Grantor Trusts, including Sales to Grantor Trusts*

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I. INTRODUCTION TO GRANTOR TRUSTS

A. Section 671 -- Tax Effect of Grantor Trust Status

(1) When the grantor or another person is treated as the owner of any portion of a trust, the grantor (or other person) shall include [on the grantor's income tax return] those items of income, deduction, and credits against tax of the trust which are attributable to that portion.

(2) What is "income"?

Treas. Reg. 1.671-2(b) states, "Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes." To refer to income for trust accounting purposes, the phrase "ordinary income" is used.

B. Overview of the Rules – When is a Trust a Grantor Trust?

(1) If grantor has retained a reversionary interest under Section 673.

(2) If grantor or non-adverse party has certain powers over the beneficial interests in the trust under Section 674.

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit under Section 675.

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor under Section 676.

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse under Section 677.

C. Who is the Grantor?

(1) The grantor is any person to the extent that person either:

(a) Creates a trust; or

(b) Directly or indirectly makes a gratuitous transfer of property to a trust.

D. What is a Gratuitous Transfer?

(1) Any transfer other than a transfer for fair market value.

(a) Transfer does not need to be a completed gift.

(b) A transfer by an entity not for a business purpose is a transfer by the owners.

E. What about a Trust to Trust Transfer?

(1) In general, the grantor of the transferor trust will be treated as the grantor of the transferee trust.

(2) An exception applies if a person exercises a general power of appointment in favor of another trust.

F. Is the "Grantor" taxed?

(1) Not necessarily because a person who is a grantor is not necessarily an "owner."

(2) To be an owner, one must make a gratuitous transfer to the trust.

G. What are the Obligations of a Grantor?

(1) A grantor can have the obligation to file tax returns with respect to the trust (e.g. under Section 6048 for a foreign trust).

(2) Thus, if an attorney creates a trust for a client with $100 and is reimbursed, both are grantors, but only the client is an owner.

H. Will a 678 Power Make You a Grantor?

(1) No.

(2) For example, if a trustee exercises a power to create a second trust after the grantor's death and retains the power to revoke the second trust, the grantor of the original trust is the grantor of the new trust, BUT the trustee is the "owner" of the new trust.

II. TO WHAT EXTENT IS A TRUST A GRANTOR TRUST?

A. The Extent of Grantor Trust Status Is Determined by the "Portion" Rule

(1) Reg. §1.671-3 says a portion may consist of specific trust property, an undivided fractional interest, an interest represented by a dollar amount, only ordinary income or only income allocated to corpus.

(2) A power over corpus can cause the grantor to be taxable on the ordinary income portion as well if ordinary income may be accumulated and thus become subject to the power over corpus.

(3) If a grantor or another person is treated solely as the owner of the ordinary income portion, the grantor will be taxed in the same manner as a current

income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income.

B. Exercise of a General Power

(1) Makes the powerholder the grantor of the new trust, even if the original trust was a grantor trust.

(2) It seems that no other power will change the grantor of the transferee trust.

III. COLLATERAL TAX EFFECTS OF CREATING A GRANTOR TRUST

A. Under Rev. Rul. 2004-64, 2004-2 C.B. 7

(1) The fact that a trust is a grantor trust and the tax attributes of the trust are reported by the grantor will cause neither grantor nor any beneficiary to be treated as making a taxable gift to the trust.

(2) Discretionary power of reimbursement for income taxes paid by the grantor, by itself, will not cause estate tax inclusion.

B. Additional Requirements under Rev. Rul. 2004-64

(1) If trustee has a discretionary power to reimburse the grantor for income taxes paid.

- (a) Grantor may not act as a trustee.
- (b) Grantor may not remove and replace trustees with related and subordinate parties.
- (c) State law must prohibit creditors from accessing the trust by reason of the reimbursement power.
- (d) No implied understanding to exercise the power.

C. Other Consequences of Creditors' Rights

(1) Gift to the trust is incomplete.

- (a) If grantor can relegate her creditors to the trust then the grantor will be deemed to have retained dominion and control.

(2) Some States have reversed this rule relative to a reimbursement power.

D. What if Trustee Must Reimburse?

(1) Automatic estate tax inclusion

(a) BUT should it be 100% since the effective tax rate is not 100%?

(b) Maybe the fact that income allocated to corpus could produce a taxable gain in excess of accounting income is enough to capture the entire trust.

IV. CREATING A GRANTOR TRUST

A. What Methods Might Be Used to Create a Grantor Trust?

(1) Powers of disposition

(2) Spouse as a discretionary beneficiary

(3) Power of substitution

(4) Power to add beneficiaries

(5) Power of appointment

(6) Actual borrowing

(7) Power to borrow

(8) Decanting

B. Power of Disposition by a Related and Subordinate Party

(1) 674(a) states that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(2) Adverse Party/Nonadverse Party

(a) An adverse party is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. A general power of appointment is a beneficial interest, but not automatically substantial.

(b) A nonadverse party – Everyone else.

(3) Independent Trustee Exception

(a) 674(c) says that 674(a) shall not apply to a power exercisable solely by a trustee none of whom is the grantor (or the grantor's spouse) and no more than half of whom are related and subordinate parties who are subservient to the wishes of the grantor.

(4) 672(c) – Related and Subordinate Party

(a) Grantor's spouse **who is living with the grantor**, grantor's father, mother, sister, brother, issue, employee, subordinate employee of a corporation in which grantor is an executive, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from viewpoint of voting control.

(b) Related and subordinate party is presumed subservient unless shown not to be by a preponderance of the evidence.

(5) 672(e) – Spousal Unity Rule

The spousal unity rule of under 672(e) says the grantor is treated as holding any power or interest held by any individual (i) who was the grantor's spouse at the time of the creation of the power or interest (but not considered married if legally separated) or (ii) who became the spouse after the creation of the power or interest.

(6) Reasonably Definite Standard

(a) 674(b)(5) creates an exception for a power to distribute **corpus** provided the power is limited by a reasonably definite standard that is set forth in the trust instrument.

(b) And 674(d) states that 674(a) shall not apply to a power exercisable by a trustee (not the grantor or spouse living with the grantor) to distribute, apportion or accumulate **income** to or for the benefit of beneficiaries if such power is limited by a reasonably definite **external** standard which is set forth in the trust instrument.

(7) Conclusion

To achieve a wholly grantor trust, you need a power of disposition not limited by a reasonably definite (external) standard held by trustees more than half of whom are related and subordinate parties who are subservient to the wishes of the grantor.

(8) What Estate Tax Implication Would That Have?

(a) Rev. Rul. 2004-64 implies that a trustee who is not independent may be presumed to exercise authority in the grantor's favor pursuant to an implied understanding that would attract 2036 inclusion.

