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Estate Planning in Anticipation of the Death and Resurrection of the Estate Tax: The Design and Administration of GRATs and QPRTs

-by-

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POSSIBLE 2017 TAX LAW CHANGES

- Analysis of three primary sources:
  - Trump 2016 campaign website
  - One-page 2017 Tax Reform for Economic Growth & American Jobs
  - 2016 GOP "Blueprint for Tax Reform"
- Many of the tax law changes exist in each of the three sources

2016 TRUMP CAMPAIGN WEBSITE TRANSFER TAX PLAN

	2017 Tax Year	Trump Tax Plan
Estate Tax	$5,490,000 (later adjusted for inflation) with top tax rate of 40%	Eliminates estate tax
Portability of estate and gift tax exemption	Unused exemption of deceased spouse available (with limitations)	Eliminates estate and gift tax
Lifetime gift tax exemption	$5,490,000 (later adjusted for inflation) with top tax rate of 40%	Eliminates gift tax
Generation-skipping transfer tax	$5,490,000 (later adjusted for inflation) with top tax rate of 40%	Eliminates generation-skipping transfer tax
Gift tax annual exclusion	$14,000 per done (as indexed for inflation - $15,000 anticipated in 2018)	Eliminates gift tax
Basis of inherited assets	Step up to fair market value at death	Uncertain: gain either taxed at death or disposition, with possible exemption for first $10 million and full exemption for small businesses and family farms.
Private Foundations	Gift of appreciated publicly traded stock deductible at fair market value	"Disallows" contributions of appreciated assets "into a private charity" established by decedent or decedent's family

2016 TRUMP CAMPAIGN WEBSITE INCOME TAX PLAN

	2016 Tax Year	Trump Tax Plan
Ordinary Income Tax Rates	7 brackets with a top rate of 39.6%	3 brackets: 12%, 25% & 33% rate
Phase out of itemized deductions and personal exemptions	Applies to AGI over: $259,400 (single) $311,400 (married)	Limit on itemized deductions, $100,000 (single) $200,000 (married)
Alternative minimum tax	28% minimum rate, with exemption amount of $53,900 (single); $83,800 (married); or $23,900 (trusts)	Eliminates the Alternative Minimum Tax
Rates on capital gains/dividends	Top rate of 20%; 1 year holding period	Top rate of 20%; 1 year holding period
Surtax on net investment income	3.8%, if above either: $200,000 AGI (single); $250,000 (married); or Trusts with income over $12,400	Eliminates through the repeal of the Affordable Care Act (Obamacare)
Retirements accounts	Various rules and limitations	No specific proposal
Taxation of carried interests	Taxed as capital gains	Taxed as ordinary income

THE 2017 TAX REFORM FOR ECONOMIC GROWTH AND AMERICAN JOBS

One page summary with less than 200 words and 9 numbers

- Reading the “tea leaves” for anticipated changes
- However, please note the President occasionally “changes his mind”
- Primary elements of tax reform (repeated verbatim below):
    - “Repeal the death tax”
    - Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%
    - 15% business tax
    - Eliminate tax breaks for special interests
    - Protect the home ownership and charitable gift deductions

PROCESS IN MONTH OF MAY:
LISTENING SESSION WITH STAKEHOLDERS

- "The Biggest Individual and Business Tax Cut in American History"
- The one-page tax plan release states that "Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input . . . ."
- Regrettably, these sessions did not begin prior to the date for submission of these materials

2016 GOP BETTER WAY FOR TAX REFORM

- House Ways & Means Committee released a "blueprint" for tax reform
- The primary elements of the "blueprint" include:
    - Three tax brackets of 12%, 25% and 33%
    - Capital gains at 50% of marginal rate
    - 25% business tax rate
    - Repeal of estate and GST tax
    - Retains full "step up" of cost basis at death

2017 GOP TAX REFORM PLAN

	2017 Tax Year	2017 Tax Plan
Ordinary Income Tax Rates	7 brackets with a top rate of 39.6%	3 (perhaps 4?) brackets: 12%, 25% & 35% rate (4th rate?)
Standard Deduction	$6,000 (single) $12,000 (married)	Doubles standard deduction $12,000 (single) $24,000 (married)
Alternative minimum tax	28% minimum rate, with exemption amount of $53,900 (single); $83,800 (married); or $23,900 (trusts)	Eliminates the Alternative Minimum Tax
Rates on capital gains/dividends	Top rate of 20%; 1 year holding period	Top rate of 20%; 1 year holding period
Estate Tax	$5,490,000 (later adjusted for inflation) with top tax rate of 40%	Eliminates estate tax

Portability of estate tax exemption	Unused exemption of deceased spouse available (with limitations)	Eliminates estate tax
Lifetime gift tax exemption	$5,600,000 (2018 adjustment for inflation) with top tax rate of 40%	No change
Generation-skipping transfer tax	$5,490,000 (later adjusted for inflation) with top tax rate of 40%	Eliminates generation-skipping transfer tax

WHO IS IMPACTED BY ESTATE TAX REPEAL?

- 0.2% of Americans pay federal estate tax (approximately 5,000/year)
- Raises $20 billion per year
- Use of term “death tax” is effective, but misleading
- Effect on family businesses and farms is vastly overstated
- Economic stimulus effect is lower than with income tax cuts
- Taxes assets which have already been taxed several times
- Does not take into account “step up” in cost basis

RECONCILIATION BILL – 10 YEAR REPEAL

- Need to pass tax reform under reconciliation process
- Only 50 votes are needed in the Senate to pass a reconciliation tax bill
- Otherwise 60 votes are needed – extremely difficult
- Can only use reconciliation in limited circumstances
- Need to pass 2017 & 2018 budgets in 2017 to use reconciliation
- Reconciliation legislation is effective for 10 years only
- Tax reform would “sunset” (as in year end 2010 and 2012)

ESTATE & GST REPEAL – BUT THE GIFT TAX LIVES

- The estate tax would be repealed immediately.
- The GST tax would also be repealed immediately.
- There are no anticipated changes to the gift tax.

POSSIBLE MODIFIED COST BASIS “STEP UP” AT DEATH

- All assets receive a “step up” in cost basis at death
- The “step up” occurs regardless of whether estate tax is paid.
- Trump campaign plan had a modified “step up”
    - May allow a “step up” for assets up to a limited amount
    - Could possibly include a recapture tax at death
- GOP “Blueprint” does not address “step up” in cost basis

USE OF PORTABILITY & STEP UP IN COST BASIS

- Clients have the option of using either:
    - Portability; or
    - Credit shelter trust for spouse
- Portability has a few advantages:
    - Simple election on estate tax return
    - “Step up” in cost basis on death of both the first and surviving spouse
    - No need to file of credit shelter trust fiduciary income tax returns
- Credit shelter trust shelters all future appreciation from estate tax

ESTATE PLANNING IF NO GST TAX

- Should all assets left to children at death be held in lifetime trusts?
- Would avoid transfer tax for 360 years even if estate tax is reinstated
- May also provide asset protection for the child
- Can structure with child as sole trustee if HEMS standards used
- Trust can allow broader distributions if independent trustee is used
- Testamentary limited power of appointment provides flexibility

PROACTIVE ESTATE TAX REDUCTION PLANNING

- Should we continue implementing estate tax reduction plans?
- If the estate tax repeal sunsets in 2028, the failure to plan now can be very expensive

- The downside of planning for clients who ultimately pass away when the estate tax is repealed may be nothing more than the transactional costs
- Almost all clients we have spoken to expect that the estate tax will be resurrected some day

GRANTOR RETAINED ANNUITY TRUST (GRAT)

- GRATs can transfer appreciation of assets in excess of the Section 7520 rate gift tax free
- Even under an estate tax repeal regime, transferring assets gift tax free during life will be highly desirable to many clients
- Carryover basis of transferred assets may be less of an issue
    - May be a limited step up in cost basis at death under the new law
    - Can still use grantor trust status to "swap" assets for cost basis reasons
- May wish to use GRATs with more than a 10 year term
- May be able to "skip" generations through a GRAT if the GST tax is repealed at the time the GRAT is funded

QUALIFIED PERSONAL RESIDENCE TRUST (QPRT)

- As with GRATs, can structure QPRTs with a 10+ year term
- If the client dies within 10 years, the residence will be returned to estate (and would not be subject to estate taxation)
- If the client survives the 10+ year term, the residence will pass gift tax free to the client's beneficiaries (even if the estate tax is reinstated)
- May be able to "skip" generations through a QPRT if the GST tax is repealed at the time the QPRT is funded
- Loss of basis "step up" may not matter

FAMILY LIMITED PARTNERSHIP (FLP) PLANNING

- Can use FLP to obtain substantial valuation discounts for:
    - Minority interest; and
    - Lack of marketability
- May use in planning through:
    - Gift of limited partnership interest

- Sale of limited partnership interest to an intentionally defective grantor trust (IDGT)
- Funding of GRAT

BRIEF LIFE & SUDDEN DEATH OF SECTION 2704 REGULATIONS

- The proposed Section 2704 regulations were issued on August 2, 2016
- Donald Trump was elected president four days later
- Regulations were never made final
- On January 20, 2017, President Trump declared a moratorium on all new federal rulemaking
- On October 4, 2017, the proposed restrictions on the use of certain valuation discounts were withdrawn and will not take effect.

REVIEW OF ALL LIFE INSURANCE POLICIES

- All life insurance coverage purchased to provide liquidity for estate taxes should be reviewed with clients
- Insurance policies should be independently reviewed to determine the probability that the policy will implode before mortality

PLANNING FOR ELDERLY CLIENTS AND OTHERS WITH POSSIBLE REDUCED MORTALITY

- Revise current estate planning documents to eliminate credit shelter trust provisions and maximize GST planning
- Continue implementation and administration of estate tax reduction strategies
- Focus on obtaining "step up" in cost basis if limitations are not imposed under the new law

PLANNING FOR CLIENTS WHO SHOULD (OR EXPECT) TO LIVE BEYOND 10 YEARS

- Revise current estate planning documents to eliminate credit shelter trust provisions and maximize GST planning
- Continue implementation and administration of estate tax reduction strategies

LIST AND IDENTIFY ALL OF YOUR CURRENT FIRM ESTATE PLANNING CLIENTS

- Meeting with all of our clients following tax reform will take time
- Need to develop lists of estate planning clients
    - All firms should have a sub list of their best clients (80%/20% rule)
    - Need to identify elderly clients and those in poor health
- Determine which clients to meet with and when

REVIEW ALL CLIENT ESTATE PLANS PRIOR TO ESTATE TAX REPEAL

- Begin review of current documents to identify formula provisions:
    - Credit shelter trust provisions
    - GST exemption planning
    - Life insurance
- Develop basic prototype amendments for "stop gap" planning

CREDIT SHELTER FORMULA PROVISIONS

- May no longer be necessary, but do they cause any harm?
- Some credit shelter trusts direct funding of GST trusts on the death of the surviving spouse

GST FORMULA PROVISIONS

- In some cases, current formula provisions ("I leave an amount equal to the GST exemption amount") may result in zero funding of GST trust unless modified
- In other cases, the formula provisions may leave more to lifetime GST trusts than a client may originally have intended
- Lifetime GST trusts could avoid transfer tax in Florida for 360 years even if estate tax is reinstated
- May also provide asset protection for the child
- Can structure with child as sole trustee if HEMS standards used
- Trust can allow broader distributions if independent trustee is used
- Testamentary limited power of appointment provides flexibility

PROJECT AMOUNTS & TIMING OF DISTRIBUTIONS TO BENEFICIARIES AFTER ESTATE TAX REPEAL

- A simple step which clients appreciate
- Not all clients wish to leave large amounts to children/grandchildren
- Very helpful in describing terms of trust and ages of distribution
- Occasionally leads to philanthropic planning

MAXIMIZE USE OF GST EXEMPT TRUSTS

- Explain to clients both the benefits and downside of using GST exempt trusts
- Provide an outline and/or flowchart demonstrating how a lifetime GST trust would operate
    - HEMS distributions if sole trustee
    - Broad distributions if independent trustee
    - Possible use of sprinkling provisions for more remote descendants
    - Use of corporate trustee
    - Fiduciary income tax returns and annual accountings

QUALIFIED RETIREMENT PLANS AND ROTH IRAs

- What will the new maximum income tax rates be?
- Deductions now at lower tax rates to get deferral at higher rates?
- Depends on client’s age & the power of tax deferred compounding
- Will there be special Roth IRA conversion opportunities?
- Continuation of IRA charitable rollover?

