹⁵

III. THE GIFT TAX CONSEQUENCES OF CREATING, FUNDING, ADMINISTERING AND TERMINATING A GRAT

A. Creating and Funding

The value of a grantor's transfer to a GRAT for gift tax purposes is determined by subtracting from the value of the property transferred to the GRAT an amount equal to the actuarial value, determined under the tables prescribed by the Treasury pursuant to §7520, of the grantor's retained annuity interest.¹⁶ The tables use an interest rate equal to 120% of the federal mid-term rate in effect under §1274 on the date of the gift. The interest rate is changed monthly.

In the case of an annuity payable for a fixed period of years, the actuarial value of the annuity is determined by four factors – (1) the period of time over which the annuity is payable, (2) the frequency of the payments, (3) the size of each of the payments and (3) the §7520 rate in effect in the month that the GRAT is created and funded. If the first three factors are held constant, the value of the retained annuity will increase with decreases in the §7520 rate. This is so because a decrease in the deemed rate of current return will bend to make the right to receive fixed amounts in the future more valuable.

The table below shows how changes in the §7520 rate will affect the amount of annuity payment necessary to produce an annuity with a value equal to the value of the transferred property if the payments are constant and are made annually over a 2, 5, 10, 15 or 20 year period.

¹⁴ Treas. Reg. § 25.2702-3(d)(3).

¹⁵ 69 F.R. 44476-44480 (July 23, 2004). Example 5 of Treas. Reg. §25.2702-3(e) currently provides that only the portion of an annuity payable during the life of the annuitant is a qualified interest even though the annuity is actually payable for a term of years and any payments made after the annuitant's death are required to be paid to her estate. In December 2000 a unanimous Tax Court held in *Walton v. Commissioner* that Example 5 is invalid. *Walton v. Commissioner*, 115 T.C. 589 (2000). The Tax Court concluded in *Walton* that Congress intended to permit a grantor to retain qualified annuity interests for a specified term of years, that the appropriate method for doing so is to provide that the balance of any payments due after the grantor's death should be payable to her estate, and that Example 5 is an unreasonable and an invalid extension of §. 2702.

¹⁶ §2702(a)(2)(B).

Table 1

| §7520 Rate | Annuity as % of Value of Transferred Property | | | | |
|---------------|---|----------------|-----------------|-----------------|-----------------|
| | 2-Year GRAT | 5-Year GRAT | 10-Year GRAT | 15-Year GRAT | 20-Year GRAT |
| 3.00% | 52.26% | 21.84% | 11.72% | 8.38% | 6.72% |
| 4.00% | 53.02% | 22.46% | 12.33% | 8.99% | 7.36% |
| 5.00% | 53.78% | 23.10% | 12.95% | 9.63% | 8.02% |
| 6.00% | 54.54% | 23.74% | 13.59% | 10.30% | 8.72% |
| 7.00% | 55.31% | 24.39% | 14.24% | 10.98% | 9.44% |
| 8.00% | 56.08% | 25.05% | 14.90% | 11.68% | 10.19% |
| 9.00% | 56.85% | 25.71% | 15.58% | 12.41% | 10.95% |
| 10.00% | 50.75% | 26.38% | 16.27% | 13.15% | 11.75% |

B. Administering

1. Income Tax Issues

A GRAT is likely to be a so-called grantor trust because the retained annuity interest is almost always worth more than 5% of the value of the trust at its inception.¹⁷ This means that all of the income, deductions and credits attributable to its investments will be treated as belonging to its grantor and that the grantor will pay all of the income tax on income earned by the GRAT's investments.

Until recently, the IRS refused to give taxpayers the assurance that their payment of income taxes on the income earned by trusts treated as owned by them under § 671 would not be treated as taxable gifts. This changed with the issuance of Rev. Rul. 2004-64.¹⁸

In Rev. Rul. 2004-64, the IRS ruled that the grantor of a trust, who is treated as the owner of the trust and who pays the income tax attributable to the inclusion of the trust's income in her taxable income, is not treated as making a gift of the amount of the tax to the trust beneficiaries. Additionally, it ruled that if, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets will be includible in the grantor's gross estate under Code § 2036(a)(1).

2. Changing the Governing Instrument During the Annuity Term

The regulations do not impose any adverse consequences if the parties, the trustee and the beneficiaries, subsequently decide to disregard a

¹⁷ §673.

¹⁸ 2004-27 I.R.B. 7.

requirement contained in the trust instrument. For example, as discussed above, the regulations require that the trust instrument prohibit prepayment of the annuity. In many states, the creator of a trust, with the consent of all of the beneficiaries, may revoke or amend the terms of a trust.¹⁹ What would the consequences be under § 2702 if a trust that otherwise qualified as a GRAT were subsequently amended to provide a commutation clause?

The IRS might take the position that an amendment is a new transfer and, if the trust immediately after the amendment does not satisfy the regulations' requirements, subject the full value of the trust to gift tax. An amendment, however, that resulted in the simultaneous termination of the trust would probably not be vulnerable to a new application of §2702 since, immediately after the amendment, neither the transferor nor any other family member would have an interest in the trust.

3. Terminating

If when a GRAT terminates, there is property left in the GRAT to be paid to the GRAT's remainder beneficiaries, the property will pass to them free of gift tax. This will be so even if the creation of the GRAT was not treated as a taxable gift by the grantor because the value of the retained interest was treated as equal to the value of the property transferred. The transfer tax system does not permit the IRS to make any post-transfer adjustments in the value of transferred property to reflect the fact that its investment performance was significantly better than the assumed performance on which the original valuation was based.

IV. STRUCTURING THE SUCCESSFUL GRAT

A. Creating GRATs With No Taxable Gifts

There is generally no good tax planning reason to create a GRAT to produce anything other than a nominal taxable gift. In fact, the ability to structure GRATs that will shift the economic advantage of the transferred property's investment return from the grantor to the GRAT's remainder beneficiaries is one of the reasons to use the GRAT rather than an alternate estate planning technique. A GRAT will produce a zero taxable gift if the actuarial value of the retained annuity payments is equal to the value of the property transferred to the GRAT. A GRAT that is created without a taxable gift is generally referred to as a "zeroed-out" GRAT.

When a grantor incurs a taxable gift as a result of her transfer to a GRAT, creates the possibility of reverse leverage producing a negative transfer tax result. If the transferred property fails to produce a rate of return equal to the §750 rate, the gifted portion of the transferred property will be used to pay the required annuity to the grantor.

¹⁹ See, e.g., Cal. Prob. Code § 15404; Fla. Stat. § 737.4032; and NY EPTL § 7-1.9.

Consider this example:

Example 1: G creates a 10-year GRAT and transfers \$1 million worth of stock in the X corporation to it in a month in which the §7520 rate is 4%. G retains the right to receive an annuity equal to \$61,600 per year for 10 years. This transfer will create a taxable gift of \$500,000 because the right to receive \$62,600 per year for 10 years has an actuarial value of \$500,000. The stock declines in value over the 10 year term. The annuity payments are made by distributing interests in the real estate. The remainder beneficiary receives nothing. The grantor has either wasted \$500,000 of her unified credit, protecting a gift from gift tax that resulted in no economic benefit to the donee or has paid a gift tax on a gift that resulted in no economic benefit to the donee.

If the grantor had limited her transfer to the GRAT to \$500,000 worth of the stock and had made an outright gift of the other \$500,000 worth of stock, at the end of the 10-year period, the donee would have been left with one-half of the stock. Her unified credit or her payment of gift tax would not have been completely wasted.

B. Period of Time Over Which Annuity is Payable

1. Reasons to Choose a Short-Term GRAT

The 2-year term offers two advantages over a longer term.²⁰ First, it minimizes the possibility that a year or two of poor performance of the transferred property will adversely impact the over-all effectiveness of the GRAT. When a GRAT is funded with a volatile security, a series of short-term GRATs will generally perform better than a single long-term GRAT, the term of which is equivalent to the cumulative terms of the short-term GRATs. Tables 1 and 2 below compare the results of a 10 year GRAT with a series of 5 2-year GRATs, each of which was funded at a time when the § 7520 rate was 4% and each of which was structured to produce a zero taxable gift. Both tables assume a rate of return on the GRAT's stock consistent with the performance of the NASDAQ Composite Index from 1993 through 2003. The tables show that the series of short-term GRATs leave the remainder beneficiary with significantly more value than does the long-term GRAT.

²⁰ An even shorter term would be more advantageous. But in setting the trust's term, care must be taken to avoid an argument that this trust is so short that it won't be recognized for tax purposes. In addition, it might be possible to interpret Code § 2702(b)(1) as requiring a period of at least two years, since it defines a qualified interest as "the right to receive fixed amounts payable not less frequently than annually." Private letter rulings have recognized the validity of 2-year GRATs. *See, e.g.*, PLR 9239015 (June 25, 1992).

Table 2**Long-Term GRAT**

| | Value of X Stock | % Increase or Decrease | Annuity Payment |
|----|---------------------|--------------------------------|--------------------|
| 1 | \$ 1,000,000 | 14.75% | \$ 123,291 |
| 2 | \$ 1,024,209 | -3.20% | \$ 123,291 |
| 3 | \$ 868,143 | 39.92% | \$ 123,291 |
| 4 | \$ 1,091,415 | 22.71% | \$ 123,291 |
| 5 | \$ 1,215,985 | 21.64% | \$ 123,291 |
| 6 | \$ 1,355,833 | 39.63% | \$ 123,291 |
| 7 | \$ 1,769,859 | 85.59% | \$ 123,291 |
| 8 | \$ 3,161,390 | -39.29% | \$ 123,291 |
| 9 | \$ 1,795,989 | -21.05% | \$ 123,291 |
| 10 | \$ 1,294,642 | -31.53% | \$ 123,291 |
| | \$ 763,151 | Left for Remainder Beneficiary | |

Table 3**Series of Short-Term GRATs**

| | Value of X Stock | % Increase or Decrease | Annuity Payment | Payment to Remainder Beneficiary | Grantor's Stock at End of Each GRAT | Value of Remainder Beneficiary's Stock |
|---|---------------------|---------------------------|--------------------|--|---|---|
| 1 | \$ 1,000,000 | 14.75% | \$ 530,196 | | | |
| 2 | \$ 617,304 | -3.20% | \$ 530,196 | \$ 67,354 | \$ 1,043,426 | \$ 67,354 |
| 1 | \$ 1,043,426 | 39.92% | \$ 553,220 | | | \$ 94,242 |
| 2 | \$ 906,741 | 22.71% | \$ 553,220 | \$ 559,442 | \$ 1,232,077 | \$ 675,086 |
| 1 | \$ 1,232,077 | 21.64% | \$ 653,242 | | | \$ 821,175 |
| 2 | \$ 845,456 | 39.63% | \$ 653,242 | \$ 527,268 | \$ 1,565,364 | \$ 1,673,875 |
| 1 | \$ 1,565,364 | 85.59% | \$ 829,950 | | | \$ 3,106,544 |
| 2 | \$ 2,075,209 | -39.29% | \$ 829,950 | \$ 429,910 | \$ 1,333,812 | \$ 2,315,893 |
| 1 | \$ 1,333,812 | -21.05% | \$ 707,182 | | | \$ 1,828,397 |
| 2 | \$ 345,863 | -31.53% | \$ 345,863 | \$ - | \$ 830,070 | \$ 1,251,904 |

The choice between a series of short-term GRATs and a long-term GRAT is not as clear as the discussion above suggests. It is possible, for example, that an increase in the Code § 7520 rate between the time the first GRAT was established and the times the subsequent ones are established may outweigh the advantage of separating different years' investment experiences. Additionally, a change in tax law during the time a grantor planned to establish successive short-term GRATs might prevent the creation of some of the planned-for GRATs.

The second advantage the 2-year term has over a longer term is the reduced exposure to the risk that the grantor will die during the term. Some portion of the trust will be included in the gross estate of the grantor if she dies while the GRAT is in effect under 2036 or 2039 or some combination of the two. Each time one of a chronological series of short-term GRATs terminates and distributes its excess value to its remainder beneficiaries, the distributed amount is protected from possible inclusion in the grantor's gross estate.

2. Reasons to Choose a Long-Term GRAT

When funding annuity payments is likely to be a problem because of insufficient cash flow, a long-term graduated GRAT may provide a good solution. If the term is sufficiently long and if the annuity payments are scheduled to increase by 20% each year, the amount of required payments in the initial years will be quite small. The table below shows the percentage annuity payment required to be paid in GRATs that last, 10 years, 15 years, 20 years, and 25 years in order to produce a zero taxable gift using the assumption that the Code § 7520 rate is 4.0%.

Table 4

| Years | Annuity % |
|-------|-----------|
| 10 | 12.3290% |
| 15 | 8.9941% |
| 20 | 7.3581% |
| 25 | 6.4012% |

The longer term has an additional advantage in a low interest rate environment of locking in the low interest rate applicable at the beginning of the GRAT.

On the downside, the longer term increases the possibility that the GRAT will fail to produce any transfer tax savings because the death of the grantor occurs before the end of the term. As discussed below, in many cases this risk can be managed by careful monitoring.

