Advanced Designs Professional Guide

Advanced Estate Planning Techniques and Life Insurance for the Ultra Wealthy

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I. Introduction

The gift and estate tax imposed on transfers of wealth during life or at death can quickly reduce the value of an individual's estate passed to heirs. While the applicable exemption amount allows an individual to transfer some property free from gift or estate tax, it does little to solve the transfer tax problem of the ultra wealthy. The ultra wealthy need to do more than establish a living trust; they need to develop a wealth transfer plan. Without an effective wealth transfer plan, an individual may make the government an heir to a substantial part of the family's wealth.

Wealth accumulated inside of an individual's estate may be subject to estate, and possibly, generation-skipping transfer (GST) tax. The goal of any wealth transfer plan is to structure ownership of property so that wealth accumulates outside of an individual's estate. The techniques described in this pocket guide freeze the value of property at its current fair market value so that appreciation occurs outside of the estate. An individual can structure a freeze as an intra-family gift or an intra-family sale. Either structure should maximize the transfer of wealth from one generation to the next.

Given that most individuals are unwilling to give away everything they own during life, even the best planned estates may owe estate or GST tax. Although the primary purpose of life insurance is death benefit protection, life insurance may provide the estate with the liquidity it needs to pay the transfer tax liability. It may also provide funds to equalize the inheritance among family members that are not parties to a particular wealth transfer technique. Lastly, life insurance may restore the transfer tax savings that may be lost if an individual lives too long or dies unexpectedly.

This pocket guide describes the following, more common, advanced planning techniques:

- Dynasty trusts
- Qualified personal residence trusts
- Grantor retained annuity trusts
- Family limited partnerships
- Installment sales to intentionally defective irrevocable trusts
- Private annuities
- Self-canceling installment notes
- Combination techniques

Unless stated otherwise, all citations are to the Internal Revenue Code of 1986, as amended (the Code). For the sake of simplicity, the Internal Revenue Service will be referred to as the IRS and a life insurance policy will be referred to as a policy.

Glossary of Terms

Applicable Estate and Gift Tax Exemption

The applicable gift and estate tax exemption amounts allow each taxpayer to transfer, during his or her lifetime or upon death, respectively, a certain amount of cash or other assets without incurring gift or estate tax liability.[1] Under current law, the unified estate and gift tax exemption amount is $10,000,000 (indexed for inflation for tax years after 2011; $11,580,000 for 2020) and the maximum federal estate tax rate is 40%.[2]

Annual Gift Tax Exclusion

In 2020, the annual gift tax exclusion allows an individual to exclude from gift taxes gifts of up to $15,000 per donee per year (as adjusted for inflation).[3] The Taxpayer Relief Act (TRA) of 1997 provided that for gifts made in a calendar year after 1998, the annual gift tax exclusion amount will be increased by an inflation adjustment. Increases will be made if the cost-of-living adjustment is a multiple of $1,000; otherwise, it will be rounded to the next lowest multiple of $1,000.[4] Gifts made by a husband or wife to third parties as split gifts may be treated as made one-half by each if such an election is made on either spouse's gift tax returns.[5] In 2020, gift splitting effectively allows married couples to exclude from gift tax gifts $30,000 per donee per year, as indexed for inflation. In order to qualify for the annual exclusion, a gift must be of a present interest.

Generation-Skipping Transfer Tax

In addition to gift and estate taxes, the Code also imposes an additional GST tax for transfers to grandchildren or other skip persons.[6] The GST tax imposes a flat tax equal to an applicable rate (the product of the maximum federal estate tax rate in effect at the time of the generation-skipping transfer (and the inclusion ratio with respect to the transaction)).[7]

The GST tax is imposed on every generation-skipping transfer. A GST is defined as a transfer to a beneficiary assigned to a generation two or more generations below that of the transferor.[8] This tax is most commonly levied against transfers from individuals to their grandchildren and great-grandchildren. There is a GST tax exemption which can be allocated to exempt up to that amount of transferred property from the GST tax. Under current law, the GST tax exemption is $10,000,000 (as indexed for inflation effective for tax years after 2011; $11,580,000 for 2020). As with the estate and gift tax exemption amount, the maximum GST rate is 40%.

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[1] IRC Secs. 2010(a), 2505(a).

[2] According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011).

[3] IRC Sec. 2503(b).

[4] *Id.*

[5] Treas. Reg. Sec. 25.2513-1.

[6] A "skip person" is defined as: a lineal descendant at least two generations below the transferor; a non-relative, at least 37 1/2 years younger than the transferor; or an irrevocable trust, if all interests in the trust are held by skip persons. IRC Secs. 2613(a), 2651(d).

[7] IRC Secs. 2601, 2641.

[8] IRC Sec. 2613(a).

II. Dynasty Trusts

A. What is a dynasty trust?

A dynasty trust, also commonly referred to as a Multi-Generational Trust, is an irrevocable trust that is established by wealthy individuals for the benefit of children, grandchildren, and successive generations. It is designed to use some (or all) of the GST tax exemption amount of the grantors to protect the trust assets from the GST tax and shelter the assets from estate taxation in the estates of future generations. If properly drafted and administered, the trustee[9] of the dynasty trust can make distributions to the grantor's heirs free from federal estate, gift, and GST tax. A dynasty trust typically continues for multiple generations, limited only by state law (see discussion below regarding the Rule Against Perpetuities).

The following example illustrates the features of a dynasty trust. Grandmother dies in early 2020 and leaves her $20,000,000 estate to Child A. Child A receives $16,632,000 after federal estate tax has been paid.[10] Scenario 1: Assuming Child A passes away prematurely later that same year (in 2020) with the full amount of his or her inheritance ($16,632,000) and leaves everything to his or her children (Grandchildren), only $14,611,200 of the original $20,000,000 is left for Grandchildren after federal estate tax is paid at Child A's death.[11]

Scenario 2: Now assume that Grandmother had not previously used any of her lifetime estate and gift tax exclusion amount and decided to utilize her entire $11,580,000 GST tax exemption and estate tax exemption and gift $11,580,000 to a dynasty trust for the benefit of Grandchildren. Grandmother then left the remaining $8,420,000 to Child A and pays estate taxes totaling $3,368,000[12] (leaving Child A with $5,052,000 after estate taxes). Now, when Child A passes away in 2020 and leaves everything to Grandchildren (while using his or her $11,580,000 estate tax exemption amount), Grandchildren would, instead, receive a total of $16,632,000 ($11,580,000 that Grandmother left them plus $5,052,000 that Child A left, for which no estate taxes were due since $5,052,000 of Child A's estate tax exemption was used). In other words, by utilizing her GST tax and estate tax exemption amount at her death in Scenario 2, Grandmother has completely shielded $11,580,000 from federal estate and GST tax. Additionally, by using Scenario 2, Grandchildren have received an additional $2,020,800 (as compared to Scenario 1).

The federal GST tax is designed to essentially make up the federal estate tax that would have otherwise been imposed on the transfer of assets to the skipped generation. The GST tax is in addition to any federal gift and estate tax that may be imposed. For example, assume Grandfather, in 2020, creates a dynasty trust to benefit, among others, children, grandchildren and great grandchildren (the last two groups are considered skip persons). Grandfather uses his lifetime gift

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[9] The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.

[10] This assumes that the grandmother passes away in 2020 with an estate valued at $20,000,000 and has not utilized any of her $11,580,000 estate tax exemption; the estate tax liability is $3,368,000.

[11] This assumes that Child A passes away later in 2020 unmarried with an estate valued at $16,632,000 and has not utilized any of his or her $11,580,000 estate tax exemption amount; the estate tax liability is $2,020,800.

[12] Note, here, Grandmother has already utilized her estate tax exemption amount when she made the gift to Grandchildren.

tax exemption amount and transfers $10,000,000 to the dynasty trust during his life. Grandfather also allocates and uses $10,000,000[13] of his GST tax exemption to the gift. In this instance, all distributions from the dynasty trust to children, grandchildren, and successive generations should pass free from gift and GST tax.

Wealthy individuals with substantial assets may achieve their goal of passing the greatest amount of assets to as many successive generations of heirs as possible by funding a dynasty trust with life insurance. First, the individuals may use all or a portion of their lifetime gift tax exemption amount and lifetime GST tax exemption amount to fund the dynasty trust. Next, these assets would be used to pay premiums on a life insurance policy owned by and benefiting the dynasty trust. If the dynasty trust is properly drafted and administered, the death benefit proceeds from the life insurance policy should not be subject to federal income,[14] estate, or GST tax. Therefore, distributions to children, grandchildren, great grandchildren, and future generations should also be free from federal estate and GST tax.

B. Why are dynasty trusts used?

There are a number of reasons why individuals may choose to create a dynasty trust. While a dynasty trust can be established during the individual's lifetime (or at his or her death), there are certain features associated with creating and funding a dynasty trust during one's lifetime. These features include, but are not limited to, the following:

Limited out-of-pocket transfer tax liability incurred because lifetime gift tax exemption and GST tax exemption may be used.

If the amount each person transfers to the dynasty trust is equal to or less than his or her remaining lifetime gift tax exemption amount ($11,580,000 in 2020), each individual would be able to allocate a portion of their GST tax exemption ($11,580,000 in 2020, as indexed for inflation) to the transfer without incurring any out-of-pocket gift or GST tax liability. Therefore, married individuals that have not previously used any of their lifetime gift tax exemption amounts would be able to transfer $23,160,000 to the dynasty trust and the distributions from the dynasty trust should be free from federal estate tax and GST tax.

Appreciation outside taxable estate and reduction of taxable estate.