EFFECT OF PRIOR ATTEMPTS AT TAX REFORM

- Economic Recovery Tax Act of 1981
- Tax Reform Act of 1986
- Economic Growth & Tax Reform Reconciliation Act of 2001
- Tax Reform, Unemployment & Job Creation Act of 2010
- American Tax Relief Act of 2012 (enacted January 2, 2013)
- 2017 Tax Reform for Economic Growth & American Jobs

2017 Tax Rates, Exemptions and Interest Rates

FEDERAL INCOME TAX RATES

Income Taxes	2012	2017
Income tax rates	Maximum rate of 35% (10%, 15%, 25%, 28%, 33% and 35% brackets)	Maximum rate of 39.6% (or 43.4% with health care surtax) (15%, 28%, 31%, 36% and 39.6% brackets)
Dividends	15% (0% for taxpayers under 25% bracket)	Ordinary income treatment (taxed at rates listed above)
Long-term capital gains	15% (0% for taxpayers under 25% bracket)	20% (or 23.8% with health care surtax)
Health care surtax	Not Applicable	3.8% on lesser of (i) net investment income; or (ii) excess of modified adjusted gross income over the “threshold amount” ($250,000 for married couple; $200,000 for individual taxpayers)

FEDERAL GIFT, ESTATE & GST EXEMPTION AMOUNTS/TAX RATES

Transfer Taxes	2000	2001	2009	2012	2017
Gift tax exemption	$1,000,000	$1,000,000	$1,000,000	$5,120,000	$5,490,000
Estate tax exemption	$1,000,000	$1,000,000	$3,500,000	$5,120,000	$5,490,000
GST tax exemption	$1,000,000	$1,000,000	$3,500,000	$5,120,000	$5,490,000
Gift, estate & GST tax rate	Up to 55%	Up to 50%	45%	40%	40%
Portability	No	No	No	No	Yes

APPLICABLE FEDERAL INTEREST RATES

October 2017 Loans	Term of Loan	Interest Rate
Short-term loan	Under 3 years	1.27%
Mid-term loan	3-9 years	1.83%
Long-term loan	Over 9 years	2.47%

October 2017 Section 7520 Rate: 2.20%

Design, Funding & Administration of Grantor Retained Annuity Trusts

The use of grantor retained annuity trusts ("GRAT") have become an integral part of estate plans for high net worth clients. A GRAT allows you to transfer all appreciation over the Section 7520 interest rate to children or other beneficiaries free of gift tax. The current Section 7520 rate is only 2.2%; this rate has fluctuated between 1% and 3% over the last seven years.

This paper begins by discussing how to design a GRAT. A GRAT can be structured with a term of as little as two years. GRATs can be established on a zeroed-out basis, with less than $1 of gift tax exemption used to shift all growth of the GRAT assets in excess of the Section 7520 rate to the GRAT beneficiaries at the end of the GRAT term. It has been described as a "*Heads I win, tails I break even*" estate planning technique. Prominent families (such as the Walton family and Sheldon Adelson) have shifted hundreds of millions of dollars of stock gift tax free through the strategic use of GRATs.

The grantor of a GRAT must survive the GRAT term for the GRAT to be effective. The grantor receives a fixed GRAT annuity payment on an annual basis. Many of our clients have embarked on a "rolling GRAT" plan, using the minimum two year term permitted and "rolling over" the first year GRAT annuity payment to a new two year GRAT. There are two GRATs to be administered in the second year of a rolling two year GRAT plan. This concept allows clients to capture significant gains in GRAT assets realized over a short term and hedge against volatility in the markets.

This outline will also discuss the steps to be taken in the implementation of a GRAT. A GRAT is a statutory creature, specifically permitted under the Internal Revenue Code. The required and desired provisions of a GRAT, funding, use of a trust tax identification number and other steps will be reviewed. A GRAT can be established with escalating payments, which can be useful for GRATs funded with illiquid assets with an anticipated liquidity event down the road.

The administration of the GRAT is extremely important. Annuity payments must be made on a timely basis. Tax compliance in the form of gift tax return reporting and annual grantor trust tax returns should be filed on a timely basis with adequate disclosure.

The performance of the GRAT assets should be monitored closely: a GRAT can be "immunized" to lock in a substantial gain or start over if the GRAT assets are "under water."

In closing, this outline also addresses what to do when we discover instances of improper GRAT administration. GRATs are sometimes funded on different dates, in a month following the execution of the GRAT, and sometimes not at all! Funding at a later time or other drafting errors occasionally results in the use of the wrong 7520 rate. Other times, the trustee may fail to make timely GRAT payments or pays improper expenses from a GRAT.

I. Grantor Retained Annuity Trusts

A. GRAT Definition. A GRAT is an irrevocable trust under which:

(a) **Retained Annuity Interest**. The grantor retains the right to receive fixed annuity payments:

1. Payable at least annually.

2. For a term of two or more years.

(b) **Remainder Interest**. At the end of the GRAT term, the remaining principal is distributed outright, or in trust for, the remainder beneficiaries (usually the grantor's children).

1. If the grantor survives the GRAT term, the remaining GRAT assets are excluded from the grantor's estate for federal gift and estate tax purposes.

2. If the grantor fails to survive the GRAT term, the GRAT assets are included in the grantor's gross estate under IRC Section 2036 (retained income, possession and/or enjoyment of trust/GRAT assets) or 2039 (retained right to receive annuity in transferred trust/GRAT property).

B. Gift and Estate Tax Consequences

(a) **Taxable Gift**. The amount of the taxable gift is the difference between:

1. The fair market value of the property transferred by the grantor to the GRAT, less:

2. The value of the interest retained by the grantor.

(b) **Application of IRC Section 2702**.

1. The value of an interest in trust transferred to an "applicable family member" is determined under IRC Section 2702.

   (i) The subtraction method is used to determine the value of the transferred interest.

   (ii) Applicable family members include children and grandchildren, but do not include nieces, nephews and unrelated individuals.

2. The actuarial value of the grantor's retained annuity interest is measured based on the rate of return set forth in IRC Section 7520 (the "7520 rate") for the month of GRAT funding.

3. If the GRAT assets generate a return in excess of the 7520 rate, the excess growth passes to the GRAT beneficiaries at the end of the GRAT term free of gift tax.

4. The interest retained by the grantor that is a "qualified interest" is valued under the tables in IRC Section 7520, and any interest retained by the grantor that is not a qualified interest is valued at zero.

    (i) A right to receive fixed amounts payable not less frequently than annually is a qualified interest. IRC Section 2702(b)

    (ii) Thus, the annuity retained by the grantor in a GRAT is a qualified interest and will be valued using the factors contained in the Section 7520 rate tables.

    (iii) Those tables determine the present value of the annuity using the Section 7520 rate as the discount rate.

        a. The Section 7520 rate is equal to 120 percent of the mid-term AFR, compounded annually, rounded up to the nearest 2/10ths of one percent.

        b. The October 2017 mid-term AFR is 1.83%.

        c. The October 2017 7520 rate is 2.2% (120% of 1.83%, rounded up to 2.20%).

    (iv) In contrast, if the grantor instead retained the right to all the income earned by the trust, the income interest would not be a qualified interest and it would be valued at zero for purposes of determining the gift made.

        a. As the grantor's interest is valued at zero, there is nothing to subtract from the value of the property transferred to the trust in determining the taxable gift to the remaindermen.

b. In other words, the gift to the remaindermen would equal the full value of the property transferred to the trust.

5. If the annuity is paid other than annually (such as semiannually, quarterly, monthly, or weekly), then the annuity factor must be adjusted to compute the annuity interest.

6. *Planning Note*: Avoid using a GRAT payout period of less than annually.

(i) The Service can argue that the GRAT "profits" are included in the grantor estate if the GRAT annuity payments are not made on a timely basis.

(ii) The Service was successful in *Atkisson vs. Commissioner*, a case involving the late payment of an annuity to the grantor of a charitable remainder annuity trust

(c) **Remainder and Reversionary Interests.** The grantor may retain a reversionary interest in a GRAT.

1. The GRAT provides that if the grantor fails to survive the GRAT term, the GRAT will terminate and the grantor's estate will receive the GRAT property, causing the property to pass under his or her will or revocable trust.

2. As stated above, if the grantor fails to survive the GRAT term, the entire trust property may be included in his or her gross estate.

3. By retaining a reversionary interest and causing the GRAT property to pass under the grantor's will or revocable trust, it may be possible to defer or eliminate estate tax through the use of the marital and charitable deductions.

(i) If the grantor retains a reversionary interest in a GRAT, the interests in the GRAT will consist of three components:

a. The annuity interest for the shorter of a term of years or the grantor's life;

b. The remainder (paid to the remaindermen if the grantor survives the term); and

c. The reversion (paid to the grantor's estate if the grantor fails to survive the term).

(ii) Only the annuity interest is subtracted from the value of the property transferred to the GRAT in determining the taxable gift.

(iii) The value of the reversion retained by the grantor does not reduce the value of the gift because a reversion is not a qualified interest under IRC Section 2702.

a. The reversion is valued at zero for purposes of determining the value of the interest retained by the grantor.

b. The taxable gift includes the value of the remainder and the value of the reversion.

c. In other words,, the value of the annuity is reduced due to the possibility that the grantor will not survive for the entire term, in which case he or she may not receive the full amount of all of the annuity payments, thus decreasing the, present value of the annuity interest. The decrease in the annuity value is equal to the reversion value.

4. If the grantor retains the right to an annuity for a fixed term regardless of whether he or she is living (i.e., no reversion is created), the interests in the GRAT will consist of two components:

(i) The annuity interest for a fixed term of years payable to the grantor or, if the grantor does not survive the term, to the grantor's estate; and

(ii) The remainder interest (paid at the end of the term).

5. Under *Walton v. Commissioner*, 115 T.C. No. 41 (2000), the value of the annuity interest is based on the stated term of the GRAT and is not decreased by the possibility that the grantor will not survive for the entire term. The annuity interest is subtracted from the value of the property transferred to the GRAT in determining the taxable gift. The taxable gift includes only the value of the remainder because there is no reversion. This form of GRAT is referred to as a "Walton GRAT."

(d) **Estate Inclusion.** IRC Sections 2036 and 2033 apply to a GRAT where the grantor does not survive the GRAT term.

1. IRC Section 2033 would include the present value of the remaining annuity payments (or all the trust property if the grantor retains a reversion).

2. However, IRC Section 2036 would not merely include the present value of the remaining annuity payments but would include the amount of property necessary to produce a sufficient amount of income (using the prevailing Section 7520 rate) to fund the remaining annuity payments from such income. See Revenue Ruling 82-105.

(e) Making the Annuity Payment.

1. Asset Type.

(i) Promissory Note from a GRAT. The use of a note to pay a GRAT's annuity obligation, either "directly or indirectly," is prohibited under Reg. §25.2703-(b)(1)(i).

(ii) Borrowed Money and the Step Transaction Doctrine.

a. From Others. The borrowing money from others by a GRAT is acknowledged in the preamble to the regulations, but the regulations do not expressly address this practice. Because there is no express prohibition of using borrowed funds from others to make the annuity payment, practitioners believe such funds may be used to make the annuity payment.

i. *The Step Transaction Doctrine*. Although not prohibited, caution should be exercised to avoid the step transaction doctrine when paying the annuity amount with money borrowed from others. An example of a step transaction is where the GRAT borrows from a bank and the bank requires payment from the grantor in the amount of the loan. A step transaction is disallowed because it violates the prohibition stated in Section 2702 from using funds owned by the grantor "directly or indirectly" to pay the GRAT annuity.

ii. *Income to the Grantor.* If money borrowed from others remains outstanding when a GRAT no longer qualifies as a grantor trust,, the Service will treat this amount as income to the grantor.

b. From the Grantor. Money borrowed from the grantor may not be used to make the annuity payment. However, funds borrowed from the grantor to the GRAT for other purposes is acceptable, as long as the funds are in fact used for that purpose and not to fund the annuity payment.

(iii) In Kind Distributions.

a. The preamble to the regulations states that the funding the annuity payment with in kind trust assets is permissible under the regulations.

b. Some confusion was generated in TAM 9604005 which states that "it is clear that [the grantor], acting as trustee, would not distribute…the stock to himself and [his wife] in satisfaction of the annuity, since such a distribution would clearly defeat the purpose of creating the GRATs." This TAM has not changed the widely held view that the practice of paying the annuity in kind is within the purview of the regulations and is permissible.

2. Timing of Annuity Payment.

(i) *Due Date.* Reg. § 25.2702-3(b)(4) provides that an annuity payment that is based on the anniversary date of the funding of the trust must be paid no later than 105 days after the anniversary date.

a. GRAT instruments can be drafted to protect against late payment.

i. For instance, a GRAT can include language that if the payment is not made within a certain time within the due date, the GRAT will terminate to that extent, and the trustee holds the annuity amount as an agent for the grantor, but not as the trustee.

ii. Special agency language can be included in the GRAT agreement to protect again this potential problem.

b. A second option is to pay the annuity amount plus interest.

i. The interest may be calculated from the last date of the required annuity payment (generally 105 days after the funding date of the GRAT).

ii. There is no authority expressly approving this approach.

