

TAX NEWS & COMMENT

© 2010 LAW OFFICES OF DAVID L. SILVERMAN, LAKE SUCCESS, NY (516) 466-5900

VOL. XIX NO. 2

JUNE 2010

www.nytaxattorney.com

IRS MATTERS

NEW CARRYOVER BASIS RULES; SECTION 2053 FINAL REGS.

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 Since the estate tax has, for the time being at least, been repealed, no double taxation would result from the loss of the step-up in basis at death.

For decedents dying after December 31, 2009, and before January 1, 2011, the basis of property acquired from a decedent is the lesser
(Please turn to page 5)

FROM THE COURTS

Northern District Finds Successive Tax Penalties Imposed by NYS-AG and NYS-DTF to be Unconstitutional

Finding that Tax Law § 481(1)(b)(i) effectively operates as a criminal penalty, the Northern District held that the assessment of a tax penalty by the Department of Taxation and Finance under § 481(1)(b)(i) following the taxpayer's previous prosecution and conviction by the Attorney General for the same offense under Tax Law § 1814, violated the Double Jeopardy Clause of the Fifth Amendment. *Abuziad v. N.Y.S. Department of Taxation & Finance*, No.1:08-CV-1213, 2/19/10, (NDNY), *motion to reconsider denied*, 5/12/10; *appeal docketed*, No. 10-1210, 3/22/10 (2nd Circuit).

[Tax Law § 481 authorizes a
(Please turn to page 3)]

FROM WASHINGTON

HOUSE PASSES \$56 BILLION "TAX EXTENDERS" BILL

The House, on May 29th, by a vote of 215-204, approved a \$56 billion tax bill, the "American Jobs and Closing Tax Loopholes Act". The Senate has already approved a similar measure. President Obama is expected to sign the bill. Most of the provisions retroactively extend to January 1, 2010, tax provisions that expired on December 31, 2009. Among significant provisions:

¶ The bill extends until December 31, 2010, the additional standard deduction of \$500 (\$1,000 for married filing jointly) for qualified state and local real property taxes
(Please turn to page 2)

**Tax
Analysis**

Asset Sales to Grantor Trusts: Antidote to New Estate Tax?

I. Introduction

Asset sales to grantor trusts exploit income tax provisions enacted to prevent income shifting by capitalizing on different definitions of "transfer" for transfer and income tax purposes. The objective of the sale is to effectuate a complete transfer for transfer tax purposes, but not for income tax purposes. Since no transfer occurs for income tax purposes, no income tax gain is recognized by the grantor on the sale. Despite this, the grantor has made a
(Please turn to page 15)

**Tax
Planning**

MARITAL DEDUCTION PLANNING

I. Review of Current Wills

The estate tax will resume no later 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 in a later year 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
(Please turn to page 9)

JUNE COMMENT Gift Planning in 2010

I. Introduction

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
(Please turn to page 8)

**Estate
Planning**

FROM WASHINGTON, CONT.*(Continued from page 1)*

available for non-itemizing persons..

¶ The bill extends through December 31, 2010 a provision allowing taxpayers the choice of itemizing either (i) state or local income taxes or (ii) state or local sales taxes.

¶ Extended through December 31, 2010 is a provision allowing qualified taxpayers an above-the-line deduction for qualified higher education tuition and expenses. The maximum deduction of \$4,000 is available for individuals with adjusted gross income not exceeding \$65,000 (\$130,000 married/joint). A \$2,000 deduction is available for taxpayers whose AGI does not exceed \$80,000 (\$160,000 married/joint).

New Tax Revenues

Although the focus of the bill is to extend expiring tax provisions, the measure also contains several tax revenue proposals. Among them:

¶ Congress is concerned with the perceived manipulation of employment taxes by professionals operating through an S corporation or limited partnership and receiving a low salary. The bill addresses this perceived abuse through new rules taking effect January 1, 2011.

¶ The House has proposed increasing the federal oil spill recovery trust excise tax to \$0.32 per barrel through December 31, 2020. The "single spill incident expenditure cap" would be eliminated from the Oil Spill Liability Trust Fund.

¶ The bill would increase estimated tax payments for large corporations by 30.5 percent due in July, August and September 2015.

Provisions for Businesses

Congress appears ready to enact various business incentives. Among them:

**DAVID L. SILVERMAN, ESQ.**

J.D., Columbia Law School, LL.M. (Taxation) NYU Law School. Formerly associated, Pryor Cashman, LLP, Manhattan. Former editor, ABA Taxation Newsletter. Author, *"Like Kind Exchanges of Real Estate Under IRC § 1031."* (2007). Former Treasurer, NY Virtuosi Symphony Orchestra. Approved sponsor for CPE credits, NYS Board of Public Accountants.