Income and capital appreciation earned by the assets placed in a properly structured dynasty trust should not be included in the individual's taxable estate. Had the assets not been transferred to the dynasty trust, the accumulated income and capital appreciation would have increased the taxable estate and, thus, the federal estate tax and GST tax liability. Therefore, individuals may want to consider funding a dynasty trust with a highly appreciating and/or income-producing asset to freeze the value of their estate.

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[13] Indexed for inflation.

[14] For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e., the transfer-for-value rule); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).

C. Common Questions About Dynasty Trusts

1. How long can a dynasty trust last?

This depends on the particular states Rule Against Perpetuities (RAP). The RAP is a complicated property law concept. Put simply, most state laws disfavor and/or prevent property from being held perpetually in a trust. The RAP limits how long a trust may exist – typically 80 to 100 years. However, there are several states which have no RAP and therefore no limit on how long a dynasty trust can continue. Please consult with legal counsel in your jurisdiction for more information about your state's RAP, if any.

2. How is GST tax exemption allocated to a dynasty trust?

During life, the GST tax exemption is allocated to all transfers made to a dynasty trust. This allocation is made on the individual's federal gift tax return (Form 709). At death, any unused GST tax exemption is usually allocated to any trust established via the decedent's estate planning documents, most commonly the B-Trust (also commonly referred to as a bypass or credit shelter trust).[15] The post-mortem GST tax allocations are made by the executor of the estate on the estate tax return (Form 706).[16]

3. What is the best method to structure distributions from a dynasty trust?

No one can predict how federal transfer taxes will change over successive generations. Thus, many estate planning attorneys strongly recommend that a dynasty trust be structured to incorporate substantial flexibility. Therefore, the trustee[17] of the dynasty trust is often given broad discretion to distribute income and/or principal among the descendants, as the trustee deems appropriate. For individuals who prefer not to give the trustee such discretion, it is possible to structure the dynasty trust with a family line distribution so there is an equal share benefiting the heirs of each of their children.

4. Can a dynasty trust own life insurance policies on the lives of its beneficiaries?

Individuals may consider life insurance on their children's or grandchildren's lives as alternate methods of funding a dynasty trust. Provisions in the dynasty trust would need to allow the trustee to purchase life insurance on the lives of the beneficiaries. If the individual's child or grandchild serves as trustee of the dynasty trust, then that child or grandchild should not be an insured. If an insured serves as trustee of the dynasty trust, the life insurance policy death benefit proceeds are

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[15] For a more detailed explanation of life insurance planning with a B-Trust, please refer to Pacific Life's marketing brochure titled "Maximizing B-Trust Assets Using Life Insurance."
[16] Please consult an experienced tax advisor to ensure compliance with all IRS rules and regulations.
[17] The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.

includible in that insured's taxable estate because the insured is viewed as having incidents of ownership over the life insurance policy.[18]

5. Is there a GST tax annual exclusion amount?

Certain transfers that qualify for the annual exclusion amount may also qualify for the GST tax annual exclusion amount.[19] The availability of the GST tax annual exclusion amount depends on whether the transfer is in the form of an outright gift or a gift made to a trust.

Outright Gifts. An outright gift to individuals who are considered skip persons may qualify for the GST tax annual exclusion amount under IRC Section 2503(b). The transfer must be a present interest gift. Assuming the gift qualifies for the GST tax annual exclusion, it should be a non-taxable gift. The GST tax annual exclusion is in addition to the GST tax exemption amount. In other words, if grandparent makes a $15,000 gift to grandchild that qualifies for the GST tax annual exclusion, grandparent still has available to him or her the GST tax exemption amount in the event that grandparent decides to make a gift that does not qualify for the GST tax annual exclusion amount.

Gifts Made to Trusts. To qualify a transfer of property to a trust for the GST tax annual exclusion, the following conditions must be met: 1) the trust can have only one individual beneficiary; 2) during that individual's life, no portion of the trust's corpus or income may be distributed to (or for the benefit of) any other person; and, 3) if the trust terminates before the individual dies, the trust's assets must be includible in his or her gross estate.[20]

Thus, the GST tax annual exclusion amount is typically not available for transfers to irrevocable life insurance trusts (ILITs), including dynasty trusts, because ILITs are typically created with multiple beneficiaries, each holding annual *Crummey* withdrawal powers. The typical ILIT usually gives the trustee powers to distribute income and principal to (among others) children, grandchildren and spouses. Therefore, the transferor will need to allocate part of his or her GST tax exemption.

6. Is it possible to use annual exclusion gifts to fund a dynasty trust?

While it may be possible to fund a dynasty trust with one's annual exclusion gifts, certain considerations should be kept in mind:

Administrative burden of allocating GST tax exemption each year.

If an individual uses his or her annual exclusion gifts to fund a dynasty trust, he or she would need to allocate GST tax exemptions to each of the transfers to the dynasty trust. Given the need to

[18] IRC Sec. 2042(2); Treas. Reg. Sec. 20.2041-1(c)(4). Most legal and tax advisors believe the insured should not be selected as the investment advisor and given power to control asset selection in variable life insurance products.
[19] As of January 1, 2020, the annual gift tax exclusion is $15,000 per donee (as indexed for inflation).
[20] IRC Sec. 2642(c).

allocate GST tax exemptions to each gift, the administrative burden of filing gift tax returns each year to allocate GST tax exemption may be overly burdensome. This, however, may be avoided by transferring a one-time gift that uses most, if not all, of an individual's lifetime gift tax exemption as well as one's GST tax exemption.[21]

Possible lapse of beneficiary's Crummey withdrawal right.

To ensure that the transfer of funds to the dynasty trust constitutes a present interest gift eligible for the annual gift tax exclusion, each beneficiary of the dynasty trust is typically given a *Crummey* power.[22] A *Crummey* power is a right to withdraw a portion of the amount contributed to the dynasty trust for a stated period of time. A beneficiary's power to withdraw contributions to a dynasty trust results in the beneficiary possessing a general power of appointment over the amount that he or she could withdraw.[23]

A beneficiary typically will not exercise his or her right to withdraw funds from the dynasty trust because each beneficiary understands that the money will be used to pay the premiums on the life insurance policy owned by the dynasty trust. If a *Crummey* beneficiary does not exercise his or her *Crummey* withdrawal right, the *Crummey* withdrawal right will have deemed to have lapsed. The lapse or non-exercise of a *Crummey* power constitutes a taxable release by the beneficiary and a transfer of the property to the extent the lapsed withdrawal right exceeds the greater of $5,000 or 5% of the dynasty trust assets.[24] Any amount that lapses in excess of $5,000 or 5% of the dynasty trust assets (commonly referred to as five or five safe harbor) can be a current gift by the beneficiary and can be a transfer includable in the beneficiary's estate.[25] The beneficiary will be treated as a new transferor for GST tax purposes for the amount that has lapsed which exceeds the five or five safe harbor.

If the dynasty trust has been designed to avoid GST tax on distributions to any beneficiary and the individual has allocated part or all of his or her GST tax exemption to the dynasty trust, then the aforementioned lapse by the beneficiary could have unfortunate results. To the extent the beneficiary has allowed a lapse of a general power of appointment in excess of the five or five safe harbor, the beneficiary could be deemed to have made a generation-skipping transfer to the dynasty trust. This would cause the beneficiary to use his or her own GST tax exemption and would, essentially, waste the GST tax exemption that the individual had already allocated.

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[21] If a one-time transfer is made to the dynasty trust, caution needs to be exercised when funding a life insurance policy so as not to create a Modified Endowment Contract (MEC) under IRC Sec. 7702A. Generally, it is not advantageous to cause a policy to become a MEC because cash surrender values cannot be accessed on a tax-favored basis. This would be a concern if the dynasty trust contained provisions allowing the trustee to make distributions to the beneficiaries of the dynasty trust from the cash value of a life insurance policy.

[22] Crummey Notices are used to ensure that contributions to an irrevocable trust are considered present interest gifts to qualify for annual gift tax exclusions under IRC Sec. 2503(b) for the irrevocable trust beneficiaries. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

[23] IRC Secs. 2041(b); 2514(c).

[24] IRC Secs. 2041(b)(2); 2514(e).

[25] IRC Secs. 2041(b); 2514(c); 2036.

7. How do allocations of the GST tax exemption and inclusion ratios affect transfers to a dynasty trust?

When any transfer is made to a dynasty trust, an inclusion ratio is calculated for the dynasty trust. The inclusion ratio indicates the portion of the transfer that will be subject to GST tax. The inclusion ratio shows the portion of dynasty trust assets that has not been sheltered by allocations of the GST tax exemption.

A dynasty trust fully protected from GST tax has an inclusion ratio of zero. In other words, transfers to skip persons from a dynasty trust with a zero inclusion ratio are not subject to GST tax. An irrevocable trust to which no GST tax exemption has been allocated has an inclusion ratio of one. In other words, transfers to skip persons from an irrevocable trust with an inclusion ratio of one are fully subject to GST tax. Transfers to skip persons from an irrevocable trust with an inclusion ratio between zero and one are partially subject to GST tax.

To avoid intermediate inclusion ratios, it usually makes sense to maintain dynasty trusts with inclusion ratios of zero separate and apart from an irrevocable trust (or trusts) with an inclusion ratio of one. If this strategy is implemented, individuals can allocate GST tax exemption to a dynasty trust benefiting skip persons and not allocate GST tax exemption to trusts benefiting non-skip persons. For example, a trustee could make distributions to skip persons from a dynasty trust with a zero inclusion ratio, while distributions to non-skip persons are made from another irrevocable trust with an inclusion ratio of one.