(ii) *Frequency and Deferred Payments.* An annuity amount may be paid annually or more frequently, such as semi-annually, quarterly, or monthly. Reg. § 25.2702-3(b)(3)

a. Annuity payments are almost always made annually because amounts payable more frequently complicate the valuation of the gift and the administration of the trust.

b. Deferred payments of an annuity may be desirable where the GRAT owns marketable assets such as stock of a publicly-traded corporation, because changes in the market value are known daily. Where the GRAT holds marketable securities, the trustee may study market trends and time the annuity payment accordingly.

c. The benefit of deferred payments can be especially useful when payments are made on a monthly basis (or other frequency less than a year) because of the application of the 105-day grace period of Reg. § 25.2702-3(b)(4).

i. Reg. § 25.2702-3(b)(4) provides that when an annuity payment is based on the anniversary date of the GRAT, then the annuity payment must be made no later than 105 days from the anniversary date. Therefore, if a GRAT is created on June 1, 2016 and requires monthly payments, the first of which becomes due on July 1, 2016, the regulations do not require the payment to be made until September 15, 2017 (105 days from the anniversary date). This is true for each monthly annuity payment due in the year and gives the trustee a lot of flexibility on the timing of the payments.

d. When drafting a GRAT that will make annuity payments more frequently then annually, it is recommended that the GRAT be funded with an asset whose fair market value can be determined easily. Such a GRAT will be appropriate and welcomed by a grantor that is concerned about the prohibition stated in Reg. §25.2702-3(d)(4) against prepayment of an annuity amount.

(iii) *Deferred Payment and Valuation of Gift.*

a. The 105-day grace period stated in Reg. § 25.2702-3(b)(4) is not required to be drafted in the GRAT. However, if the GRAT explicitly allows a 105-day delay in payment, questions arise as to which date the valuation of the remainder for gift tax purposes should be based on. For instance, may the valuation be based on the later permissible payment dates? This answer is likely uncertain. The practitioner should weigh this uncertainty against the benefit of using the grace period to take advantage of market volatility, especially where a GRAT allows for monthly annuity payments, which effectively allows prepayment.

3. Final Annuity Payment.

(i) The final annuity payment, due at the end of the GRAT term, must be carefully considered. If the grantor dies before the final GRAT payment is made, an issue of whether the annuity amount is includable in the grantor-decedent's estate may arise and gain may be realized if appreciated property is distributed in kind because the trust ceased to be a grantor trust.

(f) **Use of Short Term GRATs/Examples**. There are a number of factors to consider in determining whether to use a short or longer term GRAT:

1. Reduced mortality risk.

2. Reduced investment risk.

3. Interest rate risk.

(i) The October 2017 AFR was 2.2%.

(ii) The AFR has been as low as 1.2% as recently as May 2015.

(iii) The chart set forth below shows the fluctuation of the AFR for the month of May since 2006:

Month	§ 7520 Rate	Month	§ 7520 Rate
May 2017	1.8%	May 2011	3.0%
May 2016	1.8%	May 2010	3.4%
May 2015	1.2%	May 2009	2.4%
May 2014	2.4%	May 2008	3.2%
May 2013	1.2%	May 2007	5.6%
May 2012	1.6%	May 2006	5.8%

(iv) Any increase in the AFR raises the "hurdle" rate of return a GRAT may achieve to be successful.

(v) The risk of increased interest rates may be offset by the capture of investment volatility achieved through short term GRATs.

4. Asset Liquidity. It is difficult to administer a short-term GRAT initially funded with illiquid assets.

(g) **Example 1 – Tesla 2 Year GRAT**. Elon Musk transfers 100,000 shares of Tesla Motors to a 2 year GRAT on 3/1/12. Tesla traded at $34 per share. The fair market value of the transfer to the 2012 GRAT was $3,400,000. The March 2012 AFR was 1.4%. The GRAT was structured to pay 51.05166% of the initial GRAT value to Elon on an annual basis for two years. The annual annuity payment is $1,735,756.

1. Tesla did not appreciate in value from over the first GRAT year ending 3/1/13. The GRAT distributed 51,052 shares of Tesla to Elon in satisfaction of the required first year annuity payment.

2. There were 48,948 shares of Tesla remaining in the 2012 GRAT.

3. Tesla increased in value from $34 per share to $250 over the second GRAT year.

   (i) Elon received a second annuity distribution of 6,943 shares of Tesla (the required $1,735,756 GRAT payment).

   (ii) The remaining 42,005 shares of Tesla (valued at $10,501,250) pass to the Musk children free of gift tax.

   (iii) The amount of gift tax exemption used to transfer $10,501,200 without gift tax was only $0.54 (yes, 54 cents).

(h) **Example 2 – S&P 500 Index 2 Year GRAT**. Joe Index transfers 1,000 shares of an S&P 500 Index Fund to a 2 year GRAT on 3/1/12. The S&P 500 traded at $1,370 per share. The fair market value of the transfer to the 2012 GRAT was $1,370,000. The March 2012 AFR was 1.4%. The GRAT was structured to pay 51.05166% of the initial GRAT value to Joe on an annual basis for two years. The annual annuity payment is $699,408.

1. The S&P 500 Fund appreciated in value by 10.82% from $1,370,000 to $1,518,200 over the first GRAT year ending 3/1/13. The GRAT distributed 461 shares of the S&P 500 Index Fund to Joe in satisfaction of the required first year

$699,408 annuity payment.

2. There were 539 shares of the S&P 500 Index remaining in the 2012 GRAT.

3. The S&P 500 Index increased in value from $1,518.20 to $1,859.45 over the second GRAT year.

   (i) Joe received a second annuity distribution of 376 shares of the S&P 500 Index Fund (the required $699,408 GRAT payment).

   (ii) The remaining 85 shares of the S&P 500 Index Fund (valued at $158,053) pass to the Taxpayer children free of gift tax.

4. The amount of gift tax exemption used to transfer $158,053 without gift tax was only $0.54.

C. Rolling Two Year GRATS.

(a) **Minimum GRAT Term**. GRATs are permitted to have a term as short as two years.

(b) **Annual GRATS**. Many of our clients have established a rolling two year GRAT program, "rolling over" the first year annuity payment to a new two year GRAT.

1. These clients may have one GRAT in year one and two separate two year GRATs beginning in year two.

2. This approach captures volatility of a stock or fund holding.

(c) **Example 3 – Rolling 2 Year Tesla GRATs**. A rolling two year GRAT allowed Elon Musk to transfer the full appreciation of the Tesla stock transferred to his 2012 GRAT.

1. Tesla did not increase in value in year one.

2. Elon received 51,052 shares of Tesla worth $1,735,756 as his initial year GRAT annuity payment.

3. If Elon contributed the 51,052 shares to a 2013 GRAT under a rolling two year GRAT plan, the $1,735,756 would have appreciated to $12,763,000 from 3/1/13 to 3/1/14.

(i) The required 3/1/14 first year annuity payment from the new 2013 GRAT would have been $1,735,756.

(ii) Likewise, the second year payment due 3/1/15 would also be $1,735,756.

(iii) The $9,141,488 (adjusted by investment gain/loss in the second GRAT year) passes gift tax free to the Musk children.

D. Escalating GRAT Annuity Payments.

(a) **Level or Escalating Payments**. GRAT payments can be made:

1. Equally over the term of the GRAT; or

2. Increasing at a rate of 120% per year.

(b) **Escalating GRAT Percentages Under 2012 Tesla GRAT Example**. Using the March 2012 Tesla GRAT example, the annual GRAT payments can range from:

1. 51.05166% annually for two years; or

2. 46.44034% in year 1 and 55.72840% in year 2.

(c) **Example 4 – Tesla Escalating 2 Year GRAT**. Elon Musk transfers 100,000 shares of Tesla Motors worth $3,400,000 to an escalating 2 year GRAT on 3/1/12.

1. The GRAT was structured to pay to Elon:

(i) 46.44034% of the initial GRAT value in year one; and

(ii) 55.72840% of the initial GRAT value in year two.

2. The annual annuity payment in year one is $1,579,000.

3. Tesla did not appreciate in value from over the first GRAT year ending 3/1/13. The GRAT distributed 46,441 shares of Tesla to Elon in satisfaction of the required first year annuity payment.

4. There were 53,559 shares of Tesla remaining in the 2012 GRAT.

5. Tesla increased in value from $34 per share to $250 over the second GRAT year.

   (i) Elon received a second annuity distribution of 7,579 shares of Tesla (the required $1,894,766 GRAT payment).

   (ii) The remaining 45,980 shares of Tesla (valued at $11,495,000) pass to the Musk children free of gift tax.

6. The Escalating 2 Year GRAT transferred an additional $993,750 to the Musk children free of gift tax as compared to a 2 year GRAT with level payments.

7. The amount of gift tax exemption used to transfer $11,495,000 without gift tax remains at $0.54.

E. GRAT Prohibitions

(a) **Restrictions in GRAT Agreement**. The GRAT agreement must prohibit the following actions:

1. Additional contributions to the GRAT. Treasury Regulation Section 25.2702-3(b)(5).

2. Prepayment of the annuity interest to the grantor (“commutation”). Treasury Regulation Section 25.2702-3(b)(4).

3. Use of a promissory note or similar financial arrangement to satisfy the annuity payment obligation. Treasury Regulation Section 25.2702-3(b)(5)(1).

4. Payments to any person other than the grantor/annuitant before the expiration of the GRAT term. Treasury Regulation Section 25.2702-3(b)(5).

(b) A GRAT is permitted to return an amount greater than the required annuity payment to the grantor if stated in the GRAT agreement. Treasury Regulation Section 25.2702-3(b)(1)(iii).

1. This would run counter to the goal of the GRAT.

2. The GRAT agreement should have a provision adjusting the annuity payment if an error was made by the trustee. Treasury Regulation Section 25.2702-3(b)(2).

F. GRAT Income Tax Rules

(a) **Grantor Trust**. A GRAT is a grantor trust for income tax purposes.

1. May hold Subchapter S stock.

2. No gain or loss is recognized on transactions between the grantor and the GRAT.

(b) **Tax Reporting/Effect**. All items of the GRAT income, deduction, losses and credits are reported by the grantor on his or her individual income tax return.

(c) **Qualification as a Grantor Trust**. A GRAT is a grantor trust if either:

1. The annuity interest retained by the grantor is at least 5% of the value of the GRAT assets (which is almost always the case). IRC Section 673; or

2. The grantor retained one of the other enumerated powers specified in IRC Sections 671-679.

3. GRAT agreements often state that the grantor has the right to swap assets of equivalent value, qualifying the GRAT as a grantor trust under IRC Section 675(4).

(d) **Grantor Trust Status of GRAT**.

1. The grantor of a GRAT cannot elect out of grantor trust status.

2. Compare: Grantor trust status may be waived/terminated in a sale to an IDGT transaction.

(e) **Carryover Basis**. Although GRATs can be very effective in transferring assets gift tax free to a younger generation, the cost basis of the assets will not be "stepped up" at the grantor's death.

1. The grantor may elect to sell the assets in the GRAT prior to the termination of the GRAT term and pay the income tax on the sale individually.

2. Results in a "tax free" gift of the income tax liability from the grantor to the GRAT beneficiaries.

3. More important as a result of the increase of capital gain rates from 15% to 20% or 23.8%.

(f) **Example 5 – Payment of Capital Gain Tax in Tesla 2 Year GRAT**. Elon Musk transferred $3,400,000 worth of Tesla Motors to a 2 year GRAT on 3/1/12. The GRAT resulted in 42,005 shares of Tesla stock worth $10,501,250 passing to the Musk children free of gift tax. Elon has a nominal $12 cost basis in the Tesla stock. If Elon elects to sell the stock just prior to the expiration of the GRAT term, he would realize $10,000,000 of capital gains and pay $2,000,000 of tax.

1. The 20% capital gain tax should be applied to this sale.

2. The special 3.8% additional Affordable Care Act surtax is not imposed on an active participant in a business.)

(g) The amount of gift tax exemption used to transfer $10,501,200 without gift tax was only $0.54 (yes, 54 cents).

G. GRAT Income Tax Reporting

(a) **Tax Reporting Requirement**. Grantor trusts are subject to the same tax reporting requirements as other trusts.

(b) **Alternate Methods of Reporting**. There are two general methods of trust reporting:

1. Traditional Method:

(i) The trust obtains a taxpayer identification number.

(ii) All items of income, deduction and credit of the trust are reported on a separate form attached to Form 1041 naming the grantor as the owner of these items.

2. Payor Notice Method:

(i) The trust can use the grantor's social security number and need not obtain a trust taxpayer identification number.

(ii) The trustee must send to the payor a statement showing the name and social security number of the grantor.

(iii) The trustee must give the owner a statement showing:

a. All items of income, deduction and credit of the trust for the tax year.

b. The payor of each item.

c. Noticed that the income must be included in the grantor's taxable income for the year.

