Strategic Estate Planning for Another Year of Change*

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Chapter 6
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Synopsis

Strategic Estate Planning for Another Year of Change[1]

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¶ 600 Introduction

The world faced numerous uncertainties in 2020, many of which have spilled over into 2021. The world of estate planning was not immune to these factors, and the calendar year 2021 brings with it the potential for a rapidly shifting environment that will make estate tax planning even more critical.

During the calendar year 2020, many taxpayers were able to avail themselves of the increased U.S. estate and gift tax exemption of $11.58 million. Faced with a potential "use it or lose it" opportunity, many taxpayers elected to fully utilize the "bonus" gift tax exemption. Many others took a "wait and see" approach to see if the increased exemption would remain available in 2021. These taxpayers may have had reservations, remembering the rush in 2012 to take advantage of a soon expiring increased gift tax exemption that instead was increased in 2013.

The calendar year 2021 brings its own uncertainties and challenges to planners, but also presents a number of planning opportunities. In addition to the potentially still available increased gift tax exemption (currently $11.7 million), the continuance of low interest rates, low values, and traditional wealth transfer techniques all contribute to an environment that can facilitate some powerful wealth transfer approaches. With some creativity, individuals can "supercharge" a number of traditional planning structures by re-evaluating structures, challenging the status quo, and thinking "outside the box" to make full use of traditional techniques and approaches, but in different ways.

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The content in this article is general in nature and should not be viewed as specific planning advice. While planning is discussed, taxpayers need to consider factors outside of tax, such as economic, social, and related variables when evaluating their overall estate plan.

The views reflected in this article are those of the authors and do not necessarily reflect the views of the global EY organization or its member firms or Greenberg Traurig, P.A.

¶ 601 Approaches Under a Biden Administration

¶ 601.1 Using the "Bonus" Gift Tax Exemption During Uncertainty Period

With the Biden Administration and a Democratic-controlled Senate in place in 2021, planners and clients are trying to determine the best course of action to take. As of the time of writing this outline, there is uncertainty over whether the "Bonus Exemption" will remain available for taxpayers for some or all of 2021, or if the increased exemption may be reduced, perhaps retroactively to January 1, 2021, to pre-TCJA levels or even to some lower amount. The challenge is to create approaches that will allow clients to use the bonus exemption, if and to the extent it remains available in 2021, but also to "do no harm, should the law change," particularly, should a change be enacted with retroactive effect. This means that providing flexibility so that if a taxpayer makes a transfer to absorb what they think would be their remaining gift tax exemption amount under the law as it currently exists (referred to herein as the "Assumed Bonus Exemption[2]"), there is a mechanism in place to avoid a taxable gift and the payment of gift taxes should the law change such that the exemption amount is reduced retroactively. There are a number of "toggle" type approaches that might be considered.

¶ 601.2 Sale for Note – Potential for Subsequent Cash Gift

In a typical installment sale to a grantor trust, a grantor trust purchases assets from its grantor for an installment note. The note usually provides for payments of interest only for a period of time followed by a balloon principal payment at maturity.

In the current economic climate, individuals who have implemented an installment sale to a grantor trust may find that the transaction is **"**underwater." An underwater sale is one in which the fair market value of the asset purchased by the trust and not used to pay off the installment note has fallen below the outstanding principal due on the installment note.

One possibility would be to lower the interest rate on the installment note to a current market rate.[3] This simple step can have a surprisingly beneficial effect on the outcome.

The interest rate used for an installment sale is generally determined by the applicable federal rate under Section 1274, rather than the higher Section 7520 rate, and those rates are exceptionally low at the present time.[4] The interest rate on a nine-year note issued in March 2021 would be only 0.56 percent. Implementing an installment sale to a grantor trust when interest rates are low, and using a long term note to lock in that rate, has the potential to accomplish substantial wealth transfer, even if rates of return are assumed to be conservative. The benefits are significantly enhanced if the purchasing trust is also exempt from GST tax.

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[2] It should be noted that unless a taxpayer gifts assets in excess of the expected exemption level after a tax law change, the taxpayer will not receive a benefit from utilizing their Bonus Exemption.

[3] *See* J. Blattmachr, B. Crawford, E. Madden, "*How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*," Journal, J. of Taxation, Vol. 109, No. 1, p.22 (2008).

[4] The Section 7520 rate is the mid-term AFR times 1.2 and rounded to the nearest even two-tenths of one percent. It is possible that the short-term AFR or long-term AFR could be greater than the Section 7520 rate. All references to a "section" or "Section" are to a section of the Internal Revenue Code of 1986, as amended.

One relatively straightforward way to plan for uncertainty is to engage in a sale of assets, ideally to a grantor trust, for fair market value equal to the taxpayer's Assumed Bonus Exemption, should it remain intact. The sale could be in exchange for a promissory note with interest imposed at the applicable federal rate ("AFR"). If the higher exemption remains applicable, the taxpayer could make gifts of cash or other assets to the trust to absorb the exemption. The taxpayer could also transfer the promissory note, perhaps to a different grantor trust with different terms. The original trust could enter into a program to repay the promissory note in installments over time, or perhaps could prepay the promissory note. The repayment of the loan over time may be more beneficial in that it would allow both the purchased assets as well as the gifted assets to grow in the grantor trust.

If, however, the bonus exemption is reduced retroactively, then there should not be any taxable gift in this scenario since the sale transaction would presumably be made for full and adequate consideration. Of course, there is always a risk that the IRS could assert that the asset sold had a higher fair market value than the consideration received. This risk can be mitigated to some extent through the use of defined value or price adjustment mechanisms

It is critical that the promissory note be respected as bona fide debt in order to avoid recharacterization of the sale as a deemed gift. The *Bolles* case[5] serves as a recent reminder of the need to create and properly administer any loan transactions, taking into consideration a number of different factors in order to prevent the loan from being recharacterized as a deemed gift, either from inception or at some point during the life of the loan, under certain circumstances.

¶ 601.3 Formula Allocation Gift

One approach may be to make a current gift transfer out of the donor's name that is structured as a formula allocation type of gift, which would split the transferred assets into a share equal to the donor's available gift tax exemption amount (whatever that amount may be) as of the date of the transfer and the excess amount. While the actual amount of the donor's available gift tax exemption may not be known at the time of the transfer, at some point it will be clear what amount was available at the time of the transfer. Once the law is settled and the amount of the available exemption is clear, then that amount would be allocated (along with a pro-rata share of any post transfer appreciation) to a trust for the donor's beneficiaries, which would absorb his/her available gift tax exemption (the "Exemption Share"). The excess over the Exemption Share (the "Excess Share") would be allocated to a recipient that would not trigger a gift tax, for instance an marital deduction trust such as a general power of appointment trust under Section 2523(e),[6] a grantor retained annuity trust ("GRAT"), an incomplete gift trust, or even a charitable organization.

For instance, donor makes a current gift of say $7 million, relinquishing dominion and control, so as to ensure that the gift is "complete" for gift tax purposes.[7] If we assume that it is determined later in the year that the bonus gift tax exemption will not remain in place for all of 2021, as a result of which donor's available gift tax exemption amount as of the date of the gift

[5] *Estate of Bolles v. Comm'r*, T.C. Memo 2020-71 (June 1, 2020).

[6] A qualified terminable interest property trust or "QTIP trust" is not preferred because it is not permissible to make a protective QTIP election with respect to a inter vivos QTIP trust.

[7] Treas. Reg. Section 25.2511-2(b).

was $5.5 million, then 78.5714 percent (5.5/7) of the transferred $7 million and any appreciation since the transfer will be allocated to the Exemption Share, and the remaining balance will be allocated to the Excess Share. Thus, if the $7 million has appreciated to $7.2 million by the time of the allocation of the shares, $5.6574 million will be allocated to the Exemption Share and the balance of $1.5426 million would be allocated to the Excess Share.

While one might consider making a straight formula gift of assets equal in value to the donor's available gift tax exemption amount as determined to exist on the date of the gift, one concern with this approach is whether such an approach would give rise to risks of an incomplete gift. If, for instance, the assets are not transferred until such time as the amount of the donor's available gift tax exemption is determined, then query whether the donor has not made a completed gift until such time. If the exemption is reduced in the meantime, then the donor risks possibly having made a completed gift at that later date when a lower exemption might apply. Another concern is that a straight formula gift may protect the taxpayer from a gift tax adjustment but may not protect the taxpayer from a second-look at death to determine the portion of the transferred property that remains includible in the taxpayer's gross estate.[8]

¶ 601.4 Gift into QTIP-Eligible Marital Trust

Another approach would be for taxpayer to make a gift equal to the Assumed Bonus Exemption into a marital trust for the lifetime benefit of taxpayer's spouse for which a QTIP election could be made (or not made). If the bonus exemption remains intact, the taxpayer would not make a QTIP election in his/her gift tax return, thereby resulting in a taxable gift. In such case, while the marital trust would be held for the lifetime benefit of the taxpayer's spouse, the assets would not be subject to estate taxation upon the spouse's death since no QTIP election would have been made.

If, however, the bonus exemption amount is retroactively reduced, then taxpayer would make a QTIP election on his/her gift tax return, thereby allowing the gift in the amount of the Assumed Bonus Exemption to qualify for the lifetime marital deduction under Section 2523, or potentially make a partial QTIP election to the extent of the amount in excess of the available exemption. Thus, no taxable gift would occur, and the marital trust will qualify as a QTIP trust to the extent desired, which would then be included in the spouse's gross estate under Section 2044 upon his/her death.

The benefit of this approach is that a QTIP election would not need to be made until the gift tax return for 2021 is filed, which would be April or potentially October of 2022.

¶ 601.5 Gift into Marital Trust Subject to Qualified Disclaimer

A variation on the above would be for taxpayer to make a gift equal to the Assumed Bonus Exemption into a marital trust for the lifetime benefit of taxpayer's spouse. If the bonus exemption remains intact, the spouse/beneficiary could make a qualified disclaimer of his/her interest in the marital trust under Section 2518, as a result of which the assets in the trust would pass into a trust

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[8] *See* A. Bramwell and B. Dillon, "Not Another *Wandry* Article: Real Issue with *Wandry* Formulas," 41 Estate Planning 5 (May, 2014).

for the benefit of the grantor's descendants. This would cause the grantor's transfer to be a taxable gift into the trust, which would absorb the Assumed Bonus Exemption amount.

If, however, the bonus exemption amount is retroactively reduced, then the spouse would not disclaim the interest in the marital trust, or would partially disclaim the interest in the marital trust, in which case the gift would qualify for the gift tax marital deduction to the extent of the portion not subject to the disclaimer. Some special considerations would need to be carefully navigated depending upon the type of marital trust used. If, for instance, the marital trust would be designed to qualify as a QTIP trust, then there are some special timing considerations. The QTIP trust would require that all income be distributed to the spouse beneficiary annually; however, in order to preserve the ability to make a qualified disclaimer of an interest in trust under Section 2518 it is critical that no distribution be received by the beneficiary, in this case, the spouse. Thus, in the case of a gift into a marital trust made later in the year, it may be possible that the spouse may have less than nine months in which to execute a qualified disclaimer if the ability to make a QTIP election is to be preserved.

It is important to note that in the disclaimer strategy, the disclaimer must be made within nine months of the transfer to the trust in order to be a qualified disclaimer. However, the strategy could be coupled with the QTIP election strategy discussed above.

¶ 602 Proactive Planning with Section 2701 and Preferred "Freeze" Partnerships[9]

Preferred partnerships are often referred to as "Freeze Partnerships" because such partnerships effectively "freeze" the return of one class of partnership interests at a fixed rate. Such interests are preferred relative to the common interests, in that they have priority over the common interests with respect to the payment of a fixed coupon on the holder's investment and up liquidation of the entity. They do not, however, participate in the upside growth of the partnership, as all the future appreciation in excess of the preferred coupon and liquidation preference inures to the benefit of the common "growth" class of partnership interests, typically held by the younger generation or trusts for their benefit. The preferred interests are typically held by the senior generation family member.

¶ 602.1 Structuring the Preferred Interest

A parent's preferred partnership interest is typically structured as a "qualified payment right" in accordance with Section 2701 to prevent the parent's contribution of assets to the Preferred Partnership from being a deemed gift under the Section 2701 "zero valuation" rule. To be a qualified payment right, the parent generally must receive a fixed percentage payment on his or her capital contribution, payable at least annually, and on a cumulative basis. The use of this "qualified payment right" structure will result in the parent's preferred interest being valued under

[9] This discussion was originally included in N. Todd Angkatavanich, *Warming Up To Preferred Partnership Freezes: Multiple Planning Applications with This Versatile Vehicle*, 51st Annual Heckerling Institute on Estate Planning, January 2017. For excellent additional comprehensive discussions of Preferred Partnership planning, *see generally* Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle*, 35-3 Univ. of Miami Law Center on Est. Planning (Jan. 2001). *See also* Paul S. Lee & John W. Porter, *Family Investment Partnerships: Beyond the Valuation Discount* (Sept. 2009), *available at* http://apps.americanbar.org/rppt/meetings_cle/joint/2009/Materials/Stand_Alone_Programs/LeeFamilyInvestmentPartnershipsOutlineSeptember2009.pdf.

traditional valuation principles for gift tax purposes, and not the unfavorable "zero valuation rules" of Section 2701.

Typically, the preferred interest would also provide parent with a priority liquidation right in addition to the preferred coupon; meaning that upon liquidation, parent will first receive a return of his or her capital before the common interest holders receive their capital. Parent, however, will not receive any of the potential upside growth in the Preferred Partnership above his or her preferred interest. Anything in excess of the amount needed to pay the preferred coupon will accrue to the benefit of the common interest holders (i.e., child, or trust for the child's benefit).

¶ 602.2 Valuation of the Preferred Coupon

Even if the parent's preferred interest is properly structured to avoid what some have called the "draconian" aspects of Section 2701, there are still deemed gift issues to consider, as the foregoing structuring merely makes the parent's distribution right component of the preferred interest not valued at "zero" for purposes of determining parent's deemed gift to younger generation family members. However, there may still be a partial gift under traditional valuation principals if the parent's retained preferred coupon is less than what it would have been in an arm's-length situation. For example, if the parent's retained coupon under the partnership agreement is a five percent coupon, but a seven percent return would be required in an arm's-length transaction, then a deemed gift has still been made by the parent to the extent of the shortfall, albeit not as dramatic a gift as would occur by violating Section 2701.

A vital step in arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal in order to determine the preferred coupon required for the parent to receive value equal to par value for his or her capital contribution. In preparing the appraisal, the appraiser should consider the factors set forth by the IRS in Rev. Rul. 83-120.[10] The starting point under this guidance is to analyze comparable preferred interest returns on high quality publicly traded securities. Additional factors for consideration include: the coverage of the preferred coupon and liquidation preference, the size and stability of the partnership's earnings, asset coverage, management expertise, business and regulatory environment and any other relevant facts or features of the Preferred Partnership.

The partnership's "coverage" of the preferred coupon, which is its ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the partnership, will be important factors in determining the required coupon. A higher percentage of the partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for this greater risk. Conversely, a partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage, which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint, as growth above the lower coupon will shift to the younger generation owning the common interests.

[10] Rev. Rul. 83-120, 1983-2 C.B. 170.

¶ 602.3 Gift Tax Formation Issues

There are various issues that must be considered in connection with the formation of a newly created Preferred Partnership. The most notable issue is Section 2701 of the Code, which generally can result in a deemed gift upon a Senior Family Member's capital contribution of assets into a Preferred Partnership in which he or retains senior equity interests, unless very specific requirements are satisfied with respect to the Senior Family Member's preferred interest. A "transfer" that can potentially trigger a deemed gift under Section 2701 is broadly defined and includes not only traditional gift transfers, but also capital contributions to new or existing entities, redemptions, recapitalizations or other changes in the capital structure of an entity.[11]

¶ 602.4 Liquidation Preference

In addition to being entitled to a preferred coupon payment, the preferred interest would typically provide the Senior Family Member with a priority liquidation right, meaning that upon liquidation, Senior Family Member will receive a return of his or her capital before the common interest holders receive a return of their capital. Senior Family Member, however, will not receive any of the potential upside growth in the Preferred Partnership based on his, her or its preferred interest.[12] Anything in excess of the amount needed to pay the preferred coupon and liquidation preference will accrue to the benefit of the common interest holders (i.e., child, or a trust for the child's benefit).

¶ 602.5 Subtraction Method of Valuation

If Section 2701 applies to a transfer, the value of an interest transferred to a Junior Family Member will be determined by subtracting from the value of all family held interests the value of the interest retained by the Senior Family Member. A deemed gift will occur from the Senior Family Member to the Junior Family Member to the extent of the value of all family held interests, less the value of any interests retained by the Senior Family Member, as determined under the Subtraction Method of valuation.[13]

¶ 602.6 Preferred Partnerships and Qualified Payment Right Election Alternatives

Preferred partnership structures can provide some interesting ways to effectively "toggle" whether a capital contribution into a partnership in exchange for a preferred interest would constitute a taxable gift under Section 2701 or not. While a comprehensive discussion on preferred partnerships is outside the scope of this discussion, generally, a capital contribution could be made into a partnership that would constitute a "transfer" under Section 2701, which could result in a deemed gift by the taxpayer receiving the preferred interest. Taxpayer's children or a trust for their benefit would receive the common interest (presumably by way of initial capital contribution). Taxpayer could make a capital contribution equal to the Assumed Bonus Exemption in exchange for a preferred equity interest that would be structured as a Qualified Payment Right

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[11] Treas. Reg. Section 25.2701-1(b)(2)(i).

[12] Typically, the Senior Family Member will also retain at least a one percent common interest to ensure that his or her preferred interest is not recharacterized as debt. Such common interest would participate by its terms in any upside experienced by the Preferred Partnership.

[13] Treas. Reg. Section 25.2701-1(a)(2).

(“QPR”)[14], which would ensure that no deemed gift would occur under Section 2701, as a default position.