TAX LITIGATION

- ¶ Federal Tax Litigation & Appeals
- ¶ NYS Tax Litigation & Appeals
- ¶ Employment & Sales Tax Litigation
- ¶ Criminal Tax Matters; Liens & Levies
- ¶ Declaratory Judgments; Refund Litg

TRUSTS & ESTATES

- ¶ Probate & Estate Administration
- ¶ Estate & Gift Tax Planning
- ¶ Wills & Trusts, LLCs & FLPs
- ¶ Will Contests; Trust Accountings
- ¶ Estate Litigation; Estate Tax Audits

TAX & BUSINESS PLANNING

- ¶ Opinion Letters & Ruling Requests
- ¶ Like Kind Exchges; Corporate Plann'g
- ¶ Asset Protection; Domestic AP Trusts
- ¶ Business Succession; Buy-Sell Agree.
- ¶ Prenuptial Agreements; Divorce Plnng

REAL ESTATE & CIVIL LITIGATION

- ¶ Commercial & Resident'l Real Estate
- ¶ NYS Tax Appeals Tribunal Litigation
- ¶ NYS Civil & Appellate Tax Litigation
- ¶ Article 78 Tax Appeals; Injunctions

Law Offices of David L. Silverman

2001 Marcus Avenue, Ste. 265A South

Lake Success, NY 11042

Tel. (516) 466-5900 Fax (516) 437-7292

www.nytaxattorney.com

Email: nytaxatty@aol.com

**SHIRLEE AMINOFF, ESQ.**

Ms. Aminoff earned her J.D. from Benjamin N. Cardozo School of Law, with a concentration in property and real estate. Ms. Aminoff is admitted to the New York State Bar. Ms. Aminoff practices tax, trusts & estates, estate administration, real estate, tax litigation, trademarks, and estate planning.

aminoffs@gmail.com

2010 TAX OUTLOOK, CONT.

¶ The bill would extend until December 31, 2010, the qualified research and experimentation tax credit.

¶ The 15-year MACRS recovery period for (i) qualified leasehold improvement property (normally depreciated over 39 years) and (ii) qualified retail improvement property, placed in service before January 1, 2010 would be extended to January 1, 2011.

¶ The bill extends expiring provisions relating to regulated investment companies until December 31, 2010. The provisions relate primarily to short-term capital gain treatment of dividends of mutual funds. The bill also addresses (i) the estate tax treatment of non-U.S. citizens and (ii) the tax treatment of dispositions of U.S. real property by mutual funds investments by non-U.S. citizens.

¶ The bill extends through December 31, 2010, expiring provisions relating to investments by U.S. share-

(Please turn to page 3)

FROM WASHINGTON, CONT.

(Continued from page 2)

holders in controlled foreign corporations (CFCs). The provisions extend several exceptions to the rule requiring U.S. shareholders of CFCs to report income not currently distributed.

Charitable Contributions

¶ The bill extends until December 31, 2010 a provision allowing individuals 70½ or more to donate up to \$100,000 from IRA accounts to a charitable organization without recognizing income and without itemized charitable deduction limitations.

¶ The bill extends until December 31, 2010, provisions set to expire on December 31, 2009, which provide special rules for contributions of real property for conservation purposes.

¶ The bill extends until December 31, 2010, a provision allowing special deductions for charitable contributions by corporations of contributions of computer technology and computer equipment.

Energy Provisions

Congress also favors the following energy incentives:

¶ Tax credits for hybrid automobiles, and hybrid light trucks, medium trucks and heavy trucks, now due expire in 2009, 2010 and 2014, would each be extended for one year.

¶ Tax credits for (i) natural gas; (ii) liquefied petroleum gas used as transportation fuel; (iii) biodiesel fuel and (iv) renewable biodiesel fuel would be extended through December 31, 2010.

¶ The bill also proposes (i) extending the energy efficient home credit; (ii) modifying credits for energy efficient windows by allowing for regional climate variations; (iii) extending incentives for alternative fuel

and alternative fuel mixtures; and (iv) extending the suspension of taxable income limit to tax years beginning before January 1, 2011, for the depletion of qualified marginal oil and gas wells.