(b) Would that apply to a power exercisable in favor of persons other than the grantor?

(9) Rev. Rul 95-58, 1995-2 C.B. 191

(a) Rev. Rul. 95-58 dealing with the donor's retention of a power to remove and replace the trustee states that a power to remove a trustee and replace that trustee with a person that is not related and subordinate to the donor (within the meaning of 672(c)) would not cause the donor to be treated as having retained the trustee's discretionary control over trust income.

(b) Rev. Rul. 95-58 does not address the initial appointment of a related and subordinate trustee.

(c) In *Estate of Vak. v. Commissioner*, 973 F. 2d 1409 (8th Cir. 1992), the initial trustees were related and subordinate trustees and the settlor retained the power to remove the trustees at any time and replace them with trustees who were not related and subordinate to the settlor. Court held the gift to the trust was complete.

(d) Toggling Off

(i) Grantor could retain the power to remove the related and subordinate trustees and replace them with an independent trustee.

(ii) But the grantor cannot have the power to toggle back on by appointing related and subordinate trustees because of Rev. Rul. 95-58.

(10) Problem for an Installment Sale to a Grantor Trust

Generally want independent trustees engaging in the arms length sale of assets from the grantor to the trust to enhance the position that it is a bona fide sale for full and adequate consideration, arm's length and free from donative intent.

(11) Good for an Irrevocable Life Insurance Trust

(a) It might be the right power to use in an ILIT where you want to preserve your opportunities to shift around the policies under Rev. Rul. 2007-13, 2007-11, I.R.B. 684.

(b) Rev. Rul. 2007-13 says that moving a policy for value into a wholly grantor trust qualifies as a transfer to the grantor and is therefore excepted from the application of the transfer for value rule under section 101(a)(2) that would cause the proceeds of a policy that has been transferred for value to be includible in income. Exceptions to the rule exist for transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, and a corporation in which the insured is a shareholder or officer, as well as transfers if the transferee has, at least in part, a carryover basis.

(12) Power over more that 5% of Corpus

(a) 674(b)(3) creates an exception to grantor trust status for a power which can affect beneficial enjoyment only after the occurrence of an event such that the grantor would bit be treated as an owner if the power were a reversionary interest.

(b) In PLR 200846001, the IRS ruled that a power not limited by a standard held by a related and subordinate trustee to distribute the income and principal of a GRAT upon the expiration of the GRAT term, where the actuarial value of the remainder interest exceeded 5%, was sufficient to cause the trust to be a wholly grantor trust. This type of power would also work well for a charitable lead annuity trust, although both GRATs and CLATs are less tax efficient if the remainder is not zero or near zero.

C. Grantor's Spouse As A Discretionary Beneficiary Under 677(A)(1) or (2)

(1) "Spouse" appears to mean person to whom you are married and the provision applies "during the period of the marriage" according to the regulations, but would include income accumulated for future distribution to the grantor's spouse after the grantor's death.

(2) 677(a)(1) and (2) provide that the grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or in the discretion of the grantor or a nonadverse party or both, may be, distributed to the grantor or the grantor's spouse or accumulated for future distribution to the grantor or the grantor's spouse.

(3) Wholly Grantor Trust

(a) If the trust is to be WHOLLY grantor, the power needs to extend also to "taxable income" allocable to corpus. One possibility is to make the spouse a discretionary beneficiary as to both income and corpus.

(b) Alternatively, make the spouse a discretionary income beneficiary and give the spouse a special power of appointment over the corpus at his death (which would flunk the exception under 674(b)(3) applying the spousal unity rule as to income allocated to corpus that would be deemed accumulated for future disposition by the grantor).

(4) Toggling Off

(a) May present a difficulty in toggling off if you use this method to achieve grantor trust status because the spouse must be removed as a beneficiary.

(b) Even the relinquishment of a discretionary interest by the spouse may have gift tax consequences (albeit difficult to quantify).

(c) One possibility would be to give an independent trustee the power to remove the spouse as a beneficiary, but consider the challenge the trustee would face exercising that power.

(5) Other Problems

(a) Grantor trust status would terminate at the spouse's death.

(b) Spouse cannot split a gift to a trust where spouse's interest cannot be quantified.

(c) If the spouse splits gifts to the trust with the grantor, that will not have any implication other than for gift and GST tax purposes, e.g., if the spouse is a trustee with powers of disposition that do not implicate 2036 or 2038.

D. Power of Substitution

(1) Under 675(4)(C), the power exercisable in a non-fiduciary capacity without the approval or consent of a person in a fiduciary capacity to "reacquire the trust corpus by substituting other property of an equivalent value."

(2) Two Problems

(a) Is the power really held in a non-fiduciary capacity?

(b) Does the existence of the power held in a non-fiduciary capacity create estate tax inclusion concerns?

(3) PLR 20060304; PLR 200606006

IRS refused to rule favorably on the estate tax inclusion issues under 2033, 2036, 2038 and 2039 without a representation that the power was held in a fiduciary capacity.

(4) Estate of King

(a) *Estate of King v. Commissioner*, 37 T.C. 973 (1962), decedent was in the professional banking business and retained investment control over the trust estate.

(b) Each trust provided for income to child for life and remainder to child's issue, *per stirpes*.

(c) Government argued 2036(a)(2) and 2038 alleging the grantor could increase the interests of the life income beneficiaries to the detriment of the remainder beneficiaries, the grantor could dispose of the assets for little or no consideration, and the grantor had an unlimited right to substitute assets of unequal value.

(d) Court held the grantor was constrained by NY law, and his actions were subject to the review of a court in equity.

(e) Therefore, the grantor was in effect a fiduciary and was not at liberty to administer the trust for his own benefit or to ignore the rights of the beneficiaries, even though he no doubt would be permitted wide latitude in the exercise of this discretion as to the types of investments to be made.

(f) HELD, no estate tax inclusion.

(5) Estate of Jordahl

(a) *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975) is to the same effect. Life insurance trust over which decedent retained a power of substitution not only as to the policies but also as to the securities and other property in the trust.

(b) Court held that substitutions of property of equal value could not result in shifts of beneficial interests.

(c) Powers would have to be exercised in good faith in accordance with fiduciary responsibility.

(d) Equivalent to a power to direct investments.

(e) Power to substitute policies is not an incident of ownership under 2042.

(f) The requirement of equal value would seem to demand equal cash surrender and face value, comparable premiums and a similar form of policy.

(6) What are the limits on a substitution power?

(a) Can you substitute high income assets for low income assets with an equal fair market value?

(b) It seems that you can substitute one publicly traded stock for another.

(7) Revenue Ruling 2008-22, 2008-16 I.R.B. 796

(a) We think they are trying to help.

(b) Deals only with Section 2036 and 2038.

(c) May not deal with Section 2036(b).