D. Life Insurance Applications

While the primary purpose of life insurance is death benefit protection, there are a number of reasons why life insurance may be an ideal asset to be held by a dynasty trust. First, allocating the GST tax exemption to life insurance premiums typically leverages the amount of assets free from GST tax. Generally, life insurance premiums are relatively small compared to the amount of the life insurance death benefit proceeds. As a result, individuals that allocate GST tax exemption to the money transferred to the dynasty trust (used to pay life insurance premiums) make better use of their GST tax exemption. As previously mentioned, the allocation of an individual's lifetime gift tax exemption amount and GST tax exemption to the funds transferred to the dynasty trust to pay life insurance premiums allows the death benefit proceeds to pass free from GST tax. In other words, a large life insurance policy may be purchased using a small amount of an individual's lifetime gift tax exemption and GST tax exemption. This is one of the primary reasons why life insurance may be an ideal asset to be held by a dynasty trust.

Second, life insurance policy cash value grows tax-deferred and generally does not generate income tax while the insureds are alive, so it is a particularly attractive asset for a dynasty trust to own. In addition, death benefit proceeds from a life insurance policy paid because of the death of the insured are generally excludable from the beneficiary's gross income for federal income tax purposes.

Finally, a dynasty trust funded with a single life or second-to-die life insurance policy can be used for the purpose of providing liquidity to an estate for the payment of any federal estate tax due at the first death or at the surviving spouse's death. The life insurance death benefit proceeds (or the assets of the insureds' estate purchased with such proceeds) remain in the dynasty trust and continue to grow for the benefit of the future generations.

III. Qualified Personal Residence Trust (QPRT)

A. What is a qualified personal residence trust?

A qualified personal residence trust (QPRT) is an irrevocable trust to which an individual transfers his or her residence, reserving the right to live in the residence rent-free for a term of years, with the remainder interest passing to specified beneficiaries.[26] While there may be an initial gift tax imposed upon the transfer of the remainder interest in the QPRT, ownership of the residence eventually passes to the grantor's beneficiaries without the imposition of additional gift tax if the grantor survives the selected term. If the grantor fails to survive the selected term, all or a portion of the value of the residence will be included in the grantor's gross estate.

For example, assume Dad, a 65-year-old man, has a sizeable estate. One of his assets is a cabin in Lake Tahoe that he wants to pass to Daughter. His daughter intends to keep the cabin in the family. With the help of an attorney, Dad creates a QPRT and transfers his cabin to the QPRT. The terms of the QPRT agreement permit Dad to use the cabin for a period of ten years, after which time (if Dad survives the 10-year period) the cabin will pass to the QPRT beneficiary, Daughter. The value of the gift that Dad makes by transferring the cabin to the QPRT is substantially less than the fair market value of the cabin because Dad retains the right to live in the cabin for ten years and the right to have the cabin revert to his estate should he fail to survive the ten-year term. If we assume that the fair market value of the cabin is $1,000,000 on the date Dad transfers the cabin to the QPRT, the interest Dad retains in the QPRT is valued at $179,652.[27] Accordingly, Dad will make a gift of $820,348 in the year he transfers the cabin to the QPRT. This gift may be subject to gift taxes depending on Dad's use of his lifetime gift tax exemption amount. Nonetheless, this gift is still significantly less than the fair market value of the cabin – $1,000,000. If Dad survives the ten-year period, ownership of the cabin will pass to Daughter at the end of the term of years without the imposition of any additional gift tax. If the value of the cabin appreciates at a rate of five (5) percent per year to $1,628,895[28] and Dad passes away immediately after the ten-year term, the potential transfer tax savings would be $323,419.[29]

Even if Dad passed away during the term of the QPRT so that all or a portion of the value of the cabin is brought back into his estate, his estate receives a credit for any prior gift taxes paid. From a transfer tax perspective, the QPRT is a win-tie situation because if Dad survives he wins (i.e.,

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[26] Treas. Reg. Sec. 25.2702-5(c).
[27] The QPRT calculations were obtained using NumberCruncher software, Leimberg & LeClaire, Inc., assuming a 2.0% Section 7520 Rate.
[28] This calculation was obtained using NumberCruncher software, Leimberg & LeClaire, Inc.
[29] The potential tax savings assumes Dad's lifetime gift tax exemption was not used for the transfer of the cabin to the QPRT and are calculated by multiplying the assumed estate tax rate of 40% by the difference between the fair market value of the cabin in year ten and the amount of the previous taxable gift .40 x ($1,628,895 - $820,348) = $323,419.

the cabin and all appreciation is outside of his estate) and if he does not survive the QPRT term, he is in the same position he would have been in had he continued to personally own the cabin (less any fees associated with creating the QPRT).

B. Why are QPRTs used?

1. The grantor can pass his or her residence to the intended beneficiaries at a reduced transfer tax cost.

The grantor's gift of the remainder interest in the QPRT should be significantly less than the fair market value of the residence. The gift is equal to the fair market value of the residence reduced by the interest the grantor retains. The grantor typically retains two interests: the right to live in the residence rent-free until the end of the selected term and the right to have the residence revert to his or her estate should he or she fail to survive the selected term.[30] Accordingly, after reducing the value of the gift by these retained interests, the taxable gift may be only a fraction of the fair market value of the residence. The initial transfer to the QPRT is considered a taxable gift of the remainder interest, calculated using the Code Section 7520 rate. The higher the rate, the higher the value of the grantor's right to use the residence as his or her own during the term of years, and the lower the future remainder interest. So, as the §7520 rate increases, the taxable gift decreases, making the QPRT a more attractive strategy at higher interest rates.

2. The grantor can freeze the value of the residence and pass all future appreciation to his or her intended beneficiaries.

The grantor's gift of the remainder interest in the QPRT is based on the fair market value of the grantor's residence at the time he or she transfers the residence to the QPRT. If the grantor survives the selected term, there should be no additional gift tax imposed when ownership of the residence passes to the grantor's beneficiaries, regardless of the amount by which the residence appreciates over the term of the QPRT. In other words, the appreciation inside the QPRT is passed to the QPRT beneficiaries without the imposition of additional gift taxes.

C. Appropriateness of a QPRT

In general, other than the fees associated with creating a QPRT, an individual has little to lose and much to gain by establishing a QPRT. If he or she survives the term, he or she may remove the residence from his or her estate at a significantly reduced transfer tax cost. If he or she dies before the end of the selected term and the value of the residence is brought back into his or her gross estate, he or she is in no worse situation than he or she would have been had he or she not established the QPRT, other than paying the fees associated with establishing the QPRT.

An individual should consider establishing a QPRT if he or she desires to pass his or her residence as a legacy. However, if an individual's beneficiaries intend to sell the residence at the end of the

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[30] QPRTs are typically drafted so that ownership of the residence reverts to the grantor's estate if the grantor fails to survive the selected term. A reversion right prevents the estate from experiencing a liquidity problem upon the grantor's death during the selected term because the grantor's estate may sell the residence to pay the estate tax arising from the inclusion of the residence in the grantor's estate.

selected term, tax advisors may discourage the use of a QPRT because of the rules relating to income tax basis. When a gift is made, the donee receives the asset with a carry-over cost basis. This means that the donor's original cost basis will be carried over to the donee.[31] On the other hand, most assets that are transferred at death may receive a step-up in cost basis.[32] This means assets transferred to beneficiaries at death receive a cost-basis equal to the fair market value of the asset at the time of the decedent's death.

In the case of a QPRT, if the beneficiaries intend to sell the residence, they would likely obtain an income tax basis in the residence that is significantly lower than their income tax basis in the residence had the beneficiaries received the property at the grantor's death. Specifically, if the grantor does not transfer his or her residence to the QPRT and the residence is instead included in his or her gross estate at death, the beneficiaries take an income tax basis in the residence that is stepped-up to the fair market value of the residence at the individual's death.[33]

If, on the other hand, the beneficiaries receive the residence as remaindermen of the QPRT, the income tax basis will be a fraction of the grantor's income tax basis at the time he or she transferred the residence to the QPRT.[34] If the residence appreciated prior to the transfer or appreciates in value after the transfer and the beneficiaries subsequently sell the residence, they may need to recognize gain on the sale. Accordingly, the grantor should weigh the cost of losing the step-up in income tax basis with the benefit of removing the residence from his or her estate at a reduced transfer tax cost. This should not be an issue if the QPRT beneficiaries intend to keep the residence.

Additionally, an individual may consider establishing a QPRT if the real estate market is relatively depressed. In a depressed real estate market, the fair market value of the residence will be relatively low. Given that the value of the gift to the QPRT beneficiaries is based upon the fair market value of the residence at the time of the transfer, the taxable gift may be significantly less than the fair market value of the residence in an inflated real estate market.

Another factor an individual should consider when deciding whether to implement a QPRT is the interest rate environment. As mentioned earlier, QPRTs are generally more appropriate in a higher interest rate environment because the calculated value of the retained interest using the Section 7520 rate may be higher and, thus, the value of the taxable remainder interest gift may be lower.

A QPRT is not recommended if an individual is relying on the proceeds from the sale of the residence as a supplemental source of retirement income or needs the equity in his or her residence to secure a loan. Another factor to consider is the health of the individual because the length of the retained term that an unhealthy individual is likely to live may not be long enough to reduce the value of the gift to the QPRT. Accordingly, a QPRT is not recommended when the individual has

[31] IRC 1015(a).
[32] According to the Tax Cuts and Jobs Act of 2017, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are all $10,000,000 per person (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. In 2026, the federal estate, gift and generation-skipping transfer (GST) tax exemption amounts are scheduled to revert to $5,000,000 per person (indexed for inflation for tax years after 2011).
[33] IRC Sec. 1014.
[34] IRC Sec. 1015, Rev. Rul. 77-413, 1977-2 C.B. 298.

a short life expectancy because the cost of establishing a QPRT may exceed the tax benefits derived from the arrangement.

