

Estate Planning in 2010: Comprehensive Analysis

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1. Period of Uncertainty.

- a. **Estate Tax Repealed for 2010.** The federal estate tax was repealed midnight, December 31, 2009. If Congress fails to act in 2010, the estate of every decedent who dies this year will owe no federal estate tax. This could complicate existing wills. As it now stands, the estate tax will return on January 1, 2011, and the exemption amount will be reset at pre-2001 levels. This means the applicable exclusion amount will be \$1 million, and the highest estate tax rate will be 55 percent. Throughout this period, the maximum New York Estate Tax rate will be 16 percent. The credit for state death taxes would reappear in 2011, replacing the current deduction for state estate taxes.
 - i. **Audit Risk High.** Since there are far fewer estates subject to estate tax, the risk of estate tax audit may have increased substantially. The number of taxable estates has decreased from 45,000 in 2002 to 5,400 in 2009.
- b. **New Estate Tax Legislation?** The “default” scenario could change if Congress passes legislation later this year which President Obama signs.
 - i. **White House Position.** Mr. Obama appears to favor a \$3.5 million exemption amount and a top estate tax rate of 45 percent. The 2009 budget proposal of President Obama in a footnote projecting revenues, assumes that “the estate tax is maintained at its 2009 parameters.”
 - ii. **Senate Position.** In April of 2009, the Senate approved a bipartisan amendment that would have increased the applicable exclusion amount to \$5 million. Senate Finance Committee Chairman Baucus, who favors an estate tax retroactive to January 1, 2010 stated “the correct public policy is to achieve continuity with respect to the estate tax.”
 - iii. **House Position.** The House passed a bill in December of 2009 that would have permanently extended the \$3.5 million exemption and the 45 percent top estate tax rate in effect in 2009. However, the Senate failed to act, with Republicans and conservative Democrats appear to favor a higher exemption amount of \$5 million.

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- c. **Retroactivity of Estate Tax Possible.** Congress may reinstate the estate tax retroactively to January 1, 2010. Most believe that the longer Congress takes to act, the less likely it is that reinstatement of the estate tax will be retroactive. However, retroactive reinstatement would probably not be unconstitutional. The Supreme Court, in *U.S. v. Carlton*, 512 U.S. 26 (1994), held that Congress may validly impose retroactive legislation concerning an estate tax deduction. The Court remarked: "The amendment at issue here certainly is not properly characterized as a 'wholly new tax,' and its period of retroactive effect is limited."
- i. **Congressional Delay Reduces Likelihood of Retroactivity.** If Congress waits past the summer to reinstate the estate tax for 2010, Congress may forego retroactivity. If Congress does reinstate the estate tax retroactively any time this year, the Supreme Court will more than likely be called upon to decide the constitutionality issue.
- d. **New York Estate Tax.** New York continues to impose an estate tax on taxable estates in excess of \$1 million. Therefore, it may be prudent for a New York testator to leave at least that amount outright or to a credit shelter trust to make use of the \$1 million New York exemption amount. The rate of tax imposed ranges from about 10 percent for taxable estates of \$2 million to 16 percent for estates over \$10 million.
- e. **Review of Existing Documents**
 - i. **Importance of Will.** If a person dies intestate (without a will), then the rules of intestacy found in EPTL 4-1.1 will apply in determining who receives the decedent's property. The estate of a person who dies intestate also needs to be administered, and administration can be more complicated in situations where no will exists.
 - (1) **Bonding Requirements.** Often, a will provides for a waiver of bond otherwise imposed on the executor. If there is no will, there can be no waiver of bond with respect to the administrator. In that case, the Surrogate may require the administrator to post a bond.
 - (2) **Intestacy Formula for Distribution.** Under EPTL 4-1.1, the spouse of a person who dies intestate receives one-half (plus \$50,000) of the decedent's estate. The right of election found in

EPTL 5-1.1A provides that a spouse who is bequeathed less than 1/3 of the predeceasing spouse's estate, may elect against the estate and take 1/3 of the estate. Taken in combination, these provisions create the situation whereby a spouse who wishes to leave less than one-half of his estate to his spouse needs a will to accomplish this.

- f. Testators at Risk of Death in 2010.** Wills for testators at risk of death in 2010 should be reviewed. Existing wills may contain a formula provision allocating the maximum amount which can pass free of estate tax to a credit shelter trust. Since there is no estate tax in 2010, the amount called for in the formula could consume the decedent's entire estate. Most testators who included this formula provision were motivated by a desire to avoid burdening the estate of the surviving spouse with unnecessary estate tax liability, not a desire to disinherit the spouse. However, if no estate tax exists, then this surprising result could occur. Similarly, a bequest to a QTIP trust of the maximum amount qualifying for the estate tax deduction may be difficult to interpret if there is no estate tax for which a deduction could be claimed.
- i. Codicil May Provide Solution in 2010.** Since the estate tax will resume in 2011, even an elderly testator at risk of death in 2010 may resist drafting a new will addressing the issues which might be effective only for only one year. A simple codicil may provide an effective solution. The codicil could provide that (i) should the client die at a time when the estate and GST tax do not apply, and (ii) if the estate tax and GST tax are not retroactively reinstated, then (iii) notwithstanding any contrary provisions in the will, for purposes of all formula computations, it would be conclusively presumed that the estate tax laws in effect on December 31, 2009 would be applicable at the client's death. This would prevent the overfunding of the credit shelter trust. The language of such a codicil could read:

Article [x]

Intent if No Federal Estate Tax

"For purposes of gifts made under this Will, if at the time of my death there is no federal estate tax, and it appears to my Executor that retroactive reinstatement by Congress of the federal

estate tax is unlikely to occur, it is my intention that all dispositive provisions under my Will be given the same force and effect as if I had died in 2009, and that all dispositive provisions in my Will be interpreted according to the federal tax law as it existed in 2009, regardless of the federal tax law in effect at the time of my death."

- g. Avoiding Step Down in Basis in 2011.** Many assets today will have a fair market value less than the adjusted basis. Since under IRC §1014 a basis adjustment is made at death to fair market value, this means that a loss of basis could occur in many situations. Various strategies may be considered to reduce the likelihood of this issue:

 - i. Losses may be recognized on sales to unrelated parties.** IRC § 1001(a).

 - (1) Caution:** Losses on sales to related parties cannot be recognized, but basis is carried over to related party. IRC §267.
 - ii. Transfers between spouses (gift or sales) are considered gifts.** Therefore, the transferee spouse takes a carryover basis. IRC § 1041; Treas. Reg. § 1.1041-1T(d), Q&A 11.

 - (1) No Gift Tax Liability.** Since the gift qualifies for the marital deduction, no gift tax liability will arise. IRC §2523.
 - iii. Gifts to Non-Spouses May be Beneficial.** Gifts of property with a realized loss to related parties who are non-spouses may have some benefits, if the property increases in value. While the basis for determining later loss is the lower basis at the time of the gift under IRC § 1015(a), if the asset recoups its value, the basis for determining later gain is the original basis, increased by any gift tax paid. IRC §1015(d)(6).
- h. Transfers to Non-Grantor Trusts Beginning in 2010.** IRC §2511(c) treats transfers to trusts made after December 31, 2009 as taxable gifts unless the trust is a wholly grantor trust under IRC §§ 671-679 as to the donor or the donor's spouse.

The statute is intended to prevent the donor from making a transfer complete for income tax purposes but incomplete for transfer tax purposes, thereby shifting income tax responsibility without incurring gift tax.

- i. **Section 2053 Final Regulations.** Treasury issued final regulations limiting the estate tax deduction for unpaid claims and expenses. With respect to decedents dying on or after October 20, 2009, an estate may deduct an expenditure only if the claim or debt is *actually paid*. *Under the new regs, the amount of claim or expense may be determined by (i) court decree; (ii) consent decree; or (iii) settlement. No deduction is allowed to the extent a claim or expense is or could be reimbursed by insurance. Notice 2009-84.*

- i. **Exceptions.** Nevertheless, several exceptions exist to the rule requiring actual payment. If a potential for reimbursement exists, the claim may still be deductible if the executor provides a “reasonable explanation” of why the burden of collection would outweigh the anticipated benefits of collection. Another exception provides that a claim or expense may be deducted by the estate if the amount to be paid is ascertainable with “reasonable certainty.” No deduction may be claimed for claims that are contested or contingent.

- j. **New York State Estate Tax**

- i. **Source of Estate Tax Payments.** New York estate tax can be paid out of either the marital trust or the credit shelter trust.

- (1) **No Difference for Federal Purposes.** Since estate tax imposed by New York will again qualify as a deduction for federal estate tax purposes beginning in 2011, it is inconsequential for federal estate tax purposes whether New York estate taxes are paid out of the marital share or the credit shelter share. However, New York estate tax liability will differ depending on the source of the payment.

- (2) **New York Estate Tax Liability Will Differ Depending on Source**

- (a) **Payment from Credit Shelter Share.** If payment is made from the credit shelter share, the amount that can ultimately pass free from federal estate tax will be reduced. This could

result in greater exposure to future federal estate tax.

- (b) **Payment from Marital Share.** If New York estate taxes are paid out of the marital share, a loss of the marital deduction will cause an immediate increase in New York estate tax. However, credit shelter share will not be reduced.

ii. **Nonresidents**

- (1) **Pro Rata Estate Tax.** New York imposes estate tax on a *pro rata* basis to nonresident decedents with property subject to New York estate tax.

- (a) **Intangibles.** New York imposes no estate tax on nonresidents' intangibles. TSB-M-92 provides that "New York has long maintained a tax policy that encourages nonresidents to keep their money, securities and other intangible property in New York State." TSB-A-85(1) further provides that shares of stock of a New York corporation held by a nonresident are not subject to New York estate tax since shares of stock are considered intangible personal property.

- (i) **Caution.** TSB-A-08(1)M, provides that an interest of a nonresident in an S Corporation which owns a condominium in New York is an intangible asset provided the S Corporation has a legitimate business purpose. Presumably, if the S Corporation had only a single shareholder, and its only purpose was to hold real estate, New York could attempt to "pierce the veil" of the S Corporation and subject the condominium to New York estate tax in the estate of the nonresident.

- (b) **Real Estate.** Real property is generally taxed in the state where it is situated. Since LLC or partnership interests are intangibles, they would not be subject to New York estate tax.

Therefore, nonresidents who own New York real property might consider converting the real property to personal property by contributing the real property to an LLC and taking back membership interests.

k. New York State Income Tax

- i. Divesting New York of Trust Jurisdiction.** Planning to divest New York of jurisdiction to impose fiduciary income tax on undistributed trust assets can produce income tax savings. Tax Law §605(b)(3) taxes trusts created by New York settlors. However, a resident trust is not subject to tax if (i) all trustees are domiciled in a state other than New York; (ii) all property, both real and intangible, is located outside of New York; and (iii) all income and gains of the trust are derived from sources outside of New York. Therefore, New York will not tax a trust that has no New York trustees and no New York assets or income.

- (1) Illustration.** A trust created by a New York resident and administered in New York must pay \$76,992 of New York State tax on a capital gain of \$1 million. However, if the trust were domiciled (or redomiciled) in Delaware, this tax would be avoided, as Delaware imposes no income tax on capital gains incurred on an irrevocable nongrantor trust provided that no remainder beneficiary lives in Delaware. Del. Code Ann., §§ 1101-1243.
- (2) Planning Technique.** The sale of an asset by a New York resident with a large potential capital gain to a trust with no trustees in New York, no assets in New York, and no New York source income, will not be subject to New York tax.

- (a) Effect of IRC §2511(c) on New York Residents.** One of the effects of IRC §2511(c), which imposes gift tax on sales of assets to nongrantor trusts, the new rule will impede the use of "Defective Intentional Non-Grantor Trusts" ("DING" trusts), a variation of intentionally defective grantor trusts which have been used by New York State residents to avoid New York State capital gains tax on sales of appreciated

assets. By selling appreciated assets to a trust with no New York Trustees and no New York source income, the sale of those assets will produce no New York income tax. While the technique will still produce the favorable intended New York State income tax result, the result in 2010 will be that the grantor will be required to report the transfer as a taxable gift. However, since the gift tax exclusion amount is \$1 million, the technique may still be beneficial for some grantors.

2. **GST Tax Uncertainties in 2010.** The GST tax will reappear in 2011, at an amount equal to \$1 million, indexed for inflation since 1997.
 - a. **Overview of Generation Skipping Transfer Tax.** The Generation Skipping Transfer (GST) tax impedes multigenerational transfers of wealth by imposing a transfer tax "toll" at each generational level. GST tax is imposed all transfers, whether made directly or indirectly, to "skip" persons. A skip person is a person who is two or more generations below the generation of the transferor. A trust can also be a skip person, if all of the interests are held by skip persons. IRC §2613(a)
 - i. **Rationale for GST Tax.** Prior to its enactment, beneficiaries of multigenerational trusts were granted lifetime interests of income or principal, or use of trust assets, which lifetime interests never rose to the level of ownership. Thus, it was possible for the trust to avoid imposition of gift or estate tax indefinitely. The GST tax, imposed at rates comparable to the estate tax, operates for the most part independently of the gift and estate tax. Therefore, a bequest (*i.e.*, transfer) subject to both estate and GST tax could conceivably require nearly three dollars for each dollar of bequest. The importance of GST planning becomes evident. Generation Skipping transfers are taxed at the highest estate tax rate imposed under IRC § 2001.
 - ii. **GST Tax Applies to Three Types of Transfer.** Under IRC §2611(a), three transfers are subject to the GST: (i) "direct skips"; (ii) "taxable distributions;" and "taxable terminations."
 - b. **GST Exemption.** IRC §2631 allows every transferor a GST exemption that may be allocated to transfers made by the transferor either during the transferor's life or at death. Affirmative allocations of GST exemption are generally made on Form 709.

Under IRC §2642(b)(1), if a transferor allocates GST exemption on a timely filed gift tax return, the transferor may allocate an amount of the GST exemption equal to the value of the property on the date of the transfer to reduce the "inclusion ratio" to zero. Automatic allocations of GST exemption are made under IRC §2632 to certain transfers made during life that are direct skips, so that the inclusion ratio for such transfers may be reduced to zero even without any affirmative allocation of GST exemption.

- i. **Caution.** Under the automatic allocation rules, the exemption is applied first to direct skips, which are least costly type of GST tax. Therefore, it may be prudent at times not to have GST Exemption automatically allocated to direct skips.
 - ii. **Reverse QTIP Election.** Where a QTIP election is made by the executor, the donor's estate takes the marital deduction. Normally, the surviving spouse is considered to be the transferor for GST tax purposes. However, the executor of the donor spouse may make a *second election* to treat the donor spouse as the transferor for GST tax purposes. IRC § 2652(a)(3).
 - iii. **Pre-Deceased Parent Rule.** If a lineal descendant of the transferor's parent is deceased when a transfer subject to gift or estate tax occurs, the children of the deceased parent may be reassigned to the generation of his deceased parent. IRC §2651(e).
- c. **Calculation of GST Tax.** The GST tax imposed on a transfer equals the amount amount transferred multiplied by the "applicable rate." IRC § 2602.
- i. **"Applicable Rate".** The applicable rate equals the maximum federal estate tax rate multiplied by the "inclusion ratio." IRC §2641
 - (1) **"Inclusion Ratio".** The inclusion ratio is one minus the "applicable fraction."
 - (a) **"Applicable Fraction"**
 - (i) **Numerator.** The amount of the GST tax exemption allocated to the transfer (or trust).

(ii) **Denominator.** FMV of assets transferred (or held in trust).

1) **Result.** If more of the GST tax exemption is allocated to the transfer, the applicable fraction will be greater, the inclusion ratio will be less, and the GST tax imposed will be less.

ii. **Expressed as a Formula:**

$$\text{GST Tax Imposed on Transfer} = \text{Amount Transferred} \times \text{Applicable Rate}$$

$$\text{Applicable Rate} = \text{Maximum Federal Estate or Gift Tax Rate} \times \text{Inclusion Ratio}$$

$$\text{Inclusion Ratio} = 1 - \text{Applicable Fraction}$$

$$\text{Applicable Fraction} = \frac{\text{Amount of GST Exemption Allocated to Transfer}}{\text{Fair Market Value of Assets Transferred}}$$

iii. **Illustration Where Exemption Amount \$1 Million.** On January 1, 2011, father gives \$2 million cash to grandson on his 21st birthday. Assume Congress has not acted with respect to the estate tax. All of father's GST tax exemption automatically allocated to the transfer. The applicable fraction is $\frac{1}{2}$ ($1 - \frac{1}{2}$). The inclusion ratio is $\frac{1}{2}$. The applicable rate is 0.225 (0.5×0.45). GST tax imposed on the transfer is \$450,000 (i.e., \$2 million \times .225).

(1) **Illustration Where Exemption Amount \$3.5 million.** If the exemption amount had been \$3.5 million, \$2 million of the the GST exemption would have been allocated to the transfer, resulting in an applicable fraction of 1, and an inclusion ratio of 0. This would cause the applicable rate to be 0. No GST tax would be imposed on the transfer. Father would have \$1.5 million of the GST exemption remaining to apply to future transfer during life or at death.

iv. **Inclusion Ratio for Trusts.** The GST tax exemption may be applied to

a trust. In such a case, the rate of tax applied to a taxable distribution from the trust or a taxable termination will also be determined by the inclusion ratio. An inclusion ratio of zero will mean that no GST tax will be imposed on the trust. For the inclusion ratio be zero, the amount of the GST exemption allocation made must equal the value of the trust when the allocation is effective. A timely allocation is effective on the date of the gift. A late allocation is effective on the date the gift tax return is filed.