3. Capitalizing on Disparities Between Actual Life Expectancy and Life Expectancy Under IRS Tables

a. In General

GRAT terms are usually measured by fixed terms of years. If, however, the life expectancy of the grantor or her spouse is less than the life expectancy assumed in the IRS tables, a GRAT measured by the life of the grantor or her spouse may produce significant transfer tax savings.

b. **Revocable Spousal Annuity**

Use of a revocable spousal annuity payable for the duration of a spouse's life could achieve significant transfer tax savings if, at the time of the GRAT's creation, the spouse had less than the average life expectancy for a person of his age. The IRS is required to assume that a selected measuring life has an average life expectancy, as determined by tables set forth in the Treasury Regulations, no matter what the individual's actual life expectancy is unless she has an incurable illness or other deteriorating physical condition that gives her a 50% chance of dying within one year.²¹

Suppose, for example, that the grantor's 50-year old spouse has a condition that decreases his life expectancy substantially but which is not expected to cause his death within a year. The donor could create a GRAT the terms of which provide that the spouse is to receive an annuity payable for the remainder of the spouse's life. The value of the revocable interest, which would be treated as an incomplete gift for gift tax purposes, would be calculated as if the spouse were expected to live for another 33 years. This calculation is likely to cause a significantly higher portion of the transfer to be treated as an incomplete gift than the actual value of the spouse's revocable interest in the GRAT. If the donor transferred \$1,000,000 to a GRAT to pay a \$100,000 annuity to her spouse for the rest of the spouse's life in a month in which the IRS rate is 4.2%, she would be able to reduce the amount of her taxable gift by \$960,000, the actuarial value of a 50 year old's right to receive \$100,000 per year for life from a \$1,000,000 fund. If the property produces a rate of return of 5% and the spouse dies within two years, property worth almost \$900,000 can pass to the grantor's children at the price of a gift tax on only \$40,000.

c. **Measuring the Term of the GRAT by the Grantor's Life**

Similar results can be achieved if the grantor's life expectancy is less than the life expectancy assumed in the IRS's tables unless she has an incurable illness or other deteriorating physical condition that gives her a 50% chance of dying within one year. In this case, a GRAT term measured by the grantor's life followed by a gifted remainder interest would not achieve any transfer tax savings because the full value of the trust property would be included in the grantor's gross estate under §2036. Transfer tax savings would be achieved, however, if the grantor created a GRAT in which she retained an annuity for life and simultaneously sold the remainder interest for its full actuarial value. In this case, §2036's exception for transfers for adequate and full consideration in money or

²¹ Treas. Reg. §§ 25.7520-1(b)(2) and 25.7520-3(b)(3).

money's worth would protect the GRAT from inclusion in the grantor's gross estate.²²

C. The Amount of Each Annuity Payment

1. Using a Formula to Define the Annuity Amount

When a GRAT is funded with difficult to value assets, such as, for example, interests in family limited partnerships, the amount of the annuity payment should be defined by formula. The use of a formula to define the amount of the annuity rather than a provision that requires the payment of a specific dollar amount protects the GRAT's grantor from any significant increase in the gift tax if the IRS successfully challenges her valuation. The consequence of a successful challenge would be an increase in the amount of her annuity. Consider the following example.

Example 2: G creates a 10-year GRAT and transfers what she believes to be \$1 million worth of stock in the X corporation to it in a month in which the §7520 rate is 4%. G retains the right to receive an annuity equal to \$123,100 per year for 10 years. This annuity will protect \$1 million worth of transferred property from the gift tax because the right to receive \$123,100 per year for 10 years has an actuarial value of \$1,000,000. If the IRS successfully argues that the shares of X Corp. transferred to the GRAT were worth \$2,000,000, double her estimate, the amount of G's taxable gift will be \$1 million. If, instead, the terms of G's GRAT had defined her annuity amount as the minimum amount necessary cause her Annuity Payments to have a value equal to 99% of the fair market value of the transferred X stock as finally determined for federal gift tax purposes. G's taxable gift would be zero no matter what value is put on the X stock by the IRS. Any increase in value would cause the trust to be required to increase her annuity payment from the amount she had thought it would be to the amount necessary to cause her taxable gift to be near zero.²³

To some individuals, the ability to define a difficult-to-value gift by means of a formula will be the most important advantage of establishing a GRAT. Other taxpayer approaches toward minimizing valuation risks by means of various types of adjustment clauses have generally been rejected by the IRS. Clauses that require post-transfer adjustments in the price of a

²² See *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999); *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997); *D'Ambrosio v. Commissioner*, 101 F.3d 309 (1996) *cert. denied*, 520 U.S. 1230 (1997). But see, *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed Cir. 1990)

²³ It is possible to provide a formula that produces an annuity with a value exactly equal to the value of the transferred property. If there is a possible valuation problem, however, the IRS might attempt to apply the so-called *Procter* doctrine. In *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), the Fourth Circuit invalidated, for gift tax purposes, an agreement that required a transferee to return property to a transferor if the transfer was held to be subject to the gift tax. The Fourth Circuit said that the agreement was void as against public policy since "it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift." A formula that produces a small taxable gift should avoid this risk.

purchased asset or in the quantity of property transferred, if the value of the transferred property is later determined to be greater than the original estimate, with few exceptions, have been rejected by the courts and by the IRS.²⁴

A formula clause that works simultaneously with (rather than after) the gift and works to define the amount of the gift should not be disregarded by the IRS because, without the clause, there would be no way to determine the amount of the gift. The following is an example of a definitional formula clause:

“I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is \$100,000 and the denominator is the value of such property as finally determined for federal gift tax purposes.”

The IRS objects to this kind of clause as well as the adjustment clauses discussed above because it forces the IRS to use its limited resources to challenge taxpayer valuations even though a successful challenge would not produce any immediate additional tax revenue.²⁵ The Tax Court considered the validity of this type of clause in *McCord v. Commissioner* in 2003. It rejected the particular clause used by the taxpayers in *McCord* because the clause failed to link the value to be used to measure the gift to the value as finally determined for gift tax purposes.

It may be that a definitional formula clause with the appropriate tie-in to final gift tax values will be upheld by the courts. But until it has been, the GRAT provides the only sure way to protect against the gift tax risk of valuation challenges.

For individuals who want to make gifts of property that is difficult to value, combining a gift with a GRAT may permit the GRAT's valuation formula to protect the gift from unanticipated gift tax. For example, suppose G wants to transfer \$1 million worth of the shares of X Corp. to a

²⁴ E.g., *Ward v. Commissioner*, 87 T.C. 78 (1986); *Harwood v. Commissioner*, 82 T.C. 239 (1984); Rev. Rul. 86-41, 1986-1 C.B. 300; TAM 9309001 (Sept. 30, 1992). But see *King v. United States*, 545 F.2d 700 (10th Cir. 1976). For discussions of this issue see McCaffrey, *supra* footnote 160; Peterson, *Savings Clauses in Wills and Trusts*, 13 Tax Mgmt. Est., Gifts & Trusts Journal 83 (1988) and McCaffrey & Kalik, *Using Valuation Clauses to Avoid Gift Taxes*, 125 Tr. & Est. 47 (Oct. 1986). But see *McCord v. Commissioner*, 120 T.C. 358 (2003), in which the Tax Court suggested that it might have honored a valuation clause if the valuation standard had been the value of the transferred property as finally determined for federal gift tax purposes.

²⁵ A 2001 Non-Docketed Service Advice Review opinion as to whether a savings clause which gifted limited partnership interests to be valued at certain dollar amounts should be recognized for tax purposes warned against recognizing formula clauses. “To give substance to this clause effectively nullifies our regulations, defeats the gift tax, obstructs justice and hampers the administration of the tax laws. . . . Fair administration of the gift tax will become even more difficult if formula clauses are given effect, for scarce resources cannot reasonably be expended examining returns if the examination will have no tax effect. 2001 IRS NSAR 0417, 2001 WL 34056189 (IRS NSAR)(2/27/01).

trust for the benefit of C, her child. She believes that 100 shares have a value of \$1 million but is unwilling to pay a gift tax on any value of these shares in excess of \$1 million. She could transfer 101 shares of X Corp. to the trustee of a GRAT, the terms of which require the trustee to pay her an annuity for 5 years, the actuarial value of which is equal to the excess, if any, of the transferred property over \$1 million.

2. Using a Pattern of Increasing Annuity Amounts

As discussed above, the regulations permit a GRAT to make different annuity payments each year of its term so long as the amount to be paid in any year is determinable from inception and so long as the payment in any one year does not exceed the payment in the preceding year by more than 20%. In general, a pattern of increasing annuity payments will produce more value for the beneficiaries at the end of the term than would a pattern of constant annuity payments if the property grows in value at a relatively constant rate throughout the term of the GRAT. The table below shows the annuity percentages required to zero out a GRAT assuming a 4.2% §7520 rate, a pattern of annuity payments that increases each year by 20% and terms of 20 years, 15 years, 10 years and 5 years.

Table 5

| Years | 20 Years | 15 Years | 10 Years | 5 Years |
|--------------|-----------------|-----------------|-----------------|----------------|
| 1 | 0.998% | 2.161% | 5.091% | 15.405% |
| 2 | 1.197% | 2.593% | 6.110% | 18.486% |
| 3 | 1.437% | 3.112% | 7.332% | 22.183% |
| 4 | 1.724% | 3.734% | 8.798% | 26.619% |
| 5 | 2.069% | 4.481% | 10.557% | 31.943% |
| 6 | 2.482% | 5.377% | 12.669% | |
| 7 | 2.979% | 6.452% | 15.203% | |
| 8 | 3.575% | 7.743% | 18.243% | |
| 9 | 4.290% | 9.291% | 21.892% | |
| 10 | 5.148% | 11.149% | 26.270% | |
| 11 | 6.177% | 13.379% | | |
| 12 | 7.413% | 16.055% | | |
| 13 | 8.895% | 19.266% | | |
| 14 | 10.674% | 23.120% | | |
| 15 | 12.809% | 27.744% | | |
| 16 | 15.371% | | | |
| 17 | 18.445% | | | |
| 18 | 22.134% | | | |
| 19 | 26.561% | | | |
| 20 | 31.873% | | | |
| NPV | 100.000% | 100.000% | 100.000% | 100.000% |

Table 6 shows the extra value passing to the remainder beneficiaries of a 20 year and of a 15 year GRAT, assuming increasing GRAT payments rather than constant payments. In each case, a 4.2% §7520 rate and an annuity pattern sufficient to zero out the taxable gift is assumed.

Table 6

| Year # | 20 Years | | | | | 15 Years | | | | |
|--------|---------------------|----------------|-------------------|----------------|--|---------------------|----------------|-------------------|----------------|--------------|
| | Increasing Payments | | Constant Payments | | | Increasing Payments | | Constant Payments | | |
| | | \$ 1,000,000 | | \$ 1,000,000 | | \$ 1,000,000 | | \$ 1,000,000 | | \$ 1,000,000 |
| 1 | 1.00% | \$1,090,023.51 | 7.49% | \$1,025,109.25 | | 2.16% | \$1,078,391.54 | 9.12% | \$1,008,796.57 | |
| 2 | 1.20% | \$1,187,054.06 | 7.49% | \$1,052,729.42 | | 2.59% | \$1,160,300.53 | 9.12% | \$1,018,472.79 | |
| 3 | 1.44% | \$1,291,393.32 | 7.49% | \$1,083,111.61 | | 3.11% | \$1,245,214.40 | 9.12% | \$1,029,116.64 | |
| 4 | 1.72% | \$1,403,293.27 | 7.49% | \$1,116,532.01 | | 3.73% | \$1,332,396.41 | 9.12% | \$1,040,824.87 | |
| 5 | 2.07% | \$1,522,935.33 | 7.49% | \$1,153,294.46 | | 4.48% | \$1,420,828.74 | 9.12% | \$1,053,703.93 | |
| 6 | 2.48% | \$1,650,404.15 | 7.49% | \$1,193,733.16 | | 5.38% | \$1,509,142.85 | 9.12% | \$1,067,870.89 | |
| 7 | 2.98% | \$1,785,654.92 | 7.49% | \$1,238,215.72 | | 6.45% | \$1,595,534.60 | 9.12% | \$1,083,454.54 | |
| 8 | 3.57% | \$1,928,472.82 | 7.49% | \$1,287,146.54 | | 7.74% | \$1,677,661.03 | 9.12% | \$1,100,596.57 | |
| 9 | 4.29% | \$2,078,423.01 | 7.49% | \$1,340,970.44 | | 9.29% | \$1,752,514.70 | 9.12% | \$1,119,452.79 | |
| 10 | 5.15% | \$2,234,788.79 | 7.49% | \$1,400,176.73 | | 11.15% | \$1,816,271.24 | 9.12% | \$1,140,194.64 | |
| 11 | 6.18% | \$2,396,495.84 | 7.49% | \$1,465,303.65 | | 13.38% | \$1,864,104.45 | 9.12% | \$1,163,010.67 | |
| 12 | 7.41% | \$2,562,019.23 | 7.49% | \$1,536,943.26 | | 16.06% | \$1,889,962.20 | 9.12% | \$1,188,108.30 | |
| 13 | 8.90% | \$2,729,269.73 | 7.49% | \$1,615,746.83 | | 19.27% | \$1,886,295.19 | 9.12% | \$1,215,715.70 | |
| 14 | 10.67% | \$2,895,454.99 | 7.49% | \$1,702,430.76 | | 23.12% | \$1,843,728.83 | 9.12% | \$1,246,083.84 | |
| 15 | 12.81% | \$3,056,910.43 | 7.49% | \$1,797,783.08 | | 27.74% | \$1,750,666.65 | 9.12% | \$1,279,488.79 | |
| 16 | 15.37% | \$3,208,893.41 | 7.49% | \$1,902,670.64 | | | | | | |
| 17 | 18.44% | \$3,345,333.07 | 7.49% | \$2,018,046.95 | | | | | | |
| 18 | 22.13% | \$3,458,526.75 | 7.49% | \$2,144,960.89 | | | | | | |
| 19 | 26.56% | \$3,538,771.89 | 7.49% | \$2,284,566.23 | | | | | | |
| 20 | 31.87% | \$3,573,920.03 | 7.49% | \$2,438,132.10 | | | | | | |

D. Using Single Asset GRATs

A grantor who has more than one asset the future return of which she would like to protect from transfer taxes with a GRAT technique should consider transferring each asset to a separate GRAT. Multiple GRATs for separate assets prevent underperforming assets from diluting the effectiveness of the good performers. The principle is the same as the one that recommends use of a chronological series of short-term GRATs rather than a single long-term GRAT to maximize the advantage to the remainder beneficiaries of the years of good investment return.

