Grantor Trusts
Reference Outline

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GRANTOR TRUSTS

I. INTRODUCTION

The grantor trust, over recent years, has been transformed from a trust to be avoided to a trust embraced as the "new" tool utilized by estate planning practitioners to migrate wealth from one generation to the next. By utilizing the grantor trust correctly the practitioner can assist his or her client in migrating wealth from one generation to the next with minimal transfer tax costs; however, without a clear understanding of the grantor trust rules which drive this wealth migration techniques, an unwary practitioner can create unintended income, gift and estate taxation.

A. What is a Grantor Trust.

A grantor trust is a trust under which the grantor or someone other than the grantor is treated as the "owner" of the trust assets for tax purposes, specifically income tax, under §§671 through 679 of the Internal Revenue Code of 1986, as amended (hereinafter referred to as "IRC" or the "Code").

B. History

From 1924 through 1939 the United States tax laws attacked piecemeal the perceived abuses of taxpayers who sought to shift income from high tax brackets to lower tax brackets by creating trusts and retaining sufficient control to assure the grantor's continued dominion over the trust assets and transactions. The 1939 codification of the tax laws into the Internal Revenue Code expanded the definition of gross income and the recodification of the tax laws in 1954 adopted the current grantor trust rules in substance. Over that time period there are two cases most practitioners associate with the grantor trust rules:

•Helvering v. Clifford, 309 U.S. 331 (1940)

•Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945), aff'g 2 T.C. 1128 (1944 cert. Denied, 324 U.S. 871 (1945)

1. Clifford

a. In Helvering v. Clifford, Mr. Clifford funded an irrevocable trust with securities "for the exclusive benefit" of his wife and declared himself to be trustee. As trustee, Mr. Clifford retained the right to make discretionary distributions of trust income to his wife, along with several important powers, including the power to: (1) vote the shares held by the trust; (2) "sell, exchange, mortgage, or pledge" the stock and any other trust properties, in whole or in part, and for such consideration and under such terms as the trustee, in his sole discretion, should determine appropriate; (3) invest the trust assets by loans, whether secured or unsecured, in bank accounts, or by the purchase of any type of personal property, without restricting the speculative character of the investments or the rate of return, or any applicable state laws regarding trust investments; (4) collect all trust income; (5) compromise and settle claims held by the trust; and (6) hold property in the trust in names of "other persons or in" the trustee's own name "as an individual." As trustee, Mr. Clifford had no liability for losses to the trust assets except those which he caused by "willful and deliberate" breaches of his fiduciary duty. The trust terminated at the end of five years, at which time it was to pay the principal to the grantor and treat any proceeds from the investment of the net trust income as the separate property of the grantor's wife. Mr. Clifford paid a gift tax on the trust's creation.

b. The IRS contended that the general concept of gross income was sufficiently broad to tax the grantor on the trust income. The Supreme Court agreed and reasoned that the grantor should be taxed on the trust income because the facts demonstrated that the entire trust arrangement was no more than a "temporary reallocation of income within an intimate family group." 309 U.S. at 336. The Court identified three main factors in its decision: (1) the short duration of the trust; (2) *the grantor's retention of control over the trust principal and income through various administrative powers*; and (3) the

beneficial interest remaining within the family unit; i.e., with the grantor's wife." (emphasis added) 309 U.S. at 335-336.

c. Treasury promulgated the so-called "Clifford regulations" in 1946, based on the Supreme Court's interpretation of the gross income concept. The regulations taxed the grantor on a trust's income if the trust corpus or income would or might return to the grantor after a short term of years. This could occur either by the grantor retaining a reversionary interest that would vest within 10 years or less, or certain administrative powers that would vest within 15 years. The grantor could also be taxed if the grantor or a nonadverse person (or both) had a power of disposition over the beneficial enjoyment of corpus or income. Finally, the grantor could be taxed if the grantor retained any of a series of broad administrative powers primarily for the benefit of the grantor. Section 29.22(a)-21; Treas. Dec. 5488, 1946-1 C.B. 19.

2. Mallinckrodt

a. Mallinckrodt involved a trust established by the taxpayer's father to provide for the taxpayer's mother and her children. The trust instrument designated the taxpayer as co-trustee along with a corporate trustee. The trust instrument directed net income first to the payment of certain debts and obligations arising out of a building enterprise, and next to fund a $10,000 annuity for the taxpayer's mother during her lifetime. Finally, the trustees could pay any additional net income to the taxpayer upon his written request. Furthermore, the taxpayer could request in writing that the trustees distribute principal to him during his life, even to the extent of terminating the trust in his favor. The trust recognized income in excess of the amounts used to discharge debts and expenses and to pay the $10,000 annuity to the grantor's wife, but the taxpayer did not actually request distribution of any income or principal to him. The IRS contended that, notwithstanding his failure to request distribution, the taxpayer should be taxed on trust income to the extent he could have required its distribution. The Tax Court agreed in a split decision and the Eighth Circuit affirmed. The Tax Court noted that, had the taxpayer been the grantor, he clearly would have been taxed on trust income under the grantor trust rules then in effect and under Clifford. The fact that a third person held these powers, the court reasoned, should make no difference, since these rules were based on the concept of gross income. The Eighth Circuit agreed, equating the power to dispose of income with the receipt of the income.

b. Since the 1954 Congress has been adjusting the grantor trust rules providing us with what is now in under §§671 through 679 Code.

C. Common Types of Grantor Trusts

There are two common types of grantor trusts:

★Grantor Retained Interest Trusts, including
Grantor Retained Income Trust
Grantor Retained Annuity Trust
Grantor Retained Unitrust
Personal Residence Trust
Qualified Personal Residence Trust

★Intentionally Defective Grantor Trust

II. GRANTOR TRUST RULES

Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. Section

1.671-3 outlines the rules for determining the items of income, deduction, and credit against tax that are attributable to the trust.

Below is a list of the IRC §§671-679 grantor trust rules.

§671 Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners
§672 Definitions and Rules
§673 Reversionary Interests
§674 Power to Control Beneficial Enjoyment
§675 Administrative Powers
§676 Power to Revoke
§677 Income for Benefit of Grantor
§678 Persons Other Than Grantor Treated as Substantial Owners
§679 Foreign Trusts Having One or More United States Beneficiaries (Not discussed as part of this article)

A. §671 Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

When the grantor or another person is deemed the "owner" of any portion of a trust, such owner is then required to include in computing his or her taxable income those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust. Remaining items of income, deductions and credits against tax are taxed to the trust, or beneficiary, as applicable, in determining taxable income.

B. §672 Definitions and Rules

Section 672 contains the general definitions and rules for implementing the remaining sections within the grantor trust rules.

1. "Adverse party" is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust. IRC §672(a). Of course, that means that a "nonadverse party" is any person who is not an adverse party. IRC §672(b). A "related or subordinate party" is any nonadverse party who is the grantor's spouse if living with the grantor or any one of the following: grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive. IRC §672(c).

2. A person shall be considered to have a power described in §§671-678 even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power. IRC §672(d).

3. Attribution: A grantor shall be treated as holding any power or interest held by such grantor's spouse (if married to the grantor at the time of the creation of such power or interest), or any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor. An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married. IRC §672(e).

4. Income Tax Stays in US: In general, only a U.S. citizen, resident, or domestic corporation can be taxable as the owner of a trust under the grantor trust rules. IRC §672(f).

C. §673 Reversionary Interests

1. For transfers made in trust after March 1, 1986, the grantor shall be treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent (5%) of the value of such portion. For transfers made on or before to March 1, 1986, the grantor was treated as the owner of the trust unless the reversionary interest would not vest in present possession within a term of 10 years or within the life of the income beneficiary.

2. The crucial two factors to the current rule are the valuation of the reversionary interest and the 5% test. Similar to IRC §2037, the valuation of the grantor's reversionary interest is calculated based upon life expectancy. The interest shall also be determined by assuming the maximum exercise of discretion in favor of the grantor. §673(c).

D. §674 Power to Control Beneficial Enjoyment

1. The general rule states that the grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. §674(a). However, there are eight major exceptions which require more discussion than the general rule. Such exceptions delineate powers which the grantor or any other person may hold, two powers which an independent, nonadverse trustee may exercise, and one power which a nonindependent, nonadverse trustee (other than the grantor or the grantor's spouse) may exercise, without causing the grantor to be taxable as the owner of the trust.

a. A grantor is not taxable as the trust's owner merely because a trustee or the grantor, in a fiduciary capacity as trustee or co-trustee, <u>may use</u> trust income to discharge a legal support obligation of the grantor. §674(b)(1); Regs. Section 1.674(b)(-1(b)(1). The grantor is taxable as the trust's owner only to the extent the trust income is <u>actually used</u> to discharge the support obligation described in §677(b), discussed below. Regs. Section 1.677(b)-1.

b. A postponed power that will only affect the beneficial enjoyment of the trust income will create a grantor trust <u>unless</u> it is postponed for a period which, were it a reversionary interest it would have a value that did not exceed five percent (5%) of the value of the trust or portion of the trust.

c. A power to direct the enjoyment of the trust exercisable solely by one's will does not create a grantor trust, even if the grantor or a nonadverse person (or both) holds the power and the power is exercisable without an adverse person's approval or consent. IRC §674(b)(3). However, what the Code provides the regulations take away. A grantor (not a nonadverse person) who holds a power exercisable without an adverse person's approval or consent to appoint the trust principal by his or her will is still taxed as the owner of those items of trust income, deduction, and credit properly allocated to the trust principal. Regs. Section 1.674(b)-1(b)(3). Further, if the grantor or a nonadverse person (or both) holds a power to dispose by will of the trust's accumulated income, and the same or another person holds the power to accumulate income for ultimate disposition, the trust is a grantor trust regarding such income under §674(b)(3). Additionally, a power to appoint to one's estate or the creditors of one's estate could also reasonably be viewed as a reversionary interest in the trust, causing the trust to be a grantor trust under §677(a). Regs. Section 1.674(b)-1(b)(3).

d. A grantor is not taxed as a trust's owner if the grantor retains a power to allocate the beneficial enjoyment of trust corpus or income if such corpus or income is irrevocably payable to a charitable beneficiary for a charitable purpose as described in section 170(c) (relating to definition of

charitable contributions) or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1)). IRC §674(b)(4).

e. A grantor is not taxed as a trust's owner if such grantor or a nonadverse person (or both) has a power to distribute corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument (a.k.a. "ascertainable standard") §674(b)(5)(A); or to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. IRC §674(b)(5). The "ascertainable standard" is further explained in Treas. Reg. 1.674(b)(-1(b)(5)(i) and includes the following powers retained by the grantor: power to distribute corpus for the education, support, maintenance or health of the beneficiary; for the beneficiary's reasonable support and comfort; or to enable the beneficiary to maintain his accustomed standard of living; or to meet an emergency of the beneficiary.

f. A grantor is not taxed as a trust's owner if such grantor or a nonadverse person (or both) has a power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children. §674(b)(6).

g. A grantor is not taxed as a trust's owner if such grantor or a nonadverse person (or both) reserves a power, exercisable without an adverse person's consent or approval, to distribute or apply income to or for a current income beneficiary or to accumulate income for a current income beneficiary during any legal disability of the beneficiary or until such beneficiary attains age 21. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children. §674(b)(7). It is important to note that when the income is accumulated under §674(b)(7), it is not necessary that the accumulated income ultimately be paid to the beneficiary. The income may be added to corpus and eventually paid to other beneficiaries. Treas. Reg. 1.674(b)-1(b)(7).

h. A power held by the grantor or a nonadverse person (or both) to allocate receipts and disbursements as between corpus and income, even though expressed in broad language, does not constituted a power to dispose of the beneficial enjoyment of the trust corpus or income that would cause the grantor to be taxed as the trust owner. §674(b)(8).