(d) Does not deal with Section 2042. (See Revenue Ruling 2011-28 discussed below).

(e) Ruling provides guidance on whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 if the grantor retained the power, exercisable in a non-fiduciary capacity, to acquire property held in trust by substituting other property of equivalent value.

(f) Substitution will not, by itself, cause the value of the trust corpus to be includible in grantor's gross estate if the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of the power by:

(i) Satisfying itself that the properties acquired and substituted are in fact of equivalent value; and

(ii) The substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

(g) <u>Revenue Ruling 2008-22 – Facts</u>

(i) Trust for D's descendants.

(ii) D is prohibited from serving as trustee.

(iii) D must certify in writing that the substituted property and the trust property are of equivalent value.

(iv) The trustee has a duty of impartiality in investing and managing trust assets.

(v) Local law, without restriction in the trust instrument, confers on trustee power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition and manage the trust property.

(h) <u>Revenue Ruling 2008-22 -- Holding</u>

Trustee's fiduciary obligation to ensure grantor's compliance with the terms of the power may be under local law or the trust instrument.

(i) <u>Revenue Ruling 2008-22 -- Analysis</u>

(i) Trustee has duty to "prevent" the exercise of the power if assets being substituted have a lesser value.

(ii) Therefore, D cannot exercise power in a manner that would reduce the value of the trust corpus.

(iii) Duty of impartiality requires T to prevent shifting of benefits between or among the beneficiaries.

- What is meant by "shifting benefits"?
- Either trustee has duty of impartiality and can reinvest, or

(iv) Nature of trust investments or level of income does not impact the respective interests of the trust beneficiaries, such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.

(j) Word of Caution

(i) In PLR 200910008, the IRS in the facts recites that the grantor had a power of substitution which, pursuant to section 675(4), would cause the trusts to be grantor trusts. But the conclusion makes the alarming assertion that under the terms of the trusts "the power to reacquire assets of the trust by substituting property of equivalent value affects beneficial enjoyment. Accordingly, the grantors are treated as owners . . . under 674(a)"!

(8) Revenue Ruling 2011-28, 2011 I.R.B. 830

(a) <u>Revenue Ruling 2011-28 – Facts</u>

(i) D establishes an irrevocable trust for D's descendants, with T as trustee. D is prohibited from serving as trustee.

(ii) Subsequently, the trust purchases a life insurance policy on D's life. The proceeds of the policy are payable to the trust upon D's death.

(iii) D makes yearly gifts to the trust. The trust pays the premiums on the life insurance.

(iv) The trust agreement provides D with a substitution power, exercisable by D in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. To exercise the power, D must certify in writing that the substituted property and the trust property are of equivalent value.

(v) Local law requires the trustee to ensure that the property D seeks to substitute is of equivalent value. Local law also requires the trustee to act impartiality in investing and managing trust assets. Local law, without restriction in the trust instrument, confers on trustee power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition and manage the trust property.

(vi) D has no incidents of ownership in the insurance policy unless D's right of substitution is considered as such.

(vii) D dies without having exercised the substitution power.

(b) <u>Revenue Ruling 2011-28 – Holding</u>

A grantor's retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under section 2042, provided that the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries.

(c) Revenue Ruling 2011-28 – Analysis

(i) Section 2042, incidents of ownership, refers to right of the insured to the economic benefits of the policy, i.e. change beneficial ownership in policy or proceeds, or time or manner of enjoyment thereof. Treas. Reg. 20.2042-1(c)(2),(4).

(ii) Rev. Rul. 84-179, decedent transferred insurance policy to his wife and subsequently reacquired incidents of ownership in a fiduciary capacity. Ruling held no incident of ownerships, provided the decedent could not exercise the powers for the decedent's personal benefit and devolution of the powers was not part of a prearranged plan.

(iii) *Estate of Jordahl* (previously discussed).

(iv) Rev. Rul 2008-22 (previously discussed).

(v) Given terms of trust, D cannot exercise the power to substitute assets in a manner that will reduce the value of the trust corpus or increase D's net worth.

(vi) Duty of impartiality requires T to prevent shifting of benefits between or among the beneficiaries.

(vii) A substitution power cannot be exercised in a manner that can shift benefits if (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries.

(9) Substitution Clause. The Settlor shall have the power (the "Power of Substitution"), by an instrument signed and acknowledged by the Settlor and delivered to the Trustees of any trust created hereunder, to reacquire any property held in such trust (the "Original Property") by substituting other property of equivalent value (the "New Property"). The Power of Substitution shall be exercisable, in the sole discretion of the Settlor, at any time or from time to time and in a nonfiduciary capacity, without the approval or consent of the Trustees or of any other person acting in a fiduciary or a nonfiduciary capacity. It is the intention of the Settlor that

the Power of Substitution shall constitute a power described in Section 675 of the Code. The Trustees shall have the obligation to ensure that the New Property is property of equivalent value to the Original Property. Furthermore, the Power of Substitution may not be exercised in a manner that may shift benefits among the trust beneficiaries. The Settlor may surrender the Power of Substitution at any time, with respect to any trust created hereunder, by an instrument signed and acknowledged by the Settlor and delivered to the Trustees of such trust. If, after such surrender, the Settlor is treated (under Subpart E, Part 1, Subchapter J, Chapter 1 of the Code) as the owner of all or part of such trust, then such person(s) then authorized to appoint additional Trustees of such trust shall appoint so many additional non-related, non-subordinate Trustees so that at no time more than half the Trustees of such trust are related to or subordinate to the wishes of the Settlor within the meaning of Sections 672(c) and 674(c) of the Code.

(10) What about using a third party?

(a) Statute refers to "any person" which appears to override the use of the word "reacquire".

(b) Third party with a substitution power should not be a trust beneficiary without special drafting to avoid Sections 2041 and 2042.

(c) Alternatively, use the spouse.

E. Power to Add to Class of Beneficiaries

(1) Exception to the exception appears five times in Section 674.

(2) *Madorin v. Commissioner*, 84 T.C. 667 (1985) court assumed the power conferred grantor trust status and relinquishment of the power eliminated grantor trust status

(3) A 679 perspective would say if you can add someone, that person is already deemed to be a beneficiary.

(4) But it must mean something.

(5) Other difficulties

(a) Fiduciary discomfort.

(b) Do the persons added have to receive something for it to be real?

(6) Some solutions

(a) Give the power to a non-fiduciary.

(b) Draft the trust so that when a beneficiary is added something beneficial for the existing beneficiaries occurs – such as broader discretion to distribute or required distributions.

(c) Require some distributions to the persons added to the class.

F. Power of Appointment

(1) A presently exercisable power of appointment held by a nonadverse party not acting as a trustee should make a trust a wholly grantor trust.

