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**You Got Me Into This, Now How Do I Get Out?**

**Exit Strategies From Leveraged Gifting Transactions  
(with Particular Emphasis on Underwater Estate  
Planning)**

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# You Got Me Into This, Now How Do I Get Out?

## Planning With Underwater Estate Planning

By: Edward F. Koren<sup>©</sup>

### I. Introduction.

- A. Planners have long focused on the intricacies of various value shifting techniques, such as grantor retained annuity trusts (GRATs), qualified personal residence trusts (QPRTs), and sales to intentionally defective irrevocable trusts (IDITs).
- B. Little time, however, is spent considering how to deal with these techniques after implementation, when either they have performed too well or, perhaps more frequently, they have not performed as well as expected.
- C. Generally, the success of these techniques hinges on two expectations—highly appreciating assets and survival of the grantor for the entire term.
- D. When either of these expectations is not likely to be met, there are certain steps a client can take to minimize the damage. This outline focuses on some of the exit strategies available to planners and their clients.
- E. In addition, there is some focus on the other planning that is available because of the significant asset decline over the past year, both on a pre and post mortem basis.

### II. Grantor Retained Annuity Trust (GRAT).

- A. A GRAT is a technique for shifting appreciation to younger family members.
  - 1. The grantor's interest in a GRAT is a qualified interest under IRC § 2702, which means that the Treasury Tables and the monthly applicable interest rate determined (i.e., 7520 rate) apply to value the gift made when the Trust is created, regardless of the type of asset used to fund the Trust.
    - a) Usually, the annuity amount is based upon a fixed percentage of the initial fair market value of the assets used to fund the trust. Reg. § 25.2702-3(b)(1)(ii)(B).

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- b) As a result, the GRAT can be funded with cash, marketable securities, real estate, closely held stock or other assets, with little risk of valuation controversies with the Service.
  - c) The application of the Treasury Tables applies so long as the remaindermen are "members of the family," which is defined to include the grantor's spouse, ancestors, descendants, or siblings, or spouses of any of them. IRC § 2702(e), adopting the definition of IRC § 2704(c)(2).
  - d) Section 2702 also permits the retained interest of the grantor to be in the form of a unitrust interest (a GRUT), but that is rarely, if ever, used as a value shifting technique.
2. A GRAT is not an effective generation-skipping transfer (GST) tax planning tool, because of the "ETIP" rules of IRC § 2642(f).
- a) These rules prevent the grantor from allocating GST exemption to the GRAT to the extent that it would be included in the grantor's estate if he or she died immediately after the transfer.
  - b) Consequently, a GRAT is generally reserved for transfers to children.
3. Under a GRAT, the grantor retains the right to receive fixed annuity payments, payable at least annually, for a certain term.
- a) At the end of the term, the grantor receives no further interests, and any remaining assets in the GRAT pass to children (or are held in trust for their benefit).
  - b) If the grantor survives the term, that principal is excluded from the grantor's estate for federal estate tax purposes, so the only transfer tax "cost" of the transaction is the gift tax consequences upon initial funding.
4. As noted, the annuity must be payable at least annually, which can either be based on a calendar year or fiscal year basis.
- a) If the annuity is payable based on a calendar year, there will be three payments in a two year GRAT, for the annuity payment for each particular calendar year must be made no later than the date by which the trustee is required to file the federal income tax return of the trust for the taxable year, without regard to extensions. Reg. § 25.2702-3(b)(4).
  - b) If the annuity is made on a fiscal year basis, so that only two payments would be made for a two year GRAT, the annuity amount must be paid no later than 105 days after

- the anniversary date of the funding of the trust. Reg. § 25.2702-3(b)(4).
5. The Regulations under Section 2702 permit a number of variations in the structure of a GRAT; the most often used is the permitted increase in the amount of annuity of up to 20% over the preceding year's amount. Reg. § 25.2702-3(b)(1).
    - a) This alternative is most desirable where the grantor is contributing assets that are expected to achieve a return only after the passage of a few years.
    - b) But even where the annuity term is short, delaying the amount of the payments until the end of the term generally will result in a larger transfer to the remaindermen, particularly where payments are made on a calendar year basis, so that actually there will be three payments made during a two year GRAT, for example. See Reg. § 25.2702-3(b)(4).
    - c) **Example:** Grantor creates a two year GRAT, with the annuity payment of 49.5% in year one and 59.4% in year two. Even assuming a constant appreciation rate, only a partial payment would need to be made by April 15<sup>th</sup> of the year following the initial funding, a completion of the first year's payment and a portion of the second annuity payment by the next April 15<sup>th</sup>, and then the balance of the annuity payment by the third April 15<sup>th</sup>. As a result, a deferral of the higher payout means that more has remained in the Trust to grow for a longer period, thereby maximizing the amount for the remaindermen.
  6. The Service has issued Regulations that prohibit the use of promissory notes, other debt instruments, options and similar financial arrangements to satisfy the annual payment obligation of a GRAT. Reg. § 25.2702-3(b)(1).
    - a) The rationale is that use of a note from the Trust is not actually a payment of the annuity, for it substitutes one obligation (the note) for another (the annuity).
    - b) Where a closely-held business interest is used to fund the GRAT, however, these Regulations do not prohibit borrowing by the entity to make distributions to its owners (including the GRAT).
  7. The transfer of property to a GRAT constitutes a gift equal to the total value of the property transferred, less the value of the retained annuity interest. Reg. § 25.2702-1(b).
    - a) The value of the qualified annuity interest is determined under the Treasury Tables, using the applicable interest

rate (i.e., 7520 rate) for the month of the transfer. Reg. § 25.2702-2(b)(2).