Disaster Relief

The bill extends the provisions of the 2008 National Disaster Relief Act through December 31, 2010. The 2008 Act provides temporary relief to taxpayers affected by a qualified disaster. Other measures related to national disasters include the following:

¶ The bill extends, through December 31, 2011, a provision waiving the personal casualty loss deduction limitation of 10 percent of adjusted gross income for personal casual losses qualifying as "net disaster losses." Net disaster losses are defined as the excess of personal casualty losses in a disaster area over personal casualty gains.

¶ The bill extends the allowance of an additional 50 percent bonus depreciation for property which rehabilitates or replaces business property affected by a federally declared disaster if placed in service before January 1, 2011.

¶ The bill extends until December 31, 2010, a provision allowing "qualified businesses" to deduct currently, rather than capitalize, disaster clean-up and repair expenses. Qualified expenses include those incurred in connection with a federally declared disaster for (i) abatement of hazardous substances; (ii) debris removal or demolition of structures damaged or destroyed; or (iii) repair of business-related property.

¶ The bill extends until December 31, 2010, a provision allowing a five-year net operating loss (NOL) carryback for "qualified disaster losses."

Single-Employer Pensions

The bill addresses the funding of shortfalls in underfunded defined benefit pension plans. Single-employer pension plans funding shortfalls must now be amortized in equal installments over seven years. Under the proposal, the sponsor could elect to amortize the shortfall over either nine years or 15 years.

The nine-year method would provide for interest only payments for the first two years. The 15-year method would require equal payments over the 15-year period. The bill would also allow a single-employer defined benefit plan to apply a minimum contribution credit balance to a later year if the plan is at least 80 percent funded. The measure would apply to minimum contributions made to plans in 2009 through 2011.

International Tax

President Obama has expressed concern that the foreign tax credit is being manipulated in a manner that allows corporations to avoid U.S. tax on foreign-source income that is never repatriated to the U.S. Under the House proposal, recognition of foreign tax credits would be suspended until the related foreign income was subject to U.S. tax.

The bill also addresses the perceived abuse of tax treaties to increase foreign source income, which in turn increases the available foreign tax credit. The bill would prevent source-shifting of U.S. securities and other assets to increase the foreign tax credit.

Carried Interest

Carried interest represents a partner's interest in future profits received in exchange for services. Carried interest is currently taxed at capital gains rates. Under the bill, 50 percent of carried interest would be taxed as ordinary income beginning January 1, 2011. Beginning January 1, 2013, 75 percent of carried interest would be subject to ordinary income tax rates.

FROM THE COURT, CONT.

(Continued from page 1)

cigarette tax of \$15 per carton by means of tax stamps. Abuzaid was charged under Tax Law § 1814(e) with purchasing cigarettes for sale bearing counterfeit tax stamps, a class E felony. On November 13, 2006, approximately seven months after Abuzaid pled and was sentenced for the crime of possessing unlawfully stamped cigarettes, the N.Y.S. Department of Taxation and Finance ("the Department") assessed a penalty under Tax Law § 481(1)(b)(i) for the same conduct.

Abuzaid filed an administrative appeal with the Division of Tax Appeals (DTA) asserting that the assessment violated both the state and federal constitutions. On March 19, 2009, ALJ Timothy J. Alston issued a Determination which denied the petition of Abuzaid and sustained the Department's Notice of Determination.]

The ALJ Determination

Judge Alston first addressed the issue of whether the penalty under Tax Law § 481(1)(b)(i) was civil or criminal in nature. The ALJ determined that the penalty was civil in nature for two reasons: First, the tribunal found that "the fact that authority to impose the subject penalty was conferred on an administrative agency is prima facie evidence that the Legislature intended to provide for a civil sanction." Second, the ALJ noted that the existence of a criminal sanction in Tax Law § 1814(e) for the same conduct "indicates that the Legislature intended a civil fine under Tax Law § 481(1)(b)(i)." Judge Alston concluded that since § 481(1)(b)(i) is "clearly a civil statute [] penalties imposed thereunder are not 'punishment' for purposes of the double jeopardy clause."

[On August 21, 2009, Abuzaid joined an action which had been commenced by three other similarly situated persons who had been arrested in the same sting operation. Before the District Court were Plaintiff taxpay-

ers' and the Defendant Department's cross-motions for summary judgment.]

The District Court Opinion

The District Court's opinion first addressed the issue of whether the federal court had jurisdiction over the action. The Tax Injunction Act ("TIA") precludes a district court from enjoining the collection of any tax under State law where an effective remedy exists in the courts of such State. The District Court concluded that TIA was inapplicable, since the Notices of Determination (NODs) themselves indicated that the assessments were penalties, and not taxes. The court then addressed the Fifth Amendment Claim.