(2) Should work even if the power holder would be considered independent.

(3) Consider using a related and subordinate party in case the power is deemed held in fiduciary capacity.

(4) Provide for succession of power holders.

G. Actual Borrowing by the Grantor or the Grantor's Spouse – 675(3)

(1) 675(3) says that the grantor will be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year.

(2) Does not apply if the loan is made for adequate interest and adequate security, if the loan is made by a trustee other than the grantor and other than a related and subordinate trustee subservient to the grantor.

(3) Applies to "spouse" as defined in 672(e)(2) meaning married to and not legally separated from the grantor.

(4) Rev. Rul. 85-13

(a) Rev. Rul. 85-13, 1985-1 C.B. 184, stands for the proposition that transactions between a grantor and her grantor trust are ignored for income tax purposes.

(b) But it also states that if the grantor purchases all the assets of her trust for a note, the trust becomes a grantor trust simultaneously, and there is no gain recognition as a result of the purchase itself.

(c) Facts of 85-13, unsecured promissory note with adequate interest.

(d) IRS views the transaction as an indirect borrowing.

(e) Be aware that *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984) is to the contrary. Court held that the transaction constituted an indirect borrowing and caused the trust to become a grantor trust, BUT the transaction itself resulted in gain recognition.

(5) What about Rosen?

(a) If the loan is without adequate security, does Rosen say that it is not arms length, bona fide and for full and adequate consideration?

(b) If you use a related and subordinate party trustee maybe that raises other concerns because it is a transaction with the grantor.

(c) So the issue arises have you cleared the 2036 and 2038 hurdles?

(6) Rev. Rul. 86-82, 1986-1 C.B. 253

(a) States that the trust is a grantor trust for the entire year.

(b) Does that permit you to reverse engineer grantor trust status?

(7) Grantor trust to what extent?

(a) Appears, under *Bennett v. Comm'r,* 79 T.C. 470 (1982), that the trust may be a grantor trust only as to the portion directly or indirectly borrowed.

(b) Therefore, to make the trust wholly grantor, must borrow/purchase the entire corpus.

(c) May present practical obstacles or valuation issues.

(8) <u>Lending.</u> To lend such sums out of the income (other than of any trust that qualifies for the marital deduction under either Federal or state law) or principal of the trusts hereunder, with or without adequate security, and upon such other terms and conditions as they deem advisable. Notwithstanding the foregoing, the Trustees, in their absolute discretion, may lend such sums as they deem advisable (other than any insurance policies held hereunder) to the Settlor without adequate security, provided, however, that the Trustees may irrevocably release and waive such power to lend by delivering written notice of such release and waiver to the Settlor and each adult income beneficiary.

H. Power to Borrow

(1) Section 675(2) covers a power exercisable by the grantor or a nonadverse party, or both, that enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.

(2) Exception where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Need to negate the general lending power.

(4) Should use only an independent trustee to avoid 2036 and 2038 implications.

(5) Probably should only permit loans to the grantor without adequate security.

(6) See PLR 200840025 (non-adverse trustee with power to make loans, with or without security, to the settlor was sufficient to make the trust a grantor trust).

I. Decanting to Achieve Grantor Trust Status

(1) States with a statute (23 states):

   (a) Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin, Wyoming (as of May 2015).

(2) What is Decanting?

   (a) *Phipps v. Palm Beach Trust*, 142 Fla. 782 (1940) held that a trustee with absolute discretion to distribute principal among a class of beneficiaries may distribute to a new trust for a member of the class.

   (b) Is in the nature of a power of appointment.

   (c) Can be used to confer a power of appointment.

(3) GST concerns?

   (a) Depends on whether the trustee is deemed to have had the power since the inception of the trust.

(b) Issues are shifting beneficial interests to lower generations or extending the time for vesting.

(c) If converting to a grantor trust is not a gift, should not be a GST event.

(4) Adding powers to cause grantor trust status

(a) Could the trustee do this without the grantor's consent?

(b) Would the trustee do this without the grantor's consent?

(c) What is the effect of the grantor's actual or implied consent?

(5) If you don't have decanting in your State

(a) Add a clause to your governing instrument.

(b) Change situs and governing law to a State that permits decanting – may require court approval depending on the governing instrument. Alaska permits decanting if the trust has an Alaska trustee and the trustees, by an acknowledged statement, shift the principal place of administration to Alaska.

(c) Probably best to have the power in the hands of an independent trustee in any event.

J. Section 677(a)(3)

(1) Grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

(2) In general, under old case law, thought to require the trust actually to own a policy – *see Rand v. C.I.R.*, 40 B.T.A. 233 (1939), *aff'd,* 116 F.2d 929 (8th Cir. 1941) and *Iverson v. Comm'r.*, 255 F.2d 1 (8th Cir. 1958).

(3) Actual payment of premiums, even if in violation of the trust agreement, may nevertheless cause grantor trust status – PLR 8839008.

(4) DANGER – IRS NSAR 20062701F

(a) Provisions of foreign trust authorizing the purchase of life insurance on the grantor's life caused the trust to be a grantor trust.

K. Section 678(a)

(1) A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(a) Such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself, or

(b) Such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(2) Section 678(b)

Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(3) Genesis of Section 678

(a) *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945)

(i) Held if grantor taxable as owner because grantor held certain broad powers then third person should also be taxable as a trust's owner if third person holds similar broad powers.

(ii) Trustees were to distribute trust income to the beneficiary upon his request.

(4) 678 and Ascertainable Standard

Under *U.S. v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960 *en banc*) and *Funk v. Comm'r,* 184 F.2d 127 (3rd Cir. 1950), an ascertainable standard (needs, maintenance and comfort) bars income taxation to the beneficiary.

(5) What about trumping?

In PLR 200730011, the beneficiary of the trust had a 30 day power of withdrawal. The grantor's spouse (who was also the trustee) had the power to **withhold** distributions of trust principal (a power not excepted under section 674(b)). The IRS ruled that under Treas. Reg. 1.671-3(b)(3), the spouse's power over corpus includes both ordinary income and income allocable to corpus making the trust wholly grantor.

Accordingly, the grantor was treated as the owner of the entire trust under Sections 674(a) and 678(b).

(6) What happens when the grantor dies?

(a) Who knows?

(b) Two rulings issued on same facts where wife created a trust for husband and gave husband a 30 day power of withdrawal.

(i) PLR 9026036 says powerholder becomes the owner under 678(a).

(ii) PLR 9321050 says powerholder does not become the owner.

L. Using Section 679

(1) If a U.S. person, directly or indirectly, transfers assets to a foreign trust and if there is a U.S. beneficiary of any portion of the trust, the trust is automatically a grantor trust under Section 679 with respect to the portion attributable to the property transferred.