D. Common Questions About QPRTs

1. What type of property can a grantor transfer to a QPRT?

A grantor can establish a QPRT to hold his or her principal residence and another to hold one other residence.[35] If a grantor intends to transfer his or her residence to a QPRT, he or she can share the residence only with a spouse or dependent.[36] The grantor can only transfer a rental vacation residence to a QPRT if he or she occupies the vacation residence for the greater of 14-days or 10 percent of the number of days it is rented to another during the taxable year.[37] While an individual's personal residence cannot include personal property such as the furniture located inside the residence, it may include appurtenant structures used by the grantor for residential purposes and adjacent land if it is reasonably appropriate for residential purposes.[38]

A grantor may transfer mortgaged property to a QPRT,[39] but the tax consequences of such a transfer are uncertain. Presumably, the value of the gift of the remainder interest will be reduced by the amount of the debt.[40] While the IRS has not yet ruled on the effect of making mortgage payments on a residence held by a QPRT, each mortgage payment appears to be an additional gift. Gifts of the remainder interest in the QPRT do not qualify for the annual exclusion from gift tax. Thus, the grantor would be required to file a gift tax return each year he or she makes a mortgage payment. In addition, the grantor may recognize gain on the transfer of the residence to the QPRT if the debt on the residence exceeds the grantor's income tax basis in the residence when the grantor gifts his or her residence to the QPRT.[41] To address this problem, an individual could transfer his or her residence to the QPRT unencumbered by the debt by assuming the obligation to make all future mortgage payments.[42] With this approach, the value of the residence should not be reduced by the value of the mortgage.

2. Will the grantor of a QPRT lose his or her ability to deduct certain items from income?

Most QPRTs are designed to be grantor trusts.[43] If the QPRT is a grantor trust, the grantor can continue to take an income tax deduction for mortgage interest on his or her personal residence under Section 163(h)(4)(d) and an income tax deduction for property tax payments under Section

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[35] Treas. Reg. Secs. 25.2702-5(a), 25.2702-5(c)(2).
[36] Treas. Reg. Sec. 25.2702-5(b)(1).
[37] Treas. Reg. Sec. 25.2702-5(c)(2).
[38] Treas. Reg. Sec. 25.2702-5(c)(2)(ii).
[39] *Id.*
[40] Jackman v. Comm'r., 44 B.T.A. 704 (1941) *acq*. 1942-1 C.B. 9.
[41] Estate of Levine v. Comm'r., 72 T.C. 780 (1979), *aff'd.* 634 F.2d 12 (2nd Cir. 1980).
[42] If the grantor takes this approach and then the trustee of the QPRT sells the residence, the grantor would need to have other assets to pay the outstanding debt because the full proceed from the sale of the residence would be payable to the QPRT and not the grantor.
[43] A grantor trust is a trust that is a grantor trust as to both income and principal. An attorney can draft the QPRT as a grantor trust by intentionally implicating one or more of the grantor trust rules which yield grantor status for income tax, but not estate tax, purposes.

164.[44] If the attorney drafts the QPRT as a grantor trust, transactions between the grantor and a grantor trust are ignored for income tax purposes.[45] This means that the grantor recognizes all the QPRTs income even though it is paid to the beneficiaries or accumulated in the QPRT. The QPRT property thus grows without a reduction to pay income taxes. The grantor's payment of income tax attributed to the QPRT is not considered a gift to the QPRT because the grantor is obligated to recognize the QPRT's income as his or her own income.[46]

3. Can the trustee of a QPRT sell the residence?

Most QPRTs permit the trustee to sell the residence and hold the proceeds in a separate account. If the trustee has this power, the trustee must reinvest the sale proceeds in another residence within two years of the sale of the initial residence.[47] If the trustee purchases a smaller residence, the proceeds that were not reinvested cannot be paid outright to the grantor if the QPRT is to remain a QPRT. Rather, this amount must be paid to the grantor as a qualified annuity for the balance of the term of the QPRT.[48] If the grantor's adjusted income tax basis in the residence is less than the amount the QPRT receives in the sale, the grantor will recognize gain; however, the grantor may be able to exclude up to $250,000 of this gain ($500,000 for a married couple) under Section 121(b)(1)-(2) if the QPRT is a grantor trust.[49]

4. Can the grantor live in the residence after the selected term?

If the grantor lives in the residence beyond the expiration of the selected term without paying rent to the QPRT, the IRS may argue that the grantor retained an interest in the QPRT beyond the selected term. The grantor may, however, pay the QPRT fair market value rent to live in the residence without causing the QPRT assets to be included in his or her gross estate at his or her death.[50] While a grantor may frown upon the idea of paying rent to live in a residence he or she previously owned, the payment of rent is actually another tool by which he or she can make gift tax-free transfers to his or her intended beneficiaries.

5. Will a grantor's transfer of his or her personal residence to a QPRT qualify for the annual exclusion from gift tax?

The annual gift tax exclusion is only available for present interest gifts. The grantor's gift of the remainder interest is a future interest gift that will not qualify for the annual exclusion gift. The grantor cannot qualify the gift for the annual exclusion from gift tax using *Crummey* powers because the Treasury Regulations prohibit distributions from the QPRT to anyone other than the grantor during the selected term.[51]

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[44] Priv. Ltr. Rul. 9448035 (Sept. 2, 1994).
[45] Rev. Rul. 85-13, 1985-1 C.B. 184. An attorney can draft the QPRT as a grantor trust by intentionally implicating one or more of the grantor trust rules that yields grantor status for income tax, but not estate tax purposes. IRC Sec. 671 *et. seq.*
[46] Rev. Rul. 2004-64, IRB 7; Priv. Ltr. Rul. 95-43-049 (Aug. 3, 1995).
[47] Treas. Reg. Sec. 25.2702-5(c)(7)(ii).
[48] Treas. Reg. Sec. 25.2702-5(c)(8)(ii)(B).
[49] Priv. Ltr. Rul. 9026036 (Mar. 28, 1990).
[50] Priv. Ltr. Ruls. 94-48-035 (Sept. 2, 1994), 9626041 (June 28, 1996) and 199931028 (Aug. 9, 1999).
[51] Treas. Reg. Sec. 25.2702-5(c)(4).

6. Can a grantor make his or her grandchildren beneficiaries of the QPRT?

Section 2642(f) prohibits the allocation of GST tax exemption during an estate tax inclusion period (ETIP). The grantor's retained term is an ETIP because the QPRT's assets will be included in the grantor's gross estate if he or she dies during that term. As a result, a grantor cannot allocate GST tax exemption to the initial gift of the residence. Grantors typically avoid the implication of GST tax by designating children, and not grandchildren (or other skip persons), as beneficiaries of a QPRT. If a grantor desires to make his or her grandchildren the beneficiaries of the QPRT, he or she will have to wait to allocate the GST tax exemption until the end of the QPRT term.

7. Who can serve as trustee of the QPRT?

Any competent adult, including the grantor, can serve as trustee of the QPRT.[52] If the grantor serves as trustee, the QPRT should not give the grantor the option to distribute the funds to the grantor or convert the QPRT to a qualified annuity if any part of the QPRT ceases to be a QPRT. If the grantor retains these powers, the IRS may argue that the grantor retained a power over the QPRT and that the assets of the QPRT should, therefore, be included in the grantor's gross estate upon his or her death.[53] Thus, these powers should be given to a special trustee.

8. Can a spouse be a beneficiary of the QPRT?

By providing his or her spouse with a life estate interest in the QPRT, the grantor may provide the spouse with the right to live in the residence at the end of the selected term.[54] Moreover, the grantor could live with the spouse without paying rent to the QPRT after the selected term if the QPRT provides the spouse with a life estate interest. If, however, the grantor continued to live in the residence after his or her spouse's death, the grantor must pay rent to the QPRT to avoid estate inclusion of the residence.

E. Life Insurance Applications

While the primary purpose of life insurance is death benefit protection, life insurance can also be an important part of a grantor's wealth transfer plan. If the QPRT is successful, the grantor's residence will be removed from his or her gross estate. While a successful QPRT should reduce the grantor's overall estate tax liability, it may create a liquidity problem because the grantor's residence cannot be sold to pay any estate tax due on the balance of his or her gross estate. Life insurance may be an excellent source of estate tax liquidity to prevent the forced sale of other assets to pay the potential estate tax due upon the grantor's death. Additionally, the distribution of the residence to certain family members, but not others (e.g., the grandchildren), may cause family acrimony. Thus, life insurance may assist the grantor in equalizing the passage of wealth among all family members.

[52] The trustee appointed should not be the insured or the insured's life insurance producer. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.
[53] IRC Secs. 2036(a)(1) and 2038(a)(2).
[54] If the spouse is a trust beneficiary, the grantor should wait some period of time before transferring his or her residence to the QPRT if his or her spouse recently transferred her interest to him or her. Otherwise the IRS might argue, under the step transaction theory, that the non-grantor spouse was a co-grantor of the QPRT.

If, on the other hand, the grantor fails to survive the term of the QPRT, all or a portion of the residence will revert back to his or her estate. For this reason, the grantor or the QPRT beneficiaries often ensure against the risk of the grantor's death during the selected term. If the grantor dies during the term of the QPRT, the beneficiaries could use the life insurance policy proceeds to purchase the residence from the grantor's estate. If the estate sells the residence to the beneficiaries, it will have funds to pay any estate taxes incurred by the inclusion of the residence in the grantor's gross estate.