2. Under §674, a grantor is not taxed as a trust's owner if an independent trustee has the power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). An independent trustee is not the grantor, nor a related or subordinate party who is subservient to the wishes of the grantor. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children. §674(c).

3. A grantor is not taxed as a trust's owner if a trustee who is not the grantor or grantor's spouse (without the approval or consent of any person) holds the power to distribute, apportion or accumulate income to or for a beneficiary, if the power is limited by a reasonably definite external standard. The exception to grantor trust treatment for this permissible trustee power is not available if the grantor or the grantor's spouse (if living with the grantor) is a trustee; however, unlike the §674(c) exception, any of the trustees may be related or subordinate to the grantor. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children. §674(d).

4. Trustee Removal/Replacement: A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d) and therefore may qualify as a grantor trust. On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c). Treas. Regs. §1.674(d)-2(a).

E. §675 Administrative Powers

Certain administrative powers exercisable in favor of the grantor rather than for the trust beneficiaries will cause the trust to be taxable to the grantor as owner of the trust. Such powers include:

1. The Power to Deal With Trust Assets for Less than Adequate and Full Consideration. A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

2. The Power to Borrow Trust Assets Without Adequate Interest and Security. A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

3. Borrowing Of The Trust Funds. The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the

grantor any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

4. General Powers of Administration. A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For this paragraph, "power of administration" means one or more of the following:

a. a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

b. a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

c. a power to reacquire the trust corpus by substituting other property of an equivalent value.

F. §676 Power to Revoke

If a grantor (or grantor's spouse) or any other nonadverse person retains the power to revest the title to the trust assets in the grantor, then the grantor shall be treated as the owner of such portion, even though no other provision of Sections 671-678 apply.

G. §677 Income for Benefit of Grantor

1. The grantor is taxable as the owner of any trust or trust portion as to which the grantor, or any nonadverse person (or both) has the ability to use the trust income for the benefit of the grantor or the grantor's spouse in one or more specified ways, without the consent or approval of an adverse person. Grantor trust status results when income may be used for the grantor's benefit in the following ways:

a. distributed, either actually or constructively, to the grantor or the grantor's spouse;

b. accumulated for future distribution to the grantor or the grantor's spouse; or

c. applied, either actually or constructively, to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse, other than certain charitable policies.

This subsection shall not apply to a power the exercise of which can only affect the beneficiarl enjoyment of the income for a period commencing after the occurrence of any event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

2. Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision merely because such income in the discretion of another person, the trustee, or the grantor acting as Trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied and distributed.

H. §678 Persons other than Grantor Treated as Substantial Owners

1. Under §678(a), a person other than a the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable alone to vest the corpus or income in himself or herself (i.e., a Mallinckrodt power); or (2) such person has previously partially released or otherwise modified such Mallinckrodt power and after the release or modification retains such

control as would, within the principles of §§671-677, inclusive, subject a grantor of a trust to treatment as the owner thereof. Examples of §678 powers are inter vivos general powers of appointment and where the beneficiary has a demand or Crummey power.

2. The third person will not be treated as the grantor under §678(a) if such third person's power in §678(a) is a power over income and the grantor of the trust or transferor is otherwise treated as the owner under the provision of §§671-677.

3. A reading of §678(a) is fairly straight forward as to the third party, until it is read in conjunction with §678(b) and §§671-677. If the third party has released the power to vest corpus or income, then they must hold one of the powers described above in order for the trust to be taxable to them as grantor. When reading the provisions of §§671-677, it is very confusing because of the use of the word "grantor." Some say that §678 should be read first, and then the word "grantor" in section §§671-677 should be ready as to the third party "grantor." Reading the subsections this way helps in the interpretation of the Code sections. The reading of §678(b)(2) also leads the reader to believe that the person who must hold the power under §§671-677 must be the same person whom released the Mallinckrodt power.

4. Notice that under §678(b), the grantor (creator) is only treated as the owner over the third party in §678(a) if the third party's continuing power in §678(a)(2) is a power over income. This causes some ambiguities depending on the continuing power that the third party has. For example, an admininstrative power under§675(4)(C) to substitute assets is a power to substitute corpus. This is not a power over income. Although any person holding this power creates a grantor trust as to the creator, if a beneficiary of the trust had a Mallinckrodt power that lapsed, and continued to hold the power to substitute assets, arguably, the trust would be a grantor trust as to the beneficiary (assuming the grantor had no other powers under §§671-677), because the power is not a power over income. See PLR 9311021.

III. USING THE GRANTOR TRUST

Once the grantor trust rules are understood, the grantor trust status can be avoided if avoidance is the desired result. However, use of the grantor trust can leverage estate planning wealth migration from one generation to the next by minimizing the use of the transfer tax exemptions and transfer tax payments. The two most commonly used grantor trusts in wealth migration are:

★Grantor Retained Interest Trusts, including
  Grantor Retained Income Trust
  Grantor Retained Annuity Trust
  Grantor Retained Unitrust
  Personal Residence Trust
  Qualified Personal Residence Trust

★Intentionally Defective Grantor Trust

IV. GRANTOR RETAINED INTEREST TRUSTS

A. Introduction

In an effort to reestablish some measure of certainty in intra-family transfers, primarily on the gift tax implications at the time the transaction is made, Congress enacted Chapter 14, entitled "Special Valuation Rules", which includes sections 2701-2704, as a part of the Revenue Reconciliation Act of 1990. The statute sets forth criteria for determining whether a taxable gift has been made and for establishing the value of the gift. Chapter 14 is divided into four sections:

★Section 2701 – Family Business Interests

★Section 2702 – Transfers of Interests in Trust
★Section 2703 – Options and Buy/Sell Agreements
★Section 2704 – Lapsing Rights and Restrictions

Section 2702 of the Internal Revenue Code of 1986, as amended ("Code"), specifically addresses grantor retained interest trusts. The Grantor Retained Interest Trust is primarily used in gifting property to family members in the future at less than the property's fair market value at the time the gift is made and at less than the property's fair market value at the time the grantor's retained interest terminates.

B. Section 2702: General Rule, Definitions, and Exceptions

1. General Rule

If an individual (transferor) makes a transfer in trust (or assigns an interest in an existing trust) to or for the benefit of a "member of the transferor's family" and if there is any retention of an interest in the trust by the transferor or an applicable family member, any such retained interest (other than a "qualified interest") is valued at zero for purposes of determining the amount of such gift. IRC §2702(a).

2. Definitions

Section 2702 and the Regulations thereunder specifically define interrelated terms which are important in order to understand the scope of the statute.

a. Transfer in Trust

A "transfer in trust" includes any transfer to a new or existing irrevocable trust and an assignment of an interest in an existing trust. Treas. Regs. §25.2702-2(2).

b. Interest

An "interest" in trust includes a power held with regard to a trust if the existence of the power would cause any portion of the transfer to be treated as an incomplete gift. Treas. Reg. §25.2702-2(a)(4).

c. Member of the Family

"Member of the family" means the transferor's spouse, any ancestor or any lineal descendant of the transferor or the transferor's spouse, any brother or sister of the transferor and any spouse of any person described above. Treas. Reg. §25.2702-2(a)(1).

d. Retained

"Retained" means held by the transferor both before and after the transfer in trust. Treas. Reg. §25.2702-2(a)(3).

e. Applicable Family Member

"Applicable family member" means the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and any spouse of any such ancestor. IRC §2702(a)(1). (Note that neither children nor siblings are included in this definition).

f. Qualified Interest

A "qualified interest" means a qualified annuity interest, a qualified unitrust interest, or a qualified reminder interest. Treas. Reg. §25.2702-2(a)(5). These terms are specifically defined below.

g. Subtraction Method

The "subtraction method" is used to value the gifted interest as the total amount transferred to the trust less the value of the retained interest. The value of the retained interest will be based on the special valuation rules described in Code §2702. Treas. Reg. §25.2702-2(b).

C. Qualified Interests

The primary exception to valuing a retained trust term interest at zero is the qualified interest exception. There are generally three types of qualified interests: a) qualified annuity interest, b) a qualified unitrust interest, and c) a qualified remainder interest. IRC §2702(b).