This approach obviously adds complexity but can substantially enhance the ability of the GRAT technique to shift value to the next generation. Suppose, for example, that G, had two assets she wished to transfer to a 2-year GRAT - \$500,000 worth of shares of the X Corp. and \$500,000 worth of shares of the Y Corp. in a month in which the §7520 rate was 4.2%. Suppose during the 2-year term of the GRAT that the shares of X increased by 10% per year and that the shares of Y decreased by 10% per year. If she had established a single GRAT and had funded it with the shares of X and Y, at the end of the 2-year term, there would be nothing in the trust to pass to her remainder beneficiaries. The excess

return on the X stock would be needed to compensate for the poor performance of the Y stock. On the other hand, if she had established two GRATs and had funded one with the shares of X and the other with the shares of Y, the remainder beneficiary would have received property worth \$46,698 at the end of the 2-year term.

E. Using Clauses That Reimburse the Grantor for Income Taxes

Many grantors would like their trustees to have the power to reimburse them for their income tax liability attributable to trust income, in order to provide them with relief from the tax burden if, in the future, they believe they can no longer afford to sustain it. Rev. Rul. 2004-64, discussed above, concludes that the mere existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate but that this discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion; a power retained by the grantor to remove the trustee and name herself as successor trustee; or applicable local law subjecting the trust assets to the claims of the grantor's creditors) may cause inclusion of Trust's assets in the grantor's gross estate for federal estate tax purposes.

If it is unclear whether local law would subject trust property to the claims of its grantor's creditors because of a trustee's power to reimburse her for her income taxes attributable to trust income, inclusion of a reimbursement provision would be risky. In such a case, the reimbursement provision should, by its terms, be operative only if, as a matter of law in the applicable state, the reimbursement provision would not cause the trust assets to be subject to the claims of the grantor's creditors.

F. Planning for the Marital Deduction

The possible application of the marital deduction should be considered in connection with the creation of a GRAT. If a portion of a GRAT is included in the grantor's gross estate, and if she is survived by her husband, the marital deduction could be disallowed for any portion of the included interest even if the transferor bequeaths her entire estate to her surviving spouse.

Suppose, for example, that the terms of the GRAT require any annuity amounts payable after the death of the grantor to be paid to the grantor's estate and that the remainder is to be paid to her children. Suppose also that, under the grantor's will, annuity payments received by the estate are to be paid to the surviving spouse. Because the trust will end in favor of the remainder beneficiaries, the annuity payable to the surviving spouse will be a nondeductible terminable interest.²⁶ To avoid this result, the GRAT might give the grantor a power of appointment exercisable over such portion of the trust as is includible in her gross estate. She could then exercise this power in favor of her husband. If the

²⁶ §2056(b)(1).

grantor's husband is to receive both the remaining annuity payments and the property held in the GRAT at the end of its term, the nondeductible terminable interest rule will not apply. Alternatively, the power of appointment could be exercised in favor of a marital deduction trust to which the grantor specifically bequeaths her remaining annuity payments.

G. Avoiding Spendthrift Clauses

Drafters often include a provision in trust agreements that prohibit trust beneficiaries from transferring their interests in trusts to others. These clauses should not be used to prevent GRAT beneficiaries from transferring their interests for two reasons.

First, in two recent cases, *Gribauskas v. Commissioner*²⁷ and *Shakleford v. United States of America*²⁸ the Second Circuit and the Ninth Circuit, respectively determined that transferability restrictions should be taken into account in valuing annuity payments to be received by lottery winners despite §7520's rules for valuing annuities. It is possible that the IRS may try to turn these decisions against taxpayers by using them to decrease the value of a retained interest in a GRAT if the grantor has no power to transfer her right to receive future payments.

Second, as discussed in further detail below, there may be good transfer tax reasons for arranging for the grantor or remainder beneficiaries to sell or otherwise dispose of their interest in a GRAT.

²⁷ 342 F.3d 2003 (2d Cir. 2003).

²⁸ 262 F.3d 1028 (9th Cir. 2001).

H. Identifying the Remainder Beneficiaries

In order to maintain flexibility for dealing with future circumstances, the grantor of a GRAT should consider designating a separate grantor trust as the remainder beneficiary of her GRAT. The beneficiaries of the separate grantor trust should include beneficiaries who are assigned to the grantor's children's (or higher) generation in order to avoid the termination of the annuity period from being treated as a taxable termination.²⁹ Inclusion of the grantor's spouse as a beneficiary will ensure that GRAT profits are available for his support if the other assets of the grantor and her spouse become insufficient. Use of a grantor trust will enable the grantor to continue to pay the income taxes on the investment earnings of the GRAT profits. And use of a separate trust will facilitate future transfers of the remainder interests, as discussed below, to minimize estate tax exposure.

Use of a separate grantor trust may also facilitate generation-skipping transfer tax planning. Assume, for example, that a grantor created a grantor trust a number of years ago and allocated her GST exemption to it ("Trust #1"). Its assets are now worth \$1 million. The beneficiaries of Trust #1 include her children, grandchildren and more remote descendants. All future distributions from Trust#1 to the grantor's grandchildren or more remote descendants will be free of generation-skipping transfer taxes because of the GST exemption allocation. The grantor creates a 5-year GRAT in a month in which the §7520 rate is 4.2%. She transfers property worth \$1 million to it. She is entitled to receive an annuity of \$220,000 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is \$974,000. As a result, she has made a taxable gift of \$24,000. The remainder beneficiary of the GRAT is a separate grantor trust for the primary benefit of her children ("Trust #2). The grantor does not allocate any GST exemption to this new trust because §2642(f) (the so-called "ETIP" rule) would prevent the allocation from being effective until the end of the 5-year term of the GRAT. Six months later, when the actuarial value of the remainder beneficiary's remainder interest in the GRAT is worth \$100,000, Trust #2 sells its remainder interest to Trust # 1 for a price equal to its value of \$100,000. The sale, so long as the price paid is equal to the then value of the GRAT remainder interest should not be treated as an addition from the unprotected trust to the protected trust. As a result, when the GRAT remainder is paid to the protected trust, the transfer should not be subject to generation-skipping transfer tax. And when distributions are made from Trust #1 to the grantor's grandchildren, the distributions should not be treated as taxable distributions

²⁹ §2612(a)(1).

Alternatively, the GRAT remainder beneficiary could enter into a contract with the protected trust to pay to the protected trust an amount equal to the value of the remainder interest at the end of the GRAT. The protected trust would pay the GRAT remainder beneficiary, at the time the contract is entered into, an amount equal to the then value of the remainder interest.³⁰

I. Targeting the Profit Level

Most GRATs are structured to deliver all of the increase in value of the GRAT's assets over the § 7520 rate to the remainder beneficiaries, no matter how great that increase may be. In some cases, however, a grantor is willing to create a GRAT for the benefit of her children but wants to insure that she will receive property with a certain specified value back from the GRAT and/or that her children's trust will receive property with a certain maximum value. It is possible to structure a GRAT's provisions to deliver to the remainder beneficiary precisely the amount that the grantor wants it to have so long as the GRAT's property appreciates sufficiently.

For example, suppose G owns \$10 million worth of stock in a closely held business that she expects will be sold over the next several years for a price of more than \$20 million. She would like her children's trust to receive \$5 million of this increase and would like to use the GRAT technique to accomplish this result. But she wants to make sure that she receives back property from the GRAT worth at least \$15 million. Her GRAT would provide first that she is to receive an annuity in an amount sufficient to zero-out her taxable gift, say 22.59% of the initial value each year if the GRAT is a 5-year GRAT created in a month in which the § 520 rate is 4.2%. It would then provide that the grantor is to receive at the end of the GRAT term property with a value equal to \$15 million reduced by the aggregate amount of the five annuity payments, that the children's trust is to receive the balance of the property remaining in the GRAT up to an aggregate amount of \$5 million and that the grantor is to receive the balance of the property.

³⁰ This idea is discussed in Handler and Oshins, *The GRAT Remainder Sale*, 142 Tr. & Est. 33 (Dec. 2002).

V. **SELECTING INVESTMENTS TO ENHANCE THE PROBABILITY OF SUCCESS**

A. **In General**

A successful GRAT is one that produces a remainder interest with a positive value at the end of the annuity term. In order to produce such a positive value, the GRAT's internal rate of return, taking into account the timing of its investment gains and losses and the timing of its annuity payments must produce an internal rate of return in excess of the §7520 rate in effect at the time of the GRAT's creation.

Normally, it is impossible to predict accurately the rate of return for any particular investment. Nevertheless, there are certain assets and investment approaches that can enhance the probability of success. These assets and approaches are discussed in this portion of the outline.

B. **Using Assets Subject to Restrictions**

Some assets are subject to transferability restrictions that are expected to lapse at some future time. Examples include restricted securities that cannot be sold for some period of time because of SEC rules, because of lock up agreements entered into in connection with initial public offerings, or because of employer conditions imposed in connection with the issuance of stock to employees. In most cases, the owner of these shares expects these restrictions to disappear over a period of time. In many cases, the restrictions on transfer will not prevent intra-family transfers, including transfers to GRATs for the benefit of family members.

The existence of these restrictions will provide a basis for discounting the value of the property if it is transferred to a GRAT. If the term of the GRAT extends beyond the term of the restrictions and if a source of funding can be found to satisfy annuity payments that are required before the restrictions are lifted, this kind of property is a likely candidate for transfer to a GRAT.

Suppose, for example, that G owns 100,000 shares of the X corporation the shares of which are traded on the New York Stock Exchange at \$10 per share. G's shares, however, cannot be sold by her or her transferees for a period of two years. Assume that this restriction on transferability would result in a valuation discount of 25%.³¹ Assume that G transfers her shares to a 2-year GRAT at a time when the §7520 rate is 4.2%. She retains the right to a payment equal to 53.17% of the value of the shares (\$398,787) at the end of each of the two years. The actuarial value of the right to these two payments is equal to \$750,000, the discounted value of her shares. At the end of the first year, her trustees borrow \$398,787 from a financial institution to make the required payment to her. At the end of the second year, the trustees sell the stock for \$1 million, pay the financial institution \$415,000 (including interest), and pay G the second annuity payment.

³¹ This discount is assumed for illustrative purposes only. The discount allowed for any particular security must be established by a qualified appraiser who will take into account many factors specific to the corporation and the trading pattern of its shares.

Because the GRAT is a grantor trust for income tax purposes, all of the tax on the gain is paid by G, not by the GRAT. After the required payments are made, there is \$186,000 left for the remainder beneficiaries of the GRAT.

This GRAT succeeded despite the fact that the market value of the stock transferred to it did not appreciate in value. The success was entirely attributable to the existence of restrictions at the beginning of the GRAT period that the GRAT creator knew would be lifted before the end of her GRAT.

C. Using Assets With Limited Marketability

The value of some assets, such as non-controlling interests in family controlled entities and fractional interests in tangible property, is determined for gift tax purposes using discounts from the value of their proportional interest in their underlying assets to reflect lack of marketability. For example, the value of each of 25% of the stock in a family business that could be sold for \$10 million, a 25% limited partnership interest in a partnership that owns \$10 million worth of marketable securities and a 25% interest in a \$10 million home is not \$2.5 million. Valuation discounts of varying proportions would be used to determine their value for gift tax purposes. If the term of the GRAT extends beyond the period of time that the assets are expected to have limited marketability and if a source of funds can be found to satisfy annuity payments that are required before a market for the property is created, this kind of property is a likely candidate for transfer to a GRAT.

Suppose, for example, that G owns all of the stock of a corporation engaged in the manufacturing business. The corporation could be sold for \$10 million. G has no present intention of selling the corporation but believes that it is likely to be sold at some time during the next 5 years. She transfers a 25% interest in the corporation to a 5-year GRAT at a time when the §7520 rate is 4.2%. She retains the right to a payment equal to 22.59% of the value of the shares as finally determined for gift tax purposes at the end of each of the five years. Assume that the value of the shares is \$1.375 million after taking a valuation discount of 45%. G would have the right to receive \$310,599 at the end of each of the five years. The actuarial value of the right to these five payments is equal to \$1,375 million, the discounted value of her shares. At the end of each of the first 4 years, the trustee borrows the funds necessary to make the annuity payments to G. During the fifth year, the corporation is sold to a third party for \$10 million. The GRAT's share of the proceeds is \$2.5 million. Because the GRAT is a grantor trust for income tax purposes, all of the tax on the gain is paid by G, not by the GRAT. The trustees use the cash to repay the financial institution \$1.372 million (including interest), and pay G the final annuity payment of \$310,599. After the required payments are made, there is \$818,000 left for the remainder beneficiaries of the GRAT.

