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AUTHOR'S NOTE

*The **Estate Planning Strategist** is a quarterly publication for attorneys and accountants with some experience in estate planning. It features practical tips, timely commentary, drafting instructions, and tax return preparation examples of sophisticated estate planning techniques. It reviews current developments, new rules, statutes, and caseluw.*

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IN THIS ISSUE

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Is the Sale to a Grantor Trust Superior to the Use of a GRAT?

The estate planner is often preoccupied with, and sometimes intrigued by, developing and implementing transactions that reduce or "freeze" the value of a client's estate. One such technique is the use of a Grantor Retained Annuity Trust (GRAT) which involves the transfer of assets to an irrevocable trust in exchange for the right to receive annuity payments over a specified trust term.[i] In its purest form, the GRAT is an estate freeze technique, but if funded with assets eligible for discounts in value (i.e., limited partnership units) can also result in estate reduction.[ii]

An intriguing alternative to the GRAT has been the recent recipient of considerable attention among estate planners. Under this alternative, the transaction would be structured as a sale of assets to an irrevocable trust intentionally drafted to be a "grantor trust" for income tax purposes in exchange for a promissory note issued by that trust. This type of trust is commonly called an intentionally defective grantor trust, or IDIT; and this transaction will be referred to herein as the "IDIT Transaction".

IDIT and GRAT Compared—In case of a GRAT, the Grantor is entitled to annuity payments over the trust term. The annuity payments are determined on the basis of the published Section 7520 rate (i.e., 120% of the federal mid-term rate under Section 1274, rounded to the nearest 2/10ths of 1 percent) on the date the trust is established and funded. The annuity payments include the interest factor and a return of principal.

In the case of a sale, the Grantor would sell assets to an IDIT in return for a promissory note. The promissory note would provide for interest at the Section 7872 rate (which is lower than the Section 7520 rate) determined pursuant to the rules of Section 1274. The note could have the same term as the grantor trust and can provide for interest only with a balloon payment at the end of the term. Alternatively, the note can provide for amortization of the principal balance over the term.

Either technique can result in estate and gift tax savings if the assets of the trust produce a net return (income and appreciation) that exceeds the payments required under the respective transaction. The IDIT transaction, however, can result in larger tax savings and is in many respects superior to the GRAT. While potentially advantageous, there are several unique problems or risks, and hence, disadvantages to using the IDIT transaction. These advantages and disadvantages are explored below.

ADVANTAGES

1. More to IDIT Beneficiaries.
The IDIT transaction can result in larger tax savings since the payments to the Grantor will generally be lower than the GRAT. This increases the value of income (and appreciation) remaining in the IDIT and thereby increases the likelihood and amount of property that can pass tax free to the trust beneficiaries. Consider the following:

Assume a Section 7520 rate of 8½%, and the transfer of a $1,000,000 asset to a five (5) year GRAT by a 70 year old Grantor. Assume further that the assets earn a net return of 10% (income and appreciation). In this example, the Grantor would receive annual payments of $252,000 for a total of $1,260,000 over the five (5) year term, leaving $72,000 in the trust at the end of the term. Under the Section 2702 Regulations, this $72,000 amount would pass to the trust beneficiaries, gift and estate tax free, subject to a taxable gift of

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approximately $50,500 if Example 5 of Regulation Section 25.2102-3(e) is upheld.[iii]

Compare the GRAT results to a sale of the same $1,000,000 asset to an IDIT in exchange for a five (5) year note that provides for interest only and a balloon payment in the fifth year. Assuming a Section 7872 rate of 6.85%, the Grantor would receive annual payments of $68,500 for a total of $342,500 over the five year period, leaving $157,500 in the trust to pass to the trust beneficiaries without gift and estate tax consequences (i.e., the difference between the $100,000 earnings and the $68,500 annual payment, or $31,500 annually over the five (5) year period).

As the above comparison illustrates, an additional $85,500 ($157,500 - 72,000) remains in the IDIT to pass to the beneficiaries gift and estate tax free. Accordingly, more of the net income and appreciation can pass to the beneficiaries of the IDIT when compared to the GRAT.

2. No Taxable Gift. The IDIT Transaction does not result in a taxable gift; therefore, the filing of a United States Gift (and Generation Skipping Transfer) Tax Return, Form 709 is not required.[iv] On the other hand, the Section 6501(c)(9) disclosure rules necessarily require the Grantor to report the GRAT transaction on Form 709 in order to start the statute of limitations running.[v] In addition, the transfer of assets to the GRAT can result in a taxable gift if Example 5 of Treasury Regulation 25.2702-3(e) is correct (i.e., the GRAT cannot be "zeroed out").