1. Qualified Annuity Interest

A qualified annuity interest is an irrevocable right to receive stated amounts payable not less frequently than annually. IRC §2702(b)(1); Treas. Reg. §25.2702-3(b)(1). Additional requirements are:

a. Amount Paid

The annuity amount may be either a stated dollar amount or a fixed fractional percentage of the initial fair market value of the property transferred to the trust as finally determined for federal tax purposes, as long as the fixed amount or percentage of a particular year does not exceed 120% of the fixed amount or percentage in the preceding year. Treas. Reg. §25.2702-3(b)(1)(ii).

b. Excess Income

Income in excess of the annuity amount may be paid to the annuitant; however; a right to receive the excess income is not a qualified annuity amount and is not taken into account in valuing the gift. Treas. Reg. §25.2702-3(b)(1)(iii).

c. Payment to Transferor or Applicable Family Member Only

The annuity amount must be payable to (or for the benefit of) the transferor or an applicable family member (i.e. the holder of the annuity interest) for each taxable year of the term. Treas. Reg. § 25.2702-3(b)(1)(i). The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest. Treas. Reg. §25.2702-3(d)(2).

d. Withdrawal Right Does Not Qualify

A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Treas. Reg. §25.2702-3(b)(1)(i).

e. Promissory Notes

Issuance of a note, other debt instrument, option or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount. Treas. Reg. §25.2702-3(b)(1)(i). In the case of a trust created on or after September 20, 1999, the trust instrument must prohibit the trustee from issuing such debt obligation. Treas. Reg. §25.2702-3(d)(5)(i).

f. Payment Date

The annuity payment may be made after the close of the taxable year, provided the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the taxable year (without regard to extensions). Treas. Reg. §25.2703-3(b)(1)(i).

g. Incorrect Valuations of Trust Property

If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of section 1.664-2(a)(1)(iii) of the regulations (relating to adjustments for any incorrect determination of the fair market value of the property in the trust). Treas. Reg. §25.2702-3(b)(2).

h. Computation of Annuity Amount in Certain Circumstances

The governing instrument must contain provisions meeting the requirements of section 1.664-2(a)(1)(iv) of the regulations (relating to the computation of the annuity amount in the case of short taxable year of the term). The governing instrument meets the requirements with respect to short taxable

years, if any, and the last taxable year of the term, if the governing instrument provides that the fixed amount or a pro rata portion thereof must be payable for the final year/short period of the annuity term. Treas. Reg. §25.2702-3(b)(3).

i. Additional Contributions Prohibited

The governing instrument must prohibit additional contributions to the trust. Treas. Reg. §25.2702-3(b)(4).

j. Term

The governing instrument must fix the term of the annuity interest. The term must be for the life of the payee, a term of years, or the shorter of these periods. Successive term interests for the benefit of one individual will be treated as the same term interest. Treas. Reg. §25.2702-3(d)(3).

k. Commutation

The governing instrument must prohibit prepayment of the annuity to the payee. Treas. Reg. §25.2702-3(d)(4).

2. Qualified Unitrust Interest

A qualified unitrust interest is an irrevocable right to receive amounts payable not less frequently than annually that are a stated percentage of the fair market value of the property in the trust, determined annually. IRC §2702(b)(2); Treas. Reg. §25.2702-3(c)(1).

a. Amount Paid

The unitrust percentage must be a fixed fraction or percentage of the net fair market value of the trust assets, determined annually, but only to the extent the fraction or percentage does not exceed 120% of the fixed fraction or percentage payable in the preceding year. Treas. Reg. §25.2702-3(c)(1)(ii).

b. Excess Income

Income in excess of the unitrust percentage amount may be paid to the unitrust beneficiary; however, the right to receive the excess income is not a qualified unitrust interest and is not taken into account in valuing the gift. Treas. Reg. §25.2702-3(a)(1)(iii).

c. Payment to Transferor or Applicable Family Member Only

The unitrust amount must be payable to (or for the benefit of) the transferor or applicable family member (i.e. the holder of the unitrust interest) for each taxable year of the term. Treas. Reg. §25.2702-3(c)(1)(i). The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified unitrust interest during the term of the qualified interest. Treas. Reg. §25.2702-3(d)(2).

d. Withdrawal Right Does Not Qualify

A right of withdrawal, whether or not cumulative, is not a qualified unitrust interest. Treas. Reg. §25.2702-3(c)(1)(i).

e. Promissory Note

Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the unitrust amount does not constitute payment of the unitrust amount. Treas. Reg. §25.2702-3(c)(1)(i). In the case of a trust created on or after September 20, 1999, the trust instrument must prohibit the trustee from issuing such debt obligation. Treas. Reg. §25.2702-3(d)(5)(i).

f. Payment Date

The unitrust payment may be made after the close of the taxable year, provided that the payment is made no later than the date by which the trustee is required to file the Federal income tax return of the trust for the year (without regard to extensions). Treas. Reg. §25.2702-3(c)(1)(i).

g. Incorrect Valuations of Trust Property

The governing instrument must contain provisions meeting the requirements of Section 1.664-3(a)(1)(iii) of the regulations (relating to the incorrect determination of the fair market value of the property in the trust). Treas. Reg. §25.2702-3(c)(2).

h. Computation of Unitrust Amount in Certain Circumstances

The governing instrument must contain provisions meeting the requirements of Section 1.664-3(a)(1)(v) of the regulations (relating to the computation of the unitrust amount in the case of short taxable years and the last taxable year of the term). The governing instrument meets the requirements with respect to short taxable years, if any, and the last taxable year of the term, if the governing instrument provides that the fixed amount or a pro rata portion thereof must be payable for the final year/short period of the unitrust term. Treas. Reg. §25.2702-3(c)(3).

i. Term

The governing instrument must fix the term of the unitrust interest. The term must be for the life of the payee, a term of years, or the shorter of these periods. Successive term interests for the benefit of one individual will be treated as the same term interest. Treas. Reg. §25.2702-3(d)(3).

j. Additional Contributions Allowed

The regulations contain no requirement that a qualified unitrust interest prohibit additional contributions.

k. Commutation

The governing instrument must prohibit prepayment of the unitrust interest to the payee. Treas. Reg. §25.2702-3(d)(4).

3. Requirements Common to Both Qualified Annuity Interests and Qualified Unitrust Interests

To be a qualified annuity or unitrust interest, an interest must be a qualified annuity interest in every respect or a qualified unitrust interest in every respect. For example, if the interest consists of the right to receive each year a payment equal to the lesser of a fixed amount of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is not a qualified interest. If, however, the interest consists of the right to receive each year a payment equal to the greater of a stated dollar amount or a fixed percentage of the initial trust assets or a fixed percentage of the annual value of the trust assets, the interest is a qualified interest that is valued at the greater of the two values. To be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust. Treas. Reg. §25.2702-3(d)(1).

4. Qualified Remainder Interest

A qualified remainder interest is any non-contingent remainder interest where all of the other interest in the trust consist of a qualified annuity interest or a qualified unitrust interest. Treas. Reg. §25.2702-3(3)(f).

a. A remainder interest must be non-contingent, meaning that it is payable to the beneficiary or the beneficiary's estate "in all events." Treas. Reg. §25.2702-3(f)(1)(iii).

b. The remainder interest must be a right to receive all or a fractional share of the trust property on termination, including any appreciation attributable to that share. A right to receive a stated

or pecuniary amount on the termination of the trust is not a qualified remainder interest. Treas. Reg. §25.2702-3(f)2).

c. The qualified remainder interest can be utilized when an individual wishes to transfer payments to another individual for a specified term.

D. Examples

1. Example – Non-Qualifying Grantor Retained Income Trust

a. Parent transfers property to an irrevocable trust, retaining the right to receive the income of the trust for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to parent's child. The retained interest is valued at zero because it is not a qualified interest. Treas. Reg. §25.2702-2(c). This is the traditional grantor retained income trust (GRIT). The parent's income interest would be valued as other than zero if the beneficiary on the expiration of the trust term is other than a family member.

2. Example – Qualifying Grantor Retained Annuity Trust or Unitrust

a. Parent transfers property to an irrevocable trust, retaining a 10-year qualified annuity or unitrust interest. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to parent's child. The amount of the gift is the fair market value of property transferred to the trust less the value of the retained qualified interest determined under §7520. Treas. Reg. §25.2702-2(d).

3. Example – Qualifying Remainder Interest

a. A transfers property to an irrevocable trust which provides that $10,000 per year be paid to A's child for the child's life. The trust will terminate at the child's death and the trust corpus will be paid to A or A's estate. No other interest in the trust exists. A's reversionary interest is a qualified remainder interest and can be valued according to the Treasury actuary tables. If all the requirements for a qualified remainder interest were not satisfied, A's reversionary interest would be valued at zero, and A would be treated as making a gift in the entire amount contributed to the trust.

E. Exceptions to Section 2702

1. Incomplete Gift

Section 2702 does not apply to a transfer, no portion of which would be treated as a completed gift without regard to any consideration received by the transferor. IRC §2702(a)(3)(A)(i).

a. Examples

(i) Transfers to a revocable trust; (ii) transfers with the Grantor retaining the power over whom, among several beneficiaries, will receive income; and (iii) transfers with the Grantor retaining a special power of appointment.

2. Personal Residence Trust

Section 2702 does not apply to a transfer of a residence, to be used as a personal residence, in trust. IRC §2702(a)(3)(A)(ii).

3. Charitable Trusts

Section 2702 does not apply to charitable remainder annuity trusts, fixed percentage charitable remainder unitrusts, charitable lead trusts and pooled income funds. New regulations issued December 10, 1998 modified the charitable remainder unitrust exception specifically omitting from the exception a net income CRT for the benefit of two non-charitable beneficiaries where the donor has the first interest. The donor may be the recipient of the second life interest. Treas. Reg. §25.2702-1(c)(3), (4) and 5.

4. Certain Assignments of Remainder Interests

Excluded from the application of section 2702 is the assignment of a remainder interest if the only retained interest of the transferor or an applicable family member is as the permissible recipient of distributions of income in the sole discretion of an independent trustee [as defined in section 674(c)].

5. Marital Property Settlements

Not subject to section 2702 are transfers in trust if the transfer of an interest of a spouse is deemed to be for full and adequate consideration by reason of section 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse. Treas. Reg. §25.2702-1(c)(7).

6. Transfer or Assignment

Section 2702 does not apply to a transfer or assignment to a qualified domestic trust. Treas. Reg. §25.2702-1(c)(8).

7. Gift to "Non-Member of the Family"

Section 2702 does not apply to a transfer if such transfer is for the benefit of an individual outside the definition of "family member".

F. Certain Property Treated as Held in Trust

1. In General

A transfer of an interest in property with respect to which there are one or more term interests is treated as a transfer in trust. A term interest is either a life estate or a term of years. Treas. Reg. §25.2702-4(a).

a. **Example:** Parent sells a remainder interest in property following parent's life estate to child for an amount equal to the actuarial value of the remainder interest. The parent's interest is valued at zero, since it is not a qualified interest, and is treated as transferring the entire property to child. Treas. Reg. §25.2702-4(d)(2).

2. Leases

A leasehold interest in property is not a term interest to the extent the lease is for full and adequate consideration. Treas. Reg. §25.2702-4(b).