This GRAT succeeded despite the fact that the market value of the corporation did not appreciate in value. The success was entirely attributable to the elimination of the marketability discount by reason of the liquidity event that occurred during the term of the GRAT.

D. Using Compensatory Stock Options

Compensatory stock options give an employee the right to purchase shares of stock at a price generally equal to the market price of the stock at the time the option is granted. The IRS has ruled that the gift of such an option is a completed gift when the employee's right to exercise it is no longer conditioned on her performance of services.³² The fair market value of such options for gift tax purposes is not limited to its intrinsic value, i.e., an amount equal to the excess of the stock's market value over the exercise price. It is generally determined using one of the standard option valuation methods such as the Black-Scholes model. These methods take into account factors such as the exercise price, the current value of the optioned stock, the stock's volatility, expected dividends, the risk-free rate of return over the option's life and the option's remaining life. The IRS has stated that it will accept, for gift and estate tax purposes, a value for non-publicly traded compensatory options derived using the Black-Scholes model or a similar binominal valuation model.³³ As a condition for relying on this safe harbor, the transferor is not permitted to use any marketability discounts generally used in valuing options.

Despite the fact that the use of a Black-Scholes derived value for an option will produce a value in excess of the option's extrinsic value, the transfer of compensatory options can produce excellent results when compared with the transfer of shares of the underlying stock. This is so because of the leverage inherent in the option. If, for example, a share of X stock with a value of \$100 is transferred to a GRAT, a 100% increase in the value of the X stock, will produce an increase in value for the GRAT of \$100. If an option to purchase that share of stock for 10 years at a price of \$100 is transferred to the GRAT, that same 100% increase will translate into a greater percentage increase in value for the GRAT so long as the initial option value is less than the value of the share of stock. Suppose, for example, that the option value determined using the Black-Scholes model is \$30. By transferring an asset worth \$30, the grantor transfers the right to receive the return on an asset worth \$100. As a result, a 100% increase in the value of the stock will result in a value for the option of at least \$100, more than a 300% increase in value for the GRAT.

Options valued using the Black-Scholes model are not particularly attractive candidates for outright gifts because the option leverage would work against the grantor if the stock failed to appreciate sufficiently in value. As a practical matter, the option itself will not be sold in a market transaction. As a result, the donee will never be able to capitalize on the value of the option itself but will only realize a return if she is able to exercise the option and sell the underlying stock. Unless the value of the stock increases sufficiently to offset the initial value of the option, the gifted option will eventually be worth less than its original value. For example, suppose the X stock describe above grows in value to only \$125 before the option expires. In that case the donee will eventually realize \$25 from the

³² Rev. Rul. 98-21, 1998-1 C.B. 975.

³³ Rev. Proc. 98-34, 1998-1 C.B. 983.

gifted property yet the donor will have made a taxable gift of \$30. Transferring options to a zeroed-out GRAT protects against this reverse leverage. If the stock fails to appreciate sufficiently, the option or the stock will be returned to the grantor with no gift tax cost and no impact on her adjusted taxable gifts.

E. Enhancing the Performance of a GRAT with Derivatives

If a grantor transfers a marketable security to a GRAT, particularly a highly volatile stock, the possibility of success can be increased if the grantor purchases a call on the stock from the GRAT. Suppose, for example, that the grantor transfers \$10,000,000 worth of a highly volatile marketable security to a 5-year GRAT. As discussed above, Rev. Proc. 98-34³⁴ establishes a safe harbor for valuing, for gift tax purposes, compensatory stock options that are exercisable to acquire publicly traded stock. The revenue procedure provides that such options can be valued by using a generally recognized option model such as the Black-Scholes model or an accepted version of the binomial model. The Black-Scholes model would value a 5-year call, the exercise price of which is double the stock's current value, at about 60% of the market price of the stock if the stock is highly volatile.³⁵ Using Black-Scholes as a basis for establishing value, the grantor or her spouse could purchase from her GRAT the right to buy the \$10,000,000 worth of stock at any time during the 5-year term of the GRAT for \$20,000,000. She would pay \$5,983,000 for the call. With the purchase price as part of its assets, unless the stock declines in value substantially, the GRAT will succeed in producing value at the end of its term for the remainder beneficiary. If, for example, the stock remains at its current level throughout the GRAT's term, at the end of the term, the GRAT will have assets for its remainder beneficiary worth about \$5,700,000.

VI. MONITORING THE GRAT

A. In General

A GRAT's performance should be monitored in order to curtail losses generated by an unprofitable GRAT, to protect a profitable performance from erosion as a result of future investment losses and to protect a profitable performance from disappearance as a result of the premature death of the grantor.

B. Monitoring to Minimize the Impact of Investment Losses

A GRAT that underperforms in its initial years is unlikely to be a profitable GRAT. This is so because losses in the early years must be compensated for by better than average gains in the later years.

Suppose, for example, that G creates a 5-year GRAT in a month in which the §7520 rate is 4.2%. She transfers property worth \$1 million to it. She is entitled to receive an annuity of \$225,900 at the end of each of the next 5 years. The

³⁴ 1998-1 C.B. 983.

³⁵ Calculation provided by Lance Hall of FMV Opinions, Inc.

actuarial value of the right to receive these annuity payments is \$1 million. Suppose, the value of the property declined by 10% in each of the GRAT's first two years. It is now worth only \$380,808, and will be required to make three more payments of \$225,900 to the grantor. In order to produce any profit at all for the remainder beneficiary, the GRAT's investments would have to grow in value by more than 35% per year in each of the next three years. Except in unusual circumstances, this is unlikely to happen.

When losses of this magnitude occur, the grantor should consider purchasing the GRAT's remaining assets and transferring them to a new GRAT. Because the GRAT is a grantor trust, the purchase can be accomplished without income tax cost. The grantor could pay the purchase price with a note, portions of which would be distributed to him over the remaining term of the GRAT. With a fresh start, the property in the new GRAT would have a significantly better opportunity for producing a profit for the remainder beneficiary.

C. Monitoring to Protect Investment Gains

A GRAT that generates good investment performance in its initial years is likely to produce a profit for its remainder beneficiaries, but there is no guarantee that poor performance in later years will not substantially reduce its profitability. A GRAT's successful investment results can be locked in by one of two different transactions.

First, the grantor could purchase the GRAT's assets for a note. Because the GRAT is a grantor trust, the purchase can be accomplished without income tax cost. She could then transfer the assets to a new GRAT. If the interest rate on the note is equal to the §7520 rate that was in effect when the GRAT was created, whatever profit has been generated prior to the sale will remain in tact until the end of the GRAT term.

Second, the grantor could purchase the remainder interest from the remainder beneficiary. If the remainder beneficiary is a separate grantor trust treated as owned by the grantor, the purchase can be accomplished without income tax cost.

Suppose, for example, that G creates a 5-year GRAT in a month in which the §7520 rate is 4.2%. She transfers property worth \$1 million to it. She is entitled to receive an annuity payment of \$225,900 at the end of each of the next 5 years. The actuarial value of the right to receive these annuity payments is \$1 million. At the end of the 5-year term, the remaining GRAT property is to be paid to a separate grantor trust for the benefit of her children. Suppose, the value of the property increased by 20% in each of the GRAT's first two years. It is now worth \$943,041, and will be required to make three more payments of \$225,900 to the grantor. The net present value of the right to receive these payments is \$624,495 (assuming a §7520 rate of 4.2%). Therefore, the present value of the remainder interest is \$318,545. The grantor could lock in the profit generated by the GRAT by purchasing the remainder interest from the separate grantor trust for \$318,545. The grantor would then own all interests in the trust, the right to receive annuity payments and the right to receive the remainder at the end of the 5-year term.

And the separate grantor trust would have cash of \$318,545, the amount of which would not be affected by future investment performance of the GRAT assets.

D. Monitoring to Protect Against Mortality Risk

If a grantor dies while she has the right to receive further annuity payments from her GRAT, some portion, or all, of the GRAT will be included in her gross estate for federal estate tax purposes under § 2036. This section requires that a transferor include in her gross estate the value of property transferred during her life if she retained for life, or for a period that did not end before her death, the right to the income from the transferred property.

The grantor of a GRAT does not explicitly retain the right to income. Instead, she retains the right to an annuity which may be more or less than the actual income received by the trust. The IRS treats this type of retained interest as if it were the right to receive the income from a portion of the trust corpus. That portion is required to be included in the gross estate. The included portion is that fraction of the corpus which would be required to be invested at the § 7520 rate in effect on the date of the grantor's death to produce annual income equal to the required annuity payment.

In several private letter rulings the IRS has taken the position that the gross estate of a decedent who died before the termination of her right to receive an annuity from a GRAT must include the full value of the trust corpus under §2039(a).³⁶ This section requires inclusion of the value of an annuity or other payment receivable by any beneficiary by reason of surviving the deceased annuitant under a contract or other agreement under which an annuity or other payment was payable to the decedent

The estate tax inclusion risk can be managed by using a separate grantor trust as the GRAT's remainder beneficiary and causing the grantor to purchase the remainder interest from the separate grantor trust at some time during its term after the performance of the GRAT's investments has caused the remainder interest to have significant value.

Suppose, for example, that a grantor established a 20-year GRAT using the annuity scheduled set forth in Table 5 and funded it with an asset worth \$1,000,000. At the end of the 20-year term, the remainder was to pass to a separate grantor trust. Suppose further that the asset increased in value by 20% per year over the first 5 years. At the end of the 5-year period, the GRAT assets would be worth about \$2.4 million and the present value of the remainder interest (assuming a 4.2% § 7520 rate) would be about \$1.2 million. The grantor could purchase the remainder interest from the separate grantor trust for \$1.2 million. This purchase would eliminate the risk that the \$1.2 million value that had accrued for the benefit of the remainder beneficiary would be subject to estate tax if the grantor died before the end of the 20-year term.

³⁶ PLR 20021009 (Nov. 19, 2001); FSA 200036012 (Sept. 8, 2000); PLR 9451056 (Sept. 26, 1994); PLR 9448018 (Aug. 30, 1994); PLR 9345035 (Aug. 13, 1993). The IRS had earlier reached a similar result in a private letter ruling dealing with a charitable remainder unitrust. PLR 8321104 (Feb. 24, 1983).

Alternatively, at the end of the 5-year period, the separate grantor trust could purchase the assets of the GRAT for a self-canceling installment note that would terminate on the death of the grantor with no further payments due. If the grantor died before the 20-year term of the GRAT had expired, no further payments would be due on the note, and little, if any, value would be included in the grantor's gross estate.

Part IV: FORMS OF DEFERRED PAYMENT SALES

There are three forms of deferred payment sales, fixed payment installment sales, SCIN sales³⁷ and private annuity sales. Traditionally, the IRS distinguished between SCINs and private annuities on the basis of the maximum term of the deferred payment obligation—if the maximum term was shorter than the transferor-seller’s actuarial life expectancy,³⁸ a sale was classified as a installment sale under § 453; if longer, it was classified as a private annuity governed by § 72.³⁹ A SCIN for a maximum term exceeding the seller’s life expectancy is sometimes referred to as a private annuity for a term of years (a “PATY”), with income tax reporting generally under the § 72 annuity rules. However, a 1998 regulation amendment designed primarily to prevent noninsurance company financial institutions offering tax-sheltered investments⁴⁰ may require treating PATYs as installment sales under § 453, in effect, as SCINs, leaving only annuities for life with no term limits or refund features subject to traditional private annuity taxation.

As indicated, any of the three deferred payment sale transactions can be either be a sale to a grantor trust that is not treated as a sale for Federal income tax purposes or to another purchaser that is treated as a taxable sale for Federal income tax purposes, even if the sale is to a partnership or S corporation in which the transferor-seller is substantially the sole owner.⁴¹

³⁷ Frequently referred to simply as SCINs although technically a SCIN is the form of promissory note that contains the cancellation feature, usually based on the seller’s death.

³⁸ Using the Reg. § 1.72-9 Table V mortality table. The lives in Table V are based on a 1983 study of individuals who purchased annuities. Annuity purchasers tend to live longer than people of the same age in the general population, presumably because they are self-selected and have better living conditions.

³⁹ See G.C.M. 39503 (Jun. 28, 1985); see Hesch and Manning, Family Deferred Payment Sales: Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas, 26th U. Miami Philip E. Heckerling Inst. on Est. Plan. Ch. 3, ¶ 310.3 (1992).

⁴⁰ See the Preambles for the proposed and final regulations. FI-33-94, 1995-1 C.B. 920, 921-22 and T.D 8754, 1998-1 C.B. 146, 146-48.

⁴¹ If Senior’s grantor trust is a 100% shareholder in an S corporation, or a 99% limited partner in a partnership, a sale by Senior to his controlled entity is a taxable sale despite the fact that Senior is deemed to be the income tax owner of the purchasing entity under the grantor trust rules. Under Reg. § 1.707-3(a)(3) and (f) Example 1, a transfer may be a sale only in part if the amount paid is less than the fair market value of the property. Under Reg. § 1.707-5(a)(1) and (f) Example 1 a transfer of property subject to a liability is a disguised sale only to the extent that a share of the liability is shifted to other partners. Thus, if the note is considered a distribution, the transfer is a sale because it equals the fair market value of the property, but if it is analyzed as a transfer subject to a liability, only the portion attributable to other partners is a sale. The grantor trust provisions (§§ 671-679) do not apply related party or attribution rules similar to those found in the income tax area, §§ 267(b) and (c), 318, 453(f)(1) and 707(b) and the related party rules used in Chapter 14. See § 2701(e)(3). In the absence of specific statutory authority, a sale by a grantor to an entity owned by a grantor trust is not treated as a sale to the grantor trust.