(2) Can make a trust a foreign grantor trust by giving a foreign person a veto power over a substantial power over the trust.

(3) Difficulties with Section 679

(a) Substantial reporting obligations.

(b) Need a relationship with a foreigner.

(c) Section 684 could apply on the grantor's death to cause an income recognition event.

V. REPORTING OBLIGATIONS FOR A GRANTOR TRUST

For an excellent article on such reporting obligations, see Scott Bowman & Ivan Taback, Frequently Asked Questions on Grantor Trust Tax Reporting, 39 ESTPLN 34, 39 (2012).

A. In General

(1) A grantor trust is ignored for income tax purposes and all items of income, deduction and credit are treated as belonging directly to the grantor. This applies to any portion of a trust that is treated as a grantor trust.

(2) The income taxable to the grantor or another person under sections 671 through 678 and the deductions and credits that apply to that income must be reported by that person on their own income tax return.

(3) Husband and wife joint settlors: If married filing jointly, treated as one grantor. If married filing separately, it is necessary to determine in what proportion each spouse is treated as the owner based on the assets that each transferred, and then tax items are allocated to each spouse in proportion to ownership.

B. How to Report – Default Method: Treas. Reg. 1.671-4(a)

(1) If the entire trust is a grantor trust, only complete the entity information of Form 1041. Do not show any dollar amounts on the form itself; show dollar amounts only on an attachment to the form. Do not use Schedule K-1 (Form 1041) as the attachment. It is merely an information return.

(2) If only part of the trust is a grantor type trust, the portion of the income, deductions and credit that is allocable to the non-grantor portion of the trust is reported on Form 1041 under normal reporting rules. The amounts that are allocable directly to the grantor are shown only on an attachment to the form. Do not use Schedule K-1 (Form 1041) as the attachment. However, Schedule K-1 is used to reflect any income distributed from the portion of the trust that is <u>not</u> taxable directly to the grantor or owner.

(3) In any case, the fiduciary must provide the grantor of the trust a copy of the 1041 Attachment. The Attachment must show:

(a) The name, identifying number, and address of the person(s) to whom the income is taxable;

(b) The income of the trust that is taxable to the grantor or another person under sections 671 through 678. The income is reported in the same detail as it would be reported on the grantor's return had it been received directly by the grantor;

(c) Any deductions or credits that apply to this income. Report these deductions and credits in the same detail as they would be reported on the grantor's return had they been received directly by the grantor.

(d) The income taxable to the grantor or another person under sections 671 through 678 and the deductions and credits that apply to that income must be reported by that person on their own income tax return.

(4) The fiduciary, or an authorized representative, must sign Form 1041. If there are joint fiduciaries, only one is required to sign the return.

C. How to Report – Optional Method 1: Treas. Reg. 1.671-4(b)(2)(i)(A)

(1) For a grantor trust treated as owned by one grantor or one other person, the trustee must provide all payers of income during the tax year the name and TIN of the grantor or person treated as the owner ("other owner") and the address of the trust.

(2) The grantor or owner must provide the trustee with a signed Form W-9, Request for Taxpayer Identification Number and Certification.

(3) Unless the grantor or other owner of the trust is the trustee or a co-trustee of the trust, the trustee must provide the grantor or other owner a statement that:

(a) Shows all items of income, deduction, and credit of the trust;

(b) Identifies the payer of each item of income;

(c) Explains how the grantor or other as owner takes those items into account when figuring the grantor's or other person's taxable income; and

(d) Informs the grantor or other owner that those items must be included when figuring taxable income and credits on his or her income tax return.

(4) Grantor trusts that have not applied for an EIN and file under Optional Method 1 do not need an EIN for the trust as long as they continue to report under that method.

D. How to Report – Optional Method 2: Treas. Reg. 1.671-4(b)(2)(i)(B)

(1) For a grantor trust treated as owned by one grantor or by one other person, the trustee must provide all payers of income during the tax year the name, address, and TIN of the trust.

(2) The trustee also must file with the IRS the appropriate Forms 1099 to report the income or gross proceeds paid to the trust during the tax year that shows the trust as the payer and the grantor or other owner as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately. The due date for any Forms 1099 required to be filed with the IRS by a trustee under this method is March 2, 2015 (March 31, 2015, if filed electronically).

(3) Unless the grantor or other owner of the trust is the trustee or a co-trustee of the trust, the trustee must provide the grantor or other person treated as owner of the trust a statement that:

(a) Shows all items of income, deduction, and credit of the trust;

(b) Explains how the grantor or other owner takes those items into account when figuring the grantor's or other owner's taxable income; and

(c) Informs the grantor or other owner that those items must be included when figuring taxable income and credits on his or her income tax return. This statement satisfies the requirement to give the recipient copies of the Forms 1099 filed by the trustee.

E. How to Report – Optional Method 3: Treas. Reg. 1.671-4(b)(1)

(1) For a trust treated as owned by two or more grantors or other persons, the trustee must provide all payers of income during the tax year the name, address, and TIN of the trust.

(2) The trustee also must file with the IRS the appropriate Forms 1099 to report the income or gross proceeds paid to the trust by all payers during the tax year attributable to the part of the trust treated as owned by each grantor, or other person, showing the trust as the payer and each grantor or other owner as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately. The due date for any Forms 1099 required to be filed with the IRS by a trustee under this method is March 2, 2015 (March 31, 2015, if filed electronically).

(3) The trustee must provide each grantor or other person treated as owner of the trust a statement that:

(a) Shows all items of income, deduction, and credit of the trust attributable to the part of the trust treated as owned by the grantor or other person;

(b) Explains how the grantor or other owner takes those items into account when figuring the grantor's or other owner's taxable income; and

(c) Informs the grantor or other owner that those items must be included when figuring taxable income and credits on his or her income tax return. This statement satisfies the requirement to give the recipient copies of the Forms 1099 filed by the trustee.

F. Optional Methods Unavailable to Certain Trusts

(1) Certain trusts are not permitted to report under the alternative methods and must use the default method. These trusts include:

(a) Trusts that have a situs outside the U.S.

(b) Trusts that are treated as having one (or more) owner who is not a U.S. person.

(c) Qualified Subchapter S trusts

(d) Trusts that are treated as owned by a single owner whose tax year is a fiscal year (in which case the trust must file based on this fiscal year).

(e) Common Trust Funds under Section 584(a).

G. Changing Filing Methods

(1) A trustee who previously had filed Form 1041 can change to one of the optional methods by filing a final Form 1041 for the tax year that immediately precedes the first tax year for which the trustee elects to report under one of the optional methods.

(2) On the front of the final Form 1041, the trustee must write "Pursuant to section 1.671-4(g), this is the final Form 1041 for this grantor trust," and check the Final return box in item F.