3. Joint Purchase

A joint purchase of a term interest and remainder interest, in the same transaction or series of transactions, by family members is treated as a purchase of the entire property by the person who ultimately acquires the term interest, and transferring to each of those family members the interests acquired by that family member in exchange for any consideration paid by that family member. Treas. Reg. §25.2702-4(c).

a. **Example:** A purchases a 20-year term interest in an apartment building and A's child purchases the remainder interest in the property. A and A's child each provide the portion of the purchase price equal to the value of their respective interests in the property determined under section 7520. Solely for purposes of section 2702, A is treated as acquiring the entire property and transferring the remainder interest to A's child in exchange for the portion of the purchase price provided by A's child. In determining the amount of A's gift, A's retained interest is valued at zero because it is not a qualified interest. Treas. Reg. §25.2702-4(d) Ex. 1.

G. Tax Consequences

1. Grantor Retained Income Trust ("GRIT")

a. Gift Tax

The gift of a remainder interest is a future interest and will not qualify for the gift tax annual exclusion. Treas. Reg. §25.2503-3(a). Under the typical GRIT, the trust provides that all of the income will be paid to the grantor for a specified term of years, at which time the remaining assets will pass to another individual. In this situation, the retained income interest is not a qualified annuity interest or qualified unitrust interest. The retained income interest must be valued at zero unless one of the exceptions to §2702 apply.

(i) **Example:** Remainder interest of the GRIT passes to a niece or nephew or other non-family member; therefore, the income interest could be valued according to the Treasury actuarial tables. If the retained income interest is valued at zero, the grantor will typically be treated as making a gift of the entire amount contributed to the trust.

b. Income Tax

The grantor of a GRIT will be liable for income tax on ordinary income earned by the trust. IRC §677(a)(1). Where the grantor retains certain powers over the corpus, most commonly a non-fiduciary power to reacquire trust corpus by substituting other property of an equivalent value, the grantor would report on his or her income tax return all income, deductions, and credits attributable to the trust property. IRC §675.

c. Estate Tax

(i) Grantor Dies During Term of Trust. If the grantor dies during the term of the trust, all trust property will be included in the gross estate because of the grantor's retained income interest. IRC §2036(a)(1). If the trust assets are included in the grantor's estate, the adjusted taxable gifts made upon creation of the trust would not be added in determining the grantor's estate tax. IRC §2001(b).

(ii) Grantor Survives to End of a Trust Term. If the Grantor survives to the end of the trust term, the remaining trust assets pass to a designated beneficiary and none of the trust assets will be included in the grantor's estate for estate tax purposes at his or her subsequent death.

d. Generation-Skipping Transfer Tax

GST exemption cannot be allocated to a trust until the end of the "estate tax inclusion period" (when the property would no longer be included in the grantor's estate or at the grantor's death, if earlier). IRC §2642(f). Therefore, GST exemption may not be allocated to the trust until the end of the grantor's retained interest (i.e. trust term). If the grantor dies during the term, the retained interest could be a direct skip or could result in a later taxable termination and/or distribution. IRC §2612(c)(2).

2. Grantor Retained Annuity Trust ("GRAT") or Grantor Retained Unitrust ("GRUT")

a. Gift Tax

The gift to the remainder beneficiary is a future interest and will not qualify for the gift tax annual exclusion. Treas. Reg. §25.2502-3(a). The grantor's retained annuity or unitrust interest will generally be treated as a qualified interest that can be given value for purposes of determining the value of the gift of the remainder interest.

b. Income Tax

The grantor of a GRAT or GRUT will be treated as the owner of the income portion of the trust if the retained interest exceeds 5% of the value of the trust. IRC §673. This tax would be applied annually. If the value of the annuity or unitrust interest for the year exceeds the 5% test, the

grantor will be taxed on all trust income, even though the annuity or unitrust amount may be less than the total trust income. Where the grantor retains certain powers over the corpus, most commonly a non-fiduciary power to reacquire trust corpus by substituting other property of an equivalent value, the grantor would report on his or her income tax return all income, deductions, and credits attributable to the trust property. IRC §675(4)(c).

c. Estate Tax

(i) GRAT – Where the grantor dies during the trust term, the amount includable in the grantor's estate depends on whether the annuity is for life or for a term of years and also requires a review of IRC §§ 2033, 2036 and 2039. Additionally, Congress has proposed a change and addition in Treasury Regulation 20.2036-1 that, if passed, will have an effect on the valuation of the assets of a grantor retained annuity trust included in a decedent's estate and provide guidance on the appropriate calculations.

(1) GRAT FOR LIFE – If the annuity is for life, analyzing the charitable remainder unitrust procedure under Revenue Rule 82-105, 1982 C.B. 133 and the application of section 2036(a)(1), the amount includable in the gross estate is that portion of the trust property that would generate the income necessary to produce the annuity amount, using the Treasury actuarial table rate in effect at the transferor's death. If the annuity amount is shared with other recipients, the proposed regulations require the amount of corpus sufficient to produce enough income to support the annuity payment if the decedent survived the other income beneficiaries, reduced by the present value of any other current recipient's interest, but not less than the amount of corpus sufficient to produce the required income of the present interest of the decedent upon his death. The proposed regulations provide a straightforward way to calculate the inclusion:

Step 1: Determine the fair market value of the trust corpus on the date of death.

Step 2: Determine, in accordance with paragraph (c)(2)(i) of this section, the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment (determined on the date of the decedent's death) payable to thw decedent fo rhte trust year in which the decedetn's death occurred.

Step 3: Determine, in accordance with paragraph (c)(2)(I) of this section, the amount of corpus required to generate sufficient income to pay the annuity, unitrust, or other payment that the decedent would have been entitled to receive for each trust year if the decedent had survived the current recipient.

Step 4: Determine the present value of the current recipient's annuity, unitrust, or other payment.

Step 5: Reduce the amount determined in Step 3 by the amount determined in Step 4, but not below the amount determined in Step 2.

Step 6: The amount includible in the decedetn's gross estate under section 2036 is the lesser of the amounts determined in Step 5 and Step 1.

Notwithstanding the foregoing, the Service has applied section 2039 causing the date of death value of all property in the trust to be included in the gross estate.

(2) GRAT FOR TERM OF YEARS – If the annuity interest is for a term of years, using the same approach could result in a very large amount includable in the gross estate. Estate of Pardee, Commissioner, 49 T.C. 410 (1967), acq., 1973-2 C.B. 3. Another approach to determining the amount includable in the grantor's gross estate would be by referencing the fixed annuity payment to the IRC §7520(a) rate in effect on the date of the transferor's death, that is, divide the annuity amount by the IRC §7520(a) rate to determine what is included. The maximum amount includable would be the value of

the trust at the date of the transferor's death. However, the Service has applied section 2039 causing the date of death value of all property in the trust to be included in the gross estate.

Example: A transfers $1,000,000 to a GRAT and retains the right to receive an annuity of $50,000 per year for a fifteen year term. A dies at the end of year ten when the IRC §7520 rate is 6.6% (March 1996). The fair market value of the remaining property in the GRAT on the death of A is $1,500,000. The value of the property to be included in A's estate should be $757,575 ($50,000 ÷ .066) since that is the value of the portion of the remaining property required to produce the annual annuity amount.

(3) GRAT FOR TERM OF YEARS/PAYMENTS TO GRANTOR'S ESTATE UPON DEATH OF GRANTOR DURING TERM – If the grantor's estate is entitled to receive remaining payments for the balance of the specified trust term, the actuarial value of the payments may be included in the gross estate under 2033.

(ii) GRUT – Where grantor dies during the trust term, the following applies.

(1) GRUT FOR LIFE OR TERM OF YEARS – Again analyzing the charitable remainder trust rulings, where the grantor dies during the trust term, the amount included in the estate is determined under a two-step process.

First, the "Equivalent Income Interest Rate" is determined as follows:

Equivalent Income Interest Rate =

Unitrust Adjusted Payout Rate (unitrust percent divided by 1 plus $7520 rate)
1 minus Unitrust Adjusted Payout Rate

Second, the portion includable in the estate is determined by dividing the Equivalent Income Interest Rate by the actuarial table rate in effect at the time of the transferor's death.

Example: A transfers $1,000,000 to a GRUT and retains the right to receive a unitrust payment of 5% per year for a fifteen year term. A dies at the end of year ten when the IRC §7520 rate is 6.6% (March 1996). The fair market value of the remaining property in the GRUT on the death of A is $1,500,000.

Step 1: Equivalent Income Interest Rate =

$$\frac{(.05 \div 1.066)}{1 - (.05 \div 1.066)} = \frac{.046904}{1 - .046904} = \frac{.046904}{.953096} = .04921$$

Step 2: Unitrust Percentage =

$$\frac{.04921}{.066} = .74560 = 74.560\%$$

Therefore, the value of property to be included in A's estate should be $1,118,400 ($1,500,000 x 74.560%).

(2) GRUT FOR TERM OF YEARS/PAYMENTS TO GRANTOR'S ESTATE UPON DEATH OF GRANTOR DURING TERM – Again, if the grantor's estate is entitled to receive remaining payments for the balance of the specified trust terms, the actuarial value of the payments would be included in the gross estate. Rev. Rul. 76-173, 1976-2 C.B.268.

(iii) Grantor's Death after the End of the Term. Where the grantor survives the term, the property should not be included in the transferor's estate. If the transferor retains prohibited rights and powers as trustee after the end of the grantor's trust term, inadvertent inclusion of the property in the transferor's estate could occur.

(iv) Generation-Skipping Transfer Tax ("GST")

GST exemption cannot be allocated to a trust until the end of the "estate tax inclusion period" (i.e. trust term) (when the property would no longer be included in the grantor's estate or at the grantor's death, if earlier). IRC §2642(f). Therefore, GST exemption may not be allocated to the trust until the end of the grantor's retained interest. If the grantor dies during the term, the retained interest could become a direct skip, or could result in a later taxable termination and/or distribution. IRC §2612.

H. Transfers of Retained Interest in Trusts

1. Inter Vivos Transfers

If an individual subsequently transfers by gift an interest in trust previously valued (when held by that individual) under section 25.2702-2(b)(1) or (c), the individual is entitled to a reduction in aggregate taxable gifts. Thus, if an individual transferred property to an irrevocable trust, retaining an interest in the trust that was valued at zero under Treas. Reg. §25.2702-2(b)(1), and the individual later transfers the retained interest by gift, the individual is entitled to a reduction in aggregate taxable gifts on the subsequent transfer. For purposes of this section, aggregate taxable gifts means the aggregate sum of the individual's taxable gifts for the calendar year determined under §2502(a)(1). Treas. Reg. §2502-6(a)(1).