The income tax and transfer tax consequences of the three basic deferred payment sale situations as sales to nongrantor trusts and to grantor trusts will be evaluated in this paper. As always, the discussion assumes that the intra-family sales are not shams.⁴²

A. SITUATION ONE—INSTALLMENT SALE TO A NONGRANTOR TRUST

Example: Senior sells the limited partnership interest to a family trust taking back the purchaser's interest-only promissory note for the entire \$10,000,000 purchase price. The promissory note is for a fixed term at the long-term AFR and has no termination at death contingency. The trust is not a grantor trust.

The transaction is a taxable sale for Federal income tax purposes. The reporting of the gain is postponed under the installment method and is reported only as principal payments on the note are received.⁴³ If Senior dies during the term of the note, the note is included in his gross estate at its fair market value. Because the gain was realized while Senior was alive, it is income in respect of a decedent ("IRD").⁴⁴ Consequently, there will be no tax-free step-up in basis for the note.⁴⁵ Under Section 691(a)(4), the successor-in-interest will report the capital gain and interest income as payments are made on the promissory note, subject to a deduction under § 691(c) for any estate tax attributable to inclusion of the note in Senior's gross estate. The purchaser has a cost basis in the property equal to the principal amount of the note. That cost basis is not affected by Senior's death, so that any predeath appreciation that escapes transfer tax is subject to, presumably capital gain, tax to the purchaser. Since the estate tax will eventually be 45% and the capital gain tax is 20% and may be further delayed, the tradeoff is usually a good one. If there is a decline in value, the reverse may be true, except to the extent that the value of the promissory note is correspondingly reduced.

1. Assets Eligible for the Installment Method

Generally, only capital gains, long- or short-term, can be postponed under the installment method. Section 453 does not list eligible assets; it lists specific assets and transactions—inventory,⁴⁶ dealer dispositions,⁴⁷ depreciation recapture,⁴⁸ marketable securities,⁴⁹ sale of depreciable property to a controlled entity,⁵⁰ and sales for demand or marketable obligations⁵¹—

⁴² See *Stokes v. Commissioner*, 77 T.C.M. (CCH) 2206 (1999) (disregards private annuity sale to a family trust, arranged with the assistance of what was apparently a professional promoter, shortly before a sale of the business for cash, because nothing changed with respect to the operation of the annuitant's pizza business after the private annuity sale and prior to the resale).

⁴³ Unless the reporting of Senior's gain is accelerated as a result of a second disposition of the property under § 453(e).

⁴⁴ § 691(a).

⁴⁵ § 1014(c).

⁴⁶ § 453(b)(2)(B).

⁴⁷ Other than unimproved lots and timeshares. § 453(b)(2)(A) and (1)(2)(B).

⁴⁸ § 453(i)(1)(A).

⁴⁹ § 453(k)(2)(A).

⁵⁰ § 453(g)(1)(A) and (f)(7).

that are not eligible for the installment method. Therefore, gain from the sale of ordinary income assets that are not inventory or stock and trade may be eligible for deferral under the installment method. For example, the income from intellectual property is typically characterized as ordinary income.⁵² The gain from a sale of this income stream could potentially be reported under the installment method.⁵³ A taxpayer who has a royalty right or a fee under a licensing arrangement may also be able defer the recognition of the ordinary income by using seller-provided financing, although there is a significant argument that the transfer is taxable immediately as an assignment of income.⁵⁴

If the family purchaser resells the property within two years, the deferred gain is accelerated under anti-*Rushing* rule.⁵⁵

2. Avoiding § 453A—Exceeding the \$5,000,000 Maximum without Interest on the Deferred Tax Liability

Section 453A provides for interest on the taxes on the gain deferred under the installment method if outstanding installment obligations exceed \$5,000,000, but only by aggregating deferred payment sales made in the same tax year. The rate of interest to be used is the Federal short-term rate, determined each quarter, plus 3%.⁵⁶ This is the interest rate charged on tax underpayments. This interest charge eliminates much of the time value of money benefit from deferring the tax under the installment method. A close reading of § 453A shows that each taxpayer is tested under this \$5,000,000 threshold separately. The threshold can be increased to \$10,000,000 when two taxpayers, even if related, each make a deferred payment sale for \$5,000,000 or less. It is simple for a senior family member to gift \$5,000,000 worth of property to each of his or her children. For example, if, prior to the sale, Senior gives a portion of the property to be sold to one or more children, the amount that could be sold without incurring an interest charge would be increased. Unfortunately, the gift would involve a gift tax liability that is likely to be more expensive than the interest charge. Since gifts between spouses that qualify for the unlimited marital deduction avoid gift taxes and since each spouse is a “taxpayer” notwithstanding joint returns,⁵⁷ the threshold can be increased \$10,000,000 for each tax year

⁵¹ § 453(f)(4).

⁵² § 1221(3).

⁵³ There is a possibility that the deferred payment sale may be viewed as an anticipatory assignment of income and the promissory note may be viewed as a payment in kind. Also, consider the impact of the anti-churning rule under § 197(f)(9) on the purchasers. The installment method is not available if the purchaser is a related party who amortizes or depreciates the purchased asset. § 453(g)(1)(A).

⁵⁴ See *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *United States v. Dresser Industries*, 324 F.2d 56 (5th Cir. 1963); *Fox v. Commissioner*, 84 T.C. 50 (1985); *Commissioner v. P.G. Lake, Inc.* 356 U.S. 260 (1958).

⁵⁵ § 453(e)(1) and (2), which changed the result of *Rushing v Commissioner*, 441 (F.2d 593 (5th Cir. 1971), *aff’d* 52 T.C.888 (1969) (sale to family trust eligible for installment method notwithstanding immediate resale by trust). See H.R. Rep. No. 833, 96th Cong. 2nd Sess. 48-51 (1980).

⁵⁶ §§ 453A(c)(2)(B) and 6621(a)(2).

⁵⁷ See §§ 151(b) and 6013(a) providing for joint returns and for each taxpayer taking a personal exemption. A close examination of the language in § 6013(a) shows that a joint return is filed by two taxpayers. See Tech. Adv. Mem. 98-53-002 (Issue 2) (Sep. 11, 1998) (spouses are separate taxpayers for purposes of the \$5,000,000 threshold; relies on Notice 88-81, 1988-2 C.B. 327, which provides that installment obligations of partnerships and S corporations are owned by the partners or shareholders applying the definition in § 453A(b)(2) that incorporates the definition of single owner in § 52 so that no attribution to family members is appropriate).

without a gift tax. Of course, gifts immediately before a sale run the risk of being disregarded under the step-transaction principle.⁵⁸

Another way of increasing the threshold is to sell part of the property in one taxable year and another part in a subsequent taxable year, increasing the threshold to \$10,000,000. For example, an individual contemplating a sale in December can, instead, sell a one-half interest in December and the other one-half interest in January of the following year. Combining the bifurcation of the sale among two separate taxable years with gifts to a spouse increases the threshold to \$20 million.

A lease with an option to purchase is another way of increasing the threshold. If there were a ten-year lease, there could be a sale of \$5,000,000 each year for ten years, so that an installment sale of \$50,000,000 could avoid the interest threshold under § 453A.

Of course, each of these arrangements is subject to attack under sham, reality-of-sale and step transaction principles. The planner must be sure not only to use them only if justified by the facts, but also to have sufficient authority to avoid accuracy related penalties.

B. SITUATION TWO—INSTALLMENT SALE TO A GRANTOR TRUST

Example: Senior makes the installment sale to an irrevocable family trust, that is nevertheless a grantor trust because of retained administrative powers that do not require inclusion of the trust assets in Senior's gross estate. A grantor-seller must provide some funds by gift in addition to the property sold, so that the trust can be treated as a grantor trust.⁵⁹

Such a family trust is sometimes called a "defective" grantor trust,⁶⁰ but it is not defective since the grantor trust status is intentional. Perhaps a better term is intentional or deliberate grantor trust.

Under Rev. Rul. 85-13,⁶¹ no sale has occurred for Federal income tax purposes when the property is exchanged for the note. Because there is no sale, principal and interest payments on the Family trust's promissory note have no tax effect and none of the installment sale issues

⁵⁸ See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1951); *American Bantam Car. Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3rd Cir. 1949); *Turner Broadcasting Systems, Inc. v. Commissioner*, 111 T.C. 315 (1998); *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1998).

⁵⁹ See *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975) (a taxpayer is considered a grantor only with regard to the property actually contributed to the trust and owned by the taxpayer at the time of contribution). Prop. Reg. § 1.671-1(e)(1) takes a similar approach.

⁶⁰ See, e.g., Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996); Oshins, King and McDowell, *Sale to a Defective Trust: A Life Insurance Technique*, 137 Tr. & Est. 35 (1997); Weinberg, *Reducing Gift Taxes Liability Using Intentionally Defective Irrevocable Outstanding Trusts*, 4 J. Asset Prot. 62 (1999); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. Tax'n 152, 159 (2000).

⁶¹ 1985-1 C.B. 184; Reg. § 1.1001-2(c) Example 5. Cf. Rev. Rul. 92-84, 1992-2 C.B. 216 (income beneficiary of qualified subchapter S trust is taxed on gain on sale of S corporation stock allocated to corpus because treated as grantor and therefore as owner of trust's assets).

discussed in *Situation One*. Despite the title of this section, it is not necessary to limit this technique to assets that qualify for the installment method. The technique can be used, for example, to transfer marketable securities.

If Senior dies before payment of the promissory note, the value of the note is included in his gross estate. Since there was no gain realized while Senior was alive, the rights under the installment note are not IRD. The estate's basis in the note is stepped up to its value at the date of death, based on the AFR at that time.⁶² The family trust is deemed to have acquired the assets by purchase for income tax purposes at the time of death when its grantor trust status terminates. It takes a cost basis in the assets, which should be equal to its principal amount if the interest provided is at least equal to the AFR, at the time of Senior's death.⁶³ The trust is not entitled to a stepped-up basis in the assets under § 1014(a). Thus, if the property has appreciated before death, the negative effect of the estate freeze and the exclusion of the appreciation from the gross estate is the loss of the income tax advantage of the basis step up above the principal (or other tax amount) of the promissory note. As discussed below, it is the authors' opinion that, because the death of Senior is not a realization event, no gain is recognized by Senior or his estate upon the death of Senior despite the termination of grantor trust status for any excess of the note over the pre-transfer basis in the property.

C. SITUATION THREE—SELF-CANCELING INSTALLMENT NOTE SALE TO A NONGRANTOR TRUST

Example: The facts are the same as in Situation One except that the installment note is a SCIN cancelled on Senior's death. Because of the possibility that all or part of the principal of the SCIN will be cancelled on Senior's death, the total specified payments under a SCIN must be greater than those for a fixed payment installment sale if the promissory note is to have a value equal to the value of the property transferred. The premium can make a SCIN a negative freeze if Senior lives to collect the entire sale price.

The SCIN term cannot be set to expire too far beyond the grantor's life expectancy because of both practical and reality-of-sale considerations. As a practical matter, the greater the SCIN term, the greater the risk premium and corresponding increase in interim interest payments. Moreover, under reality-of-sale principles, if the principal payment is postponed to a date that makes payment of principal during the grantor's life highly unlikely, the transaction is

⁶² The terms of the note may provide for a rate adjustment to avoid creating OID at that time. One commentator believes that the note may be valued at less than its principal because the AFR is likely to be less than prevailing interest rates; see Mulligan, *supra* note 60 at ¶ 1507.1; but some believe that § 7872 requires valuation at principal. See Hatcher and Manigault, *supra* note 60.

⁶³ 1274(a)(1); Reg. § 1.1274-2(b)(1); *Mayerson v. Commissioner*, 47 T.C. 340, 352, *acq.* Rev. Rul. 1969-77, 1969-1 C.B. 59; *Bolger v. Commissioner*, 59 T.C. 760 (1973), *acq.* 1976-1 C.B. 1.

likely to be recast as an annuity of the interest only for senior's life.⁶⁴ Possibly because of the practical considerations, there has been little discussion of the maximum SCIN term.⁶⁵ One possible analogy is Reg. § 1.1275-1(j)(6)(iii) that treats an annuity with a time limit greater than twice the annuitant's life expectancy as not being subject to a significant limitation, which suggests the contrary—that a SCIN for a term greater than twice the decedent's life will not be treated as a bona fide sale for a stated principal amount. The negative pregnant—that a sale for any shorter period will be treated as bona fide—is sound. Whatever actuarial table is used to measure the decedent's life expectancy already has a built-in assumption that approximately 50% of the class of persons measured—the general population in Table 90CM and annuitants in Reg. § 1.72-9 Table V—will die before the specified term. Accordingly, any term more than a small period beyond that date is subject to substantial risk. The Reg. § 1.72-9 Table V more closely reflects the individuals who are likely to engage in the types of transactions considered in this paper. Any period longer than the Reg. § 1.72-9 Table V life is risky, and should be used only for clients who take an aggressive approach to estate planning even recognizing that, because of the risk premium, a SCIN is only a good deal if the grantor-seller dies before payment of the principal on the promissory note

When Senior dies, any unpaid balance on the SCIN is not included in Senior's gross estate because of the self-canceling feature.⁶⁶ Nevertheless, the trust has a cost basis in the assets measured by the initial principal amount of the SCIN. This is because notwithstanding the cancellation of the note at death, it is deemed to be satisfied at its principal amount because the obligee is a related party,⁶⁷ so that the previously realized but deferred gain is recognized. Although the *Frane* case held that the gain is reported as IRD on the estate's income tax return, the better rule is that the accelerated gain is reported on the decedent's final income tax return.