If, however, the bonus exemption is retroactively reduced, then no deemed gift should occur, since the preferred interest would be structured to qualify as a QPR. If, however, the bonus exemption remains intact, then taxpayer could make a “election out” of QPR status on a timely filed gift tax return under Section 2701(c)(3)(C)(i).6.[15] As a consequence, taxpayer’s preferred equity interest would be valued at zero, thereby causing a deemed gift in the amount of the capital contribution amount equal to the Assumed Bonus Exemption amount. It should be noted, however, that under this approach, it is critical that that the coupon be adequate in order to not have a deemed gift under traditional valuation principles, even if the preferred is structured as a QPR.[16] Unlike valuation discounts for non-controlling interests in a family entity, there is no significant body of case law setting forth the range of acceptable coupons for a preferred partnership.

A variation on the preferred partnership would be for the preferred interest to, as a default matter, be structured to not qualify as a QPR on its face, but to be susceptible to being administered as a QPR. In such case, assuming that the bonus exemption remains intact, then the capital contribution would constitute a “transfer” and thus a deemed gift under Section 2701, which would absorb the Assumed Bonus Exemption amount. If, however, the bonus exemption remains intact, then taxpayer could make an “election in” to QPR treatment, thus ensuring that no deemed gift would occur under Section 2701.[17]

At the donor’s death, the value of the preferred interest is includable in the gross estate. The mitigation rule in Treas. Reg. Section 25.2701-5(a)(3) makes the zero-value rule less significant since the donor’s estate will be reduced by the same amount as the gift value was increased due to the zero-value rule.

Another possibility is that the preferred interest could be structured to fall outside the "qualified payment" exception by, for example, providing for non-cumulative preferred payments and a put right equal to the liquidation preference. Under the subtraction method of valuation, the distribution right attributable to the preferred interest would be given a value of zero, as would the put right as an extraordinary payment right, resulting in a taxable gift equal to nearly all, or perhaps all, of the full value of the parent’s contribution to the partnership (taking into account any applicable valuation discounts).

While this may seem like a worst case scenario, as the retained preferred interests would trigger a deemed gift and would still be included in the taxpayer’s taxable estate at death, as discussed above, the Treasury Regulations under Section 2701 provide for an offsetting adjustment for the prior taxable gift to prevent double taxation. The adjustment is equal to:

[14] Section 2701(c)(3)
[15] Treas. Reg. Section 25.2701-2(c)(1) and (5).
[16] *See* Rev. Rul. 83-120, 1983-2 C.B. 170.
[17] Treas. Reg. Section 25.2701-2(c)(2).

> "the amount by which the initial transferor's taxable gifts were increased as a result of the application of Section 2701 to the initial transfer."[18]

Stated differently, the adjustment permitted in the Treasury Regulations will effectively "net out" the value of the preferred interest included in the taxpayer's taxable estate.[19] Moreover, the Treasury Regulations would appear to allow the full offset to the taxpayer's estate even if the exemption amount is decreased between the time of the deemed gift and the parent's death.[20] The non-cumulative nature of the retained preferred interest permits the parent to retain a somewhat flexible income stream during his or her lifetime, although the potential implications of Section 2036 favor substantial compliance with the terms of the partnership agreement.

¶ 603 Overcoming Inertia

Notwithstanding the opportunities, clients are unlikely to be motivated to engage in substantial lifetime estate planning when interest rates are low, and values are depressed. For many clients, this may be the first time they have had to contemplate lifestyle changes because of the uncertain economic outlook. Further dilution by current wealth transfers may be challenging to accept.

Lower interest rate environments provide certain estate planning opportunities. Approaches that do not involve substantial or long-term transfers of wealth might prove the most attractive to individuals who are not feeling financially secure. In addition, methodologies that transfer wealth in trust so that the trustee may directly or indirectly benefit the grantor will provide greater comfort. Restructuring planning that has already been implemented to enhance the after-tax benefits might be particularly attractive as no new wealth transfer would be involved. A failed prior strategy might be renewed to advantage, and depressed values might even make direct gifts an attractive and highly leveraged opportunity.

One method to overcome the psychological and economic impediments to current wealth transfer planning is the use of trusts. A trust as the recipient of a current wealth transfer affords many important flexibilities. The client can, within the constraints of Rev. Rul. 95-58,[21] control the identity of the trustee without adverse estate or gift tax effects. A properly drafted trust will provide the trust beneficiaries with asset protection and thereby avoid the dissipation of family wealth. Asset protection can be accomplished by including spendthrift provisions in the trust instrument. But a wholly discretionary trust will likely provide similar asset protection so long as the beneficiaries are not able to control distributions to themselves by powers of withdrawal or because they are serving as trustees without limitations, either under local law or the governing instrument, on distributions in favor of themselves.[22] Distributions from a trust can be made

[18] Treas. Reg. Section 25.2701-5(a)(3).

[19] Treas. Reg. Section 25.2701-5(d)(3), Ex. 2.

[20] *See* Breitstone, O'Reilly & Spence, Get a GRIP! How to Lock in the Exemption and Still Benefit from It with the Grantor Retained Interest Partnership, LISI Estate Planning Newsletter #2827 (September 29, 2020); Lynagh, Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion, Tax Management Estates, Gifts, and Trusts Journal, 45 EGTJ 03, 05/07/2020.

[21] 1995-2 C.B. 191.

[22] *See, e.g.,* F.S. 736.0504(2)(b) which provides that a wholly discretionary trust does not permit creditors of a beneficiary to attach the assets of the trust prior to distribution.

entirely discretionary, and it will be exceptionally unlikely that any beneficiary can contest, as an abuse of discretion, the trustee's exercise of discretion to constrain distributions.[23]

In view of the foregoing, one possible method for a settlor to keep indirect access to a lifetime trust is for the settlor to include his or her spouse as a discretionary beneficiary. Such a structure should not, by itself, give the spouse the right to demand distributions from the trustee. However, for so long as the settlor and his or her spouse remain married and living together, the trustee could make distributions for the spouse's benefit that would indirectly benefit the settlor, thus providing an element of financial security. The trust could be drafted so as to include the spouse that the settlor is married to at any given time. In addition, if the settlor becomes divorced and the trust is settled in a state that permits self-settled trusts without adverse effects (see discussion below), the settlor could be introduced as a discretionary beneficiary. The ability to become a trust beneficiary upon divorce should not be considered a retained interest in the trust because divorcing one's spouse would be deemed a fact of independent significance.[24]

Importantly, the client can choose to settle the trust in a state with so-called asset protection legislation.[25] In general, a trust created for the settlor's own benefit is available to the settlor's creditors to the extent of the settlor's beneficial interest.[26] If the settlor's interest is discretionary, the trust will deemed available to the settlor to the maximum extent of the trustee's ability to make discretionary distributions in the settlor's favor. Such discretion will have the collateral negative consequence of making the transfer to the trust incomplete for federal gift tax purposes, as well as includible in the settlor's gross estate for federal estate tax purposes.[27]

Whether the assets of a self-settled trust are available to the settlor's creditors should depend upon the law of the state that governs the trust. In *Estate of German v. U.S.,*[28] the decedent, who was not a resident of Maryland, settled trusts governed by Maryland law which provided that during her lifetime:

> "the trustees had the power in their absolute an uncontrolled discretion to pay to or apply for the benefit of the grantor all or any part of the income or principal as the trustees should determine for any reason whatsoever, including the termination of the trust,"

with the written consent of the trust's remainder beneficiary. The court concluded that under Maryland law, the trusts would not be available to the grantor's creditors because distributions to the grantor would require that the grantor obtain the consent of an adverse beneficiary. Because the government could not establish that the trusts were available to the decedent's creditors at the time of her death under Maryland law, the government's motion for summary judgment for

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[23] *See, e.g., Sarasota Bank & Trust Co. v. Rietz,* 297 So. 2d 91 (FL 2nd DCA 1974) ("A trustee's exercise of its discretion is not subject to control by the court except to prevent an abuse of discretion.")

[24] *Estate of Tully v. U.S.,* 208 Ct. Cl. 596 (1976); Rev, Rul. 80-255 1980-2 C.B. 272.

[25] *See, e.g.,* Alaska Stat Section 34.40.110; Del. Code Ann. tit. 12, Section 3570-3576.

[26] *See, e.g., In re Lawrence,* 251 B.R. 630 (S.D. FL 2000), *aff'd,* 279 F.3d 1294 (11th Cir. 2002) ("Florida and federal bankruptcy law both prohibit individuals from setting up self-settled spendthrift type trusts and maintaining the benefits of and the ability to significantly control same, while keeping the assets away from creditors.")

[27] *See* Rev. Rul. 76-103, 1976-1 C.B. 293; *Paolozzi v. Comm'r,* 23 T.C. 182 (1954); *Outwin v. Comm'r,* 76 T.C. 153 (1981); *Estate of Uhl v. Comm'r,* 25 T.C. 22 (1955).

[28] 7 Ct. Cl. 641 (1985).

inclusion of the trusts in the decedent's gross estate was denied. More recently, the IRS has ruled that a self-settled trust in a state that does not permit creditors of the settlor to access the trust will result in a completed gift to the trust for federal gift tax purposes.[29] The IRS refused to rule on whether the trust would be includible in the settlor's gross estate, but the gift tax ruling is encouraging and might possibly foreclose an adverse estate tax ruling unless the IRS could demonstrate an implied understanding sufficient to cause inclusion under Section 2036 or 2038.

Accordingly, one potential approach that may be considered is to settle the trust in a state that generally prohibits the settlor's creditors from accessing the trust and either restricting distributions to the settlor's spouse during a healthy marriage, or restricting distributions to the settlor to economic circumstances unlikely to occur prior to death, but that nevertheless provide coverage for the "rainy day." Last, one might structure the trust to provide a third party, who is not a fiduciary, the ability to appoint the assets of the trust to the settlor after some period of time. A person with a personal power of appointment not subject to any fiduciary duties would be unlikely to provoke an argument for an impermissible retained interest by the settlor.[30]

Another possibility is to afford the settlor a full discretionary interest from inception, with the additional authority to remove and replace independent trustees, coupled with the ability of a trust protector to remove the settlor as beneficiary. Such a removal power should not be within the reach of Section 2035(a),[31] even if the settlor were construed to have retained an interest in the trust. This is because the settlor is not making a transfer of his or her interest, instead the settlor's interest is being extinguished by an independent third party. Perhaps the protector's authority could be limited to the circumstance in which the settlor's death has become imminent. Last, would be to confer the discretionary interest with no ability to remove the settlor on the basis that either (1) it accomplishes the estate planning while providing the necessary financial comfort or (2) if it does not, the gift in trust would be deemed incomplete, avoiding current gift tax, with the collateral consequence that the property is includible in the settlor's gross estate as if the settlor had not engaged in lifetime planning.

¶ 604 Taking Obama "Greenbook" Proposals Off the Back-Burner?

Estate planners will recall the "Greenbook" proposals from the Obama Administration (during which time President Biden served as Vice President). Notable for estate planning professionals were the proposed elimination or significant restriction of a number of popular wealth transfer techniques, including zeroed-out GRATs, GST tax-exempt Dynasty Trusts and Sales to Intentionally Defective Grantor Trusts. In addition, the Proposed Regulations to Section 2704 that were issued in August 2016 proposed to substantially curtail the availability of valuation discounts.[32] More recently, Senator Sanders in 2019 proposed legislation entitled the

[29] PLR 9837007 (not precedent).

[30] *See* A. O'Connor, M. Gans & J. Blattmachr, *SPATS: A Flexible Asset Protection Alternative to DAPTS*, 46 Est. Plan. 03 (Feb. 2019).

[31] Section 2035(a) includes in the gross estate of a decedent property that would have been includible in the decedent's gross estate under Sections 2036, 2037, 2037 or 2042, but for the decedent transfers for less than full and adequate consideration in money or money's worth of the retained power or interest causing estate tax inclusion within three years of the decedent's death.

[32] 81 Fed. Reg. 5143-51425 (Aug. 4, 2016).

"For the 99.8 percent Act," that included restrictions to these estate planning techniques that largely echoed the provisions of the Obama-era Greenbook proposals.[33]

¶ 604.1 "Shelf" Dynasty Trusts

Taxpayers might consider implementing "On the Shelf" Dynasty Trusts in order to plan in advance for the potential elimination of the ability to create trusts that can last perpetually in a GST-exempt format. An Obama-era Greenbook proposal would have imposed a 90-year limitation on a trust having a GST inclusion ratio of zero, after which time, while the trust could still exist, the inclusion ratio would automatically become one. The Sanders' proposal from 2019 would have adopted an even shorter period of only 50 years. While it cannot be said with certainty, any changes to the GST rules would presumably only apply to GST-exempt trusts created and/or funded after the effective date of such legislation, and any trusts that would exist prior to the effective date of such legislation would presumably be "grandfathered" and not subject to the limitation.

If we assume that "grandfathered" Dynasty Trusts will be "safe" from any future modifications to the GST rules, taxpayers might consider creating "Shelf" Dynasty Trusts under current law, but creating a GST-exempt trust in a "Dynasty" jurisdiction, such as Delaware, New Hampshire, South Dakota, Alaska, Nevada and a handful of other jurisdictions.

¶ 604.2 Grantor Retained Annuity Trusts

In a GRAT, the grantor of the trust retains the right to receive an annuity for a fixed term of years, following which the remainder will pass to the specified successor beneficiaries. The greater the value of the annuity interest, the smaller the taxable gift involved in the creation of a GRAT. A lower interest rate increases the actuarial value of the retained annuity. Thus, the same annuity payments will produce a lower taxable gift at a lower interest rate.

It would seem that a low interest rate environment (that is, a low Section 7520 rate) would increase the probability of success for a GRAT. However, it turns out that the performance of a short-term GRAT is actually interest rate neutral. Computations prepared by one financial institution[34] show that, if one assumes a two-year GRAT is created at the beginning of every month since Section 7520 rates were available until January 2009 (and structured so that using the applicable Section 7520 rate for that month, the annuity payments are actuarially equal to the value of the property contributed to the GRAT) and if the assets of the GRAT were invested in an S&P 500 Index Fund, the probability that remainder would be positive is virtually uncorrelated to the Section 7520 rate. Thus, if publicly traded equities are used, short-term GRATs may not have a

[33] On January 31, 2019, Senator Sanders introduced S. 309 titled "For the 99.8 Percent Act." With respect to GRATs, the bill proposed to impose a minimum annuity term of ten years and a maximum term of the life expectancy of the annuitant plus ten years, as well as a minimum value of the remainder interest of not less than the greater of 25 percent of the fair market value of the trust property or $500,000. With respect to transactions between a grantor and a grantor trust, the bill proposed estate inclusion in grantor's gross estate, distributions being treated as gifts from the grantor, and a gift of the entire trust if it ceases to be a grantor trust during the grantor's life. In addition, the bill would have eliminated the generation-skipping transfer tax exemption for any trust that has a termination date that is not greater than 50 years after its creation, targeting so-called Dynasty Trusts.

[34] *See* computations performed by J.P. Morgan Private Bank for ACTEC Summer Meeting 2008, "Estate Planning in a Low Interest Rate, Down Market: Making Lemonade Out of Lemons."

particular advantage just because rates are low. Nevertheless, the success of a GRAT strategy improves if asset performance is volatile. Therefore, the current climate may favor GRATs even if low interest rates do not provide a particular advantage for a very short term GRAT.

Although short-term so-called "rolling" GRATs has been a favored strategy, a risk of using a rolling GRAT approach is that GRATs may not survive potential changes to the estate and gift tax laws. Accordingly, one might reconsider using a longer-term GRAT with the following variation. One difficulty with a longer-term GRAT is that early success may be offset by future failure in asset performance. One might overcome that risk in part by using a power of substitution under Section 675(4)(C) to capture the volatility in a GRAT.[35] The strategy would be for the taxpayer to exercise the power of substitution when the assets have reached what in the taxpayer's view is a peak value in order to preserve that enhanced value for the benefit of the GRAT remainder beneficiaries. The grantor would substitute a less volatile asset or one that is perceived to have a depressed value.

Another negative of a longer-term GRAT is that death within the term of the GRAT will likely cause a substantial portion, if not all, of the assets of the GRAT to be included in the grantor's gross estate for Federal estate tax purposes.[36] The probability of death within the term of a GRAT can be estimated using the current mortality tables. In a short-term GRAT, the probability of survival is above 95 percent even if the taxpayer is 70 years old. On the other hand, in a much longer term GRAT, such as a ten-year term, the probability of survival for a 50-year-old is over 93 percent, but for a 70-year-old it is only about 70 percent.

The risk of death would typically be slightly higher for a male and slightly lower for a female.[37] In addition, statistics have shown that wealthier individuals tend to live longer, potentially reducing even further the risk of death within the term for the typical client who would consider creating a GRAT. Accordingly, for a relatively younger client, when interest rates are very low, a longer-term GRAT may be a viable estate planning alternative, particularly if other techniques, such as employing a substitution power, are used to capture asset volatility thereby simulating the performance of the GRAT, without the risk of fluctuations in the Section 7520 rate.

A. Long-Term GRATs

Another strategy might be to consider a very long-term GRAT, perhaps for a period of 50 years. Depending on the age of the grantor, death within the term may be a virtual certainty. However, if interest rates rise, substantial assets may nonetheless be excluded for the grantor's gross estate. For example, a 50-year GRAT funded with $1,000,000 commenced when the Section 7520 rate is 0.4 percent requires an annuity of only $22,106.48 annually to virtually zero out the value of the remainder interest. If in 50 years, interest rates rise to three percent, even if

[35] PLR 200846001 (not precedent) allowed the taxpayer to exercise a power of substitution over a GRAT without negative gift tax effects. The power of substitution in the private letter ruling was held in a fiduciary capacity, but a power of substitution that complies with the requirements of Rev. Rul. 2008-22, 2008-16 I.R.B. 796, should have the same effect because it requires that the trustee have a fiduciary duty to ensure that the property substituted for the trust property be of equivalent value.

[36] *See* Treas. Reg. Section 20.2036-1(c).

[37] Computations performed using *Estate Planning Tools*, Stephen R. Leimberg & Robert T. LeClair, Brentmark Software, Inc. and *Tiger Table*s, Lawrence P. Katzenstein.

the GRAT assets earn only enough to make the annuity payments, only $735,883 of the $1,000,000 value would be included in the grantor's gross estate. If the Section 7520 rate increases to five percent, only $442,130 would be included. If the GRAT term is longer, or the Section 7520 increases more significantly, the value included in the grantor's gross estate would be even less. And, as with all GRATs, asset appreciation will improve the benefits.