- b) If the annuity interest is not a qualified interest that meets all the requirements of Reg. § 25.2702-3(b) and (d), it is valued at zero, and the amount of the gift to the trust is the entire value of the property transferred. Reg. § 25.2702-1(b).
- c) Thus, the grantor is treated as making an immediate gift when the trust is funded, but the value of the gift is discounted, because it represents a future benefit.
- d) If the grantor survives the annuity term, the property will pass to the designated remaindermen without further transfer tax consequences.
- e) If the grantor does not survive the annuity term, there will be inclusion of trust assets in the gross estate.
  - (1) Initially, practitioners thought it might be possible to include only a portion of the GRAT property in the grantor's estate if there was not a contingent reversion, for two charitable tax Revenue Rulings supported this conclusion. Rev. Rul. 76-273, 1976-2 CB 268; Rev. Rul. 82-105, 1982-1 CB 133.
  - (2) The Service later indicated, however, that it would treat the entire GRAT as being included under Section 2039 if the grantor died during the term. PLR 9345035; 9448018; 200036012; and 20021009.
  - (3) The Service later issued Proposed Regulations reflecting their refined position on the portion of a GRAT (or a GRUT or CRT) properly include in the grantor's estate under §§ 2036 and 2039 if the grantor died the trust term. REG-119097-05. These Proposed Regulations incorporated the positions taken by the two charitable tax revenue rulings cited above, but held that the portion of the trust that would be includable under IRC § 2036 would be the portion necessary to generate a return sufficient to provide for the decedent's retained interest. Prop. Reg. § 601.601(d)(2)(ii)(b). The Proposed Regulations also provided that if both §§ 2036 and 2039 could apply toward a retained interest, § 2036 (and when applicable, § 2035), rather than § 2039, will be applied. Accordingly, the Proposed Regulations also intended to amend

§ 20.2039-1 to reflect the priority given to IRC § 2036.

- (4) The IRS finalized the Regulations in July, 2008, T.D. 9414, amending Reg. §§ 20.2036-1(c)(3), 20.2039-1(f). The Service considered comments that IRC § 2036 should not apply, but ultimately rejected them for reasons fully explained in the preamble to the Treasury Decision. As a result, the Regulations provide that the portion of the GRAT includable in a deceased grantor's gross estate "is that portion, valued as of the grantor's death (or the § 2032 alternate valuation date, if applicable), necessary to yield that annual annuity, unitrust or other payment without reducing or invading principal. This portion is determined by using the Section 7520 interest rate in effect on the decedent's date of death (or on the alternate valuation date, if applicable)."
- (5) As a result of this Regulation, the entire amount of a Walton GRAT obviously will be included in the gross estate of a grantor who does not survive the GRAT term.

- B. Obviously, to the extent that the value of the gift can be minimized, the greater the transfer tax benefits.
1. For many years, practitioners would often include a provision to continue to pay the annuity to a surviving spouse (a designation that was revocable by the grantor), which the Service had originally ruled would permit a valuation based upon the value of both potential annuities. *See* Ltr. Ruls. 9449012; 9449013.
  2. More recently, however, the Service ruled that the revocable spousal interest would be ignored in determining the value of the grantor's retained rights, which increases the value of the gift, particularly at older ages, at least if the Regulations and Rev. Rul. 77-455, 1977-2 CB 93 were followed.
  3. The Service then announced it was revoking the earlier rulings. Ltr. Ruls. 199951031; 199951032.
  4. This position has been upheld in the Tax Court. *Cook v. Comm.*, 115 T.C. 15 (2000); *Schott v. Comm.*, T.C. Memo 2001-110 (2001); *Estate of Focardi v. Comm.*, T.C. Memo 2006-56.
  5. In between the first two of those cases, however, the Tax Court also concluded that an annuity payable in all events for the entire term, either to the grantor or to the grantor's estate, would be valued solely as an annuity for a term of years, without

the necessity of determining the probability of death of the grantor during the term. This ruling held invalid Example 5 of Reg. § 25.2702-3(e), and seemingly allowed truly "zeroed out" GRATs. *Walton v. Comm.*, 115 T.C. 589 (2000).

6. To deal with this problem, the Service issued new Regulations conforming to the Tax Court position. Reg. § 25.2702-2(a)(6).
  7. The controversy is not resolved, however, for the Tax Court was reversed in *Schott v. Comm.* 319 F.3d 1203 (CA 92003), and *Focardi* was appealed and settled favorably.
  8. Given the *Walton* result, however, the use of this technique has waned, so it is not likely to be an issue going forward.
- C. In order for a GRAT to be effective to shift appreciation to children, the assets funding the GRAT must appreciate (or generate income) more than the IRC § 7520 rate applicable in the month the GRAT is funded, and the grantor must survive the term of the GRAT.
1. If the GRAT assets appreciate (or generate income) at a rate less than the IRC § 7520 rate, then nothing is shifted to younger family members, because everything comes back to the grantor in the form of annuity payments, so the transfer tax benefits are lost. This was the case in the famed Walton GRAT that was the subject of the Tax Court case noted above.
  2. Because the grantor retains an annuity interest for a certain term, if he or she dies during that term, the GRAT assets are includible in his or her estate under IRC § 2036, so the transfer tax benefits are lost.
- D. What can the planner do when the GRAT assets are not appreciating as rapidly as expected (or are depreciating)?
1. Many GRATs have a short term (e.g., 2 or 3 years), so the window of opportunity for them to be successful in generating transfer tax benefits is not open for very long.
    - a) In other words, if the GRAT assets underperform for a year or two (as did the stock market in 2000 and 2001 and since the summer of 2008) then the grantor is probably out of luck and the GRAT may be "underwater" (i.e., its assets are exhausted) after making the required annuity payments to the grantor.
    - b) The risk of an "underwater" GRAT is increased by the fact that most practitioners seek to "zero out" GRATs, by having the grantor retain very large annuity payments (oftentimes, greater than 50% per year for 2 year GRATs), so as to minimize the gift tax consequences to the grantor.