The first issue involved a determination of whether the imposition of penalties under § 481(1)(b) following criminal conviction under § 1814(e) constituted multiple criminal punishments for the same offense, thereby violating the Double Jeopardy Clause. In resolving this inquiry, the court framed the issue before it as "whether the statutory scheme was so punitive either in purpose or effect, as to transform what was clearly intended as a civil remedy into a criminal penalty."

The court concluded that in enacting § 481(1)(b)(i), the "Legislature did not intend to create a criminal sanction." However, the court noted that "aspects of 481(1)(b)(i), however, indicate that that the Legislature did not clearly intend a purely civil penalty either," since § 481 provides that "the commissioner may impose a penalty."

The court also noted that the imposition of penalties under § 481(1)(b) is "dependent on the offender's mental state, with more severe penalties resulting from when the violator 'knowingly' possesses the unlawful cigarettes." Therefore, the statute was intended to "punish and deter criminal activity."

The court concluded that even if the Legislature had intended to adopt a civil sanction, since § 481(1)

(b)(i) "operates as a criminal penalty [] the imposition of penalties subsequent to a prior criminal prosecution for the same conduct [violates] Plaintiffs' rights under the Fifth Amendment."

Analysis

Taxpayers contesting Department tax assessments must first petition the Division of Tax Appeals for a hearing. The Tax Law imposes a presumption of correctness in favor of the Department at hearing. Exceptions from an ALJ Determination may be taken to the Tax Appeals Tribunal. In fiscal year 2008-09, the Department boasted a won-loss record of 31-2 in the Tribunal. (Cf. Koufax '65, 26-8; Seaver '69, 25-7).

Only after the Tribunal has ruled may the taxpayer seek review in the Appellate Division. Entry to the Appellate Division is guarded tenaciously by CPLR Article 78, which greets appellants with burdensome bonding requirements. Once the case has been docketed, the "arbitrary and capricious" standard of review of Tribunal decisions imposed by Article 78 is difficult to surmount.

Given the difficulty of prevailing in the administrative tribunal, taxpayers have sought judicial review elsewhere, either before or after exhausting administrative appeals. Although Tax Law §§ 690(b), 1090(b) and 1140 state that review by the Tax Tribunal is the "exclusive remedy available to any taxpayer for the judicial determination" of tax liability, New York courts routinely rule in declaratory judgment actions in matters involving the constitutionality or inapplicability of the Tax Law, or where the Department has exceeded its taxing jurisdiction.

As Abuzaid illustrates, federal courts may also assert jurisdiction in disputes involving constitutional issues. It would appear that where constitutional issues are involved, an Article 78 petition might also be made directly to the Appellate Division, bypassing the Division of Taxation.

IRS MATTERS, CONT.

(Continued from page 1)

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. 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.

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. The increase in basis provision references the basis of the asset, not its fair market value.

The \$1.3 million basis 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.

The \$3 million basis adjustment applies only to property passing to a surviving spouse either outright or in a QTIP trust. Property passing to surviving spouse is eligible for \$1.3 million basis adjustment as well as the \$3 million basis adjustment. Therefore, a total of \$4.3 million in basis adjustments may be allocated to property passing to a surviving spouse.

In order to qualify for the basis adjustment, the property must be "acquired from the decedent" and "owned" by the decedent at the time of death. Some property, while satisfying the former requirement, will not satisfy the latter requirement, and will therefore be ineligible for the basis adjustment.

For example, the interest of a surviving spouse in a QTIP trust will have been acquired by the surviving

spouse, but will not be considered as being owned by that spouse at death. Therefore, the estate of the surviving spouse will be unable to utilize the basis adjustment respect to QTIP property required to be included in that estate.

Similarly, property owned in joint tenancy with a spouse will not qualify for the full basis adjustment. IRC § 1022(d)(1). One-half of such property would be eligible for the basis adjustment. IRC § 1022(d)(1)(B)(i). With respect to property owned jointly with a nonspouse, a basis adjustment will be permitted to the extent consideration was furnished by the decedent. IRC § 1022(d)(1)(B)(ii).

Some property is ineligible for the basis adjustment. Thus, 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). 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).