It should also be noted that IRS has informally indicated that it will not issue rulings on "high payout" trusts with less than five-year terms. Thus, short term GRATs may be in jeopardy under current IRS thinking.

3. Income Tax Consequence to Grantor. Since the IDIT is structured as a "grantor trust", the sale does not generate an income tax and the IDIT Transaction has no income tax reporting requirements.[vi] In addition, the Grantor is not taxed on interest payments made under the note. Instead, the Grantor is taxed on all of the taxable income generated by the trust assets and will be responsible for the payment of taxes attributable to such income.[vii]

4. No Mortality Risk. The IDIT Transaction does not have a direct mortality risk. If the Grantor dies during a GRAT term, the entire value of transferred property (including any appreciation from the date the GRAT was established) is included in the Grantor's estate.[viii] Accordingly, selecting the term of the GRAT is an issue. In the IDIT Transaction, the anticipated result is that only the value of the promissory note is included in the Grantor's estate and not the post sale appreciation. Hence, the possibility of a premature death is not an issue when selecting the term of an IDIT note. This assumes that the retained life estate provision of Section 2036(a) will not apply.[ix] The 2036(a) issue is more fully developed below.

5. Generation Skip Consequences. Section 2642(f) precludes allocation of a transferor's Generation Skipping Transfer (GST) tax exemption to a transfer during any Estate Tax Inclusion Period (ETIP). Thus, the Section 2652(f) ETIP rule would preclude the allocation of GST exemption to a GRAT until the end of the GRAT term. In the IDIT Transaction (assuming 2036(a) is not applicable), there is no ETIP since the trust assets are not potentially includable in the Grantor's estate. Accordingly, an individual could engage in GST tax planning by allocating his or her GST tax exemption to the IDIT immediately, thereby allowing all post sale appreciation to be protected from the GST tax. Thus, the IDIT Transaction affords the opportunity to leverage the GST tax exemption amount.

For example, a client could establish an IDIT with a $5,000 contribution and allocate $5,000 of his or her GST tax exemption to the IDIT. Sometime thereafter, the IDIT Transaction may be consummated. In this example, all post-sale appreciation would be protected from the GST tax with no further allocations being required.

6. Payment Flexibility. The IDIT Transaction offers flexibility in designing the note. For example, the loan can call for interest only with a balloon payment at the end of the term. The interest rate can be variable or fixed. Such is not the case with a GRAT, since the GRAT must pay the annuity every year and the annuity may

change only as provided in the Regulations. See Regulation 25.2702-3 (b)(1)(ii)(B).

DISADVANTAGES AND POSSIBLE EXPOSURE TO IDIT

1. Disguised Chapter 14 Transaction. IRS may attempt to invoke debt/equity principals to reclassify the note as an equity interest in the trust assets thereby subjecting the IDIT Transaction to Section 2701 or 2702. To make these assertions, IRS must show that the transfer of property in exchange for a note is the equivalent of a transfer with a retained interest. This requires a showing that the IDIT note does not rise to the level of debt, but is instead the transfer of an equity interest.

Section 2701 applies to the transfer of an equity interest in a closely held corporation or a partnership where an "applicable retained interest" is held by the transferor (or an applicable family member) immediately after the transfer. Thus, in the case of a sale of shares of closely held business stock or partnership interests, IRS could seek to argue that the IDIT note and interest payments thereunder constitute an "applicable retained interest" (i.e., a distribution right) that should be treated as a "preferred stock". In that event, the difference between the value of the assets sold and the value of the "preferred stock" as determined under Section 2701 would constitute a gift by the Grantor.[x]

Section 2702 governs the tax treatment of transfers in trust with a retained interest. If IRS succeeds in reclassifying the note as the transfer of an equity interest, then Section 2702 can apply in which case the transaction would be taxed as a GRAT. In that event, the gift under the IDIT Transaction would be larger than the GRAT since the "qualified annuity interest" under the IDIT note is less than the qualified annuity interest required under a GRAT.[xi]

Guidance on the issue of whether IRS will seek to reclassify the IDIT note as equity can be found in Private Letter Ruling 9436006 and 9535026. In these Letter Rulings, the notes were found to be debt and did not constitute an "applicable retained interest" under Section 2701 or a "retained interest" under Section 2702.[xii]

In Letter Ruling 943006, a trust was funded with $1,200,000 of stock prior to the sale. Thereafter, other assets were sold to the trust in exchange for a promissory note. On these facts, IRS treated the note (without engaging in a debt/equity analysis) as debt carrying all of the indicia of indebtedness and ruled that Section 2701 did not apply since "debt is not an interest that is subject to the provisions of Section 2701."