2. Generally, the grantor is stuck with an underperforming GRAT, because commutation (or prepayment) of the grantor's interest is prohibited. *See* Reg. § 25.2702-3(d)(4).
  - a) Though commutation is prohibited, there is nothing to prevent a trustee from making the final annuity payment to the grantor on January 1 of the year the GRAT terminates, if the trust is so drafted.
    - (1) Typically, with a GRAT that contains appreciating assets, each annuity payment to the grantor is postponed as long as possible, so that more appreciation can be shifted to the children. Thus, the final payment is often made close to April 15<sup>th</sup> of the year following the year the GRAT terminates.
    - (2) The idea of paying the grantor on January 1<sup>st</sup> of the year of termination makes sense when the grantor has no hope that the GRAT assets will recover by the end of the term.
    - (3) The early payment will allow the grantor to sell the underperforming GRAT assets and perhaps invest in something else.
    - (4) Alternatively, even if the assets are now expected to appreciate rapidly, funding all of the underwater GRAT payments with the remaining GRAT assets and then creating a new GRAT with what has been received by the grantor from the old GRAT allows the appreciation to be measured from the current depressed value, rather than the value of the initial funding, so that there is no need to first make up the prior underperformance.
  - b) An early payment can also make sense when the grantor expects the GRAT assets to appreciate rapidly over the next couple of years and the grantor wants to capture all of that appreciation in a new GRAT (rather than drag out the existing GRAT). This is particularly true where interest rates have fallen since the initial GRAT was funded, so a new GRAT would have a lower payout to the grantor.
  - c) An existing GRAT may contain some underperforming assets and some highly appreciating assets. In that case, it may make sense for the grantor to use only the highly appreciating assets to fund a new GRAT.

- d) Another idea is to place the most risky assets in one GRAT and the less risky assets in another GRAT. By doing so, the grantor seeks a "home run" with the risky GRAT, but seeks a good probability that some appreciation will pass to children with the less risky GRAT.
  - e) Of course, these strategies involve market timing, so a crystal ball would help.
3. Another way to salvage an underperforming GRAT is to sell some or all of the existing GRAT assets and purchase assets with more appreciation potential.
- a) Because the GRAT is structured as a grantor trust by satisfying one or more of the grantor trust rules (IRC §§ 673-677), so that the grantor is treated as the owner of the entire trust (both income and corpus) for income tax purposes, any tax on gain realized on such a sale would not deplete the GRAT assets, but would be taxed to the grantor.
    - (1) There does not appear to be a prohibition on the grantor purchasing assets from the GRAT.
      - (a) If the grantor purchases assets from the GRAT (which is a grantor trust), then there would be no income tax consequences, because in effect the grantor is purchasing the assets personally.
      - (b) A grantor would want to make sure he or she pays fair market value for the GRAT assets (e.g., he or she would not want to pay too much), because additional contributions to a GRAT are prohibited. *See* Reg. § 25.2702-3(b)(5). This may create a problem where the GRAT assets are hard-to-value.
      - (c) Obviously, the grantor needs to have sufficient assets outside the GRAT that are at least equal to the fair market value of the remaining assets in the GRAT at the time of the transaction, and there are always concerns about whether the assets that are involved in the swap are appropriately valued. This is a particular concern when the GRAT is funded with a closely held business interest or real estate or similar hard to value assets.

- (d) In addition, there are the same concerns there always are with respect to GRAT transactions involving publically traded securities if the grantor is an insider for SEC purposes.
- (2) A safer way to accomplish this would be a payment for cash or by substituting marketable assets of equivalent value as the consideration. In other instances, where that avenue is not available, it may be possible to make the sale of the existing assets (at their fair market value at the time of this transaction) in exchange for an installment note.
  - (a) One concern about this approach would be that the IRS might argue that this was a commutation if the installment note is disregarded as lacking economic substance, or if there is a potential argument on its valuation. See Reg. § 25.2702-3(d)(5).
  - (b) If, on the other hand, too much is paid for the old GRAT's assets, then there could be a possible constructive contribution that would be contrary to Reg. § 25.2702-3(b)(4).
  - (c) Some may argue that a debt obligation violates Reg. § 25.2702-3(d)(6), but on its face that Regulation would appear to bar only notes issued by the GRAT trustee, not notes payable to the trustee.
  - (d) There are, of course, securities law issues under §16(b) if the assets being held are publically traded securities and the grantor is an insider, as noted above.
  - (e) In any event, the assets acquired from the old GRAT should be contributed to a new GRAT, which will then begin its measurement of appreciation from the fair market value at the time of the transaction.
- (3) One way to avoid the concern about additional contributions may be by having the grantor retain a power to reacquire the trust corpus by substituting other property of an equivalent value. See IRC § 675(4).
  - b) Depending on the remaining term of the GRAT, the trustee would need to purchase replacement assets with

great potential for short term appreciation in order to salvage the GRAT.