(iv) The trustee must obtain Form W-9 from the grantor.

H. GRAT Gift Tax Reporting

(a) **Adequate Disclosure**. Satisfy the adequate disclosure rules in reporting of hard-to-value assets to GRATs.

(b) **Automatic GST Exemption Allocation for Transfers to GRATs**.

1. The automatic GST exemption allocation rules apply to transfer to GRATs.

(i) Nominal result if funding zeroed-out GRATs.

(ii) GST exemption cannot be allocated until the close of the ETIP period.

2. Elect out of the automatic GST exemption allocation on the gift tax return.

I. Improper GRAT Administration.

(a) **Funding of GRAT on Different Dates**.

1. A GRAT can be funded only on one date.

2. GRATs cannot receive additional contribution after initial funding. Treasury Regulation Section 25.2702-3(b)(5).

3. There are times when a GRAT is inadvertently funded on different dates.

4. Possible solutions:

(i) Treat the funding as if multiple GRATs were created on the same date - divide the GRAT into two or more separate GRATs.

(ii) Characterize and document the second transfer as a loan by the grantor to the GRAT.

(iii) Refund the improper contributions immediately to the grantor.

(b) **GRAT is Funded in Month Following Date of Formation of GRAT**.

1. A GRAT agreement should specify that the annuity payments begin on the anniversary of the funding date, not the date of formation.

2. The GRAT could be funded in a month following the GRAT formation date.

3. The percentage GRAT annuity payments stated in a "zeroed-out GRAT" agreement sometimes use the 7520 rate in effect in the date of formation.

(i) A higher 7520 rate in the month of funding results in a larger gift:

a. The gift reported on the funding of a $10,000,000 two year "zeroed-out GRAT" with a 2.0% 7520 rate is $0.83.

b. The gift reported on the funding of a $10,000,000 two year GRAT with a 2.6% 7520 rate is $87,557.

(ii) A lower 7520 rate in the month of funding results in the payment of an annuity greater than necessary:

a. The required annuity payment of a $10,000,000 two year "zeroed-out GRAT" with a 2.0% 7520 rate is $5,150,391.

b. The required annuity payment of a $10,000,000 two year "zeroed-out GRAT" with a 1.40% 7520 rate is $5,105,166.

4. There is no way to correct the late funding – the grantor must bear the consequences of the resulting taxable gift.

(c) **Change in IRC Section 7520 Rate**.

1. Funding may occur in a later month than first intended.

2. Use a savings clause provision to adjust the annuity payout rate accordingly.

(d) **Trustee Fails to Make Timely GRAT Payments**.

1. Annuity payments are due within 105 days of the GRAT anniversary date.

2. Use the funding date as the anniversary date, not the date the GRAT is executed.

(e) **Payment of a GRAT Expenses**.

1. Reg. § 25.2702-3(b) prohibits additional contributions from being paid to a GRAT, which raises the question of how expenses of a GRAT can be paid.

2. Generally, GRATs are low maintenance, unsupervised trusts with short terms. Further, individuals, often the grantor, serve as the trustee of such trusts. These reasons contribute to why GRAT expenses tend to be low.

3. Typical GRAT expenses include the following:

   (i) Legal fees to monitor the grantor trust status and to ensure proper gift and estate tax treatment of the gift and trust; and

   (ii) Accounting and appraisal services to determine the calculation and payment of the annuity.

4. Such expenses incurred for the maintenance and proper administration of the GRAT generally benefit the grantor, and are therefore properly payable by the grantor.

5. When the assets of the GRAT are purchased by a third party, the acquisition of the assets can be costly. In this situation, the expenses should be incurred by all the parties involved, including the GRAT.

(i) Practitioners should exercise care when a grantor pays a share of the GRAT's expenses.

(ii) Such payment by the grantor should be treated as a loan that can be traced to a payment *other than* the annuity amount to avoid violation of Reg. § 27.2703-(b)(1)(i).

(f) Failure to Fund the GRAT.

1. Believe it or not, there are times when a GRAT is not formally funded.

(i) Some clients simply list assets on Schedule A of the GRAT agreement and assume that the legal transfer of assets has taken place.

(ii) Other times the GRAT is not funded due to a legal formality (for example, the failure to obtain the proper consent of the transfer of a limited liability company or limited partnership interest).

(g) **Grantor Fails to Report the GRAT Funding on a Gift Tax Return**.

1. GRAT transfers must be reported on a gift tax return file April 15 of the following year (unless extended). Treasury Regulation Section 301.6501-1(f).

2. Filing of the gift tax return starts the statute of limitations.

(i) Generally three years.

(ii) Six years if substantial undervaluation of assets.

(iii) Gift tax return may be filed late.

3. Adequate disclosure rules are applicable. Treasury Regulation Section 301.6501-1(e).

J. Planning Issues with Illiquid GRATs.

(a) **Selection of Term**. Choose a term beyond the expected liquidity event date.

(b) **GRAT Back-loading**. Backload the GRAT by using the 20% annual escalating annuity payment structure.

(c) **Partial Liquid GRAT Funding**. Fund the escalating GRAT with some liquid assets to facilitate the required GRAT payments in early years.

K. Immunization of GRAT Assets.

(a) **Grantor Option to Immunize**. The grantor has the option to "immunize" the GRAT at any time during the GRAT term.

1. Immunization serves to freeze the gain in the GRAT prior to the expiration of the GRAT term.

2. Immunization can also be used to withdraw assets which have declined appreciably.

(i) In both cases, the immunized assets can be used to "re-GRAT" beginning a new GRAT term.

(ii) No clear authority that "re-GRATing" is permitted by the Internal Revenue Service.

(iii) Likewise, there is no authority which prohibits "re-GRATing."

3. Property owned by an underperforming GRAT may be sold to the grantor or the grantor's spouse without any income tax consequences if the GRAT is a wholly-owned grantor trust. Revenue Ruling 85-13.

4. The use of a promissory note in the sale from the GRAT to the grantor is permissible. This practice involves a note from the grantor to the GRAT, which is distinguished from the prohibition of the GRAT issuing a note to the grantor in order to make the annuity payments.

5. The property repurchased by the grantor may be placed in a new GRAT with a lower annuity payment and the original GRAT will pay out its cash or notes and terminate.

(b) GRAT Immunization can be accomplished by:

1. Substitution of other assets having equivalent value.

2. Use of a promissory note.

(i) Very low applicable federal rates allow immunization at an extremely low cost.

(ii) Use a short-term note (less than 3 years) and short-term interest rate when immunizing a 2 year GRAT.

L. Planning to Obtain Step Up in Cost Basis.

(a) **No Step Up in Basis**. The GRAT "profit" passing to the beneficiaries at the end of the GRAT term do not receive a "step up" in cost basis for capital gain purposes.

(b) **23.8% Rate**. Planning to avoid "carryover basis" is of greater importance at a 23.8% capital gain rate.

(c) **Planning Options**. There are two options for the grantor to consider:

1. Sell the assets before the GRAT terms ends.

(i) The grantor will pay the capital gain tax on the sale.

(ii) The capital gain rate may be the same or higher than that of the GRAT beneficiary.

(iii) The 3.8% surcharge is only applicable to certain high income taxpayers.

(iv) The grantor may have capital losses to offset the sale.

(v) Payment of the capital gain tax is in effect a "tax free gift" to the beneficiaries not using any of the grantor's estate and gift tax exemption.

2. Swap assets with the GRAT.

(i) The GRAT agreement should direct that the grantor may swap assets having equivalent value under IRC Section 675(4).

(ii) The grantor is not required to sell the assets received in the swap.

a. The assets can be used to fund a new 2 year GRAT under a rolling GRAT plan.

b. The grantor may simply retain the swapped assets and hold them for life.

M. Generation-Skipping Issues to Consider.

(a) Section 2642(f) provides rules regarding the allocation of GST tax exemption during an estate tax inclusion period (the "ETIP" rule). During an ETIP, the value of the property transferred by the transferor would be included in his or her gross estate for estate tax purposes if the transferor died during the ETIP. Section 2642(f) prevents allocation of GST exemption to a GRAT until the expiration of the ETIP, namely the length of the GRAT term, which, if the GRAT is successful, is after the property has increased in value.

(b) Because of the ETIP rules, practitioners should be thoughtful when drafting GRATs and should generally avoid naming the grantor's grandchildren as the remainder beneficiaries of a GRAT. For example, drafters should avoid the use of the term "descendants per stirpes" because if the grantor's child dies during the ETIP, the grantor's grandchildren will succeed the interest of their deceased parents and GST exemption cannot be applied, making the transfer to the grantor's grandchildren subject to double taxation. If the parents have already died when the GRAT is created, then the grandchildren can be named as the beneficiaries of the GRAT.

(c) Techniques to Draft Around the ETIP Dilemma

1. Instead of naming "descendants per stirpes" as the remainder beneficiary, practitioners can instead suggest that the GRAT remainder beneficiaries be comprised only of the grantor's surviving children of the GRAT term. If a parent dies during the GRAT period, his or her share will be distributed to his or her living siblings. To ensure the children of the deceased parent are treated fairly, the grantor can "equalize" the treatment of children of the grantor's predeceased child in his or her will or revocable trust. Using this technique, any property going to the grantor's grandchildren would be exempt from GST tax under the predeceased parent rule of Section 2651(e).

2. Alternatively, the grantor's children can be made *vested* remainder beneficiaries of the GRAT. As a vested beneficiary, the grantor's child does not need to survive the GRAT term to be entitled to share in the remainder and can leave that share to his or her children.

3. Following the GRAT's creation, the following steps could be taken in order to employ this technique:

    (i) The grantor's children should sell their vested remainders to a generation-skipping trust for the benefit of the grantor's grandchildren[1];

    (ii) The grantor should then fund the generation-skipping trust with cash equal to the value of the child's remainder interest in order to make the purchase;

    (iii) The grantor then allocates GST exemption to the trust in the amount of the funding.

4. If the sale of the child's vested remainder in the GRAT is done early in the GRAT term and the GRAT property has yet to appreciate greatly, the value of the remainder may be small. This results in only a small amount of the grantor's unified credit being used for the transfer to the generation-skipping trust.

5. If upon creation of the GRAT the grantor *retained* a reversionary interest in the GRAT, then Section 2702 valuation rules may prohibit reduction of the purchase price of the remainder interest by the value of the grantor's reversionary interest. A scenario where the sale price can be reduced by the value of the grantor's reversion is where the parent sells his or her reversionary interest to one or more generation-skipping trusts for the benefit of each grandchild. This is permissible because the sale is not made to "members of the family" under Section 2702.

6. In the event that some of the grantor's children do not have children when the GRAT is created, and local law does not allow the creation of a trust for a class of beneficiaries not yet living, then one of the grantor's living grandchildren could be named as a temporary or permanent beneficiary of such trust. However, the descendants of the child selling his or her vested remainder may not be a beneficiary of the trust.

7. Practitioners should be aware of a possible risk of re-characterization of these sales under the "reciprocal trust doctrine."[2]

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1 Neither the grantor nor the grantor's children may have an interest in this trust.
2 *United States v. Estate of Grace*, 395 U.S. 316 (1969).

(i) The sales to each trust could be deemed to have underpaid the selling child by an amount equal to the proportion of the grantor's reversionary interest resulting in a gift of that amount by the child selling his or her interest. The result of this re-characterization is that the child's own GST exemption would be applied to the trust to maintain the trusts' GST exempt status.

(ii) However, the purpose of the reciprocal trust doctrine articulated in *Grace* was to identify the transferor who retained an interest in the trust for estate tax purpose. Here, the selling children will have not retained an interest in the GRAT or the generation-skipping trust, and is therefore distinguishable from *Grace*.

8. Practice tips when implementing this technique:

(i) The trust instruments involved in this type of transaction should be drafted to allow the trustee of the GST exempt trust to invest in contingent remainders.

(ii) Further, ensure that any spendthrift clauses found in the GRATs do not prohibit the sale of the vested remainder interest.

(iii) Practitioners should take care to disclose the sale transaction to the trust on gift tax returns to begin the running of the statute of limitations under 6501(c)(9).

(iv) Lastly, practitioners should be aware of income tax basis consequences. The income tax basis may be lost when using this technique, which may not be a concern if the family expects to retain the interest.

(d) Another option is to place some of the grantor's unified credit into a GST exempt trust and allocate the grantor's GST exemption to the trust at the end of the ETIP.

1. This technique would work as follows:

(i) The grantor shelters the initial transfer to the GRAT from gift tax;

(ii) Upon the termination of the GRAT, the grantor then allocates up to $5,490,000 (the 2017 unified credit amount), or, if gift-splitting with a spouse, up to $10,980,000, to the GST exempt trust.

(e) Lastly, a grantor retrained income trust (GRIT) can be used if the right asset is involved.