In PLR 9535026, the IRS did not express any opinion about whether the notes constitute debt or equity since "that determination is primarily one of fact." On the assumption that the notes did constitute debt, IRS ruled that Section 2701 and 2702 did not apply. However, on the issue of whether the value of the note was equal to the value of the property, the ruling was conditioned on satisfaction of the assumptions that (1) no facts are presented which would indicate that the notes would not be paid according to their terms, and (2) that the ability of the trusts to pay the notes is not otherwise in doubt. Letter Ruling 9535026 also went on to indicate that the inapplicability of Section 2701 and 2702, could be reversed if the promissory notes are subsequently determined to be equity and not debt.

Counsel for the taxpayer in Letter Ruling 9535026 has written that "in informal conference, IRS personnel indicated that the Service had reservations about the ability of the trusts to pay the notes and the status of the notes as debt arose out of concern that the trusts might not have sufficient assets to pay the notes or that for some other reason the notes might not be paid in full."[xiii]

Based upon the foregoing, Section 2701 and 2702 should not apply where the ability to pay the note is not in question and the trust has other assets. Therefore, if the IDIT is to be considered, the trust should be funded with assets other than those which are the subject of the IDIT purchase transaction.

It should be noted that where the trust consists solely of the purchased assets, IRS can assert a third argument. IRS could argue that the note is "high risk" and its value should be discounted, since the Trust has no equity other than the purchased assets. In that event, the sale could be converted to a part sale/part gift transaction, thereby giving rise to unanticipated gift tax.

2. Premature Death of Grantor-Estate Tax Issues. The premature death of the grantor can expose the assets purchased under the IDIT transaction to estate tax inclusion under Section 2036. If the Grantor dies while the note is outstanding, Section 2036(a)(1) could apply to the purchased assets if all of the trust income is being used to pay interest on the note. See Private Letter Ruling 9251004 where Section 2036(a)[xiv] was applied. In that case, the Grantor transferred stock of a closely held cooperation in a part sale/part gift transaction with a $1,500,000 note issued from the trust to the Grantor. The note required interest only for 15 years, with a balloon payment at the end of the 15th year. The donor retained a priority right to a major share (if not all) of the trust income in the form of a note requiring interest payments. On these facts, IRS found that Section 2036(a) applied. Thus, under this IRS view, where the interest payment under the note is significant in relation to the trust income, Section 2036(a) could be successfully applied. It should also be noted that although the Grantor retains no beneficial interest in the trust, Section 2036 (a)(1) could be applied if the Grantor's creditors may reach the trust property to satisfy the Grantor's legal obligations.

3. Premature Death—Income Tax Issues. The premature death of the grantor can also have adverse income tax consequences. If the grantor does not survive the term of the note and assuming Section 2036(a) does not apply, the promissory note, but not the underlying trust assets, will be includable in the Grantor's estate. The grantor's death causes the trust to lose its grantor trust status. Therefore, the premature death of the grantor may result in triggering the gain on the assets subject to the sale if an actual sale is deemed to occur as a result of the termination of grantor trust status.[xv] The issue is whether the sale is deemed to occur before or after death.

If the sale is deemed to occur immediately before death, gain will be triggered and the trust should receive a basis step up, equal to that portion of the asset that is treated as sold on or before the Grantor's death. If the actual sale is deemed to occur after death, then there would be no

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realization of gain on death and the entire trust assets will receive a carryover basis. Assuming the sale is deemed to occur immediately before death, it appears that the initial gain would be determined under Section 453 and the principles of *Frane v. Commissioner*, 998 F. 2d. 567 (8th Circuit 1993), reversing on the issue, 90 T.C. 341 (1992). Accordingly, if installment sale reporting is available, the gain would be income in respect of a decedent under Section 691 and would be reported by the estate or successor beneficiaries. In this event an offsetting Section 691(c) deduction should be available for the estate tax attributable to the IDIT note. If, however, installment reporting were not available, the gain would be taxable in full immediately upon death, and would probably not qualify as income in respect of a decedent. In that event, the gain would be reportable on the final Form 1040 of the decedent. No Section 691(c) estate tax deduction would be available; but the income tax to the decedent would be a deduction against the estate tax under Section 2053.

These tax risks may be avoided if the note is fully paid during the Grantor's lifetime. Thus, it may be advisable to have a plan to pay off the installment note if the Grantor's death appears imminent. In the alternative, if the Grantor reacquires trust property during his or her lifetime, in exchange for high basis assets, the income tax risks can be significantly minimized.