Examples: Facts

In 1992, X transferred property to an irrevocable trust retaining the right to receive the trust income for life. On the death of X, the trust is to terminate and the trust corpus is to be paid to X's child, C. X's income interest had a value under section 7520 of $40,000 at the time of the transfer; however, because X's retained interest was not a qualified interest, it was valued at zero under Treas. Reg. §25.2702-2(b)(1) for purposes of determining the amount of X's gift. X's taxable gifts in 1992 were therefore increased by $40,000. In 1993, X transferred the income interest to C for no consideration.

Example 1: Assume that the value under section 7520 of the income interest on the subsequent transfer to C is $30,000. If X makes no other gifts to C in 1993, X is entitled to a reduction in aggregate taxable gifts of $20,000, the lesser of the amounts by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer ($40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income interest ($30,000 minus $10,000 annual exclusion).

Example 2: Assume that in 1993, 4 months after X transferred the income interest to C, X transferred $5,000 cash to C. In determining the increase in taxable gifts occurring on the subsequent transfer, the annual exclusion under section 2503(b) is first applied to the cash gift. X is entitled to a reduction in aggregate taxable gifts of $25,000, the lesser of the amount by which X's taxable gifts were increased as a result of the income interest being valued at zero on the initial transfer ($40,000) or the amount by which X's taxable gifts are increased as a result of the subsequent transfer of the income

interests [$25,000 ($30,000 + $5,000) - $10,000 annual exclusion]. Treas. Reg. §25.2702-6(c) Ex. 1 and 2.

2. Testamentary Transfers

If either (i) a term interest in trust is included in an individual's gross estate solely by reason of section 2033, or (ii) a remainder interest in trust is included in an individual's gross estate, and the interest was previously valued (when held by that individual) under section 2702(a), the individual's estate is entitled to a reduction in the individual's adjusted taxable gifts in computing the Federal estate tax payable under section 2001. Treas. Reg. §25.2702-6(a)(2).

3. Gift Splitting on Subsequent Transfer

If an individual who is entitled to a reduction in aggregate taxable gifts (or adjusted taxable gifts) subsequently transfers the interest in a transfer treated as made one-half by the individual's spouse under section 2513, the individual may assign one-half of the amount of the reduction to the consenting spouse. The assignment must be attached to the Form 709 on which the consenting spouse reports the split gift. Treas. Reg. §25.2702-6(a)(3).

4. Amount of Reduction

The amount of the reduction in aggregate taxable gifts (or adjusted taxable gifts) is the lesser of:

a. The increase in the individual's taxable gifts resulting from the interest being valued at the time of the initial transfer under Treas. Reg. §25.2702-2(b)(1) or (c); or

b. The increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest. Treas. Reg. §25.2702-6(b)(1).

5. Treatment of Annual Exclusion

For purposes of determining the increase in the individual's taxable gift (or gross estate) resulting from the subsequent transfer of the interest, the exclusion under section 2503(b) applies first to transfers in that year other than the transfer of the interest previously valued under section 2702(a).

6. Overlap with Section 2001

The section 2702 adjustment only applies to the extent that a section 2001 adjustment would not apply to the interest. Treas. Reg. §25.2702-6(b)(3).

I. Planning Considerations

1. In General

In comparisons of the GRAT and the GRUT, the GRAT generally prevails.

a. The GRUT is not a true freezing device since the grantor retains the right to receive the same percentage of the property transferred, valued annually. Accordingly, if the property valued is appreciating, the grantor will receive an ever increasing amount as a result of the appreciation with a GRUT. This will, in turn, increase the value of the transferor's estate.

b. The property transferred to a GRUT must be valued annually. Depending upon the type of property transferred, this could pose an administrative burden.

c. The GRUT will usually result in a lower up-front gift tax cost than a GRAT.

d. The GRAT is a true freezing device since the amount to be paid to the grantor will be fixed, shifting all of the future appreciation of the property to the next generation.

2. GRATS and GRUTS with Zero Value Remainder Interests

The ultimate in valuation discounting would be for the grantor to transfer property to a GRAT or GRUT while retaining an annuity or unitrust interest that would cause the remainder interest to be valued at zero for gift tax purposes.

a. Valuation Factors

The primary factors affecting the value of a remainder interest for a GRAT or a GRUT are (a) the term of the retained annuity/unitrust interest, (b) the percentage amount of the retained interest, and (c) the Section 7520 rate. In order to decrease the value of the remainder interest, (a) and (b) are increased and (c) decreases.

b. Zeroed-Out GRAT

i. "Example 5"

For the greatest estate and gift tax advantage, the grantor will transfer an asset with high appreciation potential to a GRAT and work with the valuation factors so that the gift value of the remainder interest will be "zeroed-out." The Internal Revenue Service has taken the position that it is not possible to completely zero out the GRAT because the possibility that the grantor may die during the term would produce a remainder interest having some value and, therefore, create a gift. Rev. Rul. 77-454. Treasury Regulation Section 25.2702-3(e), Example 5 was created to illustrate the possibility that the grantor might die during the term. This is the position the IRS takes when reviewing a GRAT and determining that a GRAT cannot be "zeroed out." Treas. Reg. §25.2702-3(e), Ex. (5) states:

"Example(5). A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually for 10 years. If A dies within the 10-year term, the unitrust amount is to paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death."

The last five words of the example "or until A's prior death" were construed by the Service to mean that in valuing the qualified retained interest, the possibility that A might die would have to be factored in as an unqualified interest.

ii. The Walton Decision

Under Audrey J. Walton v. Commissioner, 115 T.C. 589(2000), a unanimous Tax Court declared that Example 5 under the Regulations is invalid. The Tax Court stated that Example 5 is an unreasonable interpretation and an invalid extension of Section 2702. Under Walton, the taxpayer created a two year GRAT and funded it with 3,611,739 shares of Wal-Mart stock. The fair market value of the stock was $27.687 per share for a fair market value of $100,000,023.56. The GRAT paid 49.35% in the first year and 59.22% in the second year. Under the valuation of a term interest, the gift was $6,195.10. The Service stated that under Example 5, the gift was $3,821,522.12. Under the facts of this case, the stock lost value and in year 2 the trust terminated because the trust assets were exhausted in paying the annuity trust. This illustrates the gamble of the GRAT as well as illustrates the disparity in the valuation of a term interest versus the valuation under Example 5. Because the Walton decision was determined by the full Tax Court, it appears this would be good law and would not be overturned. However, when analyzing the economics of the GRAT, it is important to determine the worst case scenario, that is, a valuation under the term interest and Example 5.

3. Revocable Annuity Interest for Spouse

The use of the revocable annuity interest for a spouse as a technique to reduce the value of the remainder interest was modified when the regulations under Section 2702 were modified in February, 2005. In order to obtain a valuation benefit from the spouse's annuity interest in the GRAT, the spouse's

interest must satisfy Treasury Regs. 25.2702-3. That is, the spouse's annuity interest must stand on its own but for the power of the grantor to revoke such interest. That is, if the grantor and his or her spouse have qualified interest in the GRAT (with the spouse's interest having a fixed term, subject to the grantor's power to revoke), the value of the gift to the trust should be the fair market value of the property transferred to the trust reduced by the value of the grantor's qualified interest and grantor's spouse's qualified interest. In light of the fact that the GRAT can be "zeroed out" using a term interest, the contingent revocable annuity interest for spouse does not play a vital valuation role. Structured properly, the contingent revocable interest for spouse is still useful to prevent estate tax if the grantor dies during the GRAT term.

4. Use Separate GRAT or GRUT for Each Asset

If a particular asset transferred to a GRAT does not produce sufficient cash flow, together with the principal of the asset, to make all of the required annuity payments, when there is no further value left in the GRAT, it would simply terminate for lack of any trust corpus. If other assets had been gifted to the same GRAT, the other assets would have to be used to make up the deficiencies in the required annuity payment. In order to avoid this result, it could be desirable to use a separate GRAT for each individual asset so that poor performance results of one asset will not adversely affect the trust with respect to other assets.

5. Funding GRAT with S Stock

a. Both the GRAT and GRUT can be funded with S stock, but the planner must be careful to assure that the trust will be treated as a grantor trust as to income and principal for income tax purposes. This is because only certain types of trusts can qualify as shareholders of S corporations. IRC §1361(c)(2). One of these types of trust is a "grantor trust," all of which is treated under subpart E of Part I of subchapter J of Chapter 1, as owned by an individual or resident of the United States. Section 1361(e)(2)(A)(i) requires that all of the trust be treated as owned by an individual under the grantor trust rules. Therefore, the individual must be treated as the owner of both income and principal of the trust under the grantor trust rules. Two planning techniques include giving the grantor a right to amend the trust agreement to create a non-fiduciary power of administration in another person, IRC §675, or giving the grantor a non-fiduciary power to reacquire the S corporation stock by substituting assets of equivalent value. IRC §675(4)(C); PLR 9248016.'

b. Since the grantor owner will be subject to income tax on the S stock, the GRAT can provide that the trustee make distributions to the grantor in an amount equal to the excess of the grantor's personal tax liability over the grantor's personal tax liability computed as if the grantor were not the owner of the trust. The Service stated that this distribution did not disqualify the qualified annuity interest for purposes of Section 2702 since the distribution is only relieving the grantor of paying income tax on the part of the trust property that has, in a true economic sense, been given away. PLR 9416009.

6. Payment of Annuity Amount

a. Cash

The use of cash to satisfy annuity payments is the preferred method. This may be possible if the GRAT assets are sold prior to the initial annuity payment being due or if the GRAT is funded with high income producing assets.

b. In-Kind Assets

If the asset does not produce sufficient income to pay the annuity amount, fractional interests in the asset or specific assets could be used to satisfy the annuity payments. This is not the desired method given that the GRAT is intended to be funded with appreciating assets. If an in-kind distribution is made, the grantor could set up new GRATs with the distributed assets. It is important to pay attention to the grantor trust rules when setting up the GRAT so that the GRAT is properly structured

as a grantor trust for income tax purposes so that the in-kind distribution can be made without any adverse income tax consequences.

c. Issuance of Note by GRAT

When income was not available to satisfy the annuity payment and a distribution of assets defeated the purpose of the GRAT, many practitioners recommended that the GRAT issue a promissory note bearing interest at the applicable federal rate in satisfaction of the annuity payment. Until 1996 there were no rulings prohibiting or validating this approach. In TAM 9604005 the Service stated that a series of 25 GRATs were not "qualified" GRATs because of a plan to pay the annuity payments with notes. More recently in TAM 9717008, where the donor planned to create a two-year GRAT and the GRAT instrument provided that the annuity could be satisfied with a promissory note, the Service stated that this prevented the annuity interest created for the donor from qualifying as a qualified interest under section 2702(b).