II. 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). 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." Property "acquired from a decedent includes, *inter alia*:

- ¶ Property acquired by bequest, devise or inheritance;
- ¶ property acquired by the decedent's estate from the decedent;
- ¶ property transferred to a trust

over which the decedent reserved the right to alter, amend or terminate the trust; and

¶ any other property passing by reason of the death of the decedent without consideration (e.g., property held in joint tenancy). IRC § 1022(e).

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:

(i) Name and TIN of property recipient; (ii) an accurate property description; (iii) the adjusted basis and FMV at time of decedent's death; (iv) the decedent's holding period for the property; (v) information concerning character of potential gain; (vi) the amount of the basis increase allocated to the property; and (vii) any other information that the regulations may require. *The Executor must also furnish to each property recipient a statement giving similar information.* IRC § 6018(e).

Failure to report to the IRS non-cash 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).

* * *

(Please turn to page 6)

IRS MATTERS, CONT.*(Continued from page 5)***SECTION 2053 FINAL REGULATIONS****I. General Rule Requires Payment**

Final regulations issued by Treasury limit estate tax deductions for unpaid claims and expenses. With respect to decedents dying on or after October 20, 2009, an estate may, *in general*, deduct an expenditure only if the claim or debt is actually paid. However, up to \$500,000 in unpaid claims (not expenses) may be deducted under certain conditions.

The failure to carefully parse the regulations and claim an impermissible expense could result in the IRS imposing a negligence penalty or even a preparer penalty. If a deduction for a claim or expense is taken in an ambiguous situation, the estate should consider making a disclosure on Form 8275R to avoid the imposition of a penalty.

Under Reg. § 20.2053-1(b)(2), only a bona fide claim or expense may be deducted. No deductions may be taken for amounts paid for claims if the transfer is “essentially donative in character.” Amounts paid to family members, beneficiaries and related entities are rebuttably presumed to lack legitimacy.

II. Determination of Amount

Under the new regulations, the amount of claim or expense may be determined by (i) court decree; (ii) consent decree; or (iii) settlement.

With respect to amounts paid pursuant a court degree after review, such as those incurred for funeral and administration expenses, are deductible. However, a court order allowing an expense issued without reviewing the merits of the claim will not establish deductibility under IRC § 2053, and could presumably even result in the imposition of penalties if the order is unreasonable.

A settlement of a claim will result in a deductible expense provided the interests of the parties involved are

adverse. The regulations provide that unenforceable, contested, or contingent claims cannot be deducted.

In the event a portion of the payment made for a claim which was deducted is later refunded, the deduction will be reduced and additional estate tax imposed, provided the statute of limitations for assessment has not run. However, it is not clear that the executor has an obligation to contact the IRS with such information.

Several exceptions exist to the “actual payment” rule:

¶ Although in general a deduction may not be claimed to the extent a claim or expense is or could be reimbursed by insurance, such a claim may still be deductible if the executor provides a “reasonable explanation” of why the burden of collection outweighs the anticipated benefits of collection.

¶ A claim or expense may be deducted if the amount to be paid is ascertainable with “reasonable certainty and will be paid.”

¶ The aggregate value of otherwise deductible claims (not expenses) not exceeding \$500,000 may be deducted provided the amount of the claim is determined by a “qualified appraisal” as defined in IRC § 170.

¶ Contingent claims that are almost certain to be paid may be deducted. However, the deductible amount may be reduced to reflect a contingency affecting the ultimate amount of payment.

III. Protective Claims for Refund

If a claim or expense cannot be deducted at the time of filing the estate tax return by reason of its not having been paid, but may later become deductible following payment, a “protective” claim for refund may be filed before the expiration of the period for claiming a refund under IRC § 6511. The protective claim must describe the reason for a delay in the actual payment of the claim or expense. However, the protective

claim is not required to specify the amount. The protective claim may be made directly on the Form 706 estate tax return; a separate refund claim form is not required.

Notice 2009-84 provides that the IRS will not generally seek to offset a claim for refund with an offsetting claim relating to an underpayment of estate tax.

* * *

AVOIDING STEP-DOWN IN BASIS

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, a loss of basis could occur in many situations. Various strategies may be considered to reduce the likelihood of this issue:

¶ Losses may be recognized on sales to unrelated parties. IRC § 1001 (a). Losses on sales to related parties cannot be recognized, but basis is carried over to related party. IRC §267.

¶ 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. Since spousal gifts qualify for the marital deduction, no gift tax liability will arise. IRC §2523.

