I'd like to again give a special thanks to attorney **Michael D. Mulligan** for allowing me to put his IDGT summary out there for advisors to read. I think you'll find his summary understandable and I hope it will help you identify clients who you can introduce IDGTs to in an effort to help them accomplish their estate planning goals.

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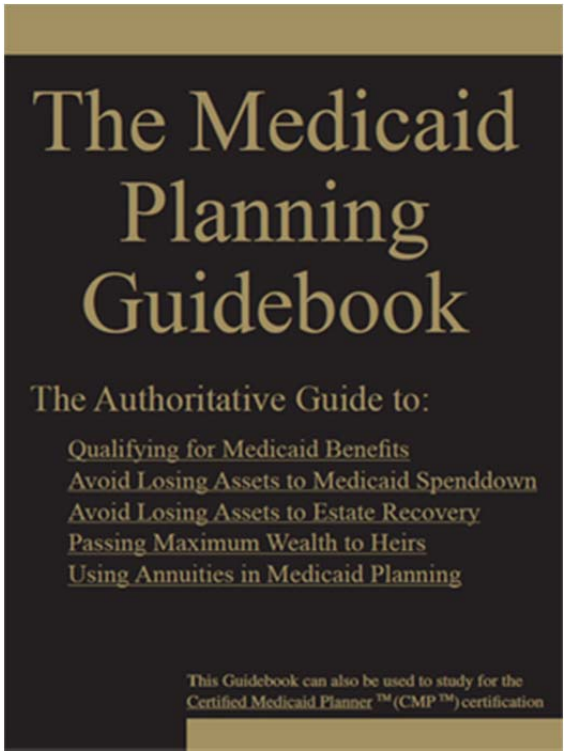

FIFTEEN YEARS OF SALES TO IDITs - WHERE ARE WE NOW?

by

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When I started working on this article, I thought I was writing it with my partner, Jaime R. Mendez. As we completed the article, however, Jaime told me that he did not feel he had contributed enough to be identified as a co-author. I very much disagree, but respect his wishes. I do, however, wish to thank Jaime for all of his help, attention and hard work in putting this article together - and, most of all, for his friendship.

I would also like to express my thanks to Jerome M. Hesch for his contributions to this article, especially the discussion in Section VII. Although I disagree with Jerry's position on one issue discussed in Section VII, he has been (as usual) very generous with his time.

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I. Introduction.

It is approaching fifteen years since the article first discussing the sale to IDIT technique was published.[1] This article examines the technique in the context of experience over that time.

II. Structure of Sale to IDIT Transaction.

The term an Intentionally Defective Irrevocable Trust ("IDIT") describes a particular type of trust. The existence of an IDIT apart from its grantor is recognized for estate, gift and generation-skipping tax purposes, but not for income tax purposes. Any uncompensated transfer to an IDIT constitutes a gift. The assets of an IDIT are not included in the estate of its grantor at death.

The position of the Internal Revenue Service ("IRS") is that an IDIT does not exist for federal income tax purposes.[2] All income of an IDIT, including capital gain, is taxed directly to its grantor. A sale of appreciate property to an IDIT causes no recognition of gain. Interest on a promissory note paid by an IDIT to its grantor is not taxed to the grantor or deductible by the IDIT. For income tax purposes, such interest is ignored. An IDIT has the option to use the social security number of its grantor as its tax identification number.[3]

The sale to an IDIT technique involves a grantor establishing an IDIT and selling assets to the IDIT in exchange for the IDIT's promissory note. The IRS has asserted in litigation that IRC Sec. 7872 applies to a promissory note given in a sale transaction, and that if, pursuant to IRC Sec. 7872(f), a promissory note bears interest at the applicable Federal rate under IRC Sec. 1274, it has a gift tax value equal to its face amount. This position has been accepted by the Tax Court.[4] The sale to an IDIT is a mechanism by which equity can be converted into debt without income tax consequences.

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[1] Mulligan, *Sale to a Defective Trust: An Alternative to a GRAT,* 23 Est. Plan. No. 1, 3 (1996).

[2] Rev.Rul. 85-13, 1985-1 C.B.184.

[3] Treas.Reg.Secs. 671-4(b)(2)(i)(A) and 301.6109-1(a)(2)(i)(B).

[4] *Frazee v. Commissioner,* 98 T.C. 554 (1992); *Estate of True v. Commissioner,* 82 T.C.M 27 (2001), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004). *See also* Ltr. Ruls. 9408018 and 9535026.

Under IRC Sec. 7872(f)(2)(A), the applicable Federal rate for a term loan is the rate in effect under IRC Sec. 1274(d) as of the date upon which the loan is made. IRC Sec. 1274(d)(2) establishes a special rule for determining the applicable Federal rate for a sale or exchange. Under IRC Sec. 1274(d)(2), the applicable Federal rate is the lowest of the interest rates for the month in which there is a binding contract for the sale or exchange, and the two immediately preceding months. Because a lower interest rate on an IDIT's promissory note reduces the value of the seller's estate, it is tempting to make use of the IRC Sec. 1274(d)(2) exception when the applicable Federal rate for one of the two months preceding the month of sale is lower than the rate for the month of sale.

IRC Sec. 1274(d) is an income tax statute. As noted in the discussion with note 2, *supra*, the IRS takes the position that transactions between a grantor trust and its grantor are not recognized for income tax purposes. It is conceivable that the IRS might apply this position to assert that a sale to an IDIT is not a sale or exchange for purposes of IRC Sec. 1274(d)(2). In most cases, the variation in the interest rates over the three month period described in IRC Sec. 1274(d)(2) is unlikely to be substantial. It would seem advisable not to risk challenge by the IRS and use the applicable Federal rate for the month of sale and not either of the two preceding months.

In the sale of difficult to value assets to an IDIT, the sales documents might describe the quantity of an asset being sold through the use of a formula expressing that quantity as a dollar amount rather than as a number or percentage of units *e.g.*, as $X worth if ABC, Inc. stock rather than XX number of shares of ABC, Inc. stock. Recent cases indicate that the courts might recognize the effectiveness of such a formula to eliminate any gift if the IRS successfully argues that the assets being sold to the trust have a greater per unit value than contemplated in the sale transaction.[5] In such event, the formula operates to reduce the number or percentage of units transferred so that the dollar amount transferred remains constant. If the effectiveness of the formula is recognized, the reduction in units transferred avoids a gift.

Similar to a grantor retained annuity trust, or GRAT, the sale to an IDIT technique produces an estate tax savings if the assets sold to the IDIT produce a total return (net income

[5] *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008); *aff'd* 586 F.3d 1061 (8th Cir. 2009); *Petter v. Commissioner*, 98 T.C.M. 534 (2009).

plus appreciation) which exceeds the interest on the IDIT's promissory note. In such case, the excess return is trapped inside the IDIT and excluded from the seller's estate. This result is easier to produce with an IDIT than with a trust which is a separate taxpayer. With an IDIT, the grantor pays all taxes due on income and capital gain generated by the assets of the IDIT. The IDIT's return on assets is not reduced by income tax liability.

Although the grantor's payment of taxes on an IDIT's income can be viewed as an indirect transfer increasing the value of an IDIT, the IRS ruled in Rev.Rul. 2004-64[6] that such payment does not constitute a transfer subject to gift tax. Rev. Rul 2004-64 permits a grantor to pay taxes on income which is not in the grantor's estate without having such payment being treated as a gift.

The sale to IDIT technique also produces favorable generation-skipping tax results. If the IDIT to which a sale is made has an inclusion ratio of zero for generation-skipping tax purposes and if the value of assets sold to the IDIT does not exceed the face amount of the promissory note which the seller receives in the sale, then the sale does not change the IDIT's inclusion ratio. In this case, any assets which are excluded from the seller's estate for Federal estate tax purposes are also insulated from generation-skipping tax. The significant point is that this insulation occurs without any allocation of additional GST exemption.

III. Avoiding IRC Secs. 2702 and 2036(a)(1).

Two statutes to be avoided in a sale to an IDIT are IRC Secs. 2702 and 2036(a)(1). Each of these statutes produces an unfavorable tax result for certain retained interests in transferred property.

A. The Fidelity-Philadelphia Trust Co. Case.

IRC Sec. 2702 provides that, for purposes of valuing a transfer to a trust for the benefit of a member of the transferor's family, any interest in the trust retained by the transferor is valued at zero unless it is a qualified interest defined in IRC Sec. 2702(b). IRC Sec. 2702 is the statutory basis for the GRAT.

A promissory note received in a sale to an IDIT would rarely, if ever, satisfy the requirements of IRC 2702 and the regulations issued under that statute. If the promissory note were deemed to be an interest in the IDIT, its value would be zero for gift tax purposes and the

[6] 2004-2 C.B. 7.

seller would be deemed to have made a gift to the IDIT equal to the fair market value of the property transferred to the IDIT in the sale transaction, unreduced by the amount due under the promissory note.

IRC Sec 2702 was enacted as a part of the Omnibus Budget Reconciliation Act of 1990. There are no reported decisions on the issue of whether a promissory note received by a seller in a sale to IDIT transaction is a retained interest under IRC Sec 2702. There are cases under IRC Sec 2036(a)(1) involving sales. These cases should be relevant to IRC Sec 2702, since both IRC Secs. 2036(1)(1) and 2702 deal with the consequences of retained interests in transferred property. The IRS has applied the authorities under IRC Sec 2036(a)(1) in examining the treatment of a sale under IRC Sec 2702.[7]

IRC Sec. 2036(a)(1) includes in a decedent's gross estate a transfer (other than a bona fide sale for adequate and full consideration) under which the decedent retained the possession or enjoyment of, or the right to income from the transferred property. The United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith*,[8] established the tests for determining whether a sale providing for periodic payments of the purchase price is to be recognized as a sale and not treated as a transfer to which IRC Sec. 2036(a)(1) applies. Rev.Rul. 77-193.[9] applied the tests established by *Fidelity-Philadelphia Trust Co.* to a sale by the decedent, A, of timber rights to B for a series of unsecured promissory notes. One month after the sale to B, A conveyed the underlying real estate to C. One promissory note remained unpaid at the time of A's death. Rev.Rul. 77-193 held that the real estate was not includable in A's gross estate, stating:

> "In addition, since B's promise to pay for the timber rights is a personal obligation of B as transferee, the obligation is not chargeable to the transferred property, and the payments are wholly independent of whether or not the transferred property produces income for the transferee. Thus, no part of the transferred property is includable in the transferor's gross estate under section 2036(a)(1) of the Code. See the following footnote in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274, 280 (1958), 1958-1 C.B. 557, 559:
>
> `Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for

[7] Ltr. Rul. 9535026.

[8] 356 U.S. 274 (1958).

[9] 1977-1C.B. 273.

> his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. E.g., *Estate of Sarah A. Bergan*, 1 T.C. 543, *Acq*. 1943 Cum.Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 1929, 35 F.2d 982, 68 Ct.Cl. 508; cf. *Welch v. Hall*, 1 Cir. 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.'
>
> "Accordingly, it is held that section 2036 of the Code does not apply . . ."

The first test enunciated by the Supreme Court in *Fidelity-Philadelphia Trust Co.* seems relatively easily satisfied. The interest rate in a sale to IDIT transaction is set pursuant to IRC Sec. 7872(f), and is not based upon the income generated by the assets sold to the IDIT.

The other two tests of *Fidelity-Philadelphia Trust Co.* should be satisfied if the IDIT has assets other than those sold to the IDIT in the sales transaction available to satisfy the promissory note. The other assets afford a cushion of equity to support the note. The IRS has indicated informally that other assets equal to or exceeding 10% of the promissory note should be a sufficient cushion.[10]

One method of creating the cushion is for the seller in the IDIT sale transaction to transfer to the IDIT assets having a value equal to or greater than 10% of the promissory note. This transfer would be subject to gift tax.

B. <u>Guarantees to Create Cushion for Promissory Note.</u>

It appears possible to avoid a gift by the seller through use of a guarantee by one or more beneficiaries of the IDIT.[11] The guarantee could be for the cushion which is determined to be appropriate, e.g. 10% of the indebtedness. The seller's spouse could effect the guarantee, whether or not the spouse is a beneficiary of the IDIT. Any guarantor must have sufficient assets to make good on the guarantee.

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[10] Abbin, *[S]He Loves Me, [S]He Loves Me Not - Responding to Succession Planning Needs Through a Three Dimensional Analysis of Considerations to be Applied in Selecting From the Cafeteria of Techniques*, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1300.1 (1997).

[11] In Lt. Rul. 9515039, the IRS held that a guarantee was sufficient to avoid application of IRC Sec. 2036(a)(1) under the tests of *Fidelity-Philadelphia Trust Co.* so long as the beneficiary had sufficient assets to pay on the guarantee if required to do so.

Although beneficiary guarantees to furnish a cushion in a sale to IDIT transaction may avoid a gift by the seller, the gift tax consequences to a beneficiary making the guarantee are uncertain. There is authority that a gift occurs when a guarantee becomes a legally binding obligation of the guarantor.[12] Although not a certainty, it appears that the IRS would likely treat any gift as a gift by the guarantor to the IDIT rather than to the seller. Even though a payment on the guarantee would not be an addition to the IDIT itself, it would reduce the indebtedness of the IDIT to the seller.

Such a gift could have a number of unfavorable tax consequences. It could, for example, be treated as an addition to the IDIT causing the IDIT not to be wholly owned by the seller under the grantor trust income tax rules. If the guarantor is treated as making an addition to the IDIT by virtue of his or her guarantee, the addition could cause a portion of the IDIT to be includable in the guarantor's estate under IRC Sec. 2036(a)(1).

If the guarantee is treated as a gift to the IDIT, it could also have generation-skipping tax consequences. If the guarantor is a beneficiary of the IDIT and the guarantee causes a portion of the IDIT to be included in the beneficiary's estate under IRC Sec. 2036(a) or 2038, the beneficiary would be precluded by the ETIP rules of IRC Sec. 2642 from allocating GST exemption to the IDIT during his or her lifetime. If the guarantor is the seller's spouse who is a beneficiary of the IDIT, the spouse would be precluded from allocating the spouse's GST exemption to the IDIT during his or her lifetime. In addition, the seller would not be able to allocate any GST exemption to the IDIT, because inclusion of any part of the IDIT in the spouse's estate creates ETIP for the seller.[13]

Potential problems with possible inclusion in the guarantor's estate and ETIP can be eliminated by drafting. A provision in the governing instrument could direct that no distribution is to be made to a guarantor from any asset or portion of an IDIT which is treated for estate, gift or generation-skipping tax purposes as having been added to the IDIT by the guarantor. Such a provision should be effective to cut off a guarantor from any beneficial interest in any portion of the IDIT deemed to have been added to the IDIT by the guarantee. The addition would be

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[12] Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶119.4 [A][2] (1992).

[13] IRC Sec. 2642(f)(4).

deemed to be a gift by the guarantor, but no portion of the IDIT would be included in the guarantor's estate. There would also be no ETIP precluding allocation of GST exemption by the grantor, or if the guarantor is the seller's spouse, by the seller.

There is also authority for the proposition that a gift occurs not when a beneficiary of an IDIT effects the guarantee, but rather when payment is made on the guarantee.[14] It can also be argued that a guarantee of a trust's liability by a beneficiary of the trust does not constitute a gift because it is given to enhance the beneficiary's own financial situation.[15] Risk of the guarantor being treated as making an addition by gift to the IDIT can be reduced by paying the guarantor a fee for the guarantee, e.g., .5% or 1% of the amount guaranteed, payable annually, so long as the guarantee continues in effect. It should be possible to eliminate the guarantee without unfavorable tax consequences if the value of the assets of the IDIT increases sufficiently to create an adequate cushion for the IDIT's note.

As discussed in Section XIV.A., *infra*, a guarantee by a spouse produces the best results if the assets sold to the IDIT decline, rather than increase, in value. As discussed in Section VI.C., *infra*, a guarantor should consider filing a gift tax return reporting the guarantee and taking the position that the guarantee is not a gift.

C. Possible Use of Incomplete Gift to Provide Cushion.

An article suggests a strategy which the article asserts can be used to create a cushion for a sale to an IDIT for purposes of a sale without triggering a gift (the "Incomplete Equity Strategy Article").[16] The Incomplete Equity Strategy Article suggests that an IDIT be structured to consist of two shares. Both shares are held for the benefit of the same beneficiaries, none of whom is the grantor of the IDIT. The provisions governing both shares are identical, except that the grantor retains a testamentary limited power to appoint one share (the "Limited Power of Appointment Share") to any appointee other than the grantor, the grantor's estate, the grantor's

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[14] Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, note 12, *supra*; August, *Planning Around Contingent Liabilities*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1802 (1992)

[15] Hatcher and Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J.Tax. No. 3, 152 (March 2000)

[16] Dunn, Such and Park, *The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts*, 34 Est.Plan. No. 2, 40 (Feb. 2007).

creditors or the creditors of the grantor's estate. The grantor retains no such power over the other share of the IDIT (the "Non-Limited Power of Appointment Share"). The testamentary limited power keeps any transfer to the Limited Power of Appointment Share from being a completed gift for Federal gift tax purposes.

Noting that the grantor retains no right to reacquire property from either the Limited Power of Appointment Share or the Non-Limited Power of Appointment Share without consideration, the Incomplete Equity Strategy Article asserts that any transfer to the Limited Power of Appointment Share is complete for property law and trust law purposes. The Incomplete Equity Strategy Article states that it is only a provision of the Internal Revenue Code, i.e., the testamentary limited power of appointment, which treats the transfer to the Limited Power of Appointment Share as incomplete for Federal gift tax purposes. The Incomplete Equity Strategy Article suggests that transfers to the Limited Power of Appointment Share of an IDIT can be used to bolster the equity behind a promissory note given by the IDIT in a sale without a gift by the grantor.