New Regulations.

(i) The IRS issued proposed regulations (REG-108287-98, June 22, 1999) that address the use of notes by GRATs to satisfy annuity payments. The proposed regulations provide that a retained interest is not a qualified interest unless the trust instrument expressly prohibits the use of notes, other debt instruments, options, or similar financial arrangements that effectively delay the grantor's receipt of the annual annuity payment. The preamble to the proposed regulations indicates that "the Service will apply the step transaction doctrine where more than one step is used to achieve similar results." The preamble states that the annual annuity payment "must be made with either cash or other assets held by the trust."

(ii) The proposed regulations include a transitional rule for trusts created before September 20, 1999. If a GRAT created before September 20, 1999, does not include the express prohibition, the retained annuity interest will still be treated as a qualified interest if (i) notes, other debt instruments or similar financial arrangements are not used after September 20, 1999, to satisfy the annuity obligation, and (ii) any note or notes or other debt instruments issued on or prior to September 20, 1999, to satisfy the annuity obligation are paid in full by December 31, 1999, such that the grantor actually receives cash or other trust assets in satisfaction of the payment obligation. Prop. Reg. section 25.2702-3(d)(5).

(iii) The proposed regulations state that an option will be considered terminated only if the grantor receives cash or other trust assets equal in value to the greater of the required annuity payment plus interest computed under section 7520 or the fair market value of the option. Prop. Reg. section 25.2702-3(d)(5)(B).

(iv) The proposed regulations became effective September 5, 2000. For trusts created after September 29, 1999, the trust instrument must prohibit the trustee from issuing a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation.

d. Loans

Prior to the Proposed Regulations another payment technique included a loan by the grantor or a third party to the GRAT. In light of the new regulations, this technique would be risky as the IRS would look closely at the transaction and may apply the "step-transaction" doctrine.

7. Varying Annuity Payments

Depending on the circumstances and the type of assets transferred to the GRAT/GRUT, adjusting the qualified interest payment can be a useful tool, so long as the increase/ decrease in each payment does not exceed 120% of the fixed payment (or fixed percentage in the case of a GRUT) of the preceding year. If there is a possibility of the grantor's death during the term, initial payments would be higher and therefore minimize the amount included in the grantor's estate. On the other hand, with

appreciating assets, lower payments in the early years could enhance the value of the GRAT since the burden of making the payments would not drain the trust.

8. Sale of A Remainder Interest

As indicated above, generation-skipping transfer tax exemption cannot be allocated to the remainder of the GRAT until the end of the ETIP (when the GRAT terminates and the remainder has considerable value). How can you leverage generation-skipping transfer tax exemption under a GRAT gift? Sell the remainder interest to a GST Trust. There are many issues involved in the sale of a remainder interest and such issues are outside the scope of this article; however, if a GRAT beneficiary sells the remainder interest in the GRAT to a GST trust early on in the existence of the GRAT for fair market value (that is, the value of the right to receive assets in the future considering all applicable factors), the wealth migration and tax exemption leveraging of the intentionally defective grantor trust compares nicely with the GRAT remainder interest sale. Due consideration, however, should be given to the Service's current position on any attempt to thwart the application of the generation-skipping transfer tax where a remainder interest in a CLAT is gifted by a non-skip person to a skip person, including a generation-skipping trust. PLR 200107015.

J. Personal Residence Exceptions – Personal Residence Trust (PRT) and Qualified Personal Residence Trust (QPRT)

The regulations provide that two types of trusts (PRT and QPRT) qualify for the statutory personal residence exception for purposes of transfers with a retained interest. Treas. Reg. §25.2702-5. When the specific requirements of the PRT and QPRT are satisfied, the value of the grantor's retained right to use the residence during the term of the trust and the value of the grantor's contingent reversionary interest may be subtracted in determining the amount of the gift when the trust is created. If the grantor survives the end of the trust term, the value of the residence is removed from the grantor's estate. The transferor may create only two trusts that are personal residence trusts or qualified personal residence trusts. For this purposes, trusts holding fractional interests in the same residence are treated as one trust. Treas. Reg. §2702-5(c).

1. Personal Residence

Certain requirements must be met for either a personal residence trust or a qualified personal residence trust.

a. In General

A personal residence is either (i) the principal residence of the term holder (within the meaning of section 1034); (ii) one other residence of the term holder [within the meaning of section 280A(d)(1)] but without regard to section 280A(d)(2); or (iii) an undivided fractional interest in either. Treas. Reg. §25.2702-5(b)(i). Specifically, the principal residence must be "physically occupied" by the taxpayer. Treas. Reg. §1.1034-1(c)(3)(i). "Other residence" must be occupied each year for at least the greater of fourteen days or 10% of the days the residence is rented at fair market value. Treas. Reg. §25.2072-5(d).

b. Additional Property

A personal residence may include appurtenant structures used for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location). Treas. Reg. §25.2702-5(b)(2)(ii).

(i) The fact that a residence is subject to a mortgage does not affect its status as a personal residence.

(ii) The term personal residence does not include any personal property (e.g., household furnishings).

c. Use Of Residence

A personal residence must be used as the term holder's residence when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements because a portion of the residence is used in an activity meeting the requirements of section 280A(c)(1) or (4) business use/day care services, provided that such use is secondary to use of the residence as a residence. A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services are provided in connection with the provision of lodging (e.g. a hotel or a bed and breakfast). A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence. Treas. Reg. §25.2702-5(b)(2)(iii).

d. Sale Of Residence

The trust must prohibit the sale or transfer of the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse, at any time after the original term interest during which the trust is a grantor trust. A sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse. Treas. Reg. §25.2702-5(a)(1) and §25.2702-5(c)(9).

e. Interests Of Spouses In The Same Residence

If spouses hold interests in the same residence (including community property interests), the spouses may transfer their interests in the residence (or a fractional portion of their interests in the residence) to the same personal residence trust, provided that the governing instrument prohibits any person other than the one of the spouses from holding a term interest in the trust concurrently with the other spouse. Treas. Reg. §25.2702-5(b)(2)(iv).

f. Qualified Proceeds

Qualified proceeds means the proceeds payable as a result of damage to, or destruction or involuntary conversion (within the meaning of section 1033) of, the residence held by a personal residence trust, provided that the governing instrument requires that the proceeds (including any income thereon) be reinvested in a personal residence within two years from the date on which the proceeds are received. Treas. Reg. §25.2702-5(b)(3).

g. Modification Of Trust

A trust that does not comply with one or more of the regulatory requirements under §25.2702-5(b) and (c) will, nonetheless, be treated as satisfying these requirements if the trust is modified, by judicial reformation (or nonjudicial reformation if effective under state law), to comply with the requirements. The reformation must be commenced within 90 days after the due date (including extensions) for the filing of the gift tax return reporting the transfer of the residence under section 6075 and must be completed within a reasonable time after commencement. If the reformation is not completed by the due date (including extensions) for filing the gift tax return, the grantor or grantor's spouse must attach a statement to the gift tax return stating that the reformation has been commenced or will be commenced within the 90-day period. Treas. Reg. §25.2702-5(a)(2).

2. Personal Residence Trust

a. In General

A personal residence trust is a trust the governing instrument of which prohibits the trust from holding, for the original duration of the term interest, any asset other than one residence to be used or held for use as a personal residence of the term holder and qualified proceeds. Treas. Reg. §25.2702-5(a).

b. Residence Occupancy

A residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence. Treas. Reg. §25.2702-5(b)(1).

c. Transfer Prohibited

A trust does not meet the requirements of this section if, during the original duration of the term interest, the residence may be sold or otherwise transferred by the trust or may be used for a purpose other than as a personal residence of the term holder. Treas. Reg. §25.2702-5(b)(1).

d. Trust Expenses

Expenses of the trust whether or not attributable to trust principal may be paid directly by the term holder of the trust. Treas. Reg. §25.2702-5(a)(1).

3. Qualified Personal Residence Trust.

a. In General

A Qualified Personal Residence Trust (QPRT) is similar to a PRT but with more flexibility. The essential difference is that the QPRT is permitted to hold assets other than the personal residence for certain periods of time.

b. Income Of The Trust

The governing instrument must require that any income of the trust be distributed to the tem holder not less frequently than annually. Treas. Reg. §25.2702-5(c)(3).

c. Distributions From The Trust To Other Persons

The trust must prohibit distributions of corpus to any beneficiary other than the transferor prior to the expiration of the retained term interest. Treas. Reg. §25.2702-5(c)(5).

d. Trust Assets

Except as outlined below, the trust must prohibit the trust from holding, for the entire term of the trust, any asset other than one residence to be used or held for use as a personal residence of the term holder.

(i) The trust document may permit additions of cash to the trust, and may permit the trust to hold additions of cash in a separate account, in an amount which, when added to the cash already held in the account for such purposes, does not exceed the amount required:

(a) for payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be paid by the trust within six months from the date the addition is made;

(b) for improvements to the residence to be paid by the trust within six months from the date the addition is made; and

(c) for purchase by the trust of the initial residence, within three months of the date the trust is created, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence; and

(d) for purchase by the trust of a residence to replace another residence, within three months of the date the addition is made, provided that no addition may be made for this purpose, and the trust may not hold any such addition, unless the trustee has previously entered into a contract to purchase that residence. Treas. Reg. §25.2702-5(c)(ii)(A).

(ii) If the trust permits additions of cash to the trust, the trust must require that the trustee determine, not less frequently than quarterly, the amounts held by the trust for a payment of expenses in excess of the amounts permitted to be held and must require that those amounts be distributed immediately thereafter to the term holder. In addition, the trust must require, upon termination of the term holder's interest in the trust, any amounts held by the trust that are not used to pay trust expenses due and payable on the date of termination (including expenses directly related to termination) be distributed outright to the term holder within 30 days of termination. Treas. Reg. §25.2702-5(c)(5)(ii)(A)(2).