4. Premature Death—Tax Consequences of Note Receivable. Assuming Section 2701, 2702 and 2036(a) do not apply to the IDIT transaction and that no "sale" is deemed to occur on or after death, the premature death of the grantor can nonetheless lead to unfavorable results. If death occurs while the note remains outstanding, the note will be includable in the grantor's estate, but the assets of the trust will not receive a Section 1014(a) basis step up, since the underlying trust assets are not part of the gross estate. The result being that the note will be subject to an immediate estate tax and the assets would be subject to an income tax upon the subsequent sale. Thus, any transfer tax savings resulting from the property's post sale appreciation will be decreased by the income taxes that the trust will incur upon the subsequent disposition of the property. Since forgiveness of the note would result in a gain under Section 453B(f), satisfaction of the note to the grantor's estate will ultimately be required. If the trust assets are sold or utilized to satisfy the note after the death of the grantor, the income tax will be recognized at that time. This situation can lead to particularly unfavorable results in the case of highly appreciated assets. However, this unfavorable result can be avoided if either (1) the note is paid in full prior to death or (2) the note contains a self-canceling feature.

If the note is paid in full, payment in kind should not result in the recognition of gain or loss since transfers between a grantor trust and the grantor are ignored. Moreover, the appreciated property used to pay the note will be includable in the grantors' estate and will receive a Section 1014(a) basis step up.

If the note is self canceling, a basis step up may be available and the note will not be included in the grantor's estate. Use of the self-canceling feature has other potentially adverse income tax implications which must be considered.[xvi]

GRANTOR TRUST PROVISIONS

The IDIT should be designed in a manner that causes grantor trust status for income tax purposes, but not estate tax purposes. This requires the intentional violation of any number of Grantor trust rules including the following:

1. Granting a nonadverse trustee the discretion to make income distributions to the grantor's spouse. This will invoke grantor trust status under Section 677.

2. The power in the trustee (who is a nonadverse party) to lend money to grantor or grantor's spouse without regard to adequate interest or security invokes Grantor trust status under Section 675(2).

3. Granting a trustee, other than the grantor, who is not an independent trustee under Section 674(c), the power to allocate income among a class of beneficiaries will invoke grantor trust status under Section 674.

4. The grantor or any other person can be given the power, exercisable in a nonfiduciary capacity and without approval or consent of any person in a fiduciary capacity, to acquire trust assets by substituting assets of equivalent value. This will invoke grantor trust status under Section 675(4)(C). In recent rulings, however, the IRS has declined to rule on the use of 675(4)(C) on the grounds that it raises a question of fact to be determined upon filing of the fiduciary income tax return. PLR 9437022.

CONCLUSION

The IDIT transaction is a technique designed to eliminate the appreciation attributable to the assets sold from the grantor's estate. The technique can achieve favorable estate, gift and GST results and should be considered as an alternative to the GRAT. However, clients should be made aware of the potential adverse tax consequence associated with the IDIT transaction, particularly if the grantor should die prior to the note being satisfied. Creative measures to avoid those consequences should be considered. ■

FOOTNOTES

i Jerome A. Deener, Esq., *Transferring Future Appreciation Without Transfer Tax Consequences (Use of Short-Term GRAT)*, Estate Planning Strategist, Volume 1, Number 3, November/December 1994.

ii Jerome A. Deener, Esq., Estate Planning Strategist, Volume 2, Number 2, September 1995, discussing the valuation of Limited Partnership interests on a discounted basis.

iii The Example 5 exposure could be considerable in the case of older taxpayers, since the actuarial probability of death within the trust term is increased. See Jerome A. Deener, Esq., *Transferring Future Appreciation Without Transfer Tax Consequences (Use of Short-Term GRAT)*, Estate Planning Strategist, Volume 1, Number 3, November/December 1994, for a more detailed discussion of Example 5.

iv No taxable gift results on formation if the fair market value of the property sold equals the face amount of the promissory note, and the appropriate Section 7872 rate is utilized. *See, Frazee v. Commissioner*, 98 T.C. 554 1992), and Letter Ruling 9535026. Accordingly, Example 5 or Revenue Ruling 77-454 are not an issue. The value of property sold may be questioned by IRS if the subject of sale is a partnership interest or stock in a closely held business.

v If a Section 2702 transaction (i.e., GRAT transaction) is not adequately disclosed on a gift tax return, the statute of limitations remains open for an unlimited period. I.R.C. 6501(c)(9) and Regulation Section 301.650(c)-1(e).