IV. Grantor Retained Annuity Trust (GRAT)

A. What is a grantor retained annuity trust?

A grantor retained annuity trust (GRAT)[55] is an irrevocable trust to which an individual transfers property but retains a fixed annuity interest for a specified term not to exceed life expectancy, with the remainder interest passing to specific beneficiaries. While there may be an initial gift tax imposed when the property is transferred to the GRAT, ownership of the transferred property passes to the grantor's beneficiaries without the imposition of additional gift tax if the grantor survives the selected term. If the grantor fails to survive the selected term, all or a portion of the GRAT corpus will be included in the grantor's gross estate.[56] A GRAT is a useful estate planning tool because it allows a grantor to transfer property and all the property's appreciation to his or her beneficiaries at a reduced transfer tax cost.[57]

The following example illustrates the features of a GRAT. Assume a 60-year-old woman, Mother, has a sizeable estate which includes a tea shop operated by Daughter and worth $1,500,000. Mother would like Daughter to own the tea shop. If Mother gifts the tea shop to Daughter, she would have to pay gift taxes on the transfer because Mother has already exhausted much of her lifetime gift tax exemption amount.

Instead of an outright gift, Mother transfers the tea shop to the GRAT, retaining a ten percent annuity interest ($150,000 per year) for ten years, and naming daughter as the GRAT beneficiary. Mother's gift to the GRAT is substantially less than the fair market value of the tea shop because her retained annuity interest reduces the value of the gift to $152,610.[58] If Mother survives the ten-year term, ownership of the tea shop will pass to Daughter without the imposition of any additional gift tax. If the value of the tea shop appreciates at the rate of five percent per year to $2,443,342

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[55] In July 14, 2008, the IRS issued final regulations on GRATs and the application of IRS Secs. 2036 and 2039. See 73 FR 40173-40179, TD 9414 (July 14, 2008). These regulations addressed the value of the GRAT assets that would be includible in the grantor's gross estate should he/she die before the GRAT term. Please consult with legal and tax counsel for more information on these final regulations.

[56] Treas. Reg. Sec. 20.2036-1(c)(2)(i).

[57] The President's annual budget has repeatedly contained a proposal that would require any new GRAT to have a term of no less than 10 years. Although the House of Representatives passed such a bill in 2010, the Senate did not take up the issue and no new legislation has been introduced.

[58] This calculation assumes a 2.0% Section 7520 rate on the date of Mother's gift and was calculated using NumberCruncher software, Leimberg & LeClaire, Inc.

and Mother passes away immediately after the ten-year term, the potential transfer tax savings would be $916,293.[59]

Even if Mother passes away during the term so that all or a portion of the value of the trust corpus is brought back into her estate,[60] her estate receives a credit for any gift taxes she may have paid. From a transfer tax perspective, except for the fees and costs associated with initially establishing the GRAT, the use of a GRAT is a win-tie situation. If Mother survives, she wins and if she does not survive, the transfer tax on her interest in the tea shop is not increased.

B. Why are GRATs used?

1. The grantor may pass property to his or her intended beneficiaries with reduced gift tax costs.

The taxable gift, if any, the grantor makes of the remainder interest in the GRAT will be significantly less than the fair market value of the transferred property because the grantor retains the right to a fixed annuity for a term of years. The gift is equal to the fair market value of the property reduced by the grantor's retained annuity interest.

Most tax advisors will, however, advise the individual to set the annuity payments as a percentage of the assets transferred so that the present value of the annuity payments is equal to (or close to) the value of the property transferred. This type of arrangement may minimize or eliminate any gift tax associated with the transfer. This type of GRAT structure is often referred to as a zeroed-out[61] GRAT because the amount gifted to the GRAT is usually minimal.[62] In calculating the present value of the annuity payments, the IRS assumes a rate of return equal to the section 7520 rate.[63] A lower 7520 rate allows a taxpayer to use a lower annuity amount to zero-out the GRAT. The results are two-fold: 1) a reduction in the amount of the annuity payments includable in the grantor's estate; and, 2) more assets and appreciation in the GRAT for the GRAT beneficiaries.

2. The grantor can freeze the value of gifted property and pass all future appreciation to his or her intended beneficiaries.

The size of the gift of the remainder is based on the fair market value of the transferred property at the time the grantor transfers the property to the GRAT. Regardless of the amount by which the transferred property appreciates over the term of the GRAT, if the grantor survives the selected term, there should be no additional gift tax imposed when ownership of the GRAT property is transferred to the grantor's beneficiaries.

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[59] The potential tax savings are calculated by multiplying the assumed estate tax rate of 40% by the difference between the pre-discounted fair market value of the tea shop in year ten and the amount of the previous taxable gift .40 x ($2,443,342 – $152,610) = $916,293.

[60] Treas. Reg. Sec. 20.2036-1(c)(2)(i).

[61] The individual's contribution to the GRAT may be valued at close to zero for gift tax purposes if the GRAT is structured as a zeroed-out GRAT. With a zeroed-out GRAT, the individual's gift to the beneficiaries is close to zero because the value of the individual's retained interest is almost equal to the value of the property the individual transferred to the GRAT.

[62] Treas. Reg. Sec. 25.2702-3(e).

[63] IRC Sec. 2702(a)(2)(B).

3. The grantor may retain the right to substitute GRAT assets and, thus, need not choose between estate tax exclusion and a step-up in income tax basis at death.

Under current law, in 2020, property included in an individual's gross estate will receive a new income tax basis equal to the fair market value of the property on the date of death.[64] For this reason, tax advisors often counsel their clients to retain low income tax basis property so that their heirs receive the benefit of a step-up in income tax basis to fair market value at death. If a grantor establishes a GRAT and outlives the selected term, the transferred property is excluded from his or her gross estate but does not receive a stepped-up income tax (as compared to a transfer of the property at the grantor's death). This means that the beneficiaries of the GRAT may recognize gain on the sale of any appreciated property transferred to the GRAT. This differs from a transfer of property at death because, at death, the transferor's beneficiaries obtain a step-up in basis and would, thus, not have recognized a gain on the sale of the property.

The benefit of estate exclusion, however, typically outweighs the benefit of a step-up in income tax basis. Property included in an individual's estate can be taxed at a federal rate of up to 40 percent. Generally, the maximum combined state and federal capital gain rate is significantly lower. Nonetheless, if the GRAT grants the grantor the power to reacquire trust corpus by substituting other property of an equivalent value, the transferor could exchange cash or other high income tax basis property for low income tax basis property held by the GRAT before the grantor's death.

Alternatively, the GRAT may distribute a portion of the GRAT property in kind to the grantor in satisfaction of the annuity interest. With either method, appreciated property can be re-included in the grantor's gross estate, providing a step-up in income tax basis at his or her death. Normally a trust must recognize gain on the transfer of appreciated property; however, the GRAT will not recognize gain on a transfer of appreciated property to the grantor if the GRAT is structured as a grantor trust.[65]

4. A grantor may make gift tax-free transfers to his or her beneficiaries equal to the annual income tax liability of the GRAT.

If a GRAT is a grantor trust for income tax purposes, all income, deduction and credit attributed to income earned by the trust is attributed directly to the grantor.[66] The grantor's payment of income tax attributed to the GRAT is not considered an additional gift to the trust beneficiaries.[67] As a result, the grantor's recognition of the GRAT's income resembles a tax-free gift to the GRAT each year equal to the income tax liability of the GRAT. This tax-free transfer of additional wealth to the GRAT may be particularly important if an individual is using his or her annual exclusion gifts for other purposes and has exhausted his or her lifetime gift tax exemption amount.

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[64] IRC Sec. 1014.

[65] Rev. Rul. 85-13, 1985-1 C.B. 184. An attorney can draft the GRAT as a defective grantor trust by intentionally implicating one or more of the grantor trust rules which yield grantor status for income tax, but not estate tax purposes. See discussion regarding grantor trusts below.

[66] IRC Sec. 671 *et. seq.*

[67] Rev. Rul. 2004-64, IRB 7.

5. The grantor can retain an income stream from transferred property for a term of years, yet eventually exclude the transferred property from his or her gross estate.

An individual may want to reduce his or her estate by transferring certain property to his or her beneficiaries, but may be reluctant to make a current gift of the property because he or she wants to retain some economic benefit from the property until some later date. A GRAT provides an individual with the opportunity to make a leveraged gift of property currently while retaining the right to receive an income stream for a specified time period.

C. Appropriateness of a GRAT

Any individual with a large taxable estate (that includes income producing and highly appreciating assets) may want to consider transferring property to a GRAT, provided that the transfer can be made with minimal gifting. Many advisors recommend that the individual structure the GRAT so that the gift to the GRAT does not exceed the individual's remaining lifetime gift tax exemption amount. Alternatively, individuals may want to consider the creation of a zeroed-out GRAT to reduce gifting.

Other than the initial cost of drafting a GRAT, an individual has little to lose and much to gain by establishing a GRAT. If the grantor survives the term, he or she will remove property and any appreciation from his or her estate at a significantly reduced transfer tax cost. If the grantor fails to survive the term, all or a portion of the trust property is brought back into his or her gross estate,[68] but he or she is in no worse situation than he or she would have been had he or she not established the GRAT (less any fees and costs associated with establishing a GRAT).

D. Common Questions About GRATs

1. What type of property can a grantor gift to a GRAT?

A grantor can transfer virtually any type of property to a GRAT because GRATs are typically drafted as grantor trusts. Income producing, rapidly appreciating property is, however, the ideal type of GRAT property. A grantor can maximize the transfer of wealth by transferring property that appreciates or produces income in excess of the Section 7520 rate because that rate greatly affects the value of the annuity payments made to the grantor.