- v. **ETIP Period.** Any GST exemption allocation made during a period in which the property would be included in the transferor's gross estate, *i.e.*, the "ETIP" period, will not be effective. IRC §2642(f)(1). Nevertheless, if a GST exemption is allocated to an ETIP period, the allocation cannot be revoked. The allocation will become effective when the ETIP period terminates.
- d. **GST Tax Has No Application in 2010.** Although technically not repealed in 2010, the generation-skipping transfer (GST) tax will have no application in 2010, since there is no estate tax. This also means that transferors will not be able to allocate any GST exemption to transfers made in 2010. As is the case with the estate tax, the GST tax will "spring back" into life on January 1, 2011.
- i. **Uncertainties in Application of GST Tax in 2010.** By reason of the language in the sunset provision in the 2001 Tax Act, *i.e.*, "the the Internal Revenue Code of 1986 shall be applied . . . as if the provisions [in the 2001 Tax Act] had never been enacted," various uncertainties arise in the application of the GST tax. For example, will GST exemption allocated to trusts after 2001 but before 2010 be allowed? Also, will decedents who die in 2010 with testamentary trusts be treated as transferors for GST purposes? Since transfers to trusts will not be subject to estate tax in 2010, such decedents might not be considered "transferors" within the meaning of IRC § 2652(a). A number of GST provisions are also scheduled to sunset in 2011 without further legislation. Among those are the allowance of a retroactive allocation of GST exemption under certain circumstances, and a late election to allocate the GST exemption.
- e. **Technical Operation of GST Tax.** The GST tax is imposed on "generation skipping taxable transfers" under IRC § 2611(a) of which there are three types:

- i. **Direct Skips.** A direct skip under IRC § 2612(c) is an outright transfer or a transfer in trust for the benefit of a person which skips a generational level, and is subject to the gift or estate tax. A grandparent's outright gift (in excess of the annual exclusion amount) or gift to a trust for the benefit of a grandchild would constitute a direct skip. Tax liability for a direct skip is imposed on the transferor in an outright direct skip, and on the trustee in the case of a transfer in trust. IRC § 2603(a). The amount subject to tax is the amount actually received by the transferee.
 - (1) **Trusts as "Skip" Persons.** A trust is a skip person only if all trust beneficiaries are skip persons. Therefore, a trust which provides for distributions to children and grandchildren would not be a skip person. However, a trust which provides only for distributions to grandchildren would be a skip person.
- ii. **Taxable Distributions.** A taxable distribution under IRC § 2612(b) is a transfer from a trust to a skip person. An example would be a discretionary distribution by a trustee to a grandchild of income or principal from a trust being held for the grantor's child. Payment of this tax is the obligation of the distributee. IRC § 2603(a). The amount subject to tax is the amount received by the distributee. IRC § 2621. If the trust pays the tax on behalf of the beneficiary, this will result in an additional distribution subject to the GST tax.
 - (1) **Distributions for Medical Care or Tuition.** Payments made directly to the provider for medical care or tuition are not subject to the GST tax. IRC § 2611(b)(1).
- iii. **Taxable Terminations.** The third type of taxable transfer is a *taxable termination* under IRC § 2612(a). A taxable termination is the termination of any present interest of any nonskip person in a trust by death, lapse, exercise or nonexercise, where no nonskip person has an interest in the trust, and a skip person could benefit from the trust. Payment of this tax is the obligation of the trustee. IRC § 2603(a).
 - (1) **Exceptions.** There are two exceptions, the first being that there is no taxable termination if immediately after the termination, a non-skip person has a present interest in the property that is more than

nominal.

- (a) **Illustration of First Exception.** A trust is created for a child, and upon the child's death, to the grandchild. While the death of the child would constitute a taxable termination, the death of the grandchild during the child's life would not.
 - (b) **Illustration of Second Exception.** The second exception provides there will be no taxable termination if "at no time after such termination may a distribution . . . be made from such trust to a skip person." Therefore, in the example, if upon the child's death a charity were to receive the trust property, there would be no taxable termination. The amount subject to tax is the amount subject to termination.
 - f. **Generation Move Down Rule.** This rule prevents the GST tax from applying more than once by reassigning the transferor to one generation below his former generation. For example, assume that a transfer to a trust is a direct skip because the only beneficiaries are grandchildren. The rule prevents a distribution to a grandchild from causing a second taxable transfer.
 - g. **Direct Skips Result in Fewest Taxes.** Of this troika of GST taxable events, lifetime "direct skips" result in the fewest GST taxes, since the tax is calculated on the value of the property that the skip person receives. Still, transfer taxes (GST and gift or estate) will consist of 122 percent of the amount transferred. In contrast, taxable terminations and taxable distributions of trusts which occur at death result in much higher GST tax liability, since an estate tax, which could nearly halve the estate, is imposed first, followed by the GST tax, which exacts another like amount. Taxable terminations and taxable distributions from trusts at death should be avoided wherever possible.
3. **Carryover Basis.** Prior to 2010, property acquired from a decedent generally received a stepped-up basis under IRC § 1014. The purpose of the statute is to avoid the double taxation that would result if the asset were first subject to estate tax at the death of the decedent, and then to income tax when the beneficiary sold the asset after the decedent's death. Since the estate tax has, for the time being at least, been repealed, no double taxation would result from the loss of the step-up in basis at death.

- a. **Decedents Dying in 2010.** For decedents dying after December 31, 2009, and before January 1, 2011, the basis of property acquired from a decedent is the lesser of (i) the decedent's adjusted basis or (ii) the fair market value of the property at the decedent's death. IRC § 1022(a)(2). Many estates that would not have been subject to estate tax at the \$3.5 million applicable exclusion amount threshold will be subject to the new carryover basis regime.
 - i. **Note:** More estates with highly appreciated assets will be affected by the carryover basis provision in 2010 (if not retroactively repealed) than would have incurred estate tax with a \$3.5 million applicable exclusion amount.
- b. **Allocation of Basis Permitted to Increase Basis of Some Assets.** To temper the harshness of the new rule, Congress provided that the executor may allocate (i) up to \$1.3 million to increase the basis of assets, and (ii) up to \$3 million to increase the basis of assets passing to a surviving spouse, either outright or in a QTIP trust.
 - i. **Retroactive Repeal?** Although constitutional arguments could be made against the retroactive repeal of the new carryover basis provisions, few would likely object, since it is difficult to envision a situation in which the new carryover basis provision could benefit an estate.
 - ii. **\$1.3 Million Basis Adjustment.** This adjustment is increased by loss carryovers and unused losses. Decedents who are nonresidents and noncitizens can claim only a \$60,000 basis adjustment and cannot benefit from unused losses or carryover losses. This adjustment can be claimed for assets passing to anyone.
 - iii. **\$3 Million Basis Adjustment.** This adjustment applies only to property passing to a surviving spouse either outright or in a QTIP trust (income payable no less frequently than annually).
 - (1) **Property Passing to Spouse Can Receive Entire Basis Adjustment.** Property passing to surviving spouse is also eligible for \$1.3 million basis adjustment. Therefore, a total of \$4.3 million be allocated to property passing to surviving spouse.
 - iv. **Increase in Basis References Basis of Asset.** The increase in basis provision references the basis of the asset, not its fair market value.

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- c. **Requirement that Property be “Owned” by Decedent.** In order to qualify for the basis adjustment, the property must be “owned” by the decedent at the time of his death. Some property, while satisfying the requirement that it be “acquired from the decedent,” will not satisfy the requirement that the property have been “owned” by the decedent at his death. For example, the interest of a surviving spouse in a QTIP trust will be acquired from the surviving spouse, but will not be considered as being owned by that spouse. Therefore, the estate of the surviving spouse will be unable to utilize the basis adjustment respect to QTIP property. Similarly, property owned in joint tenancy may not qualify for the full basis adjustment. IRC §1022(d)(1)(A).
 - i. **Property Owned Jointly With Surviving Spouse.** One-half of such property would be eligible for the basis adjustment. IRC §1022(d)(1)(B)(i)(i).
 - ii. **Property Owned Jointly With Nonspouse.** Basis adjustment permissible to the extent consideration was furnished by the decedent. IRC §1022(d)(1)(B)(i)(II).
- d. **Ineligible Property.** Property acquired by the decedent within three years of death for less than adequate and full consideration will not qualify for a basis adjustment. IRC §1022(d)(1)(C)(i).
 - i. **Rule Not Applicable to Gifts Between Spouses.** However, property acquired from a spouse for no consideration will qualify, provided the spouse did not acquire the property for less than adequate or full consideration. IRC §1022(d)(1)(C)(ii).
- e. **Procedure for Making Basis Allocation.** The Conference Report states that the basis allocation is to be done on an asset-by-asset basis by the Executor (or trustee of a revocable trust).
- f. **Requirement of Filing Information Return.** IRC § 6018 provides for the filing of an information report by the Executor. If the Executor cannot file the return, he should file a description of the property and furnish the name of every person (*e.g.*, trustee or beneficiary) who holds a legal or beneficial interest in the property. Information reporting applies to property “acquired from a decedent.”
 - i. **Property “acquired from a decedent includes, *inter alia*:**

- (1) Property acquired by bequest, devise or inheritance;
- (2) property acquired by the decedent's estate from the decedent;
- (3) property transferred to a trust over which the decedent reserved the right to alter, amend or terminate the trust; and
- (4) any other property passing by reason of the death of the decedent without consideration (*e.g.*, property held in joint tenancy). IRC §1022(e).

ii. **Two transfers occurring at death must be reported.** First, transfers at death of non-cash assets whose value exceeds \$1.3 million must be reported; and second, appreciated property acquired by the decedent within three years of death which does not qualify for the basis adjustment must be reported. IRC §6018(a). Information required with the return under IRC §6018 includes the following:

- (1) Name and TIN of property recipient;
- (2) An accurate property description;
- (3) The adjusted basis and FMV at time of decedent's death;
- (4) The decedent's holding period for the property;
- (5) Information concerning character of potential gain;
- (6) The amount of the basis increase allocated to the property; and
- (7) Any other information that the regulations may require.

(a) **Note:** The Executor must also furnish to each property recipient a statement giving similar information. IRC §6018(e).

(b) **Applicable Penalties.** Failure to report to the IRS noncash transfers of over \$1.3 million or certain transfers within three years of death may incur a penalty of \$10,000 for each failure to report. IRC §6018(b)(2). Failure to report to beneficiaries may result in a penalty of \$50 for each failure. IRC §6716(b). If the failure to file with the IRS or report to a beneficiary occurred by reason of an intentional disregard of the rule, a penalty equal to five percent of the fair market value of the property will be imposed. IRC §6716(d). However, no penalty will be imposed if there is reasonable cause. IRC

§6716(c).

- g. Caution for Estates of Decedents in 2010.** If Congress does not retroactively repeal the carryover basis provisions in 2010, failure to either make an outright bequest to a spouse, or failure to fund a QTIP trust might waste the \$3 million basis allocation that could be made to the QTIP trust. An income interest in a credit shelter trust given to a surviving spouse will not qualify for the \$3 million spousal allocation of basis.
- h. Remnants of Estate Tax Continue to Apply in 2010.** Even in 2010, the estate tax has some residual applicability. For example, the tax on distributions from qualified domestic trusts (QDOTs) to noncitizen spouses continues for 10 years. IRC §2210(b)(1). Under IRC §6166, an election may be made to pay estate tax in installments over 14 years, provided a “closely held business” interest exceeds 35 percent of the estate. Various recapture provisions, including those for installment payment of estate tax and special use valuations, continue to apply in 2010.
- i. Some 2001 Tax Act Provisions Under IRC §6166 Will Sunset in 2011.**

 - (1)** Certain provisions enacted in 2001 would no longer apply to IRC §6166 in 2011:

 - (a) Under the 2001 Tax Act, the number of shareholders or partners who are permitted in qualifying under IRC §6166 was increased from 15 to 45. In 2011, the number will revert to 15.
 - (b) An interest in a “qualified lending and financing business” qualified under the 2001 Tax Act. That provision would expire on December 31, 2010.
 - (c) Certain rules permitting stock of holding companies of operating subsidiaries to be included will no longer be applicable in 2011.

4. Planning for Married Persons

- a. Estate Tax Will Resume on January 1, 2011.** The estate tax will resume no later

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than January 1, 2011. At that time, the exemption amount may be \$1 million (if Congress fails to do anything), or it could be between \$3 million and \$5 million. Under many current wills, if either spouse were to die in 2010 at a time when there is no estate tax, or when the applicable exclusion amount is high, the credit shelter trust might be funded with more assets than the testator intends. Overfunding of the credit shelter trust might also result in unintended New York state estate tax consequences, since the New York state estate tax exemption amount is only \$1 million.

b. Exploit Estate Tax Uncertainty by Utilizing QTIP Trusts. One approach which seeks to capitalize on the uncertainty in the estate tax in 2010 involves maximizing dispositions to QTIP trusts.

i. No Election QTIP Trust Necessary in 2010. Assets in a QTIP trust with respect to which no estate tax marital deduction is allowed at the death of the first spouse will not be includible in the estate of the surviving spouse under IRC § 2044. Therefore, if no estate tax exists at the death of the first spouse in 2010, and all of the estate is left to a QTIP trust, no QTIP election will be necessary to eliminate estate tax in estate the first spouse to die. If no QTIP election is made, none of the assets in the QTIP trust will be included in the estate of the surviving spouse, *even if the estate tax is reenacted prior to the death of the surviving spouse.*

(1) Why No Inclusion in Estate of Surviving Spouse. The rights accorded to a surviving spouse in a QTIP trust are insufficient by themselves to pull the QTIP trust assets back into the her estate under IRC § 2036. QTIP assets are includable **only if** the executor of the first spouse to die makes a QTIP election and deducts the value of the assets from the gross estate of the first spouse. By making the election, the executor is agreeing to include the value of the assets in the estate of the second spouse **at their fair market value at the death of the surviving spouse.**

c. Outright Bequest May be Inferior to QTIP Bequest. If all of the assets are left outright to the surviving spouse, those assets will be included in the estate of the surviving spouse if the estate tax is reenacted prior to the death of the surviving spouse. Therefore, funding a QTIP trust may effectively shield the estate of the surviving spouse from potential estate tax liability. The QTIP trust may also impart

a significant degree of asset protection into the inherited assets, when compared to an outright bequest. Another advantage to funding the QTIP trust is to ensure that the \$3 million spousal basis adjustment can be utilized, if needed. By inserting a disclaimer provision in the will, the surviving spouse may decide whether to disclaim amounts not needed for the \$3 million spousal basis adjustment.

- d. **Separate New York State QTIP Election.** One New York State estate tax problem in connection with generously funding a QTIP was recently resolved by the New York State Department of Finance in a manner beneficial to New York residents. Previously, New York had not recognized a “state-only” QTIP election. That is, if no QTIP election were made on the 706 (and no election would be made in 2010 since none is needed to eliminate the federal tax in 2010), no separate New York QTIP election was possible.

- i. **Separate NYS QTIP Election Now Possible.** TSB-M-10(1)M, issued in February, 2010, now provides that a QTIP Election for New York State purposes when no Federal Return is Required.

- (1) **Explanation from TSB-M-10(1)M.** “In certain cases, an estate is required to file a return for New York State estate tax but is not required to file a federal return. This may occur if there is no federal estate tax in effect on the decedent’s date of death or if the decedent died while the federal estate tax was in effect but the value of his or her gross estate was too low to require the filing of a federal estate tax return. In either instance, and if applicable, the estate may still elect to take a marital deduction for Qualified Terminal Interest Property (QTIP) on a pro-forma federal estate tax return that is attached to the New York State estate tax return.”

- (a) **Election Made on Pro-Forma Federal Estate Tax Return.** For dates of death on or after February 1, 2000, the New York State estate tax conforms to the federal Internal Revenue Code of 1986 (IRC) including all amendments enacted on or before July 22, 1998. Because the IRC in effect on July 22, 1998, permitted a QTIP election to be made for qualifying life estates for a surviving spouse (see IRC § 2056(b)(7)), that election may be made for purposes of a decedent’s New York State estate tax return even if a federal return is not required

to be filed. If no federal return is required, the election must be made on the pro-forma federal estate tax return attached to the New York State return. As provided in IRC § 2056(b)(7), once made, this election is irrevocable. In addition, the value of the QTIP property for which the election is made must be included in the estate of the surviving spouse. See IRC § 2044 and New York Tax Law § 954.

- (i) **Procedure for Making Election.** The QTIP election is made for New York State estate tax purposes in the same manner as the election would have been made for federal estate tax purposes. Enter the amount of the deduction in Part A1 on Schedule M of federal Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, for the applicable date of death and complete the rest of the schedule.
 - (b) **Federal estate tax return for 2010 dates of death.** If there is no federal estate tax for 2010 dates of death and an estate is required to file an estate tax return with New York State, use the federal return for 2009 dates of death, Form 706 (Rev. 9-2009) for the pro-forma federal estate tax return
- e. **QTIP Disposition May Make Gifting More Costly.** One peculiar disadvantage to funding the QTIP trust with all of the estate assets, rather than leaving assets directly to the children, is that the surviving spouse will incur taxable gifts if lifetime transfers to children are desired. The surviving spouse may not wish to wait until her will takes effect to transfer wealth to children. Recall that although the estate tax has been repealed, the federal gift tax exemption remains at \$1 million in 2010. New York State has no gift tax. The federal rate of tax for taxable gifts has been reduced, however, from 45 percent to 35 percent.
- f. **Problem with Disclaimers.** Although a disclaimer creates post-mortem flexibility, a disadvantage to disclaimers is that the surviving spouse must actually disclaim. Some surviving spouses may not disclaim, even if sensible from a tax standpoint.

i. **Possible Solution.** If there is a concern that the surviving spouse will not disclaim, granting the surviving spouse more rights and powers over assets funding a credit shelter trust may alleviate the problem, since the spouse will have less incentive not to disclaim. The surviving spouse might be accorded some or all of the following rights:

- (1) the spouse might be named co-trustee of the trust;
- (2) the spouse might be given a testamentary limited power of appointment over the credit shelter trust;
- (3) the trustee might be directed to make greater distributions to the surviving spouse; or
- (4) the trustee or "trust protector" might be given authority to make discretionary distributions to the spouse of as much of the income or principal of the trust as the trustee or trust protector believes is in the best interest of the spouse. The credit shelter trust could also provide that the spouse would no longer be a beneficiary if the spouse were to remarry.

ii. **Problems with "Solution".** Giving the spouse more rights in a credit shelter trust may eliminate the need to rely on a disclaimer. However, this solution might result in less flexibility, and would likely result in New York state estate tax on the death of the first spouse. (The only way to avoid New York estate tax on the death of the first spouse is to make a transfer qualifying for the New York state estate tax deduction. This type of transfer could be (i) an outright transfer to the surviving spouse; (ii) a QTIP transfer for which a QTIP election is made on the 706; or (iii) a general power of appointment trust.) A final disadvantage to foregoing funding a QTIP in favor of a credit shelter trust is that as indicated above, only outright transfers or transfers for a QTIP trust are eligible for the \$3 million basis allocation at the death of the first spouse. A transfer to a credit shelter trust would not qualify for any basis allocation.

g. **Effect of Surviving Spouse Leaving NYS.** Assume a valid QTIP election is made on a New York estate tax return, but the surviving spouse is no longer a resident of New York at her death and the trust has no nexus to New York. Will New York seek to "recoup" the estate tax deduction claimed on the first spouse to die in a manner similar to the way in which California's "clawback" tax recoups deferred

tax in a like-kind exchange if out-of-state replacement property is later sold? Apparently not, provided the surviving spouse is a bona fide nonresident of New York at her death. Would the state in which the surviving spouse dies have a right to tax the assets in the QTIP trust? Also, probably not. Generally, a QTIP trust is not includible under IRC §2036 in the estate of the surviving spouse if no QTIP election is made. Although in this situation a QTIP election would have been made in New York, no QTIP election would have been made in the state in which the surviving spouse had died. Therefore, that state would appear to have no basis to impose estate tax on the assets in the QTIP trust.