- (1) Such an aggressive investment strategy by the trustee could raise fiduciary liability issues if the remainder beneficiaries were not on board and the strategy turned out to be unsuccessful.
  - (2) Again, using the power of substitution, rather than an actual sale to the grantor, may be preferable in this case, because it would avoid the fiduciary liability issue if the grantor had the right to make the substitution of other property.
- c) Another option used by some planners is to create a "Gap GRAT," where the new GRAT is funded with the annuity interest from the old GRAT.
- (1) The old GRAT will not be able to fund all of its annuity payments, but the valuation of those annuity payments should take into account the value of the old GRAT at the time of the contribution to the new GRAT. The new GRAT then pays the client the new, lower annuity, for its term, so that any possible appreciation from that point passes to the remainder beneficiaries.
  - (2) In effect, the new GRAT becomes the annuitant of the old GRAT and receives annuity payments consistent with the valuation of the remaining annuity payments from the old GRAT.
  - (3) There are, of course, valuation concerns, but it would be difficult for the Service to argue that the value of the old GRAT annuity payment exceeds the value of the assets that remain in the old GRAT. See Reg. § 25.7520-3(b)(2). In addition, the old GRAT has to be drafted in a way that does not prohibit assignability, but generally GRATs shouldn't have spendthrift provisions in them.
- d) Conceivably, if a GRAT is working too well (i.e., based on anticipated appreciation, the GRAT will pass more than the grantor wants to his or her children), the trustee could sell the existing GRAT assets and replace them with more conservative investments for the remaining term.
- (1) This situation is rare, because the grantor typically is trying to maximize the value transferred to his or her children.

- (2) This maneuver by the trustee also raises fiduciary liability issues.
  - (3) Another way to achieve the same result without the sale would be simply to pay out the GRAT annuities at the earliest date, (i.e., January 1 of each calendar year), rather than at the latest date, (i.e., April 15<sup>th</sup> of the year following each annuity year).
- E. What can the planner do when the death of the grantor prior to the end of the GRAT term appears imminent?
- 1. Because the GRAT assets will be includible in the grantor's estate, it may make sense to sell any highly appreciating GRAT assets (and replace them with slower growing assets) in order to minimize the estate inclusion for the grantor.
    - a) If possible, it may be advisable for the remainder beneficiaries of the GRAT to purchase the highly-appreciating GRAT assets prior to the grantor's death.
      - (1) Such a sale gets the highly appreciating assets into the hands of younger family members.
      - (2) The sale also assures that the remainder beneficiaries are on board with the sale, in order to minimize fiduciary liability concerns.
    - b) Again, perhaps the way to deal with this is to pay the remaining annuity to the grantor as quickly as possible, and sell the remaining assets to the remainder beneficiaries.
    - c) How this is structured may depend on the nature of the GRAT assets; if they consist of closely held interests, of which the grantor has no remaining interest in his or her estate, a sale of all the GRAT assets in exchange for cash or a note may be the best approach.
  - 2. The grantor does not appear to benefit much by gifting or selling his or her retained interest in the GRAT.
    - a) Because the grantor's death is imminent, any gift taxes paid on the gift of his or her retained interest would be included in the gross estate under IRC § 2035(b).
      - (1) Of course, a gift of the retained interest in the GRAT could keep it out of the grantor's probate estate for state law purposes.
      - (2) The same result could be achieved without gift tax consequences by transferring the interest to a revocable trust or even making a transfer to an

irrevocable trust but retaining a testamentary special power of appointment.

- b) Likewise, a sale of the grantor's retained interest would not likely avoid estate inclusion if made within 3 years of the grantor's death. *See Allen v. U.S.*, 293 F.2d 916 (10<sup>th</sup> Cir. 1961) (finding that the consideration paid for the sale of a reserved life estate in contemplation of death should have been the value of the entire corpus rather than the value of the reserved life estate).
  - (1) A sale by the grantor of his or her retained interest probably does not make much sense anyway, because the sale proceeds would be includible in the gross estate.
  - (2) In addition, it may be that the anti-commutation provisions that are required in a GRAT by Reg. § 25.2702-3(d)(4) would require a value greater than the fair market value (i.e., the full value of the remaining annuity payments, rather than a present value amount).
- c) It also is unclear what effect, if any, selling or gifting a grantor's retained interest has on the qualification of the GRAT.
  - (1) For example, Reg. § 25.2702-3(b)(1) provides that the annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.
  - (2) Also, Reg. § 25.2702-3(d)(2) provides that the governing instrument must prohibit distributions to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest.
  - (3) Do these references to "holder" mean the original holder only?
  - (4) Though Reg. § 25.2702-3(d)(4) specifically prohibits commutation (or prepayment) of a grantor's interest, it does not specifically prohibit its sale.
  - (5) Could this omission be interpreted as allowing a buyer to become the new "holder" within the meaning of the regulations?
- d) Due to the questionable benefit of gifting or selling a grantor's retained interest in a GRAT and the uncertainty relating to disqualifying a GRAT by making such a gift or sale, it may be advisable to find other exit strategies.

3. The grantor may consider purchasing the remainder interest in the GRAT from the remainder beneficiaries.
  - a) Presumably, the amount of the sale proceeds paid to the remainder beneficiaries would be removed from the grantor's estate without gift tax consequences.
  - b) Unless the remainder beneficiary is a grantor trust with respect to the grantor of the GRAT, such a sale may have adverse income tax consequences.
  - c) If the GRAT contains a spendthrift provision, then such a sale may not be possible.
  - d) If the remainder beneficiaries are not absolutely vested (e.g., alternate beneficiaries will take depending upon whether the grantor dies during the term), then such a sale may be difficult or impossible.
4. In any event, a purchase of low basis assets by the grantor will assure a step-up in basis for those assets under IRC § 1014.

### **III. Qualified Personal Residence Trust (QPRT).**

- A. Like a GRAT, a QPRT is a technique whereby the grantor retains an interest for a certain term with the remainder interest passing to younger family.
  1. Unlike a GRAT, however, a QPRT is only funded with the grantor's personal residence (which includes the grantor's principal residence and one other residence).
  2. It is a narrow variation of a grantor retained income trust, which was severely limited by the enactment of § 2702 so that, if the remaindermen are family members, then its use is limited to either a "Personal Residence Trust" or a "Qualified Personal Residence Trust."
  3. This outline only discusses the latter, although the techniques would likely apply to both.
- B. A QPRT is a trust that holds one personal residence of the term-holder and may hold certain additional property in a separate account, but the additional property cannot be in excess of the amount required to pay expenses, mortgage payments or improvements already incurred or reasonably expected to be incurred within the following six months. Reg. § 25.2702-5(c)(5).
  1. Spouses may transfer their interest to the same QPRT, so long as the governing instrument prohibits anyone else from holding a term interest in the trust at the same time. Reg. § 25.2702-5(c)(2)(iv).