(iii) The trust may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided that the residence, as improved, meets the requirements of a personal residence. Treas. Reg. §25.2702-5(c)(5)(ii)(B).

(iv) The trust may permit the sale of the residence, subject to Treas. Reg. §25.2702-5(c)(9), (see X.A.4. above), and may permit the trust to hold proceeds from the sale of the residence in a separate account. Treas. Reg. §25.2702-5(c)(5)(ii)(C).

(v) The trust document may permit the trust to hold one or more policies of insurance on the residence. In addition, the trust may hold, in a separate account, proceeds of insurance payable to the trust as a result of damage to or destruction of the residence. For purposes of this paragraph, amounts (other than insurance proceeds payable to the trust as a result of damage to or destruction of the residence) received as a result of the involuntary conversion (within the meaning of section 1033) of the residence are treated as proceeds of insurance.

e. <u>Commutation</u>

The trust must prohibit commutation (prepayment) of the term holder's interest. Treas. Reg. §25.2702-5(c)(6).

f. <u>Cessation Of Use As A Personal Residence</u>

(i) The trust document must provide that a trust ceases to be a qualified personal residence trust if the residence ceases to be used or held for use as a personal residence of the term holder. A residence is "held for use" as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

(ii) The trust must provide that it ceases to be a qualified personal residence trust upon sale of the residence if the trust does not permit it to hold proceeds of sale of the residence. If the trust permits it to hold proceeds of sale pursuant to the paragraph, the trust must provide that it ceases to be a qualified personal residence trust with respect to all proceeds of sale held by the trust not later than the earlier of:

(a) the date that is two years after the date of sale;

(b) the termination of the term holder's interest in the trust; or

(c) the date on which a new residence is acquired by the trust. Treas. Reg. §25.2702-5(c)(7)(ii).

(iii) Damage to Or Destruction of Personal Residence

See VII.C.4.e. above.

g. Disposition Of Trust Assets On Cessation As Qualified Personal Residence Trust

(i) The trust agreement must provide that, within 30 days after the date on which the trust has ceased to be a qualified personal residence trust with respect to certain assets, either

(a) the assets be distributed outright to the term holder;

(b) the assets be converted to and held for the balance of the term holder's term in a separate share of the trust meeting the requirements of a qualified annuity interest; or

(c) in the trustee's sole discretion, the trustee may elect to comply with either (a) or (b) above. Treas. Reg. §25.2702-5(c)(i).

(ii) In order for the trustee to be able to elect to convert the trust into a qualified annuity trust upon cessation of use of the personal residence, the trust agreement must contain all the requirements for a qualified annuity interest. Treas. Reg. §25.2702-3.

(iii) The trust agreement must provide that the right of the term holder to receive the annuity amount begins on the date of sale of the residence, the date of damage to or destruction of the residence, or the date on which the residence ceases to be used or held for use as a personal residence, as the case may be ("the cessation date"). However, the trust instrument may provide that the trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the assets are converted to a qualified annuity interest ("the conversion date"); provided that any deferred payment must bear interest from the cessation date at a rate not less than the section 7520 rate in effect on the cessation date. The trust may permit the trustee to reduce aggregate deferred annuity payments by the amount of income actually distributed by the trust to the term holder during the deferral period. Treas. Reg. §25.2702-5(c)(8)(ii)(B).

(iv) The trust must require that the annuity amount be no less than the amount described below.

(a) If, on the conversion date, the assets of the trust do not include a residence used or held for use as a personal residence, the annuity may not be less than an amount determined by dividing the lesser of the value of all interests retained by the term holder (as of the date of the original transfer or transfers) or the value of all the trust assets (as of the conversion date) by an annuity factor determined.

(i) For the original term of the term holder's interest; and

(ii) At the rate used in valuing the retained interest at the time of the original transfer. Treas. Reg. §25.2702-5(c)(8)(ii)(C)(2).

(b) If, on the conversion date, the assets of the trust include a residence, so that the trust does not cease entirely as a qualified personal residence trust, the annuity will be a portion of the annuity amount described above as if the entire trust were terminated. The portion is determined by multiplying the amount determined above by the Excess of the FMV of trust assets on conversion date less the fair market value of assets as to which the trust continues as a QPRT
Treas. Reg. §25.2702-5(c)(8)(i)(C)(3).

4. Planning Considerations

Due to the greater flexibility of the qualified personal residence trust over the personal residence trust, the qualified personal residence trust will almost always be used. The QPRT can be an excellent planning tool to transfer the taxpayers' residence to their children at an extremely low transfer tax cost. The main disadvantage is that the transferor must be willing to give up the residence at the end

of the trust term. The transferor can make arrangements to rent the residence but only after the expiration of the term. Any predetermined arrangement may make section 2036 apply.

a. Homestead Exemption

Texas Trust Code provides that the QPRT will not disqualify the property for the homestead exemption during the term of the trust when the trustor has the right to use the property rent-free as a principal residence. Texas Trust Code §§11.13(j), 11.26(f), 25.135, 32.07(c).

V. INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

A. Introduction

1. From an income tax standpoint the grantor trust rules have been around in one form or another since the mid 1920s. Their use from an estate planning standpoint can be traced more recently to two income tax rulings, Rothstein v. United States, 735 F.2d 704 (2nd Cir. 1984) and Revenue Rule 85-13, 1895-1 C.B. 184.

2. In Rothstein the court held that the grantor was the owner of a trust under section 675(3) of the Code because by exchanging an unsecured note for the entire trust corpus, the grantor had indirectly borrowed the trust corpus. The court held further, however, that although the grantor must be treated as the owner of the trust, this means only that the grantor must include items of income, deduction, and credit attributable to the trust in computing the grantor's taxable income and credits, and that the trust must continue to be viewed as a separate taxpayer. The court held, therefore, that the transfer of trust corpus to the grantor in exchange for an unsecured promissory note was a sale and that the taxpayer acquired a cost basis in the assets.

3. In Revenue Rule 85-13, the Service chose not to follow Rothstein. In Rev. Rule 85-13, the taxpayer created an irrevocable trust with his spouse as Trustee. The trust was for the benefit of the taxpayer's child for a term of 15 years and upon the expiration of the term, trust assets were payable to the taxpayer's child or the estate of taxpayer's child. The taxpayer funded the trust with stock. A year later, the Trustee exchanged with stock with a unsecured promissory note issued by the taxpayer. The taxpayer subsequently sold the stock. The Service held that taxpayer's receipt of the entire corpus of the trust in exchange for taxpayer's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused the taxpayer to be the owner of the entire trust under section 675(3) of the Code. Further, that at the time the taxpayer became the owner of the trust, taxpayer became the owner of the trust property. As a result, the transfer of trust assets to taxpayer was not a sale for federal income tax purposes and taxpayer did not acquire a cost basis in those assets. Accordingly, when taxpayer sold the shares of stock, taxpayer's gains was based on the carryover basis in such stock. Further, this holding would apply even if the trust held other assets in addition to the promissory note if taxpayer, under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory note because taxpayer would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction. Revenue Rule 85-13, 1895-1 C.B. 184. While this ruling was an income tax ruling, its holding has gift implications in that if the sale was made to the trust, the taxpayer does not recognizes gain.

B. What is the Intentionally Defective Grantor Trust?

The intentionally defective grantor trust ("IDGT") is an irrevocable trust under which the grantor (or in some instances the beneficiary) is treated as the owner of the trust for income tax purposes by intentionally subjecting itself to provisions under the grantor trust rules of IRC. §§671-679, but the grantor is not treated as the owner for estate, gift or generation-skipping tax purposes. The benefit of creating the IDGT under which the grantor must include in taxable income items of income, deductions and credits of the trust and pay tax on such amount, is that the amount of the tax paid is the equivalent of a tax free gift to the extent such amount is not reimbursed. Further, the tax treatment of the IDGT allows

for transfers between the grantor and the trust which do not cause income taxation upon the transfer allowing the grantor to shift future appreciation over the repayment costs to the trust and its beneficiaries.

C. Creating the IDGT

As we read earlier there are numerous provisions and circumstances which create a grantor trust. The IDGT utilizes those provisions which cause the grantor to be treated as owner for income tax purposes but not estate tax purposes. Further, it is important to select grantor trust powers which can be released by the powerholder so the trust is no longer taxed to the grantor. Below are commonly used grantor trust rules for purposes of creating the IDGT:

1. Nonadverse Trustee Power to Add Beneficiaries

A grantor is treated as owner of the entire trust if a nonadverse trustee has the power, without the approval or consent of an adverse party, to add persons, including charity, other than after-born or after-adopted children to the class of beneficiaries. §674(a). The grantor may be more comfortable with this power if the powerholder and trustee are two different individuals.

2. Power of Appointment

A grantor is treated as owner of the entire trust if a nonadverse party has the power, without the approval or consent of an adverse party, to appoint trust income and principal, exercisable during grantor's lifetime. §674(a).

3. Power to Pay Life Insurance Premiums

A grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be applied to the payment of premiums of insurance on the life of the grantor or the grantor's spouse. §677(a)(3). This power alone may be inadequate for wealth migration purposes and utilizing the IDGT. Cases decided under the predecessor to IRC 677(a)(3) held that the grantor is taxable only on trust income actually used to pay premiums.

4. Right to Substitute Assets

A grantor is treated as the owner of any portion of the trust over which the grantor has retained the right, exercisable in a nonfiduciary capacity, to reacquire trust assets by substituting assets of equivalent value. §675(4). There is a concern that this power creates a risk of estate inclusion; however, the Service has ruled that no such inclusion will occur merely because of the retention of a right to substitute assets, based on the Tax Court's holding in Jordahl Estate v. Commissioner. 65 T.C. 92 (1975, acq., 1977-1 C.B.1. To avoid this risk, one may grant the right to a party other than the grantor. Section 675(4)(C) taxes the grantor if the power to substitute assets is held "by any person."

5. Power to Borrow

The power of a grantor or a nonadverse party or both that enables the grantor to borrow from the trust without adequate interest or adequate security will cause the portion of the trust subject to such power to be treated as owned by the grantor, except where a trustee is otherwise given the right to make the loans under a general lending power. §675(2). As long as the power extends to the entire trust, the donor should be treated as the owner of the entire trust.