- i. **Inheritance Tax Issue.** Note, however, that if the state in which the surviving spouse dies imposes an inheritance tax (such as that imposed by Pennsylvania) then this tax would not be avoided, since an inheritance tax is imposed on the transferee, rather than on the estate.

5. Gift Tax Planning in 2010.

- a. **Congress Limits Lifetime Gifts to \$1 Million.** Many taxpayers wish to transfer assets to their children during their lifetimes rather than at their death. Therefore, lifetime transfer planning remains important for reasons wholly independent from the fate of the estate tax. While the \$1 million lifetime gift tax exclusion amount is a hindrance to large gratuitous transfers, gifts of interests in discounted family entities, installment sales to grantor trusts, and transfers to annuity trusts can significantly leverage the \$1 million gift tax exclusion amount.
 - i. **Annual Exclusion Amount Remains at \$13,000.** The gift tax annual exclusion amount for 2010 remains at \$13,000. Much wealth can be transferred without gift or estate tax consequences by prudent use of annual exclusion gifts, either outright or in trusts providing Crummey powers. It is unlikely that new IRC §2511(c) would operate to invalidate annual exclusion gifts made under IRC §2503 to non-grantor trusts.
- b. **Rate of Tax For Lifetime Gifts Now 35 Percent.** The federal gift tax rate (New York has no gift tax) for gifts made in 2010 and thereafter is 35 percent, down from 45 percent. Although the 35 percent rate is not scheduled to increase in 2011, Congress has historically imposed the same rate of tax on both gifts and estates. Since the 35 percent gift tax rate may prove only temporary, large gifts of \$1 million

or more made in 2010 may be considerably less expensive than the same gifts would be in 2011.

- c. **Obama Administration May Seek to Curtail Valuation Discounts.** Although the IRS has been successful in challenging gift and estate valuation discounts with arguments premised on IRC §2036, IRC §2704(b)(2)¹ has rarely aided the IRS in litigation in the twenty years since its enactment. President Obama may seek to curtail valuation discounts by means of new legislation. This creates a "window of opportunity" for gift tax planning with valuation discounts in 2010. This prospect, in combination with the historically low gift tax rates now in effect, makes transfer planning in 2010 particularly attractive.
- d. **Will Treasury Move Independently if Congress Fails to Act?** Treasury's 2010 budget proposal includes a provision that would expand the scope of IRC §2704(b). Pursuant to its statutory authority to promulgate regulations with respect to restrictions that have the effect of reducing the value of a transferred interest for tax purposes, but without reducing the value of the interest to transferees, the IRS may move independently of Congress. Although any proposed regulations are subject to public comment and may not be released in final form 18 months, under IRC §7805(b)(2), the final regulations issued within that time can be made retroactive to the date of enactment.
 - i. **New Regs Would Create New Class of "Disregarded Restrictions".** Section 2704(b)(2) ignores in valuing an interest in a closely held entity any "applicable restriction" on liquidation that would lapse or could be removed after the transfer. Restrictions in governing agreements, if not ignored, increase estate and gift tax discounts. Under the proposal, a new category of "disregarded restrictions" would be ignored under §2704(b). Disregarded

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IRC §2704(b)(1) provides: "If (A) there is a transfer of an interest in a corporation or partnership to a member of the transferor's family, and (B) the transferor or members of the transferor's family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest."

IRC §2704(b)(2) defines "applicable restriction" as "any restriction which effectively limits the ability of the corporation or partnership to liquidate."

IRC §2704(b)(3) excepts from the definition of applicable restrictions "any restriction imposed, or required to be imposed, by any Federal or State law."

restrictions would include limitations on the owner's right to liquidate the interest if the limitations are more restrictive than a standard identified in the regulations, even if they are no more restrictive than those imposed by state law. Most states have enacted statutes which take advantage of the "no more restrictive than state law" language in §2704(b). This has made it possible for estate planners to avoid the application of the statute.

- ii. **Valuation Discounts for Co-Tenants.** If new regulations are promulgated restricting the ability of taxpayers to claim valuation discounts when making gifts of interests in family entities, there may be a trend to capitalize on discounts available for undivided interests in real estate. Thus, if co-tenants by the entirety possess rights under state law to partition property, the IRS may recognize discounts in the range of 15 percent to 30 percent. *See Estate of Barge v. Com'r*, T.C. Memo 1997-188 (26% discount recognized for undivided interest in timber).
- iii. **Discounts for Undivided Interests in Tangible Personal Property Problematic.** *Estate of Stone*, 103 AFTR2d 2009-1379 (9th Cir. 2009) allowed only a 5 percent discount for an undivided 50% interest in an art collection.
- e. **Capital Accounts.** When interests in discounted family entities are gifted, the gift tax value will be less than the net asset value of the property transferred. Nevertheless, the capital account of the donor under IRC § 704(b) is transferred to the donee. When interests in discounted family entities are sold, the fair market value for purposes of computing the (discounted) selling price will be less than the net asset value. In this case, the seller's capital account under IRC §704(b) will be transferred to the purchaser.
- f. **Lifetime Gifts Reduce NYS Estate Tax.** Since New York imposes estate tax, but not gift tax, large gifts of cash or unappreciated assets by a person gravely ill can save considerable New York estate taxes. While gifts of appreciated assets will also result in New York estate tax savings, such gifts will forfeit the basis step up that would otherwise occur at death.
- i. **Gifts by Power of Attorney.** Lifetime gifts by those gravely ill pose unique problems. Gifts made under a power of attorney under New York's revised law may lessen those problems. A power of attorney is invaluable

should the principal later become incapacitated, since the appointment of a legal guardian, who can also make those decisions, requires court proceedings. A power of attorney grants an agent appointed by the principal the authority to make legally binding decisions on the principal's behalf.

- ii. **Lifetime Gifts Under Revised GOL §5-1501.** Although gravely ill persons will rarely have the capacity to make large gifts, another avenue for such gifts opened on September 1, 2009. Effective 9/1/09, NY General Obligations Law §5-1501, which governs the content and execution of powers of attorney, was revised and amended. Powers executed prior this date remain valid, but are subject to the amended statute.
- iii. **Operation of Revised GOL §5-1501.** Under the revised law, the power of attorney must be signed, dated and acknowledged not only by the principal, but also by the agent. Under the new law, a power of attorney is durable (*i.e.*, not affected by later incapacity) unless it specifically provides otherwise. If a guardian is later appointed, the agent will account to the guardian rather than to the principal. The new POA contains an optional provision whereby the principal can appoint a "monitor" who may request records of transactions by the agent. The statute also provides for a special proceeding to compel an agent to produce records of receipts. Provisions relating to health care billing should allow the agent access to health care records in accordance with HIPPA privacy requirements.
 - (1) **Statutory Major Gifts Rider.** A new "Statutory Major Gifts Rider" (SMGR), if executed multaneously with the power of attorney, authorizes the agent to make legally binding major gifts on behalf of the principal. The SMGR must be executed simultaneously with the power of attorney, and with the same formalities governing the execution of a Will. The SMGR may also authorize the agent to "create, amend, revoke, or terminate an *inter vivos* trust." The authority of the agent to create joint accounts or to modify a "Totten trust" may also be included in the SMGR. Small gifts (\$500 or less) in a calendar year may be made by the agent without a SMGR. The SMGR may be modified to supplement or eliminate the default provisions provided by new law, provided they are not inconsistent with the default SMGR provisions. A conveyance of real property to

a *bona fide* purchaser for less than adequate consideration would require a SMGR, since the conveyance would be in part a gift.

- (2) **Banks Must Now Accept Short Form Power of Attorney.** Under GOL §5-1504, acceptance of the statutory “short form” POA by banks and other third parties is now mandatory. A third party may not refuse to honor the power or SMGR without reasonable cause. The statute provides that it is unreasonable for a third party or bank to require its own form, or to object to the form because of the lapse of time between execution and acknowledgment. (Banks had sometimes insisted that their own powers be used, which created a problem where the principal had become incapacitated.) An attorney may certify that a photocopy of a duly executed power is a true copy, and banks must now accept that copy.
 - (3) **Statute Clarifies Fiduciary Obligation.** The statute requires that the agent, a fiduciary, observe a “prudent person standard of care,” and imposes liability for breaches of fiduciary duty. Fiduciary duties are imposed on agents appointed under all powers of attorney, including those executed prior to the effective date of the new law. The agent must maintain records and must make those records available within 15 days to a monitor, co-agent, certain governmental entities, a court evaluator, a guardian, or a representative of the principal’s estate. The statute expressly provides that the agent is entitled to compensation for his work. A mechanism is provided by which the agent may resign.
- g. Treasury Proposes that Taxpayers be Bound by Gift or Estate Tax Values.** Treasury has also proposed that taxpayers who receive property by gift or by bequest from a decedent must use the gift or estate tax value for future income tax purposes, even if they disagree with that value. Thus, a taxpayer who receives property from a decedent would be required to use as his basis that reported for estate tax purposes. Similarly, a taxpayer receiving property by gift would be required to use the donor's basis as reported for gift tax purposes.
- h. New Actuarial Tables.** Treasury announced new actuarial tables to reflect increased longevity. The new tables increase the value of lifetime interests and decrease the value of remainders or reversionary interests. T.D. 9448.

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6. Use of Disclaimers in Estate Planning

- a. **Introduction.** Disclaimers can be useful in accomplishing pre-mortem and especially post-mortem, estate planning. A person who disclaims property is treated as never having received the property for gift, estate or income tax purposes.² This is significant, since the actual receipt of the same property followed by a gratuitous transfer would otherwise result in a taxable gift. Although Wills frequently contain express language advising a beneficiary of a right to disclaim, such language is largely gratuitous, since a beneficiary may always disclaim.
- b. **"Qualified Disclaimers" Under IRC § 2518.** For a disclaimer to achieve the intended federal tax result, it must constitute a *"qualified disclaimer"* under IRC § 2518. If the disclaimer is not a qualified disclaimer, the disclaimant is treated as having received the property and then having made a taxable gift. Treas. Regs. § 25.2518-1(b). Under the EPTL, as well as under the law of most states, the person disclaiming is treated as if he had predeceased the donor, or died before the date on which the transfer creating the interest was made. Neither New York nor Florida is among the ten states which have adopted the Uniform Disclaimer of Property Interests Act (UDPIA).
- c. **Qualified Disclaimer Requirements.** For a disclaimer to be qualified under IRC § 2518, the disclaimer must (A) be irrevocable and unqualified; (B) be in writing, identify the property disclaimed and be signed by the disclaimant or by his legal representative; (C) be delivered to either the transferor or his attorney, the holder of legal title, or the person in possession; (D) be made within 9 months of the date of transfer or, if later, within 9 months of the date when the disclaimant attains the age of 21; (E) be made at a time when the disclaimant has not accepted the interest disclaimed or enjoyed any of its benefits; and (F) be valid under state law, so that it passes to either the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer. Under EPTL § 2-1.11(f) the right to disclaim may be waived if in writing.

² IRC § 2518 appears in Chapter 12 of the Internal Revenue Code. While Chapter 12 addresses the gift tax, other federal tax law provisions concerning disclaimers reference Section 2518.

- i. With respect to (A), PLR 200234017 stated that a surviving spouse who had been granted a general power of appointment had not made a qualified disclaimer of that power by making a QTIP election on the estate tax return, since the estate tax return did not evidence an irrevocable and unqualified refusal to accept the general power of appointment.
- ii. With respect to (C), copies of the disclaimer must be filed with the surrogates court having jurisdiction of the estate. If the disclaimer concerns nontestamentary property, the disclaimer must be sent via certified mail to the trustee or other person holding legal title to, or who is in possession of, the disclaimed property.
- iii. With respect to (D), it is possible that a disclaimer might be effective under the EPTL, but not under the Internal Revenue Code. For example, under EPTL §2-1.11(a)(2) and (b)(2), the time for making a valid disclaimer may be extended until “the date of the event by which the beneficiary is ascertained,” which may be more than 9 months after the date of the transfer. In such a case, the disclaimer would be effective under New York law but would result in a taxable gift for purposes of federal tax law.
- iv. With respect to (E), consideration received in exchange for making a disclaimer would constitute a prohibited acceptance of benefits under EPTL §2-1.11(f).
- v. With respect to (F), EPTL §2-1.11(g) provides that a beneficiary may accept one disposition and renounce another, and may renounce a disposition in whole or in part. One must be careful to disclaim all interests, since the disclaimant may also have a right to receive the property by reason of being an heir at law, a residuary legatee or by other means. In this case, if disclaimant does not effectively disclaim all of these rights, the disclaimer will not be a qualified disclaimer with respect to the portion of the disclaimed property which the disclaimant continues to have the right to receive. IRC §2518-2(e)(3).

(1) Exception to Rule for Spousal Disclaimers. An important exception to this rule exists where the disclaimant is the surviving spouse. In that case the disclaimed interest may pass to the surviving

spouse even if she is the disclaimant. Treas. Reg. §25.2518-2(e); EPTL §2-1.11(e).

d. Disclaimer Under Federal Law Where None Possible Under State Law. IRC § 2518(c) provides for what is termed a “transfer disclaimer.” The statute provides that a written transfer which meets requirements similar to IRC § 2518(b)(2) (timing and delivery) and IRC § 2518(b)(3) (no acceptance) and which is to a person who would have received the property had the transferor made a qualified disclaimer, will be treated as a qualified disclaimer for purposes of IRC §2518. The usefulness of IRC § 2518(c) becomes apparent in cases where federal tax law would permit a disclaimer, yet state law would not.

i. To illustrate, in *Estate of Lee*, 589 N.Y.S.2d 753 (Surr. Ct. 1992), the residuary beneficiary signed a disclaimer within 9 months, but the attorney neglected to file it with the Surrogates Court. The beneficiary sought permission to file the late renunciation with the court, but was concerned that the failure to file within 9 months would result in a nonqualified disclaimer for federal tax purposes. The Surrogates Court accepted the late filing and opined (perhaps gratuitously, since the IRS is not bound by the decision of the Surrogates Court) that the transfer met the requirements of IRC § 2518(c). [Note that in the converse situation, eleven states, but not New York or Florida, provide that if a disclaimer is valid under IRC § 2518, then it is valid under state law.]

e. Uses of Qualified Disclaimers.

i. **Charitable Deductions.** Treas. Reg. § 20.2055-2(c) provides that a charitable deduction is available for property passing directly to a charity by virtue of a qualified disclaimer. If the disclaimed property passes to a private foundation of which the disclaimant is an officer, he should resign, or at a minimum not have any power to direct the disposition of the disclaimed property. The testator may wish to give family members discretion to disclaim property to a charity, but yet may not wish to name the charity as a residuary legatee. In this case, without specific language, the disclaimed property would not pass to the charity. To solve this problem, the will could provide that if the beneficiary disclaims certain property, the property would pass to the specified charity.

- ii. **Marital Disclaimers.** Many wills contain “formula” clauses which allocate to the credit shelter trust — or give outright — the maximum amount of money or property that can pass to beneficiaries (other than the surviving spouse) without the imposition of federal estate tax. If the applicable exclusion amount is high, situations will arise where the surviving spouse may be disinherited if the beneficiaries of the credit shelter trust do not renounce part of their interest under such a formula clause. If such an interest is disclaimed and it passes to the surviving spouse, it will qualify for the marital deduction.
 - (1) **Renunciation by Spouse to Create QTIP Trust.** Another use of the disclaimer in a similar situation is where either the surviving spouse or a trustee renounces a power of appointment so that the trust will qualify as a QTIP trust.
 - (a) **Illustration.** A surviving spouse who is granted a general power of appointment over property intended to qualify for the marital deduction under IRC § 2056(b)(5) may disclaim the general power, thereby enabling the executor to make a partial QTIP election. This ability to alter the amount of the marital deduction allows the executor to finely tune the credit shelter amount. If both spouses die within 9 months of one another, a qualifying disclaimer by the estate of the surviving spouse can effect an equalization of estates, thereby reducing or avoiding estate tax.
- iii. **Spousal Disclaimer of Right to Income From Credit Shelter Trust.** Consider the effect of qualified disclaimer executed within nine months by a surviving spouse of his lifetime right to income from a credit shelter trust providing for an outright distribution to the children upon his death. If, within nine months of his spouse’s death, the surviving spouse decides that he does not need distributions during his life from the credit shelter trust, and disclaims, he will be treated as if he predeceased his wife. If the will of the predeceasing wife provides for an outright distribution of the estate to the children if husband does not survive, then the disclaimer will have the effect of enabling the children to receive the property that would have funded the credit shelter trust at the death of the first spouse.

- iv. **Disclaimer of Jointly Held Property to Achieve Basis Step Up.** Assume wife paid no consideration for certain property held jointly with her predeceasing husband. If she dies within 9 months and her estate disclaims, the property would pass through the predeceasing spouse's probate estate, and a full basis step up would become available. If the property would then pass to the surviving spouse under the will of the predeceasing spouse. This planning technique creates a stepped up basis for assets which would not otherwise receive such a step up if the disclaimer were not made.
- v. **Disclaimer to Create Taxable Estate in Predeceasing Spouse.** A qualifying disclaimer executed by the surviving spouse may also enable the predeceasing spouse to fully utilize the applicable exclusion amount. For example, assume the will of the predeceasing spouse leaves the entire estate of \$10 million to the surviving spouse (and nothing to the children). Although the marital deduction would eliminate any estate tax liability on the estate of the first spouse to die, the eventual estate of the surviving spouse would likely have an estate tax problem. By disclaiming \$3.5 million, the surviving spouse would create a taxable estate in the predeceasing spouse, which could then utilize the full applicable exclusion amount of \$3.5 million. The taxable estate of the surviving spouse would be reduced to \$6.5 million.
 - (1) **Disclaiming Spouse May Retain Benefits Through Trust.** To refine this example, the will of the first spouse to die could provide that if the surviving spouse disclaims, the disclaimed amount would pass to a family trust of which the surviving spouse has a lifetime income interest. The will could further provide that if the spouse were also to disclaim her interest in the family trust, the disclaimed property would pass as if she had predeceased.
- vi. **Disclaiming Power to Remove Trustee.** The grantor may wish to ensure that the named trustee will be liberal in making distributions to his children. By giving the child beneficiary the unrestricted right to remove the trustee, this objection can be achieved. However, if the child has the ability to remove the trustee, and the trust grants the trustee the power to make distributions to the child that are not subject to an ascertainable standard, this may cause problems, since the IRS may impute to the child a general power of appointment. If the IRS were successful in this regard, the entire trust might be included in the child's taxable estate. To avoid this result, the child

could disclaim the power to remove the trustee. This might, of course, not accord with the child's nontax wishes.