N. GRATs and Qualification for the Estate Tax Marital Deduction.

(a) If a grantor dies during the QPRT term, practitioners must examine how to treat the remaining annuity payments and the ultimate remainder of the GRAT when there is a surviving spouse.

(b) Simply combining these interests and paying them to the surviving spouse is not an option because it violates Reg. § 25.2702-3(d)(2), which prohibits payments from the GRAT to anyone other than the grantor (and in the case of the grantor's death, the grantor's estate) during the GRAT term.

1. Drafting Techniques to Qualify the GRAT Annuities and Remainders for Marital Deduction

(i) Draft the GRAT to provide that if the grantor dies during the GRAT term, any excess income over the annuity amount be paid to the grantor's estate.

(ii) Disallow the grace period of 105-days to make the annuity payment in the instrument.

(iii) Grant the grantor's personal representative/executor the power to require the trustee to make trust property productive of income or convert the trust property into productive property within a reasonable time.[3] When including this provision, also include language in the grantor's will allowing the surviving spouse to require the personal representative/executor to exercise this right.

a. The practitioner may also consider giving this power directly to the surviving spouse in the GRAT.

(iv) Provide that the GRAT shall continue for the surviving spouse's lifetime if the grantor dies during

3 As defined in Reg. §20.2056(b)-5(f)(4).

the GRAT term and all income shall be paid to the grantor's estate.

(v) In the grantor's testamentary instrument (will, codicil or revocable trust):

a. include a provision bequeathing the grantor's interest in the GRAT to the spouse;

b. provide language encouraging the personal representative/executor or trustee to consider a QTIP election with respect to the GRAT; and

c. expressly state that the GRAT is exonerated from section 2207B or comparable state apportionment rules during the GRAT term to comply with Reg. § 25.2702-3(d)(2). [4]

(vi) In the grantor's spouse's testamentary instrument (will, codicil or revocable trust), expressly state that the GRAT is exonerated from section 2207A or any comparable state apportionment rule during the GRAT term to comply with Reg. § 25.2702-3(d)(2).

(vii) In the GRAT, ratify reimbursement of taxes consistent with the exoneration of the GRAT from section 2207A and 2207B.

a. Drafting tip. Consider providing an indemnity from the grantor for any estate tax that must be paid notwithstanding the exoneration provisions. Note that it is not clear whether an indemnity would make the grantor's retained annuity only the stated annuity interest less the value of the indemnity.

b. Draft the GRAT to allow for the appropriate division of the trust into two shares if the grantor's personal representative, executor or trustee makes only a partial QTIP election with respect to the GRAT.

4 Providing language about 2207B should allow the GRAT to comply with the prohibition of Reg. § 25.2702-3(d)(2) on payments to anyone other than the grantor (or in the case of the grantor's death, the grantor's estate).

(viii) If state law does not clearly permit the assignment of the GRAT payments from the personal representative, executor or trustee to the surviving spouse and close the estate, then provide for assignment in the will and draft the GRAT instrument to include language requiring the trustee of the GRAT to honor the assignment.

Design, Funding & Administration of Qualified Personal Residence Trusts

Introduction. The increase in the gift tax exemption from $1,000,000 to $5,490,000 has sparked renewed interest in the use of qualified personal residence trusts ("QPRT"). Clients who previously exhausted their $1,000,000 gift tax exemption may now be interested in funding a QPRT without paying gift tax. Although the dramatic increase in the gift tax exemption amount may encourage some clients to consider a QPRT, others may not wish to enter into a long-term split interest gift when interests are at near record low rates.

This portion of the presentation will discuss the establishment and administration of QPRTs (including recent case law), examine the availability of fractional interest discounts for gifts to multiple staggered term QPRTs. We will also examine how to convert a QPRT to a GRAT following a sale of a residence, how to deal with a mortgaged residence and what to do when a QPRT terminates.

The outline closes with a comparison of the advantages and disadvantages of QPRTs to alternate techniques such as net financed gifts, sales to grantor trusts and split interest purchases.

I. Qualified Personal Residence Trusts (QPRTs)

A. **Favorable Environment to Transfer Interest in Personal Residence**. There are a number of current factors which make personal residence trusts an effective planning technique for some clients:

1. **Increase in Federal Gift Tax Exemption.** The increase of the gift tax exemption from $1,000,000 to $5,490,000 will allow many clients to form a QPRT without paying current gift tax.

(a) $5,490,000 gift tax exemption until 12/31/17.

(i) Spousal portability.

(ii) Annual inflation adjustments.

(1) $5,525,000 estate and gift tax exemption anticipated in 2018.

(2) Rule of 72 doubles exemption in 20 years to $11,050,000 by 2038 based on an annual 3.6% inflation rate.

(b) Portability and inflation adjustment increases could dramatically expand the available gift tax exemption of a surviving spouse.

2. **Fractional Interest Discount Planning.** Case law allows for significant valuation discounts for fractional interests in personal residences.

B. **Negative Factors in Using QPRT.** There are four negative factors associated with using QPRTs. The first factor is a result of the current economic environment; the second factor is a permanent prohibition which inhibits multi-generational planning. The third and fourth factors involve mortality risk and the loss of step up in basis.

1. **Low Section 7520 Interest Rate.**

(a) June 2017 applicable federal rate of only 2.4%.

(b) The lower the applicable federal rate, the greater the value of the gifted QPRT remainder interest.

2. **Generation-Skipping Transfer ("GST") Tax Planning Limitations**.

(a) Cannot allocate GST exemption at time of gift.

(b) QPRT can sell residence to a GST exempt trust.

(c) GST exemption can be allocated at end of the QPRT term

(i) Unfortunately, the asset often already has substantially appreciated in value.

(ii) In some cases, client may have sufficient GST exemption available to shelter the transferred asset.

3. **Mortality Risk**. You must survive the term for a QPRT to be effective.

4. **No "Step Up" in Cost Basis**. Donee will not receive the "step up" in basis on donee's death.

(a) Capital gain rate is lower than the estate tax rate.

(b) But there may be no estate tax payable due to increased exemptions.

C. **Advantages of Lifetime Giving.**

1. **Shelter Appreciation from Estate Tax.** Transfer of the residence to a QPRT shelters all future appreciation from estate and gift tax from the date the QPRT is funded.

2. **Fractional Interest Valuation Discounts**. Although a residence left to four children by bequest does not receive any fractional interest discount, a lifetime gift of a fractional interest in the residence to four separate QPRTs can generate a substantial valuation discount by either:

   (a) Funding four separate QPRTs with 25% interest gifts based on the principles of Revenue Ruling 81-253; or

   (b) Using multiple QPRTs with staggered terms.

   (c) Discussed further in Section V below.

3. **Allocate Lifetime Generation-Skipping Transfer Tax Exemption**. Cannot allocate GST exemption at time of funding of QPRTs, but may obtain generation-skipping tax shelter through:

   (a) Direct gift; or

   (b) Sale to an intentionally defective grantor trust.

4. **Pay Income Tax of Donee Through Use of Grantor Trust**. The donor (if gift) or transferor (if sale) may pay the income tax on earnings of the donee/transferee grantor trust.

5. **Pay Gift Tax at Lower Effective Rate**.

   (a) Tax exclusive vs. tax inclusive.

   (b) Effective gift tax rate of 33 1/3% (vs. 40% estate tax rate).

   (c) Net gift can reduce the tax rate further.

6. **Gift Tax Audit Protection**. Use of a portion of the available gift tax exemption allows a buffer against negative gift tax audit examination.

   (a) No gift tax payable even if valuation of asset is increased.

   (b) Very few gift tax returns reporting QPRTs are audited.

D. Alternate Approaches (discussed in Section P).

1. **Direct Gift.** Easiest approach.

2. **Net Financed Gift**.

(a) Net gift with donee paying gift tax with borrowed funds.

(b) Can use extremely low intra-family interest rates.

(i) 1.18% for zero to three year loan.

(ii) 1.96% for three to nine year loan.

3. **Joint "Split Interest" Purchase.** Life estate and remainder interest purchased by different parties from a third party at the outset at the proper actuarial values.

4. **Sale to Intentionally Defective Grantor Trust**. Known as a "leaky freeze," it allows full generation-skipping shelter using the allocation of generation skipping transfer exemption vs. 10% of the sales price.

II. QPRT Overview.

A. **QPRT Summary**. The creation and funding of a QPRT is similar to a grantor retained annuity trust ("GRAT"). A sample QPRT form has been issued by the Internal Revenue Service in Revenue Procedure 2003-42.

1. **Transfer of Residence.** Client irrevocably transfers title to her residence in trust and retains the right to reside in the residence for a specified term.

2. **Designation of Beneficiaries at End of QPRT Term**. The residence passes to Client's named beneficiaries upon the expiration of the specified term.

3. **Tax Free at End of Term**. If Client survives the term, her residence passes free of gift and estate tax to her beneficiaries (outright or in trust) at the end of the term.

4. **Initial Transfer a Taxable Gift**. However, the initial transfer of Client's residence to the personal residence trust involves a taxable gift.

(a) The gifted amount is the actuarial value of the remainder interest passing to Client's named beneficiary.

(b) Since Client would retain the exclusive right to use the residence for a specified number of years, the remainder interest is valued based on the following factors:

(i) The value of the residence;

(ii) The age of the grantor;

(iii) The number of years retained; and

(iv) The interest rate at the time of the gift.[5]

5. **QPRT Example #1.** Client (age 65) is contemplating the transfer a $10,000,000 condominium to a QPRT with a term of 10, 15 or 20 years.

CLIENT QUALIFIED PERSONAL RESIDENCE TRUST

QPRT TERM	TAXABLE GIFT	GIFT TAX EXEMPTION	GIFT TAX
10 Years	$ 5,957,200	$ 5,490,000	$150,880
15 Years	$ 4,084,400	$ 4,084,400	NONE
20 Years	$ 2,413,200	$ 2,413,200	NONE

(i) The amount of the gift decreases as the length of the retained term increases.

(ii) If Client transfers her residence at a value of $10,000,000 in trust and retains use of the residence for 15 years, then the amount of her gift is $4,084,400.

(iii) Assuming that Client survives the 15 year term and the residence increases in value at a 5% annual rate for 15 years, he would shelter property worth $20,789,282 from estate tax by making a taxable gift of only $4,084,400.

(iv) Using a 40% estate tax rate, estate tax savings of $6,681,953 would be obtained by funding the QPRT.[6]

(v) In addition, all appreciation in the residence after the expiration of the 15 year term and before Client passes away would also avoid the 40% estate tax.

B. **Safe Harbor.** Unlike some popular estate planning techniques, the QPRT is a statutory safe harbor in Section 2702 of the Internal Revenue Code.

1. **No Downside if Donor Does Not Survive Term**. Viewed by some as a "heads I win, tails I break even" planning technique. However, many

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5 The interest rate is computed monthly by the Department of Treasury. All examples in this outline were calculated using an applicable federal interest rate of 3.0%. (The June 2017 applicable federal interest rate is 2.4%.)

6 However, there will be capital gain tax payable if the residence is sold by the remainder beneficiaries.

practitioners object to this characterization due to the loss of the step up in value of cost basis at death.

2. **GRIT**. Similar to a common law grantor retained income trust ("GRIT"), but with statutory authority/protection.

C. **Use of Multiple QPRTs**.

1. **Multiple Residences**. Can fund a QPRT with the donor's principal residence and a second QPRT with another residence. (See Section III below.)

2. **Multiple QPRTs Funded With a Single Residence**. Can use multiple QPRTs to hold fractional interests in a single residence. *Treasury Regulation Section 25.2702-5(a)(1).*

D. **Trustee**.

1. **During QPRT Term**. Donor may serve as trustee of the personal residence trust during the QPRT term.

2. **After Expiration of QPRT Term**. Donor should no longer serve as trustee of any continuing trusts after the QPRT term expires.

(a) No express prohibition, but necessary if there is a "lease back" of the residence.

(b) Can use ascertainable standard trust if no "lease back."

E. **Factors Impacting Amount of Gift**.

1. **Section 7520 Rate**. The applicable federal rate ("AFR") in effect during the month of the transfer to the QPRT is used in determining the actuarial value of the QPRT remainder interest.

(a) The lower the AFR, the higher the actuarial value of the gift.

(b) Cannot use a higher rate from the prior two months as is the case with charitable remainder trusts.

(c) Alternate planning techniques may become preferable in low interest rate environments:

(i) Net financed gift.

(ii) Sale to an intentionally defective grantor trust.

(c) **QPRT Example #2.** Instead, Client gifted a $10,000,000 condominium to a QPRT with a term of 10, 15 or 20 years when the AFR was 6.0% (as opposed to 3.0%):

EXAMPLE #2: CLIENT QPRT (3.0% VS. 6.0% AFR)

QPRT TERM	TAXABLE GIFT @ 3% AFR	TAXABLE GIFT @ 6% AFR
10 Years	$ 5,957,200	$ 4,384,400
15 Years	$ 4,084,400	$ 2,578,900
20 Years	$ 2,413,200	$ 1,307,200

(i) If Client transfers her residence at a value of $10,000,000 in trust and retains use of the residence for 15 years when the AFR is 3.0%, then the amount of the gift is $4,084,400.