B. Potentially Taxable GRATs

The deemed gift provisions under Section 2702 may also be considered. Under this approach, taxpayer could make a gift equal to the Assumed Bonus Exemption amount into a zeroed-out GRAT. If the bonus exemption is retroactively reduced, then no significant taxable gift would result and there would little gift tax exemption used to shelter the gift from tax.

If, however, the bonus exemption remains intact, then taxpayer could intentionally violate the provisions of Section 2702 under a number of different approaches (for instance, making an annuity payment late, making an annuity payment in the form of a promissory note, making an additional contribution, or a commutation).[38] Although the IRS sometimes will not allow a taxpayer to use such strategies to the taxpayer's own advantage, the violation of any of these requirements should cause the annuity payable from the GRAT to fail to qualify as a "qualified interest" under Section 2702, thereby causing the retained annuity interest to be valued at zero, with the result that the entire transfer into the GRAT constitutes a taxable gift.

The numerous technical requirements must be strictly adhered to in order for the annuity interest in a GRAT to meet the requirements of a qualified interest. Failure to satisfy any of these requirements, either at creation or in the subsequent administration of the GRAT, can have potentially harsh consequences. Arguably, the violation of any of these requirements will cause the initial transfer into the GRAT to fail the requirements of a qualified interest under Section 2702 and, accordingly, trigger the zero-valuation rule with respect to the grantor's retained annuity interest. In such event, rather than the taxable gift equaling the actuarial value of the remainder interest (which, in the case of GRATs that are "zeroed out," is very close to zero), the taxable gift would instead be the entire value of the assets transferred into the GRAT from inception. This would appear to be the correct answer; however, it should be noted that there is no case that directly addresses this issue. While the issue has not been directly addressed in the context of a GRAT, in *Atkinson v. Commissioner*,[39] the "operational failure" of a charitable remainder annuity trust due to non-payment of annuity payments resulted in a charitable remainder trust's disqualification. The regulations under Section 2702 contain a provision similar to the charitable remainder trust provision at issue in *Atkinson*.[40]

C. "Shelf" GRATs

One way to potentially preserve the ability to plan in the future with GRATs if these vehicles are eliminated under the Biden Administration, is the creation of one or a number "On

[38] Treas. Reg. Section 25.2702-3(b)(4), (b)(5), (d)(5), and (d)(6)(i).
[39] *Atkinson v. Comm'r*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), *cert. denied*, 540 U.S. 946 (2003).
[40] Id.

the Shelf GRATs." These GRATs can be created now and effectively preserved "on the shelf" for activation in the future if GRATs are prohibited (or limited in their utility) at a future date.

A taxpayer could create a number of cash-funded GRATs today with varying terms, for example a series of zeroed-out GRATs each funded with say $5,000,000, with terms of three, five, seven and ten years, and the GRATs would be "locked-in" based upon the current historically Section 7520 rates. No taxable gift would be triggered currently since the GRATs are all zeroed-out. The GRATs could be held "on the shelf" initially, meaning that they would simply be maintained in cash until some point in the future if it is decided by the Trustee to "activate" the Shelf GRATs. If the Shelf GRATs are never activated, then they would simply maintain the cash in an account and pay back the annuity payments in cash to the Grantor over the term of years; thus, the assets would essentially be returned to the Grantor over time.

If the Trustee so determines the GRAT could be "activated," for instance by the Grantor swapping assets with appreciation potential into the GRAT(s) in exchange for cash in a fair market valued exchange, based upon the value of the appreciating assets, as determined by a qualified appraiser. In such event, it is critical that the swap be done for fair market value in order to avoid violating Section 2702, as a deemed additional contribution or a commutation. Because the GRAT is a grantor trust, the swap can be made without triggering built-in capital gain. The appreciating assets in the GRAT will thereafter grow inside the GRAT, and partial interests therein would be paid in-kind to satisfy the annuity payments for the remaining annuity term. However, to the extent that the assets appreciate inside the GRAT, the appreciation that occurs above the in-kind annuity payments made back to the Grantor will remain inside the GRAT and ultimately pass to the remainder beneficiaries if the Grantor survives the remaining annuity term, gift tax free. Thus, the activation of the GRAT essentially allows for the "creation" of a GRAT for the remaining annuity term. Even if Zeroed-out GRATs have previously been eliminated, the Shelf GRAT(s) would have been created before such elimination, so presumably would be "grandfathered."

Of course, it is possible that not only Zeroed-out GRATs would be eliminated or significantly restricted, but other techniques such as sales and/or swaps between a Grantor and a grantor trust (such as a GRAT) could perhaps also be eliminated. In such case, the swap between the Grantor and the Shelf GRAT would not be a viable alternative. However, the Shelf GRAT could still be activated in a different manner, such as by the Trustee deploying the cash into new investments with appreciation potential. The assets into which the Shelf GRAT is invested would need to be distributed in-kind, in part, to satisfy required annuity payments for the balance of the GRAT term.

D. Leveraged GRATs[41]

1. Use of Family Partnership and GRAT, But Inverted

a. Obtaining the Benefit of a Discount With a GRAT

Obtaining a valuation discount for assets contributed to a GRAT can be a challenging undertaking. If a short-term GRAT is used, the annuity payments will be very large. If discountable assets are used to satisfy the payments, the benefit of the discount will be diluted. If

[41] The authors would like to thank Stacy Eastland for his contribution of this idea.

significant distributions are made from the partnership, the IRS will likely be able successfully to challenge the valuation discount asserted for the contribution of the partnership interest to the GRAT. So how can we obtain a discount, but still have the valuation protection offered by the self-adjustment rules permitted for GRATs?

Suppose instead of selling limited partnership units to a dynasty trust, the following structure is used. An individual creates a family limited partnership and a single member LLC that holds assets worth ten percent of the anticipated discounted value of the limited partnership units of the family partnership. The limited partnership interests are contributed and/or sold to the LLC in exchange for a promissory note. Following these steps, the individual still owns 100 percent of the LLC and the balance of the partnership units, so no taxable gift has occurred.

After all assignments have been completed, suppose most of the LLC membership interests are contributed to a ten-year near "zeroed-out" GRAT. The LLC membership interest will not have a very significant value because although it will own all the limited partnership units of the family partnership, it will also owe a promissory note back to the grantor equal to the appraised value of the units. The GRAT annuity payment will be based upon the net value.

b. Improved Financial Results

When an LLC that is leveraged is owned by a GRAT, it seems possible with minimal cash flow coming out of the partnership to the LLC and on to the GRAT, that the GRAT the annuity amounts during the Annuity Period could be satisfied in cash. This eliminates the problems associated with satisfying the GRAT annuity with hard-to-value assets.

The note associated with the sale before the GRATs are created could be satisfied by the remainderman (the Grantor Trust) with hard-to-value assets after the GRAT terminates. However, the use of payments in kind to satisfy the loan after the GRAT terminates does not run the "deemed contribution" danger that may be inherent in satisfying GRAT annuity payments with hard-to-value assets.

Another advantage of the technique is that, because of the relatively modest annuity payment in comparison to value of the partnership interest passing to the remainder beneficiary, if the grantor of the GRAT dies before the Annuity Period ends, there is a much greater chance that some of the assets of the GRAT will not be included in the grantor's estate under Section 2036.

Not only is the technique structurally conservative, as far as preserving qualified interest status of a GRAT, the technique of using a leveraged LLC with a GRAT also has the desirable effect of increasing the "estate planning" success of the GRAT by more than two-fold. The reason for the substantial improvement is because: (i) the annuity amount is always paid with undiscounted cash and (ii) the average hurdle-rate "cost" of that leverage is at the applicable federal rate under Section 1274, instead of at the Section 7520 rate.

c. Risks in the Strategy?

It seems that valuation risk is well protected in the strategy. The question is will the strategy be protected from challenge under general tax doctrines such as step transaction or sham transaction? It is possible that selling an asset to an entity that you own 100 percent could raise questions. Perhaps the structure could be improved by interposing an incomplete gift trust to engage in the sale with the LLC. Suppose the family limited partnership units are first contributed to a self-settled asset protection trust that is not a completed gift, but is nevertheless independent from the settlor, with an independent trustee. The trust would give the settlor sufficient control to cause the gift to the trust to be incomplete. Thereafter, the settlor would not engage in any transaction involving the partnership interest personally. Rather, the trustee of the incomplete gift trust would engage in the transaction with the LLC. It seems that structure would improve the *bona fides* of the sale, and the *bona fides* of the debt owed by the LLC to the trust, thereby improving the potential to sustain the value of the LLC interest as reduced by the face value of the arms-length debt. The sale itself might also be protected from valuation risk by the methods described above for installment sales to grantor trusts.

¶ 605 Funding Gifting at Other Generations

It is often the case that a gift planning strategy focuses primarily, and often exclusively, on using the gift tax exemptions of the current parents' generation ("G-1"), so as to take full advantage of the gifting opportunities. This approach is often leveraged with allocation of the GST exemption and leveraged planning through sales in exchange for promissory notes. However, there is usually less of or no focus on looking at the broader family transfer planning opportunities to consider ways to also use valuable exemptions at the grandparents' generational level (referred to as "G-0"), as well as at the children's generational level (referred to as "G-2"), and, depending upon the ages of family members, potentially the grandchildren's generational level (referred to as "G-3"). In an environment with the highest gift tax exemptions that we have ever seen it may be quite useful to consider ways in which the exemptions of both older and younger generations might be utilized as part of a longer-term, integrated, multigenerational family transition plan; whether those exemptions remain at the current "bonus" level or if they are reduced back to pre-TCJA levels. Properly structured, such an integrated plan can facilitate the effective "multiplication" of gift planning, which can be coupled with a proper spending protocol, so as to provide for multigenerational wealth preservation, access and tax efficiency. This methodology can be particularly relevant should the Biden Administration reduce the gift tax exemptions before the scheduled "sunset" at the end of 2025

¶ 605.1 Funding Up-Generation Gifting (Using Grandparents' Exemption)

Ideally, the approach would already have taken into consideration utilizing grandparents' gift and GST exemptions so as to put multigenerational tax-efficient structures in place. However, it is often the case, particularly when significant family wealth has been generated at the current G-1 generation, where the grandparents' G-0 generation may have asset levels that would not enable them to make full use of their current combined gift tax exemptions. However, there are certain opportunities to shift asset value by way of appreciation to the G-0 generation, which may provide an opportunity for them to "build up" wealth in their estates so as to use some or potentially all of the current valuable gift, estate and/or GST exemptions.

Of course, to the extent that any gifts are made by G-1 to G-0, it is important to be mindful of Section 1014(e), which would eliminate any step-up in tax basis to the extent that assets are given by G-1 to G-0 and are passed back to G-1 as a result of G-0's death within one year. It should be noted, however, that the potential benefits to this type of approach does not envision any attempt to have assets that originate at the G-1 generation to "come back" to the G-1 generation. Rather, the power of this planning is in the ability to shift asset appreciation to the G-0 level so as to provide a means for the G-0 family members to be able to fund their own estate planning program including transfers to G-2 and beyond.

A. Short-Term Loans

In an environment in which there continues to be low asset values, asset volatility in the markets, and/or low interest rates, short-term loans from the G-1 generation to the G-0 generation may provide a means to shift and/or build appreciation at the G-0 level. This may provide the G-0 family members an opportunity to create their own estate planning structures.

G-1 could make loans, either short- or midterm loans (currently short-term AFR of 0.12 percent and midterm AFR of 0.56 percent for February 2021) to one or both of the G-0 grandparents. These could be cash loans that the grandparents could deploy at the right time to purchase various identified assets with upside growth potential. For instance, in a volatile market, a loan to G-0 of say $1 million is invested in assets that have a depressed value due to the economic slowdown, if values later "bounce back" such appreciation will occur in the hands of the G-0 generation without imposition of gift tax to the G-1 generation. Of course, in order for this loan program to be successful, it is absolutely critical that the loan from G-1 to G-0 be respected as bona fide debt, and indeed, the loan will need to be paid back to G-1 in strict compliance with the loan terms established from inception.

Note that in the *Bolles* case, the court determined that, while certain loans may have been considered valid debt at inception, changed circumstances in the ability of the borrower to service the debt and, consequently, changed expectation and probability that the debt would be repaid subsequently changed the nature of the loan to be considered a gift. Indeed, in this scenario, G-0 would have to repay the loan to G-1 in accordance with the loan terms and with adequate stated interest; however, the appreciation would belong to G-0, which could provide G-0 with an opportunity to engage in a gifting program so as to utilize their valuable gift tax exemptions.

B. Short-Term "Up-Gen GRATs" Variation

A variation on the loan scenario might be the use of short-term GRATs that could be created by G-1 naming G-0 as the remainder beneficiary, rather than more traditional GRATs that name the younger generation as remainder beneficiaries. As with the prior illustration, with appreciating marketable securities, any appreciation above the annuity payments back to G-1 could inure to the benefit of G-0, either outright or in trust. Of course, one major difference between the loan and the Up-gen GRAT, which may impact the efficacy of the Up-gen GRAT, will be just how long the current increased gift tax exemption and/or estate tax exemption is available. If, for instance, if the gift and estate tax exemptions are reduced to be effective at a date prior to the termination of say a two or three-year GRAT annuity term, such variation may not be viable from the standpoint of providing a means to shift value into the G-0 generation to fund their own gifting program.

One comparative benefit of the Up-gen GRAT versus the loan is that if the assets in the GRAT do not outperform the Section 7520 rate, or perhaps even go down in value, while the

GRAT will not be successful in transferring value to the G-0 family members, they will not owe any funds to G-1. In contrast, in the loan scenario above, if the G-0 family member invests the loan proceeds into assets that decrease in value, the G-0 family member will still owe the debt to G-1.

C. Sales by G-1 to G-0 Created Section 678 Trusts

Assuming G-0 either has sufficient assets or builds up sufficient assets in order to create trust structures as part of their own gifting program, there may be room to further build up those trusts by way of additional leverage transactions. Perhaps G-0 could create a trust for the benefit of G-1, G-2 and younger generations that is GST exempt. If the trust is structured so as to provide a G-1 beneficiary with either a withdrawal right over income or a withdrawal right over principal, so as to make the trust a grantor trust as to the G-1 powerholder under Section 678, this could provide a means for the G-1 powerholder to sell assets to the G-0 created trust in exchange for a promissory note at AFR.[42]

The traditional valuation considerations with respect to hard-to-value assets would need to be carefully considered so as to address the potential for a part-sale, part-gift occurring. Perhaps a formula clause could be used so as to sell a dollar-delineated number of shares to the trust to be determined as finally determined for federal gift tax purposes. Under this approach, caution should be exercised to ensure that any kind of formula sale approach is executed so as to tie-in the valuation as finally determined for federal gift tax purposes, rather than some other measure. For instance, in *Nelson*,[43] the court determined that an attempted formula clause was not effective to set the sale (or gift) to the number as shares as finally determined for federal gift tax purposes because the language of the sale agreement incorrectly tied the determination of the number of shares sold to the per-share value as determined by the valuation appraiser, rather than as finally determined for gift tax purposes.

D. Variation With G-1 as a Discretionary Beneficiary in the Purchasing Trust

There are of course a number of articles that discuss the possibility of a beneficiary of a parent-created trust engaging in an income-tax-free sale into that trust if it is created as a Section 678 grantor trust as to the selling beneficiary, under the logic of Rev. Rul. 85-13.[44] While beyond the scope of this outline, a careful analysis would need to be conducted if it is desired that the selling powerholder be a discretionary beneficiary of the purchasing trust from the standpoint of the risk of the sold assets being "pulled back" into the G-1 beneficiary's estate under Section 2036. If this variation is desired, it is critical that the sale price that the G-1 beneficiary receives for the sold assets reflect "adequate and full consideration" in the meaning of the

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[42] Essentially, it enables the G-1 powerholder to utilize the technique of sale of assets to intentionally defective grantor trust (the G-0 created trust). See: Austin Bramwell, S. Stacy Eastland, Carlyn S. McCaffrey, Edwin P. Morrow, III, *Creative Planning Techniques with Grantor and Non-Grantor Trusts*, 54th Annual Heckerling Institute on Estate Planning, January 2020.

[43] *Nelson v. Comm'r*, T.C. Memo 2020-81 (June 10, 2020).

[44] *See, e.g.*, Steve R. Akers, Ronald D. Aucutt and Kerri G. Nipp, *Heckerling Musings 2020 and Estate Planning Current Developments*, *available at* https://www.bessemertrust.com/sites/default/files/2020-03/Heckerling%20Musings%202020_03_25_20.pdf; Edwin P. Morrow, *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*, (April 19, 2018), *available at* https://ssrn.com/abstract=3165592 or http://dx.doi.org/10.2139/ssrn.3165592.

exception under Section 2036(a). In the context of closely held businesses that are inherently hard to value, this can be challenging. As discussed above, consideration should be given to utilizing a properly drafted formula clause.

E. Up-Gen Reverse Preferred Partnership

As discussed above, one of the inherent limitations with any kind of GRAT is that the grantor must outlive the stated annuity term in order to shift the future growth to the remainder beneficiary(ies) in a gift-tax-free manner. As this relates to various “Up-gen” planning applications, the GRAT application has some inherent limitations if it is anticipated that the gift tax exemptions will be reduced before the scheduled sunset at the end of 2025. In other words, if G-1 creates a GRAT that will pay the remainder to G-0 at the end of a two-year GRAT annuity term that ends in January of 2023, if the gift tax exemption is reduced with an effective date before January 2023, G-0 will receive the remainder of the GRAT but perhaps will have an asset value that exceeds the then (presumably reduced) gift tax exemption. Thus, the Up-gen GRAT planning in an uncertain environment, from a gift tax exemption standpoint, could end up forcing the acceleration of estate taxes on some family assets to the extent that appreciation that would otherwise be included in the gross estate of G-1 several decades down the line upon his or death, could instead be subject to estate tax much sooner upon the death of the G-0 generation, without enough exemption to absorb all of those assets.