1. Impact of Reg. § 1.1275-1(j)

Prior to the effective date of Reg. § 1.1275-1(j),⁶⁸ it was generally conceded that a SCIN for a fixed term greater than the seller's life expectancy, as determined by Reg. § 1.72-9, Table V, was characterized as an annuity so that its income tax consequences were determined under the § 72 annuity rules rather than the § 453 installment sale rules.⁶⁹ With the issuance of Reg. § 1.1275-1(j), it is likely that few PATYs, even ones with a maximum terms significantly greater than the seller's life expectancy, can be “annuities.”⁷⁰

⁶⁴ Cf. Rev. Rul. 77-454, 1974-2 C.B. 351 (treats private annuity from exhaustible fund as annuity for lesser of life or estimated date of exhaustion of fund).

⁶⁵ See Hartz & Banoff, Planning Opportunities Available Using a Private Annuity for a Terms of Years, 65 J. Tax'n 302, 308 (1986).

⁶⁶ *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result only* 1981-1 C.B. 2; *Cain v. Commissioner*, 37 T.C. 185 (1961), *acq.* 1961-2 C.B. 4.

⁶⁷ § 453B(g); see *Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part*, 98 T.C. 341 (1992); Rev. Rul. 86-72, 1986-1 C.B. 253.

⁶⁸ Reg. § 1.1275-1(j)(8)(i) provides an effective date of February 9, 1998.

⁶⁹ G.C.M. 39503 (Issue (1)) (Jun. 28, 1985).

⁷⁰ There appears to be an exception for annuities with a maximum payout period that is more than twice the annuitant's life expectancy, determined, not by Reg. § 1.72-9 Table V, but by the tables prescribed in § 417(e)(3)(A)(ii)(I) relating to determining present value for purposes of restrictions on cash-out of joint and survivor annuities under qualified pension plans.

The OID rules generally require current accrual of interest on “debt instruments” as defined in § 1275(a)(1) and Reg. § 1.1275-1(d). Annuities are exempted from the application of the OID rules,⁷¹ which has the effect of allowing the “inside buildup” of annuity contracts to escape taxation until amounts are paid out on the annuity. To limit financial arrangements that take advantage of this tax shelter in a manner the IRS considers improper, Reg. § 1.1275-1(j) limits the annuity exception to contracts containing terms ensuring that the life contingency under the contract is both “real and significant.”⁷² Reg. § 1.1275-1(j) takes the position that the contract is “real and significant” only if, on the day the contract is purchased, there is a *high* probability that total distributions under the contract will increase commensurately with the longevity of the individual over whose life the distributions are to be made.⁷³ The regulation identifies terms and provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity, including a maximum payout provision.⁷⁴ This applies to most PATYs and SCINs because the regulation defines a maximum payout provision as a contractual provision that provides that no distributions under the contract may be made after some date even if the terminating death has not occurred.⁷⁵ Although the Regulation provides a situation whereby the existence of a maximum payout provision can co-exist with an annuity,⁷⁶ it is highly unlikely that a SCIN or PATY would qualify. Although apparently not intended to deal with private annuities, the Regulations eliminating the G.C.M. 39503 distinction based on the relation between the maximum term and the seller-annuitant’s life expectancy is sound tax policy. Indeed, although not appropriate for an OID regulation, we believe it would probably be sound policy to treat all private annuities, even those with no maximum term, as contingent payment installment sales subject to the OID rules.⁷⁷

2. Valuation of a SCIN

A risk premium must be added because of the possibility that the note will never be paid. The premium may be reflected in either a higher interest rate or a greater principal amount, or some combination. Since the process of determining the value of the note is one of discounting, the issues become (i) which of the rates prescribed by the Code for discounting—the AFR prescribed in §§ 1274 and 7872 or the § 7520 rate prescribed for valuing certain term interests—applies and (ii) whether the income tax mortality table prescribed under Reg. § 1.72-9 Table V or the one prescribed in the Aleph Volume for transfer tax purposes applies. We believe that it is clear that the AFR, not the § 7520 rate, applies and that, with somewhat less certainty, the longer lives under Reg. § 72-9 Table V should apply.

⁷¹ § 1275(a)(1)(B)(i) exempts an annuity contract to which section 72 applies if the contract depends (in whole or in part) on the life expectancy of 1 or more individuals.

⁷² Reg. § 1.1275-1(j)(1).

⁷³ Reg. § 1.1275-1(j)(2)(i)(B).

⁷⁴ Reg. § 1.1275-1(j)(6)(i).

⁷⁵ Reg. § 1.1275-1(j)(6)(ii).

⁷⁶ Reg. § 1.1275-1(j)(6)(iii).

⁷⁷ See Manning and Hesch, Private Annuities After the Installment Sales Revision Act of 1980, 6 Rev. Tax’n Indiv. 20, 32 (1982).

a. Discount Rate

§ 7520 prescribes rates (120% of the midterm AFR) to be used for valuing annuities, life estates, remainders and term interests. Since a SCIN is not an annuity, the question is whether it is a term interest. The same considerations that lead to the conclusion that that an installment note is not a retained life estate also lead to the conclusion that it is not a term interest. This is consistent with (i) the analysis in Reg. § 1.1275-1(j) that a SCIN is treated as a debt obligation subject to the OID rules, including the provisions of § 1274, and (ii) the similar conclusion in G.C.M. 39503 for a SCIN with a maximum term less than the seller's life expectancy is treated under the installment sale rules of § 453.⁷⁸ Similarly, according to the Tax Court in *Frazee v. Commissioner*,⁷⁹ the interest rate to use in determining the value of the note for both income tax purposes and for gift tax purposes is determined by using § 7872. Furthermore, the proposed regulations under § 7872 and related provisions properly recognize that the appropriate-term § 7872 rate controls.⁸⁰

b. Mortality Tables

There is no clear authority whether the life expectancies in Table 90CM⁸¹ or the longer life expectancies in Reg. § 1.72-9 Table V should be used to value a SCIN.⁸² The correct approach is to use the income tax annuity tables.⁸³ In part this conclusion is based on the same reasoning as that supporting the use of the AFR, that a SCIN is not a term interest under § 7520. Although the § 7520 regulations prescribe use of Table 90CM,⁸⁴ there is no corresponding provision in the contingent-payment installment-sale regulations.⁸⁵ In a broader sense, however, there is no requirement for any prescribed rate. The underlying assumption for exclusion of installment sales to family trusts, including SCINs from giving rise to taxable gifts is that they are excluded as bona fide business transactions.⁸⁶ Accordingly, the question is whether the transaction in a family transaction is on arm's length terms. Unrelated parties, of course, are free to use any reasonable basis for actuarial adjustments. Related parties should have the same freedom provided they can show that they have acted within the range of arm's length

⁷⁸ Rev. Rul. 86-72, 1986-1 C.B. 253; G.C.M. 39503 (Jun. 28, 1985). See Reg. § 1.1275-1(j) for a PATY.

⁷⁹ 98 T.C. 554 (1992).

⁸⁰ Prop. Reg. §§ 1.7872-1(a), -2(a), 1.1012-2(b) and 25.2512-8.

⁸¹ See Reg. § 20.2031-7T(d)(7); Aleph Volume (Pub. 1457).

⁸² Under Table 90CM, the life expectancy of a 70-year old is 13.9 years. Under Reg. § 1.72-9 Table V, it is 16.0 years. The reason the annuity tables have longer life expectancies is that they are based on a sample pool of individuals who purchase annuities, which is by self-selection, a healthier group than the general population.

⁸³ See Shore and McClung, *Beyond the Basic Super Freeze—An Update and Additional Planning Opportunities*, 75 *Taxes* 41,50 (1997), mentioning that there is no authority requiring uses of the transfer tax tables and suggests use of Reg. § 1.72-9 Table V.

⁸⁴ Reg. § 25.7520-1T(b)(2).

⁸⁵ See Reg. § 15A.453-1(c) relating to contingent payment sales. The absence of a regulation may be due to the fact that the installment sale regulations do not even refer to actuarial issues.

⁸⁶ Reg. § 25.2512-8.

bargaining.⁸⁷ On the other hand, it is doubtful that there are many SCIN transactions entered into by unrelated parties.⁸⁸

However computed, providing for the risk premium by increasing principal rather than interest provides two advantages, the premium is eligible for capital gains rates and may be deferred until payment of principal (or even eliminated if the seller dies before the end of the SCIN term. The deferral and chance of elimination can be maximized by providing payment of interest only during the SCIN term with a balloon payment of principal at the end. The interest will, however, be increased to reflect the increased principal. On the other hand, such a deferral will increase the absolute amount of the principal payment.

3. Disregarding Actuarial Assumptions for a SCIN

Reg. § 20.7520-3(b)(3) provides that the mortality component described under §7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is “terminally ill” at the time of death. Technically, the position taken in this regulation does not apply to a SCIN because a promissory note is not an annuity or future interest as described in that regulation. However, the better view is that the statement in the regulation is generally illustrative of situations in which the impending death of the individual should be taken into account and that standard actuarial tables do not apply. Indeed, since SCIN transactions of the type being discussed depend for their effectiveness on being treated as bona fide business transactions, applying the actuarial tables for a terminally ill individual would hardly satisfy the standard.

The regulation provides an 18-month safe harbor—if the individual survives more than 18 months, that individual shall be presumed to not have been “terminally ill” unless the contrary is established by clear and convincing evidence. The regulation is an estate tax regulation, which means that the IRS can apply it with the benefit of hindsight. Unfortunately, that type of perfect 20-20 vision is not available when the terms of a SCIN are established. It can only provide limited, after the fact, protection if the grantor-seller survives the 18 months.

4. Application of Estate Freeze Rules to SCINs

Even though it has a contingent payment, a SCIN should not be disregarded in determining whether a SCIN sale to a family trust involves a gift. First, the special valuation rules of § 2701 only apply in determining “the amount of the gift,”⁸⁹ and a properly crafted SCIN is a sale for transfer tax purposes not a gift.⁹⁰ In addition, since a SCIN is a debt obligation, it

⁸⁷ Cf. § 2703(b); Reg. § 25.2703-1(b)(1) to (4) (excluding buy-sell agreements on terms “comparable to similar arrangement entered into in arms’ length transactions.”

⁸⁸ See Zerach, Private Annuities and Self-Cancelling Installment Notes, *The CPA Journal Online* (www.luca.com) (Dec. 1993); Strizever, Self-canceling notes increase planning risks of a sale over private annuities, *12 Tax’n for Law.* 298 (1984).

⁸⁹ Reg. § 25.2701-1(b)(1); see Mulligan, *supra* note 60 at ¶ 1511; Nicholson, Sale to a Grantor Trust: Better than a GRAT?, *37 Tax Mgmt. Mem.* 99, 100 (1996); Lewis and Laning, Estate Freezes and Grantor Trust for Business Owners, *1 Bus. Ent.* 10 (1994)..

⁹⁰ Reg. § 25.2512-8; Prop. Reg. § 25.2512-8 (Mar. 27, 1986).

cannot be an applicable retained interest subject to the special valuation rules.⁹¹ For similar reasons, it is not a lapsing right subject to § 2704 even though it may terminate on death. Section 2704 applies only to voting rights and limitations on liquidation, neither of which describes a SCIN. Although § 2704(a)(4) gives the Secretary the power to treat “other restrictions” as interests to be disregarded, there are no such regulations. Furthermore, as the IRS has recognized,⁹² § 2702 should not apply because the SCIN, event though subject to contingencies, is a debt obligation of, not a beneficial interest in, the family trust.⁹³ The note holder’s rights are governed by the contract, not the terms of the trust.

5. Inclusion in Gross Income

Despite the breadth of § 61’s provision that all benefits received are gross income and must be reported unless an exclusion applies, the cancellation of the SCIN at death should not result in gross income to the family trust. As discussed above, transfer of even property subject to a liability at death does not give rise to gross income for the decedent. Similarly, as recognized by § 102(a), for receipt of property as a result of death. This is not inappropriate since any unrealized gain is either reported at death under § 453B(f) if the SCIN was still outstanding, or represented by a transferred basis if it was not.

6. Basis to the Purchaser

Under general income tax principles, a contingent liability is not taken into account by the purchaser in determining basis or by the seller in determining amount realized.⁹⁴ Without more, a SCIN is a contingent liability because of the possibility it may never have to be paid. When the SCIN sale is to related party so that under § 453B(f) the termination of the obligation at death is treated as payment at its face amount, a SCIN should not be treated as a contingent liability. Accordingly, the family trust-purchaser should be entitled to include the SCIN principal in basis and the grantor-seller in determining amount realized and the selling price for installment sale purposes.⁹⁵

The 1980 Act added § 453B(f) to overturn the result in *Miller v. Ustry*⁹⁶ which refused to apply the pre-1980 version of the disposition rule except to actual sales of the note for cash, and to make it clear that a disposition by gift should also be subject to the § 453B(a) disposition

⁹¹ § 2701(a)(1) applies only to a transfer of an “interest” in a corporation or partnership when there is an applicable retained “interest.” Reg. § 25.2701-2(b)(1) defines an applicable retained interest as an “equity” interest in a corporation or partnership. See e.g. Priv. Ltr. Rul. 94-36-006 (Mar. 14, 1994) (debt is not an interest subject to § 2701); Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (same).