vi Revenue Ruling 85-13 stands for the proposition that the existence of a wholly grantor trust is disregarded for income tax purposes and that transactions between the Grantor and the trust have no immediate income tax consequence. *See also, Mandorin v. Commissioner*, 84 T.C. 667 (1985).

vii The payment of income tax on the trust earnings by the Grantor can be viewed as a tax-free gift to the trust beneficiaries, since the tax payments are made with the Grantor's own funds. This prevents the depletion of Trust assets, which in turn results in greater asset appreciation within the Trust. Moreover, since Section 671 requires the Grantor to pay such taxes, payment should not result in utilization of the Grantor's $10,000 annual exclusion of $600,000 exemption equivalent amount. Revenue Ruling 85-13 and I.R.C. Section 671. *But see,* Letter Ruling 9444033 where the GRATs that were the subject of that ruling required reimbursement to the Grantor for any income taxes paid on undistributed trust income. Pursuant to this Ruling, a taxable gift to the remaindermen can result if the Grantor has a reimbursement right, but does not exercise that right. This result is subject to challenge.

viii In Letter Ruling 9345035, IRS took the position that I.R.C. Section 2036 requires inclusion of the full value of the trust corpus on the date of the Grantor's death. However, many practitioners agree that the principals of Revenue Ruling 82-105, 1982-1CB 133 should apply when valuing the amount includable in the Grantor's estate. Under that Ruling, only the amount of the trust corpus required to generate the annual annuity for the balance of the trust term (using the Section 7520 rate for the month of the Grantor's death) would be includable. Letter Ruling 9638036 did, without explanation, apply the principals of Revenue Ruling 82-105 and not Letter Ruling 9345035.

ix The note should be effective to exclude any post sale appreciation in the net value of the trust assets from the Grantor's estate, even if the Grantor dies while the note remains unpaid. See, Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996), citing to *Cain*, 37 TC 185 (1961), acq.; *Estate of Bergan*, 1 TC 543 (1943), acq.; *Estate of Becklinberg*, 273 F.2d 297, 60-1 USTC Paragraph 11,918 (CA-7, 1959); *Revenue Ruling* 77-193, 1977-1 CB 273; and *Estate of Fabric*, 83 TC 932 (1984) for the proposition that Section 2036(a) should not apply. *But see,* Letter Ruling 9251004 to the contrary.

x Section 2701 utilizes the "subtraction method" of gift tax valuation. Under the Section 2701 rules, the value of the gift is equal to the contributed property less certain rights or interests held by the transferor. For this purpose, an "applicable retain interest" has a zero value. An "applicable retained interest" includes a "distribution right" which is further defined under Section 25.2701-2(b)(3) to mean a right to receive distributions with respect to an equity interest. The classic example of an "applicable retained interest" is preferred stock. However, if the "distribution right" rises to the level of a "qualified payment", it is not valued at zero under Section 2701. A "preferred stock" interest will be treated as a "qualified payment" if mandatory payments are required at specified times, in which case the preferred stock (i.e., qualified payment) will be treated as having a value. That value would be determined under the Rules of Section 2701 and the Regulations thereunder.

xi Section 2702 also applies the "subtraction method" to gift tax valuation. For Section 2702 purposes, a qualified interest is not valued at zero. A qualified interest includes a "qualified annuity interest" which is the right to receive fixed payments payable at least annually. Thus, the interest payments would have a value. However, the balloon payment would not be considered a qualified interest and would therefore have a zero value to the Grantor.

xii Each Letter Ruling also held that the note did not constitute a "term interest' under Section 2702(c)(3).

xiii Mulligan, *Sale to Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996).

xiv Compare *Revenue Ruling* 770193 which found that Section 2036(a) did not apply. See also *Estate of Fabric*, 83 TC 932 (1984); *LaFargue v. Commissioner*, 82-2 USTC Paragraph 9622 (CA-9, 1982); and *Stern v. Commissioner*, 84-2 USTC Paragraph 9949 (CA-9, 1984) each holding that Section 2036 did not apply to transactions involving the sale of assets in exchange for the repayment of an annuity to the Grantor.

xv In *Mandorin v. Commissioner*, 84 TC 667 (1985), the Tax Court held that the grantor recognized gain at the time the trust ceases being a grantor trust. While *Mandorin* involved the loss of grantor trust status during the lifetime of the grantor, it is likely that IRS would apply the *Mandorin* analysis to the IDIT Transaction.

xvi For a full discussion of self canceling installment note issues, see Jerome A. Deener, Esq., *Self-Canceling Installment Note (SCIN): The Bet to Die*, Estate Planning Strategist, Volume 1, Number 4, February 1995.