¶ Gifts of property with a realized loss to related parties who are non-spouses may have some benefit. If the property later increases in value, the basis for determining later gain is the original basis, increased by any gift tax paid. IRC §1015(d)(6). (The basis for determining later loss is the lower basis at the time of the gift under IRC § 1015(a).)

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

(Please turn to page 7)

ESTATE PLANNING IN 2010, CONT.

(Continued from page 6)

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.

There had been some concern among estate planners that read literally, IRC §2511(c) meant that a transfer to a wholly owned grantor trust, such as a GRAT or to an intentional grantor trust could not be complete for gift tax purposes until an event which caused the grantor trust to lose its grantor trust status, and become a non-grantor trust. If this were the case, then the benefits associated with GRATs and intentional grantor trusts would be effectively lost. Notice 2010-19 allayed the concerns of estate planners by providing that the gift tax consequences of transfers to wholly owned grantor trusts would be determined under the rules in effect prior to 2010. Therefore, gifts to GRATs and intentional grantor trusts will continue to be complete gifts.

GRATs

Treasury's 2010 budget proposal proposes that all GRATs have a term of not less than 10 years. This 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 of age would use a GRAT. The proposal would not effect the taxpayer's ability to utilize a "zeroed-out" GRAT, which result in little or no current taxable gift. Nor would the proposal prevent the taxpayer from funding the GRAT with highly appreciating assets.

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 lower, fewer GRAT assets are included in the estate, since fewer assets would be required to fund

the annuity. To reduce the effectiveness of front-loaded GRATs, Congress may limit the amount by which annuities can be reduced in later years.

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:

¶ 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.)

¶ The grantor can sell the poorly performing asset to a second grantor trust (with the same beneficiaries) for cash or a promissory note. For most of these techniques, the GRAT should possess the following attributes: (i) the GRAT should provide that the grantor may substitute assets of equal value; (ii) the GRAT should not contain a spendthrift clause, as this would impair the ability of the grantor to transfer his annuity interest; and (iii) the GRAT should not contain provisions that would impair the ability of the Trustee to sell assets to outside purchasers.

The grantor could also sell the asset for cash or a promissory note. GRAT assets may perform so well that the wealth transfer to beneficiaries exceeds that which the grantor desired. Here, the grantor can (i) purchase the over performing asset from the GRAT,

thereby limiting further wealth shift; (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. 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. The grantor may also expressly limit the amount a beneficiary can receive from the trust.

The GRAT assets may be illiquid or difficult to value. Although an in kind distribution may be made, 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. 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.

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 estate from exceeding the applicable exclusion amount, 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.

Since the assets in the GRAT will be included in the grantor's estate if the grantor dies during the trust term, the GRAT is subject to an "ETIP". A GST exemption is effective only at the end of an ETIP. Since the GST exemption is automatically allocated, the grantor should elect out of automatic allocation, by attaching a statement to the gift tax return. If the grantor fails to properly elect out of the automatic GST allocation, relief can be sought under Treas. Reg. § 301.9100-3.

GIFT PLANNING IN 2010, CONT.

(Continued from page 1)

transfers to annuity trusts can significantly leverage the \$1 million gift tax exclusion amount.

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.

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.

II. Valuation Discount Legislation?

Although the IRS has been successful in challenging gift and estate valuation discounts with arguments premised on IRC §2036, IRC §2704(b)(2) 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.

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 be retroactive to the date of enactment.

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 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.

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). *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.

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.

III. Gifts Under Power of Attorney

A power of attorney is invaluable should the principal later become incapacitated, since the appointment of a legal guardian requires court proceedings. Although gravely ill persons 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. Under revised law, a power of attorney must be signed, dated and acknowledged not only by the principal, but also by the agent. A power of attorney is now durable (*i.e.*, not affected by later incapacity) unless it specifically provides otherwise.

A new Statutory Major Gifts Rider (SMGR), if executed simultaneously with the power of attorney, authorizes an agent to make legally binding major gifts on behalf of the principal. The SMGR must be executed 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."

Under §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. The statute requires that the agent, a fiduciary, observe a "prudent person standard of care," and imposes liability for breaches of fiduciary duty.

MARITAL DEDUCTION PLANNING, CONT.

(Continued from page 1)

unintended New York state estate tax consequences, since the New York state estate tax exemption amount is only \$1 million. One approach which seeks to capitalize on the uncertainty in the estate tax in 2010 involves maximizing dispositions to QTIP trusts.

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.

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.

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. By doing so, future spousal distributions could be made entirely from the elected trust, which would reduce the size of the surviving spouse's estate.