⁹² See Priv. Ltr. Rul. 94-36-006 (Mar. 14, 1994) (valuation rules of § 2702 do not apply to debt because it is not a term interest; Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (same).

⁹³ See Mulligan, *supra* note 60, at ¶ 1507.2.

⁹⁴ *Albany Car Wheel Company v. Commissioner*, 40 T.C. 831, *aff’d per curiam*, 333 F. 2d 653 (2d Cir. 1964); Reg. §§ 1.338-4T(b)(2)(ii), 4T(d)(2), 5T(b)(2)(ii) and 5T(e)(1)

⁹⁵ See G.C.M. 39503 (Issue (2)(C)(2)(b) last sentence) (Jun. 28, 1985).

⁹⁶ 160 F. Supp. 368 (W.D. La 1958).

rule.⁹⁷ The Committee Report makes it clear that in deeming that a payment is received, it also intended that a payment is deemed to be made by stating that:

The court [in *Miller v. Usry*] did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale.

Accordingly, the payment that is certain to be either received or deemed received by the seller under a SCIN should also be considered certain to be paid by the purchaser, who should receive an immediate basis in the property purchased with a SCIN. The IRS indicated that it approves of this analysis. “We therefore think it appropriate to allow the buyer-obligor to include the full face value of a note in its basis in the property acquired in the transaction.”⁹⁸

The contingent payment OID regulations determine the amount and timing of the interest income to be reported when there is a contingent payment sale.⁹⁹ The examples illustrate that the contingent payment OID regulations¹⁰⁰ take the position that a buyer obligated on a contingent payment obligation receives no basis upon incurring the contingent liability and the seller does not initially treat the contingent liability as part of its amount realized. The OID regulations go on to illustrate that the contingent liability gives rise to basis and amount realized only when the obligation becomes fixed or is paid. These regulations do not, however, define the term “contingent payment.” The question is whether a SCIN obligation of a related party (as defined for purposes of § 453B(f)) is a contingent payment obligation for purposes of these regulations and, if so, whether they change the result in G.C.M. 39503. We do not believe it should be. Under a SCIN, even one with a balloon payment, interest will be paid on fixed basis until death or another terminating event occurs. As indicated, under a SCIN to a related party of the type we are discussing, the principal will be paid or deemed paid on or before a fixed date. Accordingly, such a SCIN should not be considered a contingent liability and the IRS position in G.C.M. 39503 remains supportable.

The legislative history to the Installment Sales Revision Act of 1980 also provides support for the position that the purchaser can include the principal amount of the SCIN obligation as part of its initial basis in the purchased property. It explicitly states that the deferred gain recognized at such time is the “quid pro quo” for the buyer’s cost basis.¹⁰¹ Accordingly, the IRS would be justified in denying a cost basis for the obligation to the buyer only if it were to concede that gain is not recognized upon the extinguishment of the note. Those commentators who have addressed the issue of the buyer’s basis for the SCIN obligation come to the conclusion that the face amount of the note, even if the note is self-canceling, should be included in the basis.¹⁰² Furthermore, the Eighth Circuit in *Frane v. Commissioner*¹⁰³ mentioned

⁹⁷ A disposition by gift comes within “any other disposition” and is necessary to prevent an assignment of income already realized by the noteholder.

⁹⁸ G.C.M. 39503 (Issue (2)(C)(1)(b) last sentence) (June 28, 1985).

⁹⁹ Reg. § 1.1275-4.

¹⁰⁰ §§ 1.483-5 and 1.1275-4(c).

¹⁰¹ See S. Rept. No. 96-1000, 96th Cong., 2d Sess. 25 (1980).

¹⁰² See *Frane v. Commissioner*, *infra* note 103 at footnote 5 stating that most commentators agree; Massey & Englebrecht, Self Cancelling Installment Notes and Private Annuities: An Analysis, 72 Taxes 27, 28 (1994); Banoff and Hartz, Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?, 59 Taxes 499,506 (1991).

in footnote 5 that it was of the opinion that the buyer is entitled to an initial cost basis for the SCIN obligation. Although this statement was only *dicta* in the *Frane* case, the court in *Frane* went on to conclude that since the G.C.M. 39503 clearly shows that the plain language of § 453B requires that the obligee recognize the gain, it follows that consistent treatment can be afforded to the obligor and no injustice results.

Nor should § 108(e)(5) require an adjustment in the purchaser's basis. Section 108(e)(5) is intended to apply to situations where the noteholder is able to deduct the cancelled obligation as a bad debt. Applying this tax symmetry analysis to the SCIN sale illustrates that § 108(e)(5) does not apply. The cancellation of the SCIN is not treated as a cancellation because, as discussed above, § 453B(a), in conjunction with § 453B(f), treats the cancellation as a deemed payment. Applying the tax symmetry principle, the noteholder cannot take a bad debt deduction because § 453B(a) deems that the noteholder received a payment equal to the amount of the liability cancelled. Therefore, the fictions created by the § 453B disposition rule remove the cancellation of the liability from the reach of § 108(e)(5).

D. SITUATION FOUR—SELF-CANCELING INSTALLMENT NOTE SALE TO A GRANTOR TRUST

Example: The promissory note is a SCIN issued by a grantor trust (with the risk premium as balloon principal).

This is a combination of Situations Two and Three. Accordingly, even though the grantor trust means that there is no current income tax effect of the sale transaction, the principal and interest payments on the SCIN must satisfy the requirements of a bona fide sale for gift tax purposes. When Senior dies, the SCIN is not included in his gross estate.¹⁰⁴ Because the SCIN sale was not recognized for income tax purposes before death, the cancellation of the SCIN at death does not result in the recognition of gain under § 453B(f) and *Frane*,¹⁰⁵ or otherwise under § 61. Similarly because the family trust is not obligated under the SCIN after death, it cannot have a cost basis in the property. Accordingly, as discussed above, the family trust's basis should be a transferred basis under § 1015.

E. SITUATION FIVE—SELF-CANCELING INSTALLMENT NOTE (TWO LIVES) SALE TO A GRANTOR TRUST

Example: The SCIN is intended to provide income not only for the seller-grantor, but also, as is not unreasonable or uncommon, for his surviving spouse, so that it does not terminate until the death of the last to die of Senior and Mrs. Senior. Because the joint lives reduce the actuarial risk, the required risk premium is less than needed only for Senior's life as discussed in Situation Four. If Mrs. Senior dies first, however, the results are the same as a SCIN based solely on Senior's life, but more favorable because of the reduced risk premium.

¹⁰³ 998 F.2d 567 (8th Cir. 1993).

¹⁰⁴ *Estate of Moss v. Commissioner*, *supra* note 66; *Cain v. Commissioner*, *supra* note 66.

¹⁰⁵ See *Frane v. Commissioner*, *supra* note 103

If Senior dies before Mrs. Senior, the note continues in existence and, presumably, will pass to Mrs. Senior. The value of the note is included in Senior's gross estate. Presumably, the transfer qualifies for the marital deduction so that no estate tax is incurred. The note is not a terminable interest because no interest in the note passes to another when Mrs. Senior dies. There is no IRD because no gain was realized while Senior was alive. Senior's death terminates grantor trust status with the consequences discussed above. The now nongrantor family trust has a cost basis in the transferred assets based on the balance of the promissory note, or if greater, Senior's transferred basis. When Mrs. Senior dies, the SCIN is cancelled with the tax consequences described above for a SCIN sale to a nongrantor trust. Because the note is deemed to be satisfied by the deemed payment, the deferred installment gain is recognized, but only to the extent, if any, that the principal amount exceeds Mrs. Senior's basis in the note, that is, the fair market value, presumably its \$1,176,470 principal (including the risk premium) included in Senior's estate (resulting in no gain if the note was not discounted). Although at first blush this appears to give an improper cost basis to the family trust without the corresponding IRD that would occur on an initial sale to a nongrantor trust, it is essentially the result that we believe occurs for Senior's sale to a grantor trust.

F. SITUATION SIX—PRIVATE ANNUITY SALE TO A NONGRANTOR TRUST

Example: Senior sells the assets to a nongrantor trust for a private annuity payable for the rest of his life. In a private annuity transaction, it is clear that the discount rate is the § 7520 rate and the mortality assumptions are based on Table 90CM. On the other hand, since the annuity terminates on Senior's death, there is still nothing included in his gross estate. Second, the annuity rules of § 72 apply instead of the installment sale and OID rules.¹⁰⁶

There is some confusion about what rules apply if the annuity obligation is secured by the property transferred. The obligation is apparently excluded from being a debt obligation for OID purposes, even under Reg. § 1.1275-1(j), because there are no provisions that can significantly reduce the probability that total distribution under the contract will increase commensurately with Senior's longevity as there would be for a SCIN (or PATY). On the other hand, there is significant authority that a secured private annuity is not entitled to deferral under the private annuity rules, apparently because only unfunded, unsecured obligations are not treated as payment under the cash method.¹⁰⁷ Although the conclusion in those authorities was that the gain was recognized immediately at the time of sale, they were decided for tax years before the enactment of § 453(j)(2) that expressly recognizes contingent payment installment sales.¹⁰⁸ Accordingly, if it is not a private annuity under § 72, a disposition of qualifying property for a secured private annuity based solely on Senior's life must qualify as an installment sale. The obligation, however, apparently is not a debt obligation under Reg. § 1.1275-1(j), since security is not one of the factors listed for qualifying for the annuity exclusion. Something has to give!! Since we find it inconceivable that an installment obligation might not be subject to OID, thereby making all payments amounts realized from the sale of the property, we believe that if a secured private annuity is taxed as an installment sale, it is subject to the contingent payment OID rules

¹⁰⁶ Rev. Rul. 69-74, 1969-1 C.B. 43.

¹⁰⁷ *Est. of Bell v. Commissioner*, 60 T.C. 469 (1973); *212 Corp. v. Commissioner*, 70 T.C. 788 (1978); cf. Reg. § 1.83-3(e); G.C.M. 39503 (Issue (2)(c)(1)(a)); H&M, SCINs and Private Annuities at ¶ 302.2.

¹⁰⁸ Sen. Rep. No. 96-1000, *supra* note 101 at 12, 1980-2 C.B. at 496.

of Reg. § 1.1275-4(c). Since we also believe that it is unsound to have radically different tax treatment of secured and unsecured private annuities, we favor treating all private annuities as installment sales. Since this recommendation has not yet been adopted by any regulations, ruling or other published IRS authority despite Congressional authority to do so,¹⁰⁹ or by any court decision, traditional private annuity treatment apparently remains available for unsecured private annuities.

The capital gain realized on the private annuity sale is realized ratably over the life expectancy of the annuitant, but the life expectancy for this purpose is that in Reg. § 1.72-9 Table V instead of the one in used to determine the annual annuity under Table 90CM. Under Table 90CM an individual age 70 has a life expectancy of 13.9 years. Under the Section 72 table, an individual age 70 has a life expectancy of 16.0 years.¹¹⁰ Obviously, the younger the individual, the longer the life expectancy and longer deferral can be achieved. A joint and survivor annuity for the senior family member and that individual's spouse increases the deferral. For example, the joint life expectancy of two individuals, both age 70, is 20.6 years for Section 72 purposes, as opposed to the 16.0 years for one individual age 70.

Under traditional private annuity treatment, gain is reported and basis is recovered pro rata as each annuity payment is received, amortizing the seller's basis and the principal over the seller's life expectancy using the mortality assumptions contained in Reg. § 1.72-9 Table V.¹¹¹ If Senior dies before his entire basis is recovered, any unrecovered basis can be deducted on his final income tax return.¹¹² The purchaser's "tentative basis" in the asset purchased is equal to the value of the annuity obligation undertaken.¹¹³ The purchaser's "final basis" is determined upon the annuitant's death by taking into account only the annuity payments actually made. Since the entire annuity payment is part of the purchaser's tentative and final basis, the purchaser cannot deduct the interest expense element.¹¹⁴

1. Comparison of Private Annuities and SCINs

In addition to the factors highlighted above, there are a number of other differences between traditional private annuity treatment and the treatment of SCINs. The exclusions from installment sale treatment, including those for marketable securities,¹¹⁵ recapture property,¹¹⁶ sales of depreciable property to related parties,¹¹⁷ do not apply to private annuities. Similarly, the second disposition rules for resales by related parties,¹¹⁸ the anti-*Rushing* rules, do not

¹⁰⁹ See Sen. Rep. No. 96-1000, *supra* note 101, at 23; 1980-2 C.B. at 506..

¹¹⁰ As adjusted in Reg. § 1.72-5 (a)(2)(1) if the payments are less frequent than quarterly.

¹¹¹ As adjusted for the frequency of payment if less often than quarterly. Reg. § 1.72-5(a)(2)(i).

¹¹² § 72 (b)(3)(A)

¹¹³ Rev. Rul. 55-119, 1955-1 C.B.352.

¹¹⁴ *Dix v. Commissioner*, 392 F.2d 313 (4th Cir. 1968); *Rye v. United States*, 92-1 U.S.T.C. ¶ 50,186 (Cl. Ct. 1992); *Bell v. Commissioner*, 76 T.C. 232 (1981), *aff'd* 668 F.2d 448 (8th Cir. 1982).