D. IDGT Taxation

As stated above, a properly drafted intentionally defective grantor trust will make the grantor liable for the income tax generated from the income of the trust. The tax liability belongs to the grantor, not the trust. However, it is possible to give the trustee of the intentionally defective trust, so long as such trustee is not related or subordinate to the grantor as defined in §672, the sole and absolute discretion to make distributions to the Internal Revenue Service (or similar state agency) in order to satisfy any federal

or state income tax liability incurred by the grantor which is attributable to income of the intentionally defective grantor trust. PLR 200120021.

E. IDGT Sale

Rather than establishing a GRAT as outline above to migrate wealth by gift to between generations, the grantor might want to sell the desired asset to an IDGT (one containing one or more of the grantor trust powers listed above) in sale transaction in exchange for an installment note, self-canceling installment note or private annuity. In this manner, the grantor is able to transfer the future appreciation of the asset without income or gift tax consequences.

1. Installment Sale Requirements

If the IDGT promissory note sale technique is to be effective and not treated as a transfer with a retained life estate causing inclusion under IRC §2036(a)(1) or a transfer with a retained interest under §2702, the transaction must be structured as a bona fide sale. The sales transaction should satisfy the following:

a. The rate of interest under the promissory note should not be based upon the income generated by the asset sold.

b. The obligation under the promissory note should not be charged to the transferred property.

c. The promissory note should be a personal obligation of the purchaser.

The first test is satisfied from the use of the AFR. Further, the Tax Court has held that if a note is given in exchange for property carries an interest rate equal to the AFR and is equal in value to the amount of the property sold, then the note is equivalent to the property. Frazee v. Commissioner, 98 T.C. 554 (1992).

2. Coverage

a. In order for the installment sale to be respected as a bona fide sale, the IDGT must have independent significance. That is, for the trust to be respected, the trust must have sufficient assets such that an independent third party would transact with the trust. The greater the value of assets within the IDGT, the better. However, the Service has indicated informally that other assets equal in value or exceeding ten percent (10%) of the purchase price should be sufficient coverage for underlying significances.

b. Coverage or independent significance is created by either a taxable gift by the grantor or personal guarantee by the trust beneficiaries. The Service has indicated that a personal guarantee by the beneficiaries is effective to avoid application of §2036(a)(1) to the seller, so long as the guarantors have sufficient assets to support the guarantee. PLR 9515039.

3. When to Consider the IDGT Sale Transaction

In most wealth migration transfers the goal is to reduce or freeze the value of the grantor's estate and shift future income and growth out of the estate. With this goal in mind, the IDGT/sale transaction should be considered when the grantor owns an appreciating asset. In addition to the appreciating asset, the discounted asset (limited partnership interests, minority stock, non-voting stock and undivided interests) are key assets to transfer. When identifying the asset to be transferred, it is necessary for the asset to produce cash flow, the IDGT to have existing cash flow or other assets be available for distribution in kind so that payments can be made by the trust on the promissory note, SCIN or private annuity.

4. Consideration

The asset to be sold to the IDGT can be sold in exchange for a promissory note, self-canceling installment note, or private annuity.

a. Promissory Note

If a standard promissory note is used, the asset is sold to the IDGT in exchange for the promissory note secured by the IDGT assets. The note would provide for periodic (at least annual) payments. Income generated by the asset sold or other IDGT assets would be utilized to make the note payments.

b. Self-Canceling Installment Note

An additional payment mechanism for use with an IDGT sale is the self-canceling installment note or "SCIN." The SCIN is an installment note that contains a provision under which the buyer's obligation to pay automatically ceases in the event a specified person, called the measuring or reference life, dies before the end of the term of the note. Income generated by the asset sold or other IDGT assets would be utilized to make the SCIN payments. The SCIN can be an effective means of transferring property to family members without estate or gift tax consequences in the event of the death of the seller-transferor before the last payment has been made under the terms of the installment note.

c. Private Annuity

Under a private annuity an agreement is executed between the transferor/annuitant and the transferee/buyer (the IDGT). The agreement requires the transferee/buyer, in exchange for the transfer, to make periodic payments to the transferor/annuitant for a specific period of time (usually the lifetime of the transferor or the transferor and transferor's spouse). The private annuity is a useful federal estate tax savings tool because payments end when the transferor dies and the entire value of the asset sold is immediately removed from the transferor's gross estate. Income generated by the asset sold or other IDGT assets would be utilized to make the annuity payments.

5. Tax Consequences of IDGT/Sale Transaction

a. Income Tax

When a grantor enters into a transaction with a trust under which he or she is deemed the owner for income tax purposes, and therefore all items of income and deduction related to the transaction are attributed to the grantor, the result is a none taxable event. Rev.Rule 85-13; Rothstein, supra. Specifically, the sale of stock by a grantor to a grantor trust for a note will not give rise to taxable income. PLR 9535026. Remember, however, that the grantor is taxed on all income earned by the assets of the trust.

b. Gift Tax

Except for the initial coverage gift, there are no gift tax consequences to the grantor under the IDGT sale transaction. However, the grantor trust rules require that the income tax generated by the trust assets be payable by the grantor. Because the income will not be actually distributed to the grantor to pay the taxes, the grantor's estate is reduced by the amount of the tax while the trust is enhanced by such amount. This result does not sit well with the Service. In the GRAT context in PLR 9444033 the Service implied that the grantor's payment of the income taxes could represent a gift to the remaindermen and a constructive addition to the trust for generation-skipping transfer tax purposes. Later, in PLR 9543049, the Service withdrew the implication without comment. It is clear from the language of §671 that the grantor has the legal obligation for the payment of the tax. The Service's position has neither statutory nor regulatory authority.

c. Estate Tax

The primary goal of the transaction is to shift future appreciation from the estate (estate freeze). If the grantor dies while the promissory note remains outstanding, the value of the balance of the note will be includable in grantor's gross estate.

(i) Promissory Note

The taxation that occurs when the grantor dies and IDGT still holds an unpaid promissory can be summed up in four words: avoid it if possible! If possible, it is wise for the IDGT to pay off any promissory note owed to the grantor prior to death. This, of course, cannot always be accomplished. There are several theories regarding the income tax results at the death of the grantor if the promissory note has not been paid. The issue to be determined is when, for income tax purposes, did the transfer of the assets received for the promissory note from the grantor to grantor's estate occur. If the transfer is deemed to have occurred immediately prior to death, then gain is reported on the decedent's final income tax return to the extent the value of the note exceeds the decedent's basis in the property sold to the IDGT. If the sale would qualify for installment treatment under IRC §453, gain or loss is reported on the decedent's estate's annual income tax return as payments on the note are received. In this instance, gain would be deemed income in respect of a decedent and no basis adjustment would occur. Another theory is that pursuant to the rationale in United States v. Land, 303 F.2d 170 (5th Cir. 1962), one must look a the instant of death as the triggering event. This lead to the conclusion that a transfer could not have occurred immediately prior to death, but by reason of death. Therefore, since the seller of property is not the decedent but his or her estate, the provisions of IRC §1014(a) would apply to revalue the basis of the asset and no gain or loss would apply. Finally, there is the Rev. Rule 85-13 argument that all the estate owns at the decedent's death is a note which receives a basis adjustment, that the assets in the trust were always owned by the trust at the grantor's basis upon transfer of the assets to the trust. Sederhaun and Hunder, Reversal of Fortune: The Use of Grantor Trust in Estate Planning, The Chase Journal, VII, Issue 4 1998).

(ii) SCIN

The value of the self-canceling installment note is zero in the grantor's gross estate if he or she dies during its term; however, the grantor must recognize unrealized gain on his or her first estate income tax return as a cancellation of an installment obligation.

(iii) Private Annuity

The value of the private annuity is zero in the grantor's estate upon his or her death. Remember, the private annuity has no term other than the life of the grantor so if the grantor lives longer than his or her actuarial life there is more value in the grantor's estate than under the promissory note or SCIN.

F. Case Law Update

As discussed earlier, unlike the GRAT or GRUT the IDGT sale is not specifically authorized under the code. Rather, the transaction theory is established utilizing the grantor trust rules under §671 – 678. Additionally, there is very little case law guidance on the IDGT sale. The most recent case is Karmarzin v Commission, Tax Court # 2127-03, which is pending in the Tax Court. The Internal Revenue Service is challenging the partnership valuation and formula clause in the IDGT sale. In Karmarzin, the Grantor and her two children formed a Family Limited Partnership. The Grantor owned a 99% limited partnership interest and each child owned a .5% limited partnership interest. The Grantor entered into three separate transactions:

1. She created a two year GRAT and funded it with limited partnership interests (an interesting note is that the GRAT itself is not challenged rather the challenge is the value of the limited partnership interest given).

2. She made a gift in trust of limited partnership interests.

3. She sold "that number of limited partnership units having a fair market value of X" to an IDGT. The sale was made for a twenty year promissory note with semi-annual payments of $50,000 at 5.8% per year. The trust pledged all of the limited partnership interests as collateral.

The Service attacked the transaction with full force by:

1. Disregarding the partnership due to the lack of an arms length bargaining among the partners, no business activity, lack of substance, lack of business purpose, and failure to meet with the requirements of §2703 (A)(2).

2. Disregarding the formula clause.

3. Classifying the debt as equity citing §2701 and 2702, and citing a lack of personal guarantees and cash flow.

4. Stating that if the transaction succeeded and the partnership was valid, then a discount of 3% would be applicable.

5. Finally, the service also stated that the Grantor was not entitled to annual exclusion deductions citing the recent decisions in Hackl v Commissioner.

On October 15, 2003, Judge Wells of the U. S. Tax Court approved the settlement between the IRS and the Taxpayer in which it was agreed that:

1. The sale of partnership units to the grantor trust was respected as a bona fide sale;

2. The transaction was not characterized as a transfer of units followed by a reservation of an annuity, as originally asserted by the Agent.

3. The interest payments paid by the trust to the taxpayer were characterized as interest, and not as an annuity.

4. Neither Section 2701 nor 2702 is applicable to the transaction.

5. For purposes of the settlement, the sale price was based upon units sold for a discounted value of 37%. Units were originally appraised by Management Planning with a 42% discount.

6. The self-adjusting clause in the Sales Agreement was determined to be invalid for purposes of the settlement ("that number of units equal to a value of 'x'").

When implementing the IDGT sale the conservative approach would be to seed the trust with an asset other than the asset to be sold. Secondly, use personal guarantees by the beneficiaries. Finally, make sure the transaction works, that is, will the trust be able to satisfy the debt obligation terms.