- a) Generally more transfer tax benefits can be achieved by splitting the interest into tenancies-in-common and establishing separate QPRTs.
  - b) In that event, if one spouse dies, the interest of the other can still achieve the intended benefits.
  - c) In addition, the splitting should entitle the value of the underlying property to be based upon a fractional interest discount, which will lower the total transfer tax cost to the family.
2. A QPRT also has certain other required provisions, including a prohibition against commutation. Reg. § 25.2702-5(c)(6).
3. In addition, the Regulations specifically prohibit the sale or transfer of the residence to the grantor, the grantor's spouse or any entity controlled by the grantor or the grantor's spouse during the income term, or at any time after the income term that the trust remains a grantor trust. Reg. § 25.2702-5(c)(9).
  - a) A sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse. Reg. § 25.2702-5(c)(9).
  - b) Nonetheless, a distribution (for no consideration) upon or after the expiration of the retained term interest to another grantor trust of the grantor or grantor's spouse pursuant to the express terms of the trust will not be considered a sale or transfer to the grantor or the grantor's spouse if such other grantor trust prohibits the sale or transfer to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse. Reg. § 25.2702-5(c)(9).
  - c) In addition, grantors may be given the right to lease the property if the lease is for adequate consideration. TD 8743.
4. As with a GRAT, a QPRT is subject to the ETIP rules of § 2642(f), so the use of the QPRT is generally reserved for transfers to children (rather than grandchildren).
5. In order for a QPRT to be successful, the personal residence must appreciate rapidly during the term and the grantor must survive the term.
  - a) Unlike a GRAT, the grantor does not retain the right to annuity payments, but retains the right to live in the personal residence. For that reason, a QPRT will never be "underwater" (unless, of course, the personal residence depreciates to zero).

- (1) In other words, something will always pass to the remainder beneficiaries with a QPRT.
  - (2) Conversely, the gift tax cost of a QPRT is far higher than a GRAT (at least a "Walton" GRAT).
- b) Nevertheless, rapid appreciation of the personal residence is sought in order to leverage the grantor's gift tax paid (or applicable exclusion amount used) in funding the QPRT.
  - c) Like a GRAT, if the grantor dies during the term of the QPRT, the QPRT assets are includible in his or her estate under IRC § 2036, so the transfer tax benefits are lost.
- C. What can a planner do when the personal residence in the client's QPRT is not appreciating as rapidly as expected (or is depreciating)?
1. As mentioned above, the economics of a QPRT are slightly different than a GRAT.
    - a) With a GRAT, if the assets fail to appreciate, then the GRAT may be underwater (i.e., nothing passes to children). With a QPRT, however, the personal residence will pass to the children at the end of the term regardless of whether it has appreciated or depreciated in value.
    - b) Of course, the gift tax paid (or applicable exclusion amount used) by the grantor in funding the QPRT is based on an assumed level of appreciation (i.e., IRC § 7520 rate).
  2. If the grantor is not satisfied with the appreciation rate of the personal residence in the QPRT, the trustee could sell the personal residence to a third party and replace it with a new personal residence with greater appreciation potential.
    - a) Under Reg. § 25.2702-5(c)(7)(ii), the trustee would have up to 2 years after the sale to purchase a new residence with the sale proceeds.
    - b) As mentioned above in the GRAT context, assuming the QPRT is structured as a grantor trust, the grantor (rather than the QPRT) would be liable for any tax on the capital gains generated by such a sale.
      - (1) If the personal residence in the QPRT is the grantor's principal residence, then he or she should be able to take advantage of IRC § 121 (relating to exclusion of gain from sale of principal residence).
      - (2) Thus, gain of up to \$500,000 for couples filing a joint return to be excluded from any income tax consequences. IRC § 121(b)(2).

3. If the grantor is not satisfied with the appreciation rate of the personal residence in the QPRT, another option is to sell the personal residence and convert the QPRT into a GRAT (*See Reg. § 25.2702-5(c)(8)(i)(B)*).
    - a) The grantor may decide that another investment opportunity would result in greater appreciation potential than the personal residence, so he or she could use the sale proceeds to purchase that investment for the GRAT.
    - b) The proceeds would be subject to taxation to the grantors noted above, but that tax would be paid by the grantor's separate funds, so that the full amount of the proceeds would be subject to reinvestment.
  4. Another option if the personal residence is sold is to collapse the QPRT by distributing all the sale proceeds to the grantor.
    - a) Under Reg. § 25.2702-5(c)(8)(i), if a trust ceases to qualify as a QPRT, the governing instrument must require the distribution of the trust assets to the term holder or the conversion of the trust into a GRAT (as discussed above).
    - b) Of course, any gift taxes paid (or applicable exclusion amount used) would be wasted if all the QPRT assets return to the grantor.
  5. As noted above, it is important to remember that Reg. § 25.2702-5(c)(9) prohibits the QPRT from selling or transferring the residence, directly or indirectly, to the grantor, grantor's spouse, or an entity controlled by the grantor or grantor's spouse during the retained term interest of the QPRT.
- D. What can a planner do when the death of the grantor prior to the end of the QPRT term appears to be imminent?
1. Because the QPRT assets will be includible in the grantor's estate, it may make sense to sell the highly appreciating personal residence in the QPRT and replace it with a personal residence that is not appreciating as rapidly.
    - a) Another alternative would be to sell the personal residence and convert the QPRT into a GRAT.
      - (1) To minimize the inclusion in the grantor's estate, the trustee of the GRAT would not want to purchase highly appreciating assets where the grantor's death was imminent.
      - (2) This investment strategy could raise fiduciary liability issues if the remainder beneficiaries were not on board.