(3) For more details on changing reporting methods, including changes from one optional method to another, see Regulations section 1.671-4(g).

VI. ANTI-GRANTOR TRUST PROPOSALS IN OBAMA'S BUDGET PLAN

A. The Estate Planning Technique: Selling Assets to a Grantor Trust

(1) Selling assets to a grantor trust in exchange for a promissory note enables the grantor to "freeze" the appreciate in his or her estate at the applicable federal rate payable on the note and then allow any appreciation greater than the APR to escape inclusion in the grantor's gross estate. The greater the appreciation, the greater the transfer tax benefit achieved.

(2) With a grantor trust, this note sale can be done without causing an income taxable event. No gain is recognized and no interest income results from the interest payable on the promissory note.

(3) The benefit of this technique is increased in that the grantor is liable for the income taxes generated by the grantor trust's investments, allowing the grantor to make a "tax free gift" of the income taxes to the trust.

B. The Proposal: ("Grantor Trust Transfer Tax" or "GTT" tax)

(1) Proposal provides that to the extent a trust is treated as a grantor trust:

(a) Assets of the trust would be included in the grantor's estate and subject to estate tax;

(b) Termination of grantor trust status would result in the entire value of the trust being subject to gift tax; and

(c) Distributions from the trust during the grantor's lifetime would be subject to gift tax.

(2) Proposal would apply to:

(a) Any person deemed to be an owner of the trust under the grantor trust rules of all or a portion of a trust and who engages in a sale, exchange, or comparable transaction with the trust that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust.

(i) Amount subject to GTT tax would be the portion of the trust attributable to property received in the transaction (including all retained income, reinvestments, and appreciation) less the consideration received by the deemed owner.

(ii) GTT tax would be reduced by the value of any taxable gift made to the trust. GTT tax would be payable from the trust.

(b) 2013 Greenbook: Any trusts created on or after date of enactment; Any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment.

(c) 2016 Greenbook: Grantor trusts that engage in a described transaction on or after the date of enactment.

(3) Proposal would not apply to:

(a) Trusts already includable in the grantor's gross estate under existing law, such as GRATs and QPRTs.

(b) 2015 and 2016 Greenbook: "[Proposal] also would not apply to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor's spouse."

(c) 2014 Greenbook: "[Proposal] also would not apply to any trust that is a grantor trust solely by reason of section 677(a)(3)."

(d) 2013 Greenbook: No mention of irrevocable trusts with life insurance or Section 677(a)(3).

(4) Regulatory authority would be granted, including ability to create exceptions to this provision.

C. Comments on the Proposal

Breadth of the proposal fails to consider the nuanced policies underlying the grantor trust rules and the transfer tax rules that have resulted in material differences between the two regimes. If the proposal becomes law, three significant estate planning areas would be impacted dramatically:

(1) First, proceeds of life insurance policies owned by traditional life insurance trusts may be estate tax includible under the GTT tax, but note that such trusts would be excluded under the 2016 and 2015 proposals, but not under the 2014 and 2013 proposals.

(a) If Proposal becomes law, IRS could potentially rely on plain language and a stricter reading of Section 677 to find a back door toward inclusion of life insurance proceeds held in a traditional life insurance trust.

(i) Section 677(a)(3) treats the grantor as the owner of any portion of a trust whose income can be used to pay life insurance premiums on a policy insuring the life of the grantor of grantor's spouse, without the consent of an adverse party.

(ii) Unsettled issue is what portion of the trust is treated as a grantor trust.

(iii) Certainly, grantor is treated as owner of the income actually used to pay insurance premiums.

(iv) Plain language of Section 677 does not require actual payment of insurance premiums.

(v) Case law[1] and a revenue ruling[2] indicate that the *power* to pay premiums from income without an *actual payment* will not necessarily cause grantor trust attribution.

(vi) Because of this authority, practitioners are leery of relying solely on a Section 677(a)(3) power to cause a traditional life insurance trust to be a grantor trust.

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[1] Weil v. Comm'r, 3 T.C. 579 (1994), *acq.* 1944 C.B. 29; Iversen v. Comm'r, 3 T.C. 756 (1944); Rand v. Comm'r, 40 B.T.A. 233 (1939), *acq.* 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1940), *cert denied*, 313 U.S. 594 (1941).
[2] Rev. Rul. 2004-64

(vii) As a result, drafters will often supplement the power to pay life insurance premiums with one or more other grantor trust powers.

(b) This would undermine the well-established policy governing the estate tax includibility of life insurance proceeds under Section 2042.

(i) Section 2042 already provides the hallmark of estate tax includibility where the decedent has retained an "incident of ownership" over the insurance policy.

(ii) Thus, the entire premise of a traditional life insurance trust is to sever the incidents of ownership from the insured's ability to continue to fund premiums through periodic contributions or form the trust assets.

(iii) To infuse grantor trust rules into this equation and override the well-established incidents of ownership test would create uncertainty as to the estate tax includibility of the death benefit of life insurance policies.

(c) Even if it were possible to structure a life insurance trust so that it is not a grantor trust (thereby avoiding GTT tax), a grantor could not sell a life insurance policy to the trust without serious income tax consequences. Current law allows the death benefit of a life insurance policy payable to the trust to pass free of income tax because a grantor's sale of a life insurance policy to a grantor trust comes within the exceptions to the transfer-for-value rules of Section 101(a).

(2) Second, a trust of which the grantor's spouse is a beneficiary may be subject to the GTT tax.

(a) Sections 677(a)(1) and (2) provide that a grantor is treated as the owner of any portion of a trust whose income, without the consent of an adverse party, may be distributed to the grantor's spouse or held or accumulated for future distribution to the grantor's spouse.

(b) Many common estate planning techniques may include a grantor's spouse as a beneficiary of a trust created by the grantor, including traditional life insurance trusts.

(c) The effect of the proposal would be that any trust of which the grantor's spouse is a beneficiary would be subject to the GTT tax, unless distributions of income were subject to the consent of an adverse party.

(d) Even if the Section 677(a)(3) issue can be avoided, the grantor could not include his or her spouse as a beneficiary during the grantor's lifetime on account of Sections 677(a)(1) and (2), or the grantor would risk GTT tax upon his or her death.

(e) The implications are broader than the effect on traditional life insurance trusts. For example, while GRATs and QPRTs would be exempt from the GTT tax, continuation trusts following the GRAT or QPRT term would not be.

(f) Often, a grantor may wish to include his or her spouse as a discretionary beneficiary following the term. Doing so, however, would defeat the benefits of the technique, as the appreciation inuring to the continuation trust during the term, and accruing in the continuation trust subsequent to the term, would be subject to the GTT tax.