Although the suggested strategy might be viewed as imaginative, the question is whether the strategy works as claimed by the Incomplete Equity Strategy Article. The objective of the Limited Power of Appointment Share is to make other assets available to satisfy a promissory note given by the IDIT to conform with the tests enunciated by the United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith* and by the IRS in Rev.Rul. 77-193. See Section III.A., *supra*.

Any assets which a grantor transfers to a Limited Power of Appointment Share remains includable in the grantor's estate under IRC Secs. 2036(a)(2) and 2038. Can assets which are included in a grantor's estate be used to avoid the application of IRC Secs. 2036(a)(1) and 2702 to assets sold to the IDIT in exchange for the IDIT's promissory note? The IRS might successfully assert that assets transferred to a Limited Power of Appointment Share and to a Non-Limited Power of Appointment Share constitute a single transfer all of which remain includable in the transferor's estate. In a "normal" sale transaction in which cushion for the IDIT's note is afforded by a gift to the IDIT or by beneficiary guarantees, a reduction in value of the assets composing the IDIT does not affect the value of the grantor's estate, so long as the other assets gifted to the IDIT or possessed by the grantor by the guarantor or guarantors are sufficient to cover such decrease in value. With the Limited Power of Appointment Share

technique suggested by the Incomplete Equity Strategy Article, any decrease in the value of the Limited Power of Appointment Share produces an equal reduction in the value of the grantor's estate.

There is at least a reasonable possibility that the assets of a Limited Power of Appointment Share do not constitute "other assets" satisfying the test established by *Fidelity-Philadelphia Trust Co.* and Rev.Rul. 77-193. The Limited Power of Appointment Share strategy suggested by the Incomplete Equity Strategy Article should be considered risky. As noted in Section III.A., *supra*, the results are disastrous if IRC Sec. 2702 applies to the transaction.

D. Indications That IRS Recognizes Sale to IDIT Technique.

There are no reported cases involving the sale to IDIT technique. The IRS has not officially pronounced upon the technique in a manner that can be relied upon by taxpayers. There are indications, however, that the IRS recognizes the effectiveness of the sale to IDIT technique.

Karmazin v. Commissioner,[17] was a case filed in the Tax Court involving an asserted gift tax deficiency arising out of a sale to IDIT transaction. In *Karmazin*, the taxpayer sold limited partnership interests to two IDITs in exchange for the IDITs' promissory notes. The notes bore interest at the applicable Federal rate. The taxpayer made gifts of limited partnership interest affording a 10% cushion. The sales documents provided for the sale of limited partnership interests having a value equal to a fixed dollar amount, which amount equaled the face amount of the promissory note given by the IDITs in the sale transactions. A discount of 42% was claimed on the gift tax return reporting the sales.

The gift tax examiner determined that IRC Sec. 2702 applied to the sales transactions, and assigned a zero value to the IDITs' promissory notes. The gift tax examiner also disallowed any discount for the limited partnerships.

The case was settled on terms very favorable to the taxpayer. In the settlement, it was agreed that IRC Sec. 2702 did not apply. The sale was recognized, and it was agreed that the promissory notes had gift tax values equal to their face amounts. The discount produced by the limited partnership was agreed to be 37%, rather than the 42% claimed. Thus, the deficiency originally asserted by the gift tax examiner was reduced by 95%. These settlement terms were

[17] Tax Ct. Dock. No. 2127-03.

so favorable to the taxpayer that one commentary concluded that the IRS "was not serious" about its IRC Sec. 2702 contentions.[18]

The IRS has recognized the sale to IDIT Technique in two private letter rulings.[19] The author's office has been involved in more than twenty-five gift tax audits of gift tax returns reporting sales to IDITs. In none of those audits was the basic structure of the sale challenged. None of the examining agents in those audits asserted that IRC Sec. 2702 was applicable. Generally, the only issue in the audits was the value of the assets sold to the IDIT. Except for the *Karmazin* case, which was highly publicized, the author is aware of no case in which the IRS has challenged the basis structure of the sale to IDIT technique as outlined in Sections III.A. and B., *supra.*

IV. Powers to Create Grantor Trust Status In An IDIT.

IRC Secs. 671-677 create a number of opportunities to create a trust which violates the grantor trust income tax rules without causing the trust to be included in the grantor's estate.[20] This result is made easier to achieve by IRC Sec. 672(e), which provides that, for purposes of the grantor trust rules, the grantor is treated as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, or who thereafter became a spouse of the grantor. In the latter case, grantor trust status exists only with respect to periods after such individual became the grantor's spouse.

A. Spouse as a Beneficiary.

Under IRC Secs. 677(a)(1) and (2), grantor trust status exists with respect to any portion of a trust whose income without the approval or consent of an adverse party may be distributed

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[18] Covey and Hastings, *Recent (2003) Developments in Transfer and Income Taxation of Trusts and Estates,* 38th Ann. Heckerling Inst. on Est. Plan. ¶ 129 (2004).

[19] Ltr. Ruls. 9436006 and 9535026. However, see Letter Rul. 9251004 which involved the right to receive annual payments on a promissory note received from a trust in exchange for the transfer of stock in a transaction described as a "sales/gift." The IRS held that the right to receive annual payments on the note constituted a retained right to receive trust income, causing the transferred stock to be included in the transferor's estate.

[20] For excellent Articles on grantor trusts, see Zaritsky, *Open Issues and Close Calls - Using Grantor Trusts in Modern Estate Planning,* 43 U. Miami Heckerling Inst. on Est. Plan. ch. 3 (2009); Akers, Blattmachr and Boyle, *Creating Intentional Grantor Trusts,* 44 Real Prop., Tr. and Est. L.J. 207 (2009); Blattmachr, Gans and Lo *A Beneficiary as Trust Owner: Decoding Section 678,* 35 ACTEC J. 106 (2009).

to the grantor or the grantor's spouse or accumulated for future distribution to the grantor's spouse. If the spouse is trustee of the IDIT and inclusion in the spouse's estate is avoided through the use of an ascertainable standard under IRC Secs. 2041(b)(1)(A), grantor trust status exists under IRC Secs. 677(a)(1) and (2). There is no provision in IRC Secs. 677(a)(1) and (2) comparable to IRC Sec. 2041(f)(1)(A) creating an exception for an ascertainable standard.

B. Power to Borrow.

A power to borrow income or principal of the trust in the grantor without regard to adequate interest or security will achieve wholly grantor trust status under IRC Sec. 675(2). By virtue of IRC Sec. 672(e), grantor trust status is also achieved if the grantor's spouse possesses such power. Grantor trust status does not result, however, if the power to lend without adequate security exists in a trustee (other than the grantor or the grantor's spouse) under a general lending power to make loans to any person without regard to interest or security.

A power to borrow without adequate security should not have any estate tax significance, because the exercise of the power has no impact on the size of the grantor's estate. Any borrowing of funds from the trust is offset by an indebtedness to the trust.

IRC Sec. 675(2) also confers grantor trust status if the grantor retains the right to borrow without adequate interest. A power to borrow from a trust without interest could be considered to be a retained right "to the possession or enjoyment of, or the right to the income from" the trust within the purview of IRC Sec. 2036(a)(1). It would appear to be unwise to use a retained right in the grantor to borrow without interest as a means of achieving grantor trust status.

C. Power of Disposition.

IRC Sec. 674(a) treats the grantor as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or 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. At first blush, violation of IRC Sec. 674(a) appears to be an easy method of achieving grantor trust status. There are, however, a number of exceptions to the broad general rule of IRC Sec. 674(a).

For example, the rule of IRC Sec. 674(a) does not apply if the power of disposition is exercisable only with the approval or consent of an adverse party. Trustees who are also beneficiaries are likely adverse parties precluding grantor trust status under IRC Sec. 674(a).[21]

If the grantor or the grantor's spouse is to act as a trustee and if the grantor's or the spouse's power to make distributions of income and principal is limited by an ascertainable standard, such standard will not prevent the grantor from being treated as the owner of the income portion of the trust. IRC Sec. 674(d), which creates an exception to IRC Sec. 674(a) for a power exercisable by a trustee or trustees to distribute, apportion or accumulate income which is limited by an ascertainable standard, does not apply if the grantor or the grantor's spouse living with the grantor is acting as a trustee. On the other hand, the ascertainable standard precludes the grantor from being treated as the owner of the corpus portion of the trust, even if the grantor or the grantor's spouse is acting as a trustee. See IRC Sec. 674(b)(5)(A).

Insulation from grantor trust status under IRC Secs. 674(b)(5)(A), (c) and (d) is not available if any person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive income or corpus, except where such action is to provide for after-born or after-adopted children. Grantor trust status under IRC Secs. 674(b)(5)(A), (c) and (d) can be achieved by giving a party the power to add beneficiaries to the trust.[22] The grantor should not be the one possessing the power to add beneficiaries. If held by the grantor, such power would cause inclusion of the trust in the grantor's estate under IRC Secs. 2036(a)(2) and 2038(a)(1). The power to add beneficiaries should likewise not be given to an existing beneficiary of the trust. The IRS might argue that an existing beneficiary's interest is adverse to the exercise of the power, making the power to add beneficiaries ineffective.[23]

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[21] See Treas.Reg.Sec. 1.672(b)-1(b). In addition, IRC Sec. 674(c) excepts powers held by independent trustees from the general rule of IRC Sec. 674(a).

[22] See Treas.Reg.Secs. 1.674(b)-1(b)(5)(iii), Example (1) and (d)-2. See also Ltr.Ruls. 200030018 and 200030019 which held that the power to add charities as beneficiaries created grantor trust status.

[23] See Treas.Reg.Sec. 1.674(d)-2(b).

D. Power to Substitute.

The power to substitute assets causes grantor trust status under IRC Sec. 675(4)(C). Under IRC Sec. 675(4)(C), grantor trust status is created if any person has a power to reacquire trust corpus by substituting other property of an equivalent value.

Commentators have suggested that retention by the grantor of the power to substitute assets in a nonfiduciary capacity so as to fall within IRC Sec. 675(4)(C) might cause trust assets to be included in the grantor's estate. The concern was that the power to substitute might be considered a power to designate the persons to possess or enjoy property or the income therefrom under IRC Sec. 2036(a)(2) or a power to alter, amend, revoke or terminate within the meaning of IRC Sec. 2038(a)(1).[24]

Rev.Rul. 2008-22[25] alleviates some concern on this point. In Rev.Rul. 2008-22, a U.S. citizen D established an irrevocable trust for the benefit of D's descendants, naming T as trustee. The Ruling states that the governing instrument prohibits D from serving as trustee. The governing instrument also grants D the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person acting in a fiduciary capacity, to acquire any property of the trust by substituting other property of equivalent value. Rev.Rul. 2008-22 holds that the grantor's power to substitute does not cause assets of the trust to be included in the grantor's estate under IRC Sec. 2036 or 2038. The Ruling states that this result is reached so long as the trustee has a fiduciary obligation (either under local law or the terms of the governing instrument) to ensure that the properties acquired and substituted by the grantor are, in fact, of equivalent value, and so long as the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries.

Rev.Rul. 2008-22 does not indicate whether the IRS attaches any significance to the fact that the governing instrument prohibited the grantor from acting as trustee. It may be that the IRS does not believe that this point is significant. However, such an assumption would appear risky. An IRS agent auditing an estate tax return could very well assert that the grantor's inability to act as trustee is a necessary prerequisite to the conclusion reached in Rev. Rul. 2008-

[24] See, e.g., Horn, *Avoiding and Attracting Grantor Trust Treatment*, 24 ACTEC Notes 204, 224-225 (1998).

[25] 2008-16 IRB 796.

22, and that a grantor with a power to substitute serving as trustee causes inclusion. The most that can be said favorably is that the Ruling doesn't address the issue. It would appear wise not to reserve in the grantor a power to substitute under authority of Rev.Rul. 2008-22 if the grantor is to serve as a trustee.[26]

A draftsperson may seek to avoid any possibility of inclusion under IRC Sec. 2036(a)(2) or 2038(a)(1) by conferring the power to substitute on a person other than the grantor. IRC Sec. 2041 is the only statute which could create estate tax inclusion in another person, and a power to substitute property with other property of equal value does not cause inclusion under IRC Sec. 2041.[27]

IRC Sec. 675(4)(C), by its express terms, applies to "any person" holding the power to substitute assets. However, IRC Sec. 675(4)(C) uses the word "reacquire" in describing the transactions to which the statute applies. It has been suggested that only the original grantor of a trust can "reacquire" trust assets, and that conferring the power to substitute on a person other than the grantor or the grantor's spouse does not insure grantor trust status..[28] To state that the power to "reacquire" can only be held by the grantor and not another person is simply incorrect. A nongrantor who has previously exercised a right to substitute could "reacquire" an asset given in exchange for the previously substituted asset. It is not reasonable to suggest that IRC Sec. 675(4)(C) only applies to a nongrantor who has previously exercised a power to substitute as opposed to one who has not previously exercised such power.

Although the statutory language of IRC Sec. 675(4)(C) could be more precise by the use of a word other than "reacquire", the fact that the statute by its terms expressly applies to "any person" renders dubious any assertion that it applies only to grantors. The clear reference to "any person" would seem more than enough to overcome any uncertainty created by the word "reacquire." Similarly, by virtue of IRC Sec. 672(e), a power to substitute in the grantor's spouse should confer grantor trust status, even if the spouse has not contributed assets to the trust

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[26] See Mulligan, *Power to Substitute in Grantor Does Not Cause Inclusion, With A Significant Caveat*, 109 J. Tax. No. 7, 32 (July 2008).

[27] Treas.Reg.Sec. 20.2043-1(a).

[28] See Horn, *Avoiding and Attracting Grantor Trust Treatment*, note 24, *supra*.

which the spouse can "reacquire." The IRS has concluded in private letter rulings that a power to substitute conferred upon a nongrantor results in grantor trust status.[29]

E. Power to Pay Life Insurance Premiums.

At first blush, it would appear that IRC Sec. 677(a)(3) affords an easy way to create grantor trust status in a manner that has no estate or gift tax consequences. That statute treats the grantor as the owner of any portion of a trust whose income, without the consent of an adverse party, may be used to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse. On its face, the language of IRC Sec. 677(a)(3) would appear to create grantor trust status if a trust instrument expressly authorizes the use of trust income to pay premiums on policies insuring the life of the grantor or the grantor's spouse. There are, however, cases decided under the predecessor of IRC Sec. 677(a)(3) which hold that the grantor is only taxed on income actually used to pay premiums.[30] It seems advisable not to rely solely on IRC Sec. 677(a)(3) to create grantor trust status.

F. Actual Borrowing from a Trust.

IRC Sec. 675(3) creates grantor trust status with respect to any portion of a trust in respect of which 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. Grantor trust status is not created by a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor (or, under IRC Sec. 672(e), the grantor's spouse), and other than a related or subordinate trustee subservient to the grantor.

The language of IRC Sec. 675(3) referring to the beginning of the taxable year is obscure. That language has been held to create grantor trust status for an entire calendar year if at any time during such year a loan described in the statute is outstanding.[31]

IRC Sec. 675(3) can be construed as affording a simple method of obtaining grantor trust status for an entire trust. It is possible to construe the statute as creating grantor trust status for

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[29] See, e.g., Letter Ruls. 9011052, 9026036 and 9037001.

[30] *Moore v. Commissioner*, 39 B.T.A. 808 (1939), *acq*. 1939-2 C.B. 25; *Rand v. Commissioner*, 40 B.T.A. 233 (1939), *aff'd* 116 F.2d 929 (8th Cir. 1941), *cert. denied*, 313 U.S. 594 (1941), *acq*. 1939-2 C.B. 30; *Iversen v. Commissioner*, 3 T.C. 756 (1944); *Weil v. Commissioner*, 3 T.C. 579 (1944), *acq*. 1944 C.B. 29.

[31] *Mau v. U.S.*, 355 F. Supp. 909 (D. Hawaii 1973); Rev.Rul. 86-82, 1986-1 C.B.253.

an entire trust if the grantor borrows even a *de minimis* amount from the trust. However, the cases indicate that this is not the correct reading of the statute, and that borrowing *de minimis* amounts from the trust does not cause the whole trust to be a grantor trust.[32]

G. Turning Off Grantor Trust Status.

It is possible that at some point the continuing obligation to pay taxes on IDIT income may become burdensome to the grantor. It would generally seem advisable for the governing instrument to contain a mechanism for turning off grantor trust status. Turning off grantor trust status would cause the income of the IDIT to be taxed to the trust or its beneficiaries.

If one of the devices used to create grantor trust status is granting the power to an individual to add to the beneficiaries eligible to receive distributions from the IDIT pursuant to IRC Secs. 674(b)(5)(A), (c) and (d), such individual could be granted the power to terminate such power. The individual could also be empowered to terminate any other powers which are utilized to create grantor trust status. If, as suggested in Section IV.C., *supra*, such individual is not the grantor and has no beneficial interest in the IDIT, the individual's possession or exercise of the power to terminate grantor trust status should not have any adverse estate or gift tax consequences.