- b) If possible, the trustee may wish to sell the highly appreciating personal residence to the remainder beneficiaries of the QPRT.
  - (1) Such a sale gets the highly appreciating personal residence into the hands of younger family members.
  - (2) The sale also assures that the remainder beneficiaries are on board with the sale in order to minimize fiduciary liability issues.
- 2. As discussed in the GRAT context above, the same uncertainty surrounding a gift or sale of the grantor's retained interest applies to QPRTs as well. Consequently, more cautious clients may wish to avoid this strategy.
- 3. The GRAT discussion considered the option of the grantor purchasing the remainder interest from his or her children when death was imminent. In the QPRT context, however, because the grantor is prohibited from purchasing the personal residence during the term of the QPRT, this idea will not work.
  - a) Technically, the grantor is not purchasing the personal residence from the QPRT, but is purchasing the remainder interest in the QPRT from his or her children; however, the IRS may not appreciate this distinction.
  - b) The same obstacles (e.g., spendthrift provision) to this strategy discussed in the GRAT context apply here.

#### **IV. Sale to an Intentionally Defective Irrevocable Trust (IDIT).**

- A. Like a GRAT and a QPRT, a sale to an IDIT is a technique for transferring assets to younger family members.
  - 1. One difference, however, is that a sale to an IDIT may be used for transfers to grandchildren because the same GST tax hurdle (i.e., the ETIP rule of IRC § 2642(f)) is not present; for that reason, this technique is favored where younger generations are to be beneficiaries.
  - 2. The grantor typically sells a highly appreciating asset to the IDIT in return for a promissory note, the interest rate of which is determined under IRC § 1274.
    - a) Because the IDIT is a grantor trust, there are no income tax consequences on such a sale, because the grantor may not be taxed on a sale to himself or herself. Rev. Rul. 85-13, 1985-1 CB 184.
    - b) Only if the asset is subsequently sold to a third party will the grantor be taxed on the resulting gain.

3. To give the transaction substance, the grantor generally funds the IDIT with "seed" money (often, 10% of the value of the assets to be sold to the IDIT). This funding is subject to gift tax.
  4. The grantor hopes that the assets sold to the IDIT appreciate greater than the interest rate on the promissory note, so that the excess appreciation is shifted to younger family members.
    - a) The interest rates under § 1274 are generally less than the § 7520 rate for GRATs (which are required to be 120% of the mid-term applicable federal rate). IRC § 7520(a)(2).
    - b) As a result, more appreciation can pass to younger family members by the use of the IDIT.
  5. If the grantor dies during the term of the note, only the remaining note balance is includible in his or her estate.
    - a) Clearly, the grantor hopes to survive the term of the note to maximize the transfer tax benefits.
    - b) Alternatively, the note can have a "self-cancellation" feature, which will require an additional actuarially-determined premium to be paid in either interest or principal, but which will cause the note to be extinguished if the grantor dies during the term (so long as the grantor is not terminally ill). See *Estate of Moss v. Comm.*, 74 T.C. 1239 (1980); *Estate of Frane v. Comm.*, 98 T.C. 341(1992), aff'd in part, rev'd in part, *Frane v. Comm.*, 998 F.2d 567 (CA8 1993).
    - c) An uncertainty that exists with this technique that is not a concern with the GRAT or a QPRT is the income tax consequences in the event the grantor dies during the term.
      - (1) Although the issue has not been raised, there is a concern that the Service will assert that the death of the grantor causes the IDIT to no longer be a grantor trust.
      - (2) Under the authority of *Madorin v. Comm.*, 84 TC 667 (1985) and Rev. Rul. 77-407, 1977-2 CB 77, the grantor would then realize income because grantor trust status is lost and there is a relief of indebtedness.
- B. What can the planner do when the IDIT assets are not appreciating as rapidly as expected (or are depreciating)?
1. Similar to GRATs and QPRTs, in order for a sale to an IDIT to be successful, the appreciation rate of the assets sold to the IDIT must be more than the interest rate used on the promissory

note; otherwise, the payments to the grantor on the promissory note could completely deplete the IDIT.

- a) As noted above, one advantage that a sale to an IDIT has over a GRAT or a QPRT is that a lower interest rate may be used. This lower rate increases the likelihood of success for a sale to an IDIT.
  - b) As discussed above, GRATs and QPRTs use the IRC § 7520 rate, which is basically 120% of the midterm rate published by the IRS. For the promissory note used on the sale to an IDIT, however, the grantor could use the midterm rate (assuming the term was between 3 and 9 years).
2. An "underwater" IDIT is especially painful, because the grantor has funded the IDIT with "seed" money and paid gift tax (or used applicable exclusion amount) for that transfer.
- a) If the IDIT is "underwater," then the "seed" money will be returned to the grantor as part of the payments on the promissory note.
  - b) In that event, the grantor would have paid gift tax (or used applicable exclusion amount) for transfers of assets that are now back in his or her estate.
3. One way to avoid an "underwater" IDIT is to give the IDIT assets sufficient time to grow.
- a) This goal may be achieved by initially choosing a long-term for the promissory note.
  - b) Another way to give the IDIT assets more time is to renew the note as it approaches maturity.
    - (1) If the grantor is very old or in poor health, then it may not be advisable to extend the maturity of the note very far.
    - (2) The interest rate on such a renewal would need to be the current rate (rather than the rate on the original note).
  - c) Initially, the grantor may choose a balloon note (e.g., principal payment at end and interest only during term) in order to minimize liquidity concerns.
    - (1) In other words, by minimizing required payments to the grantor during the term of the note, he or she will allow more assets to remain in the IDIT to grow.
    - (2) Alternatively, the grantor may choose to provide that all interest and principal payments are due

upon maturity of the note in order to maximize the growth potential of the IDIT assets.