II. Equalizing The Estates

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.

Depending on the combined size of spouses' estates, QTIP trusts can be used to avoid the imposition of federal estate tax in the estate of either spouse. 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.

III. Dispositions to QTIP Trusts

The rights accorded to a surviving spouse in a QTIP trust are insufficient by themselves to pull the QTIP trust assets back into the estate of the

surviving spouse under IRC § 2036. QTIP assets are includable only by reason of the executor of the first spouse to die making a QTIP election and deducting the value of the assets from the gross estate of the first spouse.

QTIP trust assets with respect to which no 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. If no estate tax exists at the death of the first spouse in 2010, and a QTIP trust is funded, no QTIP election will be necessary to eliminate estate tax in estate the first spouse. Since no QTIP election was made, no QTIP assets will be included in the estate of the surviving spouse, regardless of the status of the estate tax at the death of the surviving spouse.

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 there is an estate tax at his or her death. 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 to the inherited assets, when compared to an outright bequest. Another advantage to funding the QTIP trust is that the \$3 million spousal basis adjustment can be utilized, if needed. By the simple expedient of including a disclaimer provision in the will, the surviving spouse may decide whether to disclaim amounts not needed for the \$3 million spousal basis adjustment.

IV. Separate NY QTIP Election

A serious New York State estate tax problem encountered in connection with funding a QTIP was recently resolved by the 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

(Please turn to page 10)

MARITAL DEDUCTION PLANNING, CONT.

(Continued from page 9)

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. TSB-M-10(1)M, issued in February, 2010, clarified that a QTIP Election for New York purposes may be made even when no federal return is required.

As the TSB explains: For dates of death on or after February 1, 2000, New York estate tax conforms to the Internal Revenue Code of 1986, including amendments enacted on or before July 22, 1998. Because the Code in effect on July 22, 1998 permitted a QTIP election, that election may be made on a decedent's New York estate tax return even if a federal return is not required. If no federal return is required, the election is made on a *pro-forma* federal estate tax return attached to the New York return. The QTIP property for which the election is made must be included in the estate of the surviving spouse.

The QTIP election is made for New York estate tax purposes as the election would have been made for federal estate tax purposes, by entering 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 by completing the rest of the schedule. (If there is no federal estate tax for 2010, and an estate is required to file an estate tax return with New York, the Form 706 for 2009 should be used to prepare the pro forma federal estate tax return.)

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.

V. Spousal Disclaimers

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.

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.

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.

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. 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:

¶ the spouse might be named co-trustee of the trust;

¶ the spouse might be given a testamentary limited power of appointment over the credit shelter trust;

¶ the trustee might be directed to make greater distributions to the surviving spouse; or

¶ 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.

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 estate tax on the death of the first spouse. (As noted, 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 the funding a QTIP in favor of a credit shelter trust with greater spousal rights, is that 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

(Please turn to page 11)

MARITAL DEDUCTION PLANNING, CONT.*(Continued from page 10)*

trust would not qualify for any basis allocation.

VI. Residence Changes and QTIPs

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.

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.

VII. Defective QTIP Elections

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.

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.

VIII. Gifting of QTIP Distributions

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.

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)."

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.

Caution: If greater rights are given 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.

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? *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.

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 or disclaimer.

IX. Release of QTIP Interest

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, she would be *deemed* to have made a gift of the entire remainder interest in trust, in addition to the gift of the income interest. This means that a gift tax would be imposed on all trust property, even though the income in-

(Please turn to page 12)

MARITAL DEDUCTION PLANNING, CONT.

(Continued from page 11)

terest released by the surviving spouse pertained only to part of the trust property. Under IRC §2207A, she would have a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC §2519.

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, 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. 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.

To illustrate IRC §2519, 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. 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.

Net Gift Treatment of Deemed Gift

Under IRC §2207A, if the surviving spouse is deemed to have made a gift under IRC §2519, she has a right of reimbursement for gift taxes paid. Proposed regulations 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 donee receives 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.

To illustrate, assume the value of the income and remainder interest in a QTIP trust is \$500,000. Husband makes a gift of one-half of his income interest, or \$250,000. Under IRC §2519, he will be deemed to have made a gift of the entire \$500,000. An inter-related 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.

X. Disclaiming QTIP Interest

Although releasing a qualifying income interest may be effective if the surviving spouse cannot withdraw 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). However, if a spendthrift limitation bars the spouse from alienating the income interest, it may still be possible to disclaim the interest under 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".