The loan approach described above does have the benefit of avoiding the mortality risk of the Up-gen GRAT, so that any post-loan appreciation in the assets acquired with the loan proceeds with be removed from the G-1 lender’s estate. However, because such would involve a real debt, if the value of the assets that G-0 acquires to allow the loan proceeds to be “put to work” does not increase in value, but rather, decreases in value below the value of the loan, G-0 will still owe the loan to G-1.

One variation to consider is an Up-gen Reverse Preferred Partnership. Under this application, G-1 would create a preferred partnership or LLC with Common “Growth” and Preferred “Frozen” equity interests and would capitalize it with 100 percent of the assets from inception. G-1 could then make a “reverse” gift (perhaps by way of an Up-gen GRAT) or sale of the Common units up a generation to G-0, or perhaps a grantor trust for the benefit of G-0 that would provide G-0 with a general power of appointment so that the value of the Common in the trust would be included in G-0’s gross estate. Alternatively, G-1 could contribute assets in exchange for the Preferred Interests and G-0 could contribute assets, if available, in exchange for Common interests, so that G-0 owns the Common from inception.

Because the Common interests would be transferred to G-0, who is a senior family member to the G-1 “transferor,” Section 2701 would not apply to the transaction (assuming that there are no “Extraordinary Payment Rights”). This is because, the typical “tainted” type of right, a “Distribution Right” that may trigger a deemed gift under Section 2701 would not be created as a result of the “transfer” of the Common interest to G-0, since an exception to a “Distribution Right” would apply since G-0 as the senior family member to G-1 would retain an equity interest (the Common) that is a “subordinate equity interest.” Thus, the structuring of the Preferred Interest that G-1 would retain would be subject to fewer of the strict requirements typically associated with a “Forward” Preferred Partnership in which the younger family member receives the Common and the more senior family member receives the Preferred.

¶ 605.2 Funding Next-Generation Gifting (Using Children’s Exemptions)

It is very often the case that wealth transfer planning focuses on the “current” generation, so as to make full use of their gift and GST tax exemptions during their lifetimes to be able to leverage those exemptions to shift future growth outside of their taxable estates. However, in the current environment with high gift, estate and GST-exemptions, consideration should also be given to ways to use to utilize the next generation’s valuable exemptions in order to effectively “multiply” and “downstream” the planning efficiencies that can be used from a multiple generation standpoint. In the case of the ultra-affluent family with adult children and possibly adult grandchildren, failure to integrate the next generation’s gift planning to utilize the increased transfer tax exemptions could result in a significant missed opportunity if the law changes and the increased gift and GST exemptions are reduced prior to the scheduled sunset at the end of 2025.

In addition, if properly planned with existing trust structures and/or entities, it is possible that the next generation family members can engage in planning that is inherently more robust than if they were to implement those structures on a standalone basis.

A. Next-Gen Gift Funding Out of GST Non-Exempt Trusts

It is very often the case that large families will have implemented a GRAT or series of GRATs as part of their “current” generation estate-planning program (i.e., GRATs created by parents). As we know, GRATs are extremely effective statutory vehicles that, if properly structured, can effectively shift future appreciation in assets to or for the benefit of the next generation in a gift-tax-free manner. This is achieved by way of parent/grantor making a gift into a GRAT of assets and retaining an annuity stream for a set term of years that has a present value nearly equal to the value of the asset gifted into the GRAT, thus resulting in a taxable gift of nearly zero. However, any appreciation in the assets gifted to the GRAT that remain after the annuity stream paid to the grantor is concluded passes free of the gift or estate tax, typically to the next generation, either outright or into an ongoing trust for the benefit of the next generation.

However, because of the estate tax inclusion period (ETIP) rules, it is generally not possible to allocate parent/grantor’s GST exemption to a GRAT during the annuity term. While it may be possible for the parent/grantor to allocate GST exemption to the GRAT upon the termination of the annuity term, this is generally not an effective use of one’s GST exemption, because it does not permit the exemption to be leveraged. Thus, GRATs are generally considered as “two generation” planning techniques but are not considered to be “multigenerational” GST-exempt planning vehicles.

B. Distributions from GST Non-Exempt Trust to Fund Next-Gen Gifting

Because of the ETIP limitations with a GRAT, it is very often the case that families will have one or more GRAT remainder trusts with substantial assets that are available for the benefit of the next-generation family members. While this is great from a two-generation tax efficiency standpoint, because of the GST non-exempt nature of the GRAT remainder trust, those assets are “soft money” from a multi-generational transfer tax perspective. The assets in the GST non-exempt trust will either be subject to: GST tax, upon a taxable termination or taxable distribution; estate tax in the event that the trust will be included in the child beneficiary's estate by way of general power of appointment; or gift tax, to the extent that assets are distributed to the children and they gift those assets. One way or another, the GST non-exempt trust will experience a transfer tax "haircut" when the assets pass from the children's generation to the next generation down. In other words, the IRS has a 40 percent equity stake in the GST non-exempt trust for the duration of the child's lifetime.

It's also possible that a child beneficiary with an unused gift tax exemption could use assets from the GST non-exempt trust to make gifts of their own, using their (and perhaps their spouse's) previously unused gift and GST exemptions. If the GST non-exempt trust is essentially "soft money" distributions could be made to them out of the GST non-exempt trust, thus providing them with assets for this purpose. This will have the effect of allowing some of the assets in the GST non-exempt trust to be gifted into a new trust structure that will be GST-exempt for the benefit of younger generations, perhaps perpetually, depending on the jurisdiction of the trust. In addition, to the extent that the child/grantor of the new trust does not split gifts with his or her spouse, such spouse could be provided with beneficial access as well. By making these distributions, the value of the assets in the non-exempt trust will be reduced in favor of building up the new GST-exempt trust.

C. Distribution of LLC Interest Out of GST Non-Exempt Trust

Additional tax efficiency may be obtained to the extent that the GST non-exempt trust either already owns various entities, such as LLCs or limited partnerships, or alternatively, contributes some of its assets into a newly created entity. It is often the case that a trust will already own assets in different entities for a number of reasons including management, maintaining different types of investments, liability protection, and other succession-related issues.

If the GST non-exempt trust makes a distribution of non-voting LLC or limited partnership interests out of the trust to the next-generation beneficiary, and that beneficiary make gifts of those assets as part of their gifting program into a new trust, this can provide for more robust tax-efficient planning by the child/beneficiary than if they had created an LLC or limited partnership by themselves. The child beneficiary will never have made any contribution to the entity resulting in his or her ownership of the non-voting equity interests. Rather, the beneficiary would have passively received a distribution of assets from the GST non-exempt trust in the form of LLC or limited partnership interests that, presumably may be subject to valuation discounts. Those same valuation discounts should be applicable in determining the value of whatever gift the child/beneficiary makes into a newly created trust. However, many of the issues that present themselves with respect to the creation of an entity should apply since the child/beneficiary was not involved in the creation of the entity giving rise to those interests. Importantly, any "retained strings" argument that may typically arise under Sections 2036(a)(1) and/or (a)(2) should not apply, in that the child never made any capital contribution of assets into the entity. Thus, the child/beneficiary has never made a "transfer" of any assets into the entity for purposes of Section 2036(a).

D. Leveraging Newly Created GST Exempt Trust to Further Reduce and Contain the Growth of the GST Non-Exempt Trust

After the child/grantor has funded a new GST-exempt trust, additional leverage can be obtained by coordinating loans, sales or other freeze transactions with the GST non-exempt trust:

1. Distribution of Entity Interest to Child/Grantor Coupled with Sale to New GST-Exempt Trust

The GST non-exempt trust could make a distribution of additional equity interests (i.e., up to nine times the number of shares originally gifted by child/grantor to new GST-exempt trust) to the child/grantor. Child/grantor could subsequently sell those shares into the new GST-exempt trust, based upon the same valuation considerations discussed above. Assuming that the trust has been created as a grantor trust as to child/grantor, such will enable the child to freeze the value of his or her estate to the discounted value of the sold entity interests, plus the hurdle rate, presumably at the mid-term AFR. Subsequent appreciation in the sold assets will of course be shifted into the GST non-exempt trust. While this would, indeed, infuse estate-taxable assets in to the child's estate, in that the unpaid balance of the promissory note will be subject to estate taxes upon his or her death, a relative "trade off" has been achieved in that the value of the GST non-exempt trust, which will also be subject to a 40 percent transfer tax "haircut," in the form of a GST tax, will have been reduced.

2. Creation of Preferred Partnership between GST Non-Exempt and New GST-Exempt Trust

Alternatively, after child/grantor has created the new GST-exempt trust, such trust could make a capital contribution along with the GST non-exempt trust to create a preferred partnership that is compliant under Section 2701. The GST non-exempt trust could receive back all of the preferred "frozen" interests providing for a preferred return of a fixed percentage cumulative coupon, plus a liquidation preference (most likely, the preferred would be structured as a Qualified Payment Right). The newly created GST-exempt trust would contribute its assets in exchange for some or perhaps all of the common "growth" interests. To the extent that, over time, the growth in the underlying preferred partnership outpaces the preferred coupon payable to the GST non-exempt trust, this will have the impact of "freezing" the future growth in the GST non-exempt trust, and shifting the future growth above the coupon into the newly created GST-exempt trust. Of course, there are a number of technical issues under Section 2701 as well as the partnership tax implications that must be carefully considered.

3. Sale of Non-Voting Interests by GST Non-Exempt Trust to New GST-Exempt Trust

As an alternative to the preferred partnership structure, perhaps the non-exempt trust could sell additional assets, for instance, non-voting LLC units or limited partnership units, to the newly created GST-exempt trust, in exchange for a promissory note imposing interest at a historically low-, mid- or long-term AFR. Such would be sold based upon the fair market value of those interest, which would be reflected in the face value of the promissory note. Care should to taken to ensure that the sale properly reflects fair market value so as to not jeopardize the GST-exempt status of the trust. To the extent that the entity was created by the GST non-exempt trust, it would appear that the Section 2036(a)(1) and (a)(2) types of sensitivities should not apply because no individual created the entities; rather, the GST-exempt trust, which will never "die," created them.

Of course, in such instance, to the extent that the trusts are not grantor trusts as to each other, careful consideration will need to be given to the income tax implications of the sale. One idea might be for the newly created GST-exempt trust to not be a grantor trust as to the child/grantor, but instead, provide a withdrawal right in favor of the GST non-exempt trust. The existence of the withdrawal right in favor of the GST non-exempt trust arguably should make the new GST-exempt trust a "grantor trust" as to the GST non-exempt trust under Section 678. While it is not entirely clear the efficacy of this approach, if the practitioner and client can get comfortable that grantor trust status is achieved in this manner, and that the approach does not jeopardize the GST exempt status of the trust, then arguably the GST non-exempt trust could sell appreciated assets to the newly created GST-exempt trust in a transaction that would not be recognized for income taxes pursuant to Rev. Rul. 85-13.

In PLR 201633021, the IRS ruled that a non-grantor trust which retained the power to withdraw net income of another trust exercisable solely by itself was the grantor of the second trust per Section 678(a), and needed to account for items that were includable in computing tax liability of the second trust's current income beneficiaries as well as its net capital gains. More recently, in PLR 202022002, one trust sold LLC interests to another trust. The buyer trust was a grantor trust. The taxpayer, who was the sole beneficiary of both trusts and the grantor of the buyer trust, had a power exercisable by herself to vest the proceeds from the sale of those interests in herself. The IRS ruled that the taxpayer was the grantor of the seller trust under Section 678 and the transfer of the LLC interests was not recognized as a sale for federal income tax purposes because both trusts were wholly owned by the taxpayer. Of course, when considering this type of transaction, it is important to be mindful that the court has taken a contrary view in the *Rothstein*[45] case, in which the Second Circuit determined that although a grantor trust is disregarded under the grantor trust rules when computing trust income and deductions, a sale transaction between the grantor and the trust may have different implications. Although in Rev. Rul. 85-13, the IRS specifically announced that it would not follow the analysis in *Rothstein*, it should be noted that, with a different fact pattern, the IRS could potentially argue that *Rothstein* applies and decide to not follow Rev. Rul. 85-13.

¶ 606 Charitable Remainder Annuity Trusts

Interest rates will affect the qualification of a charitable remainder annuity trust ("CRAT") for a charitable deduction in at least two ways. In the case of a term-of-years CRAT, if interest rates are low, certain levels of annuity payments will cause the actuarial value of the remainder interest to fall below the ten percent minimum requirement. In the case of a life CRAT, low interest rates will make it impossible for a CRAT with a younger life beneficiary to qualify for a charitable deduction because the minimum five percent payout will cause the CRAT to fail either or both the minimum ten percent remainder requirement and the five percent probability of exhaustion test.[46]

At a 0.6 percent Section 7520 rate (the rate for July 2020), a CRAT for the life of a 40, 50 or 60-year-old will fail the minimum ten percent remainder requirement. At a 0.6 percent Section

[45] *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984).

[46] Rev. Rul. 77-374,1977-2 C.B. 329, requires that the probability that the trust will exhaust before the remainder vests in charity must not exceed five percent. Thus, in the case of a life CRAT for an individual, if the probability is greater than five percent that the fund will be exhausted before the individual dies, the trust will fail to qualify for a charitable deduction.

7520 rate, a CRAT for the life of a 65-year-old will pass the ten percent remainder test but fail the five percent probability of exhaustion test. Thus, a lower-interest environment may make obtaining a charitable deduction for a life CRAT unavailable altogether as a planning strategy for a younger measuring life.

¶ 607 Charitable Lead Annuity Trusts

A charitable lead annuity trust ("CLAT") benefits from a low interest rate environment for the same reason that GRATs do, because the annuity will have a higher actuarial value. A CLAT is usually is a longer-term strategy than is a GRAT. One reason for that is the GRAT will "fail" if the grantor dies during the annuity term; a CLAT generally will not.[47] A CLAT, therefore**,** has the potential to benefit from **"**locking in**"** a long-term low interest rate at inception.

Assume, for example, that 20-year zeroed-out CLATs were created every month from January 1926 to May 1988 and were invested in an S&P 500 index fund. Assume also for this purpose (because we do not have Section 7520 rates for that period) that the Section 7520 rate is 6 percent for each CLAT and the annuity payments to charity were escalated annually by 50 percent (meaning each subsequent year's annuity payment would be one and one-half times the amount of the payment for the prior year). In simulations run by one financial institution,[48] 92 percent of the CLATs would be successful, meaning at least $1 would be delivered to the remainder beneficiary. Indeed**,** the median remainder value would have been 557 percent of the starting value of the CLAT **–** a very impressive result.

Suppose that a client was to fund a 20-year zeroed-out CLAT in September 2020 with $1,000,000 when the Section 7520 rate is 0.4 percent. Suppose the client increases the amount of the annual annuity payable to charity by 20 percent each year. The first-year annuity payment would be approximately $5,700 and the last annuity payment would be approximately $182,000. If the assets appreciate at an average after-tax rate of seven percent, the value of the CLAT remainder would be approximately $2,358,822. If, on the other hand, the client was to simply hold on to the $1,000,000 for 20 years and experience an after-tax growth of seven percent, the assets would appreciate to approximately $3,869,684. If those assets were then subject to an estate tax at a flat rate of 40 percent, the after-tax value would be only $2,321,810, less than the remainder value of the CLAT. If the CLAT has a lower effective tax rate as the result of either upfront or annual charitable deductions, the CLAT will be even further ahead in terms of delivering value to the remainder beneficiaries. The same would be true if the effective estate tax rate on the assets retained is higher due to an increase in the applicable Federal estate tax rates, or the application of a state estate tax.

[47] *See* Treas. Reg. §20.2036-1(c)(1).
[48] Courtesy of J.P. Morgan Private Bank.

¶ 608 Split Purchase Trusts^SM [49]

¶ 608.1 Basic Structure

Section 2702 also applies to joint purchases by family members. A joint purchase occurs when a property owner purchases a temporary interest in an asset (such as a term of years or life estate) and a family member purchases the remainder.[50] Although Section 2702(a)(1) applies to any "transfer of an interest in trust," Section 2702(c)(1) and (2) provide that, for purposes of Section 2702, a joint purchase is treated as property held in trust.

If an individual acquires a term interest in property and, in the same transaction or a series of related transactions, one or more members of the individual's family acquire a nonterm interest in the same property, the individual is treated as acquiring the entire property, and transferring to each of those family members the interest acquired by that family member in exchange for any consideration paid by that family member.[51] The amount of the individual's gift in such a transaction may not, however, exceed the amount of consideration furnished by that individual for all interests in the property.[52]

Example: P purchases a life estate in property from P's parent for $100, and P's child purchases the remainder for $50. The value of the property purchased is $300, the value of the life estate determined under Section 7520 is $250, and the value of the remainder interest is $50. P is treated as acquiring the entire property and transferring the remainder interest to P's child. However, the amount of P's gift is limited to $100, the amount of consideration furnished by P for P's interest.[53]

A personal residence trust, a GRAT, and a GRUT are exceptions[54] to the rule under Section 2702 that the value of any interest in a trust retained by the transferor or any applicable family member is zero. Because a joint purchase is treated as property held in trust and, thus, falls within the purview of Section 2702(a)(1), the exceptions for personal residence trusts, GRATs, and GRUTs contained in Section 2702(a)(2) should be applicable to a joint purchase.[55] However, neither Section 2702 nor the regulations issued thereunder specifically state that the value of a term interest in a joint purchase that is a qualified interest is determined under Section 7520. Nevertheless, under a strict interpretation of Section 2702 and the regulations, the retention of a qualified interest in a joint purchase will fall under the exception in Section 2702(a)(2)(B).

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[49] Excerpted from Blattmachr, Slade & Zeydel, *836-2nd: Partial Interests -- GRATs, GRUTS, QPRTs (Section 2702)*, BNA Tax Management Portfolio (2007).

[50] Section 2702 also can apply to a circumstance where one family member buys one temporary interest in an asset (such as an income interest for life) and another family member buys another temporary interest in it (such as a secondary life income interest). *See generally* Blattmachr, *Split Purchase Trusts^sm v. Qualified Personal Residence Trusts*, 138 Tr. & Est. 56 (Feb. 1999).

[51] Section 2702(c)(2); Treas. Reg. Section 25.2702-4(c).

[52] Treas. Reg. Section 25.2702-4(c).