It would seem advisable to pay off any promissory note given by the IDIT to its grantor in a sale transaction before grantor trust status is turned off. There is a risk that turning off grantor trust status while the promissory note is outstanding would be treated as a sale causing realization of gain to the extent that the amount due on the promissory note exceeds the income tax basis of the assets held by the IDIT. With the loss of grantor trust status, the trust becomes a taxpayer separate from its grantor. At that time, it is treated for income tax purposes as having received assets from its grantor at the same time it issues its promissory note. The trust's receipt of assets simultaneously with its issuance of the note could be treated as a sale. [33]

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[32] *Benson v. Commissioner*, 76 T.C. 1040 (1981); *Bennett v. Commissioner*, 79 T.C. 470 (1982).

[33] Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J.Tax. No. 3, 149 (2002). At note 6, the article points out that there is no direct authority on this issue.

If there is not sufficient cash to satisfy the note, the note could be paid in kind. Because the IDIT will continue to be a grantor trust when the note is paid, there will be no gain on that payment, even if appreciated assets are used to pay off the note.

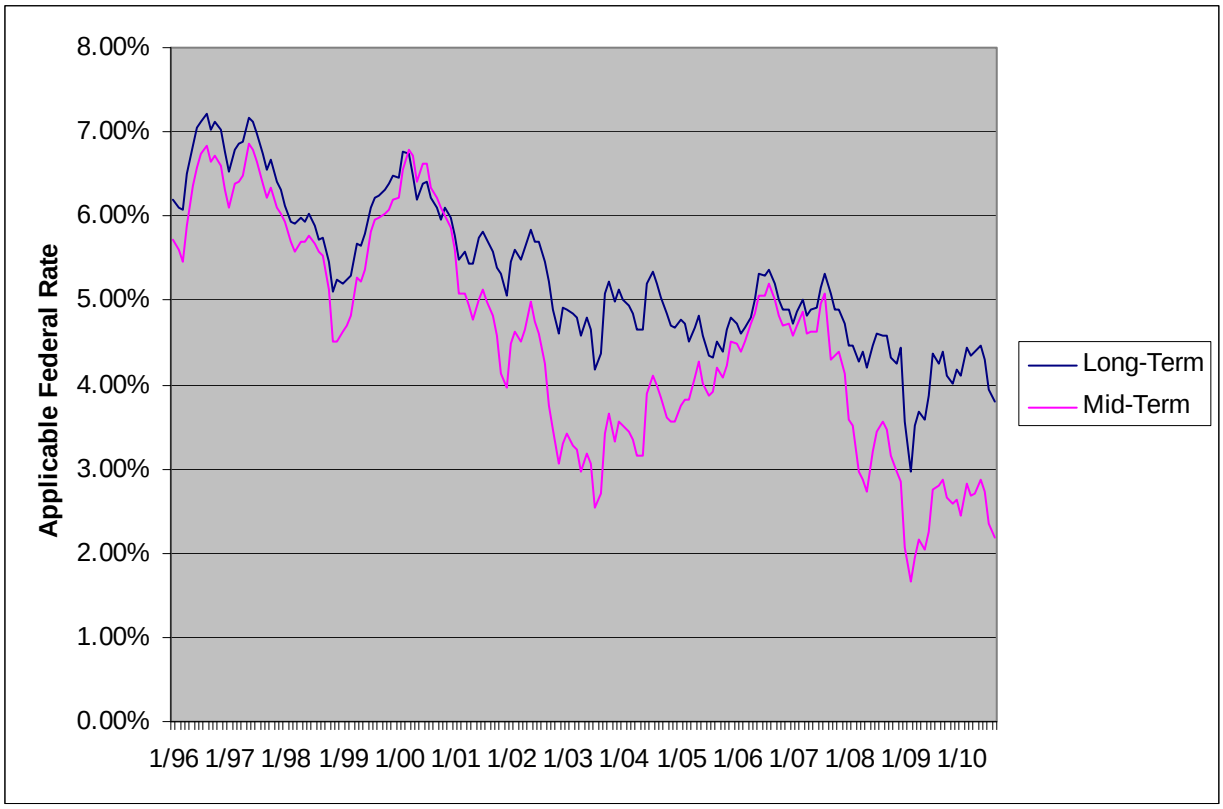
Generally, the grantor trust rules of IRC Sec. 671-677 operate on a year-to-year basis.[34] It might be possible for grantor trust status to be eliminated in one year and reinstated in another. For example, a grantor may be comfortable with paying taxes on dividend and interest income derived from assets previously sold to an IDIT, but may be uncomfortable with paying taxes on a substantial capital gain incurred if those assets are sold. In such an instance, it would be desirable to be able to turn off grantor trust status for the year in which the assets are sold and then turn grantor trust status back on in subsequent years after the sale is completed.

There does not appear to be any authority on this issue. There is reason to be concerned that the IRS might simply not recognize an attempt to toggle grantor trust status off or on from year to year. The IRS might simply take the position that a power which is capable of being reinstituted is never actually turned off, and that the existence or nonexistence of grantor trust status is not to be determined from year to year. If accepted, this argument would cause the grantor to be taxed in years in which it was thought that the IDIT was no longer a grantor trust. Worse yet, it is possible that the IRS might assert that the IDIT never was a grantor trust. Without any authority on the question of whether grantor trust status can be changed from year to year, it would seem preferable that any turn off of grantor trust status, once effected, be permanent.

V. Choice of Interest Rates.

Under IRC Sec. 1274(d), the Federal short-term rate applies to a promissory note with a term of not over three years, the Federal mid-term rate applies to a promissory note with a term of over three years but not over nine years, and the Federal long-term rate applies to a promissory note with a term exceeding nine years. The following graph compares Federal mid-term rates and long-term rates between January of 1996 and September of 2009:

[34] See, e.g., Treas.Reg.Sec. 1.671-3(a)(3) which defines the portion of a trust treated as owned by the grantor under certain circumstances for "the taxable year in question."



For much of the last fifteen years, there has not been a significant difference between the monthly applicable Federal mid-term and long-term rates. During most of the year 2000, the rates were actually inverted, i.e., the mid-term rate was higher than the long-term rate. There have been two periods since January 1996, including the present time, when the long-term rates have been significantly higher than the mid-term rates.

From January 1996 through 2001, interest rates were much higher than current rates (5% to 7%), while the spread between the mid-term and long-term rates was relatively inconsequential. Beginning in 2002, interest rates began to decrease considerably. In July of 2003, the mid-term rate bottomed at 2.55% and, more importantly, the long-term rate of 4.17% was almost 65% higher than the mid-term rate. More recently, in August of 2010, the long-term rate was 3.75%, which was about 74% higher than the mid-term rate of 2.18%.

In structuring the promissory note in a sale to IDIT transaction, the inclination in every case might be to lock in the current long-term interest rate for an extended period of time. This inclination is likely to be strongest when the Federal long-term rate is comparatively low by historical standards. The term of the notes in Ltr. Rul. 9535026 was twenty years. The term of the note in Ltr. Rul. 9436006 was twenty-five years. Selecting the long-term rate over a long

period of time is beneficial if the applicable Federal rate increases in the future. If the applicable Federal rate decreases, it appears that the promissory note can be renegotiated at the lower prevailing rate without gift tax consequences, so long as the note provides for prepayment of interest and principal without penalty.[35] Before automatically selecting the long-term rate, however, the current long-term rate should be compared with the current mid-term rate. Consideration should also be given to how long the note is likely to remain outstanding.

Even if the Federal long-term rate does not exceed the mid-term rate by much, it still may be preferable to utilize the mid-term rate in those instances in which there is a good chance that the promissory note will be paid off within nine years. For example, a seller may not be expected to live much longer than nine years. Alternatively, it may be anticipated that assets sold to the IDIT will be liquidated within nine or ten years. In such event, the promissory note might be paid off, and the cash received in payment of the note placed in a limited partnership or other entity in the manner discussed in Section IX., *infra*, to produce a valuation discount. The interests in the entity might then be sold to the IDIT. It has been the experience of the author that promissory notes given in sale to IDIT transactions rarely remain outstanding for nine years. This experience might change in a period of consistently rising interest rates.

In some cases, it may be useful to calculate the breakeven interest rate in considering whether to use the mid-term rate rather than the long-term rate. The "breakeven interest rate" can be computed by choosing a term for a hypothetical note which is to bear interest at the applicable Federal long-term rate. It is then assumed that a note with the same face amount as the hypothetical note and bearing interest at the current mid-term rate has a term of nine years. After nine years, it is assumed that this note is renegotiated into a new note with a term which ends at the same time as the term of the hypothetical note. The "breakeven interest rate" is the rate which produces the same results as produced with the hypothetical note.

The table which follows illustrates how the breakeven rate might be determined in a sale of limited partnership interests to an IDIT. In this illustration, it is assumed that the partnership has underlying assets of $10 million, and that interests in the limited partnership are sold to an

[35] Blattmachr, Crawford and Madden, *How Low Can you Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J.Tax No. 7, 22 (July 2008); Harrington, *Question and Answer Session*, 38th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1216 (2004); Zeydel, *Estate Planning in a Low Interest Rate Environment*, 36 Est. Plan. No. 7, 17 (July 2009).

IDIT at a 30% discount in exchange for a promissory note in the face amount of $7 million. Interest is paid annually. It is assumed that partnership assets produce a net return (income plus appreciation) of 6% per annum. The table compares the results of interest at the September 2009 mid-term rate (2.87%) with results at the September 2009 long-term rate (4.38%) after a period of twenty years. Interest at the long-term rate of 4.38% produces a value of $20,792,892 in the IDIT at the end of the twenty-year period. Interest at the mid-term rate of 2.87% produces a total value of $14,586,184 in the IDIT after nine years. At this point, the $7 million note is renegotiated for another eleven years. The table shows that a breakeven interest rate of 6.58% produces a final value of $20,792,892 in the IDIT at the end of that eleven-year period. Thus, selection of the mid-term rate (2.87%) rather than the long-term rate (4.38%) produces a better result so long as the rate borne by the new note executed after nine years is less than 6.58%.

		Initial use of Mid-Term AFR				Use of Long-Term AFR			
	Initial			Final		Initial			Final
Year	Assets	Interest	Growth	Assets		Assets	Interest	Growth	Assets
1	$10,000,000	$ 200,900	$ 600,000	$ 10,399,100		$ 10,000,000	$306,600	$ 600,000	$ 10,293,400
2	$10,399,100	$ 200,900	$ 623,946	$ 10,822,146		$ 10,293,400	$306,600	$ 617,604	$ 10,604,404
3	$10,822,146	$ 200,900	$ 649,329	$ 11,270,575		$ 10,604,404	$306,600	$ 636,264	$ 10,934,068
4	$11,270,575	$ 200,900	$ 676,234	$ 11,745,909		$ 10,934,068	$306,600	$ 656,044	$ 11,283,512
5	$11,745,909	$ 200,900	$ 704,755	$ 12,249,764		$ 11,283,512	$306,600	$ 677,011	$ 11,653,923
6	$12,249,764	$ 200,900	$ 734,986	$ 12,783,850		$ 11,653,923	$306,600	$ 699,235	$ 12,046,558
7	$12,783,850	$ 200,900	$ 767,031	$ 13,349,981		$ 12,046,558	$306,600	$ 722,794	$ 12,462,752
8	$13,349,981	$ 200,900	$ 800,999	$ 13,950,079		$ 12,462,752	$306,600	$ 747,765	$ 12,903,917
9	$13,950,079	$ 200,900	$ 837,005	$ 14,586,184		$ 12,903,917	$306,600	$ 774,235	$ 13,371,552
	Breakeven Interest Rate = 6.58%								
10	$14,586,184	$ 460,607	$ 875,171	$ 15,000,748		$ 13,371,552	$306,600	$ 802,293	$ 13,867,245
11	$15,000,748	$ 460,607	$ 900,045	$ 15,440,187		$ 13,867,245	$306,600	$ 832,035	$ 14,392,680
12	$15,440,187	$ 460,607	$ 926,411	$ 15,905,991		$ 14,392,680	$306,600	$ 863,561	$ 14,949,641
13	$15,905,991	$ 460,607	$ 954,359	$ 16,399,744		$ 14,949,641	$306,600	$ 896,978	$ 15,540,019
14	$16,399,744	$ 460,607	$ 983,985	$ 16,923,121		$ 15,540,019	$306,600	$ 932,401	$ 16,165,820
15	$16,923,121	$ 460,607	$ 1,015,387	$ 17,477,902		$ 16,165,820	$306,600	$ 969,949	$ 16,829,170
16	$17,477,902	$ 460,607	$ 1,048,674	$ 18,065,969		$ 16,829,170	$306,600	$1,009,750	$ 17,532,320
17	$18,065,969	$ 460,607	$ 1,083,958	$ 18,689,321		$ 17,532,320	$306,600	$1,051,939	$ 18,277,659
18	$18,689,321	$ 460,607	$ 1,121,359	$ 19,350,073		$ 18,277,659	$306,600	$1,096,660	$ 19,067,718
19	$19,350,073	$ 460,607	$ 1,161,004	$ 20,050,471		$ 19,067,718	$306,600	$1,144,063	$ 19,905,182
20	$20,050,471	$ 460,607	$ 1,203,028	$ 20,792,892		$ 19,905,182	$306,600	$1,194,311	$ 20,792,892

It is worth noting that since January of 1996, there have only been two short periods (May 1996 to October 1997 and February 2000 to July 2000) in which either the mid-term or long-term rate has been greater than 6.58%, but neither has ever exceeded 7.21%. If the decision is made to use the mid-term rate, prevailing rates can be monitored during the term of the IDIT's promissory note. If it appears that interest rates are likely to exceed the breakeven interest rate, the note can be renegotiated at the prevailing applicable Federal rate to lessen the damage. The possibility of renegotiating a note at any time during its term makes the selection of the mid-term rate less of a risk.

VI. Reporting Sale to IDIT on a Gift Tax Return.

If no gift tax return is filed reporting a sale, there is no time limit on the IRS's ability to challenge that sale and assert a gift tax liability.[36] Similarly, during the seller's lifetime, there is no certainty that an IDIT has an inclusion ratio of zero for generation-skipping tax purposes.[37]

A. Running of Statute of Limitations on Gift Tax Return Precludes IRS From Challenging Values and Asserting Inclusion Under IRC Sec. 2036(a)(1).

A gift tax return might be filed reporting a sale to IDIT transaction, and taking the position that the sale is not a gift because the value of the IDIT's promissory note is not less than the value of the assets sold to the IDIT.[38] If the gift tax return adequately discloses the sale transaction, the IRS cannot assert otherwise for any purpose after the three-year statute of limitations has elapsed.[39] A timely filed gift tax return can also be used to establish conclusively the value of property for purposes of allocating GST exemption.[40] Although reporting a sale transaction risks a possible audit, it would generally seem that reporting a sale is to be preferred. The discussion at Section III.D., *supra*, indicates that the IRS recognizes the sale to the IDIT technique, assuming that the sale is structured as outlined in this article.

In addition to precluding the IRS from asserting gift tax liability and establishing values for purposes of allocation of GST exemption, the running of the statute of limitations should also prevent the IRS from asserting that the assets sold to the IDIT are includable in the seller's estate as a transfer with retained interest under IRC Sec. 2036(a)(1). IRC Sec. 2036(a)(1), by its express terms, creates an exception to inclusion for a transfer constituting a bona fide sale for an adequate and full consideration. The adequate and full consideration element of this exception would be conclusively established by a gift tax return reporting a gift of $0 upon which the

[36] IRC Sec. 6501(c)(9).

[37] Treas.Reg.Sec. 26.2642-5(b).

[38] Treas.Reg.Sec. 301.6501(c)-1(f)(4).

[39] IRC Secs. 2001(f), 2504(c) and 6501(c)(9).

[40] IRC Sec. 2642(b)(1).

statute of limitations has run. The bona fide sale element should be established by the note itself, so long as its existence is recognized as an asset of the seller's estate.[41]

B. Conclusiveness of Legal Issues Under Treas.Reg.Sec. 20.2001-1(b) Should Preclude IRS From Asserting IRC Sec. 2036(a)(1).

Treas.Reg.Sec. 20.2001-1(b) also precludes the IRS from raising legal issues relating to the gift.[42] Treas.Reg.Sec. 20.2001-1(b) is another basis upon which an adequately disclosed sale should thwart any attempt by the IRS to include assets sold to an IDIT in the seller's estate under IRC Sec. 2036(a)(1) after the three-year statute of limitations has run.

Under IRC Sec. 2702(a)(2)(A), if the promissory note received from an IDIT in a sale transaction were a "retained interest," it would be valued at zero. The result would be that the note would not cause any reduction in the value of the assets transferred to the IDIT for gift tax purposes, and the seller would be treated as making a gift of that value. Passage of the limitations period on a gift tax return which adequately discloses a sale and reports $0 gift precludes the IRS from asserting otherwise. It follows that the promissory note received in the sale must have value. If the promissory note is not valued at zero, it cannot be a "retained interest" under IRC Sec. 2702(a)(2)(A). If the note is not a "retained interest" under IRC Sec. 2702(a)(2)(A), it should not be treated as a retention of the interests described in IRC Sec. 2036(a)(1).

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[41] *Estate of Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997).

[42] Treas.Reg.Sec. 20.2001-1(b) provides:

> For purposes of determining the amount of adjusted taxable gifts as defined in section 2001(b), if, under section 6501, the time has expired within which a gift tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) with respect to a gift made after August 5, 1997, or with respect to an increase in taxable gifts required under section 2701(d) and §25.2701-4 of this chapter, then the amount of the taxable gift will be the amount as finally determined for gift tax purposes under chapter 12 of the Internal Revenue Code and the amount of the taxable gift may not thereafter be adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

Treas.Reg.Sec. 25.2504-2(b) establishes an identical rule for gift tax purposes in valuing gifts made in preceding calendar periods.