(g) The proposal would subject to the GTT tax trusts for the benefit of a spouse for which a marital deduction wasn't claimed. So, all the planning with "spousal lifetime access trusts," or "SLATs" that is in vogue with the current $5 million exemption would be defeated by the GTT tax.

(3) Third, any trust that contains discretionary distribution powers among multiple beneficiaries (i.e., a sprinkle power) must have an independent trustee.

(a) Section 674(a) provides that a grantor is treated as the owner of any portion of a trust if the beneficial enjoyment of the income or corpus is subject to a discretionary power held by a nonadverse party and exercisable without the approval or consent of any adverse party.

(b) Section 674(c) provides an exception to this rule in the case of a discretionary sprinkle power if no more than half the trustees are related or subordinate to the grantor.

(c) The effect of the proposal, in conjunction with Section 674, is that to avoid the GTT tax, any trust with a sprinkle power must have at least half the trustees be independent.

(d) The practical implication is that a grantor would need to identify a non-family member or a bank or trust company to serve as an independent trustee or cotrustee, including on traditional life insurance trusts owning second-to-die life insurance policies.

(e) Notwithstanding the donor's release of dominion and control under traditional gift tax concepts and the estate tax includibility provisions of Sections 2035 through 2044, the proposal would result in the imposition of GTT tax where a grantor's family members serve as the only trustees.

(f) For the many clients who already struggle with the need to disclose intimate financial information as part of the estate planning process, forcing them to look outside of the family for fiduciaries may create a significant impediment in encouraging these clients to plan.

VII. SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

Referring to the transaction as a sale to an "intentionally defective" grantor trust ("IDGT") emphasizes that the grantor is purposefully creating a trust that will cause himself or her to be treated as the owner of the assets for federal income tax purposes but not for estate tax purposes.

A. Steps of the Transaction

(1) The grantor creates irrevocable dynasty trust for the benefit of his children and grandchildren.

(2) The grantor seeds the trust with a gift equal to at least 10% of the value of the assets to be purchased by the trust. The gift uses the grantor's applicable credit amount and the grantor allocates GST exemption to the gift.

(a) Unlike a GRAT, a grantor can allocate GST exemption to an IDGT at the time of funding because there is no estate tax exclusion period ("ETIP").

(3) The grantor and trust "wait for the dust to settle."

(4) The trust purchases the grantor's appreciating assets with a promissory note. The note is often structured as an interest-only balloon note (repayment of principal is deferred until the end of the term), with a 9-year term and an interest rate equal to the mid-term Applicable Federal Rate ("AFR").

Because the transaction occurs between the grantor and the grantor trust, there are no income tax consequences and no recognition of gain or loss.

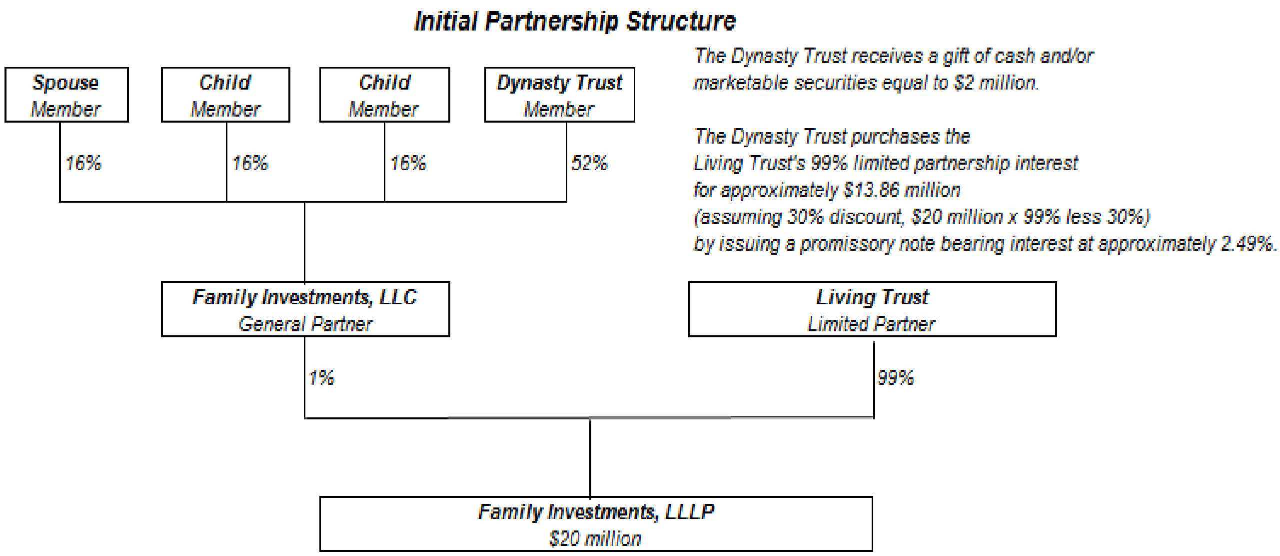
(5) As a grantor trust, the grantor is not taxed on the interest payments on the note, but the grantor continues to be taxed on all yearly income or loss generated by the trust assets.

(6) At the end of the term (i.e., 9 years), the principal of the note is paid back to the grantor in cash or in kind (or the term of the note is extended) and

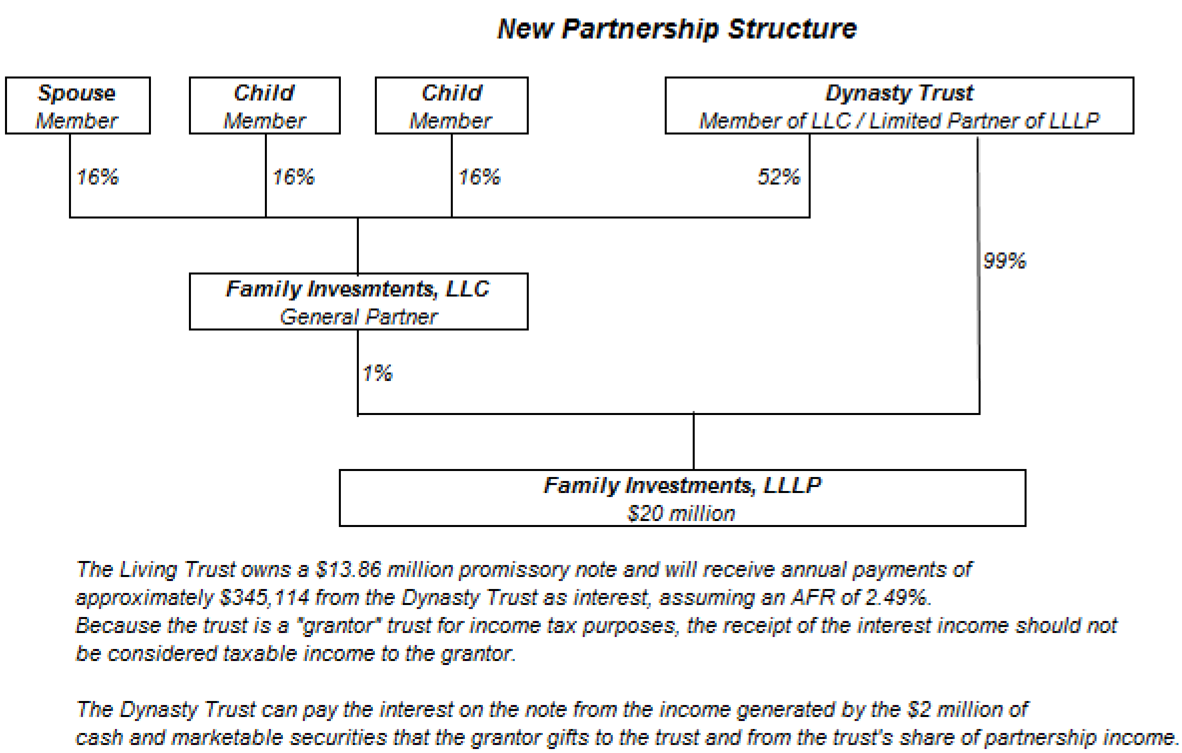
any appreciation of the trust assets in excess of the AFR passes to the beneficiaries free of any transfer tax.