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 would likely also trigger IRC §2519.

XI. Fractionalizing QTIP Assets

IRC §2044 requires remaining QTIP assets to 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.

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 already owned a separate interest in the same property.

This situation is distinguishable from one where the QTIP trust owns all of a certain piece of property, and then distributes some of that property to the surviving spouse. In that case it is less clear that the IRS would fail in attempting to aggregate the interests in the same property for the purpose of defeating a valuation discount.

ASSET SALES TO GRANTOR TRUSTS, CONT.

(Continued from page 18)

complete transfer for gift and estate tax purposes. In the past, some have referred to the resulting trust as “defective”. However, the tax consequences of the sale are firmly grounded in federal tax law, and the use of asset sales to grantor trusts can effectively leverage the applicable exclusion amount for gift and estate tax purposes especially in prevailing low-interest rate environment.

II. Overview of Asset Sale

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.

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.

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

The result of the sale to the

grantor 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

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:

¶ **IRC § 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;

¶ **IRC § 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 with-

out adequate interest or security;

¶ **IRC § 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

¶ **IRC § 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.

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.

IV. The Note Received For Assets

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

(Please turn to page 14)

ASSET SALES TO GRANTOR TRUSTS, CONT.

(Continued from page 19)

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.

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.

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.

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.

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.

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 to substitute the grantor's 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.

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).

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.

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.

What if 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?

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.

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.

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.

V. Avoiding Sections 2036 and 2702

IRC § 2702. The rules of Chapter 14
(Please turn to page 15)

ASSET SALES TO GRANTOR TRUSTS, CONT.

(Continued from page 10)

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.

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

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.

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.

Payment of 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.

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.

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.

VI. GST Tax Considerations

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.

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.

VII. Choice of 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

(Please turn to page 16)

ASSET SALES TO GRANTOR TRUSTS, CONT.

(Continued from page 11)

definite external standard.

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

The trust instrument should dispense with the typical requirement that the Trustee be required to diversify the investments of the trust.

VIII. Death of Grantor

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.

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 re-

maining balance of the note would be included in the estate and would acquire a basis equal to that value.¹³

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.

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.

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.

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.

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.

IX. Possible IRS Objections

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.

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.

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.

X. Sale of Discounted Assets to Grantor Trust

(Please turn to page 17)

ASSET SALES TO GRANTOR TRUSTS, CONT.

(Continued from page 12)

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.

Illustration.

Step 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.

Step 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;

Step 3. 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. A copy of the LLC operating agreement (containing restrictions which depress value of membership interests). 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.

Step 4. 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). The children are the only beneficiaries of the trust. The gift reduces parent's available lifetime gift tax exclusion from \$1 million to \$0.91 million. The following year, a federal gift tax return is filed reporting the gift of "seed" money to the trust.

Step 5. 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;

The discounted value of the note is determined by the following formula:

$$\begin{aligned} \text{Value of Note} &= \\ \text{Value of undiscounted interest sold)} & \\ \times (1 - \text{discount}) & \end{aligned}$$

Solving the equation:

$$\begin{aligned} \text{Value of Note} &= \$900,000 \times (1 - .3) \\ &= \$900,000 \times 0.7 \\ &= \$630,000 \end{aligned}$$

The required yearly interest payments under the Promissory Note are \$28,162. 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.

Step 6. 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 x 0.10). The grantor will report and pay tax on trust's distributive share of income reported by the LLC. 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. The grantor trust provides that the trustee has discretion to reimburse the grantor for income tax payments made. No income tax consequences attach to the reimbursement by the trust to the grantor of income tax. [

[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). By discounting the property purchased by the trust, the required interest payment to parent was reduced from \$40,230 to \$28,162.]

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.

Step 7. The LLC asset sale to the IDT will result in the following favorable tax and economic consequences: (i) \$900,000 is transferred out of the grantor's estate; (ii) the value of the note is included in the grantor's estate if the grantor dies during the term of the note; (iii) future appreciation of the asset sold is transferred out of the estate; (iv) unlike the situation obtaining with a GRAT, the favorable tax result does not depend on the grantor surviving the trust term; (v) 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; (vi) 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; (vii) 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; and (viii) while no basis step up occurs at the grantor's death; however, this problem can be

(Please turn to page 18)

ASSET SALES TO GRANTOR TRUSTS, CONT.

(Continued from page 13)

ameliorated by substituting assets with a higher basis during the grantor's life.

Endnotes:

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 pro-

vides 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.

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 pe-

riod (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.