It might be argued that the rule established by Treas.Reg.Sec. 20.2001-1(b) only applies for purposes of determining adjusted taxable gifts, leaving open the question of includability under IRC Sec. 2036(a)(1). Hopefully, this argument would not prevail. If estate and gift taxes are to be construed in *pari materia*, a seller who in a transaction is not considered to possess a retained interest in an IDIT for gift tax purposes should not in the same transaction be considered to have a retained interest in the IDIT for estate tax purposes.

C. Guarantor Files Gift Tax Return.

If guarantees are used to create a cushion or equity in the IDIT for the sale in the manner described in Section III.B., *supra*, a guarantor should consider filing a gift tax return. That return would take the position that the guarantee does not constitute a gift for Federal gift tax purposes. If the statute of limitations runs on that return, it should preclude the IRS from asserting otherwise. If the guarantor is a beneficiary of the IDIT, it should also preclude the IRS from arguing that the guarantee causes a portion of the IDIT to be included in the guarantor's estate under IRC Sec. 2036 or 2038, or that the guarantor's contribution to the IDIT taints it for generation-skipping tax purposes. While not expressly covered by Treas.Reg. Sec. 20.2001-1(b), it is to be hoped that the IRS would not, if precluded by Treas.Reg.Sec. 20.2001-1(b) and Treas.Reg.Sec. 25.2504-2(b) from asserting that the guarantee is an addition to the IDIT for estate and gift tax purposes, argue that the guarantee constitutes an addition to the IDIT for income tax purposes, causing it to cease being a wholly grantor trust.

VII. Income Tax Consequences If Seller Holds IDIT's Promissory Note at Death.

There is one issue regarding the sale to IDIT technique which has generated more discussion than any other. That issue is whether the seller's death while holding a promissory note received on the sale of appreciated property to an IDIT causes gain to be realized on the note.[43]

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[43] *See* Nicholson, *Sale to a Grantor Controlled Trust: Better Than a GRAT?* 37 BNA Tax Mgmt. Memo. 99 (1996); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation* - 1996, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶120. 2E (1997); Practical Drafting, pp. 4833-4835 (1997); Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts and Tr. J. No. 1, 3 (1999); Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J.Tax No. 1, 49 (2001); Aucutt, *Installment Sales to Grantor Trusts*, 4 Bus. Entities, No. 2, 28 (2002); Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, note 33, *supra*;

The possibility exists that the IDIT's loss of grantor trust status as a result of the seller's death causes a sale to be deemed to occur under the rationale of *Madorin v. Commissioner*.[44] In *Madorin* and the other authorities cited in note 44, *supra*, an individual transfers a tax shelter to a wholly-grantor trust. When the tax shelter is about to produce phantom income, the grantor renounces the powers which cause grantor trust status in an effort to have the phantom income taxed to the trust rather than the grantor. The cited authorities hold that the loss of grantor trust status upon the grantor's renunciation is to be treated as a transfer of the shelter to a newly-formed non-grantor trust, which is a disposition causing the grantor to recognize income.

The commentators cited in n. 43, *supra*, disagree on whether the *Madorin* rationale applies when the IDIT's loss of grantor trust status is the result of the seller's death. The commentators also disagree on the effect, if any, of the seller's death on the income tax basis of the promissory note. Finally, there is disagreement regarding the effect of the seller's death on the basis of the assets sold to the IDIT.

A. Tax Consequences of Sale to Nongrantor Trust.

Before attempting to address these disputes, it is useful to examine the consequences of a sale to a nongrantor trust, both during the seller's lifetime and at the seller's death. It is also useful to examine the tax consequences of the disposition of appreciated property subject to indebtedness, such disposition occurring either during the property owner's lifetime or at the property owner's death. There is no dispute about the tax consequences of such a sale or disposition.

Example 1. Sale to a Nongrantor Trust. Assume that an individual sells land held for investment for more than one year with a basis of $200,000 and a current fair market value of $2 million to a nongrantor trust established for the benefit of seller's descendants. The sale is in exchange for the trust's promissory note. The note provides for annual payments of $100,000 in

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Hodge, *On the Death of Dr. Jekyll - Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at Grantor's Death*, 29 Tax Mgmt. Est., Gifts and Trust J., No. 6, 275 (2004); Peebles, *Death of an IDIT Noteholder*, 144 Tr. & Est. No. 8, 28 (2005); Cantrell, *Gain is Realized at Death*, 149 Tr. & Est. No. 2, 20 (2010); Gans and Blattmachr, *No Gain at Death*, 149 Tr. & Est. No. 2, 34(2010).

[44] 84 T.C. 667 (1985). *See also* Treas.Reg.Sec. 1.1001(c), Example (5) and Rev.Rul. 77-402, 1977-2 C.B. 222.

principal over a term of twenty years, plus interest accrued at each principal payment at the long term applicable federal rate under IRC Sec. 1274. These facts can be summarized as follows:

Fair market value	=	$2 million
Basis	=	$200,000
Annual Payments of Principal	=	$100,000

The seller in this example realizes a capital gain of $1,800,000. The sale qualifies for installment treatment under IRC Sec. 453. The installment method permits the seller to defer recognition of gain ratably over the term of the promissory note. Upon receipt of each payment, the seller recognizes a $90,000 long term capital gain[45], and is taxed at ordinary rates on interest received. As a result of the purchase, the nongrantor trust's income tax basis in the purchased land is $2 million, i.e., the face amount of the promissory note.

If the seller dies after having received ten installment payments, the $1 million in principal payments remaining due on the note is included in the seller's Federal gross estate. Because the promissory note is income in respect of a decedent ("IRD"), the promissory note does not acquire a new income tax basis under IRC Sec. 1014 by virtue of the seller's death.[46] IRD is defined as amounts to which a decedent was entitled at death as gross income, but which were not properly includable in computing the decedent's taxable income.[47] The distribution of the promissory note to a beneficiary entitled to receive it under the seller's Will is not a disposition causing gain to be recognized.[48] The beneficiary is permitted to report gain on the sale under the installment method. The trust's basis in the land continues to be $2 million.

Assume the seller's Will cancels the note. The cancellation does not affect the inclusion of the promissory note in seller's estate. The cancellation is treated as a disposition causing the full $900,000 in remaining gain to be taxed to the decedent's estate.[49] Again, the trust's $2 million basis in the land is not changed.

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[45] IRC Sec. 1222.

[46] IRC Sec. 691(a)(4).

[47] Treas.Reg.Sec. 1.691(a)-1(b).

[48] IRC Sec. 453B(c).

[49] IRC Sec. 691(a)(5). Because the trust is a related party, the remaining gain cannot be less than $900,000. See IRC Sec. 491(a)(5)(B).

Example 2. Gift or Bequest/Devise of Encumbered Asset. Owner owns commercial real property with a basis of $2 million and a current fair market value of $8 million. The property is subject to a mortgage of $7,500,000 received as a loan from a bank. These facts can be summarized as follows:

Fair market value	=	$8 million
Mortgage	=	$7,500,000
Basis	=	$2 million

If owner makes a gift of the property, the owner is treated as having sold the property for the $7,500,000 liability shifted to the donee, recognizing a gain of $5,500,000 ($7,500,000 - $2 million) on the transfer.[50] This is true even if the indebtedness is nonrecourse and even if the indebtedness exceeds the fair market value of the property.[51]

On the other hand, if the owner dies, a devise of the land subject to the indebtedness is not an income realization event under authority of the United States Supreme Court's decisions in *Crane v. Commissioner*[52]. The owner's estate does not recognize gain on the transfer of land to the beneficiary entitled to receive it under the Will. If the indebtedness is recourse, the full $10 million fair market value of the property is reported on Schedule A of the owner's Federal estate tax return, and the indebtedness is listed separately on Schedule K as a deduction.[53] If the loan is nonrecourse, the net value of the property is reported on Schedule A.[54] In either event, under *Crane*, the beneficiary's income tax basis in the property is its fair market value on the owner's date of death or alternate valuation date, whichever is applicable.[55]

In *Crane*, a surviving spouse inherited an apartment building at her husband's death. The apartment building was encumbered by nonrecourse indebtedness which was exactly equal to the

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[50] Treas.Reg.Sec. 1.1001(e).

[51] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[52] 331 U.S. 1 (1947).

[53] Instructions for Form 706, Dept. of the Treasury, Internal Revenue Service, p. 20 (Rev. Sept. 2009).

[54] *Id*.

[55] IRC Sec. 1014(a).

Federal estate tax value of the building. Rather than treating the transfer of the building as a sale for an amount equal to the liability (which would have caused the spouse's income tax basis in the building to be determined under the predecessor of IRC Sec. 1012), the Supreme Court indicated that the surviving spouse's basis in the building was to be determined under the predecessor of IRC Sec. 1014, unreduced by the indebtedness.

B. Tax Consequences of Sale to an IDIT.

Assume that the trust in the posed in Example 1 is an IDIT, but that the other facts of the example remain the same. Under the rationale of Rev.Rul. 85-13, the sale is ignored for income tax purposes even though it is recognized for estate and gift tax purposes. The seller recognizes no gain when payments are made on the note. The IDIT is not deemed to exist for income tax purposes. The seller is taxed individually on any income earned by the assets held by the IDIT, but is not separately taxed on the interest payments made by the IDIT on the note. The IDIT takes the seller's $200,000 basis in the land.

1. Gain Recognized at Death?

All of the commentators cited in note 43, *supra*, agree with the consequences described in the immediately preceding paragraph. Those commentators also agree that since the IDIT is to be considered as coming into existence for income tax purposes at the seller's death, the IDIT's assets should be treated for income tax purposes as transferred to the IDIT on the seller's death. The commentators agree that for income tax purposes the promissory note also comes into existence at the seller's death.

The commentators who conclude that the seller's death causes gain to be realized come to that conclusion because the transfer of assets to the IDIT and the coming into existence of the promissory note occur simultaneously at the seller's death. Because these events occur simultaneously, these commentators believe they should be treated as a sale of the IDIT's assets under the *Madorin* rationale. Some express the view that the sale can be regarded as occurring immediately before the seller's death.[56]

If the seller's death is a taxable event under the *Madorin* rationale, the consequences are the same as those set forth on seller's death in Example 1. Although any payments received on

[56] See e.g. Covey, *Recent Developments Concerning Estate, Gift and Income Taxation* - 1996, note 43, *supra*.

the promissory note by the seller during seller's lifetime have no income tax consequence, gain is realized to the extent that amounts remaining due on the note exceed the seller's basis in the note at death. If the deemed sale at the seller's death qualifies for installment treatment, gain is recognized as payments are received by the seller's successor in interest. If the deemed sale does not qualify for installment treatment,[57] the gain is reported on the seller's final income tax return,[58] and the income tax payable on that gain is a debt deductible for Federal estate tax purposes under IRC Sec. 2053.

The position that the *Madorin* rationale should not apply to cause gain on the promissory note to be realized at the seller's death rests on the principle that transfers at death generally do not cause realization of income.[59] This is true even if an identical transfer during lifetime would cause income to be realized. The exception created by IRC Sec. 453(B)(c) for the transfer of an installment obligation at death, discussed in Section VII.A., *supra*, is an example of the principle that transfers at death generally do not cause a realization of income, and is an exception to the general rule established by IRC Sec. 453(B)(a) that the disposition of an installment note causes recognition of gain on the note.[60]

The commentators who conclude there is no realization at death believe that the Supreme Court's decision in *Crane* is direct authority for their position. As noted in the discussion of Example 2, *supra*, the transfer during the transferor's lifetime of property subject to an indebtedness which exceeds the transferor's basis in the property is deemed to be a sale causing gain to be recognized. Under *Crane*, there is no sale and no recognition of gain if the transfer occurs as a result of the transferor's death.

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[57] For example, IRC Sec. 453(k)(2) provides that installment treatment is not available for the sale of marketable securities.

[58] Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, note 43, *supra*.

[59] This general proposition was recognized in CCA200923024.

[60] For other examples of situations in which there are no income tax consequences to a transfer at death, see Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, note 43, *supra*. For a list of situations in which death produces income tax consequences, see Peebles, *Death of an IDIT Noteholder*, note 43, *supra*.

The commentators who conclude that death causes gain to be recognized find no basis in the authorities cited at note 44, *supra*, for concluding that such authorities apply only to the termination of grantor trust status during the grantor's lifetime.[61] These commentators also believe that *Crane* is not authority for the proposition that there is no recognition of gain on the seller's death. For example, one commentator states that the issue in *Crane* was the amount of income which the surviving spouse should recognize when she sold the building while it remained subject to the nonrecourse mortgage. Noting that the mortgage was equal to the fair market value of the building, this commentator observes that the surviving spouse's basis in *Crane* would have been the same whether she was viewed as having received the building by inheritance or by purchase for the amount of the nonrecourse indebtedness. The commentator further states that the court in *Crane* did not discuss whether the building was acquired by inheritance or by sale.[62]

These comments appear to give insufficient weight to the Supreme Court's reference in *Crane* to the predecessor to IRC Sec. 1014 rather than the predecessor of IRC Sec. 1012 in discussing the surviving spouse's basis in the building. The Court's reference to the predecessor to IRC Sec. 1014 rather than the predecessor IRC Sec. 1012 may not be a "discussion," but it should not simply be ignored. The Court clearly did not view the distribution of the building to the spouse in *Crane* as a sale.

2. <u>Effect of Seller's Death on Basis of IDIT's Promissory Note</u>.

One's view on the effect of the seller's death on the income tax basis of the IDIT's promissory note depends upon one's opinion on whether or not the seller's death causes gain to be realized. If one believes that the seller's death causes gain to be realized, then the results are the same as described in the discussion of Example 1, *supra*. Because gain on the promissory note is IRD, the basis of the promissory note would not be stepped up to its fair market value on date of death or alternate valuation date.

If gain is not realized on the seller's death, then the promissory note is not IRD. Because the IDIT is a grantor trust, no payments on the promissory note during the seller's lifetime can constitute taxable income to the seller. The absence of IRD results in the promissory note

[61] See, e.g., Cantrell, *Gain is Realized at Death*, note 43, *supra*.

[62] *Id*.

acquiring a new income tax basis under IRC Sec. 1014 equal to the value at which it is included in the seller's gross estate. Note that reporting the note on the seller's estate tax return at a discounted value risks converting what would have been tax free amounts due under the note into ordinary income under the market discount rules of IRC Secs. 1276-1278.

3. Effect of Seller's Death on Basis of Assets Purchased by IDIT.

If one believes that seller's death causes gain to be realized under the *Madorin* rationale, it is because a purchase and sale is deemed to occur at seller's death. Because the IDIT's assets are viewed as having been acquired by purchase, those assets acquire a new income tax basis at the seller's death under IRC Sec. 1012 equal to what is treated as the purchase price.

One would expect that a person who is of the view that death is not a realization event would also conclude that the seller's death does not cause any change to the IDIT's basis in the assets which it purchased from seller. If the seller's death is not believed to be a realization event, it is consistent to conclude that the seller's death does not bring about any change in the basis of the IDIT's assets. Several commentators who do not believe that the seller's death is a realization event have also expressed the view that the seller's death causes no change in the IDIT's basis.[63] There is a consistency in this view which is conceptually appealing. There are, however, other commentators who, while believing that the seller's death does not cause realization of gain, nevertheless believe that the seller's death causes a change in the income tax basis of the IDIT's assets.

a. Change in Basis Under IRC Sec. 1012.

The authors of one article (herein "Messrs. Manning and Hesch") express the view that the seller is to be regarded as transferring assets to the IDIT at death when the IDIT's grantor trust status for income tax purposes terminates. That transfer is in exchange for the promissory note, and, in their view, constitutes a sale requiring basis to be adjusted under IRC Sec. 1012 even though under *Crane* there is no realization of gain.[64]

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[63] Aucutt, *Installment Sales to Grantor Trusts*, note 43, *supra;* Peebles, *Death of an IDIT Noteholder*, note 43, *supra*.

[64] Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, note 43, *supra*. See also Hodge, *On the Death of Dr. Jekyll - Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at Grantor's Death*, note 43, *supra*.

Messrs. Manning and Hesch recognize that their opinion that the basis of the IDIT's assets should be adjusted under IRC Sec. 1012 seems inconsistent with their view that no gain is realized at the seller's death. Even though under *Crane* there is no realization of gain, they still view the seller's death as causing a simultaneous deemed transfer of assets to the IDIT and the deemed issuance of the promissory note. These two events, which are treated as occurring simultaneously, together with the fact that the IDIT actually gave the promissory note to the seller during the seller's lifetime in exchange for the assets purchased, should in their view cause the note to be treated as given for such assets at seller's death. Such treatment makes IRC Sec. 1012 applicable to determine the IDIT's basis in the assets.

The effort by Messrs. Manning and Hesch to address the inconsistency of their position is thought-provoking. In this author's view, however, the inconsistency should not be accepted as correct unless it is inescapable, i.e., unless there exists no other reasonable analysis or explanation that avoids the inconsistency.

This author does not believe that the inconsistency is inescapable. In this author's view, *Crane* should be regarded as establishing that there is no sale by the seller or purchase by the IDIT. If there is no realization of gain, that is because there is no purchase. This view also seems more consistent with the rationale of Rev.Rul. 85-13. Under that rationale, a wholly grantor trust does not exist apart from its grantor for income tax purposes. Under Rev.Rul. 85-13, the income tax consequences of a sale between an IDIT and its grantor during the grantor's lifetime are not suspended or delayed. The sale is treated as not occurring. Not applying IRC Sec. 1012 at the seller's death is more consistent with this treatment.