¹¹⁵ § 453(k)(2)(A).

¹¹⁶ § 453(i).

¹¹⁷ § 453(g).

¹¹⁸ § 453(e).

apply.¹¹⁹ Moreover, the interest charge on the deferred capital gains taxes for installment sales of \$5 million for the year,¹²⁰ and the acceleration rules for pledging an installment obligation as collateral for a loan¹²¹ do not apply to private annuities.

On the other hand, a major drawback to a taxable private annuity sale is that the interest element, reportable as annuity income by the annuitant, is not deductible as interest expense by the purchaser.¹²² This disadvantage for the purchaser may more than offset the benefit of the deferral of the gain realized by the grantor-seller, especially if the asset purchased is not depreciable or amortizable, for example, corporate stock.

2. Minimum Funding of Private Annuity Trust

In Rev. Rul. 77-454¹²³ the IRS imposed a minimum funding standard on a private annuity trust that had only one annuitant. The basis of the concern was that the valuation factor used to determine the value of the annuity includes the possibility that the annuitant will live beyond his actuarial life expectancy. Accordingly, it determined how many annual payments could be made by the trust taking into account its initial corpus plus earnings at the assumed rate used in computing the value of the annuity.

Under Table 90CM the life expectancy of a 70-year old individual is 13.9 years. An annuity, payable quarterly, at the § 7520 rate of 7.4% on \$1,000,000 is \$129,416¹²⁴. By definition a 70-year old individual who lives to age 83.9, will have consumed the entire original corpus plus income at 7.4% at age 83.9. Accordingly, Rev. Rul. 74-454 determines the gift by recasting the annuity as one for the lesser of 13.9 years or life, which has a value of \$572,021, resulting in a taxable gift of \$427,979. In order to have a value of \$1,000,000, the initial corpus must be sufficient to fund the annuity to age 110, the maximum age on table 90CM, or \$1,748,187. Accordingly, to avoid any gift tax, the family trust must have additional funding of \$748,187. Presumably, as with family trusts used for installment sales, the additional funding can be provided by arrangements other than current or prior transfers, including guarantees.¹²⁵ If the purchaser is an individual, there is no extra funding requirement as it is presumed an individual has the ability to obtain additional funds by his or her ability to earn future income. One way to lower the capital reserves is to use an annuity for joint lives. For example, an

¹¹⁹ *But see Stokes v. Commissioner*, 77 T.C.M. 2206 (1999) (disregards, as sham, private annuity sale of business to a nongrantor trust shortly before its resale by the trust to third parties, because nothing changed with respect to the operation of the business after it was sold to a nongrantor trust)

¹²⁰ § 453A.

¹²¹ § 453A(d); Rev. Rul. 65-185, 1965-2 C.B. 153.

¹²² *Dix v. Commissioner*, *supra* note 114, *Rye v. United States*, *supra* note 114; *Bell v. Commissioner*, *supra* note 114.

¹²³ 1974-2 C.B. 351.

¹²⁴ If the annuity payments are less frequent than quarterly, an adjustment is required by Reg. § 1.72-5(a)(2)(i). For a 70-year old individual, the adjustment for an annual annuity is -0.5 years. Thus, the 16.0-year life expectancy for a 70-year old is reduced to 15.5 years for determining the “exclusion ratio.”

¹²⁵ See *Hatcher & Manigault*, *supra* note 60 at 152.

annuity for the joint lives of a married couple, both age 70, is \$105,864 and the amount of the required capital reserve is \$348,300.¹²⁶

3. Transfer of Purchased Property to a Partnership or S Corporation

If the family trust (or other purchaser) transfers the property purchased for a private annuity to a partnership, an S corporation or even a C corporation, retaining the annuity obligation, the tentative basis is, in effect, doubled as the transferred “inside” basis to the partnership or S or C corporation and as the exchanged “outside” basis of the family trust in the partnership interest or S or C corporation stock. If the seller-annuitant dies before gross payments on the private annuity equal the tentative basis,¹²⁷ the family trust’s “final basis” in the exchanged basis property (the partnership interest or corporation shares) is reduced to the total amount of annuity payments made. When annuity payments by the family trust exceed the tentative basis, its outside basis is increased. The issue, in each case, is whether the transferee’s inside basis is similarly adjusted. Normally an adjustment to outside basis does not affect the inside basis of an S or C corporation or, unless a § 754 election is in effect or made by a partnership. Conversely, when the annuity obligation is transferred with the property, the question is whether there is an adjustment of the family trust’s outside basis equivalent to the entity’s inside basis adjustment.

On the one hand, the outside (or inside) basis adjustment assures that the family trust will eventually suffer the tax consequences of the difference so that there is no real issue of tax avoidance or even the necessity of applying tax benefit principles. Post-transfer differences between inside and outside basis are an inevitable effect of the entity characterization that applies in different degrees to all three forms of business entity. In a partnership, on the other hand, there may be support for the adjustment of inside basis in the application of the aggregate approach of *Quick Trust*¹²⁸ and *Woodhall*,¹²⁹ which refused to allow a step-up in basis for the portion of the value of a partnership interest attributable to partnership assets that would be IRD if held by the deceased partner before the enactment of § 753.¹³⁰ If the transfer is to a C corporation, or even an S corporation, the aggregate approach is probably not available even though the issue is the same.

On the other hand, failure to make an adjustment converts a “tentative” basis into a final basis for the transferee when the annuity obligation is not transferred and for the transferor when it is. Accordingly, the issue is application of the transferred basis and exchanged basis concept. We believe that concept appropriately includes applying adjustments in the tentative basis to both the transferee and transferor. There is considerable authority that transferred basis includes not only the dollar amount of the transferor’s basis but also other characteristics that are closely

¹²⁶ The joint life expectancy of two individuals, both age 70, is 18.4 years under Table 90CM and 20.6 years under Reg. § 1.72-9 Table V..

¹²⁷ Because the economic interest inherent in the annuity cannot be deducted by the purchaser, this occurs well before the seller-annuitant’s actuarial life expectancy.

¹²⁸ *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970, *aff’d per curiam*, 444 F.2d 90 8th Cir. 1971).

¹²⁹ *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972).

¹³⁰ See § 1367(b)(4)(B) applying similar rule to S corporations; Rev. Rul. 89-108, 1989-2 C.B. 100 (applies look through approach to sale of partnership interest to deny installment sale treatment to the portion of the proceeds attributable to substantially appreciated inventory).

entwined with basis,¹³¹ or liabilities transferred.¹³² We believe the same principles should apply to require subsequent adjustments to the tentative transferred basis because the potential adjustment was inherent in the basis at the time of transfer. Moreover, although not directly supported by the cited authorities, we believe the same adjustment is appropriate for the exchanged outside basis, regardless of the type of business entity—partnership, S corporation or C corporation.

G. SITUATION SEVEN—PRIVATE ANNUITY SALE TO A GRANTOR TRUST

If the sale is to a grantor trust, there is never a sale for Federal income tax purposes; Senior reports the income earned by the grantor trust's assets throughout his life. Since the annuity obligation terminates at Senior's death, as with a SCIN sale to a grantor trust, there never is a sale and the family trust has a transferred basis. The minimum independent funding required by Rev. Rul. 77-454 is still necessary to satisfy the "reality of sale" test for transfer tax or income tax purposes.¹³³

The use of a grantor trust makes a private annuity possibly a viable transaction, particularly if the assets do not qualify for the installment method or Senior's health is below average, or, better yet, both.

H. DEFROSTING THE FREEZE

All estate freezes rely on the assumption the property transferred will appreciate in value and those transactions made in the form of sales of the type we discuss are based on the assumption that the property sold plus subsequent appreciation and income will exceed the

¹³¹ See, e.g., *Commissioner v. Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738 (1968), *rev'g* 46 T.C. 698 (1966) (subsidiary required to retain parent's LIFO inventory layers for property transferred under in § 351 transaction); Rev. Rul. 70-565, 1970-2 C.B. 110 (follows *Seagram*); Rev. Rul. 79-127, 1979-1 C.B. 189 (transferee of partnership reporting inventories using lower of cost or market must restore write-downs by transferor to income as a condition of electing LIFO); *Philadelphia and Reading Corp. v. United States*, 602 F.2d 338 (Ct. Cl. 1979) (transferee in § 351 transaction entitled to amortize mining development expenditures made by transferor); *cf. Hempt Bros. Inc. v. United States*, 409 F.2d 1172 (3rd Cir. 1974) (transferee corporation must report as ordinary income receivables transferred by cash method partnership and has zero basis in inventory when predecessor partnership improperly expensed costs).

¹³² See, e.g., Rev. Rul. 80-198, 1980-2 C.B. 113 (transferee in § 351 transaction entitled to deduct accounts payable of cash method transferor); Priv. Ltr. Rul. 2000-13-044 (Jan. 5, 2000) (follows Rev. Rul. 80-198); Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent obligations on transfer under Section 351, whether deductible or capital taken into account by transferee corporation); Rev. Rul. 75-154, 1975-1 C.B. 186 (former partners entitled to deduct retirement payments to previously retired partner even after partnership terminated); *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943) (same); Rev. Rul. 83-155, 1983-2 C.B. 38 (same for payments by corporation succeeding to partnership business); GCM 39054 (Nov. 24, 1981) (same; background for Rev. Rul. 83-155; expressly follows Rev. Rul. 80-198). It is not accurate to refer to these as characteristics of "liabilities" because the obligations are not "liabilities." §§ 357(c)(3), 704(c)(3) and 108(e)(2); see Manning and Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part One)*, 11 *Tax Mgmt. Real Est. J.* 19, 19-20 (1995). See also *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939) (transferee in § 332 type transaction entitled to deduct unamortized discount and expense on liabilities assumed; prior to enactment of § 381); Reg. § 1.1232-1(b)(1)(iv) (original issue discount carries over when a new obligation is exchanged for another obligation in a nonrecognition transaction).

¹³³ In *Estate of Benjamin Shapiro v. Commissioner*, 66 T.C.M. (CCH) 1067 (1993), the court rejected the IRS's position that the trust corpus was not large enough to support its obligations if decedent lived to age 109. Followed in *Shackleford v. United States*, 2001-2 U.S.T.C. ¶ 60,417 (9th Cir. 2001).

purchase price and any interest obligation. If that assumption turns out to be mistaken, the attempted freeze can increase transfer taxes over what they would have been if there had been no planning at all.

Example: If, after an installment sale for a \$1,000,000 note, the property declines in value from \$1,000,000 to \$800,000, but because of the minimum funding or other steps taken to assure the reality of the sale, the promissory note is still worth \$1,000,000, Senior's estate will include a note worth \$1,000,000 instead of the \$800,000 asset that would have been included with no sale.

Given the long-term inflation and corresponding increases in asset values measured in nominal dollars that have occurred almost constantly over the last sixty years, this is more likely to be a short-term than a long-term problem. Accordingly, the problem is less likely to arise if there is a substantial period from the date of the sale and the date of death, particularly if the trust's assets are not dissipated in the short run by substantial payments on the purchase price. In other words, balloon payment arrangements are likely to be more effective than installment payment arrangements that amortize principal. This advantage can be reduced or lost during periods in which the fixed interest obligations on the note are higher than then current rates of return on the property sold. The period for trust accumulation can be extended by renewal of the promissory note, but such renewal will have to be made at then prevailing interest rates, the AFR or § 7520 rate as appropriate, to avoid a taxable gift.

A promissory note with an interest rate below the AFR and a correspondingly higher principal amount may help preserve cash for the family trust, particularly if the initial income from the property is lower than expected future income. This approach involves OID, which gives the family trust a deduction without cash outlay,¹³⁴ and the grantor-seller income without cash, requiring use of other assets to pay the tax.

In a grantor trust, if it appears that the wrong assets were sold, that is assets with less potential appreciation than assets Senior retained, he and the trust can exchange assets without recognition of gain by using the power of substitution under § 675(4)(C) that is a frequent power retained to make the trust a grantor trust. A fair market value exchange is not a recognition event even without such a power since the grantor owns all of the assets for tax purposes before and after the "exchange" so that he is merely changing the pocket in which he holds the property. A settlor-seller and a nongrantor trust can make a nonrecognition exchange under a § 675(4)(C) power or otherwise, only if the exchange qualifies under § 1031 as a like-kind exchange (which usually applies to real estate), or under another nonrecognition provision, such as § 1035 (exchanges of insurance policies).

Trust assets that are expected to continue to decline in value can be used to prepay a portion of the purchase obligation without recognition of gain or loss by a grantor trust. Similar use by a nongrantor trust is a recognition transaction in which gain may be recognized, but loss will be likely to be disallowed under § 267.

A more sophisticated version of the exchange between the grantor and the family trust when the assets have initially appreciated but are now likely to decline in value is to use a type of

¹³⁴ Subject to the limits of § 163(i) (the limitation of adjusted high yield debt obligations).

freeze in which the family trust transfers the assets to a limited partnership for a frozen preferred interest and an unfrozen common interest and then transfers the unfrozen common interest to the grantor in a nonrecognition exchange or as a prepayment in a grantor trust. A nongrantor trust is almost certain to have a taxable exchange in this scenario since a partnership interest is not eligible for a like-kind exchange under § 1031,¹³⁵ although under certain circumstances interests in a partnership can be rearranged in a partnership recapitalization without recognition.¹³⁶

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¹³⁵ § 1031(a)(2)(D).

¹³⁶ See Rev. Rul. 84-52, 1984-1 C.B. 157.