(1) **Disclaimer of "Five and Five" Power.** If a surviving spouse is given a "five and five" power over a credit shelter or family trust, 5 percent of the value of the trust will be included in her estate under IRC §2041. However, if the surviving spouse disclaims within 9 months, nothing will be included in her estate.

vii. **Disclaimer to Eliminate a Trust.** At times, all beneficiaries may agree that it would be better if no trust existed. If all current income trust beneficiaries, which might include the surviving spouse and children, disclaim, the trust may be eliminated. In such a case, the property could pass to the surviving spouse and the children outright. Note that if minor children are income beneficiaries, their disclaimers could require the consent of guardians *ad litem*.

viii. **Disclaimers in Medicaid, Creditor & Bankruptcy.** Under New York law, if one disclaims, and by reason of such disclaimer that person retains Medicaid eligibility, such disclaimer may be treated as an uncompensated transfer of assets equal to the value of any interest disclaimed. This could impair Medicaid eligibility. In some states, if a disclaimer defeats the encumbrance or lien of a creditor, it may be alleged that the disclaimer constitutes a fraudulent transfer. Not so in New York and California, where a disclaimer may be used to defeat the claim of a creditor. In Florida, the result is contra: A disclaimer cannot prevent a creditor from reaching the disclaimed property.

ix. **Disclaimers and the IRS.** Will a qualified disclaimer defeat a claim of the IRS? No. Prior to a 1999 Supreme Court ruling, there had been a split in the circuits. The 2nd Circuit in *United States v. Camparato*, 22 F3d. 455, *cert. denied*, 115 S.Ct. 481 (1994) held that a federal tax lien attached to the "right to inherit" property, and that a subsequent disclaimer did not affect the federal tax lien under IRC §6321. The Supreme Court, in *Drye v. United States*, 528 U.S. 49 (1999), adopted the view of the Second Circuit, and held that the federal tax lien attached to the property when created, and that any subsequent attempt to defeat the tax lien by disclaimer would not eliminate the lien.

- x. **Effect of Disclaimer on Bankruptcy Petition.** Bankruptcy courts have generally reached the same result as in *Drye*. The disclaimer of a bequest within 180 days of the filing of a bankruptcy petition has in most bankruptcy courts been held to be a transfer which the trustee in bankruptcy can avoid. Many courts have held that even pre-petition disclaimers constitute a fraudulent transfer which the bankruptcy trustee can avoid. If the *Drye* rationale were applied to bankruptcy cases, it would appear that pre-petition bankruptcy disclaimers would, in general, constitute transfers which the bankruptcy trustee could seek to avoid. However, at least one court, *Grassmuck, Inc., v. Nistler* (In re Nistler), 259 B.R. 723 (Bankr. D. Or. 2001) held that *Drye* relied on language in IRC §6321, and should be limited to tax liens.

f. **Frequently Litigated Issues**

- i. **Acceptance of Benefits.** The acceptance of benefits will preclude a disclaimer under state law. EPTL §2-11(b)(2) provides that “a person accepts an interest in property if he voluntarily transfers or encumbers, or contracts to transfer or encumber all or part of such interest, or accepts delivery or payment of, or exercises control as beneficial owner over all or part thereof”
 - (1) Similarly, a qualified disclaimer for purposes of IRC §2518 will not result if the disclaimant has accepted the interest or any of its benefits prior to making the disclaimer. Treas. Regs. §25.2518-2(d)(1) states that acts “indicative” of acceptance include (i) using the property or interest in the property; (ii) accepting dividends, interest, or rents from the property; or (iii) directing others to act with respect to the property or interest in the property. However, merely taking title to property without accepting any benefits associated therewith does not constitute acceptance. Treas. Regs. §25.2518-2(d)(1). Nor will a disclaimant be considered to have accepted benefits merely because under local law title to property vests immediately in the disclaimant upon the death of the decedent. Treas. Regs. §25.2518-2(d)(1).
 - (2) **Rule Liberally Construed.** The acceptance of benefits of one interest in the property will not, alone, constitute an acceptance of

any other separate interests created by the transferor and held by the disclaimant in the same property. Treas. Regs. §25.2518-2(d)(1). Thus, TAM 8619002 advised that a surviving spouse who accepted \$1.75x in benefits from a joint brokerage account effectively disclaimed the remainder since she had not accepted the benefits of the disclaimed portion which did not include the \$1.75x in benefits which she had accepted.

(3) Continued Residence by Joint Tenant Not a Bar to Disclaimer.

The disclaimant's continued use of property already owned is also not, without more, a bar to a qualifying disclaimer. Thus, a joint tenant who continues to reside in jointly held property will not be considered to have accepted the benefit of the property merely because she continued to reside in the property prior to effecting the disclaimer. Treas. Regs. §25.2518-2(d)(1); PLR 9733008.

ii. Testamentary Power of Appointment. The existence of an exercised general power of appointment in a will before the death of the testator is not an acceptance of benefits. Treas. Regs. §25.2518-2(d)(1). However, if the powerholder dies having exercised the power, acceptance of benefits has occurred. TAM 8142008.

iii. Possibility of Future Consideration Not a Bar to Disclaimer. The receipt of consideration in exchange for exercising a disclaimer constitutes an acceptance of benefits. However, the mere possibility that a benefit will accrue to the disclaimant in the future is insufficient to constitute an acceptance. Treas. Regs. §25.2518-2(d)(1); TAM 8701001. Actions taken in a fiduciary capacity by a disclaimant to preserve the disclaimed property will not constitute an acceptance of benefits. Treas. Regs. §25.2518-2(d)(2).

g. Disclaimer of Separate Interests. A disclaimant may make a qualified disclaimer with respect to all or an undivided portion of a separate interest in property, even if the disclaimant has another interest in the same property. Thus, one could disclaim an income interest while retaining an interest in principal. PLR 200029048. So too, the right to remove a trustee was an interest separate from the right to receive principal or a lifetime special power of appointment. PLR 9329025. PLR 200127007 ruled that the benefit conferred by the waiver of the right of recovery under IRC §2207A would constitute a qualified disclaimer.

- h. **Disclaimer of Severable Interests.** A disclaimant makes a qualified disclaimer with respect to disclaimed property if the disclaimer relates to severable property. Treas. Regs. §25.2518-3(a)(1)(ii). Thus, (i) the disclaimer of a fractional interest in a residuary bequest was a qualified disclaimer (PLR 8326033); (ii) a disclaimer may be made of severable oil, gas and mineral rights (PLR 8326110); and (iii) a disclaimer of the portion of real estate needed to fund the obligation of the residuary estate to pay legacies, debts, funeral and administrative expenses is a severable interest. PLR 8130127.
- i. **Disclaimer Must Include Residuary Interests.** For disclaimants (other than a surviving spouse) who are residuary legatees or heirs at law, the disclaimant must be careful not only to disclaim the interest in the property itself, but also to disclaim the residuary interest. If not, the disclaimer will not be effective with respect to that portion of the interest which the disclaimant has the right to receive. §25.2518-2(e)(3). To illustrate, in PLR 8824003, a joint tenant (who was not a surviving spouse) was entitled to one-half of the residuary estate. The joint tenant disclaimed his interest in the joint tenancy, but did not disclaim his residuary interest. The result was that only half of the disclaimed interest qualified under IRC §2518. The half that passed to the disclaimant as a residuary legatee did not qualify.
- j. **Disclaimant's Retained Powers.** The disclaimant may not have the power, either alone or in conjunction with another, to determine who will receive the disclaimed property, unless the power is subject to an ascertainable standard. However, with respect to a surviving spouse, the rule is more lenient. *Estate of Lassiter*, 80 T.C.M. (CCH) 541 (2000) held that Treas. Reg. §25.2518-2(e)(2) does not prohibit a surviving spouse from retaining a power to direct the beneficial enjoyment of the disclaimed property, even if the power is not limited by an ascertainable standard, provided the surviving spouse will ultimately be subject to estate or gift tax with respect to the disclaimed property.
 - i. **Disclaimant May Not Have Retained Fiduciary Powers.** An impermissible power of direction exists if the disclaimant has a power of appointment over a trust receiving the disclaimed property, or if the disclaimant is a fiduciary with respect to the disclaimed property. §25.2518-2(e)(3). However, mere precatory language not binding under state law as to who shall receive the disclaimed property will not constitute a prohibited "direction". PLR 9509003.

- k. Disclaimer of Fiduciary Powers.** Limits on the power of a fiduciary to disclaim may have profound tax implications. PLR 8409024 stated that the trustees could disclaim administrative powers the exercise of which did not “enlarge or shift any of the beneficial interests in the trust.” However, the trustees could not disclaim dispositive fiduciary powers which directly affected the beneficial interest involved. This rule limits the trustee’s power to qualify a trust for a QTIP election.
- l. Disclaimers Made on Behalf of Infants, Minors and Incompetents.** In some states, representatives of minors, infants, or incompetents may disclaim without court approval. However, EPTL §2-1.11(c), while permitting renunciation on behalf of an infant, incompetent or minor, provides that such renunciation must be “authorized” by the court having jurisdiction of the estate of the minor, infant or incompetent. In *Estate of Azie*, 694 N.Y.S.2d 912 (Sur. Ct. 1999), two minor children were beneficiaries of a \$1 million life insurance policy of their deceased father. The mother, who was the guardian, proposed to disclaim \$50,000 of each child. The proposed disclaimer would fund a marital trust and would save \$40,000 in estate taxes. The Surrogate, disapproving of the proposed disclaimer, stated that the disclaimer must be advantageous to the children, and not merely to the parent.
- m. Timeliness of Disclaimer.** Issues may arise where a disclaimer would be valid under the EPTL but not under the Internal Revenue Code. EPTL §2-1.11-(b)(2) provides that a renunciation must be filed with the Surrogates court within 9 months after the effective date of the disposition, but that this time may be extended for “reasonable cause.” EPTL §2-1.11(a)(2)(C) provides that the effective date of the disposition of a future interest “shall be the date on which it becomes an estate in possession.” Since under IRC §2518, a renunciation must be made within 9 months, the grant of an extension by the Surrogates court of the time in which to file a renunciation might result in a valid disclaimer for New York purposes, but not for purposes of federal tax law. Similarly, while the time for making a renunciation of a future interest may be extended under EPTL §2-1.11(a)(2)(C), such an extension would likely be ineffective for purposes of IRC §2518.
- n. Jointly Owned Property.** The rules for disclaiming jointly owned property can generally be divided into two categories: (i) joint bank, brokerage and other investment accounts where the transferor may unilaterally regain his contributions; and (ii) all other jointly held interests. With respect to (i) the surviving co-tenant

may disclaim within 9 months of the transferor's death but, under the current EPTL, only to the extent that the survivor did not furnish consideration.

- i. With respect to (ii), for all other interests held jointly with right of survivorship or as tenants by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation must be made no later than 9 months after the creation. A qualified disclaimer of an interest to which the disclaimant succeeds upon the death of another (*i.e.*, a survivorship interest) must be made no later than 9 months after the death of the first tenant. This is true (i) regardless of the portion of the property contributed by the disclaimant; (ii) regardless of the portion of the property included in the decedent's gross estate under IRC §2040; and (iii) regardless of whether the property is unilaterally severable under local law.

- (1) **Bill to Conform EPTL to Federal Law.** A bill has been introduced in the New York legislature which would conform New York law to federal law. EPTL 2-1.11(b)(1) now provides that a surviving joint tenant or tenant by the entirety may not disclaim the portion of property allocable to amounts contributed by him with respect to such property. Under the proposed law, the surviving joint tenant or tenant by the entirety may disclaim to the extent that such interest could be the subject of a qualified disclaimer under Section 2518 of the Internal Revenue Code.

7. Formula Disclaimers

- a. **Rationale.** Gift and sales transfers are frequently expressed by formula to avoid adverse gift tax ramifications that could result if the value of the transferred interest is changed during an audit. There are generally two types of formula clauses : (1) value adjustment clauses, and (2) value definition clauses.
 - i. **Value Adjustment Clauses.** A value adjustment clause provides for either an increase in the price of an asset or a return of a portion of the transferred asset to the donor if the value of the transferred asset is determined to be greater than anticipated at the time of the transfer. However, this technique is generally ineffective. A number of courts have ruled this would constitute a condition subsequent which would have the

effect of undoing a portion of a gift. That would be against public policy and therefore void.

- ii. **Value Definition Clauses.** Unlike a value adjustment clause, which utilizes a condition subsequent to avoid a transfer in excess of that which is contemplated, a value definition clause defines the value of the gift or sale at the time of the transfer. The agreement between the parties does not require a price adjustment or an adjustment in the amount of property transferred. The transaction is complete, but the extent of the property sold or given is not fully known at that time. An adjustment on a revaluation by the IRS will simply cause an adjustment of the interests allocated between the transferor and transferee(s).

(1) Two Types of Defined Value Clauses:

- (a) **Formula Transfer Clause.** A formula transfer clause limits the amount transferred. If the IRS revalues the asset, a small gift results. An example of a formula transfer clause:
- (i) Grantor transfers to Trustee \$5,000 multiplied by a fraction, the numerator of which is \$5,000 plus 1 percent of the excess consisting of the value of the gift as finally determined for gift tax purposes, and \$5,000; and the denominator of which is the gift tax value as finally determined for gift tax purposes. Thus, if the IRS determined that the value of the gift was \$7,500, the value of the gift would be $[\$5,000 + (.01 \times \$2,500) / \$7,500]$
- (b) **Formula Allocation Clause.** A formula allocation clause allocates the transferred amount among non-taxable transferees, which could include charities, QTIP trusts, or outright transfers to spouses.
- (c) **Use of Formula Disclaimer Upheld by 8th Circuit.** The Eighth Circuit, in *Estate of Christiansen*, approved the use of formula disclaimers. ___F.3d___, No. 08-3844, (11/13/09); 2009 WL 3789908, aff'g 130 T.C. 1 (2008). Helen

Christiansen left her entire estate to her daughter, Christine, with a gift over to a charity to the extent Christine disclaimed her legacy. By reason of the difficulty in valuing limited partnership interests, Christine disclaimed that portion of the estate that exceeded \$6.35 million, as finally determined for estate tax purposes. Following IRS examination, the estate agreed to a higher value for the partnership interests. However, by reason of the disclaimer, this adjustment simply resulted in more property passing to the charity, with no increase in estate tax liability. The IRS objected to the formula disclaimer on public policy grounds, stating that fractional disclaimers provide a disincentive to audit.

- (i) **IRS Criticized in Opinion.** In upholding the validity of the disclaimer, the appeals court remarked that “we note that the Commissioner’s role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner’s role is to enforce the tax laws.” Although “savings clauses” had since *Com’r. v. Procter*, 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944), *rev’g and rem’g* 2 TCM [CCH] 429 (1943) been held in extreme judicial disfavor on public policy grounds, carefully drawn defined value formula clauses have seen a remarkable rehabilitation. So much so that the Tax Court in *Christiansen* concluded that it “did not find it necessary to consider *Procter*, since the formula in question involved only the parties’ current estimates of value, and not values finally determined for gift or estate tax purposes.”

8. Qualified Terminable Interest Property (QTIPs)

- a. **QTIP Election.** A QTIP election will enable the decedent’s estate to claim a full marital deduction. The trust must provide that the surviving spouse be entitled to all income, paid at least annually, and that no person may have the power, exercisable during the surviving spouse’s life, to appoint the property to anyone other than the

surviving spouse. Since the Executor may request a 6 month extension for filing the estate tax return, the Executor in effect has 15 months in which to make the QTIP election.

- i. **Electing QTIP Treatment Not Always Advantageous.** Inclusion of trust assets in the estate of the first spouse to die may “equalize” the estates. Equalization may have the effect of (i) utilizing the full exemption amount of the first spouse and (ii) avoiding higher rate brackets that apply to large estates. Still, the savings in estate taxes occasioned by avoiding the highest tax brackets may itself be diminished by the time value of the money used to pay the estate tax at the first spouse’s death. On the other hand, if the second spouse dies soon after the first, a credit under IRC §2013 may reduce the estate tax payable at the death of the surviving spouse.
- b. **Partial QTIP Elections.** Although the IRS at one time litigated the issue, it now appears that the Executor may elect QTIP treatment for only a portion of the trust, with the nonelected portion passing to a credit shelter trust. If a partial QTIP election is anticipated, separating the trusts into one which is totally elected, and second which is totally nonelected, may be desirable. In this way, future spousal distributions could be made entirely from the elected trust, which would reduce the size of the surviving spouse’s estate.
- c. **Right of Estate of Surviving Spouse to Reimbursement.** QTIP property is included in the estate of the surviving spouse at its then FMV. The estate of the surviving spouse is entitled to be reimbursed for estate tax paid from recipients of trust property. IRC § 2207A. Reimbursement is calculated using the highest marginal estate tax bracket of the surviving spouse. The failure to seek reimbursement is treated as gift made to those persons who would have been required to furnish reimbursement. However, no gift will occur if the will of the surviving spouse expressly waives reimbursement.
- d. **Defective Election Not Revocable Even if No Benefit Accrues From Election.** The IRS takes the position that if the election taken on the initial federal and state estate tax returns was defective — but the IRS did not notice the defect and allowed the marital deduction — the assets will nevertheless be includible in the estate of the surviving spouse under IRC §2044. Thus, the assets are includible even if the estate of the first spouse would have incurred no estate tax had the QTIP election not been made. See PLR 9446001.