Without *Crane*, perhaps it would be appropriate to treat the simultaneous transfer of assets to the IDIT and the IDIT's issuance of the promissory note at the seller's death as a purchase and sale. However, just because two events occur simultaneously does not mean that they are actually one event. With the treatment of the transaction in *Crane* as a background, a better conceptual result is produced if IRC Sec. 1012 is not viewed as applicable, just as the predecessor to IRC Sec. 1012 was not considered applicable by the Supreme Court in *Crane*.

b. <u>Change in Basis Under IRC Sec. 1014(b)(1)</u>.

The authors of another article (herein "Messrs. Blattmachr, Gans and Jacobson") believe that the IDIT's assets acquire a new income tax basis under IRC Sec. 1014 upon the seller's death even though the assets of the IDIT are not included in the seller's gross estate for Federal

estate tax purposes.[65] Messrs. Blattmachr, Gans and Jacobson express the view that a step up in basis under IRC Sec. 1014(b)(1) does not, by the express terms of the statute, require estate tax inclusion as a prerequisite for a basis step up. The statutory language only requires that an asset be acquired from a decedent by "bequest, devise, or inheritance." Because an IDIT is not recognized to exist for income tax purposes during the grantor's lifetime under the rationale of Rev.Rul. 85-13, assets titled in the name of an IDIT at the time of the grantor's death should be viewed for income tax purposes as passing to the IDIT by "bequest, devise, or inheritance" at the grantor's death when the IDIT loses its grantor trust status and becomes a separate taxpayer.

Messrs. Blattmachr, Gans and Jacobson recognize that their view on the applicability of IRC Sec. 1014(b)(1) to increase the basis of assets held by an IDIT at the death of its grantor is unconventional. The conventional view is for the basis of an asset to be changed under IRC Sec. 1014, it must be included in an individual's gross estate. Messrs. Blattmachr, Gans and Jacobson concede that Treas.Reg.Sec. 1.1014-2(a)(1) and the 1954 legislative history appear to contemplate that IRC Sec. 1014(b)(1) applies only to property passing under a decedent's Will or under the laws of intestacy, i.e., through a probate estate, where the property is included in the Federal gross estate. They note that IRC Secs. 1014(b)(2) and (3) make IRC Sec. 1014 applicable to certain lifetime trusts which constitute grantor trusts for income tax purposes. While conceding that their construction of IRC Sec. 1014(b)(1) makes IRC Secs. 1014(b)(2) and (3) unnecessary, they reject the proposition that IRC Sec. 1014(b)(1) applies only to assets passing through a probate estate. They point out that IRC Secs. 1014(b)(1), (2) and (3) were enacted before Rev.Rul. 85-13 was issued. At the time of enactment of IRC Secs. 1014(b)(1), (2) and (3), it was not at all clear that transactions between a grantor trust and its grantor should be disregarded for income tax purposes. As a result, according to Messrs. Blattmachr, Gans and Jacobson, Congress would not have known that the rules created by IRC Secs. 1014(b)(2) and (3) were already covered by IRC Sec. 1014(b)(1).

A problem with the construction given IRC Sec. 1014(b)(1) by Messrs. Blattmachr, Gans and Jacobson is that Treas.Reg.Sec. 1.1014-2(a)(1), in describing property which passes by "bequest, devise, or inheritance," mentions only two ways such passing occurs. One is by the decedent's Will, and the other is by the laws of intestacy. Both of these methods occur only with

[65] Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, note 43, *supra*.

a probate administration. Treas.Reg.Sec. 1.1014-2(a)(1) was itself issued prior to Rev.Rul. 85-13. At the time Treas.Reg.Sec. 1.1014-2(a)(1) was issued, it was not clear that assets held in a grantor trust should be viewed, for income tax purposes, as passing to the trust upon the grantor's death. If the consequences of grantor trust status were not clarified until the issuance of Rev.Rul. 85-13, it seems improper to use the conclusions of Rev.Rul. 85-13 in construing the language of Treas.Reg.Sec. 1.1014-2(a)(1). IRC Sec. 1014(b)(1) and Treas.Reg.Sec. 1.1014-2(a)(1) should be construed as requiring an actual probate administration and not as referring to a deemed transfer at the grantor's death which exists only as a result of Rev.Rul. 85-13. It is this author's view that IRC Sec. 1014(b)(1) does not apply to adjust the basis of assets held by an IDIT at the death of its grantor.[66]

4. Conclusions on Income Tax Consequences of Seller's Death.

Summarizing, in this author's opinion, the death of a seller holding an IDIT's promissory note is essentially an income tax nonevent. Specifically, this author believes that, under *Crane*, there is no realization of gain on the seller's death. This author also believes that the IDIT's promissory note held by the seller at death acquires a new income tax basis equal to its Federal estate tax value in the seller's gross estate. Finally, this author believes that the income tax basis of the assets held by the IDIT at the seller's death does not change.

This author recognizes that these opinions are not shared by many respected commentators. He believes, however, that they represent the best analysis of what occurs at the seller's death, applying the principles of *Crane*, Rev.Rul. 85-13 and the other authorities discussed in this Section VII.B.

C. Effectiveness of "Basis Boosting" Strategy to Avoid Capital Gain at Death.

Two of the authors of the Incomplete Equity Strategy Article discussed in Section III.C., *supra*, have written another article in which they propose a strategy which they state reduces the risk that income tax is triggered when a seller of appreciated property to an IDIT in exchange for the IDIT's promissory note dies before the note is paid off (the "Basis Boosting Article").[67] The Basis Boosting Article points to the uncertainty which exists on whether the seller's death before

[66] See CCA 200937028 which reaches this same conclusion.

[67] Dunn and Park, *Basis Boosting: How to Avoid an Income Tax Problem in Sales to Grantor Trusts*, 145 Tr. & Est. No. 2, 22 (Feb. 2007).

the note is paid off has income tax consequences. It states that resolution of the question might depend upon whether assets sold to the IDIT are deemed transferred to the IDIT immediately before or immediately after the seller's death. If before, the assets are not treated as owned by the seller at death and acquire no step-up in basis. If those assets are to be considered as exchanged for the IDIT's note at the seller's death, gain is recognized, according to the Basis Boosting Article, because the basis of the IDIT's assets is less than the face amount of the note.

The Basis Boosting Article suggests that this possible result can be avoided if the seller transfers additional assets to the IDIT which have a basis sufficient to increase the basis of all assets of the IDIT to a total no less than the face amount of the promissory note. The Basis Boosting Article claims that because the face amount of the note does not exceed the IDIT's basis in its assets, no gain is recognized at the seller's death.

The Basis Boosting Article suggests that the seller retain a power over assets which the seller adds to the IDIT which avoids any gift on such addition. For example, the seller might retain the power to revoke the addition. The retained power may, however, keep the strategy suggested by the Basis Boosting Article from succeeding. Assets over which the seller has retained a power which avoids a gift will cause those assets to be included in the seller's estate at death. By being included in the seller's estate, such assets will acquire a new basis at the seller's death. As a result, the transfer of those assets might be viewed as occurring "after" the seller's death, and the basis of such assets might not be considered basis of the IDIT at the time of the seller's death. If the recognition of gain at the seller's death is actually a problem, the remedy suggested by the Basis Boosting Article does not appear to be a solution.

VIII. Discounting Value of Note in Subsequent Transfer Subject to Estate or Gift Tax.

The applicable Federal rate is generally well below the prevailing market interest rate for arm's length loan. It might seem inconsistent after using the applicable Federal rate to establish the fair market value of an IDIT's promissory note at its face amount in a sale to IDIT transaction to then, in a subsequent transfer of the note which is subject to estate or gift tax, discount the note below face amount. IRC Sec. 7872(i) appears to be an attempt to deal with this issue.

IRC Sec. 7872(i)(1)(A) directs the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the provisions of IRC Sec. 7872 in certain circumstances, including disposition of the lender's or borrower's interest in an IRC Sec. 7872

loan. Such regulations are to adjust the provisions of IRC Sec. 7872 when, because of such circumstances, the provisions of IRC Sec. 7872 do not carry out its purposes.

IRC Sec. 7872(i)(2) provides that, under regulations prescribed by the Secretary of the Treasury, any loan which is made with donative intent and which is a term loan is to be taken into account for purposes of chapter 11 (dealing with estate tax) in a manner consistent with IRC Sec. 7872(b). IRC Sec. 7872(b) deals with the transfer which is considered to be made from lender to borrower in the case of a low-interest term loan.

Proposed Regulations were issued in 1986 under authority of IRC Sec. 7872(i). These Proposed Regulations have not been finalized.

Prop.Reg.Sec. 20.2031-4 refers to Treas.Reg. 20.7872-1 for special rules governing the estate tax value of gift loans made after June 6, 1984. Prop.Reg.Sec. 20.7872-1 provides that the estate tax value of a gift term loan is the lesser of: (i) the unpaid stated principal, plus accrued interest; or (ii) the sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death. Prop.Reg.Sec. 20.7872-1 further provides that no discount is allowed based upon evidence that the loan is uncollectible, unless the facts concerning collectability of the loan have changed significantly since the time the loan was made. The last sentence of Prop.Reg.Sec. 20.7872-1 provides that the Proposed Regulation is to apply "with respect to any term loan made with donative intent after June 6, 1984, regardless of the interest rate under the loan agreement, and regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made."

Prop.Reg.Sec. 20.7872-1 is clearly designed to establish the rule envisioned by IRC Sec. 7872(i)(2). It is not clear what constitutes a "loan made with donative intent." One might speculate that a loan to a family member which bears interest at the applicable Federal rate, but which is lower than prevailing market rates, might be considered to have been with donative intent.

The other proposed regulations issued in 1986 under IRC Sec. 7872(i) deal with the valuation for gift and income tax purposes of a below-interest loan. Those proposed regulations

contain no language similar to Prop.Reg.Sec. 20.7872-1, dealing with a transfer subject to gift tax of an existing note evidencing a term loan.[68]

Although it might be argued that if formally promulgated, Prop.Reg.Secs. 20.2031-4 and 20.7872-1 would preclude discounting a note given in a sale to IDIT transaction on the seller's estate tax return, absent significant changes in collectability. Those regulations have not been adopted as final regulations and, thus, do not satisfy the requirements of IRC Sec. 7872(i)(2) to be effective. Proposed Regulations are accorded little, if any, deference.[69] There is not even a proposed regulation dealing with the gift tax value in a subsequent inter vivos transfer of a note governed by IRC Sec. 7872. In the absence of final regulations satisfying the requirements of IRC Sec. 7872(i), it would seem that it is permissible in a subsequent transfer subject to estate or gift tax to claim discounts in valuing notes originally valued at face under IRC Sec. 7872. As noted in Section VII.B.2., *supra*, reporting an IDIT's promissory note at a discounted value on a seller's estate tax return risks converting principal payments on the note into ordinary income under the market discount rules.

IX. Use of Family Limited Partnerships in Sale to IDIT Transactions.

There are numerous cases in which the courts have recognized that limited partnerships or other entities can be utilized to produce estate and gift tax valuation discounts.[70] Assets such

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[68] Prop.Reg.Sec. 25.2512-8 provides that a note given in exchange for the purchase of property in a sales transaction which is bona fide, at arm's length and free from any donative intent is to be valued in accordance with Treas.Reg.Sec. 1.1012-2. Prop.Reg.Sec. 1.1012-2(b)(1) provides that the value of a debt instrument issued by a buyer to a seller which has adequate stated interest under IRC Sec. 1274(c)(2) is its issue price, i.e., its face amount.

Prop.Reg.Sec. 25.2512-4 refers to Treas.Reg.Sec. 25.7872-1 for valuation rules in the case of gift loans made after June 6, 1984. Prop.Reg.Sec. 25.7872-1 provides that if a taxpayer makes a gift loan within the meaning of Prop.Reg.Sec. 1.7872-4(b) that is a term loan, the excess of the amount loaned over the present value of all payments which are required to be made under the loan agreement is treated as a gift from the lender to the borrower.

[69] *State Farm Mutual Ins. Co. v. Commissioner,* 130 T.C. No. 16 (2008); *Perano v. Commissioner,* 130 T.C. No. 8 (2008); *Southland Royalty Co. v. U.S.,* 91-1 U.S.T.C. ¶50, 083 (Ct. Clc. 1991); *Madden v. Commissioner*, 57 T.C.M. 84 (1989).

[70] *See Estate of Harrison v. Commissioner*, 52 T.C.M. 1306 (1987); *Estate of Nowell v. Commissioner*, 77 T.C.M. 1239 (1999); *Kerr v. Commissioner*, 113 T.C. 450 (1999), *aff'd* 292 F.3d 490 (5th Cir. 2002); *Church v. U. S.*, 2000-1 U.S.T.C. ¶60,369 (W.D. Tex. 2000), *aff'd unpub'd op.* 268 F.3d 1063 (5th Cir. 2001); *Estate of Harper v. Commissioner*, 79 T.C.M. 2232

as cash and marketable securities might be contributed to a limited partnership in exchange for limited partnership interests. If the limited partnership produces valuation discounts, the limited partnership interests can be sold to an IDIT for a smaller promissory note than would be received if the seller sold the underlying assets to the IDIT. The result is an immediate reduction in the value of the seller's estate without gift tax consequences.[71]

The IRS has had success in asserting the application of IRC Sec. 2036(a)(1) in cases in which individuals have owned limited partnership interests or interests in limited liability companies at death.[72] In these cases, the courts do not find that the existence of the limited

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(2000); *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd and rev'd sub nom. Gulig v. Commissioner*, 293 F.3d 279 (5th Cir. 2002); *Knight v. Commissioner*, 115 T.C. 506 (2000); *Estate of Jones v. Commissioner*, 116 T.C. 121 (2001); *Estate of Dailey*, 82 T.C.M. 710 (2001); *McCord v. Commissioner*, 120 T.C. 358 (2003); *Lappo v. Commissioner*, 86 T.C.M. 333 (2003); *Peracchio v. Commissioner*, 86 T.C.M. 412 (2003); *Estate of Kelley v. Commissioner*, 90 T.C.M. 369 (2005); *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005); *Temple v. U.S.*, 423 F.Supp.2d 605 (E.D. Tex. 2006); *Estate of Kohler v. Commissioner*, 92 T.C.M. 48 (2006); *Astleford v. Commissioner*, 95 T.C.M. 1497 (2008); *Holman v. Commissioner*, 130 T.C. No. 12 (2008); *Gross v. Commissioner*, 96 T.C.M. 187 (2008); *Pierre v. Commissioner*, 133 T.C.No. 2 (2009).

[71] The Obama administration has proposed amendments to IRC Sec. 2704 which would eliminate minority interest valuation discounts for interests held by an individual in limited partnerships and other entities controlled by the individual's family. See *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, Dept. of Treas. (May 2009). Even if this proposal is enacted, it may be that limited partnerships and other entities may still be used to produce lack of marketability discounts. Adoption of the Obama proposals would have a substantial impact on valuation discount planning with entities such as limited partnerships.

[72] *Estate of Schauerhamer v. Commissioner*, 73 T.C.M. 2855 (1997); *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000); *Estate of Harper v. Commissioner*, 83 T.C.M. 1641 (2002); *Estate of Thompson v. Commissioner*, 84 T.C.M. 374 (2002), *aff'd sub nom. Turner v. Commissioner*, 382 F.3d 367 (3d Cir. 2004); *Estate of Strangi v. Commissioner*, 85 T.C.M. 1331 (2003), *aff'd; sub nom. Turner v. Commissioner*, 382 F.3d 367 (3d Cir. 2004); *Kimbell v. United States*, 244 F.Supp.2d 700 (N.D. Tex. 2003), *vac'g and rem'g*, 371 F.3d 257 (5th Cir. 2004); *Abraham v. Commissioner*, 87 T.C.M. 975 (2004), *aff'd*, 408 F.3d 26 (1st Cir. 2005), *cert. denied* (June 5, 2006); *Estate of Hillgren v. Commissioner*, 87 T.C.M. 1008 (2004); *Estate of Bongard v. Commissioner*, note 70, *supra*; *Estate of Bigelo v. Commissioner*, 89 T.C.M. 954 (2005); *Estate of Korby v. Commissioner*, 89 T.C.M. 1142 (2005) and 89 T.C.M. 1150 (2005); *aff'd* 471 F.3d 848 (8th Cir. 2006); *Estate of Disbrow v. Commissioner*, 91 T.C.M. 794 (2006); *Estate of Rosen v. Commissioner*, 91 T.C.M. 1220 (2006); *Estate of Erickson v. Commissioner*, 93 T.C.M. 1175 (2007); *Estate of Gore v. Commissioner*, 93 T.C.M. 1436 (2007); *Estate of Rector v. Commissioner*, 94 T.C.M. 567 (2007); *Estate of Hurford v. Commissioner*, 96 T.C.M. 422 (2008); *Estate of Jorgensen v. Commissioner*, 97 T.C.M. 1328

partnership should be disregarded. Rather, the courts have found that the decedents in those cases retained the enjoyment of or right to income from the assets transferred into the limited partnerships causing IRC Sec. 2036(a)(1) to be applicable. The applicability of IRC Sec. 2036(a)(1) renders irrelevant the effect which the strictures caused by a limited partnership have on value. Under IRC Sec. 2036(a)(1), transferred assets are included in the estate as though the transfer had never taken place. The transferred assets are included at their underlying value without regard to how they are owned.