Accordingly, limited partnership units or non-voting units in an S-Corporation are often ideal assets to transfer to a GRAT because the undiscounted value of the interest in the entity often exceeds the value that will be used in determining the annuity payment using the Section 7520 rate.[69] Transferring property to heirs at a discount allows the clients to transfer significantly more wealth to their heirs with less gift tax costs because the gift tax consequences are based on the fair market value of the property.[70]

[68] Treas. Reg. Sec. 20.2036-1(c)(2)(i).
[69] See discussion below regarding Combination Techniques, Section A.
[70] Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.

2. Will a grantor's gift to a GRAT qualify for the annual exclusion from gift tax?

The grantor's gift of the remainder interest in the GRAT is a future interest gift that will not qualify for the annual exclusion amount. The annual exclusion amount is only available for present interest gifts. The grantor cannot qualify the GRAT gift for the annual exclusion from gift tax using *Crummey* powers. This is the case because the Treasury Regulations prohibit distributions from the GRAT to anyone other than the grantor during the selected term.[71]

3. What types of GRATs are individuals using today?

Most people creating GRATs are creating either traditional GRATs or a series of short-term GRATs known as "rolling GRATs." With a traditional GRAT, the individual chooses the longest possible annuity term that he or she is likely to outlive to reduce the gift made when transferring property to the GRAT. With a rolling GRAT, the individual transfers property to a GRAT with a short annuity term – at least two-years long but usually no longer than three years.

Given that most people will want to reduce the gift as much as possible with a short-term GRAT, the individual will receive a considerable amount of the GRAT property back in the form of annuity payments each year and then roll the annuity payments into a newly created GRAT with a similarly short annuity term. The individual continues this pattern until he or she accomplishes the targeted wealth transfer or until the property being transferred to the GRATs no longer produces returns in excess of the Section 7520 rate. It is important to keep in mind that short-term GRATs may not be permissible in the future. The President's annual budget has repeatedly contained a proposal that would require any new GRAT to have a term of no less than 10 years. Although the House of Representatives passed such a bill in 2010, the Senate did not take up the issue and no new legislation has been introduced.

4. Who uses traditional GRATs?

The choice between a traditional GRAT and a rolling GRAT is largely based upon the type of property the individual is considering transferring to the GRAT and the individual's desire for simplicity. If a person wants to transfer assets that require a valuation, such as interests in a closely-held business, the individual is usually more likely to choose a traditional GRAT over a series of short-term GRATs because the short-term GRATs would likely require annual valuations of the closely-held business. Most individuals using short-term GRATs structure the trusts to reduce the gift to near-zero; thus, the individual may need to receive more than half of the amount

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Treas. Regs. Secs. 20.2031-1(b), 20.2031-3, 25.2512-1, 25.2512-3. A person may gift property to the GRAT at a discount because a willing buyer would pay less for an interest in an entity than the proportionate share of the underlying property held by an entity. This is the case because, as a limited partner or non-voting member, the buyer would have a difficult time selling his or her interest in the entity and have no management control over the entity. The lack of marketability discount reflects the fact that a buyer would pay less for a non-controlling interest in a private entity than the proportionate value of the underlying property because he or she would experience difficulties in attempting to sell the interest, as there is no readily available market for selling non-controlling interests in a private entity. The lack of control discount reflects the fact that a buyer would pay less for a limited partnership interest than the proportionate value of the underlying property because he or she would not control the entity.

[71] Treas. Reg. Sec. 25.2702-3(b)(1).

of the property transferred to the trust back each year in the form of annuity payments. The trustee of the trust would need to accurately value the closely-held business interest each year to accurately distribute such interests back to the individual to satisfy the annuity payment made in kind. A traditional GRAT is also better suited for an individual who is less willing to bother with the creation of successive GRATs.[72]

5. Why might someone prefer to use a series of short-term GRATs?

Assuming Congress does not eliminate the use of short-term GRATs (i.e., GRATs with a less than 10-year term), a person seeking to fund an ILIT with little or no gift tax consequences might prefer rolling GRATs as opposed to a traditional GRAT because the potential property appreciation passes relatively soon and often. With a traditional GRAT, property and appreciation is usually passed at a much later date. This factor could be important to a person seeking to fund an ILIT with GRAT annuity payments or to assist in the roll out of a premium financing (or similar) arrangement to reduce the gifts to a trust (i.e., private financing arrangements) in the next few years.

An individual may also prefer rolling GRATs as opposed to a traditional GRAT because they may mitigate the mortality risk associated with a traditional GRAT. A person is probably more likely to survive a shorter term and a properly drafted and administered GRAT where the annuity term expires prior to death will not create estate tax inclusion. Another feature of rolling GRATs is that they allow the individual to transfer more wealth to heirs when the GRAT property's value and earnings fluctuate. With a traditional GRAT, the ultimate wealth transfer to heirs is lessened in the years in which the GRAT property produces returns less than the IRS' assumed rate of return (the Section 7520 rate). Returns in excess of the Section 7520 rate in previous years could be consumed to make annuity payments in years when the GRAT property produces returns less than the Section 7520 rate. With a series of short-term GRATs, less than expected returns in one GRAT may not affect the wealth transfer produced by previous or future GRATs. Instead, the less successful GRAT simply returns the GRAT property as annuity payments to the individual and transfers no wealth to the individual's heirs.

6. Can a grantor make his or her grandchildren beneficiaries of the GRAT?

Though a grantor can designate his or her grandchildren as the GRAT beneficiaries, it is typically unwise to do so from a transfer tax perspective. As with a QPRT, Section 2642(f) prohibits the allocation of GST tax exemption during an ETIP. The selected term of a GRAT is an ETIP because the value of the GRAT property will be included in the grantor's gross estate if he or she dies during the selected term. Thus, a grantor cannot allocate GST tax exemption to his or her initial transfer to the GRAT and thereby leverage the GST tax exemption. For this reason, grantors typically designate children as beneficiaries of a GRAT and thus avoid the implication of GST tax on any of the GRAT property.[73] If a grantor would like to benefit his or her grandchildren, a separate ILIT may be established for their benefit.

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[72] An attorney drafting a series of short-term GRATs might use the same general document to create each successive GRAT, but each GRAT will be a separately created trust document because the GRAT prohibits additional contributions during the GRAT annuity term. Treas. Reg. Sec. 25.2702-3(b)(5).

[73] In certain circumstances, a grantor will not be making a generation-skipping transfer even if his or her grandchild is a beneficiary of the trust if such grandchild is a child of the grantor's deceased child.

7. Who receives the GRAT property if the grantor dies during the selected term?

Traditionally, the GRAT will be drafted so that the grantor of a GRAT retains a reversionary right that returns the GRAT property to the grantor's estate if he or she fails to survive the selected term. This reversionary right prevents the estate from experiencing a liquidity problem that may otherwise occur if the grantor's estate includes only the value of the GRAT property but does not have the trust property to pay the estate tax due. Some attorneys, however, may draft GRATs that do not include this right of reversion. If the GRAT is drafted in this manner, the value of the retained annuity payments (not the asset itself) is included in the grantor’s estate if he or she fails to survive the GRAT term.

When establishing a zeroed-out GRAT, however, it is important that the annuity payments are payable in all events for the entire term of the GRAT rather than revert back to the grantor’s estate.[74] The GRAT provisions should therefore provide that the annuity payments shall continue to be paid to the grantor’s personal representative or executor as a part of the grantor’s estate if the grantor dies during the trust term. Moreover, the grantor and his or her tax advisors should consider how the payment of estate taxes will be funded if the grantor dies during the trust term because all or a portion of the GRAT property will be included in the grantor’s estate under IRC Sections 2036 or 2039. The grantor’s estate will only have access to GRAT property to pay estate tax to the extent that annuity payments are actually made. Life insurance (discussed below) on the life of the grantor may be a solution to this liquidity problem.

8. Who can serve as trustee of the GRAT?

During the GRAT term, a grantor may choose to serve as trustee of a GRAT. The primary reason is that death during the GRAT term will result in estate inclusion of all or a portion of the GRAT corpus[75] regardless of the identity of the GRAT trustee. After the GRAT term, however, a grantor of a GRAT is discouraged from serving as trustee to prevent possible inclusion of the property in the grantor's gross estate. The grantor may, if he or she chooses, continue to serve as an administrative trustee after the GRAT term but should appoint a co-trustee to manage distributions from the GRAT. To minimize any potential estate inclusion issue, the conservative approach is to choose another competent adult to serve as trustee of a GRAT.

E. Life Insurance Applications

Although the primary purpose of life insurance is death benefit protection, life insurance and GRATs are often used together because life insurance may assist a person with estate tax liquidity issues associated with a GRAT. However, life insurance should not be purchased inside the GRAT. This is the case because if the grantor dies during the GRAT term, all or a portion of the GRAT (including any life insurance death benefit proceeds) will be included in the grantor’s estate.[76] Thus, life insurance should instead be purchased inside a separate ILIT or by the beneficiaries of the GRAT.

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[74] Treas. Reg. Sec. 25.2702-3(e), Example 5.
[75] Treas. Reg. Sec. 20.2036-1(c)(2)(i).
[76] Treas. Reg. Sec. 20.2036-1(c)(2)(i).