(ii) If Client transfers her residence at a value of $10,000,000 in trust and retains use of the residence for 15 years when the AFR is 6.0%, then the amount of the gift is reduced to $2,578,900, a 37% decrease from the 3.0% AFR gift.

2. **Life Expectancy**. The donor must survive the QPRT term to transfer the residence at a reduced gift amount.

(a) Most practitioners recommend that the donor use a QPRT term equal to or shorter than the donor's life expectancy.

(i) The life expectancy of a 65 year old is currently 21 years.

(ii) The QPRT tables are gender neutral.

(b) **QPRT Example #3.** Suppose that we learn that Client was actually 70 years old (not 65) when she transferred a $10,000,000 condominium to a QPRT with a term of 10, 15 or 20 years when the AFR is 3.0%:

EXAMPLE #3: CLIENT QPRT (AGE 65 VS. AGE 70)

QPRT TERM	TAXABLE GIFT IF AGE 65	TAXABLE GIFT IF AGE 70
10 Years	$ 5,957,200	$ 5,055,800
15 Years	$ 4,084,400	$ 2,958,200
20 Years	$ 2,413,200	$ 1,367,400

(i) If Client transfers her residence at a value of $10,000,000 in trust and retains use of the residence for 15 years at age 70 instead of age 65, then the amount of the gift is $5,055,800, almost 20% less than the $5,957,200 gift at age 65.

(ii) The life expectancy of a 70 year old is 17 years, only 4 years less than the life expectancy of a 65 year old.

3. **Value of Real Estate**. The fair market value of the residence is an obvious factor in determining the amount of the QPRT gift.

4. **Fractional Interest Discounts**.

(a) QPRT can hold title to an undivided fractional interest in a residence. *Treasury Regulation Section 25.2702-5(c)(2)(i)(C).*

(b) See Section V of this outline for a survey of fractional interest valuation cases.

5. **Reporting on Gift Tax Return**. The actuarial value of the remainder interest in connection with the transfer of the residence to the QPRT must be reported on a gift tax return to commence the gift tax statute of limitations.

III. Personal Residence.

A. Two QPRTs at One Time. A grantor may form two QPRTs at one time funded with her personal residence and one other residence.

B. Personal Residence. Defined under a facts and circumstances test under *Treasury Regulation Section 1.1034-(1)(c)(3)*

1. **Not Just Real Estate**. A personal residence may include a cooperative apartment, house trailer or houseboat. *Treasury Regulation Section 1.1034-(1)(c)(3)(i)*

2. **Exclusive Use**. A personal residence may in certain cases be use by a relative or friend and leased to unrelated third parties. *Private Letter Rulings 9249041, 9448035 and 200751022*

C. Additional Property. A personal residence may include additional property such as adjacent land and certain appurtenant structures reasonable appropriate for residential purposes. *Treasury Regulation Section 25.2702-5(b)(2)(ii) and (c)(2)(ii)*

IV. Establishing the QPRT Term.

A. **Survival of QPRT Term**. As noted above, the client must survive the QPRT term to achieve the transfer tax savings.

B. **Staggered QPRT Terms**. Can use staggered QPRT terms.

1. **Example**. For example, a client who wishes to use a 20 year term may elect to fund five QPRTs with terms of 16, 18, 20, 22 and 24 years.

2. **Purpose**.

(a) Hedges mortality risk.

(b) Also generates fractional interest valuation discounts.

V. Fractional Interest Gifting and IRC Section 2036 Issues.

A. **Types of Fractional Interest Gifting**.

1. **Staggered QPRTS**. As noted above, a donor may transfer undivided interests in residence to QPRTs with staggered terms.

2. **Undivided Interests to QPRTs with Different Remainder Beneficiaries**. Donor may also gift undivided interests in a residence to QPRTs with different QPRT remainder beneficiaries.

3. **Different Donors**. Husband and Wife can each gift percentage interests in same residence to separate QPRTs.

4. **"Check the Box."** The taxpayer must "check the box" for a fractional interest discount on the federal gift tax return (Form 709) reporting the QPRT transfer.

B. **Fractional Interest Discount Decisions**.

1. **Ludwick Case**. A 50% undivided interest in a Hawaii vacation residence transferred by each spouse to separate QPRTs received a 17.2% valuation discount. *Estate of Ludwick vs. Commissioner*, Tax Court Memorandum 2010-104.

(a) The Estate of Ludwick and the Internal Revenue Service stipulated to substantial discounts for undivided interests in the following types of real estate:

(i) Taxpayers claimed a 30% discount on their gift tax returns.

(ii) The Service argued for an 11% discount, but allowed a 15% discount in its deficiency notice.

(iii) Both expert appraisals were rejected by the Tax Court.

(iv) The Tax Court allowed a 17.2% discount.

(b) A two-pronged approach was used in determining the fair market value of the 50% undivided interests in the residence:

(i) Cost of partition; and

(ii) Sale cost if partition is not necessary (with a high likelihood assigned to this possibility).

(1) 10% chance of partition generated a 26.5% discount; and

(2) 90% chance of sale resulted in a 16.2% discount

2. Mitchell Case. *Estate of Mitchell vs. Commissioner*, Tax Court Memorandum 2011-94.

(a) The Estate of Mitchell and the Internal Revenue Service stipulated to substantial discounts for undivided interests in the following types of real estate:

(i) 32% for a gifted 5% undivided interest in oceanfront real estate;

(ii) 19% for a retained 95% undivided interest in oceanfront real estate at death;

(iii) 40% for a gifted 5% undivided interest in ranch property; and

(iv) 35% for a retained 95% undivided interest in ranch property.

(b) The Service argued for limited discounts based on the cost of partition as used in *Ludwick*.

(c) The Estate of Mitchell distinguished *Ludwick* by highlighting the joint tenancy agreement.

(d) Gift was made 6 days before the taxpayer passed away, but the planning began before the cancer diagnosis.

(i) Minority discount was not recognized in a case where the minority interest was gifted 18 days before death. *Estate of*

Murphy vs. Commissioner, Tax Court Memorandum 1990-472.

(ii) Minority discount was recognized in gift by power of attorney only 2 days before death. *Estate of Frank vs. Commissioner*, Tax Court Memorandum 1995-132.

3. Miscellaneous Undivided Interest Discount Cases.

(a) *Samuel J. LeFrak vs. Commissioner*, Tax Court Memorandum 1993-526 (20% minority discount and 10% marketability discount for gifts of 10% undivided interest in apartment and office buildings – total discount 28%).

(b) *Estate of Ellie Williams vs. Commissioner*, Tax Court Memorandum 1998-59 (30% minority discount and 20% marketability discount – total discount 28%).

(c) *Estate of Brocato vs. Commissioner*, Tax Court Memorandum 1999-424 (20% discount for gifts of a 50% interest in numerous residential properties).

(d) Other cases allowing 10% discounts:

(i) *Estate of Busch vs. Commissioner*, Tax Court Memorandum 2000-3.

(ii) *Estate of Reichardt vs. Commissioner*, 114 T.C. 9 (2000).

C. Use of Residence Following End of QPRT Term.

1. Rental Payments. The donor must pay fair market value rent to the remainder beneficiaries following expiration of the QPRT term.

2. IRC Section 2036. Failure to pay fair market value rent may result in inclusion of the value of the residence in the decedent's gross estate under IRC Section 2036.

3. Riese Decision. The Tax Court recently held that there was no inclusion when the decedent intended to pay rent but passed away suddenly before rental payments were quantified and paid. *Estate of Riese v Commissioner*, Tax Court Memorandum 2011-60.

(a) The decedent remained in her residence following the end of the QPRT term and died unexpectedly before any rent was paid.

(b) There were instructions between the attorney, the decedent and the decedent's daughter (who assisted the decedent with her financial matters) when the QPRT was proposed that she would have to pay rent if she remained in the residence following the end of the QPRT term.

(i) Daughter discussed with the attorney how to determine the fair market rent when the QPRT term ended.

(ii) The attorney advised that rent could be determined and paid by the end of that calendar year.

(iii) Mother died unexpectedly in October 2003 before the fair market rent was determined and any rent payments were made.

(c) The IRS argued that there was an implied agreement of retained enjoyment. The court highlighted the following in determining that there was not an implied agreement of retained enjoyment based on the following factors:

(i) The necessity of paying rent was discussed on multiple occasions with the decedent and her daughter before the QPRT was created;

(ii) Daughter discussed with the attorney how to determine fair market rent before the decedent's death.

(iii) "While counsel's advice to determine rent by the end of the year was not the most prudent course of action, i.e., executing a lease and determining rent before the QPRT terminated would have been the ideal, we accept the parties' good faith testimony that they intended to determine rent by the end of the year... The Secretary had not issued any regulations or guidance as to how and when rent should be paid upon the termination of a QPRT. We believe that doing so by the end of the calendar year in which the QPRT expired would have been reasonable under the circumstances."

(d) In a Tax Court decision rendered earlier this year, the continued rent-free use of residence gifted to a trust resulted in estate tax inclusion under Section 2036. *Estate of Van vs. Commissioner*, Tax Court Memorandum 2011-22.

4. **Maintaining Florida Homestead Status**. The grantor of the QPRT can secure the continued benefits of the homestead exemption for the residence when leasing from the remainder beneficiaries if the following procedures are followed:

(a) The County Property Appraiser can "pre-approve" the continuation of the exemption. (This "pre-approval" can usually be obtained by email.)

(b) The Property Appraiser will require an explanatory letter and the following documents:

i. Deed;

ii. Lease

iii. Memorandum of Lease (in recordable form); and

iv. Copy of the QPRT.

(c) Following the termination of the QPRT, the Deed and the Memorandum of Lease must be recorded. Then copies of the recorded instrument should be sent to the Property Appraiser with a request for confirmation of continuing homestead eligibility.

VI. QPRT Income Tax Reporting.

A. Grantor Trust Income Tax Reporting. Grantor is required to report all income and deductions of a grantor trust on the grantor's individual income tax return (Form 1040).

B. Taxpayer Identification Number. QPRT need not obtain a federal taxpayer identification number unless it expects to receive income.

1. Rental or investment income obviously requires a taxpayer identification number and a QPRT checking account.

2. A QPRT with an interest-bearing checking account would also need a taxpayer identification number.

C. Payment of QPRT Expenses. Same effect if the QPRT pays the real estate taxes and makes the mortgage payments.

D. Grantor Trust Tax Compliance.

1. If income is earned, or payments made, by the QPRT, grantor may file a short Form 1041 tax return reporting:

(a) All income, deductions and credits are not reported on Form 1041 of the QPRT.

(b) Instead, these items are listed on a separate statement attached as an exhibit to Form 1041 of the QPRT.

(c) Must provide payor of income with the name of the grantor and the taxpayer identification number and address of the QPRT.

2. Can avoid filing Form 1041 by:

(a) Have no income paid to, or expenses paid, by the QPRT; or

(b) Provide payor of income with the grantor's name and social security number.

VII. QPRT Administration.

A. Sale of Residence. The QPRT trustee may sell the residence at any time during the QPRT term.

1. The QPRT is a grantor trust with income taxes paid by the donor.

2. QPRT rules governing the sale of a residence are covered in Section VIII below.

B. Improvements to Residence.

1. **Permitted by QPRT.** A QPRT residence may be improved following contribution of the residence to the QPRT.

2. **Contributions to QPRT.** Cash contributed to a QPRT must be expended by the trustee within six months of receipt.

3. **Payment by Grantor.** The grantor may pay for the improvements directly and treat the cost as an additional contribution to the QPRT.

C. Mortgage on Residence.

1. **Permissible to Contribute to a QPRT a Residence Subject to a Mortgage.**

(a) Transfer is measured by equity in residence, not the fair market value.

(b) Best accomplished with interest only balloon mortgages.

(c) Contribution to QPRT to pay the mortgage payment is considered a new gift to the QPRT to the extent that it reduces principal on the mortgage.

(d) Be wary of "due on sale" clauses in mortgage.

2. **QPRT Funded with Mortgaged Property / Refinancing QPRT Property**

(a) QPRT Funded with Mortgaged Property

1. When mortgaged property is used to fund a QPRT, the initial gift is typically calculated based on the donor's equity in the residence.[7]

2. A donor may contribute cash to the QPRT to make the mortgage payments. However, such a contribution by the donor must be made in anticipation that the mortgage payment will be made within six months from the transfer. Plus, any principal paid by the contributions from the donor to the QPRT will be considered an additional gift to the QPRT.

3. A donor may contribute cash to the QPRT to make the mortgage payments. However, such a contribution by the donor must be made in anticipation that the mortgage payment will be made within six months from the transfer. Plus, any principal paid by the contributions from the donor to the QPRT will be considered an additional gift to the QPRT.