A. <u>Sale to IDIT Avoids IRC Sec. 2036(a)(1).</u>

IRC Sec. 2036(a)(1) is an estate tax statute. The cases applying IRC Sec. 2036(a)(1) to limited partnership interests held at death do not apply to the gift tax valuation of limited partnership interests transferred during lifetime. The sale to IDIT technique permits limited partnership interests to be disposed of during lifetime, taking advantage of valuation discounts. If the sale transaction is structured to avoid IRC Sec. 2702 and if the value of the limited partnership interests sold to the IDIT does not exceed the face amount of the promissory note received in the sale, the limited partnership interests are removed from the estate without any gift being made. As discussed in Section III.A., *supra*, if the sale avoids IRC Sec. 2702, it should also avoid IRC Sec. 2036(a)(1) at death. The result is a reduction in the value of the estate with the IDIT's promissory note taking the place of the limited partnership interests.

One test used by the courts in applying IRC Sec. 2036(a)(1) is whether a decedent has placed most of his or her assets in a limited partnership. If so, the courts frequently conclude that the decedent must have anticipated receiving distributions from the limited partnership in order to pay living expenses. This test should be rendered irrelevant if limited partnership interests are sold to an IDIT for the IDIT's promissory note following the structure suggested in Sections III.A. and B., *supra*. With that structure, the note should not constitute a retained

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(2009); *Estate of Malkin v. Commissioner*, 98 T.C.M. 225 (2009). There are cases in which IRS attempts to assert includability under IRC Sec. 2036(a)(1) have been unsuccessful. *See Church v. U.S.*, 2000-1 U.S.T.C. ¶60,369 (W.D.Tex. 2000), *aff'd* 268 F.3d 1063 (5th Cir. 2001); *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004); *Estate of Bongard v. Commissioner*, note 70, *supra; Estate of Schutt v. Commissioner*, 89 T.C.M. 1353 (2005); *Estate of Mirowski v. Commissioner*, 95 T.C.M. 1277 (2008); *Estate of Miller v. Commissioner*, 97 T.C.M. 1602 (2009); *Keller v. U.S.*, 2009-2 U.S.T.C. ¶60,579 (S.D.Tex. 2009); *Estate of Murphy v. U.S.*, 2009-2 U.S.T.C. ¶60,583 (W.D.Ark. 2009); *Estate of Black*, 133 T.C. No. 15 (2009); *Estate of Shurtz v. Commissioner*, T.C.Memo. 2010-21 (2010).

interest to which IRC Sec. 2036(a)(1) applies, irrespective of what portion of an individual's estate has been contributed into the limited partnership. The sale to IDIT technique permits a greater portion of an individual's estate to be involved in the limited partnership planning than is the case when an individual simply retains a limited partnership interest until death.

B. Indirect Transfer of Limited Partnership's Underlying Assets.

The IRS has asserted in a number of cases with some success that a transfer of interests in a limited partnership, or other entity such as a limited liability company, really constituted a transfer of the underlying assets held by the entity for which no valuation discount was allowable. The IRS has made this argument in at least one case in which the limited partnership interests were transferred before assets were conveyed into the limited partnership.[73] The IRS has also made this argument when the sequence of funding an entity and transferring interests in the entity is uncertain.[74]

A difficulty with a number of the cases from a planning perspective is that the opinions in those cases indicate that it may not be sufficient simply to demonstrate that the transfer to the entity took place prior to the transfer of interests in the entity.[75] These cases suggest that a period of time must pass between the date of contribution of assets to the entity and the date of transfer of interests in the entity. According to these cases, the time which passes must be sufficiently long to result in the original contributor to the entity bearing a material economic risk that asset values would change between the date of contribution and the date of transfer, given the nature of the assets placed in the entity. In cases involving transfers of limited partnership interests in limited partnerships holding marketable securities, periods of six days[76]

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[73] *Shepherd v. Commissioner*, 115 T.C. 374 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002); *Estate of Malkin v. Commissioner*, note 72, *supra*.

[74] *Senda v. Commissioner*, 88 T.C.M. 8 (2004), *aff'd* 433 F.3d 1044 (8th Cir. 2006); *Holman v. Commissioner*, note 70, *supra*; *Gross v. Commissioner*, note 70, *supra*; *Linton v. U.S.*, 104 AFTR 2d 2009-5176 (W.D.Wash. 2009); *Heckerman v. U.S.*, 104 AFTR 2d 2009-5551 (W.D.Wash. 2009).

[75] *Holman v. Commissioner*, note 70, *supra*; *Gross v. Commissioner*, note 70, *supra*; *Linton v. U.S.*, note 74, *supra*; *Heckerman v. U.S.*, note 74, *supra*.

[76] *Holman v. Commissioner*, note 70, *supra*.

and eleven days[77] were held sufficient. The opinions in two cases indicate that a period of up to nine days is insufficient for cash and municipal bonds[78] or cash alone[79].

The courts' discussion of economic risk and passage of time between funding and transfer is disturbing. A legitimate question is what does economic risk associated with the underlying assets held by an entity have to do with the issue of whether a gift consists of those assets or the interests in the entity in which they are held. If economic risk is the test, it would seem that no discount should be allowable with respect to a transfer of interests in a limited partnership whose only asset was a non-interest-bearing checking account. A gift of interests in an entity holding real estate would seem to require months between funding and gifting.

In all of the cases cited in note 74, *supra*, it was unclear whether the funding of an entity preceded the transfer of interests in the entity. Hopefully, all of the discussion of economic risk will ultimately be determined to have no bearing when there is no doubt that funding preceded transfer, and when other formalities regarding the entity have been observed. Until that time, to preserve valuation discounts, practitioners would be advised to allow at least several days to pass between funding of an entity and the transfer of interests in the entity.

X. Sales of S Corporation Stock.

So long as the grantor is a citizen or a resident of the U.S., the grantor trust status of an IDIT qualifies it to be a shareholder of an S corporation.[80] Prior to a sale to an IDIT, an S corporation might be reorganized by having the shareholders surrender their existing voting common shares for new common stock. One percent of the new stock might be voting, and 99% of the new stock might be nonvoting. A corporation is not treated as having more than one class of stock, thus making the corporation ineligible to be an S corporation, solely because of differences in voting rights among the shares of common stock.[81] The shareholder might retain

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[77] *Gross v. Commissioner*, note 70, *supra*.

[78] *Linton v. U.S.*, note 74, *supra*.

[79] *Heckerman v. U.S.*, note 74, *supra*.

[80] IRC Sec. 1361(c)(2)(A)(i).

[81] IRC Sec. 1361(c)(4).

the voting stock, and sell the nonvoting stock to an IDIT in exchange for the IDIT's promissory note.

This suggested reorganization and sale arrangement produces several favorable results. It allows for a minority interest discount in valuing the shares sold to the IDIT, even if the shareholder originally possessed voting control of the corporation. It should also permit the shareholder to retain the vote associated with the old voting common stock without having the nonvoting shares included in the shareholder's estate under IRC Sec. 2036(b). IRC Sec. 2036(b) applies when a shareholder has transferred stock of a controlled corporation, but has retained the right to vote the transferred shares. [82] The statute should not be applicable to the suggested reorganization and sale arrangement because the arrangement does not result in the shareholder retaining the right to vote shares of transferred stock. The stock which is transferred is nonvoting. The voting stock is retained, not transferred.[83]

Shareholders of an S corporation are taxed directly on the corporation's income, whether or not that income is distributed by the corporation to the shareholders. Income attributable to shares of S corporation stock held by an IDIT is taxed to the IDIT's grantor. S corporations commonly pay dividends to provide funds for shareholders to pay taxes on S corporation income. If shares have been sold to an IDIT, it is the IDIT which receives the dividends, not the grantor. Since the grantor is not a beneficiary of the IDIT, these funds can be passed through to the grantor for the payment of taxes only by making payments on the promissory note.

Frequently, the dividends received by the IDIT and paid to the grantor on the promissory note will exceed the interest accruing on the promissory note. This occurs for several reasons. One reason is that the applicable Federal rate is generally lower than prevailing market rates.

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[82] Under IRC Sec. 2036(b), the retention of the right to vote, directly or indirectly, shares of stock of a controlled corporation is considered to be a retention of the enjoyment of transferred property for purposes of IRC Sec. 2036(a)(1). A corporation is a controlled corporation if at any time after the transfer of the shares and during the three year period ending on the date of the decedent's death, the decedent owned (with the application of the attribution rules of IRC Sec. 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock.

[83] Prop.Reg.Sec. 20.2036-2(a)(3) adopts this analysis. It states that if a person who owns 100% of the voting and nonvoting stock of a corporation transfers the nonvoting stock, that person is not to be treated as having retained the enjoyment of the property transferred merely because of the voting rights in the stock retained.

Another reason is that the valuation discount allowable in valuing the nonvoting stock for purposes of the sale effectively increases the stock's rate of return. Payments in excess of interest on a promissory note reduce the principal amounts due under the promissory note, and, consequently, the seller's estate. If the S corporation is particularly profitable, the reduction in the principal amount due on the promissory note can be dramatic. S corporation stock is frequently an excellent candidate for a sale to IDIT transaction.

XI. Sale in Exchange for an Annuity Payable Over Seller's Lifetime.

A seller might have a life expectancy shorter than what might be expected for an individual his or her age. In such instance, consideration might be given to selling assets to an IDIT in exchange for an annuity payable over the seller's lifetime. The actuarial tables prepared in compliance with IRC Sec. 7520 are to be used in valuing an annuity.[84] If the seller dies in a shorter time than predicted by the tables, payments which the tables assume are made to the seller are not, in fact, made. As a result, the value of the seller's estate is reduced without gift tax consequences.

With a sale in exchange for an annuity, the income tax consequences of the sale during the seller's lifetime are the same as with a sale to an IDIT in exchange for a promissory note. Under Rev.Rul. 85-13, the sale causes no recognition of gain or loss. The seller is taxed on all income of the IDIT, and the IDIT's annuity payments are not separately taxable to the seller. The annuity payments are not deductible by the IDIT, and have no effect on the IDIT's income tax basis in the purchased assets. The IDIT takes the seller's basis in the purchased assets without any adjustment resulting from its purchase or its annuity payments to the seller.

A. Terminal Illness Exception to Use of IRS Actuarial Tables.

Treas.Reg.Sec. 25.7520-3(b)(3) provides that the mortality component prescribed under IRC Sec. 7520 may not be used to determine the present value of an annuity, income interest, remainder interest or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the transaction is completed. The Regulation provides that for purposes of this rule, an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year. The Regulation also provides that if an individual survives

[84] Treas.Reg.Sec. 25.7520-1(a).

for 18 months or longer after the transaction, that individual is presumed to have not been terminally ill unless the contrary is established by convincing evidence.[85]

With an annuity, application of the tables is certain so long as the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3) is met. If that test is met, the tables are binding upon the IRS even if it is conceded that the seller's life expectancy is materially shorter than predicted by the tables. When an individual has a shorter than normal life expectancy but satisfies the 50% test, Treas.Reg.Sec. 25.7520-3(b)(3) can produce substantial estate tax savings. Essentially, it is conclusively presumed that such individual will be alive to receive annuity payments over his or her actuarial life expectancy under the tables, even though that is, in fact, not likely to be the case.

B. <u>Exhaustion Test Must Be Considered.</u>

If an annuity is used, the application of Treas.Reg.Sec. 25.7520-3(b)(2)(i) must be considered. That Regulation provides for a reduction in the value of an annuity payable from a trust or other limited fund which, considering the applicable interest rate under IRC Sec. 7520, the annuity can be expected to exhaust before the last payment is made. In the case of an annuity based upon an individual's lifetime, the possibility of exhaustion is to be determined under the assumption that the individual lives to be 110.[86] Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) illustrates the operation of Treas.Reg.Sec. 25.7520-3(b)(2)(i).

Example 5 postulates that a donor who is 60 and in normal health transfers property worth $1 million to a trust which is to make an annual payment of $100,000 to a charitable organization for the life of the donor. At the donor's death, the remainder is to be distributed to the donor's child. The IRC Sec. 7520 rate is stated to be 6.8%. The Example notes that if the trust earns the assumed 6.8% IRC Sec. 7520 rate, it will only be able to make 17 annual payments in full and will be exhausted after making a partial 18th payment. As a result, for purposes of determining the value of the distribution to charity, the Regulation requires the provisions governing the annuity payments to be recharacterized as a distribution of $100,000 per year for the donor's life or, if shorter, for a period of 17 years and an additional partial

[85] *See also* Treas.Reg.Secs. 1.7520-3(b)(3), 20.7520-3(b)(3) and the Examples at 1.7520-3(b)(4), 20.7520-3(b)(4) and 25.7520-3(b)(4).

[86] *See also* Treas.Reg.Secs. 1.7520-3(b)(2)(i) and 20.7520-3(b)(2)(i).

payment in the 18th year. Because of the limitation on the size of the fund which must be taken into account, Example 5 concludes that the actual value of the charitable annuity interest is $880,213.38. The conclusion of Example 5 means that of the $1 million originally placed in the trust, only $880,213.38 qualifies for the charitable deduction, resulting in a taxable gift equal to $119,786.62.

Although it might intuitively seem impossible to have a taxable gift upon the creation of a trust described in Example 5, the principles upon which Example 5 rests are sound. In Example 5, the charity is not actually granted an annuity payable over the individual's lifetime, because there are not enough funds to make payment if the individual survives his or her life expectancy, or longer. Necessarily, the charity is only receiving an annuity having a present value of $880,213.38. If that is the value of the amount passing to charity and $1 million is the amount of the gift to the trust, the excess $119,786.62 must necessarily be a taxable gift since it does not qualify for the charitable deduction.

Treas.Reg.Sec. 25.7520-3(b)(2)(i) essentially requires that additional assets be made available to the IDIT to cover the possibility that annuity payments might be required to be made until the seller reaches 110 years of age as required by Treas.Reg.Sec. 25.7520-3(b)(2)(i). The additional assets under Treas.Reg.Sec. 25.7520-3(b)(2)(i) are in addition to any cushion which is afforded to avoid possible applications of IRC Secs. 2036(a)(1) and 2702. A transfer of assets by the seller will involve a gift. Guarantees by beneficiaries might also be considered to be gifts by them because of the assumed shortfall mandated by Treas.Reg.Sec. 25.7520-3(b)(2)(i). It would seem that a guarantee by an unrelated party in exchange for a fee might avoid gift tax consequences as a transaction in the ordinary course of business.[87]

If the seller furnishes funds to meet the exhaustion test and to afford a cushion for the sale, use of an annuity instead of an ordinary promissory note may involve a significant gift at the time the transaction is entered into, especially in larger cases. However, if a seller meeting the 50% test of Treas.Reg.Sec. 25.7520-3(b)(2)(i) dies prior to the time predicted by the actuarial tables, the estate savings can be worth the gift tax cost.

[87] Treas.Reg.Sec. 25.2512-8.

XII. Use of a Self-Canceling Installment Note (SCIN).

Rather than using an annuity, one might consider selling assets in exchange for a self-canceling installment note, or SCIN. A SCIN is an installment note which terminates on the seller's death. Any outstanding obligation which is canceled at the seller's death is not included in the seller's gross estate.[88] The value of the balance due on the SCIN at the seller's death escapes Federal estate tax.

A question arises as to whether the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3) applies to a SCIN. The answer to this question is uncertain.

IRC Sec. 7520(b) provides that IRC Sec. 7520 is not to apply for purposes of part I of subchapter D of chapter 1 or any other provision specified in regulations. Treas.Reg.Sec. 25.7520-3(a)(7) provides that IRC Sec. 7520 does not apply for purposes of IRC Sec. 7872. Under the decision in *Frazee*, IRC Sec 7872 governs the interest rate which the SCIN must bear.[89]

The extent to which Treas.Reg.Sec. 25.7520-3(a)(7) precludes application of IRC Sec. 7520 to IRC Sec. 7872 is not clear. It may be that the intent of Treas.Reg.Sec. 25.7520-3(a)(7) is only to emphasize that the interest rate under IRC 7520 is not to apply to a IRC Sec. 7872 transactions. However, the language of Treas.Reg.Sec. 25-7520-3(a)(7) is not so limited.

Treas.Reg.Sec. 25.7520-3(a)(7) creates doubt as to whether the actuarial tables under IRC Sec. 7520 are conclusive with a sale for a SCIN as they are with a sale for an annuity. With a sale for an annuity, a seller's satisfaction the 50% test of Treas.Reg.Sec. 25.7520-3(b)(2)(i) binds the IRS to the use of the actuarial tables under IRC Sec. 7520 in determining the seller's life expectancy, even if it is conceded that the seller's actual life expectancy is substantially shorter than predicted by the IRS's actuarial tables. Given the uncertainty that exists regarding the conclusiveness of the actuarial tables with SCINs, it would seem that the sale for an annuity is generally preferable to a sale for a SCIN, especially when the seller's actual life expectancy is materially shorter than predicted by the IRS's actuarial tables.

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[88] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980) *acq. result* 1981-1 C.B.2.

[89] *See also* Treas.Reg.Secs. 1.7520-3(a)(7) and 20.7520-3(a)(7).

XIII. Use of a Beneficiary Intentionally Defective Irrevocable Trust ("BIDIT").

It is possible to use IRC Sec. 678 to create an irrevocable trust which is wholly owned by a person other than the grantor. Specifically, a grantor might transfer up to $5,000 into a trust granting a beneficiary a Crummey power over the transferred assets which lapses if not exercised within a stated period of time. So long as the grantor is not taxed under any of the grantor trust rules of subpart E, such power causes the beneficiary to be treated as the owner of the trust. While the power is outstanding, the beneficiary is treated as the owner under IRC Sec. 678(a)(1). After the power has lapsed, the beneficiary is treated as owner under IRC Sec. 678(a)(2) if the beneficiary possesses control which would, if possessed by the grantor, cause the grantor to be taxed under IRC Secs. 671-677.