B. Sale to IDGT using a Partnership Structure - $20 million securities portfolio

(1) Initial Partnership Structure



(2) New Partnership Structure



C. Latest IRS attack on Sale to IDGT

(1) *Estate of Donald Woelbing v. Commissioner of Internal Revenue*, Docket No. 30261-13 and *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13.

(a) Mr. Woelbing sold all of his non-voting stock in a closely-held company (Carmex lip balm maker Carma Laboratories Inc.) to an insurance trust in exchange for a promissory note (approx. $59 million) with an interest rate equal to the AFR.

(b) Purchase price of the stock was determined by an independent appraiser.

(c) The note contained a defined value provision which stated that the number of shares purchased would automatically adjust if the IRS determined the value of the stock to be different than the appraised value.

(d) The trusts owned life insurance policies on the Woelbings' lives. Carma Laboratories was obligated to pay the insurance premiums and the trust was obligated to repay the company for its advances on the premiums after both spouses passed away.

(e) Two of the trust beneficiaries (Woelbing sons) executed personal guarantees to the trust for 10% of the stock purchase price.

(2) The IRS is arguing (1) that section 2702 applies to the sale of stock to the IDGT (that the interest payments on the note are not qualified interest payments and, thus, the value of the retained interest in the notes is $0; (2) if section 2702 does not apply, that the transaction constitutes a taxable gift equal to the diference between the fair market value of the stock and the note received in exchange; and (3) the stock should be included in the Woelbing estate under sections 2036 and 2038.

D. Should a Sale Be Disclosed on a Gift Tax Return?

(1) Adequate Disclosure Rules

(a) Erring on the side of caution, the grantor should adequately disclose the sale of a closely held entity to the grantor trust on a gift tax return even if there was no gift component to the transaction.

(b) If adequately disclosed, a sale transaction with a zero value gift will commence the statute of limitations period for the IRS to review the transaction. The statute of limitations applicable to assessment of the gift tax is generally three years as provided by section 6501(a). Once that limitations period passes, the values in the transaction will be deemed “finally determined.”

(c) If no return is filed or if adequate disclosure is not made (or the filed return is false or fraudulent), the statute of limitations remains open indefinitely.

(d) Adequate disclosure requirements are found in Treasury Regulation section 301.6501(c)-1(f)(2). The requirements are:

(i) Description of transferred property and any consideration received by the transferor;

(ii) Identity of, and relationship between, the transferor and transferee;

(iii) If property is transferred in trust, the trust’s tax ID number and either: (a) a brief description of the terms of the governing trust, or (b) a copy of the trust instrument;

(iv) Either of an appraisal meeting certain requirements, or a detailed description meeting certain requirements:

<u>Appraisal Requirements</u>:

- (1) Prepared and signed by an individual who holds himself out to the public as an appraiser or regularly performs appraisals, (2) is qualified to make appraisals of the type of property being valued based on qualifications described in the appraisal, and (3) is someone other than the donor, donee, member of the family of the donor or donee, or employee of the donor, donee or member of the family of donor or donee,

- Provides: (1) date of the transfer, date of the appraisal and purpose of the appraisal;
  (2) description of the transferred property;
  (3) description of the appraisal process;
  (4) description of assumptions, conditions, and restrictions affecting the appraisal; (5) all information considered in determining the appraised value; (6) procedures followed and underlying reasoning; (7) the valuation method used, rationale for method, and procedure used in determining fair market value of the transferred property; and specific basis for valuation.

Detailed Description requirements:

- Includes: (1) financial data utilized in determining value; (2) restrictions on transferred property considered in determining value; (3) description of adjustments (i.e., discounts) claimed in valuing the transferred property.

- If the transferred property is an interest in actively traded entity on an established exchange: (1) recitation of the exchange where the interest is listed; (2) CUSIP number of the security; and (3) the average between highest and lowest quoted selling prices on valuation date.

- If the transferred property is an interest in an entity that is not actively traded: (1) discounts claimed in valuing interests in entity or assets owned by the entity; (2) net asset value of the entity; (3) pro rata portion of the entity transferred; and (4) fair market value of the interest transferred as reported on the return (although (4) may omitted if the value is determined without regard to the net asset value. The taxpayer bears the burden of demonstrating that the value is properly determined by the other method used).

(v) Statement describing any position taken contrary to proposed, temporary, or final Treasury Regulations or revenue rulings published at the time of the transfer.

(2) Disclosure on the Estate Tax Return

(a) If the grantor's estate is required to file an estate tax return upon the grantor's death, the transaction will have to be disclosed.

(b) Form 706, Part 4, Question 13e, asks if the decedent, at any time during his or her lifetime, transferred or sold an interest in a partnership, limited liability company, or closely held corporation to a trust in existence at the time of the decedent's death which was created by the decedent during life.

(c) If the grantor had previously adequately disclosed the transaction on a gift tax return and the statute of limitations period passes before the estate tax return is filed, the IRS will not be able to challenge the reporting of the sale transaction.

(d) Thus, disclosing the sale on a gift tax return, rather than waiting for the filing of the estate tax return, has its advantages.

(e) Would disclosure be required under Question 13e if, for example, the trust to which the decedent had sold the interest was no longer in existence at the time of death on account of a trust decanting? It seems the correct response would be to not disclose the transaction, because the interest was not sold to a trust that was in existence at the time of the decedent's death, but rather, sold to a predecessor trust that has since terminated.