[53] *See* Treas. Reg. Section 25.2702-4(d), Ex. 4. Note that P's parent made a gift with a value of $150 to P.

[54] Although technically GRATs and GRUTs are not exceptions to Section 2702, the special rule in Section 2702(a)(2)(B) causes them to function as exceptions.

[55] *See* 136 Cong. Rec. S15682 (10/18/90) (acknowledging that a joint purchase of art may fall under the special rule of Section 2702(c)(4) for certain tangible personal property).

¶ 608.2 Joint Purchase Through Personal Residence Trust

The joint purchase of a personal residence should fall under the Section 2702(a)(3)(A)(ii) exception.[56] In that case, normal valuation principles determined under Section 7520 should apply. That is, the value of the remainder in the personal residence will be determined by subtracting from the value of the residence the fair market value of the temporary interest, determined by standard income forecast and longevity (mortality) tables promulgated by the IRS under Section 7520. As a consequence, neither family member who makes a joint purchase of a personal residence, subject to the terms of a personal residence trust, should be deemed to have made a gift to the other where each pays the actuarial value, determined under Section 7520, of the interest that he or she purchases.

A. Estate Tax Considerations

It appears that the estate tax inclusion issue may be avoided by a joint purchase of a personal residence, unless the death of the individual is clearly imminent.[57] Unlike a personal residence trust, a true joint purchase does not involve a transfer from one taxpayer to another, because one taxpayer acquires a life estate (or term interest) from a third party and the other acquires the remainder. As a consequence, Section 2036(a)(1) should not apply, as it applies only if there is a transfer and a retention of an interest by the transferor.

Nonetheless, the IRS has indicated that the purchaser of the remainder interest must not have acquired the funds to buy the remainder from the purchaser of the life estate.[58] The IRS's position does not appear to be supported by the law. In only one circumstance do the estate tax rules have "clean consideration" provisions.[59] However, it probably is best to arrange, where possible, for the purchaser of the remainder in a joint purchase to acquire the funds for the purchase of the remainder interest from a source other than the person who acquires the term or life estate interest or, at least, for those funds to have been acquired in a totally unrelated transaction. TAM 9206006 also suggests that the IRS will not deem a transfer to have occurred (causing estate tax inclusion under Section 2036(a)(1)) if no gift is involved (i.e., funds are loaned to the prospective purchaser of the remainder interest and interest is payable at the applicable federal rate under Section 7872 on a *bona fide* loan).

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[56] *See* PLR 9841017; *see also* PLR 200112023. *Cf.* PLRs 200919002, 200840038, 200728018 (ruling favorably on Section 2702 aspects of sale of remainder interest in personal residence trust). It is unclear whether such a joint purchase would be required to be effected through a personal residence trust or could be effected through an agreement between the purchaser of the temporary interest (i.e., the life estate) and the purchaser of the remainder that contained the mandatory provisions of a personal residence trust. *See generally* Blattmachr, *Split-Purchase Trusts[sm] vs. Qualified Personal Residence Trusts*, 138 Tr. & Est. 56 (Feb. 1999) (discussing that a split purchase of a personal residence seems to fall within the personal residence exception under Section 2702(a)(3)(A)).

[57] Treas. Reg. Section 25.7520-3(b)(3), effective for gifts made after Dec. 13, 1995, provides that a special actuarial factor taking into account actual life expectancy, rather than the standard actuarial factor, must be used when the person who is the measuring life is terminally ill.

[58] TAM 9206006 (child's remainder interest in real estate is includible in parent's estate to extent that parent provided funds to child for split purchase with parent). *See also* PLR 9841017 (refusing to rule on whether Section 2036(a)(1) would apply in the case of a joint purchase).

[59] *See* Section 2040(a) (relating to certain joint property). *See also* former Section 2036(c)(2)(B) (repealed by the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, Section 11601).

Moreover, it is the view of the IRS, upheld in *Gradow v. United States*,[60] that if an owner of property sells the remainder interest, the entire property will be includible in the seller's estate under Section 2036(a)(1) if the seller holds an income (or use) interest in the property at death and the purchase price of the remainder interest was for less than the full value of the *entire* property (that is, not just for the actuarial value of the remainder).[61] Although Section 2036(a)(1) does not apply to a transfer for full and adequate consideration in money or money's worth, the IRS's view, affirmed in *Gradow*, is that a transfer of a remainder in an asset will be deemed to be for a full and adequate consideration in money or money's worth and, therefore, outside of Section 2036(a)(1), only if the transfer is for the full value of the property. Such a gross estate inclusion rule, however, should not apply to a joint purchase because the term holder will not have made a transfer of the remainder by gift, sale, or otherwise. In any event, the precedential effect of *Gradow* may have been significantly eroded by later decisions.[62]

Note that although the IRS has had success with the *Gradow* reasoning,[63] the Third Circuit found *Gradow* unpersuasive in *D'Ambrosio.* The Third Circuit held that the decedent's sale of her remainder interest in closely held stock fell within the Section 2036(a)(1) exception for adequate consideration. Rather than requiring the consideration to equal the fee simple value of the property, the court held that consideration equal to the fair market value of the remainder interest (determined under the IRS actuarial tables) was adequate for Section 2036 purposes. The Fifth Circuit agreed in *Wheeler*. Because the IRS's position rested principally on an analogy to the widow's election mechanism addressed in *Gradow*, the Fifth Circuit in *Wheeler* analyzed *Gradow* in detail, concluding that the widow's election cases present factually distinct circumstances that preclude the wholesale importation of the *Gradow* rationale into cases involving sales of remainder interests. The Ninth Circuit's decision in *Magnin* is consistent with *D'Ambrosio* and *Wheeler*.

Moreover, the regulations under Section 2702 appear to foreclose any such inclusion. For instance, in Reg. Section 25.2702-6(c), *Ex. 8*, an individual purchases a term (income) interest in property at the same time as his or her child purchases the remainder. The example states that if the term holder dies before his or her ten-year term ends, *the remaining term interest* is includible in the term holder's gross estate under Section 2033, with no mention of the inclusion of the remainder. The regulation further provides that the term holder's estate is entitled to the double tax mitigation relief in Reg. Section 25.2702-6(b) (which provides for a reduction in adjusted taxable gifts). Such relief is available, according to Reg. Section 25.2702-6(a)(2), *only* if the term interest in trust is includible in the individual's gross estate *solely* by reason of Section2033. The regulations, therefore, appear to imply that, with respect to a joint purchase, the entire value of the property is not includible in the term holder's estate under Section2036(a)(1) under an extension of the *Gradow* doctrine or otherwise.

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[60] 897 F.2d 516 (Fed. Cir. 1990).

[61] *See* TAM 9133001. *See also* PLRs 200840038; 200728018 (although ruling that sale of remainder interest in personal residence trust for consideration equal to actuarial value of remainder interest determined under Section 7520 was sale for adequate and full consideration for gift tax purposes, IRS expressed no opinion on application of Section 2036).

[62] *See Estate of Magnin v. Comm'r.*, 184 F.3d 1074 (9th Cir. 1999); *Wheeler v. U. S.*, 116 F.3d 749 (5th Cir. 1997); *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309 (3d Cir. 1996), *cert. denied*, 520 U.S. 1230 (1997).

[63] *See, e.g.*, *Pittman v. U. S.*, 878 F. Supp. 833 (E.D.N.C. 1994).

In addition, in Reg. Section 25.2702-4(d), *Ex. 1*, in which an individual purchases a 20-year term interest in an apartment building and his or her child purchases the remainder, it is stated that:

> *"[s]olely for purposes of section 2702*, [the term holder] is treated as acquiring the entire property and transferring the remainder interest to [the] child in exchange for the portion of the purchase price provided by [the] child." (Emphasis added.)

Because the term holder is treated as acquiring the whole property in the joint purchase and selling the remainder *only* for purposes of Section 2702, the term holder should not be treated as selling (or transferring) the remainder for purposes of Section 2036(a)(1), which would appear necessary for *Gradow* to apply.

Although the foregoing analysis suggests that the *Gradow* doctrine should not apply to a joint purchase of a personal residence where each joint purchaser provides the consideration, based upon standard actuarial principles, for his or her interest, the IRS may conclude otherwise.

If a *direct* joint purchase is made (not in connection with a trust), however, there is no basis for concluding that there was a transfer from one joint purchaser to another. TAM 9206006 may support that conclusion. Although the National Office concluded in this technical advice memorandum that the entire value of the home was included in the estate of the person who purchased the life estate, the National Office did so on a finding that the life tenant supplied the consideration (i.e., made a transfer) to the persons who bought the remainder. Although it may be necessary, in order for the joint purchase to fall under the personal residence exception, for all of the regulatory requirements for a personal residence trust to be satisfied, it does not seem that a transfer is being made by one joint purchaser to the other, so as to trigger the application of the *Gradow* doctrine. Accordingly, it appears reasonable to conclude that the *Gradow* doctrine should not apply to a true joint purchase of a personal residence, whether effected through a trust or not.[64]

B. Interest of Term Holder

In a joint purchase of a personal residence, the term holder may acquire a life interest rather than an interest for a term of years. Thus, the term holder will not have to lose possession of the property during his or her lifetime.[65] Furthermore, a purchase in which the term holder acquires the use of the residence for life probably will reduce the amount that the purchaser of the remainder has to invest in the residence[66] (compared to the size of the taxable gift of the remainder made

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[64] In PLR 9841017, the Service concluded that the joint purchase of a personal residence fell under the Section 2702(a)(3)(A) personal residence trust exception but did not rule on whether Section 2036 could apply. *See generally* Blattmachr, *Split-Purchase Trusts*[sm] *vs. Qualified Personal Residence Trusts*, 138 Tr. & Est. 56 (Feb. 1999).

[65] Even though a term holder in a personal residence trust might be able to rent the property after the term interest ends, that may not be appropriate under all circumstances. Under Rev. Rul. 85-13, 1985-1 C.B. 184, the grantor of a personal residence trust can rent the residence without taxable income to the beneficiaries or the trust if the trust is a wholly grantor trust under Section 671–679.

[66] Because it generally will be desirable to avoid having all or any part of the personal residence included in the estate of the term holder, usually any term retained by the term holder in a personal residence trust will be shorter than the anticipated life span of the term holder. Normally, the value of the life interest will be greater than the value of the term interest for a term expected to be less than the life span; hence, the value of the remainder following the life estate may be less than the remainder following the term of years.

through a personal residence trust) and, depending upon other factors, may involve other effective estate planning.[67]

C. Income Tax Considerations

A joint purchase trust, formed by the family members to purchase the temporary and remainder interests in a personal residence, probably will not be a wholly grantor trust with respect to the purchaser of the temporary interest (e.g., the life estate) because the temporary interest holder will have contributed only a portion of the assets to the trust.[68] Hence, the existence of the trust will not be entirely ignored with respect to that person. However, it appears that the entitlement to income tax deductions for certain home mortgage interest under Section 163(h)(3) and for real property taxes under Section 164(a) should apply to the person who holds a life estate interest in the residence through the joint purchase trust.[69]

If the joint purchase trust is a grantor trust with respect to the purchaser of the term or life interest, the home will be treated in its entirety as belonging to that purchaser for income tax purposes.[70] The IRS, as suggested by TAM 9206006, might contend that the purchaser of the term or life interest provided the consideration for the purchase of the remainder causing Section 2036(a)(1) to apply if the purchaser still holds the temporary interest at death. One way, perhaps, to avoid that result is to use only a grantor trust created long before the split purchase is effected.

D. Payments of Expenses

It appears that expenses incurred in maintaining a jointly purchased residence are allocable to and should be paid by the term holder or the remainder holder in accordance with state law.[71] If there is mortgage indebtedness on the residence, that probably will mean that the interest portion of a cash mortgage payment should be paid by the term holder and the principal portion by the remainder holder, unless a different allocation is required by state law.[72] It should be noted, however, that the potential wealth transfer "leveraging" of a joint purchase (or a personal residence trust) may be diminished if there is debt on the property.

¶ 609 <u>Consider Restructuring Existing Estate Planning Transactions</u>

Although there will be psychological hurdles to engaging in estate planning when clients feel less wealthy, consideration should be given to the opportunities that may exist to improve the performance of existing estate planning structures. One significant opportunity is to convert existing family trusts from a non-grantor trust to a grantor trust within the meaning of Section 671.

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[67] There is, however, at least one valuation factor in favor of a personal residence trust as opposed to a joint purchase of a residence. The value of the interests retained by the grantor in the personal residence trust apparently may include any contingent reversion. However, a contingent reversion would not in all likelihood be acquired in a joint purchase and, therefore, would not be taken into consideration in valuing the interests in a joint purchase.

[68] Sections 671–679 provide that a grantor may be taxed as the owner of any portion of a trust.

[69] *See* PLR 9448035.

[70] Rev. Rul. 85-13, 1985-1 C.B. 184.

[71] *See* PLRs 200919002, 200840038, 200728018 (expenses were split between individuals holding life interests in personal residence trust and trust that purchased remainder interest). *Cf.* PLR 9249014.

[72] *Cf.* Rev. Rul. 90-82, 1990-2 C.B. 44.

Rev. Rul. 2004-64[73] confirms that the payment of income tax by the grantor of a trust that is treated as wholly owned by the grantor for federal income tax purposes under Section 671 does not constitute a taxable gift by the grantor to the trust. Yet, the ability to enhance the value of a trust by the income tax liability on its assets effectively permits the trust to compound income tax-free. Compounded income tax-free affords a trust the same economic performance as a retirement plan or a charitable remainder trust, without any distribution requirements. Over time, the wealth transfer that can be accomplished is very substantial and may become even more substantial in the future if ordinary income tax and capital gains rates increase.

Several methods may be available to convert a trust from a non-grantor trust to a grantor trust. One method might be to apply to court for a modification or reformation of the trust.[74] Another might be to relocate the trust to a state that has legislation or state common law permitting so-called "decanting" of trusts, which is the act of a trustee contributing the assets of the original trust to a new trust with differing terms.[75]

Florida appears to have one of the earliest cases authorizing decanting of a trust. In *Phipps v. Palm Beach Trust,*[76] the Supreme Court of Florida held that a trustee with absolute discretion to distribute the principal of a trust among a class of beneficiaries, has the lesser power to distribute the principal of the trust into a new trust for a member of the class of beneficiaries, rather than making the distribution directly to the beneficiary. The *Phipps* case appears to consider the trustee's absolute discretion over distributions of principal to be in the nature of a special power of appointment, and expressly held that the trustee's power of appointment could be exercised in further trust. In *Phipps,* the purpose of decanting was to give the primary beneficiary of the trust a testamentary power of appointment over the trust estate that would permit an appointment in favor of the beneficiary's spouse.

Typically, the beneficiaries of the second trust may include only beneficiaries of the first trust. However, consistent with the discretionary authority to distribute principal to one but not all beneficiaries, from which the authority to decant derives, it is not required that every beneficiary of the first trust also be a beneficiary of the second trust. The exercise of the power usually cannot reduce any fixed income, annuity or unitrust interest in the assets of the first trust. This limitation preserves the tax effects of the first trust (such as with respect to a marital deduction trust required to pay all income to the surviving spouse) and also preserves the intentions of the settlor with respect to required income distributions. Such dispositive concerns, as opposed to tax concerns, could be regarded as misplaced to the extent that an outright distribution of principal to one or more beneficiaries would by definition defeat any fixed income interest. Yet, the concern that the notion of decanting has the potential to defeat the dispositive intention of the settlor is typically raised in the legislative process, and frequently resolved by the determination to preserve income-type interests because they may also have potential tax sensitivity.

Not all decantings will pass muster, however. In *Hodges v. Johnson,*[77] the settlor created two trusts for his wife, children and step-children and their descendants. The trust agreements

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[73] 2004-2 C.B. 7.

[74] *See, e.g.,* F.S. 736.04113 and 736.04115. *See also* F.S. 736.0412 dealing with non-judicial modification.

[75] *See, e.g.,* AK Stat. Section 13.36.157; 12 Del C. Section 3528; F.S. 736.04117; NY EPTL Section 10-6.6(b).

[76] 142 Fla. 782 (1940).

[77] 7th Cir. Ct. - Dover Probate Division, No. 2016-0130 (Sup. Ct. N.H. 2017).

expressly authorized discretionary distributions to the beneficiaries and to "distributee trusts." There were disputes within the family concerning the family business, and the settlor approached the trustees about decanting the trusts to exclude certain of the beneficiaries. The trial court found that the decantings were accomplished without consideration of the plaintiffs' beneficial interests, and therefore, held them to be invalid. The trial court implied that the decantings were accomplished solely to achieve the settlor's desires, without consideration of the interests of the beneficiaries. The New Hampshire Supreme Court held that the trustees were required to give "due regard for the diverse beneficial interests created by the terms of the trusts" and that the trustees breached their duty of impartiality because the trustees failed to treat the beneficiaries equitably in light of the purposes and terms of the trusts. In addition, the court also affirmed the removal of the trustees who engaged in the decanting for cause.

The good news is that *Hodges* confirms that decanting is a fiduciary power, subject to review for breach of trust. Accordingly, decanting is properly viewed as the exercise of discretion by the trustee under the trustee's authority to make distributions, and not as an act by the beneficiaries or the settlor to change the beneficial interests under a trust. In addition, if the trust instrument waives the duty of impartiality, it may be permissible to eliminate beneficiaries of the original trust.

Given the breadth of typical decanting statutes, it would seem that the exercise of the power to decant in order to add provisions necessary to convert a trust from a non-grantor trust to a grantor trust that are otherwise without dispositive effect ought to be reasonably non-controversial. For example, the new trust could simply add a power in the grantor to substitute assets of equivalent value within the meaning of Section 675(4)(C). That power, perhaps thought by some to present a substantial risk of estate tax inclusion of the assets, appears significantly less problematic since the issuance of Rev. Rul. 2008-22.[78] Another possibility is to change the identity of the trustees from independent trustees to trustees who are related and subordinate parties but are not otherwise beneficiaries of the trust.[79]

Extending the duration of a trust will also enhance the wealth transfer and asset protection opportunities for the trust beneficiaries, particularly if the trust is simultaneously converted to a grantor trust. A trust scheduled to terminate at a stated age will likely accumulate substantially less value than a lifetime trust that is also a grantor trust. Moreover, a trust that terminates in favor of its beneficiary will immediately become subject to the claims of the beneficiary's creditors, potentially diluting significantly the wealth transfer achieved. There appears not to be a restriction on distributing to a second trust that eliminates one or more fixed principal distributions or extends the termination date of a trust. Decanting to extend the duration of a trust can also permit the trustee to continue a trust that is protected from GST tax.[80]

[78] 2008-16 I.R.B. 796.