Although treated as owned by the beneficiary for income tax purposes, the trust can be excluded from the beneficiary's estate for Federal estate tax purposes. Because the beneficiary was not the original transferor with respect to the assets placed in the trust, IRC Sec. 2041 applies to the determination of whether such assets are includable in the beneficiary's estate rather than IRC Sec. 2036 or 2038. The lapse of the power is protected from inclusion by the "5&5" exception of IRC Sec. 2041(b)(3). The beneficiary can be given substantial beneficial interest in and control over such assets without causing inclusion under the other portions of IRC Sec. 2041.

For example, under the provisions governing a trust established by another grantor, a beneficiary may be named as sole trustee with the power to distribute income and principal to a class of beneficiaries which includes the beneficiary in amounts which the beneficiary as trustee determines to be appropriate in order to provide for the health, support, maintenance or education of any eligible distributee. The beneficiary trustee might be precluded from making any distribution to or for the benefit of another which satisfies any legal obligation of the beneficiary trustee. The beneficiary might also be granted a testamentary power of appointment over the assets composing the trust to such appointee or appointees as the beneficiary selects, other than the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.

Although these provisions confer what is the practical equivalent of outright ownership, they do not cause inclusion under IRC Sec. 2041. The beneficiary's powers to make distributions to himself or herself fall within the ascertainable standard exception of IRC Sec. 2041(b)(1)(A). The power to distribute to others and the testamentary power of appointment are

not general powers of appointment, because they do not include the beneficiary, the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.[90]

If the beneficiary were to transfer assets to that trust without consideration, the assets so transferred would be included in the beneficiary's estate at death under IRC Secs. 2036 and 2038 by virtue of the beneficiary's retained interests and powers with respect to those assets. IRC Secs. 2036 and 2038 would apply with respect to the beneficiary's transfer even though IRC Sec. 2041 governs with respect to the assets originally used to fund the trust.

A trust that is taxable to a beneficiary under IRC Sec. 678, but excluded from the beneficiary's Federal gross estate, might be called a Beneficiary Intentionally Defective Irrevocable Trust, or a "BIDIT." By their express terms, IRC Secs. 2036 and 2038 do not cause inclusion of assets transferred in "a bona fide sale for an adequate and full consideration in money or money's worth." This bona fide sale exception to the application of IRC Secs. 2036 and 2038 creates planning possibilities. Rather than selling assets to an IDIT in which the seller has no beneficial interest, the beneficiary of a BIDIT might sell assets to the BIDIT in exchange for the BIDIT's promissory note. If the promissory note bears interest at the applicable Federal rate, its gift tax value is equal to its face amount. So long as the fair market value of the assets sold does not exceed that face amount, neither IRC Sec. 2036 nor 2038 should apply to cause the assets sold to the BIDIT to be included in the seller beneficiary's estate.

If the assets sold to the BIDIT produce a total net return in excess of the interest on the promissory note, such excess will be excluded from the seller beneficiary's estate as it would be with an IDIT. Unlike the case with an IDIT, however, the seller beneficiary will still have access to such excess during his or her lifetime and retain ultimate control over the disposition of such excess at death. A person who is uncomfortable with selling assets to an IDIT because of the absence of access and control should be less hesitant about a sale to a BIDIT.

If a BIDIT is to be used, the transferor establishing the trust should use assets which are not traceable to the beneficiary. If a transfer originally funding a BIDIT can be traced to the beneficiary, the IRS would argue that the beneficiary is the true transferor with respect to that transfer, and that the nominal transferor is a mere conduit. The bona fide sale exception would

[90] *See* IRC Sec. 2041(b)(1).

not apply to that transfer, causing the full value of the trust to be subject to estate tax at the beneficiary's death.[91]

XIV. Unwinding Prior Sale When Assets Have Decreased in Value.

Given recent economic conditions, assets sold in a prior sale to IDIT transaction may have decreased rather than increased in value since the sale was effected. The decrease in value may be substantial. In such a case, a seller may wish he or she had waited to effect the sale until values had decreased so that the promissory note in his or her estate would be less than is actually the case. In certain cases it is worth considering unwinding the prior sale and effecting a new sale at lower values.

A. Unwinding Prior Sale When Cushion Furnished by Spousal Guarantee.

For example, a seller may have sold assets to an IDIT for $10 million. The seller's spouse may have guaranteed 10% of that indebtedness. The fair market value of the assets sold may now be $8 million. The seller may believe that the assets previously sold to the IDIT will ultimately recover their value, and perhaps even appreciate above their original $10 million value at the time of the sale.

If this seller were to die while the assets sold to the IDIT have a value of $8 million, the fact that the note has a face amount of $10 million should not cause it to be valued in the seller's estate at more than $8 million, plus any amount which might be due under the guarantee. Assume that amount is $1 million. Under these facts, it makes sense to pay off the note and have the seller forgive any indebtedness due from the spouse under the guarantee. The forgiveness should not have any income tax consequences, since it would be in the nature of a gift.[92] The forgiveness would qualify for the marital deduction and would, as a practical matter, be without gift tax consequences.

After the forgiveness, the seller's estate would include the $8 million in assets received from the IDIT in payment of the note, but nothing on the guarantee. There would seem to be no reason why the seller could not then resell the assets to a new IDIT for a new promissory note. The new IDIT should have provisions which differ from those of the old to avoid the IRS attempting to collapse the transaction and treat it as a forgiveness of $2 million in indebtedness

[91] *See* IRC Sec. 2043.

[92] IRC Sec. 102.

from the original IDIT, i.e. a $2 million gift to the original IDIT. In a further effort to avoid this challenge by the IRS, the documents should make it clear that the IDIT is distributing all of its assets to pay down the note to the extent those assets exist, and that the seller's forgiveness extends only to the spouse, not the IDIT. Having a new IDIT with different provisions should make it more difficult for the IRS to assert that the transaction in reality constitutes a $2 million gift to the original IDIT. If in fact the assets increase from $8 million to $10 million, the unwinding of the prior sale and the new sale results in a $2 million reduction in the value of the seller's estate.

B. When Cushion Afforded by Seller's Gift or Guarantee by an Individual Other Than Seller's Spouse.

If in the original sale transaction the seller made a gift to the IDIT to fund the cushion for the IDIT's promissory note, paying down the note and re-selling to a new IDIT will not produce any estate planning benefit unless the value of the assets sold to the IDIT and the current value of the cushion are less than the balance due on the promissory note. Any taxable gift which the seller made in funding the cushion will remain unchanged after the repayment, even though the assets used for the cushion have been returned to the seller and are now a part of the seller's estate.

The considerations involved when a guarantee of the IDIT's promissory note was given by a beneficiary who is not the seller's spouse are similar to those involved when the seller has made a gift to the IDIT to provide the cushion. In this case, the seller presumably did not make a gift upon the original sale. If the seller forgives the guarantee, the amount of the seller's gift on that forgiveness is a cost of unwinding the transaction. It would seem that the prior transaction should not be unwound unless the sum of the current value of the assets of the IDIT plus the taxable gift on the forgiveness is less than the amount due on the IDIT's promissory note.

Any gift which the guarantor makes in paying on the guarantee makes unwinding the prior sale even more unlikely to be economical. If a non-spousal guarantor who has been paid a fee for the guarantee pays on that guarantee, the guarantor should consider filing a gift tax return disclosing the payment and taking the position that the payment does not constitute a gift because of the fee. As noted in Section VI., *supra*, if the statute of limitations runs on the gift tax return, that position is binding upon the IRS.

The discussion in this Section XIV. indicates that a spousal guarantee of a portion of the IDIT's liability under its promissory note is generally the preferred method of providing a cushion for that note. If the value of the assets sold to an IDIT increases, any of the methods discussed in Section III., *supra,* to provide a cushion for the sale (other than the Limited Power of Appointment Share strategy discussed in Section III.C., *supra*) is likely to be satisfactory. The different methods of affording a cushion become significant only if values decrease to such an extent that the ability to unwind and redo the prior sale would be advantageous. In such case, the spousal guarantee becomes the superior method of affording the cushion because it can be forgiven and eliminated from the seller's estate without a taxable gift.

XV. Variations in the Sale to IDIT Technique As An Alternative to the Standard Irrevocable Life Insurance Trust.

A. The Standard Irrevocable Life Insurance Trust.

An Irrevocable Life Insurance Trust ("ILIT") is the traditional estate planning device which is used to eliminate insurance from an insured's estate. Practitioners commonly use so-called Crummey withdrawal powers (after the Ninth Circuit's decision in *Crummey v. Commissioner*[93]) to qualify funds added to the ILIT to pay premiums for the gift tax annual exclusion. The Crummey power grants beneficiaries of an ILIT the right to withdraw additions to the ILIT for a period of time, e.g., thirty days. If the Crummey power is not exercised within the specified time, the power lapses and the trustee can utilize the added funds for premium payments.

The IRS takes the position that for a Crummey power to be recognized, a beneficiary holding a Crummey power must have a beneficial interest in the trust other than the power itself.[94] Crummey withdrawal powers given to persons holding contingent remainder interests have been recognized.[95]

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[93] 397 F.2d 82 (9th Cir. 1968). *See also* Rev. Rul. 73-405, 1973-2 C.B. 321; Rev. Rul. 81-7, 1981-1 C.B. 474; *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result* 1992-2 C.B. 1; AOD 1996-010.

[94] *See, e.g.*, Ltr. Ruls. 8727003, 9045002, 9141008, 9628004 and 9731004.

[95] *Estate of Cristofani v. Commissioner*, note 93, *supra*; AOD 1996-010, note 93, *supra*; *Estate of Kohlsaat v. Commissioner*, 73 T.C.M. 2732 (1997).

A lapsed power does not constitute a gift by the beneficiary of the trust if the lapsed amount does not, during any calendar year, exceed the greater of $5,000 or 5% of the value of the assets out of which the withdrawal power could be satisfied.[96] The "hanging" Crummey power is frequently used to permit use of the maximum per donee annual exclusion without violating the "5 & 5" limit of IRC Sec. 2514(e). With a hanging power, a beneficiary's withdrawal power lapses in any calendar year only up to the 5 & 5 limit. Any excess of that limit remains open and exercisable until its lapse does not constitute a gift by the beneficiary under IRC Sec. 2514(e).

An individual may wish to acquire substantial amounts of life insurance with premiums in excess of annual exclusion gifts which could be covered by Crummey withdrawal powers in a conventional ILIT. Even with a hanging Crummey power, there might not be a sufficient number of persons to whom the individual is willing to grant beneficial interests in the ILIT to cover premium payments completely. Conversely, there may be a sufficient number of Crummey power donees, but the individual may prefer to make gifts of cash or other assets that can be used immediately, rather than using Crummey powers to make annual exclusion gifts which do not confer an immediate financial benefit on the donees. Such an individual might consider alternatives to the standard ILIT.

B. <u>The Brody and Weinberg Technique.</u>

One of those alternatives is a private split dollar arrangement suggested by Messrs. Brody and Weinberg to reduce the amount of gifts which are treated as having been made to the ILIT below the premiums that are actually paid.[97] The arrangement suggested by Messrs. Brody and Weinberg ("the Brody and Weinberg Technique") is a non-equity collateral assignment between the insured and an IDIT created by the insured. The IDIT owns and is beneficiary of the insurance. The collateral assignment is executed by the IDIT in favor of the insured and is filed with the insurer. The collateral assignment provides that the insured is to pay premiums. If the agreement is terminated during the insured's lifetime, the amount of premiums advanced (or the

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[96] IRC Sec. 2514(e).

[97] Brody and Weinberg, *The Side Fund Split-Dollar Solution™: A New Technique for Split-Dollar*, 33 Est. Plan. No. 1, 3 (2006) and *How an Innovative New Technique for Split-Dollar Life Insurance Works*, 33 Est. Plan. No. 2, 12 (2006). *See also* Brody and Ratner, *Today's Split Dollar*, 146 T.&E. No. 5, 38 (2007).

cash surrender value of the insurance, if greater) is to be repaid to the insured. If the insured dies while the agreement is in force, such amount is to be paid to the insured's estate or a revocable trust established by the insured.

To avoid the rights given the insured under the collateral assignment conferring incidents of ownership on the insured causing the insurance to be included in the insured's estate under IRC Sec. 2042, the collateral assignment is a "limited rights" collateral assignment. A limited rights collateral assignment limits the insured's rights under the collateral assignment solely to be paid for the premiums advanced (or cash surrender value, if greater) without any power over the insurance itself.

The Brody and Weinberg Technique permits the split dollar arrangement between the insured and the IDIT to be governed by the economic benefit regime rather than the loan regime. Thus, if the insured pays all premiums on the insurance, those payments are treated as conferring an economic benefit on the IDIT rather than as a loan to the IDIT. The amount of economic benefit is determined under Table 2001, or the insurer's lower term rates to the extent use of those rates is permitted under applicable IRS guidelines.

Under the economic benefit regime, the insured in the Brody and Weinberg Technique is treated as making annual gifts to the IDIT of the economic benefit.[98] While the insured is young, the amount of the gifts by virtue of the economic benefit treatment is less than the premiums paid on the insurance. The technique reduces the amount which must be covered by Crummey withdrawal powers. In the case of the loan regime, there is no gift, but amounts advanced by the insured are treated as loans to the IDIT which must bear interest at the applicable Federal rate. Because the loans are made to an IDIT, the interest has no income tax consequences. It does, however, increase the size of the insured's estate. This is the principal advantage of the economic benefit regime compared to the loan regime. The amounts due the insured to be included in the insured's estate do not bear interest which increase the insured's estate as time passes.

The economic benefit under the Brody and Weinberg Technique continues every year the split dollar arrangement is in existence. Under Table 2001, the economic benefit and the resulting gift increase as the insured ages and can ultimately exceed the amount of premiums on

[98] Rev. Rul. 2003-15, 2003-1 C.B. 302.

the insurance. At some point, assuming the continued survival of the insured, the split dollar arrangement becomes uneconomical.

To deal with this eventual problem, Messrs. Brody and Weinberg suggest that funds be transferred to the IDIT over time creating a side fund, utilizing a number of gift tax favored techniques such as Crummey power annual exclusion gifts, gifts using the insured's lifetime gift tax exemption and sales to the IDIT in exchange for the IDIT's promissory note. It is contemplated that at some point when the split dollar technique is no longer economical, funds from the side fund can be used to pay the amounts due the insured. At this point, the split dollar arrangement is terminated, and the economic benefit ceases. The Brody and Weinberg Technique uses split dollar to initially reduce the insured's gifts resulting from premium payments, and contains a mechanism for exiting the split dollar arrangement when it becomes uneconomical.[99]

C. Life Insurance/Limited Partnership Sale to IDIT Technique.

Another alternative strategy to the standard ILIT does not involve split dollar. It also does not involve any gift by the insured in making premium payments. This alternative strategy might be called the "Life Insurance/Limited Partnership Sale to IDIT Technique."

1. Contribution of Funds to Limited Partnership to Pay Premiums.

An individual might transfer income producing assets to a limited partnership in exchange for limited partnership interests. The limited partnership might then acquire insurance on the individual's life. The limited partnership would be owner and named beneficiary of such insurance. The individual then sells the limited partnership interests which the individual received upon the formation of the limited partnership to an IDIT in exchange for the IDIT's promissory note. After the sale, income from the liquid assets which the individual transferred to the limited partnership could be used to pay insurance premiums. Because the limited

[99] In the split dollar arrangement described in this article, the insured is obligated to make all premium payments directly to the insurer. This structure has been utilized to illustrate the economic benefit concept and the potential gift tax consequences of split dollar. This is not the actual structure proposed by Messrs. Brody and Weinberg. With the actual Brody and Weinberg Technique, the IDIT contributes premiums in the amount of each year's economic benefit. This payment eliminates any gift by the insured. Funds for both the IDIT's contributions of premiums and the payments due the insured must come from the side fund created by gifts or sales to the IDIT.

partnership owns and is beneficiary of the insurance, the premium payments would not have any gift tax consequences. Although the insurance is acquired with funds which the insured transferred into the limited partnership, the insured never possesses incidents of ownership with respect to the insurance and the insurance is not includable in the insured's estate.[100]

If the individual were not to effect the sale of limited partnership interests to the IDIT but were to die owning the limited partnership interests, the insurance death benefit would not be included in the individual's estate under IRC Sec. 2042, but would be taken into account in determining the value of the limited partnership interests included in the individual's estate under IRC Sec. 2031.[101] The sale eliminates any impact by the insurance proceeds paid at the insured's death on the value of the insured's estate. Because the limited partnership interests are owned by the IDIT, any increase in the value of those interests as a result of the receipt by the limited partnership of life insurance proceeds does not increase the value of the insured's estate.

An example illustrates this technique. Assume that an individual contributes $4.5 million to a limited partnership in exchange for limited partnership interests. If the limited partnership produces a 30% discount, the individual can sell the limited partnership interests to an IDIT in exchange for the IDIT's promissory note having a face amount of $3,150,000 and bearing interest at the applicable Federal rate without gift tax consequences. Assume that the applicable Federal rate is 5% per annum, compounded annually. The technique produces an immediate reduction in the insured's estate of $1,350,000 ($4,500,000 - $3,150,000). That note increases in value in the insured's estate as interest is paid or accrued over time. This increase can be viewed as the Life Insurance/Limited Partnership Sale to IDIT Technique's cost of eliminating the insurance from the insured's estate.