- i. **Distinguish Unnecessary Election.** On the other hand, a properly made but unnecessary QTIP election will occasion of fewer harsh results. Under Rev. Proc. 2001-38, an unnecessary QTIP election for a credit shelter trust will be disregarded to the extent that it is not needed to eliminate estate tax at the death of the first spouse. Similarly, a mistaken overfunding of the QTIP trust will not cause inclusion of the overfunded amount in the estate of the surviving spouse. TAM 200223020.
- e. **QTIP As Buffer for Bequests Above Applicable Exclusion Amount.** Since the estate tax is a “tax inclusive,” as opposed to the gift tax, which is “tax exclusive,” there is a distinct tax benefit to making lifetime, as opposed to testamentary, gratuitous transfers. A QTIP trust can assist in overcoming this problem. Assume at a time when the applicable exclusion amount (AEA) is \$3.5 million, father has an estate of \$6 million, and mother has an estate of \$2.5 million. Father (who has made no lifetime gifts other than annual exclusion gifts) wishes to give his children \$4.5 million. If \$4.5 million were left to the children outright, the \$1 million excess over \$3.5 million would attract a federal estate tax of \$450,000. This would result in children receiving only \$4.05 of the \$4.5 million father desired to them. If instead of leaving \$4.5 million to his children outright, father were to leave only \$3.5 million to them outright and place \$1 million in a trust qualifying for a QTIP election, the federal estate tax would be entirely avoided in both estates. Although New York would ultimately impose tax on the \$1 million whether left in a QTIP trust or outright, the amounts left in a QTIP trust would not become taxable until after the death of the surviving spouse. Of course, the children also would receive nothing from the QTIP trust until the death of the surviving spouse.
- f. **Leveraging Applicable Exclusion Amount.** Although there must be no prearranged agreement that spouse will make the contemplated transfer of his or her lifetime income interest, use of a QTIP trust can leverage the \$3.5 million AEA by leaving assets to the surviving spouse in a QTIP trust. The surviving spouse would then be expected — but not required — to make a gift of the qualifying income interest.
- g. **Trust Principal May Also be Used for Gifting.** A surviving spouse's right to withdraw principal may be used for gift planning, but the trust may not require the surviving spouse to apply the principal in that manner, as this would constitute an impermissible limitation on the spouse's unqualified right to income during his or her

lifetime. Treas. Reg. §20.2056(b)-7(d)(6) provides: "The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of IRC § 2956(b)(7)(B)(ii)(II)."

- i. **Effect of Giving Surviving Spouse Greater Withdrawal Rights.** If the spouse is given an unlimited right to withdraw principal, the trust might constitute a general power of appointment trust. While this would preserve the unlimited marital deduction, the right of the decedent to choose who would ultimately receive the property could be lost. The IRS has ruled, however, that granting the surviving spouse a power to withdraw the greater of 5 percent of trust principal or \$5,000 per year (a "five and five" power) will not result in disqualification of QTIP treatment.
 - (1) **Caution:** If greater rights are giving to surviving spouse under an intended QTIP, but those rights do not rise to the level of a general power of appointment, the trust no longer qualifies for QTIP treatment, and the marital deduction could be lost. The result would be inclusion of trust assets in the estate of the first spouse to die.
- ii. **Trust Grants Surviving Spouse No Right to Withdraw Principal.** If the surviving spouse has no right in the trust instrument to withdraw principal, may the trustee make discretionary distributions of principal to further gift planning by the surviving spouse? If such discretionary distributions were disallowed, the gifts could be brought back into the estate of the surviving spouse. *Estate of Halpern v. Com'r*, T.C. Memo. 1995-352 held that discretionary distributions made to the surviving spouse and used to make gifts were not included in her estate.
- iii. **Surviving Spouse Has No Withdrawal Rights and Trustee Cannot Make Discretionary Distributions of Principal.** If the surviving spouse has no right to withdraw principal and the trustee cannot make discretionary distributions of principal, gift planning is more difficult, but still possible by a release or a disclaimer. However, IRC §2519 may pose a problem with a release.
 - (1) **The Problem of the "Transfer of All Interests" Rule.** The surviving spouse can make a gift of or release her qualifying income interest in the trust property to which she would otherwise be entitled.

This would constitute a garden variety gift under IRC §2511. However, the disposition would also trigger IRC §2519. IRC §2519(a) provides that the disposition of "all or part of a qualifying income interest for life in any property" for which a QTIP election was made is treated as a "transfer of all interests in such property other than the qualifying income interest." Therefore, were spouse to gift one-half of a qualifying income interest, he would be deemed to have made a gift of the entire remainder interest in trust, in addition to the gift of the income interest. Under IRC §2207A, he would have a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC §2519.

- (2) **Statutory Rule is Harsh.** If the surviving spouse releases part of his qualifying income interest, he will be treated, under IRC §2519, as having disposed of all trust property. This means that a gift tax would be imposed on all trust property, even though the income interest released by the surviving spouse pertained only to part of the trust property. The harshness of the rule is unjustified from a transfer tax standpoint. If the statute required reporting as a gift only that portion of the trust property which related to the qualifying income interest disposed of -- which most commentators believe is correct -- then the estate of the surviving spouse would include the trust assets not previously reported as a gift. Nevertheless, this is not the case, and a gift of a partial qualifying income interest will in fact trigger the harsh result mandated by IRC §2519, and if no curative measure is found to alter this result, the surviving spouse would be required to report as a gift the entire value of the QTIP trust.
- (3) **IRS Permits Harsh Rule to be Avoided by Severing QTIP.** Fortunately, the IRS allows taxpayer to sever QTIP trusts prior to the surviving spouse disposing of a partial income interest in the QTIP. This avoids the harshness of the "transfer of all interests" rule. *See* PLRs 200438028, 200328015.
- (4) **Operation of IRC §2519.** IRC §2519 provides that if a surviving spouse disposes of a qualifying income interest in trust property, he is deemed also to have disposed of all interests in that property other than the qualifying income interest. Assume the surviving spouse is

85 years old and releases his qualifying income interest in a trust worth \$1 million. Under the prevailing applicable federal rate (AFR) and using actuarial tables, the surviving spouse is deemed to have made a gift of \$180,000. For purposes of IRC §2511, the surviving spouse has made a taxable gift of \$180,000. For purposes of IRC §2519, the surviving spouse is deemed to have made a gift of \$820,000, *i.e.*, all interests in the property *other than* the qualifying income interest.

- (a) **Note:** If instead of releasing the qualifying income interest, the surviving spouse had made a qualified disclaimer with respect to that interest, no gift would have resulted.
- (b) **Net Gift Treatment Under Proposed Regs.** Under IRC §2207A, if the surviving spouse is deemed to have made a gift under IRC §2519, he has a right of reimbursement for gift taxes paid. Proposed regs provide for “net gift” treatment of the deemed gift of a remainder interest under IRC §2519. A net gift occurs where the donee is required, as a condition to receiving the gift, to pay gift taxes associated with the gift. Since the value of what the donees receive is reduced by the gift tax reimbursed to the surviving spouse, the amount of the gift reportable is also reduced by the reimbursement. The gift tax so paid by the donee is deducted from the value of the transferred property to determine the donor’s gift tax.
- (c) **Calculation of Net Gift.** Assume the value of the income and remainder interest in a QTIP trust is \$500,000. Wife makes a gift of one-half of her income interest, or \$250,000. Under IRC § 2519, she will be deemed to have made a gift of the entire \$500,000. An interrelated calculation gives the result that at a 50 percent gift tax rate, a gift of \$333,333 would result in a gift tax of \$166,667. Backing into the hypothetical, a gift of \$500,000 would result in a net gift of \$333,333, since the value of the gift is reduced by the gift tax, which in this case is \$166,667. In this case, \$500,000 is reduced by \$166,667, to leave \$333,333.

- (5) **Problem of Spendthrift Limitations.** Although releasing a a qualifying income interest may be effective if the surviving spouse cannot withdrawal principal and the trustee cannot make discretionary distributions, typical spendthrift limitations which appear in most testamentary trusts may pose problems. An income beneficiary of a spendthrift trust generally cannot assign or alienate an income interest once accepted. *See, e.g., Hartsfield v. Lescher*, 721 F.Supp. 1052 (E.D. Ark. 1989). Is this the end of the road? Not necessarily.
- (a) **Will Disclaimer Overcome Spendthrift Limitation?** If a spendthrift limitation bars the spouse from alienating the income interest, it may still be possible to disclaim the interest under New York's disclaimer statute, EPTL 2-1.11. New York law requires that the disclaimer be made within nine months, but the time period may be extended for "reasonable cause".
- (b) **Nonqualified Disclaimer.** To be a qualified disclaimer under federal law, the disclaimer must be made within nine months. If a New York Surrogate extended the time for reasonable cause, the renunciation would not constitute a qualified disclaimer under IRC §2519. Rather, the disclaimer would be a "nonqualified disclaimer". A nonqualified disclaimer could also trigger IRC §2519.
- iv. **Pre-Mortem Planning with QTIP Trusts.** IRC §2044 requires that remaining QTIP assets be included in the gross estate of the surviving spouse. However, those assets are not aggregated with other assets in the estate of the surviving spouse. Thus, in *Estate of Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996) the surviving spouse at her death owned certain interests outright, and others were included in her estate pursuant to IRC §2044. The estate claimed a fractional interest discount, which the IRS challenged. The Fifth Circuit held that assets included in the decedent spouse's gross estate which were held outright were not aggregated with those included under IRC §2044 by virtue of the QTIP trust. The estate was entitled to take a fractional interest discount. Apparently, even if the surviving spouse were a co-trustee of the QTIP trust, no aggregation would be required. *See* FSA 200119013.

- v. **Estate Planning Possibility under *Bonner*?** Under *Bonner*, could the trustee of the QTIP trust distribute a fractional share of real estate owned by the QTIP trust in order to generate a fractional interest discount at the death of the surviving spouse? Possibly, but in *Bonner*, the surviving spouse owned an interest in certain property, and then became the income beneficiary of a QTIP trust which was funded with interests in the same property. The surviving spouse in *Bonner* already owned a separate interest in the same property. This situation is distinguishable from one in which the QTIP trusts owns all of the interest in a certain piece of property, and then distributes some of that interest to the surviving spouse. In that case, it is less clear that the IRS would not succeed in attempting to aggregate the interests in the same property for the purpose of precluding the estate from claiming a valuation discount. The case would be weaker if the distribution of the fractional interest to the surviving spouse had, as one of its principal purposes, no intention other than to support a later assertion of a fractional interest discount.

9. Sales of Assets to Grantor Trusts. Installment sales of assets to grantor trusts indirectly exploit income tax provisions enacted to prevent income shifting at a time when trust income tax rates were much lower than individual tax rates. Specifically, the technique capitalizes on different definitions of “transfer” for transfer tax and grantor trust income tax purposes. The resulting trusts are termed “defective” because the different definitions of “transfer” result in a divergence in income and transfer tax treatment when assets are sold by the grantor to his own grantor trust.

a. Overview of Asset Sale

- i. **Transfer Complete for Transfer Tax, but Not For Income Tax, Purposes.** For income tax purposes, following an asset sale, the grantor trust holds property the income from which the grantor continues to report. However, the grantor is no longer considered as owning the asset for transfer tax purposes. Therefore, trust assets, as well as the appreciation thereon, will be removed from the grantor’s estate.

- (1) **Illustration.** Assume the grantor sells property worth \$5 million to a trust in exchange for a \$5 million promissory note, the terms of which provide for interest payable over 20 years, and a balloon payment of principal when the note terminates. If the trust is drafted so that the grantor retains certain powers, income will continue to be

taxed to the grantor, even though for transfer tax purposes the grantor will be considered to have parted with the property.¹

- ii. **Accelerated Growth of Trust Assets.** The result of the sale to the defective grantor trust (“IDT” or “trust”) is that the income tax liability of the profits generated by the business remains the legal responsibility of the grantor, while at the same time the grantor has parted with ownership of the business for transfer tax purposes. A “freeze” of the estate tax value has been achieved, since future appreciation in the business will be outside of the grantor’s taxable estate. Nonetheless, the grantor will remain liable for the income tax liabilities of the business, and no distributions will be required from the trust to pay income taxes on business profits. This will result in accelerated growth of trust assets.³

(1) **Illustration.** Assume grantor sells a family business worth \$5 million to the trust, and that each year the business generates approximately \$100,000 in profit. Assume further that the trust is the owner of the business for transfer tax purposes.² With the grantor trust in place, the grantor will pay income tax on the \$100,000 of yearly income earned by the business. If the business had instead been given outright to the children, they would have been required to pay income taxes on the profits of the business.

- iii. **Grantor Trust Provisions in Internal Revenue Code.** Achieving grantor trust status requires careful drafting of the trust agreement so that certain powers are retained by the grantor. The following powers, if retained over trust property, will result in the IDT being treated as a grantor trust:

¶ § 677(a) treats the grantor as the owner of any portion of the income of a trust if the trust provides that income may be distributed to the grantor’s spouse without the approval or consent of an adverse party;

¶ § 675(3), treats the grantor as owner of any portion of a trust in which the grantor possesses the power to borrow from the trust without adequate interest or security;

¶ § 674(a) treats the grantor as owner of any portion of a trust over which the grantor or a

nonadverse party retains the power to control beneficial enjoyment of the trust or income of the trust. [Sec. 674(a) is subject to many exceptions; for example, the power to allocate income by a nonadverse trustee, if such power were limited by an ascertainable standard, would not result in the trust being taxed as a grantor trust]; and

¶ § 675(4)(C) provides that if the grantor or another person is given the power, exercisable in a nonfiduciary capacity and without the approval or consent of another, to substitute assets of equal value for trust assets, grantor trust status will result.

- iv. **Caution.** The objective is for the grantor to part with as many incidents of ownership as are required to effectuate a transfer for transfer tax purposes, while retaining enough powers to prevent a transfer for income tax purposes. Therefore, it is not necessarily advisable to include more powers than necessary to accomplish grantor trust treatment for income tax purposes, since the cumulative effect of retaining many powers which cause the trust to be a grantor trust for income tax purposes could also result in rendering the transfer incomplete for transfer tax purposes as well, entirely defeating the purpose of the sale. IRC § 675(4)(C), which provides that the grantor may in a nonfiduciary capacity substitute assets of equal value, should not result in an incomplete gift.
 - v. **No Taxable Sale When Assets Sold to Trust.** For as long as grantor trust status continues, trust income is taxed to the grantor. A corollary of the grantor trust rules would logically provide that no taxable event occurs on the sale of assets to the grantor trust because the grantor has presumably made a sale to himself of trust assets.⁴ If this hypothesis is correct, the grantor can sell appreciated assets to the grantor trust, effect a complete transfer and freeze for estate tax purposes, and yet trigger no capital gains tax on the transfer of the appreciated business into the trust.
- b. **The Note Received For Assets**
- i. **Note May Contain Balloon Payment Provision.** Consideration received by the grantor in exchange for assets sold to the trust may be either cash or a note. If a business is sold to the trust, it is unlikely that the business would

have sufficient liquid assets to satisfy the sales price. Furthermore, paying cash would tend to defeat the purpose of the trust, which is to reduce the size of the grantor's estate. Therefore, the most practical consideration would be a promissory note payable over a fairly long term, perhaps 20 years, with interest-only payments in the early years, and a balloon payment of principal at the end.⁵ This arrangement would also minimize the value of the business that "leaks" back into the grantor's estate. For business reasons, and also to underscore the bona fides of the arrangement, the grantor could require the trust to secure the promissory note by pledging the trust assets. The note should permit prepayment, which can be of benefit if the parties wish to terminate the transaction earlier, or in the event the assets fall in value, in which case the parties could renegotiate the term of the Note.

- ii. **Payments in Kind if Insufficient Cash.** If there is insufficient cash flow to make payments on the Note, resort will have to be made to payments in kind. However, payments in kind conflict with the grantor's objective in selling assets to the trust to remove them from his estate. Payments in kind could also require costly valuations.
- iii. **Caution.** Although balloon payments may be desirable from a cash flow standpoint, periodic payments of principal and interest would imbue the note with a greater degree of commercial reasonableness. Provided the other terms of the note are commercially reasonable, the provision for a balloon payment of principal should not be problematic. However, the more the terms of the note deviate from those of a commercial loan, and the higher the debt to equity ratio, the greater the chance the IRS will assert that the debt is actually disguised equity. In this case, the IRS could argue that inclusion in the grantor's estate should result from IRC §2036.
- iv. **Note May Provide for Renegotiation of Interest Rate.** If the value of the assets sold to the trust decreases significantly, the trust may seek to renegotiate the interest rate if the AFR has decreased since the date of the sale of assets to the trust. Alternatively, the grantor could sell the note, at a discounted value, to another grantor trust. However, to the extent renegotiation is not feasible, wealth will be transferred back into the grantor's estate.
- v. **Note Need Bear Interest Only at AFR, Not 120% of AFR as With GRAT.** The note issued in exchange for the assets must bear interest at a rate determined under § 7872, which references the applicable federal rate

(AFR) under §1274.6 In contrast, a qualified annuity interest such as a GRAT must bear interest at a rate equal to 120 percent of the AFR. A consequence of this disparity is that property transferred to a GRAT must appreciate at a greater rate than property held by an IDT to achieve comparable transfer tax savings. As with a GRAT, if the assets fail to appreciate at the rate provided for in the note, the IDT would be required to “subsidize” payments by invading the principal of the trust.

- c. **Consequences of Transferred Basis** While no taxable event occurs when the grantor sells assets to the trust in exchange for the note, if grantor trust status were to terminate during the term of the note, the trust would no longer be taxed as a grantor trust. This would result in immediate gain recognition to the grantor, who would be required to pay tax on the unrealized appreciation of the assets previously sold to the trust. Note that for purposes of calculating realized gain, the trust will be required substitute the grantor’s basis.
 - i. **No Cost Basis.** Even though the assets were “purchased” by the trust, no cost basis under § 1012 is allowed since no gain will have been recognized by the trust in the earlier asset sale. Another situation where gain will be triggered is where the trust sells appreciated trust assets to an outsider. One way of mitigating this possibility is for the grantor to avoid selling low-basis assets to the trust. If this is not possible, the grantor may substitute higher basis assets of equal value during the term of the trust, if the trust is drafted to permit the grantor to substitute assets of equal value.
 - ii. **Sale of Appreciated Assets Not Ideal.** Care should be exercised in selling highly appreciated assets to the grantor trust for another reason as well. If the grantor dies during the trust term, the note will be included in the grantor’s estate at fair market value. However, assets sold to the trust will not receive the benefit of a step-up in basis pursuant to § 1014(a).
 - (1) **Solution to Basis Problem.** To avoid this result, the trust might either (i) authorize the grantor to substitute higher basis assets of equal value during his lifetime; or (ii) make payments on the note with appreciated assets.
 - (a) **Note:** If the grantor receives appreciated assets in payment of the note, those assets will be included in the grantor’s estate, if not disposed of earlier. However, they would at least

be entitled to a step-up in basis in the grantor's estate pursuant to § 1014.

iii. Assets Decline in Value. What happens if the assets in the trust decline in value, so that the payments under the note can no longer be made?