Life insurance on the life of the grantor can be used to provide liquidity for estate taxes that may be incurred by the inclusion of the GRAT property in the grantor's estate if he or she dies during the GRAT term. As discussed above, the transfer tax benefits of a GRAT are realized only if the grantor survives the term of the GRAT. If the grantor fails to survive the retained GRAT term, all or a portion of the transferred property will be included in the grantor's estate for estate tax purposes. If a zeroed-out GRAT is used, the annuity payments must continue even after the grantor's death for the remaining GRAT term. This means that if the grantor dies during the GRAT term, all or a portion of the GRAT property will be included in his or her estate but only the annuity payments actually made to the grantor's estate will be available to pay estate tax. Purchasing a life insurance policy on the life of the grantor may provide the liquidity that the estate may need to pay the estate tax.

Additionally, if the grantor of a GRAT survives the selected term of the GRAT, he or she will remove property and the appreciation on the property from his or her gross estate. Although a successful GRAT reduces the grantor's overall estate tax liability, it may create a liquidity problem because the transferred property cannot be sold to pay any estate tax that may be due on the balance of the grantor's gross estate. Life insurance may provide the funds to prevent the estate from selling other estate assets to pay estate tax due after the grantor's death.

Finally, life insurance may also be used to equalize the grantor's estate. If the GRAT is successful, the distribution of the property to certain family members, but not others (i.e., grandchildren), may cause family acrimony. Life insurance may assist the grantor in equalizing the passage of wealth amongst all family members.

V. Family Limited Partnership (FLP)

A. What is a family limited partnership?

A family limited partnership (FLP) is a legal entity established under an individual's state partnership laws. FLPs are used to consolidate and manage wealth, provide some asset protection and, in the estate planning context, to transfer property to junior generations at a reduced transfer tax cost.

For example, assume Parents, who are both fifty years of age, own and operate a manufacturing business with a fair market value of approximately $34,000,000. Their tax advisors have indicated that the property is expected to grow to approximately four to five times the current value and, therefore, tens of millions in estate taxes will likely be due upon the death of the survivor. Parents decide to transfer the business to an FLP in exchange for general partnership and limited partnership interests. After formation of the FLP, Parents each use their lifetime gift tax exemption amount ($11,580,000 each in 2020) to gift limited partnership interests worth $23,160,000 to their children. This is the maximum amount Parents can transfer using their respective lifetime gift tax exemption amount without paying gift tax. If a qualified appraiser determines that the gift of the limited partnership interests is entitled to a discount for lack of marketability and lack of control, Parents may be entitled to use the discounted value to determine the gift tax value. Assuming a 30 percent discount for lack of marketability and lack of control, Parents' gift is leveraged. Although Parents are transferring limited partnership interests to Son and Daughter valued at $23,160,000, the transferred limited partnership units represent $33,085,714 of pro rata value in the manufacturing business. Even if Parents make no further gifts to Son or Daughter, their gifts of the FLP units could save the family substantially in estate taxes with the discounted shares passing to the children – presuming that the entity and the transactions between Parents and the FLP is structured to withstand IRS scrutiny.

Over the years, the IRS has had mixed success in challenging FLPs. Even though the IRS was unsuccessful in most of its earlier arguments designed to reduce or eliminate the discount,[77] the tide appears to be changing. Recently it has been successful in bringing the partnership assets back into the estate pursuant to IRC Section 2036 where the taxpayer retained an express or implied benefit from the partnership[78] or too much control over the partnership.[79]

Two cases underscore the IRS's recent success in this arena: Linton v. U.S., 638 F. Supp.2d 1277 (W.D. Wash. July 1, 2009) and Holman v. Commissioner, 105 AFTR 2d 2010-721 (8th Cir. April 7, 2010) aff'g 130 T.C. 170 (2008). In Linton, the court found in favor of the IRS where the

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[77] Until very recently the IRS has been losing the argument that the FLP lacked economic substance provided that the partnership was validly formed under state law, losing the argument that the grantors made a gift on formation of the entity equal to the difference between the value of the property transferred less the fair market value of the partnership interests received, losing the argument for applying Section 2703 which was intended to govern buy-sell and option agreements, not family limited partnership, and losing the argument for applying 2704(b) to ignore restrictions on partnership liquidation for transfer tax purposes if the restrictions are more restrictive than the limitations under state law. *See* Church v. U.S., 85 AFTR 2d 2000-804 (DC Tex. 2000), aff'd without opn., 268 F.3d 1063 (5th Cir. 2001); Estate of Strangi, 115 T.C. 478 (2000), aff'd in part and rev'd in part, 293 F.3d 279 (5th Cir. 2002); Knight v. Comm'r., 115 T.C. 506 (2000); Estate of Jones v. Comm'r., 116 T.C. 121 (2001); Estate of Thompson v. Comm'r., 382 F.3d 367 (3d Cir. 2004), aff'g, T.C. Memo. 2002-246; Kerr v. Comm'r., 292 F.3d 490 (5th Cir. 2002), aff'g, 113 T.C. 449 (1999); and Estate of Harper v. Comm'r., T.C. Memo. 2002-121. However, in *Holman v. Commissioner*, 105 AFTR 2d 2010-721 (8th Cir. April 7, 2010) aff'g 130 T.C. 170 (2008), the IRS rejected the taxpayers' arguments and concluded that the transfer restrictions in the transfer to the FLP did not satisfy the bona fide business arrangement requirement in Sec. 2703(b). If you are considering this strategy, please consult with legal and tax counsel to discuss the implications of *Holman* and other recent decisions.

[78] Estate of Reichardt v. Comm'r., 114 T.C. 144 (2000); Harper, T.C. Memo. 2002-121; Thompson, 382 F.3d 367; Estate of Strangi v. Comm'r., 115 T.C. 478 (2000) aff'd in part, rev'd in part, and remanded (for consideration of IRC Section 2036 issue), (Strangi I), Gulig v. Comm'r., (Estate of Strangi), 293 F.3d 279 (5th Cir. 2002), on remand, Estate of Strangi v. Comm'r., T.C. Memo. 2003-145,aff'd, (Strangi II), Estate of Strangi v. Comm'r., No. 03-60992 (5th Cir. 2005) (Strangi III); Estate of Abraham v. Comm'r., T.C. Memo. 2004-39, aff'd, 408 F3d 26 (1st Cir. 2005); Estate of Hillgren v. Comm'r., T.C. Memo. 2004-46; and Estate of Virginia A. Bigelow, T.C. Memo. 2005-65; Estate of Schauerhamer v. Comm'r., T.C. Memo. 1997-242; Estate of Stone v. Comm'r. T.C. Memo. 2003-309; Estate of Bongard v. Comm'r., 124 T.C. 95 and Estate of Rosen v. Comm'r., T.C. Memo. 2006-115. In general, the courts have considered the following factors indicative of an implied agreement to retain benefits over transferred property: (1) contributing substantially all of the person's assets to the partnership without retaining assets outside of the partnership sufficient to support the person; (2) post-death payments of debts and expenses; (3) testamentary characteristics resembling an estate plan versus an arms-length joint enterprise; (4) commingling of personal and entity funds; (5) disregard for entity formalities and treating the partnership assets without regard to the partnership entity and operations; and (6) making disproportionate distributions not in accordance with the terms of the partnership agreement.

[79] The IRS might also use Section 2036(a)(2) to bring property previously transferred by the person back into the estate if the person, alone or with others, retains control over who enjoys the transferred property or its income based upon the person's ability, with other partners, to compel a liquidation of the partnership and his or her ability, with the other general partners, to control the partnership distributions.

property was contributed to an LLC on the same day that gifts of LLC interests were made to a trust (also created on the same day for the benefit of the grantor's children). The court disallowed a discount with regard to the LLC interests and, instead, concluded that the gifts were indirect gifts of the underlying assets.[80]

The Holman case involved an FLP created to own publicly traded stock (Dell). There, the court concluded that transfer restrictions did not satisfy the "bona fide business arrangement" requirement of Sec. 2703(b) safe harbor. The taxpayer, however, was still permitted to apply a smaller, 22.4% discount, for the lack of marketability and control on the most significant asset transferred.

There are, at this time, some uncertainties as to how to properly structure an FLP to withstand IRS scrutiny. However, the IRS appears to be paying special attention to FLPs that use aggressive discounting. Given the IRS's recent FLP challenges, individuals considering establishing an FLP should consult with an attorney or tax advisor to discuss the appropriateness of this concept to a particular situation and for up-to-date information on FLPs.

B. Why are FLPs used?

1. An individual can transfer limited partnership interests to intended beneficiaries at a reduced transfer tax cost.

Transferring property to heirs at a discount allows the individual to transfer significantly more wealth to their heirs with lower gift tax costs. With the uncertainty surrounding changes to the estate tax system, people may be reluctant to engage in estate planning techniques that would require them to pay gift tax. Accordingly, they may maximize the use of the available exemption equivalent amounts by gifting or selling property to heirs at a discount.

Gift and estate tax consequences are based upon the fair market value of property. A person may use an FLP to transfer property to heirs at a discount because the fair market value of an interest in the entity may be significantly lower than that of the proportionate interest in the underlying property held by the entity. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.[81] FLPs may allow individuals to either gift or sell assets to heirs at a discount because a willing buyer would pay less for a limited partnership interest than the proportionate share of the underlying property held by the FLP. This is the case because, as a limited partner, the buyer would have a difficult time selling his or her interest in the FLP and have little or no management control over the FLP.[82]

[80] This analysis would likely apply to FLPs as both are pass-through entities that are oftentimes used to transfer assets at a discount (lack of marketability and/or control).
[81] Treas. Reg. Secs. 20.2031-1(b), 20.2031-3, 25.2512-1, 25.2512-3.
[82] The lack of marketability discount reflects the fact that a buyer would pay less for a limited partnership interest than the proportionate value of the underlying property because he or she would experience difficulties in attempting to sell the limited partnership interest, as there is no readily available market for selling limited partnership interests. The lack of control discount reflects the fact that a buyer would pay less for a limited partnership interest than the proportionate value of the underlying property because he or she would not control the FLP.