[79] *See* Section 674 and Section 672(c) for the extent to which discretionary authority over trust distributions held by related and subordinate trustees will cause a trust to be treated as owned by its grantor for federal income tax purposes.

[80] *Compare* Treas. Reg. Section 26.2601-1(b)(4)(i)(E) *Example 1* (express authority granted in a trust instrument to appoint in further trust without the approval or consent of any beneficiary permitted the trustee to extend the duration of the trust within the scope of that express authority without losing the GST exempt status of an irrevocable trust created prior to the effective date of Chapter 13) *with Example 2* (decanting in favor of a new trust under a decanting

Another possible approach would be to take advantage of a client's enhanced GST exemption, currently a maximum of $11,700,000. If values are depressed, it may be advantageous to allocate unused GST exemption to an existing trust using a so-called late allocation.[81] One may elect to value the assets as of the first day of the month in which the allocation is made, or to value the assets on the date the allocation is made by filing a Form 709 that is late with respect to the date of transfer.[82] If a client has previously created trusts some of which are exempt from generation-skipping transfer tax and some of which are not, it may be appropriate to consider a sale of assets between trusts. If both trusts are grantor trusts, or can be made to be grantor trusts, there will be no income tax consequence to such a sale. And when interest rates are low and values are depressed, the leverage provided by moving assets to a transfer-tax free environment using a long term, low interest note may be substantial over time.

The purpose of the foregoing discussion is not to provide an exhaustive list of the available options, but simply to point out that even if a client feels constrained in engaging in additional estate planning, a review of existing estate planning structures might present the opportunity for a number of possible wealth transfer modifications without parting with large sums of additional capital.

¶ 610 Turner and Protecting FLPs from Estate Tax Inclusion[83]

¶ 610.1 The Turner Estate Tax Inclusion Problem.

In *Estate of Turner v. Commissioner*, 138 T.C. No. 14 (2012) ("*Turner II*"), the United States Tax Court refused to change its conclusion made in *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209, 102 T.C.M. (CCH) 214 ("*Turner I*"), that the underlying assets of the partnership that the decedent had contributed to it were included in his gross estate, for Federal estate tax purposes, even with respect to partnership interests he had transferred by gift to persons other than his wife prior to his death. More important, perhaps, it also held that no marital deduction would be permitted for value of the partnership interests that were the subject of those lifetime gifts. The court indicated that there could be a further reason for at least a partial disallowance of the marital deduction where the underlying assets of the partnership are included in the estate and are worth more than the partnership interests which the decedent owned at death.

Turner II raises significant issues in representing a married person who holds a substantial partnership interest at death and who wishes a portion of the estate to qualify for the estate tax marital deduction to avoid the imposition of estate tax upon his or her death.

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statute enacted after the original trust became irrevocable and requiring the consent of all parties was a modification but did not shift a beneficial interest in the trust to a beneficiary in a lower generation).

[81] *See* Treas. Reg. Section 26.2632-1(b)(4)(ii).

[82] It is not clear whether a late allocation can be made to a transfer in the immediately preceding taxable year if the Form 709 for that year is not yet due. The regulations refer to a "late allocation" as one that is made on a return filed after the due date for a timely return with respect to the transfer. *Id.* Suppose a transfer is made in trust in December 2008, and the taxpayer wishes to allocate all of her enhance GST exemption to the trust as of January 1, 2009. There does not appear to be a policy reason why this should not be permitted as a late allocation, and certainly the additional $1.5 million of GST exemption that became available in 2009 cannot be allocated any earlier than 2009.

[83] Excerpted from J. Blattmachr, M. Gans & D. Zeydel, *Turner II and Family Partnerships: Avoiding Problems and Securing Opportunity*, 117 J. Tax'n 32 (July 2012).

In the third installment of the Turner trilogy,[84] the Tax Court rejected the IRS's argument that the marital deduction would need to be reduce for by the amount of federal estate and state death taxes attributed to the value of property contributed into an FLP by the decedent.

The IRS took the position that because the assets contributed into the FLP and included in the gross estate under Section 2036, assets during his life and they were not available to the executor to fund the payment of federal estate or state death tax liabilities, the assets passing to the surviving spouse and qualifying for the marital deduction are the only source to fund the tax liabilities, and, thus, the marital deduction must be reduced accordingly.

The estate countered the IRS's position by arguing, successfully, that since the estate was entitled to reimbursement under Section 2207B from the recipients of the assets that were included in the gross estate under Section 2036, the value of the marital deduction should not be reduced as those assets would ultimately pass to the spouse.

The court clarified that Section 2207B provides the executor a means to be reimbursed for the estate assets used to pay federal estate and state death tax liabilities attributable to the value of the estate tax inclusion under Section 2036. Since the Section 2036 included assets are already included in the gross estate, the court noted that:

> "any recovery under Section 2207B should not increase the gross estate but will enable the executor to distribute to the surviving spouse the net value of the estate, undiminished by the tax liabilities attributable to the Section 2036 inclusion."

While this was good news for the estate, it should not be presumed that Section 2207B will always come to the rescue in the case of Section 2036 inclusion as was the case in *Turner III*. The favorable result for the estate on this issue was obtained only after the court carefully analyzed the intention of the decedent as expressed in his estate plan, determined that there was not an waiver of the estate's right to reimbursement, and undertook an analysis of applicable state law to reach its conclusion. It is quite possible under different circumstances, however, that a court would not be able to conclude that the estate's Section 2207B right of reimbursement was waived, in which case this relief would not be available to save the date for the estate.

¶ 610.2 Attempt to Qualify for a Marital Deduction

In *Turner*, the decedent, pursuant to his will, had bequeathed his estate by a disposition called an "optimum" marital deduction provision. Such a disposition essentially directs that all property pass in a form qualifying for the estate tax marital deduction except for any unused estate tax exemption.[85] The structure is intended, by using the unused estate tax exemption and the marital deduction, to avoid the imposition of any Federal estate tax when the married person dies and to avoid having the unused estate tax exemption amount of the spouse dying first, unlike the

[84] *Estate of Clyde W. Turner, Sr., et al. v. Commissioner*, 151 T.C. No. 10 (2018) ("Turner III").

[85] For the structure and common language to effect such a disposition, *see generally* J. Blattmachr & I. Lustgarten, *The New Estate Tax Marital Deduction: Many Questions and Some Answers*, 121 Tr. & Est. 18 (Jan. 1982); J. Blattmachr, D. Hastings & D. Blattmachr, *The Tripartite Will: A New Form of Marital Deduction*, 127 Tr. & Est. 47 (Apr. 1988); and M. Gans & J. Blattmachr, *Quadpartite Will: Decoupling and the Next Generation of Instruments*, 32 Est. Plan. 3 (Apr. 2005).

marital deduction amount, be included in the gross estate of the surviving spouse upon his or her later death. That seems to be what Mr. Turner intended. His estate, in its request for reconsideration of *Turner I*, contended that no estate tax should be payable because Mr. Turner had so structured his will. According to the court:

> "[t]he estate argues that even if Section 2036 applies, the will requires the estate to increase the value of the marital gift."

The court rejected that contention essentially because the partnership interests that were given away before death could not be transferred to the surviving spouse and would not be included in the gross estate at her death (or subject to consumption by her during her remaining lifetime or could be made the subject of gifts by her). The court refers to a situation in which assets are included in the decedent's gross estate which cannot pass to the surviving spouse (because they have passed to someone else) as a type of "mismatch" because the optimum marital deduction cannot include such assets—essentially, a "not available for the spouse" mismatch. However, it seems that the estate may have made the argument that such assets should be allowed to qualify for the estate tax marital deduction on account of another or, perhaps, what may be viewed as a more fundamental type of "mismatch" that the IRS had not apparently made in *Turner I*—a "valuation" mismatch.

The type of mismatch that could have been raised in *Turner I* but apparently was not is a mismatch between the value of the partnership units passing to the surviving spouse in a form qualifying for a marital deduction and the value of the underlying assets of the partnership included in the decedent's gross estate under Section 2036. The court states:

> "[the IRS] allowed an increased marital deduction that [was] calculated on the basis of the value of assets transferred in exchange for the partnership interests that [the decedent] held at death, rather than on the basis of the discounted values of the general and limited partnership interests that [the decedent] owned at death, to the extent that they passed to [his wife]."

Perhaps, that allowance by the IRS was inadvertent. Certainly, the IRS had raised the issue previously in other cases. The court noted that the issue was raised in *Estate of Black v. Commissioner*, 133 T.C. 342 (2009); *Estate of Shurtz v. Commissioner*, T.C. Memo. 2010-21, 99 T.C.M. (CCH) 1096, but stated it did not have to address the issue because it found in those cases that the underlying assets of the partnership were not included in the decedent's estate.[86] However, if a court does find them included in the gross estate of a married person and if the IRS raises the valuation mismatch as a ground to limit the marital deduction, the question is how the courts will rule. The action of the IRS in *Turner I* may indicate the Service will not contend there is a valuation mismatch.

However, rather than inadvertence being the reason the IRS did not raise the valuation mismatch in *Turner*, it may be that the Service concluded that the Wife could unilaterally terminate the partnership (essentially as a general partner) under the terms of the partnership agreement. In

[86] The court states, "In some cases the IRS has taken the position that even when Section 2036(a) applies, the marital deduction is measured by the value of what actually passes to the surviving spouse, which is a discounted partnership interest, and not by the value of the underlying assets," citing to *Black, supra,* and *Schutz, supra.*

other words, to the extent Mr. Turner's wife inherited partnership interests from him she could access the proportionate underlying assets, assuming she could do so under the terms of the partnership agreement. Of course, even if she had a unilateral right to terminate the partnership, she could not access the underlying partnership assets attributable to the partnership interests Mr. Turner had given away to others during his lifetime.

Based upon the reasoning the Tax Court used in *Turner II* to not allow the marital deduction for partnership units that could not pass to the surviving spouse, it may well be that no marital deduction will be allowed by a court for the excess of the estate tax value of the underlying assets of the partnership included in the gross estate over the value of the partnership interests the decedent could pass to his or her surviving spouse, at least where the surviving spouse may not unilaterally access the partnership assets attributable to the partnership interest the survivor acquires from the first spouse to die.

¶ 610.3 Avoiding the Application of Section 2036

There seem to be at least two ways in which Section 2036(a) may be avoided. The first is to cause the entity to be formed in a manner so that transfers to it fall under the "*bona fide* sale for full and adequate consideration" exception to the Code Section. Case law has established that the exception consists of two parts, both of which must be met for it to apply: (1) the transfer must be "*bona fide*" and (2) it must be for full and adequate consideration in money and money's worth. The courts seem to have concluded that the transfer will be deemed to have been for full and adequate consideration in money or money's worth if the transferor receives back a proportionate interest in the income and equity of the entity (e.g., the amount contributed by a partner is fully reflected in the partner's capital account and represents a proportionate part of all contributions to the partnership and distributions are made in accordance with the partners' interests).[87]

The courts also appear to have concluded that a transfer will be regarded as "*bona fide*" if there is a significant and legitimate non-estate tax reason for the formation of the entity. The Court of Appeals for the Fifth Circuit in its famous decision in *Strangi* in 2005, cited above, suggests that there will be a finding of a significant and legitimate non-tax reason only if, measured from a purely objective standard, the formation was likely to achieve the non-tax purpose. It seems that a legitimate concern about a real threat of a creditor may be such a reason.[88] A need to provide management for a business or investment may be sufficient.[89] A wish to avoid diversification of certain public stock holdings may be a sufficient reason.[90] It also seems that in making the objective determination the courts will look at facts after formation of the enterprise—for example, a claim that the parties pooled their assets to change investments will probably not be found if no sales and reinvestments of the contributions are made. Similarly, having the entity make large distributions to the partners may be used as evidence that the recited reason is not true. Also, failure to pool business assets may be used as evidence of a lack of a *bona fide* reason for the

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[87] *See, e.g., Estate of Bongard v. Comm'r,* 124 T.C. 95 (2005); *Estate of Strangi v. Comm'r,* 417 F.3d 468 (5th Cir. 2005).

[88] *See, e.g., Estate of Hilgren v. Comm'r,* T.C. Memo. 2004-46, 87 T.C.M. (CCH) 1008.

[89] See, e.g., *Estate of Kimbell v. Comm'r,* 371 F.3d 257 (5th Cir. 2004).

[90] *See, e.g., Estate of Schutt v. Comm'r,* T.C. Memo. 2005-126, 89 T.C.M. (CCH) 1353.

formation of the enterprise.[91] In any event, it seems appropriate to make a contemporaneous record of the legitimate and significant non-tax reasons for the formation of the entity and have the operation of the entity made consistent with those reasons if it is desirable to fall under *bona fide* sale exception. However, as *Turner II* illustrates, there is no assurance that Section 2036(a) will not be found to apply.

An alternative way to avoid the application of Section 2036(a) is to avoid having the transferor be found to have retained the right to income or the right to control the beneficial enjoyment of the transferred property or its income. Because a transferor may be found to have retained the right to income through an implied, non-legally enforceable understanding, it may be difficult to prove a lack of a retained right if significant distributions are made to the transferor from the entity. A statement in the last decision in *Estate of Strangi v. Commissioner*, *supra,* may suggest that pro rata distributions to the partners will not be used as evidence of such an understanding if there are other partners whose interests are significant. But the meaning and scope of the statement is uncertain. What does seem more certain is that the failure of the transferor to maintain adequate assets to maintain a reasonable lifestyle for life will be used as evidence of an implied understanding (as it may show the transferor knew that he or she would need distributions from the entity).[92] Perhaps, the strongest proof will be the fact that no distributions are made. (If a need to additional funds arises, the transferor could sell partnership units.) However, it must be emphasized that the courts may still find Section 2036(a) to apply. The court in *Estate of Bongard v. Commissioner, supra,* applied Section 2036(a)(1) even though no distribution had been made.

¶ 610.4 <u>If All Else Fails – Qualifying the Included Property for a Marital Deduction</u>

One solution to the estate tax inclusion problem, and it may be the reason why the IRS raised the valuation mismatch in *Turner*: the surviving spouse had the unilateral right to withdraw the underlying assets from the partnership to the extent she inherited partnership interests from her husband. Hence, the partnership agreement could provide for a contingent marital deduction. In other words, the partnership agreement could provide that assets of the partnership that are included in a deceased married partner's gross estate shall pass in a form qualifying for the estate tax marital deduction.[93] That should mean that there is no problem with respect to the allowance of the marital deduction: the included assets themselves are being transferred to (or for) the surviving spouse and there should be no valuation mismatch.[94]

That, nonetheless, may present some additional issues to consider. For example, assume the spouse who dies first, and in whose estate underlying partnership assets are included, wishes the marital deduction share to pass into a marital deduction trust and not directly to the surviving

[91] *See, e.g., Estate of Thompson v. Comm'r*, 382 F. 3d 367 (3d Cir. 2004). Note that this 2004 decision is not related to *Turner I* or *Turner II.*

[92] *Cf. Estate of Stone v. Comm'r*, T.C. Memo. 2003-309, 86 T.C.M. (CCH) 551.

[93] Many practitioners use a QTIP trust described in Section 2056(b)(7) as the form of the contingent marital deduction because, among other advantages, it permits the decedent's estate to elect how much, if any, of the trust will qualify for the estate tax marital deduction. If the surviving spouse may not be a United States citizen, it should be in the form of a qualified domestic trust described in Section 2056A.

[94] It appears that the payment of the assets to or for the surviving spouse pursuant to the terms of the partnership agreement would be considered as passing from the deceased spouse to the surviving spouse for purpose of Reg. Section 20.2056(c)-2(b).

spouse.[95] Even if the provision in the partnership agreement requires the distribution of the assets of the partnership that are included in the deceased spouse's gross estate to be distributed to the surviving spouse or a marital deduction trust if but only if those assets would be so included in the estate of the deceased spouse without regard to that provision in the partnership agreement, the IRS might argue that the provision gave the deceased spouse additional control. For example, if the partnership agreement required that the interest transferred by the deceased spouse or a marital deduction trust must be redeemed as of the deceased spouse's death by a distribution of a pro rata portion of the partnership's underlying assets, the decedent would have the power until death to control whether the partnership assets so included would pass outright or in trust for his or her spouse. The Service might contend that this power to control that disposition causes the underlying assets of the partnership to be included in the deceased spouse's gross estate under Section 2036(a)(2). That argument should not prevail if the redemption of the partnership interest bequeathed by the deceased spouse outright to the surviving spouse or to a marital deduction trust occurs if but only if the partnership assets with respect to the partnership interest bequeathed to the surviving spouse or marital deduction trust are included in the deceased spouse's gross estate without regard to the partnership redemption interest.

Perhaps, some will be concerned that such a provision in a partnership agreement will be used to suggest that there was no significant and legitimate non-tax reason for the formation of the partnership. But that should not be the case. The fact that the IRS has repeatedly attempted to have a partnership's underlying assets be included in the gross estate of a deceased partner is not a secret. Every planner should be aware of it and take action to avoid adverse consequences which would arise in such a case; this does not seem to belie the non-tax reasons for the partnership's formation.

An alternative that might be considered is to have the partnership agreement provide that, with respect to any partnership interest inherited by the surviving spouse (or a marital deduction trust), the surviving spouse (or marital deduction trust) has a unilateral right to "put" the partnership units to the partnership in exchange for a pro rata portion of the underlying partnership assets to the extent the underlying partnership assets are included in the deceased spouse's gross estate.[96] (Of course, the surviving spouse may wish to rid himself or herself of this put right prior to death by sale, for example, of that right.[97]) As mentioned above, such a put right may be why the IRS did not raise the valuation mismatch in *Turner I*: the surviving spouse could redeem the units on account of her status as a general partner.