- (1) Renegotiate Note.** One option is for the trustee and grantor to renegotiate the terms of the Note, perhaps by lengthening the term and decreasing the interest rate. It is possible that the IRS would assert that a gift had been made in this situation.
- (2) Sell Note to Another Trust.** Another option would be to sell the note to another grantor trust whose beneficiaries are the same. Since the purchase price would be lower, there is more of a chance that future appreciation would be shifted to family members.
- (3) Cancel the Note.** Finally, the grantor could extinguish the Note in exchange for the return of the assets sold to the trust. This approach might violate the fiduciary obligations of the Trustee.

d. Avoiding Sections 2036 and 2702

- i. IRC § 2702.** The rules of Chapter 14 must also be considered. If § 2702 were to apply to the sale of assets to a grantor trust, then the entire value of the property so transferred could constitute a taxable gift. However, it appears those rules do not apply, primarily because of the nature of the promissory note issued by the trust. The note is governed by its own terms, not by the terms of the trust. The holder in due course of the promissory note is free to assign or alienate the note, regardless of the terms of the trust, which may contain spendthrift provisions. Ltr.Ruls 9436006 and 9535026 held that neither § 2701 nor § 2702 applies to the IDT promissory note sale, provided (i) there are no facts present which would tend to indicate that the promissory notes would not be paid according to their terms; (ii) the trust's ability to pay the loans is not in doubt; and (iii) the notes are not subsequently determined to constitute equity rather than debt.
- ii. IRC § 2036.** As noted above, since the assets are being transferred to the grantor trust in a bona fide sale, those assets should be excluded from the grantor's estate. However, since the grantor is receiving a promissory note in exchange for the assets, the IRS could take the position that under IRC §

2036, the grantor has retained an interest in the assets which require inclusion of those assets in the grantor's estate.⁷ In order to minimize the chance of the IRS successfully invoking this argument, the trust should be funded in advance with assets worth at least 10 percent as much as the assets which are to be sold to the trust in exchange for the promissory note.⁸

iii. **Beneficiaries as Guarantors.** In meeting the 10 percent threshold, the grantor should himself make a gift of these assets so that following the sale, the grantor will own all trust assets. The IRS stated in PLR 9515039 that IRC § 2036 could be avoided if beneficiaries were to act as guarantors of payment of the promissory note.⁹ To enhance the bona fides of the note, all trust assets should be pledged toward its repayment. To emphasize the arm's length nature of the asset sale, it is preferable that the grantor not be the trustee.

(1) **Guarantee Could be Counterproductive.** The grantor should be circumspect in employing guarantees. If the assets decline in value, the guarantee could result in wealth being retransferred to the grantor, which result is the opposite of the objective. In addition, the guarantee will be liability of the guarantor, and will be required to be shown on the guarantor's balance sheet.

iv. **Grantor's Payment of Income Tax of Trust Normally Beneficial.** Payment of grantor trust income by the Grantor is a desirable feature of sales of assets to grantor trusts, since trust assets continue to grow without imposition of income tax. The payment by the grantor of the income tax liability of the grantor trust can be considered a gift-tax free gift of the income tax liability by the grantor to the trust.

(1) **Trustee May be Given Discretion to Reimburse Grantor For Income Taxes Paid.** Although beneficial from an estate planning perspective, the grantor may at times not wish to pay the income tax liability of the trust. The trust instrument may authorize, but not require, the Trustee to reimburse the grantor for income tax payments made by the grantor. In that case, inclusion under IRC §2036 should not result. However, if there is even an implied understanding that the grantor will be reimbursed for the income tax payments, it is the IRS position that inclusion in the grantor's estate under §2036 will result. Rev. Rul. 2004-64.

- (a) **Loan from Trust.** If the grantor is cash-short, he may borrow money from the trust to pay income taxes, if the trust so permits. Recall that under IRC § 675(3), a provision in the trust allowing the grantor to borrow money from the trust without adequate security is a provision which actually causes the trust to be a grantor trust.

e. **GST Tax Considerations**

- i. **Sale of Assets Not Occurring During the ETIP.** The sale of assets to a grantor trust has particularly favorable Generation Skipping Transfer (GST) tax consequences. Since the initial transfer of assets to the grantor trust is a complete transfer for estate tax purposes, there would be no possibility that the assets could later be included in the grantor's estate. The transfer would be defined as one not occurring during the "estate tax inclusion period" (ETIP). Accordingly, the GST tax exemption could be allocated at the time of the sale of the assets to the grantor trust¹¹.

- (1) **Contrast GRAT.** In sharp contrast, the GST exemption may not be allocated until after the term of a GRAT has expired.¹² If the grantor of a GRAT were to die before the expiration of the trust term, all of the assets in the GRAT would be included in the grantor's estate at their appreciated value. This would require the allocation of a greater portion of the GST exemption to shield against the GST tax. The inability to allocate the GST exemption using a GRAT is quite disadvantageous when compared to the IDT, where the exemption can be allocated immediately after the sale, and all post-sale appreciation can be protected from GST tax.

f. **Choice of Trustee**

- i. **Grantor Should Not be Trustee.** Trustee designations should also be considered. Ideally, the grantor should not be the trustee of an IDT, as this would risk inclusion in the grantor's estate. If discretion to make distributions to the grantor is vested in a trustee other than the grantor, then the risk of adverse estate tax consequences is reduced. The risk is reduced still further if the grantor is given no right to receive even discretionary distributions from the trust. If the grantor insists on being the trustee of the IDT, then the grantor's powers should be limited to administrative powers, such as the power to allocate receipts and disbursements between income and

principal. The grantor may also retain the power to distribute income or principal to trust beneficiaries, provided the power is limited by a definite external standard.

- ii. **Grantor's Spouse May be Named as Trustee.** The grantor as trustee should not retain the right to use trust assets to satisfy his legal support obligations, as this would result in inclusion under §2036. However, if the power to satisfy the grantor's support obligations with trust assets is within the discretion of an independent trustee, inclusion in the grantor's estate should not result. However, if the grantor retains the right to replace the trustee, then the trustee may not be independent, and inclusion could result. Note that despite the numerous prohibitions against the grantor being named trustee, the grantor's spouse may be named a beneficiary or trustee of the trust without risking inclusion in the grantor's estate.¹⁰
- iii. **Diversification.** The trust instrument should dispense with the typical requirement that the Trustee be required to diversify the investments of the trust.

g. Death of Grantor

- i. **Trust Becomes Irrevocable.** The following events occur upon the death of the grantor: (i) the trust loses its grantor trust status; and (ii) presumably, assets in the trust would be treated as passing from the grantor to the (now irrevocable) trust without a sale, in much the same fashion that assets pass from a revocable living trust to beneficiaries. The basis of trust assets would not be stepped-up under §1014(a) on the death of the grantor, nor would the assets be included in the grantor's estate. In contrast to the problem arising with a GRAT when the grantor dies before the expiration of the trust term, trust assets will never be included in the grantor's estate, although the discounted value of the note will.
- ii. **Note Included in Estate of Grantor.** The tax consequences of the unpaid balance of the note must also be considered when the grantor dies. Since the asset sale is ignored for income tax purposes, the balance due on the note would not constitute income in respect of a decedent (IRD). The remaining balance of the note would be included in the estate and would acquire a basis equal to that value.¹³

- (1) **Income Tax at Grantor's Death?** Some authorities believe that if the grantor dies while the note is outstanding, the estate could realize capital gain to the extent that the debt exceeds the basis of the trust in the assets.
 - (2) **SCIN May Avoid Inclusion in Grantor's Estate.** It may be possible to avoid inclusion of the note in the seller's estate if a self-canceling installment note (SCIN) feature is included. A SCIN is an installment note which terminates on the seller's death. Any amounts payable to the seller would be cancelled at death, and are excluded from the seller's estate. However, use of a SCIN requires that the payments under the note be increased to avoid a deemed gift at the outset.
 - (a) **Seller Outlives Note with SCIN Provision.** As a result of the increased payments, if the seller does survive the full term of the note, the amount payable to the seller from the trust utilizing the SCIN will be greater than if a promissory note without a SCIN were used. This would tend to increase the seller's taxable estate.
 - (b) **Conversion of Note to Note with SCIN.** An existing Promissory Note can be renegotiated to include a SCIN, provided the grantor is not terminally ill (*i.e.*, not a 50% probability that grantor will die within 1 year). As noted, the inclusion of the SCIN will require an additional premium, determined actuarially.
- h. Comparison to GRAT.** In addition to not suffering from the same problems occasioned by the early death of the grantor as would be the case with a GRAT, the asset sale technique also accomplishes a true estate freeze by transferring assets at present value from his estate without being subject to the limitations imposed by IRC §§ 2701 or 2702, to which the GRAT is subject. As noted, the GST exemption may be allocated to the assets passing to the trust at the outset, thus removing from GST tax any appreciation in the assets as well. In these respects, sales to grantor trusts are superior to the GRAT. The principal disadvantages are that (i) no step-up in basis is received at the death of the grantor for assets held by the trust (or if the trust sells appreciated assets during its term); and (ii) the technique, though sound, has no explicit statutory basis, as does the GRAT.

i. **Possible IRS Objections**

- i. **No Bona Fide Sale.** The general principles governing the tax consequences of the asset sale seem firmly grounded in the Code and the law, and their straightforward application appears to result in the tax conclusions which have been discussed. Nevertheless, the IRS could challenge various parts of the transaction, which if successful, could negate the tax benefits sought. In particular, the IRS could attempt to assert that (i) the sale by the grantor to the trust does not constitute a bona fide sale; (ii) § 2036 applies, with the result that the entire value of the trust is includible in the grantor's estate; (iii) the initial asset "sale" is actually a taxable sale which results in immediate tax to the grantor under IRC § 1001; or (iv) that § 2702 applies, the annuity is not qualified, and a taxable gift occurs at the outset.
- ii. **Step Transaction Doctrine.** The IRS has recently interposed the step transaction doctrine in situations where limited liability companies were formed shortly before the sale to the grantor trust. In view of this, it is advisable to permit the limited liability company (or partnership) to "age" prior to transferring the asset to the trust.
- iii. **Filing of Gift Tax Return to Commence Statute.** Although the sale to a grantor trust is not a gift, the grantor may wish to file a gift tax return solely for the purpose of commencing the statute of limitations. If this route is taken, the transaction should be disclosed on the return. Often, the transaction will be disclosed in any event by reason of the grantor's gift of "seed" money to the trust.

j. **LLC Combined with Asset Sale to Grantor Trust**

- i. **Discounted LLC Interests Result in Lower Note Payments.** By combining the LLC form with asset sales to grantor trusts, it may be possible to achieve even more significant estate and income tax savings. LLC membership interests are entitled to minority and marketability discounts since the interests are subject to significant restrictions on transfer and management. If the value of the LLC membership interest transferred to the trust is discounted for lack of marketability and lack of control, the value of that interest will be less than a proportionate part of the underlying assets. Consequently, in the case of an asset sale to the trust, the sale price will be less than if the assets had been directly sold to the trust.

ii. Illustration of Sale of Discounted Asset to Grantor Trust.

- (1) Parent forms an LLC with two children. Parent is Managing Member. Members each contribute \$10,000 in exchange for a 33 percent interest in the LLC. Parent may give children the money to purchase their interests.
- (2) Parent transfers real estate worth \$1 million to the LLC. Parent's capital account is now \$1.01 million, and Parent now owns 99.7 percent of all membership interests in the LLC;
 - (a) In determining the fair market value of the LLC membership interest to be sold by parent to the trust, parent engages the services of a real estate appraiser and a professional valuation discount appraiser.
 - (i) A copy of the LLC operating agreement (containing restrictions which depress value of membership interests)
 - (ii) The valuation discount appraiser determines that the membership interests should be discounted by 30 percent after application of the lack of control and lack of marketability discounts.
- (3) Parent decides to sell a 90 percent membership interest to the trust. Before doing so, parent makes a taxable gift of \$90,000 (10 percent of the value of interests to be sold to the newly formed grantor trust)
 - (a) The children are the only beneficiaries of the trust.
 - (b) The gift reduces parents's available lifetime gift tax exclusion from \$1 million to \$0.91 million.
 - (c) The following year, a federal gift tax return is filed reporting the gift of "seed" money to the trust.
- (4) Parent sells a 90 percent membership interest to the trust in exchange for a 10-year promissory note whose principal amount is \$630,000, which bears interest at 4.47 percent pursuant to IRC § 1274 (the long-

term AFR for May, 2010) and which calls for a balloon payment of principal at the end of the 10-year term of the Note;

- (a) The discounted value of the note is determined by the following formula:
 - (i) $(\text{Value of undiscounted interest sold}) \times (1 - \text{discount})$
 - (b) In numerical terms:
 - (i) $\$900,000 \times (1 - .3)$
 - (ii) $\$900,000 \times 0.7$
 - (iii) $\$630,000$
 - (c) The required yearly interest payments under the Promissory Note are \$28,162.
 - (d) No income tax consequences attach on payments from the trust to the grantor, since they are considered to be the same taxpayer for income tax purposes.
- (5) If the real estate appreciates at a yearly rate of 10 percent, the FMV of trust assets will increase by \$90,000 in year one; $(\$900,000 \times 0.10)$.
- (a) The grantor will report and pay tax on trust's distributive share of income reported by the LLC.
 - (i) The payment by the grantor of the income tax liability of the trust will result in trust assets continuing to appreciate without the imposition of income tax on trust assets.
 - 1) The grantor trust provides that the trustee has discretion to reimburse the grantor for income tax payments made.
 - a) No income tax consequences attach to the reimbursement by the trust to the grantor of income tax

- (6) Had the membership interests not been discounted, the trust would have paid of \$900,000, and the yearly interest would have been \$40,230 (*i.e.*, \$900,000 x .0447).
 - (a) By discounting the property purchased by the trust, the required interest payment to parent was reduced from \$40,230 to \$28,162.
 - (b) If the underlying assets grow at a rate of 10 percent, then 68.71 percent of the growth (\$61,838/90,000) will remain in the trust. If the trust had been required to pay income tax, the rate of growth of trust assets would be significantly lower.
- iii. The LLC asset sale to the IDT will result in the following favorable tax and economic consequences:
 - (1) (i) \$900,000 is transferred out of the grantor's estate;
 - (a) The value of the note is included in the grantor's estate if the grantor dies during the term of the note;
 - (2) future appreciation of the asset sold is transferred out of the estate;
 - (3) unlike the situation obtaining with a GRAT, the favorable tax result does not depend on the grantor surviving the trust term;
 - (4) since the note could bears a lower rate of interest than a GRAT, fewer funds would be brought back into the grantor's estate, resulting in a more perfect "freeze" for estate tax purposes;
 - (a) since the LLC assets are discounted, the purchase price by the trust reflects that discount, making the effective yield of assets within the LLC even higher; and
 - (5) the sale does not occur during an estate tax inclusion period (ETIP), meaning that GST exemption can be allocated initially, before the trust assets increase in value

- (6) No basis step up occurs at the grantor's death; however, this problem can be ameliorated by substituting assets with a higher basis during the grantor's life.

1 A grantor trust is a trust defined in Secs. 671 through 679 of the Code. To be taxed as a grantor trust, the grantor must reserve certain powers, the mere reservation of which in the trust instrument will confer grantor trust status, unless and until those powers are released.

2 IRC Secs. 2036 and 2038, which cause the retention of interests or powers to result in estate inclusion must be avoided when funding an IDT. The retention by a grantor-trustee of administrative powers, such as the power to invest and the power to allocate receipts and disbursements between income and principal will not result in inclusion, and will not negate the transfer for transfer tax purposes, provided the powers are not overbroad and are subject to judicially enforceable limitations. See *Old Colony Trust Co.*, 423 F.2d 601 (CA-1, 1970).

3 The IRS has indicated displeasure with the payment of income taxes by the grantor of a grantor trust when the grantor receives no distributions. However, as the payment of taxes by the grantor is mandated by the grantor trust provisions themselves, it is doubtful that the IRS would prevail on this issue were it to litigate.

4 The IRS takes the position that a wholly grantor trust is disregarded for income tax purposes, and that transactions between the trust and the grantor have no income tax consequences. Rev. Rul. 85-13, 1985-1, C.B. 184.

5 Treas. Reg. § 25.2702-3 prohibits this type of "end loading" with respect to a GRAT. That regulation provides that an amount payable from a GRAT cannot exceed 120 percent of the amount paid during the preceding year. However, if § 2702 does not apply to the IDT, which appears likely, then the promissory note could provide for a large principal payment at the conclusion of the term of the note.

6 A promissory note given in exchange for property must bear interest at the rate prescribed by § 1274. Sec. 1274(d) provides that a promissory note with a term of between two and ten years should bear interest at the federal midterm rate.

7 *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), held that where a decedent, not in contemplation of death, transfers property in exchange for a promise to make periodic payments to the transferor, those payments are not chargeable to the transferred property, but rather constitute a personal obligation of the transferee. Accordingly, the property itself is not includible in the transferor's estate under § 2036(a)(1).

8 In an analogous situation, § 2701 requires that the value of common stock, or a "junior equity interest," comprise at least 10 percent of the total value of all equity interests.

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9 Presumably, if the beneficiaries were to guarantee the note and if the value of the assets which secure the note were to decline, there would still be a realistic prospect of the note being repaid.

10 Sec. 677(a), which treats the grantor as owner of any portion of a trust whose income may be distributed to the grantor or the grantor's spouse, has no analog in the estate tax sections of the Internal Revenue Code.

11 Sec. 2642(f) prohibits allocation of any portion of the Generation Skipping Transfer tax exemption to a transfer during any estate tax inclusion period (ETIP). Sec. 2642(f)(3) defines ETIP as any period during which the value of transferred property would be included in the transferor's estate if the transferor were to die.

12 The period during which the grantor receives annuity payments from a GRAT is an ETIP. Therefore, no part of the GST exemption may be applied to the GRAT until after its term; at that point, the property inside the GRAT will have appreciated, requiring a greater allocation of the GST exemption.

13 Some argue that a sale occurs immediately before the death of the grantor, causing capital gain to be recognized by the grantor's estate to the extent the balance due on the note exceeds the seller's basis in the assets sold to the trust. This view is inconsistent however, with the central premise that the sale by the grantor of assets to the IDT produces no taxable event.