4. If the IDIT assets are underperforming and the grantor has little hope for their recovery, then the trustee of the IDIT could purchase other assets with greater appreciation potential.
  - a) Because the IDIT is a grantor trust, any capital gains on such a sale would be taxed to the grantor.
  - b) As discussed in the GRAT context, a grantor may want to purchase the IDIT assets in order to assure no income tax consequences on the sale.
  - c) Another option might be to change the interest rate or perhaps reduce the principal, given the change in circumstances.

- (1) This should not result in a gift, even if the loan is not totally underwater, but the change is only because there has been an interest rate drop. Reg. § 25.2512-4; Prop. Reg. § 1.7872-3(c)(3), ex. (5)(iii). See also Blatmacher, Crawford and Madden, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109 *Journal of Taxation* 22 (July, 2008).

- (2) Similarly, Prop. Reg. 20.7872-1, which is an estate tax provision, also seems to indicate that the cap on the transfer tax value of an installment note is the unpaid stated principal, plus accrued interest.

- (3) Thus, the value of the assets in the original trust, plus any guarantees, should cap the transfer tax value of the installment note if the value of those interests, plus any guarantees, is less than the unpaid stated principal, plus accrued interest.

C. What can a planner do when the death of the grantor prior to the end of the term of the note appears imminent?

1. Unlike a GRAT or a QPRT, if the grantor dies during the term, the entire value of the IDIT is not included in his or her estate. Instead, the remaining balance on the note held by the grantor would be included in his or her estate.

- a) If the note provided for a balloon payment at maturity and, therefore, had not been paid down, then the inclusion amount may be very large.

- b) Of course, if the note was of a self-canceling variety, then there would be no inclusion and a greater amount would have been shifted to the next generation transfer tax-free. See *Estate of Moss v. Comm.*, 74 T.C. 1239 (1980).

2. To the extent the grantor could make gifts of any additional payments received on the note, the trustee of the IDIT might consider prepaying all or part of the note.
  - a) Of course, to the extent the grantor died within 3 years of paying any gift taxes, those gift taxes would be included in his or her estate. *See* IRC § 2035(b).
  - b) Consequently, this gifting strategy would make more sense if the grantor was making annual exclusion gifts with the payments on the note.
3. If the grantor's death is imminent, then a sale of the note would not likely yield much of a benefit, because the sale proceeds would end up in the grantor's estate unless he or she could make annual exclusion gifts or otherwise spend those proceeds prior to death.
4. As discussed above, if the note was a self-canceling installment note (SCIN), sometimes referred to as a death terminating installment note (DTIN), then death of the grantor during the term is not such a bad thing from an estate tax perspective.
  - a) With a SCIN, the right to any remaining payments on the note terminates at the grantor's death. Consequently, there is no inclusion in the grantor's estate. *Estate of Moss v. Comm.*, 74 T.C. 1239 (1980).
  - b) In order to compensate for this self-canceling feature, however, the note must pay a premium (either principal risk premium or interest risk premium), which results in greater required payments on the note. *See Frane v. Comm.*, 998 F.2d 567 (CA 8 1993).
  - c) If the grantor survives the term of a SCIN, then it will result in more assets returning to him or her (due to the premium mentioned above) than is the case with a regular note.
  - d) If the grantor dies during the term of the SCIN, however, a SCIN often results in less returning to him or her because future payments on the SCIN are terminated.

## V. Estate Tax Return Elections and Options—Alternate Valuation

- A. As a general rule, a decedent's gross estate is valued as of the date of death. I.R.C. §2031 But, in certain situations, the personal representative may elect to value the property on its alternate valuation date, which is six months after date of death. I.R.C. §2032.

1. Following the enactment of the unlimited marital deduction in 1981, it became possible for even the largest estate to pass tax-free upon the death of the first to die.
  2. Astute planners quickly recognized that the alternate valuation election in an inflationary economy was an opportunity to achieve a greater step-up in basis without any transfer tax costs.
    - a) Thus, alternate valuation elections were being made solely for income tax purposes in many instances.
    - b) This was far different from the original purpose of the section, which was to provide relief from a sudden drop in the value of property prior to the time taxes had been paid.
  3. Accordingly, in 1984, Congress limited the use of the election to those instances in which it will reduce both the size of the gross estate and the estate tax liability. I.R.C. §2032(c), enacted by Tax Reform Act of 1984, Pub. L. No. 98-369, §1023(a), 98<sup>th</sup> Cong., 2d Sess. (1984).
    - a) This eliminates any favorable income tax treatment under the section from an overall standpoint, because the value of the gross estate must have decreased.
    - b) Similarly, without post-mortem planning, the election is no longer available in those estates in which a surviving spouse receives a devise under a "reduce to zero" formula, for there should be no estate tax liability under the formula to be reduced by the alternate valuation election.
  4. Where the value of the estate has decreased and the estate desires to maximize a credit shelter gift because the marital gift is a preresiduary devise, it will be necessary to involve one or more disclaimers.
    - a) By disclaiming an amount sufficient to create a tax as of the date of death, then both requirements under IRC § 2032 (c) will have been satisfied.
    - b) One must be careful, however, to ensure that the amount of the disclaimer at the date of death is sufficiently large to still create a little tax at the alternate valuation date.
- B. If an asset is no longer in the estate at the alternate valuation date, then its Section 2032 value is the value as of the date the asset was "distributed, sold, exchanged, or otherwise disposed of," if that occurred prior to the six month period. I.R.C. §2032(a)(1).
1. Thus, if property is sold within six months, the sales price is the alternate value; this may be contested, however, if the property has been altered for sale. See *Estate of F. G. Holl v. Comm.*, 967 F2d. 1437 (CA. 10 1992).