4. The best practice, if possible, is to pay off the mortgage prior to funding the QPRT.

(b) Refinancing QPRT Property

1. Refinancing property owned by a QPRT is difficult because banks do not typically like to loan to irrevocable trusts and can generally not be done. A bank may suggest the following technique, which should <u>not</u> be followed:

2. A bank may propose that in order to refinance the property held by a QPRT, the trustee distribute the real property out of the QPRT for a day, refinance the loan, and then transfer the property back to the QPRT. A lender may do this with revocable trusts, but this technique is not property for irrevocable trusts such as QPRTs.

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7 PLR 9340009 suggests that when a donor remains personally liable to pay off the mortgage, the fair market value of the mortgaged residence may be used to calculate the initial gift. However, this approach has been questioned by commentators.

3. What if a client followed the bank's advice without discussing with his or her attorney first?

(i) It would be prudent to contact the lender who prepared the quit claim deed transferring the property and have another deed prepared transferring the property back to the QPRT. Because the lender's actions were likely based on a misunderstanding of QPRTs, this would be considered a correction of a mistake (unilateral or mutual).

(ii) Such a result could likely be compelled by the remainder beneficiaries because the trustee did not have the authority to distribute the residence to the donor during the term.

D. Rental of Residence.

(a) Termination of the QPRT Term / Donor as Tenant

(a) If a donor continues to live in the trust residence following the termination of the QPRT term, the donor must pay fair rental value to the remainder beneficiary of the QPRT for the use of the property.

(b) Best practice is for the donor to enter a lease agreement with the remainder beneficiary. Further, fair rental value should be determined by an independent party qualified to calculate fair rental value of the property.

(c) If the donor fails to pay fair rental value, then the likely result is inclusion of the residence in the donor's estate under §2036 because the donor retained an interest in the property.

(d) Note that sometimes inclusion in the donor's estate is desirable if a donor has adequate estate tax exemption available because the estate would then get a step up in basis, and in such a situation a lease agreement may be problematic.

(b) Rental income is paid to the QPRT trustee.

(c) Grantor may depreciate residence and offset rental income through grantor trust status.

(d) May lose benefit of IRC Section 121 gain exclusion on subsequent sale of personal residence.

VIII. Sale of Residence by QPRT.

A. **May Sell At Any Time**. The trustee of a QPRT may sell the residence at any time during the QPRT term.

1. **Purchase of Replacement Residence**. May use net proceeds of the sale to purchase another residence. (See Section VIII D. below)

2. **Conversion to GRAT**. Must convert to a GRAT after a specific period of time. (See Section VIII E. below)

B. **Cost Basis**. Grantor retains tax basis in residence for capital gain and depreciation purposes.

C. **Section 121 Exclusion from Tax on Sale of Personal Residence**. IRC Section 121 exclusion of gain on sale of personal residence is preserved during QPRT term.

1. **Single Owner**. $250,000 of capital gain excluded from tax.

2. **Married Couple**. $500,000 exclusion for a married couple filing a joint return.

3. **Surviving Spouse Exception**. Surviving spouse can use the Section 121 exclusion if grantor dies during the QPRT term and the other principal residence ownership rules are satisfied.

   (a) Must use the property as principal residence for 2 of the prior 5 years.

   (b) Must be used by surviving spouse, not only by grantor.

D. **QPRT Status After Sale of Residence**. Can retain QPRT status for up to two years following sale of the residence.

1. **Separate Accounts**. Net sales proceeds must be held in a separate account.

2. **Options**. Net sales proceeds can be used to:

   (a) Purchase a replacement residence;

   (b) Convert the remaining sales proceeds (or all of the proceeds, if a replacement residence is not purchased) to a Grantor Retained Annuity Trust ("GRAT"); or

   (c) A combination of (a) and (b) above.

E. Sale of Trust Residence.

(a) The Regulations provide that a QPRT may allow for the sale of the trust residence during the trust term. All or only a portion of the sale proceeds may be reinvested to purchase a new trust residence; the QPRT status as to the reinvested sales proceeds will remain intact.

(a) When the purchase price of the replacement trust residence is *less than* the sale proceeds from the old residence, the excess funds must either be

1. Converted to a GRAT (see Section E below);

2. Expended on capital improvements pursuant to Reg. §25.2702(5)(c)(5)); or

3. Distributed to the donor if permitted by the QPRT.

(b) When the purchase price of the replacement residence is *greater than* the sale proceeds from the sale of the old residence, the donor's options include:

1. Contributing the difference between the sale proceeds and the purchase price of the replacement residence to the existing QPRT.

(i) Calculation of the amount of the gift from the donor to the existing QPRT is based on the following: (i) the age of the donor at the time of the contribution, (ii) the term remaining of the initial QPRT term and (iii) the §7520 rate in effect on the date of contribution.

(ii) Unless the amount of the price differential is small, contribution of cash from the donor to the existing QPRT may not be tax efficient.

2. Purchasing a portion of the new residence with the existing QPRT as tenants in common and either (1) retaining the interest or (2) contributing the interest to a new or existing QPRT.

(i) If the donor's interest in the new residence is contributed to the existing QPRT, the gift calculation is based on the same factors stated in Section II. E (b)(1)(A) above.

(ii) A valuation discount should be applied to the value of the fractional interest of the residence held in the donor's name if it is contributed to a new or existing QPRT. (*See Ludwick v. Commissioner*, TCM 2010-104).

(b) When the trust residence is sold and a replacement trust residence is purchased, timing issues are presented in regards to the date of the sale of the trust residence and the date of the purchase of the replacement residence because a QPRT can only hold an interest in one residence at a time.

(a) This issue is not efficiently solved when the donor purchases a new residence in his or her name, then, following the sale of the trust residence, sells the new residence to the QPRT because this results in an extra level of real estate excise tax.

(b) Ideally, the closing for the sale of the old residence will occur just before (at least one week before) the closing of the sale of the new residence.

(c) When the sale of the old residence is to one or more children or descendants of the donor, the timing issues are more workable.[8]

(d) The timing issues can also be worked around if a non-donor spouse with sufficient assets creates a QPRT for the new residence. This is possible because each spouse may maintain two QPRTs at one time.

F. Conversion of QPRT to a GRAT.

(a) **QPRT Conversion**. A QPRT must convert to a GRAT when one of the following events occurs:

(a) The trust residence held by the QPRT is sold and the sale proceeds are not reinvested to purchase a replacement trust residence within two years of the sale;

(b) The sales price of the original trust residence is less than the purchase price of the replacement trust residence, resulting in excess sale proceeds being held by the QPRT; or

(c) The trust residence ceases to be used or held for use as the donor's residence.

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8 Reg. §25.2702-5(c)(9) provides that a QPRT is prohibited from selling the residence to the grantor, the grantor's spouse or an entity controlled by either of them while the QPRT is a grantor trust. However, the regulations do not provide a prohibition against the sale of the trust residence to a child or descendant of the grantor.

(b) **GRAT Annuity Payments**. Upon conversion to a GRAT, the QPRT must pay an annuity to the donor for the remaining initial QPRT term. *See* Reg. §25-2702-5(c)(8). The calculation of the annuity payments due to the donor are based on the §7520 rate and mortality rates in effect upon the creation of the QPRT, not at the time of the conversion.

(c) **Multiple GRAT Conversions**. It is possible for there to be multiple GRAT conversion from a single QPRT. In the event of multiple GRAT conversions, practitioners should comply with Rev. Proc. 2003-42, which addresses multiple GRAT conversions, and create separate shares for each GRAT conversion.

(d) **Need for Cash Flow**. The situation may arise where a donor needs money back from the QPRT (for health expenses, for example), which is when a conversion from a QPRT to a GRAT can be useful. However, the conversion typically requires a sale of the trust residence. Conversion to a GRAT may also be useful when a donor must move into assisted living and needs assets for monthly payments, but does not need access to the principal of the trust.

(e) **Required Conversion Date**. GRAT conversion does not occur for 2 years, but requires GRAT payments to begin as if the GRAT was established on the residence sale date.

(f) **Required GRAT Payment Date**. Initial GRAT payment is not due for 105 days following the first year of the GRAT.

  (a) In other words, the initial GRAT payment is made 2 years after the date of sale.

  (b) Interest must be paid from the date of the initial GRAT payment would have been due until the 2 year mark.

7. Amount of GRAT Payment. Grantor must receive from the GRAT the greater of:

  (a) The income earned by the GRAT; or

  (b) The required GRAT payment.

8. Calculation of GRAT Payment Amount. Calculation of required GRAT annuity payment.

  (a) The GRAT value is the lower of:

(i) The grantor's retained interest in the QPRT (i.e., the value of the residence less the taxable gift when the QPRT was formed); or

(ii) The fair market value of the QPRT assets (generally the net sales proceeds) at the time residence was sold.

(b) The required GRAT annuity payment is the multiple of:

(i) Annuity factor equal to the value of $1 payable annually for the full term of the QPRT (from the outset), times

(ii) The value of the donor's retained interest at the time the QPRT was created.

9. **Example**. If a 65 year old donor funds a ten year QPRT (3.0% AFR) with a $1,000,000 residence which is sold for net proceeds of $1,200,000 after year five, the required annuity payout is $53,615.

(a) Gift of $584,250 and retained interest of $415,750.

(b) Annuity factor of 7.7544.

(c) $415,750/7.7544 = $53,615 annuity for last 5 years (a 4.47% annual return until conclusion of QPRT in five years)

IX. Use of Residence by Donor after QPRT Term.

A. **Repurchase by Donor**. Donor can repurchase residence at fair market value.

1. **Grantor Trust**. Best to do so from a grantor trust.

2. **Section 2036 Concerns**. Need an MAI appraisal to determine fair market value.

B. **Lease Back by Donor.** Must be at fair market value (See *Riese* and *Van* cases discussed in Section V.C.3. above).

X. Flexibility with Irrevocable Trust.

A. **Judicial Reformation**. A trust that fails to comply with the QPRT rules may be modified to do so by judicial reformation.

B. **Judicial Recission**. May wish to undo a QPRT by means of recission if based on mistake of law.

C. **Poor Health**. In the event of poor health, the term holder may transfer her retained interest by gift or sale at actuarial value.

XI. Dealing With a QPRT Formed by a Client in Poor Health.

A. Gift of Retained Interest.

1. **Gift of Retained QPRT Interest**. Grantor may gift the retained interest to the remainder beneficiaries.

    (a) Must gift at actuarial value.

    (b) Must survive three years to avoid gift from being made "in contemplation of death" and returned to estate. IRC Section 2035(a).

2. **Rental to Avoid Section 2036**. Grantor must rent residence at fair market value at conclusion of QPRT term to avoid IRC Section 2036 inclusion at time of Grantor's death.

B. Sale of Retained Interest.

1. **Sale to QPRT Remainder Beneficiaries**. Grantor may sell the retained interest to the remainder beneficiaries.

2. **Actuarial Value**. Must sell retained QPRT interest to third party at its actuarial value.

    (a) Difficult to determine.

    (b) Taxable event (unless sold to a grantor trust for beneficiaries).

    (c) Avoid "three year rule" of IRC Section 2035(a).

    (d) Must rent residence at fair market value to avoid IRC Section 2036 inclusion at time of death.

XII. Common QPRT Fallacies and Problems.

A. Senior clients cannot use QPRTs due to mortality risk.

B. Client cannot sell residence following gift to QPRT.

C. Client will be "kicked out" of family home after QPRT term.

D. QPRT Problems:

(a) Early Termination of the QPRT.

(a) There are situations that arise where a client may no longer want to be subject to the QPRT, such as:

1. A terminally ill donor;

2. The donor's desire to receive a step up in basis for residence upon death;

3. Federal estate tax exemption; or

4. The desire to control the residence after the death of the initial grantor.

(b) Options to consider and discuss with your client when considering early termination:

1. *Distribution to Donor*. If the QPRT allows for a distribution to be made from the QPRT to the donor as permitted under Reg. §25.2702-5(c)(7) and (8), then the trust assets can be distributed back to the donor.

(i) The QPRT may grant the trustee a power of authority to distribute trust assets to the donor within thirty (30) days of the QPRT ceasing to be a qualified personal residence trust.[9] In certain circumstances, it may be possible to intentionally cause the QPRT to cease being a qualified trust.

(ii) Note that the result of distributing the assets to the donor, if allowed pursuant to the terms of the QPRT, will likely be a waste of the gift tax exemption already allocated to the QPRT upon creation of the trust.

2. *Spendthrift Clause.*

(i) Donor's Purchase of Remainder Interest from QPRT Beneficiaries.

A. If possible under the spendthrift clause[10], the donor may consider purchasing the remainder interest from the beneficiaries,

9 Reg. §25.2702-5(c)(7) and (8)

10 The spendthrift clause may need to be drafted to specifically allow for such a sale by the donor.

usually the grantor's children. The value of this interest is calculated using the IRS tables.