10. Asset Protection

- a. **Traditional Trusts.** Many estate planning trusts also possess significant asset protection features. For example, a qualified personal residence trust ("QPRT") results when an interest in real property, which could be attached by a creditor, is converted into a mere right to reside in the residence for a term of years. The sale of an asset to a "defective" grantor trust in exchange for a promissory note converts the asset into an instrument which may be unattractive to a creditor if it provides only for interest payments. Since these trusts are ubiquitous in estate planning, they are less likely to be vulnerable to a claim that they were formed with an intent to hinder, delay or defraud creditors. Less commonly, trusts are called upon to achieve purely asset protection objectives. Their effectiveness in this role appears to militate in favor of their greater use.
- b. **Asset Protection Trusts.** Asset protection features of an asset protection trust ("APT") may arise by virtue of a discretionary distribution provision. The trust may provide that the Trustees "in their sole and absolute discretion may pay or apply the whole, any portion, or none of the net income for the benefit of the beneficiaries." Alternatively, the Trustees' discretion may be limited by a broadly defined standard, *i.e.*, "so much of the net income as the Trustees deem advisable to provide for the support, maintenance and health of the beneficiary."

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- i. **Effect of Discretionary Distribution on Creditor Rights.** The effects of a discretionary distribution provision on the rights of a creditor are profound. If the trust provides that (i) the beneficiary cannot compel the trustee to make distributions, and assuming that (ii) the rights of a creditor can be no greater than those of the beneficiary, it follows that (iii) a creditor cannot compel the trustee to make distributions. Therefore, properly limiting the beneficiary's right to income from the trust may determine the extent to which trusts assets are protected from the claims of creditors.
- ii. **Limiting Beneficiary's Interest Impotent.** Failure to properly limit the beneficiary's right to income from an APT can have deleterious tax consequences if the creditor is the IRS. TAM 0017665 stated that where the taxpayer had a right to so much of the net income of the trust as the trustee determined was necessary for the taxpayer's health, maintenance, support and education, the taxpayer had an identifiable property interest in the trust which was subject to a federal tax lien. Since the discretion of the trustee was broadly defined, and subject to an "ascertainable standard" rather than being absolute, the asset protection feature of the trust was diminished.
- iii. **Creditor Protection is a Function of Trustee Discretion.** If asset protection is a major objective, the trustee's obligation to distribute income should not be subject to an ascertainable standard. Rather, distributions should be within the trustee's absolute discretion. However, that is not enough. Even if the trustee's discretion is absolute, a court may review the trustee's discretion. Fortunately, courts have generally been disinclined to substitute their judgment for that of the trustee, even where the trustee's discretion is absolute. The Uniform Trust Code is in accord, providing that a creditor of a beneficiary may not compel a distribution even where the trustee has abused his discretion.
 - (1) **Beneficiary Who is Sole Trustee Should Not Have Discretion.**
A beneficiary should not be named sole trustee of his own discretionary APT, since the interest of a beneficiary who has discretion to determine his own distributions may be attached by a creditor. On the other hand, if the sole trustee — even a beneficiary — has no discretion with respect to distributions made to himself, his interest in the trust would not likely be subject to attachment by a creditor. However, amounts actually distributed could be reached.

- c. **Spendthrift Trusts.** Even if the trustee's discretion is absolute, the APT should also contain a valid spendthrift clause, since it is not enough for asset protection purposes that a creditor be unable to compel a distribution. The creditor must also be unable to attach the beneficiary's interest in the trust. A spendthrift provision prevents the beneficiary from voluntarily or involuntarily alienating his interest in the trust. The Supreme Court, in *Nichols v. Eaton*, 91 U.S. 716 (1875), recognized the validity of a spendthrift trust, holding that an individual should be able to transfer property subject to certain limiting conditions.
- i. **Advantages of Spendthrift Trust.** A spendthrift trust may thus protect a beneficiary from (i) his own profligacy or bankruptcy; (ii) his torts; and (iii) many of his creditors, (including his spouse). No specific language is necessary to create a spendthrift trust, and a spendthrift limitation may even be inferred from the intent of the settlor. Still, it is preferable as well as customary to include spendthrift language in a trust. A spendthrift provision may also provide that required trust distributions become discretionary upon the occurrence of an event or contingency specified in the Trust. Thus, a trust providing for regular distributions to beneficiaries might also provide that such distributions would be suspended in the event a creditor threat appears.
- ii. **Exceptions to Spendthrift Protection.** A few exceptions may reduce the effectiveness of a spendthrift trust. As indicated, if a beneficiary is also the sole trustee of a discretionary spendthrift trust, the trust will be ineffective as against creditors' claims. Other exceptions are in the nature of public policy exceptions. Thus, assets in a spendthrift trust may be reached to enforce a claim against the beneficiary for support of a child. Courts might also invalidate a spendthrift trust to satisfy a judgment arising from an intentional tort. Furthermore, a spendthrift trust would likely be ineffective against claims made by the government relating to taxes, since the strong public policy in favor of the government collecting taxes may be deemed to outweigh the public policy of enforcing spendthrift trusts.
- d. **"Self-Settled" Spendthrift Trusts**
- i. **Definition.** A "self-settled" trust is one which the beneficiary creates for his own protection. Here, the settler is either one of the beneficiaries or the sole beneficiary of the trust. A self-settled trust may also be spendthrift. Prior to 1997, neither the common law nor the statutory law of any state permitted a self-settled trust to be endowed with spendthrift trust protection.

- ii. **Five States Now Permit Self-Settled Spendthrift Trusts.** Since 1997, five states, including Delaware and Alaska, have enacted legislation which expressly authorizes the use of self-settled spendthrift trusts. A self-settled spendthrift trust, if established in one of these five states, may effectively allow an individual to put assets beyond the reach of creditors while retaining some control over and access to trust assets. These states now compete with exotic locales such as the Cayman and Cook Islands, and less exotic places such as Bermuda and Lichtenstein, which for many years have been a haven for those seeking the protection of a self-settled spendthrift trust.
- iii. **Self-Settled Spendthrift Trust Void as Against Creditors in New York.** New York has never been, and is not now, a haven for those seeking to protect assets from claims of creditors. Most states, including New York, continue to abhor self-settled spendthrift trusts. This is true even if another person is named as trustee and even the trust is not created with an intent to defraud existing creditors. New York's strong public policy against self-settled spendthrift trusts is evidenced in EPTL §7-3.1, which provides that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator." Still, there appears to be no reason why a New York resident could not transfer assets to the trustee of a self-settled spendthrift trust situated in Delaware or in another state which now permits such trusts. Even though a New York Surrogate or Supreme Court Justice might look askance at an APT created in Delaware, the Full Faith and Credit Clause of the Constitution would impart significant protection to the Delaware trust.
 - (1) **"Reciprocal" Trusts Will Generally Not Provide Asset Protection.** Trust arrangements nominally not self-settled spendthrift trusts, but which seek to achieve that status by indirect means, will likely fail in that desired objective. Thus, a "reciprocal" or "crossed" trust arrangement, in which the settlor of one trust is the beneficiary of another, would likely offer little or no asset protection. (In fact, the "reciprocal trust doctrine" has often been invoked by the IRS to defeat attempts by taxpayers to shift assets out of their estates.)
- iv. **Creditor Protection Increases Likelihood of Transfer for Transfer Tax Purposes.** If a self-settled spendthrift trust is created in Delaware, the creditor protection will likely eliminate the possibility of estate inclusion under IRC §2036. Assets placed beyond the reach of creditors are generally also considered to have been effectively transferred for transfer tax purposes.

If the settlor's spouse is beneficiary, there is even less likelihood of estate inclusion.

- (1) **IRC § 2036.** Typical estate tax rules must be considered when planning for asset protection. Thus, the estate of a settler who retains the right to receive trust distributions will be required to include trust assets in the estate under IRC § 2036. The problem may still exist even if the "right" to receive income is within the discretion of the Trustees, since it is the retained right which causes inclusion. Nonetheless, PLR 200944002 stated that a Trustee's authority to make discretionary distributions to the Grantor will not, by itself, cause inclusion under IRC § 2036. By utilizing a domestic APT in which the settler retains no right whatsoever to income, inclusion under IRC § 2036 should be avoided.

11. GRATs

- a. **Qualified Interest Under IRC § 2702.** Generally, IRC § 2702 provides special rules for transfers in trust to family members. The retained interest is zero unless the interest transferred is a "qualified interest". A qualified interest is generally an annuity or unitrust interest, or a noncontingent remainder interest following an annuity or unitrust interest. A qualified interest is valued under the valuation table rates of IRC § 7520.
- b. **Treasury Proposals for 2010 Would Impose 10-Year Minimum Term.** Treasury's 2010 budget proposal includes a requirement that all GRATs have a term of not less than 10 years. This limitation is intended to ensure that the transaction has at least some downside risk. The 10 year requirement would make it unlikely that many taxpayers over 75 years old would utilize a GRAT. Instead, those individuals would likely use sales to grantor trusts to shift appreciation in transferred assets to donees. Congress is also considering requiring a minimum 10-year period for GRATs.
 - i. **Zeroed-Out GRATs Not Affected.** If enacted, the proposal to require a minimum 10-year term for GRATs would not effect the taxpayer's ability to utilize a "zeroed-out" GRAT, which result in little or no current taxable gift. Also, the proposal would not prevent the taxpayer from funding the GRAT with highly appreciating assets. To benefit from current law, estate planners may wish to use GRATs whose duration is less than ten years, but more than two or three years. The rationale being that if a short-term GRAT is used, the

taxpayer will be forced to choose within a few years whether to use a ten-year GRAT or no GRAT.

- c. **Front-Loaded GRATs..** Under IRC §2036, if the grantor dies before the term of the GRAT, inclusion in the grantor's gross estate occurs. In a front-loaded GRAT, annuity payments during the early term of the GRAT are disproportionately large. If the grantor outlives this period, but dies at a time when the annuity payments are much lower, fewer GRAT assets are included in the estate. This is because fewer assets would be required to fund the annuity. To reduce the effectiveness of short-term GRATs in this respect, Congress may limit the amount by which annuities can be reduced in later years. No action has yet been taken in this regard.

i. **Reducing the Risk of the Grantor's Death in Long-Term GRATs.**

- (1) **Grantor May Sell Retained Annuity Interest.** If the grantor's retained annuity interest is sold to a grantor trust, no income tax consequences will occur. However, under IRC §2035, if the grantor were to die within three years of the sale, the retained annuity interest would still be includible in the grantor's estate under IRC §2036. Although some have suggested that the grantor may avoid the three-year rule by simply purchasing the remainder beneficiary's interest, the IRS would likely view this as a prohibited "commutation". See Rev. Rul. 98-8 (IRS objects to purchase of remainder QTIP interest).
- (2) **Caution: GRAT Must Permit Transferability of Interests.** Most trusts contain spendthrift provisions, which prevent the transfer of interests. If the purchase of an interest in a GRAT from a beneficiary is contemplated, the trust must not contain a spendthrift provision.
- (3) **Grantor Purchases Remainder Interest from Remainder Beneficiary.** The Grantor may purchase the remainder interest from a beneficiary to avoid the risk of death prior to the end of the GRAT term.
- (4) **Repurchasing GRAT Assets.** If the value of assets in a funded GRAT decline, the grantor may wish to repurchase those assets and fund a new GRAT.

- d. **Underperforming GRATs.** For a GRAT to shift wealth, the asset transferred to the trust must outperform the Section 7520 rate. If the asset declines in wealth, no wealth will be transferred from the grantor's estate. This situation is termed a "burned out" GRAT. Here, the grantor may do nothing and let the GRAT run its course. If so, the grantor will be in the same economic and tax situation that he would have been if no GRAT had been created. However, other options are available. These include the following:
- i. **Swap assets of equal value and create a new GRAT.** One of the powers which confers upon a trust grantor trust status, is the power of the grantor to substitute assets of equal value. IRC § 675(4)(c). If the assets in the GRAT are performing poorly, the grantor can substitute other assets and form a new GRAT to hold the underperforming asset. Since there will be lower required annuity amount in the new GRAT, the potential for wealth transfer increases. (If the grantor trust does not contain a swap provision, the grantor can simply purchase the asset for cash or a promissory note and create a new GRAT.)
 - ii. **Sell Poorly Performing GRAT to Grantor Trust.** The grantor can also sell the poorly perform asset to a second grantor trust (with the same beneficiaries) for cash or a promissory note.
 - iii. **Drafting Considerations.** For most of these techniques, the GRAT should possess the following attributes:
 - (1) The GRAT should provide that the grantor may substitute assets of equal value;
 - (2) The GRAT should not contain a spendthrift clause, as this would impair the ability of the grantor to transfer his annuity interest.
 - (3) The GRAT should not contain provisions that would impair the ability of the Trustee to sell assets to outside purchasers.
- e. **Exceptionally Performing GRATs.** If the GRAT has performed extremely well, and the grantor wishes to lock in the wealth transfer achieved, he can substitute assets of equal value (assuming again that the trust contains such a power) but which carry less downside potential. The grantor could also sell the asset for cash or a promissory note.

- f. GRAT Transfers Too Much Wealth.** The GRAT assets may perform so well that the wealth transfer to beneficiaries exceeds that which the grantor desired. In this situation, the grantor can (i) purchase the over performing asset from the GRAT, thereby limiting further wealth shift to trust beneficiaries; (ii) substitute cash or other assets not expected to perform as well; (iii) add or change trust beneficiaries; or (iv) turn off grantor trust status, as this will cause trust income to be taxed to the now nongrantor trust, rather than to the grantor, thereby reducing the value of trust assets by the income tax liability of the trust.
- i. Drafting Trust Provision Limiting Beneficiary's Interest.** The grantor may also expressly limit the amount a beneficiary can receive from the trust. Thus, the trust could provide that upon the termination of the trust term, Beneficiary A will receive \$100x dollars, with the remainder to be distributed to Beneficiary B.
- g. GRATs Whose Assets are Illiquid.** The GRAT assets may be illiquid or difficult to value, although not necessarily without significant worth. Although an in kind distribution may be made, if the GRAT assets consist of interests in a family business, valuing the interest may be difficult, and this difficulty may be compounded by applicable valuation discounts available. Paying the annuity with a note is forbidden by Treasury Regulations. However, the trust may borrow money from a third party. Some believe that the loan may be guaranteed by the grantor, provided the GRAT pays the grantor a fee for guaranteeing the note.
- i. Increasing Annuity.** Problems associated with an illiquid GRAT may be avoided by using a long-term GRAT whose annuity payments increase over the years. It may be advisable to fund the GRAT with some cash or liquid assets at inception.
- h. Problem of Grantor Dying During Trust Term.** If the Grantor dies during the term of the GRAT, all or part of the trust assets will be included in the Grantor's estate. To prevent the grantor's estate from exceeding the applicable exclusion amount and incurring an estate tax, the GRAT could provide that in the event of the death of the grantor prior to the trust term, the assets could be distributed to the surviving spouse. Estate tax would thus be averted at the death of the grantor. If the grantor is unmarried, a similar contingent bequest could be made to a charity. Note that although this solution would prevent an estate tax problem, it would also defeat the grantor's objective of shifting wealth to other generations.

- i. **Problem of Automatic GST Allocation.** Since the assets in the GRAT may be returned to the grantor's estate if the grantor dies during the trust term, the GRAT is subject to an "ETIP", which is an "estate tax inclusion period." A GST exemption becomes effective only at the end of an ETIP. Since the GST exemption is automatically allocated, the grantor should elect out of automatic allocation of the GST exemption. This can be done by attaching a statement to the gift tax return, Form 709.
- i. **Failure to Elect Out of Automatic GST Allocation.** If the grantor fails to properly elect out of the automatic GST allocation, relief can be sought under Treas. Reg. § 301.9100-3. Relief will generally be granted if the taxpayer establishes to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith.
- j. **Failure to File Gift Tax Return Reporting GRAT.** If the grantor fails to file a gift tax return adequately reporting the transfer to the GRAT, the statute of limitations will not commence. In this case, the grantor should file a late or amended gift tax return adequately disclosing the transaction.
- k. **Adherence with Legal Formalities.** As is the case with many estate plans involving family entities and documents, adherence with formalities is important. If necessary formalities are not observed, the IRS may argue that the GRAT is not entitled to favorable tax treatment under IRC §2702.

12. Qualified Personal Residence Trusts

- a. **In General.** In essence, a QPRT is formed when a grantor transfers a personal residence (and some cash for expenses) into a residence trust, and retains the right to live in the residence for a term of years. If the grantor dies before the end of the trust term, the trust assets are returned to the grantor's estate, and pass under the terms of the grantor's will. However, if the grantor outlives the trust term, the residence passes to named beneficiaries without any gift or estate tax event. A longer trust term will increase the value of reserved term and decrease the initial taxable gift. Any contingent reversionary interest that the grantor retains will also reduce the value of the remainder interest for gift tax purposes. Accordingly, to minimize the initial taxable gift, the trust term should be as long as possible, taking into account that estate tax benefits will be diminished if not foregone if the grantor dies before the end of that term.

- i. **Qualified Interest Under IRC § 2702.** QPRTs, like GRATs, find their statutory basis in IRC § 2702, which values transfers in trust of “qualified interests.”
- b. **Contingent Reversionary Interest.** The contingent reversionary interest the grantor retains will also reduce the value of the remainder interest for gift tax purposes. Accordingly, to minimize the initial taxable gift, the trust term should be as long as possible, taking into account that estate tax benefits will be diminished if not foregone if the grantor dies before the end of that term.
- c. **QPRT is Split-Interest Trust.** The QPRT is a “split-interest” trust in which the grantor retains a reserved use term and a contingent reversionary interest. A gift is made to beneficiaries of a future interest, which vests only if the grantor outlives the trust term. Any appreciation in the residence during the term of the trust would also have been diverted from the grantor’s estate if the grantor outlives the trust term.
- d. **QPRTs Most Desirable When Interest Rates High.** The interest rate used in valuing the retained interest is at historic lows. The lower the value of the interest rate, the lower the retained interest, and the greater the value of the taxable gift. Still, QPRTs may be attractive since real estate values are extremely low. In addition, even though the value of the retained income interest is lower during times of low interest, the value of the retained reversion also increases.
- e. **Spouse’s Right to Reside in Residence Following Trust Term.** The trust can contain a provision allowing the grantor’s spouse the right to reside in the residence following the trust term. Since the grantor is married to his spouse, the grantor should be able to continue to live in the residence past the trust term without the payment of rent.
- f. **QPRT Disadvantages.** There are three principal disadvantages to using a QPRT. First, if the grantor dies during the trust term, all trust assets will be included in his estate under IRC §2036(a). Second, the basis of the residence will not receive a basis step-up at death under IRC §1014. Third, neither the grantor nor the beneficiary may pledge the assets in the trust for a loan, nor can the assets be listed on a financial statement.
- g. **Technical Requirements.** The QPRT is an improved version of the personal residence trust which preceded the QPRT. Any residence trust drafted today, with rare exception, would seek to qualify as a QPRT. The major advantage of the QPRT is that it may hold a small amount of cash. The QPRT may hold only one personal

residence of the term-holder. The QPRT may also hold improvements related to the residence, but it may not hold the cash used to make the improvements. The regulations limit the number of residence trusts held by the grantor to two. Treas. Reg. §25.2702-5(a). A “personal residence” may, but is not required to be, the grantor’s “principal residence” as the latter term is defined under IRC §1034. Under the formula stated in IRC §280A(d)(1), a personal residence would be one used by the grantor for the greater of (i) 14 days per year or (ii) 10 percent of the number of days for which it is rented at fair market value.