In any event, an automatic redemption provision in the partnership agreement or the granting of a put right to the surviving spouse (or the marital deduction trust) would not seem to

[95] If the surviving spouse is not a U.S. citizen, the estate tax marital deduction would be permitted only for assets passing into a qualified domestic trust described in Section 2056A.

[96] *Cf. Estate of Nowell v. Comm'r,* T.C. Memo. 1999-15 (general partnership interest inherited was valued as a full partnership interest, and not as an assignee interest, by reason of a partnership provision conferring general partnership status on the inheritor).

[97] If the right is conferred on a so-called QTIP trust described in Section 2056(b)(7), consideration should be given to ensuring the transfer of this right will not trigger Section 2519. Perhaps, distributing the right outright to the surviving who could dispose of it would be safer course than having the QTIP trust sell it. It should be made certain that the put right does not disappear upon the transfer to ensure Section 2704 does not apply. In fact, it might be a "floating" put right that would apply to the "number" of partnership units the surviving spouse inherited as opposed only to the units the survivor inherited.

salvage the marital deduction for partnership interests given away during lifetime to persons other than the surviving spouse by the deceased spouse as happened in *Turner*. Presumably, any redemption of those partnership interests would result in underlying partnership assets being transferred to the recipients of the gifts and not to the surviving spouse. Perhaps, some will consider going all the way: providing in the partnership agreement that, to the extent underlying partnership assets are included in the estate of the deceased spouse without regard to the partnership provision, those assets must pass to the surviving spouse or a marital deduction trust.[98]

¶ 610.5 Can the Included Partnership Assets Qualify for a Marital Deduction Without a Redemption?

There is another possible solution, which is in some respects similar to the manner in which the assets of a grantor retained annuity trust (a so-called GRAT) or a qualified plan or an individual retirement account (IRA) may be qualified for an estate tax marital deduction. In the case of a GRAT, the annuity causes estate tax inclusion of the underlying assets held in the GRAT under Section 2036.[99] With a qualified plan or IRA, the decedent's interest causes inclusion of the underlying assets of the qualified plan or IRA. But the decedent or the decedent's estate cannot always control the administration of the trust or plan that holds the assets included in the gross estate. Nevertheless, it seems that in each of those cases, if all the income from the GRAT, plan or IRA is in fact distributed to the surviving spouse or to a marital deduction trust, followed by that income being distributed to the surviving spouse, with no possibility of the underlying assets being paid to anyone else, then the GRAT, plan or IRA itself may be qualified for a marital deduction.[100] This may mean that the valuation mismatch problem could be avoided if the partnership agreement requires the underlying assets included in the deceased spouse's gross estate to be administered as a marital deduction trust.

This solution might be easiest to comprehend in the context where the deceased spouse continues to own limited partnership units until the deceased spouse's death. The deceased spouse's estate believes the deceased spouse's gross estate includes the limited partnership units, but the IRS asserts that under Section 2036 the underlying assets of the partnership are included in the deceased spouse's estate. Suppose that the partnership agreement requires that if any of the assets of the partnership are included in the gross estate of a deceased partner or former partner, then the partnership shall hold the included assets in a segregated fund, and shall distribute in respect of the deceased partner's partnership interest from the date of the deceased partner's death all of the income (as defined for purposes of the estate tax marital deduction) of the segregated fund to the owner of the deceased partner's partnership interest. Might that permit the included assets to qualify for a marital deduction? Perhaps, a prohibition on distributions to any other partner coupled with a mandatory distribution of all income (as defined for marital deduction purposes) to the spouse or to a marital trust for the spouse might be sufficient to obtain a marital

[98] Using a QTIP trust described in Section 2056(b)(7) as the recipient of the partnership assets provides an additional measure of flexibility on estate taxation: the executor of the deceased spouse's will could determine not to elect marital deduction treatment for the trust (or elect it only in part). Another option to engage in postmortem estate tax planning may be for the surviving spouse to disclaim pursuant to Section 2518 the partnership interest received by the spouse or a marital deduction trust by reason of the deceased spouse's death.

[99] See J. Blattmachr, M. Gans & D. Zeydel, Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues, 109 J. Tax'n 217 (Oct. 2008).

[100] *See, e.g.*, Rev. Rul. 2006-26, 2006-1 C.B. 939.

deduction. And a conversion, essentially, to a partnership that is required to distribute all its income to its partners may be less detrimental from a valuation standpoint than a mandatory redemption clause. This is because with an automatic redemption, the underlying partnerships will be owned by the surviving spouse and included in his or her gross estate, barring other action, without any discount while, with the marital deduction trust arrangement, it may be that a discount would be permitted because the surviving spouse never acquired ownership of the partnership's assets. Of course, if only the partnership units are included in the gross estate of the surviving spouse (because they were in the marital deduction trust for the surviving spouse), they may be valued with a lesser discount than if the partnership was not required to distribute its income (as defined for marital deduction trust qualification purposes). In any event, the redemption provision or the mandatory payment from the partnership of income to the marital deduction trust, as the case may be, should be conditioned on the underlying partnership assets being included in the deceased partner's gross estate without regard to the provision.

The difficulty with this "mandatory partnership income distribution to a marital deduction trust" solution may be a metaphysical one. It may be that the IRS will assert that what is transferred to or in trust for the surviving spouse is a limited partnership interest, not the underlying assets that are included in the deceased spouse's gross estate. In that event, even if the partnership distributes all of its income (as defined for marital deduction purposes) to the surviving spouse or a marital deduction trust for the surviving spouse, the partnership interest commands a valuation discount, causing the valuation mismatch problem. Nevertheless, if the spouse in fact receives a qualifying income interest in the assets included in the deceased spouse's gross estate, it seems possible for those assets to qualify for a marital deduction in the manner described above, even if the limited partnership interest is discountable for other purposes.[101]

¶ 611 Carried Interest Estate Planning

Estate planners often implement a variety of different techniques to "freeze" the value of the taxpayer's estate by locking in, or "freezing" the value of an asset at its current value, while shifting the future appreciation potential into the hands of the recipients. These estate freeze techniques are generally effective from a transfer tax (i.e., estate, gift and generation-skipping taxes) standpoint when the actual rate of return on the assets transferred will exceed a "hurdle" rate – generally, the Section 7520 Rate or the AFR, depending upon the type of vehicle used.

Because of the significant potential for future appreciation associated with carried interest in a private investment vehicle, an interest in the general partner of a fund are often considered

[101] Courts, including the Tax Court in *Turner I*, have indicated that the purpose of Section 2036 is to bring into the gross estate inter vivos transfers that are part of a testamentary plan. They have considered the testamentary nature of the plan not only in analyzing the applicability of the bona fide exception but also in determining whether the decedent had retained the requisite "string" to cause the section to apply. *See Turner I* ("Factors indicating that a decedent retained an interest in transferred assets under section 2036(a)(1) include a transfer of most of the decedent's assets, continued use of transferred property, commingling of personal and partnership assets, disproportionate distributions to the transferor, use of entity funds for personal expenses, *and testamentary characteristics of the arrangement*." (Emphasis added.)). While it would seem that the "string" issue should not be impacted by the testamentary flavor of the transaction (for example, it is uncertain how it would affect the right to income or control of the transferred assets), it must be acknowledged that the courts nonetheless seem to be taking this approach. Thus, before using the QTIP approach suggested in text, consideration should be given to the question whether such an approach would lead the courts to view the arrangement as a testamentary one.

good candidates for wealth transfer planning. Specifically, in a typical fund where, for instance, a 1 percent capital contribution by the fund general partner may be entitled to an allocation of 20 percent of the profits, (the "carried interest") there is great potential for the value of the general partner interest to grow, perhaps exponentially (throughout this outline, the entity that is the general partner of a fund, which receives the special profit allocation or carried interest is sometimes referred to as the "GP" and the donor/parent who decides to transfer that interest is sometimes referred to as the "Fund Principal"). If that growth occurs in an estate planning vehicle that is excluded from the Fund Principal's estate, then this will result in a very transfer-tax efficient shift of future appreciation to or for the benefit of the next generation(s). If leverage is applied to the transaction, the planning becomes even more powerful potentially resulting in a much greater shift of appreciation particularly when interest rates are lower.

When planning for transfers of carried interests in funds, the primary Chapter 14 concern is with Section 2701 which contains certain deemed gift provisions generally relating to various "transfers" of a subordinate equity interests to or for a junior family member (generally speaking, although the class is a bit broader) when the senior family member (generally speaking, although the class is a bit broader) continues to own another class of interest, typically a senior interest. The deemed gift determined under these provisions are created by applying a "zero valuation" concept that very broadly assigns a value of zero to certain interests that are held by senior family members in a family controlled entity following a "transfer" of another interest in the entity generally to a junior family member (additional types of retained rights need not be held with respect to a family-controlled entity). This results in a deemed gift of some portion or potentially all of the value of the business interests in connection with a transfer of an equity interest to a junior family member under a "Subtraction Method" of valuation. There are, of course, numerous additional technical provisions and exceptions to this very broad description that will be discussed in this outline, but this is conceptually how Section 2701 operates. While reasonable minds may differ as to the application and the extent of the risks associated with Section 2701, it is critical that carried interest transfer planning take into consideration the potential application of Section 2701 and the deemed gift tax pitfalls associated with this Code Section.

In the wealth transfer arena, a discussion of carried interest transfer planning just about always will contain the phrase "Vertical Slice" as a means to make a transfer without running afoul of the deemed gift issues under Section 2701. Simply put, under the Vertical Slice approach, in order for a Fund Principal who wishes to transfer a portion of his carried interest to his family members by making a Vertical Slice transfer, the Fund Principal must proportionately transfer all of his or her other equity interests in the fund (This may include capital invested in the general partner, profits allocation in the GP, capital invested as a limited partner in the Fund, and possibly interests in the Management Company). Although there are advantages to this "safe harbor" approach, such as it being relatively low-risk and relatively straightforward to implement, it can often prevent the client from fully accomplishing his wealth transfer objectives. The dilemma that often presents itself is that the Fund Principal wants to transfer all of his carried interest but only some or none of his limited partner interest or capital in the GP, both for economic reasons (transferor wants to retain some portion of his capital investment in the fund) and gift tax reasons (transferor does not want to make a taxable transfer of high-value assets).

An example of the practical limitations that "Vertical Slice" planning can impose is as follows:

Fund Principal has an interest in the GP of a Fund with an appraised value of $1 million and also has LP interests in the Fund valued at $20 million. Ideally, Fund Principal wants to gift 50 percent of the GP with the carried interest to his child. A Vertical Slice approach would require Fund Principal to gift 50 percent of both the GP ($500,000) and the LP interest ($10,000,000), thus resulting in a taxable gift of $10,500,000. Assuming a 40 percent gift tax and no remaining gift tax exemption, this would result in a gift tax of $4.2 million.

Because the Vertical Slice exception does not accommodate a disproportionate transfer, Fund Principals are frequently advised to transfer a smaller percentage of the carried interest so that a proportional limited partner interest can be transferred in compliance with the "rule" and still avoid triggering a deemed gift.

¶ 611.1 Trust for Other Beneficiaries

Another approach involves the Fund Principal transferring some or all of his carried interest into an irrevocable trust created for the benefit of the Fund Principal's parent, and/or perhaps a sibling or non-family member. The trust's terms would provide the beneficiary with a lifetime and/or testamentary limited power of appointment and provide the trustee of such trust with absolute discretion over distributions to the beneficiaries. The power would be drafted as broadly as possible without creating a general power of appointment.

Section 2701 applies to a transfer only to a "Member of the Family" of the transferor. Treas. Regs. Section 25.2701-1(d)(1) defines "Member of the Family" as the transferor's spouse, any lineal descendant of the transferor or the transferor's spouse and the spouse of any such lineal descendant. Since the Fund Principal is transferring the carried interest to a trust for a beneficiary(ies) other than a Member of the Family, Section 2701 wouldn't apply.

The trust's beneficiary, or perhaps another person, could have the power to appoint some trust assets to or for a class of potential appointees. Because the beneficiary wouldn't have a legal entitlement to trust assets due to the absolute discretion given to the trustees and because the power is a limited rather than general power of appointment, the exercise of that power arguably shouldn't be considered a taxable gift.[102] Treas. Reg. Section 25.2701-1(b)(3)(iii) specifically provides that a "transfer" doesn't include a transfer resulting from:

> "a shift of rights occurring upon the release, exercise, or lapse of a power of appointment other than a general power of appointment described in Section 2514, except to the extent the release, exercise or lapse would otherwise be a transfer under Chapter 12."

Thus, so long as the power of appointment is structured so that it's not a general power of appointment, and the exercise of the power will not be a taxable gift under Chapter 12, its exercise by the beneficiary shouldn't be considered a transfer that triggers Section 2701. Of course, the practical risk with this approach is that the beneficiary has very broad power to appoint or not appoint assets to a broad class of people, and thus it is very possible that trust assets could be

[102] But see PLR 8535020 and PLR 9451049 (exercise of limited power of appointment characterized as a gift based on all of the attendant facts and circumstances).

appointed to unanticipated recipients, and the Fund Principal would have legal power to prevent such an exercise.

¶ 611.2 <u>Section 1061 Issues and Final Treasury Regulations</u>[103]

Section 1061 was introduced into law as part of the Tax Cuts and Jobs Act of 2017 ("TCJA"). The Section recharacterizes certain net long-term capital gain with respect to an Applicable Partnership Interest ("API") as short-term capital gain. The statute imposes a three-year holding period to qualify for long-term capital gain treatment on carried interest received by general partners of private equity (PE) funds and other alternative asset management funds) and recharacterizes certain gain generated from the sale of investments held for one year or more (but less than three years) as short-term capital gains.

The Proposed Regulations initially provided some welcome news, which was ultimately included in the Final Regulations[104], with respect to transfers of APIs in the context of typical wealth transfer transactions with grantor trusts. Additionally, the Final Regulations provided some further positive news with respect to gifts of an API to a non-grantor trust, in response to a number of comments received.

Section 1061(c)(1) defines an API as any interest in a partnership transferred to or held by a taxpayer, directly or indirectly, in connection with the taxpayer (or any related person) performing substantial services in an "applicable trade or business" ("ATB") for the partnership. Section 1061(c)(2) defines an ATB as any activity conducted on a regular, continuous, and substantial basis, through one or more entities that consists of, in whole or in part, (1) raising or returning capital and (2) investing in or disposing of "specified assets," identifying such assets for investment or disposition, or developing such assets. Section 1061(c)(3) defines a "specified asset" as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives contracts with respect to any of the foregoing, and an interest in a partnership to the extent of such partnership's proportionate interest in any of the foregoing.

In addition, under the so-called "API Operational Rules", the Proposed Regulations and the Final Regulations provided that entities that are disregarded from their owners (referred to as "disregarded entities") under any provision of the Code or Regulations, which specifically include grantor trusts and qualified subchapter S subsidiaries, "are disregarded for purposes of [the] Regulations." Thus, the Final Regulation Section 1.1061-2(a)(1)(v), entitled "Grantor trusts and entities disregarded as separate from their owners," provides:

> "a trust wholly described in subpart E, part I, subchapter J, chapter 1 of the Code (that is, a grantor trust), a qualified subchapter S subsidiary described in Section 1361(b)(3), and an entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Code or any part of 26 CFR (including Treas. Reg. Section 301.7701-3 of this chapter) are disregarded for purposes of Section 1061,"

[103] *See* Kevin T. Matz, *IRS Issues Final Regulations on Carried Interest*, WealthManagement.com, January 22, 2021.

[104] 26 CFR Part 1 [TD 9945] RIN 1545-BO81.

with essentially identical language to the Proposed Regulations.

It was initially thought that Section 1061(d) caused an acceleration of the recognition of capital gain in connection with the direct or indirect transfer of an API to a "related party" and recharacterizes certain long-term capital gain and short-term capital gain. However, the Preamble to the Final Regulations indicates that, while the statute could be interpreted as an acceleration, the approach under the Final Regulations would not be to cause an acceleration, but rather a recharacterization. The Proposed Regulations initially provided a broader definition of a "transfer" that "include[d], but [was] not limited to, contributions, distributions, sales and exchanges, and gifts."[105] And a related person for purposes of Section 1061(d)(2) included only members of the taxpayer's family within the meaning of Section 318(a)(1) (without any reference to Section 318(a)(2)). Due to the reference in Section 1061(d)(2) only to Section 318(a)(1) but not to Section 318(a)(2) in defining a "related person", some concerns were raised in comments by ACTEC as well as other organizations seeking clarification as to whether Section 1061(d) applied with respect to transfers to and transaction with non-grantor trusts. They sought clarification on issues such as whether a gift transfer of an API to a non-grantor trust would trigger the statute, as well as other things such as turning-off grantor trust status or a sale of an API to a non-grantor trust.

The Final Regulations did provide some further welcome clarification by narrowing the definition of a "transfer." To this end, the Final Regulation Section 1.1061-5(b) defines a "transfer" to mean:

> "a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code."

Thus, the Final Regulations make clear in an example that a gift (in the example a gift of an API is made outright to the taxpayer's daughter, rather than in trust) of an API will not be a "transfer" for these purposes since it is not a sale or an exchange.[106] The Final Regulations still make reference only to Section 318(a)(1) in the definition of a "Related Person"[107] without further clarification, however, the Preamble to Final Regulations do acknowledge the fact that Section 1061(d) is silent as to the application of Section 318(a)(2). Thus, while the Final Regulations have provided welcome clarity that a transfer to a non-grantor trust or to an individual Related Party by way of a gift will not trigger Section 1061(a), since no sale or exchange has occurred as required to fall within the definition of a "transfer," it is not entirely clear how non-gift transfers to an individual or non-grantor trust should be regarded.

¶ 612 Planning With Qualified Opportunity Funds[108]

The TCJA introduced broad sweeping changes in the tax law, including the introduction of Qualified Opportunity Zones ("QOZ") under Section 1400Z-2. The intent of the statute was to

[105] Prop. Reg. Section 1.1061-5(b).

[106] Treas. Reg. Section 1.1061-5(f), Ex. 1.

[107] Treas. Reg. Section 1.1061-5(e)(1).