If there is no gift on the sale, the sale transaction also produces favorable generation-skipping tax results. If the IDIT has an inclusion ratio of zero prior to the sale, the sale (not involving a gift) does not constitute a transfer which changes the inclusion ratio of the IDIT for generation-skipping tax purposes. Similarly, since the payment of premiums does not constitute a gift, premium payment has no impact on the IDIT's inclusion ratio. Further, if the insurance

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[100] *Estate of Leder v. Commissioner*, 893 F.2d 237 (9th Cir. 1989); *Estate of Headrick v. Commissioner*, 918 F.2d 1263 (6th Cir. 1990); *Estate of Perry v. Commissioner*, 927 F.2d 209 (5th Cir. 1991); AOD 1991-012.

[101] Treas.Reg. Sec. 20.2042-1(c)(6).

proceeds payable to the IDIT upon the insured's death are not includable in the insured's estate, their receipt does not change the IDIT's inclusion ratio. Thus, the Life Insurance/Limited Partnership Sale to IDIT Technique has no generation-skipping tax consequences on the IDIT. The result compares favorably with those produced by the Brody and Weinberg Technique, and split dollar arrangements generally, in which GST exemption in the amount of any gift to the IDIT must be allocated to the IDIT if the IDIT is to be protected from generation-skipping tax.

If the insured transfers existing policies on his or her life into the limited partnership and dies within three years of the sale of limited partnership interests to the IDIT, IRC Sec. 2035 must be considered. That statute would cause the insurance proceeds to be included in the insured's estate unless the transaction falls within the bona fide sale for an adequate and full consideration exception of IRC Sec. 2035(d).

The IRS has been inconsistent in its treatment of what constitutes a bona fide sale for adequate and full consideration under IRC Sec. 2035(d). In Ltr. Ruls. 9413045 and 199905010, the IRS ruled that proceeds of insurance purchased for the policies' interpolated terminal reserve (or cash surrender value, if greater), plus unearned premiums, would not be included in the insured's estate even if the insured possessed incidents of ownership prior to the purchase and died within three years of the purchase. In Ltr. Rul. 8806004, the IRS stated that consideration is not adequate under IRC Sec. 2035(d) unless it is equal to the amount of policy proceeds.

The IRS is likely not to view the IDIT's payment of full value for the limited partnership interest in the Life Insurance/Limited Partnership Sale to IDIT Technique as a bona fide sale for an adequate and full consideration under IRC Sec. 2035(d). Given the uncertainty as to the application of IRC Sec. 2035(d) to the Life Insurance/Limited Partnership Sale to IDIT Technique, consideration should be given to including a provision in the partnership agreement directing that the proceeds of any insurance on a partner's life which is included in the partner's Federal gross estate are to be distributed to the partner's estate or revocable trust. Such payment would make the proceeds available for the payment of taxes which they generate or, if the insured is survived by a spouse, qualify the proceeds for the estate tax marital deduction and postpone estate taxation on such proceeds until the death of the surviving spouse.

2. Annual Contributions to Limited Partnership For Specified Period.

An insured may be unable or unwilling to make a single contribution to a limited partnership of sufficient size to support premiums due on insurance held by the limited

partnership. In such a case, consideration might be given to providing in the limited partnership agreement that the insured's contribution to the limited partnership is to consist of an amount paid each year for a specified time.[102] The amount of the annual contributions and the period of time over which they are to continue might be correlated with the anticipated need for premiums.

For example, a limited partnership agreement might provide that an individual is to contribute $300,000 each year for 15 years. It would seem that the tables under IRC Sec. 7520 should be used to determine the present value of the obligation to make these contributions. If the applicable IRC Sec. 7520 interest rate is 6%, the present value of the individual's contribution to the limited partnership would be $2,913,660. With a further 30% discount produced by the limited partnership, the limited partnership interests sold to the IDIT would have a value of $2,039,052. This $2,039,052 would also be the face amount of the promissory note which the insured would receive from the IDIT upon the sale. If the individual lives to make the 15 contributions totaling $4.5 million, the $2,460,948 difference between that $4.5 million and the $2,039,052 face amount of the promissory note is eliminated from the individual's estate.

This $2,460,948 is not the actual reduction in the value of the estate produced by the transaction. Interest on the promissory note received in the sale of limited partnership interests would accrue or be paid. As the insured continues to live, the value of the note in the insured's estate becomes greater, reducing the estate tax saved by the elimination of the insurance from the insured's estate. This increase in the value of the insured's estate by virtue of interest earned on the promissory note is similar to the results under the split dollar loan regime.

Rather than dying after making all of the specified contributions to the limited partnership, the individual might die before they are completed. Assume that the individual in the factual situation posed above dies immediately after the sale having made a single $300,000 contribution to the limited partnership. The immediate effect of the transaction is that the individual's estate is increased by the $2,039,052 promissory note and decreased by only the single $300,000 contribution. This result is not problematic so long as the present value of the

[102] Section 501 of the Uniform Limited Partnership Act (2001) provides that a partner's contribution to a limited partnership "may consist of tangibles or intangible property or other benefit to the limited partnership, including money, services performed, promissory notes, other agreements to contribute cash or property, and contracts for services to be performed."

obligation to make the remaining $4,200,000 in contributions is deductible for Federal estate tax purposes.

It seems settled that an individual's contributions to a limited partnership in which all partners receive equity interests in the partnership proportionate to their contributions does not constitute a gift for Federal gift tax purposes.[103] Under the oft-stated maxim that Federal gift and estate taxes are in *pari materia*, the obligation to make contributions should be deductible for estate tax purposes to the extent it remains unsatisfied at death. Technically, however, the deductibility of the obligation to make further contributions depends upon whether the limited partnership agreement providing for the contributions is "bona fide" and whether the limited partnership interests received in exchange for such contributions constitute "full and adequate consideration" under IRC Sec. 2053(c)(1)(A).

The language of IRC Sec. 2053(c)(1)(A) is similar to the parenthetical language of IRC Sec. 2036(a), excepting from inclusion under that statute a transfer which is "a bona fide sale for an adequate and full consideration." Many of the cases cited in note 72, *supra*, examine the question of whether the receipt of interests in an entity such as a limited liability company or a limited partnership in exchange for contributions to that entity constitutes a bona fide sale for an adequate and full consideration under IRC Sec. 2036(a). The rule enunciated by the Tax Court is that such an exchange is a bona fide sale for adequate and full consideration only if the entity was formed for legitimate and significant non-tax reasons.[104] It is unlikely that the formation of a limited partnership holding life insurance as its only asset would be viewed as satisfying this test by the courts deciding the cases cited in note 72, *supra*.

There is considerable doubt as to whether the obligation to make future contributions to the limited partnership would be deductible for Federal estate tax purposes.[105] The non-

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[103] *Church v. U.S.*, note 70, *supra*; *Estate of Strangi v. Commissioner*, note 70, *supra*; *Estate of Jones v. Commissioner*, note 70, *supra*.

[104] *See, e.g., Estate of Bongard v. Commissioner*, note 70, *supra*.

[105] This conclusion results in what appears to be a conceptually unsatisfying difference in the treatment given the obligation to make contributions to a limited partnership under the gift tax and estate tax regimes. Upon analysis, however, this really does not appear to be so. In the case of a pro-rata partnership, i.e., a partnership in which partners receive interests in proportion to their contributions, the absence of a gift is not because of the receipt of adequate and full consideration by the contributing partners. Rather it is because no value has passed from one

deductibility of the obligation to make future contributions is a detriment, especially if the insured dies shortly after the limited partnership is formed and a large portion of the contributions remain unsatisfied. Depending upon the amount of the obligation and the amount of the individual's exemption equivalent remaining at the individual's death, the non-deductibility of the obligation to make future contributions could generate a Federal estate tax even if the individual is survived by a spouse and has a will or a revocable trust containing an optimum marital deduction clause designed to eliminate such tax.

3. Contributions to Limited Partnership for Specified Period Or Insured's Earlier Death.

The issue of the estate tax deductibility of the obligation to make future contributions to a limited partnership can be avoided by a provision in the limited partnership agreement terminating an insured's obligation to make further contributions to the limited partnership upon the insured's death. In addition to dealing with the deductibility of future contributions issue, such a provision reduces the value of the insured's contributions to the limited partnership. The present value of specified contributions over a fixed period of time or the insured's earlier death is less than the value of the specified contributions over the fixed period alone.

For example, the individual in the illustration posed in Section XV.C.2., *supra*, might be obligated to make the annual $300,000 contribution for 15 years or the individual's earlier death. If the individual is 50 years of age and if the IRC Sec. 7520 rate is 6%, the present value of the individual's contribution to the limited partnership is $2,795,820, or $117,800 less than the $2,913,660 value for the fifteen year fixed term. With a 30% discount, the promissory note given to the insured in exchange for the limited partnership interest is $1,957,074, or $81,978 less than the $2,039,052 note in the illustration of Section XV.C.2., *supra*.

Terminating the insured's obligation to make annual contributions to the limited partnership at the insured's death has two beneficial consequences. One is the elimination of the deductibility of future contributions issue. The second is a reduction in the face value of the IDIT's promissory note payable to the insured. A problem with the specified period contribution approach is that the promissory note received in the sale creates a receivable for the insured and

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partner to another. The gift tax is not imposed upon decreases in value, but rather on value that passes. *U.S. v. Land*, 303 F.2d 170 (5th Cir. 1962); Rev. Rul. 93-12, 1993-1 C.B. 202; Ltr. Rul. 9449001.

the insured's estate without an immediate payable. It is only after the insured has survived a period of time and has been able to make contributions to the partnership that the increase in the value of the insured's estate by the receipt of the promissory note is worked off.

D. Comparison of the Brody and Weinberg Technique to the Life Insurance/Limited Partnership Sale to IDIT Techniques.

The Brody and Weinberg Technique reduces the gift tax consequences of premium payments, at least while the insured is relatively young. The payment due the insured resulting from premium advances and included in the insured's estate does not increase due to interest on the obligation to make that payment. GST exemption in the amount of the gifts to the IDIT must be allocated to the IDIT to insulate the IDIT from generation-skipping tax.

All variations of the Life Insurance/Limited Partnership Sale to IDIT Technique have the advantage of being without any gift tax consequences. No variation of the Life Insurance/Limited Partnership Sale to IDIT Technique requires the allocation of additional GST exemption to maintain an IDIT's inclusion ratio at zero.

The first variation of the Life Insurance/Limited Partnership Sale to IDIT Technique involving a single contribution of assets to a limited partnership described in Section XV.C.1., *supra*, produces an immediate reduction in the value of the insured's estate. That reduction is lessened as interest is paid or accrued on the promissory note which the insured receives on the IDIT's promissory note. If the insured lives long enough, this variation causes an increase in the value of the insured's estate when the amount of the note exceeds the value of the assets contributed to the partnership.

The second variation of the Life Insurance/Limited Partnership Sale to IDIT Technique, which involves contributions to a limited partnership over a specified time irrespective of whether or not the insured is living and is described in Section XV.C.2., *supra*, produces a reduction in the value of the insured's estate if the insured survives long enough to make all of the specified contributions. If the insured does not survive long enough to make the specified contributions, the second variation produces a reduction in the value of the insured's estate if the present value of the remaining contributions is deductible for Federal estate tax purposes. That deductibility is at least questionable. Any decrease in the value of the insured's estate is gradually lost and ultimately turns into a continual increase in the value of the insured's estate by interest on the promissory note as the insured continues to survive.

The third variation of the Life Insurance/Limited Partnership Sale to IDIT Technique involves contributions to the limited partnership for a specified time or the insured's death and is described in Section XV.C.3., *supra*. This technique produces an immediate increase in the value of the insured's estate brought about by the insured's receipt of the IDIT's promissory note. This increase is reduced over time if the insured survives to make the contributions to the partnership. After the insured has completed making the specified contributions to the limited partnership, the insured's estate begins to increase as interest on the IDIT's promissory note is paid or accrues.

The first alternative of the Life Insurance/Limited Partnership Sale to IDIT Technique is the preferred one of the three alternative techniques. That alternative involves a single contribution to the limited partnership. It produces an immediate reduction in the value of the insured's estate followed by a gradual increase from the reduced value. On balance, the third variation involving contributions to the limited partnership over a specified time or the insured's earlier death seems preferable to the second variation, which involves contributions over a specified time irrespective of whether the insured continues to survive. The third alternative seems preferable to the second because it reduces the amount of the note received by the insured on the sale and also because it eliminates the uncertainty over the Federal estate tax deductibility of any contributions which remain unpaid at the insured's death under the second alternative.

If the insured dies survived by a spouse, any note which the insured receives under any of the three alternatives of the Life Insurance/Limited Partnership Sale to IDIT Technique can be left to or for the benefit of the surviving spouse in a manner qualifying for the estate tax marital deduction. The availability for the marital deduction allows for estate planning by the surviving spouse in the event of the insured's premature death.

One attribute which is common to all three alternatives of the Life Insurance/Limited Partnership Sale to IDIT Technique is the gradual increase in value of the IDIT's promissory note over time as interest is paid or accrued. This attribute should be considered in implementing one of those alternatives. It may be that an individual currently unable or unwilling to make substantial annual exclusion gifts may anticipate changing that position in the future, perhaps with an expected increase in the number of descendants (and perhaps even spouses of descendants) who could be granted beneficial interests in the IDIT. That insured

might anticipate being able to counteract the increase in the value of the note by forgiving amounts due from time to time.

The forgiveness could be treated as additions to the IDIT which could be qualified for the annual gift tax exclusion through the use of Crummey withdrawal power provisions in the trust instrument. By virtue of IRC Sec. 678(b), Crummey powers do not cause an IDIT to lose its grantor trust income tax status as owned completely by the grantor so long as the original grantor continues to be the owner of the IDIT under IRC Secs. 671-677.[106]

If an IDIT has a number of beneficiaries eligible to receive distributions, additions to the IDIT do not qualify as non-taxable gifts under IRC Sec. 2042(c)(2). Although qualifying additions for the gift tax annual exclusion, Crummey powers do not qualify additions to the IDIT as non-taxable gifts for generation-skipping tax purposes. As a result, it is necessary to allocate GST exemption to an IDIT in the amount of any forgiveness if the IDIT is to continue to be fully insulated from generation-skipping tax after the forgiveness.

E. Switching From the Brody and Weinberg Technique to a Variation of the Life Insurance/Limited Partnership Sale to IDIT Techniques.

An insured, especially a younger insured, for whom the economic benefit regime produces comparably modest gifts, may prefer to use the Brody and Weinberg Technique over the Life Insurance/Limited Partnership Sale to IDIT Technique in choosing an alternative to the standard ILIT. That insured might make use of a variation of the Life Insurance/Limited Partnership Sale to IDIT Technique described above if the increase in economic benefit causes the Brody and Weinberg Technique to become uneconomical. There may be no side fund in the IDIT or the side fund may not be large enough to pay the insured off fully for amounts due the insured under the collateral assignment.

Under the Brody and Weinberg Technique, the IDIT owns the insurance on the insured's life and the insured possesses the right to receive reimbursement from the IDIT to premiums

[106] IRC Sec. 678(b) that the general rule of IRC Sec. 678(a) taxing a non-grantor because of a "power over income" does not apply if the original grantor of the trust is taxable under IRC Secs. 671-677. The reference to "power over income" can be construed as limiting the override of IRC Sec. 678(a) over IRC Sec. 671-677 as to income but not principal of a trust. Although the intended result of the reference to a "power over income" could have been expressed more clearly, it is clear that the IRS views IRC Sec. 678(b) as creating a priority of IRC Secs. 671-677 over IRC Sec. 678(a) as to both income and principal. *See*, Zaritsky, *Open Issues and Close Calls - Using Grantor Trusts in Modern Estate Planning*, note 20, *supra*, at ¶302.3.

`advanced, or, if greater in amount, the cash surrender value of the insurance. The IDIT could contribute its interests in the insurance to a limited partnership in exchange for a limited partnership interest in that partnership. The insured could contribute his or her right to reimbursement (reduced by any available amounts in a side fund) under the split dollar agreement to the limited partnership in exchange for limited partnership interests. A third party could contribute funds into the limited partnership in exchange for a general partnership interest in the partnership. All partners would receive interests in the limited partnership proportionate to their contributions.

After the contributions described in the preceding paragraph, all interests in the insurance would be held by the limited partnership and the split dollar arrangement would be terminated. After the split dollar agreement is terminated, there would no longer be economic benefit resulting from the insurance remaining in force. Instead of the reimbursement right, the insured would now own a limited partnership interest. To avoid having the increase in the value of that limited partnership interest upon the partnership's receipt of insurance proceeds being included in the insured's estate, the insured could sell his or her limited partnership interest to the IDIT (or another IDIT), in exchange for a promissory note. Presumably, the value of the amounts due the insured for premiums advanced could be discounted because of the limited partnership.

The result of this transaction is the elimination of economic benefit under the split dollar agreement. The insured does not receive the promissory note and interest increasing the value of insured's estate until after the split dollar arrangement has become uneconomical. The modified Partnership Sale to IDIT Technique utilizes the economic benefit regime, with no interest accruing on the obligation to repay the insured, until such time, if any, as the gift tax consequences become unacceptable and there is insufficient side fund to pay the insured the amounts due under the split dollar arrangement.

XVI. Conclusion.

Where are we now? The sale to IDIT technique appears to have developed into a reliable estate planning strategy which can be utilized in different circumstances and with a variety of different types of assets, including limited partnerships, S corporations and life insurance. Although questions remain about certain aspects of the technique, overall it appears to have withstood the test of time.