- i. Residence May Include Office.** The grantor may use a portion of a personal residence as an office without risking disqualification as a personal residence. So too, a personal residence includes appurtenant structures and any adjacent land that does not exceed an amount reasonably appropriate for residential purposes, taking into account the size and location of the residence. Treas. Reg. §§ 25.2702-5(b)(2)(C)(ii) and 25.2702-5(c)(2)(C)(ii).
- h. Required Trust Provisions.** A trust failing to qualify as a QPRT will result in an immediate taxable gift of the assets in the trust. The following provisions must be included in the trust instrument to qualify as a QPRT:

 - i. Mandatory Distribution of Income.** The trust instrument must require, without qualification or exception, that all trust income will be distributed to the grantor at least annually. Treas. Reg. §25.2702-5(c)(3).
 - ii. Trust May Not Hold Excess Cash.** A residence trust may hold only a personal residence. However, a QPRT may authorize the trustee to hold a limited amount of cash to pay trust expenses reasonably expected to be incurred within the following six months. Treas. Reg. §25.2702-5(c)(5)(ii)(A)(1).
 - iii. Distributions to Others Prohibited.** A QPRT must expressly prohibit the distribution of income or principal to any person other than the grantor during the trust term. Treas. Reg. 25.2702-3(c)(4).
 - iv. Commutation Prohibited.** Under state law, parties to a trust may terminate the trust and distribute a fractional share of the real estate to the term owner and the remaindermen based upon actuarial calculations. However, a QPRT must prohibit any commutation or prepayment of the interest of the term holder. Treas. Reg. §25.2702-5(c)(c). The rationale for

this rule is that a sick grantor could, without this prohibition, commute the trust and exclude a portion of the trust proceeds from his estate.

(1) **Sale of Term Interest Not Prohibited?** Some commentators have opined that the prohibition against commutation does not preclude a sale by the grantor of his term interest for “adequate and full consideration,” which would remove the trust from the grantor’s estate. IRC §§2035(d), 2036(a).

v. **Termination of Residence Status.** The trust instrument must provide that the trust will cease to be a QPRT if the residence ceases to be used as the grantor’s personal residence by reason of its sale or destruction. However, the trust may provide that if the trustee purchases another residence within two years, QPRT qualification will continue.

(1) **Conversion to GRAT.** The residence may cease to be the grantor’s personal residence without the purchase of another residence by the trustee. The trust instrument must therefore provide that if trust property ceases to be the grantor’s personal residence (i) the trustee must distribute all funds to the grantor; or (ii) the trust must be converted to a grantor retained annuity trust (GRAT). Since distribution of trust funds would result in inclusion in the grantor’s estate, conversion to a GRAT would generally be preferable.

vi. **Limitation on Repurchase.** The trust instrument must prohibit the trust from selling the personal residence to the grantor, the grantor’s spouse, or a related person during the trust term. Treas. Reg. §25.2702-5(b)(1). This rule was promulgated to prevent the grantor from repurchasing the property with a note, and then achieving a basis step-up at death while at the same time providing beneficiaries with cash.

i. **Determining the QPRT Term.** The length of the QPRT term is an important decision when drafting the trust. While the selection of a longer trust term will result in a smaller gift, if the grantor does not outlive the trust term, the entire trust will be returned to the grantor’s estate. Conversely, a short term will result in few gift and estate tax savings. Whatever trust term is chosen, the residence should be valued by a professional appraiser to minimize the consequences of a later valuation inquiry by the IRS.

- j. **Remainder Interest in QPRT.** The remainder interest in a QPRT may be distributed outright at the end of the trust term, or may be held in further trust for the beneficiaries. Treas. Reg. §25.2702-5(c)(1). If the grantor dies during the trust term, the assets will, of course, be included in the grantor's gross estate for estate tax purposes.
- i. **Not Part of Grantor's Probate Estate.** If the grantor dies prior to the end of the QPRT term, the residence held by the QPRT will pass to beneficiaries according to the terms of the trust, and will not be part of the grantor's probate estate. This means that the grantor's probate estate may be required to pay taxes attributable to the QPRT.
 - (1) **Possible Solution.** To avoid this problem, the trust can either provide for (i) a remainder interest to the grantor's spouse, which would qualify for the unlimited marital deduction; or (ii) a contingent reversionary interest in the grantor's estate or a contingent power to appoint trust funds to the grantor's estate, which could be used to satisfy estate tax liability. The contingent reversionary interest also helps to reduce the value of the taxable gift to the beneficiaries at the inception of the trust.
- k. **Designating a Trustee.** Under the grantor trust provisions, a grantor is treated as the owner of the trust assets for income tax purposes. Therefore, for income tax purposes, the choice of the grantor as trustee is actually helpful. However, the effect of the choice of the grantor as trustee must also be considered for transfer tax purposes.
 - i. **Grantor as Trustee Not Ideal for Transfer Tax Purposes.** Since the right of remainder beneficiaries to receive the trust principal at the conclusion of the trust term is vested and not subject to divestment, the initial gift would not generally be imperiled by the choice of the grantor as trustee. However, if the trust gives the grantor the discretion to sell the residence and distribute the trust funds to the grantor, this would result in an incomplete gift at the outset. Therefore, it is probably best that the grantor not be named trustee of the QPRT. However, the choice of the grantor's spouse as trustee should pose fewer problems, as would the choice of a child as trustee or successor trustee. However, as the trustee's duties are not merely ministerial, but require management of trust property, choosing a precocious 14 year old as trustee of a QPRT might be injudicious.

- l. Generation-Skipping Transfer Tax.** The retained interest in a QPRT causes an “estate tax inclusion period” (ETIP). Therefore, any generation-skipping transfer tax exemption allocated to the QPRT will be based upon the value of the (appreciated) residence at the end of the trust term. In this respect, the QPRT has unfavorable GST tax attributes, but still no worse than if no trust had been utilized. (However, in contrast, the intentionally defective grantor trust does not suffer from this infirmity: the sale of assets to a grantor trust does not result in an ETIP.)
- m. Possession after QPRT Term.** The regulations provide that the grantor may not repurchase the residence from the QPRT. However, the regulations do not prohibit the grantor from continuing to reside in the residence if the grantor pays fair rental. The IRS has stated that the trust may even require the trustee to lease the residence to the grantor at the end of the trust term. Alternatively, the trust could also grant the term holder’s spouse a life estate in the residence following the trust term. Since the grantor is married to the spouse, inclusion in the gross estate should not occur under IRC §§2036 and 2038. *See* PLR 199906014.

13. Buy-Sell Agreements.

- a. Purpose of Buy-Sell Agreements.** Family business owners may wish to exclude outsiders from ownership. A buy-sell agreement is a contract between shareholders or partners which restricts the transfer of closely-held stock in the event of the shareholder’s retirement, death, or receipt of an outside offer. The agreement creates a market for the stock by requiring or (granting an option to) the remaining shareholders or to the corporation to purchase the shares in the event of the specified contingency. The buy-sell agreement may succeed in fixing the value of stock for estate tax purposes. However, because of perceived abuses in the use of buy-sell agreements to freeze values of family businesses, IRC § 2703 was enacted.
- i. Operation of IRC § 2703.** To depress the estate tax value of closely held businesses, buy-sell agreements often contained significant rights or restrictions that were never intended to be exercised. Congress sought to stem this perceived abuse by enacting § 2703, under which options, agreements and rights to use or acquire property at less than FMV are ignored in determining estate or gift tax value, as are restrictions on the right to sell or use property.

 - (1) Exception for Bona Fide Business Arrangement.** However, § 2703(b) provides an exception for an option, agreement, right or restriction which (i) is a bona fide business arrangement; (ii) is not a

“device” to transfer property to family members at less than FMV; and (iii) contains terms which are comparable to those which would have obtained in an arm’s-length transaction. Earlier case law which survived the enactment of §2703 adds that the estate must be obligated to sell the stock at the price determined under the agreement at death, and that the deceased must have been unable to sell the stock during his or her lifetime without first having the right to put (*i.e.*, sell) such stock to the corporation.

(2) **Objective to Come Within Exception.** A primary tax objective is therefore to come within the statute’s exception. Courts have traditionally found an agreement bona fide if the price determined thereunder was equal to the value of the interest at the time of execution of the agreement. However, since §2703 imposes an independent “device” requirement, the buy-sell agreement must also possess an independent legitimate business purpose. Establishing that the right or restriction was the result of an arm’s length transaction requires, according to legislative history, consideration of factors such as (a) the expected term of the agreement; (b) the current FMV of the property; (c) anticipated changes in value; and (d) the adequacy of consideration.

(3) **Importance of Appraisal.** An agreement which sets the estate tax value at a price established by an independent appraisal at the death of the shareholder would likely withstand IRS challenge, yet it would also provide little in the way of freezing estate tax values. Alternatively, the agreement could require periodic determination of purchase price using a formula. §2703 would appear to require the expertise of a professional business appraiser in establishing that formula. If the business is to be continued by the family, to avoid family discord, professional appraisals of the business should be obtained initially and at regular intervals. The IRS will also be more likely to accept a value specified in the contract if buttressed by a professional appraisal.

b. **Determining Purchase Price.** The agreement must formulate the manner in which the purchase price will be determined. Under the fixed price method, the owners would agree to a price after financial statements have been issued on an annual or other basis. The agreement may instead employ book value and adjusted book value to determine price. A third method would require appraisal of the

business when the interest is sold. Finally, a capitalization of earnings method may be used. Each method of determining price has its own distinct advantages and disadvantages. In addition to determining price, the agreement must also set forth whether the purchase price will be paid in cash or in installments.

- c. **Funding Estate Tax Liabilities.** A traditional buy-sell agreement may enable the estate of an owner of a closely held business to raise cash to fund testamentary bequests and pay estate taxes. The agreement may also be effective in valuing an estate for tax purposes. Typically these agreements are funded by life insurance. However, a traditional buy-sell agreement for a family-owned business may be impractical, especially where only the immediate family operates the business.
- d. **Devolution of the Family Business.** A family business may simply be sold following the death of the parent. However, it is unlikely that the family will receive adequate consideration from the sale of a single-owner business. An alternative is for the business to be carried on by the spouse and children of the owner. If among two or three children only one wishes to remain active in the business, this creates estate planning issues, since the business may comprise most of the wealth of the estate. In this case, leaving the business to the child interested in continuing the business may be unfair to the other children, or the surviving spouse. Simply leaving the business to the surviving spouse, a tempting option, is fraught with its own potential perils, since the surviving spouse may have no conception of how to manage the business.
- i. **Life Insurance May Assist in Equalizing Estates.** One method of “equalizing” an estate which is comprised primarily of a family business is to create additional estate assets by purchasing life insurance. In this manner, each child can be left assets of approximately equal value, and the surviving spouse can be adequately provided for. If structured properly, the proceeds of the life insurance would not be included in business owner’s estate. Another solution would be for the parent and child to enter into a modified buy-sell agreement. The parent would be obligated to sell, and the child obligated to purchase the business, at a price determined under the contract. The consideration for purchase could again be provided for by life insurance carried on the owner’s life. An installment note could also be used in lieu of, or in conjunction with, a life insurance policy. In this case, the child would be obligated to make cash payments to the estate from cash flow generated by the business.

- ii. **Problems With Life Insurance.** The buy-sell agreement must also provide for the purchase or redemption of the shares. Money must be available either to the remaining shareholders or to the corporation to purchase the departing or deceased owner's shares. Life insurance is sometimes an attractive funding mechanism in testamentary situations because amounts received by beneficiaries are excludable under IRC § 101. However, life insurance may be cumbersome when many owners are involved, since each owner would be required to purchase a policy on every other owner. Moreover, premium payments for insurance purchased to fund a buy-sell agreement are not deductible by either the corporation or by the shareholders, and must therefore be paid with after-tax dollars, an expensive proposition. Nevertheless, since C corporations may reduce earnings by paying reasonable salaries, it may be feasible for a corporation in a 15 percent tax bracket to forego the deductibility of the premiums.
- iii. **Limitations With Life Insurance.** Life insurance may fund the agreement in the event of the death of a shareholder. However, other contingencies may trigger obligations under the agreement that cannot be funded with life insurance. For example, the corporation or shareholders may be required to purchase or redeem shares from a retired or disabled shareholder. Disability insurance could be obtained, but it would be quite expensive. In this situation (or as an alternative to the use of insurance in general), the corporation may simply set aside a reserve in order to fund obligations arising under the buy-sell agreement. In that case, tax counsel must ensure that the corporation does not become subject to the accumulated earnings tax under IRC § 531, which would apply if the accumulation were not considered to be for "reasonable needs of the business." However, a strong argument could be made that funding a buy-sell agreement constitutes a reasonable need.
- e. **Types of Buy-Sell Agreements.** In most buy-sell agreements, either the company or the shareholders are required to purchase the shares. Under a "cross-purchase agreement," the remaining shareholders are either obligated or granted an option to purchase the ownership interest of the withdrawing or deceased shareholder. Under a "redemption agreement," the entity itself is either obligated or granted an option to purchase that interest. Under a "hybrid agreement," the entity has either an option or obligation to purchase, but may assign that obligation to the remaining owners. The cross-purchase agreement is often preferred since it suffers from the fewest tax and nontax impediments.

- f. Tax Problems With Redemptions by C Corporations.** Income tax considerations may militate against the use of redemption agreements. Since a corporate redemption distribution that fails to meet the requirements of IRC § 302(b) (after the application of attribution rules found in IRC § 318) will be taxed as a dividend to the redeemed shareholder, no recovery of basis will be permitted. In contrast, a sale to another shareholder pursuant to a cross purchase agreement should result in capital gain treatment. Furthermore, the basis of the shares of remaining shareholders will not be increased as a result of a corporate redemption. In contrast, if a cross-purchase agreement is used, each remaining shareholder would receive a cost basis in the shares. (If the shares are expected to be held in the family until death, the basis of the shares themselves is less important.) Basis considerations are not relevant in the context of a redemption by an S Corp or by an LLC — both pass-thru entities — since the remaining shareholders will necessarily receive a basis increase.
- g. Tax Advantages of Redemptions by C Corporations.** Some income tax factors favor redemption agreements. Interest paid by a C corporation to redeem shares will be fully deductible by the corporation. Conversely, interest paid by corporate shareholders under an installment note purchase pursuant to a cross-purchase agreement will constitute investment interest subject to limitations on deductibility. In the case of an LLC and a cross-purchase agreement, interest paid by the owners will be classified as either deductible business interest, investment interest, or passive interest, depending on whether the assets of the entity are used in the conduct of a trade or business, and whether the owner materially participates. Where an LLC itself redeems its shares, the interest deduction and its characterization would pass through to its members.
- h. Local Law Considerations.** Local law considerations must also be considered when drafting a buy-sell agreement. For example, state law may effectively preclude or discourage the use of a redemption agreement, by prohibiting a corporation from redeeming its shares unless sufficient capital surplus or retained earnings exist for the redemption. This problem may be surmounted by including a provision in the redemption agreement requiring shareholders to take action to cause the redemption to satisfy capital requirements under state law. For example, the agreement might require the corporation to increase the capital surplus by reducing stated capital, or to revalue appreciated assets to obtain a more accurate estimate of their fair market value.
- i. Financial Considerations.** Financial considerations also impact which type of buy-sell agreement should be used. Loan agreements must be reviewed, since

restrictive covenants may prohibit an entity from redeeming its own shares. Even if the lending institution is indifferent, the obligation to redeem the interest of the deceased owner may adversely affect the entity's ability to borrow funds in the future. This problem could in theory be solved by the owners' becoming personally liable on future loans. However, the owners may be unwilling or unable to undertake such a commitment, with good reason.

14. Inter Vivos Trust

- a. **In General.** As a testamentary instrument, the *inter vivos* (sometimes call a "living") trust possesses attractive attributes, especially for elderly testators. For younger persons, the will is generally preferable as a testamentary device. Property placed in a will passes automatically into the probate estate, where it may could become the subject of a will contest. However, property placed in an *inter vivos* trust cannot become the subject of a will contest since it does not constitute part of the probate estate. Moreover, having begun operating before death, questions concerning the trust instrument, or the competence or mental capacity of the grantor are likely to have been resolved during the grantor's lifetime.
- b. **Income and Transfer Tax Implications of Revocability.** An *inter vivos* trust, like other trusts, affords the grantor flexibility in disposing of property and in making use of tax-favored planning techniques. A "revocable" living trust, as its name implies, may be modified or revoked before the death of the grantor, while an "irrevocable" living trust may not be revoked. Whether a trust is revocable or irrevocable will have important gift and estate tax consequences. Whether to make the living trust irrevocable depends upon the tax and planning objectives of the grantor. Obviously, the grantor's "comfort level" will be greater when a revocable trust is used. An *inter vivos* trust may also be either a "grantor" trust or a "nongrantor" trust for income tax purposes.
- c. **Inter Vivos Trust Requires Titling Assets in Name of Trust.** Many of the legal tasks necessary to create a living trust in effect serve as a proxy for, and merely accelerate into the grantor's lifetime, tasks that would otherwise have awaited probate administration. Although it may involve a significant present cost (when compared to merely drafting a will), the grantor of a living trust will be able to assist in many facets of its creation, and thus ensure that the task proceeds efficiently.
- d. **Many Estate Planners Prefer Wills as Testamentary Instruments.** Despite its attractive features, the living trust has not supplanted the will as the first choice among most estate planning practitioners and testators in effecting testamentary

dispositions. Many attorneys prefer the simplicity and versatility of the will. Nearly all of the flexibility of the trust can also be accomplished using trust provisions within the will. Nearly every tax benefit which can be achieved using a living trust can also be attained using a will. Probate is, in most cases, efficient and relatively quick.

- i. **Inter Vivos Trust Requires Monitoring.** Ministering to the needs of an inter vivos trust also requires a constant vigilance which testators who are not elderly are likely to find burdensome. In addition, any property not properly placed in the living trust during the testator's lifetime will pass by will or intestacy anyway. For this reason, even when a living trust is used, a will is usually required to dispose of any property which the testator neglected to place in the trust. For these reasons, the will remains a superior testamentary vehicle for many persons.