- a) There, the Court rejected the IRS's argument that minerals sold within six months of the decedent's death should be valued at close to the sales price; instead, the Court remanded for further valuation on the basis that the "severed" minerals that had been sold were not the same as the unextracted minerals that had passed to the estate, and therefore the sales price was not necessarily applicable.
  - b) On remand, the Tax Court continued to side with the IRS on the valuation issue, but did allow a 7 percent discount for risk and uncertainty. *Holl Estate v Comm.*, 101 T.C. 455 (1993).
  - c) Nevertheless, on appeal of the second determination, the Tenth Circuit again reversed and remanded, instructing the Tax Court to adopt the taxpayer's expert's approach to valuation, which was to value all the unextracted minerals and then apportion part of that value to the amount that had been sold. *Estate of Holl v. Comm.*, 54 F.3d 648 (CA 1995).
2. Similarly, if property is distributed to a beneficiary prior to the six month date, the value at the date of distribution is the alternate value. Reg. § 20.2032-1(c).
  3. This opens the door to some planning opportunities; if some property has decreased in value but is beginning to recover, a distribution to the beneficiaries may permit the estate to qualify for Section 2032, when a retention of the property for the full six months might otherwise disqualify it.
  4. Of course, the beneficiary will receive a basis equal to the value of the asset at the time of distribution, under I.R.C. §1014, but this should be considered and the respective tax benefits balanced.
- C. Assuming the estate qualifies for alternate valuation, the election applies to all of its assets. Reg. §20.2032-1(d).
1. In other words, it is an all-or-nothing approach, for the estate may not simply make an election for assets whose value has dropped without also valuing those assets that have appreciated.
  2. The net effect on the entire gross estate is measured in determining qualification. Reg. §20.20321(d).
  3. Thus, nonprobate assets are affected as well, and their valuation may be established by actions of persons other than the personal representatives (for example, sale of joint property by the

surviving tenant within six months of death). Reg. §20.32-1(c)(3).

- D. In determining whether to make the election, the question arises what changes in value must be given effect for alternate valuation purposes?
1. The Regulations distinguish between "included" property and "excluded" property. Reg. 20.2032-1(d).
  2. Included property is defined as all property interests as of the decedent's date of death includable in the gross estate under Sections 2033 to 2044.
  3. Conversely, excluded property is property earned or accrued after the decedent's death.
  4. Thus, the Regulations provide that dividends declared to shareholders of record on or before the decedent's date of death constitute included property to the estate, while dividends declared to shareholders of record after the date of death are excluded property. Reg. §20.2032-1(d)(4).
  5. Note the Service's position is that retained corporate earnings are not necessarily excluded—they must be "declared" (or distributed) as a dividend in order to be excluded. See T.A.M. 200343002.
- E. Conversely, differences in value that are attributable to a "mere lapse of time" are not taken into account for purposes of the alternate valuation. I.R.C. §2032(a)(3).
1. For example, a life estate or remainder interest will diminish as time elapses, as will an annuity or patent, so generally they are valued at their date of death value. Reg. §20.2032-1(0)(1) and (2).
  2. But the definition does not refer to obligations for the payment of money, the value of which changes with the passing of time; in these instances, the valuation must be made as of the alternate date. Reg. §20.2032-1(f).
  3. Other examples of assets that must be valued at the alternate date are a recurring crop for a farmer, or offspring of livestock for a rancher. Rev. Rul. 58-436, 1958-2 C.B. 366; Rev. Rul. 68-154, 1968-1 C.B. 395.
- F. The alternate valuation election is made on the estate tax return. I.R.C. §2032(d)(2).
1. Once made, the election is irrevocable. I.R.C. § 2032(d).
  2. No election may be made on a return that is filed more than one year after the due date. I.R.C. §2032(d)(2).
  3. Accordingly, a return filed after the one-year period cannot be used to make an alternate valuation election. See Estate of

Eddy v. Comm. 115 T.C. No. 10 (2000) (return filed 18 months late-without explanation).

4. The Service has, however, allowed a supplemental return—filed more than one year after a timely filed original Form 706—to change the valuation from the date-of-death value to the alternate valuation election. See Ltr. Rul. 200021021 (the executor included with the supplemental return a letter requesting an extension of time to make the alternate valuation date election).
5. Extensions also have been granted under the "9100" provisions, which allow extensions to make regulatory elections, generally under circumstances where the taxpayer has reasonable cause for relief.
  - a) See Ltr. Rul. 200227029, applying Regs. §§301.9100 et seq., where date-of-death value had been elected based on erroneous information that had been provided by the deceased stockbroker.
  - b) The Service also allowed an estate to make a late election (within one year of the estate tax return due date), where the return preparer did not consider alternate valuation and had not discussed it with the executors. Ltr. Rul. 200348010.
  - c) Similarly, a Supplemental Form 706, filed within one year of the return due date, was allowed (after the estate had received a closing letter) where the attorney submitted an affidavit stating that he had failed to recognize the effect of an alternate valuation election, but after recomputing estate asset values requested an extension to file. The Service allowed it, noting that one of the general rules under which it will grant an extension is where the taxpayer acted reasonably and in good faith relied on a tax professional and the professional failed to make, or advise the taxpayer to make, the election. Ltr. Rul. 200740009.