B. Following the purchase, the donor will be the sole owner of the residence, causing the trust to terminate.

C. The beneficiaries may experience income tax liability following the sale.

(ii) Remainder Beneficiaries Purchase of Donor's Retained Interest.

A. If possible under the spendthrift clause[11], the donor may consider purchasing the remainder interest from the beneficiaries, usually the grantor's children. The value of this interest is calculated using the IRS tables.

B. Following the purchase, the beneficiaries become the sole owner of the residence, causing the trust to terminate.

C. For this option to be viable, the beneficiaries must have adequate assets to make the purchase.

D. Following such a sale, the donor must either vacate the residence, or pay fair market value rent to the beneficiaries.

E. The residence will be excluded from the donor's estate under this scenario, even if the donor dies during the initial QPRT term. (If this option is considered, the practitioner may want to draft the trust instrument to include a power allowing the donor to assign or transfer the his or her interest in the trust.)

3. *Conversion to a GRAT.* If the donor wishes to sell the residence, the client may want to convert the QPRT to a GRAT, as discussed in Section III.B, resulting in annuity payments to the donor from the trust.

11 The spendthrift clause may need to be drafted to specifically allow for such a sale by the donor.

4. *Termination of the QPRT*. Under Reg. §25.27025(c)(6), the QPRT must prohibit commutation (prepayment) of the term holder's interest.

(i) Review applicable state law which may allow a court to grant the trustee of the QPRT powers that are not inconsistent with the trust purposes or provisions. If state law does allow early termination, the following must be considered:

A. Who are the interested parties who need to join such a proceeding?

B. Will a guardian ad litem or other representative be required to represent unborn, unascertained or minor parties?

C. If the residence is distributed back to the donor, is this a reportable gift by the remainder beneficiaries to the grantor?

D. Will the gift tax exemption allocated to the QPRT funding be returned to the donor's estate in calculation of adjusted taxable gifts?

(b) Amending the QPRT.

(a) The ability to amend the QPRT is governed by state law. State law may grant the parties interested in a QPRT, assuming all parties are in agreement, the ability to amend a QPRT.

(c) Death of Donor During Initial QPRT Term.

(a) If the donor dies before the end of the QPRT term, the QPRT terminates and the residence is included in the donor's estate.

(b) The residence will receive a step up in basis under IRC §1014.

(c) The initial gift tax exemption applied to the gift of the residence to the QPRT will be recovered by the estate of the donor.

XIII. Compare to Other Planning Techniques.

A. Direct Gift of Residence. Donor may simply gift the residence to his or her beneficiaries.

1. Easiest Method. Gift can be outright or in trust.

2. **Increased Exemption to Shelter Gifts**. The increased $5,000,000 gift tax exemption may be sufficient to cover the gift.

3. **Three Year Contemplation of Death Rule**. Must survive three years for gift to be effective. *IRC Section 2035*.

4. **No Step Up in Basis**. Would not receive benefit of "step up" in cost basis at death.

5. **Partial Interest Direct Gifts**. May be useful in conjunction with substantial fractional interest valuation discounts.

6. **GST Exemption**. Can allocate generation-skipping tax exemption at the time of the gift.

B. **Net Financed Gift**. Donor gifts the residence to the beneficiaries on a "net gift' basis.

1. **Gift Tax Paid by Donees**. Gift tax is paid by the beneficiaries, not by the donor.

2. **Reduced Effective Gift Tax Rate**. Reduced the gift tax rate from 35% to 25.92%.

(a) Funds to pay the gift tax may be loaned by donor to the beneficiaries:

(i) June 2017 short-term AFR is 1.18%.

(ii) June 2017 mid-term AFR is 1.96%.

(b) Net financed gift is not used when client has sufficient gift tax exemption to shelter the gift of the residence form gift tax.

3. **Donor Use of Residence**. Fair rental value must be paid by the donor for subsequent use of the residence.

(a) Subject to income tax with related deductions at the donee level.

(b) May avoid by using grantor trust.

4. **Example**. Donor gifts a 50% interest in an $8,000,000 residence on a "net gift" basis to a grantor trust for her two children. The fractional interests are valued at a conservative 15% discount at a combined $6,800,000 value. Donor has no gift tax exemption available. The gift tax payable is $1,762,961, payable on April 15 of the year following the gift. Need to survive the three year contemplation of death period to avoid later inclusion

in donor's gross estate. Donor can loan the gift tax funds to her children using a nine year interest-only promissory note with a balloon payment of principal at the end of the term. Rental payments begin immediately (as opposed to the end of a QPRT term).

(a) Assuming annual rent of $420,000 and net proceeds (after payment of real estate taxes, insurance, etc.) of $200,000, the children could pay off the note by the end of the 9 year term.

(b) Assuming further that the house appreciates in value from $8,000,000 to $12,000,000 over the same period, $4,200,000 of estate taxes (at an assumed 35% estate tax rate) are avoided.

C. **Split Purchase**.

1 **Life Estate and Remainder Interest**. The restrictions of IRC Section 2036 (a)(1) and Chapter 14 may be avoided through the split purchase of a new residence by two parties (generally senior and junior family members):

(a) Life estate (at actuarial value); and

(b) Remainder interest (also at actuarial value).

(c) Cannot use actuarial value if life estate purchaser is terminally ill. *Treasury Regulation Section 25.7520-3(b)(3).*

2. **Use of Residence for Lifetime**. The advantage is that senior family member can retain the use of the residence through the life estate ownership until death without estate tax exposure.

3. **Appellate Court Split.** There is a split of authority for the sale of a remainder interest in property.

(a) The Federal Circuit has held that the sale of a remainder interest for its actuarial value by the life estate holder results in inclusion in the gross estate under IRC Section 2036(a)(1). *Gradow vs. United States*, 897 F. 2d 516 (Fed Cir 1990).

(b) However the Third, Fifth and Ninth Circuits have held otherwise:

(i) The sale of a remainder interest in stock for its actuarial value qualifies for the "full and adequate consideration" exception to IRC Section 2036(a)(1). *D'Ambrosio Estate vs. Commissioner*, 101 F. 3d 309 (3d Cir 1996).

(ii) Similar results in ***Wheeler vs. United States***, 116 F. 3d 749 (5th Cir. 1996); ***Magnum Estate vs. Commissioner***, 184 F. 3d 749 (9th Cir 1999).

D. Sale to an Intentionally Defective Grantor Trust. Some clients choose to sell the residence at its fair market value to an intentionally defective grantor trust in exchange for a promissory note (bearing interest at the required Section 7520 rate) with the requisite "seed money" down payment gifted to the grantor trust (and the corresponding GST exemption allocated to create a zero inclusion ratio).

1. Example. Client sells a $10,000,000 home to a grantor trust for the lifetime benefit of her children, with the remainder passing to lifetime trusts for grandchildren, great-grandchildren, etc. for the longest duration permitted under the state rule of perpetuities.

2. Advantages.

(a) Uses lower interest rate "hurdle" (1.96% for 9 year note versus 2.4% AFR for June 2017 QPRT gift).

(b) Neutral income tax effect.

(i) Capital gain tax on the sales proceeds paid by grantor, not the grantor trust.

(ii) No income tax on the interest paid by the grantor trust to the grantor.

(iii) Likewise, the grantor trust need not report the rental income (and cannot deduct the real estate taxes paid by the grantor trust).

(c) Eliminates mortality risk

(d) Can allocate generation-skipping tax exemption to the grantor trust.

(e) Can refinance note when beneficial.

(f) Can waive grantor trust power.

(g) Transfer "net rent" to trust for younger generation which could be used (after payment of required expenses of residence) for:

(i) Payment of interest and principal on note; and/or

(ii) Current needs of the trust beneficiaries.

3. **Disadvantages**.

(a) More complicated to establish and administer than a QPRT.

(b) No statutory safe harbor protection.

E. Reporting Gift of Property to a QPRT or GRAT

1. **Purpose**

(a) The transfer of property to a GRAT or QPRT should be disclosed on a United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) in the year the transfer is made. This will begin the running of the statute of limitations.

(b) After the statute of limitations has run, the Service is barred from examining the nature of the transfer and the basis for the value reported on the Form 709.

(c) If adequate disclosure does not occur, the statute of limitations is not tolled and the Service can audit the transfer at any time, which may lead to additional tax and interest and potential penalties.

2. **Adequate Disclosure Requirements**[12]

(a) The requirements for adequate disclosure on Form 709 include:

(i) A description of the transferred property and any consideration received by the transferor.

(ii) The identity of, and relationship between, the transferor and transferee(s).

(iii) The trust's tax identification number and <u>either</u>:

a. a brief description of the terms of the governing trust, or

b. a copy of the trust instrument.

(b) Either:

(i) An appraisal, which must:

12 Treas. Reg. § 301.6501(c)-1(f)(2)

(ii) Be prepared and signed by an individual who:

a. holds himself out to the public as an appraiser or regularly performs appraisals;

b. is qualified to make appraisals of type of property being valued, based on qualifications described in appraisal; and

c. is someone other than the donor or donee, is not a member of the family of the donor or done, or an employee of the donor or donee.13

(iii) Provide the following:

a. date of the transfer, date of the appraisal, and the purpose of appraisal;

b. description of the transferred property;

c. description of the appraisal process;

A. description of the assumptions, conditions, and restrictions affecting the appraisal;

B. all of the information considered in determining the appraised value;

C. the procedures followed and the underlying reasoning;

D. the valuation method used, the rationale for method, and the procedure used in determining the fair market value of the transferred property; and

E. the specific basis for valuation.

OR

d. A detailed description meeting the following requirements:

F. The financial data (e.g. balance sheets with explanations of adjustments) utilized in determining the value);

G. The restrictions on transferred property considered in determining the fair market value; and

H. The description of adjustments claimed in valuing the transferred property (e.g. discounts for blockage, minority or fractional interests, and lack of marketability).

e. If the transferred property is an interest in an actively traded entity on an established exchange, the description must also include:

I. A recitation of the exchange where the interest is listed;

J. The CUSIP number of the security; and

K. The mean between the highest and lowest quoted selling prices on the valuation date.

f. If the transferred property is an interest in an entity not actively traded, the description must include:

L. Any discounts claimed in valuing the interests in the entity or the assets owned by the entity;

M. The net asset value of the entity;

N. The pro rata portion of the entity transferred and

O. The fair market value of the interest transferred as reported on the return.[14]

g. If the entity in which the interest was transferred is not actively traded and owns an interest in a non-

14 If the fair market value of the entity is properly determined without regard to the net asset value, then this statement may be omitted. However, the Regulations place the burden of proof on the taxpayer to demonstrate that the value is properly determined by some other method.

actively traded entity, then the description must provide the information required in (ii) above for the second entity if the information is relevant and material in determining the value of the first entity.

AND

(b) A statement describing any position taken that is contrary to proposed, temporary, or final Treasury Regulations or revenue rulings published at the timer of the transfer.

F. Qualified Appraiser Required

1. The appraisal must be performed by a *qualified appraiser*.

2. Treas. Reg. § 1.1704-13(c)(5)(iv) provides that the following persons cannot be qualified appraisers:

   (a) The donor or taxpayer reporting the sale on his, her or its income tax return, a member of the donor, donee or selling taxpayer's family;

   (b) Any party to the transaction in which the donor or seller acquired the subject property, unless the property is transferred within two months of acquisition and the appraised value does not exceed the acquisition price;

   (c) The person(s) or business entities receiving or purchasing the subject property;

   (d) An employee of the person or organization listed above;

   (e) Any person related to, or married to a person related to, a person or organization listed in I.R.C. § 267(b); or

   (f) An appraiser regularly used by an excluded person described in (1)-(3) above and who does not perform the majority of appraisals made during the taxable year for other persons.

G. Adequate Disclosure Requirements Specific to Transfers of Interests in Corporations, Partnerships and Trusts

1. In order to adequately disclose the transfer of an interest in a corporation, partnership, or trust,[15] the taxpayer must provide the below ***in addition to*** the requirements listed above:

15 Such a transfer is subject to the special valuation rules of I.R.C. §§ 2701, 2702.

(a) A description of the transaction, including a description of the transferred and retained interests and the method(s) used to value each;

(b) The identity of, and relationship among the following parties:

1. The transferor;

2. The transferee;

3. All persons participating in the transaction; and

4. All parties related to the transferor holding an equity interest in any entity involved in the transaction;

5. A detailed description of the method used to determine the amount of the gift arising from the transfer or taxable event, including actuarial factors and discount rates used;

AND

(c) If the transfer is of an entity interest not actively traded, a detailed description of all financial and other data used in determining the value, which will generally include:

1. Balance sheets;

2. Statements of net earnings;

3. Operating results; and

4. Dividends paid for each of 5 years immediately before the valuation date.