[108] This discussion was originally included in N. Todd Angkatavanich & Kevin T. Matz, *Opportunity is Knocking: Frozen O-Zone Planning with Qualified Opportunity Funds*, presented with Benetta Park, 54th Annual Heckerling Institute on Estate Planning, January 2020.

provide an incentive to spur investment in various designated underdeveloped areas around the country by providing certain income tax incentives to contribute or essentially "rollover" proceeds of capital gains into newly created income-tax advantaged Qualified Opportunity Funds ("QOF").[109] There are, however, interesting estate planning applications that can be considered that may provide both income tax and transfer tax benefits.

¶ 612.1 <u>Traditional "Freeze" Planning Balance of Transfer and Income Tax Considerations</u>

Estate planners are intimately familiar with the concept of "seeding" an investment in a multi-generational, generation-skipping transfer ("GST") exempt trust, that hopefully will grow over time from the initial "seed gift." Of course, the name of the game with wealth transfer planning is to get in early while the value of the gifted asset has a lower value for gift tax purposes, either as a result of the early speculative nature of the asset, valuation discounts and/or simple time value of money – likely a combination of all of these factors.

While the transfer-tax-efficient benefits of "getting in early" with gifts prior to appreciation occurring is clear, the conventional understanding is that "other side of the coin" may be less advantageous due to the loss of the stepped-up basis at death that must be sacrificed by making a gift or a sale to a grantor trust. Indeed, as the exclusion amount has steadily increased over the years, thereby making the transfer tax regime less of a cost for the large majority of American families, there has been a shift in thinking in the estate planning industry to focus more on income tax rather than transfer-tax-efficient planning. Of course, new emphasis has been placed on ways to build-up basis, perhaps via partnership tax transactions, timing of swaps of low basis assets out of grantor trusts in exchange for high basis assets before the grantor's death, as well as the debate about whether a stepped-up basis can be obtained with respect to assets sold to a grantor trust upon his or her death.[110]

¶ 612.2 <u>Background</u>

Section 1400Z-2 contains a new tax incentive provision that is intended to promote investment in economically distressed communities, referred to as "Opportunity Zones." Through this program, investors can achieve the following three significant tax benefits:

a. The deferral of gain on the disposition of property to an unrelated person until the earlier of the date on which the subsequent investment is sold or exchanged, or December 31, 2026, so long as the gain is reinvested in a QOF generally within 180 days of the disposition of the underlying property;

b. The elimination of up to 15 percent of the gain that has been reinvested in a QOF provided that certain holding period requirements are met;[111] and

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[109] *See* Section 1400Z-2.

[110] *See* Lester B. Law & Howard M. Zaritsky, *Basis After the 2017 Tax Act – Important Before, Crucial Now*, 53rd Annual Heckerling Institute on Estate Planning, January 14-18, 2019; *see also* Paul S. Lee, *Putting It On & Taking If Off: Managing Tax Basis Today for Tomorrow*, 52nd Annual Heckerling Institute on Estate Planning, January 22-26, 2018.

[111] This is accomplished through basis adjustments. Section 1400Z-2(b)(2)(B)(iii) provides that in the case of any investment in a QOF that is held for at least five years, the basis of such investment shall be increased by ten percent

c. The potential elimination of tax on gains associated with the appreciation in the value of a QOF, provided that the investment in the QOF is held for at least ten years.

An Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Internal Revenue Service (IRS). All Opportunity Zones were designated as of June 14, 2018, and a list is available on the U.S. Department of Treasury website.[112]

While many estate planning professionals may be starting to gain an awareness of the income tax benefits offered by the vehicles created under Section 1400Z-2, they have largely been viewed as vehicles that provide a unique opportunity to defer capital gain for a period of time and provide a means to shelter future growth from future capital gain. However, there are a number of emerging potential planning ideas that may provide advantages from a wealth transfer structuring standpoint, in addition to the inherent income-tax-efficient benefits that the statute was designed to provide.

¶ 612.3 QOF Freeze Planning with Potential to Obtain Partial Stepped-Up Basis

With the arrows that have traditionally been in the estate planner's quiver, a decision to engage in traditional "freeze planning" has always inherently involved a balancing of the relative benefits and costs of lifetime transfer tax-efficient planning versus income tax-efficient planning by not making transfers.

However, the introduction of QOFs by the TCJA, while by all accounts not intended to be designed with any estate planning applications in mind, may just provide a way by which one can achieve both tax- efficient transfer tax and income tax planning. Because the income tax benefits offered by these vehicles would be based upon certain holding periods being satisfied, these investments would generally lend themselves to longer-term types of investments. In the context of multi-generational estate planning structures, trusts and other vehicles are often created for the long haul and funded with "patient capital" intended to be held and invested spanning several generations. Thus, such long-term vehicles are directionally aligned with the longer investment horizon inherent with a QOF.

Additionally, because of the ability provided by a QOF to shelter post-acquisition appreciation from capital gains after ten years, these investments, when coupled up with either a long-term grantor (or perhaps a non-grantor) trust, can provide for a means to essentially "layer" long-term transfer tax and income tax efficiency into a multi-generational vehicle. In the context of multi-generational trust planning (indeed, even in the context of less transfer-tax efficient two-generational GST non-exempt trust planning), ten years is generally considered a relatively short period of time. Indeed, in this context, a trust that only has a lifespan of 90 years or so, due to the trust being created in a non-dynasty jurisdiction, may be referred to as a "less efficient" or a "shorter term" trust, with many large families opting to create multi-generational trusts in longer

(10 percent) of the deferred gain. In addition, Section 1400Z-2(b)(2)(B)(iv) provides for an additional five percent (5 percent) increase in the basis of the QOF investment if it is held by the taxpayer for at least seven years.

[112] *See Opportunity Zones Resources*, *available at* https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

term jurisdictions such as Florida, providing for a rule against perpetuities of 360 years, or, if that's not long enough, in one of the many dynasty jurisdictions such as Delaware, South Dakota, Alaska or New Hampshire, to name a handful that have abolished the rule against perpetuities altogether.[113]

Regardless of the choice of longer-term jurisdiction, the point is that, in the broader context of long-term family wealth preservation planning, a ten-year holding period is, no more than a little "cat nap." At the same time, planners are well aware of the power of future growth that can be shifted into a trust over time by a combination of a number of planning concepts, including: pre-appreciation transfer, valuation discounts, leverage, grantor trust status, preferred and common interests, profits or carried interests and "good old" time value of money. In the context of estate planning with interests in a QOF, and assuming the ten-year holding period is met, the planning implications are far and wide-reaching from both an income and transfer tax planning standpoint.

As a basic example, assume the following:

Mom sells appreciated stock that has a zero basis for $10,000,000 in 2019. Rather than paying the capital gains tax in 2019, Mom instead makes a capital contribution of the $10,000,000 sales proceeds into a QOF. Shortly thereafter she makes a gift into a newly created GST exempt Dynasty Trust (and, critically, is a grantor trust as to Mom for income tax purposes) of her entire $10,000,000 in value of her interest in the QOF, that she creates for the benefit of her children, grandchild and more remote descendants. After five years, ten percent of the gain is eliminated; and after seven years another 15 percent is eliminated. In year seven, the capital gains tax on the remaining 85 percent of the gain will indeed have to be paid, but Mom has been able to eliminate 15 percent of the gain overall and has been able to defer the remaining 85 percent of the gain for seven years. Mom pays the deferred capital gains tax liability in year seven out of her other assets, which, as with any grantor trust, reduces the value of Mom's overall estate without the imposition of gift tax for the payment of such income taxes.

Additionally, assuming the Dynasty Trust, which is a grantor trust to Mom, holds the QOF interest for at least ten years, the post-transfer appreciation can eventually be sold without gain recognition. This is a meaningful advantage to a grantor trust that holds a non-QOF interest, for instance interests in an FLP, in which gain on the eventual sale will have to be paid by the grantor (in the case of a grantor trust) or the trust (in the case of a non-grantor trust). Thus, the trust's ownership of a QOF interest provides the benefit of obtaining both a transfer-tax-efficient freeze, and also obtaining a stepped-up basis after a ten-year hold.

The ability to exclude post-acquisition capital gains from gross income can be an extremely powerful planning benefit. This benefit will be even more powerful when combined with other types of traditional planning applications such as leverage at the AFR and the ability of the grantor to pay the income taxes on behalf of the grantor trust – both of these concepts will facilitate the further growth of the QOF interests in the grantor trust, which would be "supercharged" in a sense in that the growth would be transfer-tax free and would be free of any post-acquisition capital gains income.

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[113] *See* Howard Zaritsky, *The Rule Against Perpetuities: A Survey of State (And D.C.) Law*), *available at* https://www.actec.org/assets/1/6/Zaritsky_RAP_Survey.pdf.

¶ 612.4 Gifts of QOF Interests

Similar to planning with other types of assets, straight gifts of QOF Interests can be made into a trust that is a grantor trust as to the taxpayer without being an Inclusion Event. As with traditional gifts to grantor trusts, the grantor will continue to be the owner of the asset in the trust for income tax purposes and will be responsible for payment of income taxes in connection with the QOF, which allows the grantor's estate to be reduced by the amount of that tax liability paid on behalf of the trust.

Additionally, upon the "day of reckoning" in 2026, income taxes due on the deferred gain will be payable out of the taxpayer's otherwise estate-taxable assets, and the grantor trust will continue to hold the QOF interest. In addition, the Final Regulations make clear that the grantor trust, as donee of the gift, will take a "tacked" holding period from the donor so that the grantor trust will be able to enjoy the benefit of income tax-free appreciation in the QOF after a ten-year hold dating back to the original acquisition of the QOF interest by the taxpayer.

As with non-QOF assets that are owned by a grantor trust, while the payment of the income taxes on behalf of the trust out of the grantor's assets can be very powerful from a tax planning perspective, because such payment will reduce the otherwise estate-taxable assets for the grantor, nonetheless, this will be a real tax liability to grantor who will indeed have to pay the deferred capital gains tax liability on the day of reckoning. Therefore, it is critical before embarking upon such a gifting program that there will be adequate liquidity in the grantor to satisfy such payment of capital gains tax. Additionally, unlike in the case of grantor trust planning with non-QOF assets, in which there is some optionality for the grantor to evaluate whether to not to "turn off" grantor trust status before the grantor trust sells appreciated assets, such optionality will not be available in the case of a grantor trust holding a QOF interest. This is because the Final Regulations clarify that, if the grantor "turns off" grantor trust status with respect to a trust holding a QOF interest (other than such an event occurring as a result of the death of the grantor), such will be considered an Inclusion Event.[114]

As mentioned previously, unlike a traditional gift to a grantor trust, in which the transfer tax benefits of gifting assets before appreciation occurs must be weighed against the income tax cost of having a low-basis asset in the trust, a gift of a QOF has the potential to avoid some of the income tax cost, since future appreciation after ten years is excluded from income tax.

¶ 612.5 Gift of Opportunity Zone Interest into GRAT. Annuity Payments Of QOF Interests

The Final Regulations also clarified that not only gifts to a grantor trust, but transactions between the grantor and a grantor trust with QOF interest are excepted from an Inclusion Event. Thus, QOFs can be transferred into and out of GRATs. GRATs are statutorily blessed vehicles that can be very powerful in traditional estate planning, in that they provide a means to make a gift into a trust whereby the taxpayer/grantor retains an annuity interest that is roughly equal to the fair market value of the transferred asset, resulting in a nearly-zero taxable gift. However, to the extent that transferred asset grows beyond what is needed to pay the required annuity steam back to the grantor, all of that future appreciation passes to the grantor's remainder beneficiaries (typically,

[114] Treas. Reg. Section 1.1400Z2(b)-1(c)(5)(ii).

children or their trusts), gift tax-free. Thus, GRATs provide a statutorily mandated way to essentially make a gift tax-free transfer of future appreciation.

Because GRATs are nearly always created to be grantor trusts for income tax purposes, the clarification in the Final Regulations that gifts of QOF interest into grantor trusts are permitted should provide a basis to do GRAT planning with these investments. Thus, such a combination could provide a powerful way to achieve not only a gift-tax-free transfer of future appreciation, but also allow that gift-tax-free transfer to potentially be excluded from income tax on further appreciation after a ten-year hold.

The Final Regulations clarified that broader transactions between a grantor and a grantor trust will not be an Inclusion Event. Thus, distributions of QOF interests from a GRAT to the grantor, as in the case of an in-kind payment of an annuity payment, will be excluded from being an Inclusion Event.

Another critical point to consider is that the Final Regulations clarify that the change of status from grantor to non-grantor trust (except when that status change occurs due to the grantor's death) will be considered an Inclusion Event that will cause the deferred gain to be included in taxable income.[115] Therefore, it is important that the remainder beneficiary of a GRAT funded with a QOF be structured as a grantor trust, rather than having the remainder interest pass outright to individual remainder beneficiaries or into non-grantor trusts.

¶ 612.6 Sale to and Swaps with Grantor Trusts

As mentioned above, the Final Regulations provides that transactions between a grantor and a grantor trust will not be an Inclusion Event.

Thus, the holder of a QOF interest can engage in a sale of such interest to a grantor trust or a swap of such interest with a grantor trust in exchange of other assets. In addition, similar to the discussion above with respect to in-kind GRAT annuity payments, in-kind payments of QOF interests could be made by a grantor trust to the grantor in satisfaction of promissory note payments or could be swapped out of a grantor trust back to the grantor.

¶ 612.7 Building Basis in Parent's Hands for Future Swaps with Existing Grantor Trusts

One transaction that has long been considered as a way to manage the transfer tax benefits of making gifts of appreciating assets into a grantor trust without the downside of losing the stepped-up tax basis at the grantor's death is to have the grantor swap high basis assets into a grantor trust in exchange for the grantor trust's low basis appreciated assets. This allows the low-basis assets to be obtained by parent in an income- and gift-tax-free transaction so that those assets will acquire a stepped-up tax basis at the parent's death, while the high-basis assets will be acquired by the grantor trust, which will not obtain a stepped-up basis at the parent's death.

One of the challenges with doing this transaction is that the parent often may not have high-basis assets available with which to engage in such an exchange. Often the parent's individually held assets have appreciated alongside the assets held in the grantor trust. Because of the unique

[115] Treas. Reg. Section 1.1400Z2(b)-1(c)(5)(ii).

ability to have appreciation following a ten-year holding period escape future income tax on disposition, such can provide a way to provide a parent who has enough investment horizon "runway" to obtain high-basis assets in the form of future appreciated interests in a QOF that he or she can later use in connection with a swap transaction with a grantor trust.

¶ 613 GRAT ETIP Issue: Preferred Partnership Grat [116]

¶ 613.1 The ETIP Issue

The general inability to allocate GST tax exemption to a GRAT is another negative aspect of this type of planning, as it effectively prevents practitioners from structuring GRATs as multi-generational, GST-exempt planning vehicles in a tax-efficient manner. This is because of the "estate tax inclusion period" rule (the "ETIP Rule"), which basically provides that GST exemption cannot be allocated to a trust during its trust term if the assets would otherwise be included in the grantor's estate if he or she died during that term. If the grantor were to die during the annuity term, a portion of the GRAT assets would be included in his or her estate. As a result, the ETIP Rule precludes the grantor from allocating GST exemption to a GRAT until the end of the ETIP (i.e., the end of the annuity term). Because of this limitation, there would be little if any ability to leverage the grantor's GST exemption with a GRAT. Allocation of the grantor's GST exemption to the trust at the end of the ETIP would have to be made based upon the values of the trust's assets at the time of creation, and therefore would be an inefficient use of GST exemption. As a result, GST exemption is very often not allocated to a trust remaining at the expiration of a GRAT annuity term; as a consequence, such assets will typically be subject to estate tax at the death of the second generation beneficiaries, or will be subject to a GST tax upon a GST event at the second generation's death.

¶ 613.2 Preferred Partnership GRAT to Address ETIP Issue

The creation of a "Preferred Partnership GRAT," which involves the combination of a statutory GRAT with a statutory Preferred Partnership, may provide a way to obtain the statutory certainty of a GRAT while at the same time shifting future appreciation into a GST-exempt trust and, perhaps, even containing the amount of potential estate tax inclusion if the grantor dies during the GRAT term. This technique dovetails the planning advantages of the Preferred Partnership with those of a GRAT by combining these two statutorily mandated techniques.

With this technique, parent could create a Preferred Partnership, initially owning both common "growth" and preferred "frozen" interests. Thereafter, the parent would make gift transfers of preferred interest to a long-term Zeroed-Out GRAT, which would not trigger any gift taxes. Parent would also create a GST-exempt trust into which parent would make taxable gifts of common interests and would allocate the GST exemption. The GRAT would be structured so that the preferred payments made annually to the GRAT would be sufficient to satisfy its annuity payments to the grantor. The GST-exempt trust owning the common interests would receive all growth above the preferred coupon payable to the GRAT. At the end of the GRAT term, if the parent is living, the GRAT remainder would be distributed to the remainder beneficiaries, however these assets would have been "frozen" to the amount of the liquidation preference and the coupon

[116] N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009).

(as this would be payable in a non GST-exempt manner). Any appreciation above the coupon will exist in the common interests held by the GST-exempt trust.

If the grantor dies during the GRAT's annuity term, the estate tax inclusion would be limited to the frozen preferred interest gifted into the GRAT. However, because the common "growth" interest would never have been held in the GRAT, but, rather, it was obtained by the GST-exempt trust via initial capital contribution, the grantor's death during the annuity term would become irrelevant with respect to the appreciated common interests.

¶ 613.3 "Rolling" Preferred Partnership GRAT

A variation on the Preferred Partnership GRAT would be to make "rolling" annuity payments to the parent from the GRAT (that are in turn funded by the preferred payments paid by the Preferred Partnership to the GRAT). That is, each time that the parent receives his or her GRAT payment(s), parent could reinvest such payment(s) into the Preferred Partnership in exchange for additional preferred interests. If desired, the parent could then make additional gifts of the preferred payments into new GRATs.

¶ 614 Summary and Conclusions

Planning in a year of change can be challenging. By maintaining flexibility, and employing techniques that permit a strategy to be modified or unwound, taxpayers may reap the benefits without undue risk of unexpected tax consequences.

¶ 615 Author Biographies

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