2. An individual can freeze the value of property by passing future appreciation to his or her intended beneficiaries.

When an individual gifts limited partnership interests in the FLP, he or she may accomplish two things: a) removing the value of the limited partnership interest from his or her gross estate; and, b) removing the corresponding appreciation on the limited partnership interest from his or her gross estate. Of course, this assumes that the structure of the FLP and the transaction survives IRS scrutiny.

3. An individual can reduce his or her gross estate while potentially protecting the underlying property from creditors and non-family ownership.

An FLP may provide some degree of creditor protection. Ordinarily, a creditor's only remedy against a limited partnership interest is a charging order against that limited partnership interest. A charging order is a court order requiring all distributions from the partnership to the debtor-partner be paid to the creditor until the debt is discharged.[83] It is not equivalent to ownership of the limited partnership interest. While a charging order may entitle a creditor to the income from the limited partnership interest, the creditor will likely not be able to reach the property held by the FLP because most partnership agreements treat a creditor as an assignee – not a limited partner that is entitled to any distribution made to the debtor-partner. In fact, the creditor will not receive any cash or property if the FLP does not make any distributions to its partners. Despite this, the IRS requires the creditor to pay his or her proportionate share of the FLP income taxes, regardless of whether or not he or she received a distribution from the FLP.[84]

C. Appropriateness of an FLP

An individual with a large estate may consider establishing an FLP if he or she wants to transfer property to heirs at a discount to reduce the size of the estate. As with everything else discussed in this piece, it is wise to first consult with legal and tax advisors to obtain up-to-date information on FLPs and to determine the appropriateness of this technique in a particular situation. This is especially true because of the IRS's recent challenges on FLPs.

While there is no real roadmap as to how to minimize an FLP from a challenge by the IRS, the individual should avoid the implied retention of benefits over the partnership by, among other things: (1) having a real business purpose for establishing and maintaining the partnership or pooling of assets among partners to indicate an arms-length enterprise; (2) avoiding contributing substantially all of his or her assets to the partnership without retaining assets outside of the partnership sufficient to support himself; (3) avoiding post-death payments of debts and expenses; (4) avoiding co-mingling personal funds with entity funds; and, (5) respecting the entity formalities, including, but not limited to, transferring title of assets to the entity, keeping adequate records and making proportionate distributions in accordance with the terms of the partnership agreement.

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[83] Revised Uniform Limited Partnership Act Sec. 703.
[84] Rev. Rul. 77-137, 1977-1 C.B. 178.

In addition to taking steps to avoid any implied retention of benefits or control that may cause inclusion under Section 2036, the individual may want to qualify the initial funding of the partnership for the bona fide sale (BFS) exception. The BFS exception is a statutory exception within Section 2036 that precludes the property that the decedent transfers, over which he or she retains the right to income or control, from being included in the estate where such property was transferred as part of a BFS for adequate consideration.[85] The Tax Court and Circuit Courts of Appeal each have different views as to what constitutes a BFS for adequate consideration. Thus, the individual's legal and tax advisors need to advise him or her as to how best qualify for this exception. Generally, a person may qualify for the BFS exception if: (1) there was an arms-length, negotiated transaction between the partners concerning the exchange of partnership interests for the transfer of property funding the partnership; (2) the partners received partnership interests proportionate to the value of the property transferred to the partnership; (3) the partnership has a significant business or significant non-tax purpose for its existence, or the partners genuinely pool assets and services (as opposed to a mere recycling of value); and, (4) the partners respect the formalities of forming and operating the partnership.[86]

It is also important to note that establishing and administering an FLP is a costly endeavor. The individual must employ valuation experts to value the underlying property to determine the appropriate discounts, attorneys to prepare the partnership agreement and accountants to prepare annual tax returns. The cost of establishing and administering an FLP may outweigh the benefits of the FLP if an individual does not have a substantial amount of property to contribute to an FLP.

[85] IRC Section 2036(a) provides: (a) GENERAL RULE – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he or she has retained for his or her life or for any period not ascertainable without reference to his or her death or for any period which does not end before his or her death: (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom.

[86] The Tax Court has indicated that legitimate negotiations and a legitimate business or non-tax purpose for the transfer of assets to the partnership or pooling of resources is necessary to qualify for the BFS exception. *See* Estate of Harper v. Comm'r., T.C. Memo. 2002-121; Thompson v. Comm'r., T.C. Memo. 2002-246; Estate of Reichardt v. Comm'r., 114 T.C. 144 (2000); Estate of Bongard v. Comm'r., 124 T.C. 95; Estate of Virginia A. Bigelow, T.C. Memo. 2005-65 and Estate of Rosen v. Comm'r., T.C. Memo. 2006-115. The Third Circuit Court of Appeals has indicated that a legitimate business or non-tax purpose for the transfer of assets to the partnership and respect for the formalities of forming and operating the partnership are necessary to qualify for the BFS exception. *See* Estate of Thompson v. Comm'r., 382 F.3d 367 (3d Cir. 2004), aff'g, T.C. Memo. 2002-246. The Fifth Circuit Court of Appeals has indicated that receiving partnership interests proportionate to the value of the property transferred to the partnership, a substantial business or substantial non-tax purpose for the transfer of assets to the partnership and respect for the formalities of forming and operating the partnership are necessary to qualify for the BFS exception. *See* Estate of Strangi v. Comm'r., No. 03-60992 (5th Cir. 2005) (Strangi III), aff'g Estate of Strangi v. Comm'r., T.C. Memo. 2003-145 (Strangi II). For a detailed discussion of qualifying for the BFS exceptions, see Korpics, Qualifying New FLP for the Bona Fide Sale Exception: Managing *Thompson, Kimbell, Harper and Stone,* Journal of Taxation (WG&L) (Feb. 05).

D. Common Questions About FLPs

1. What type of property can an individual contribute to an FLP?

a. Closely-Held Business. Stock in a closely-held business is an ideal asset for an individual to contribute to an FLP. An individual can transfer stock in a closely-held business to an FLP provided that he or she does not transfer voting shares of a controlled corporation to the FLP.[87] If an individual transfers voting stock in a closely-held corporation to an FLP and then votes those shares as general partner of the FLP, the individual would be deemed to have retained enjoyment of the transferred stock. This retained enjoyment would cause any limited partnership interests that the individual transferred to the FLP to be included in his or her gross estate. An individual can avoid this problem by recapitalizing the controlled corporation and transferring only non-voting stock to the FLP.

FLPs are not permissible shareholders of S-Corporation stock. Accordingly, S-Corporation stock should not be transferred to an FLP because such a transfer would cause the loss of S-Corporation status.[88]

b. Marketable Securities. Most appraisers allow a discount for limited partnership interests in an FLP holding marketable securities. Recently, the IRS has challenged a number of cases involved FLPs that own marketable securities (i.e., the *Holman v. Commissioner* case discussed earlier). These cases underscore the fact that (as with most cases) FLP cases will depend on the particular facts of each case. For example, in *Estate of Jorgensen v. Commissioner,*[89] the Tax Court concluded that two FLPs that owned marketable securities were subject to Section 2036(a)(1) and did not meet the required "legitimate and significant non-tax" business purpose in order to qualify for the BFS exception under Section 2036(a). In *Estate of Jorgensen,* the Court found that the partnerships' management of the FLPs' portfolio of marketable securities did not rise to the level of "active" management.[90]

On the other hand, in *Estate of Valeria M. Miller v. Commissioner*,[91] the tax court concluded that one (of two) FLPs that owned marketable securities satisfied the BFS exception and was not governed by Section 2036. The Court concluded that there was a legitimate and substantial non-tax reason for forming this FLP and those assets were actively managed. With regard to the second FLP, however, the Court determined the transfers to be driven by the desire to save estate taxes and, thus, no discounts were allowed under the authority of Section 2036(a)(1) and those assets were included in the decedent's gross estate.[92]

If marketable securities are being transferred to an FLP, steps should be taken to prevent the FLP from being treated as a partnership investment company. If an FLP is classified as a partnership

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[87] A controlled corporation is a corporation in which the individual owned (with application of Section 318 family attribution rules) or had the right to vote stock equal to at least 20% of the combined voting power of all classes of stock. IRC Sec. 2036(b)(2).
[88] IRC Sec. 1361(b)(1).
[89] T.C. Memo. 2009-66, No. 21936-06 (March 26, 2009).
[90] Id.
[91] T.C. Memo. 2009-119; No. 5207-07 (May 27, 2009).
[92] Id.

investment company, any individual contributing appreciated property to that FLP will recognize gain upon the contribution of the appreciated property to the FLP. An FLP is a partnership investment company if: (1) 80 percent or more of the value of the FLP property is held for investment and is stock and securities defined by Section 351(e)(1)(B) after the transfer;[93] and (2) the transfer directly or indirectly results in the diversification of the transferor's interest in the FLP.[94] If there is a risk that the stock and securities will represent 80 percent of the value of the FLP, the partners may avoid diversification by contributing identical stock, securities or other property to the FLP. If the contributing partners are married, they can avoid diversification by contributing property to a tenancy-in-common account prior to transferring the account to the FLP.

c. Real Estate. Investment real estate is often contributed to an FLP. However, an individual may recognize gain on the contribution to the FLP if he or she contributes property with debt in excess of his or her income tax basis to the FLP.[95]

2. Does the gift of a limited partnership interest qualify for the annual exclusion from gift tax?

Only gifts of a present interest qualify for the annual exclusion from gift tax.[96] A present interest is the unrestricted right to the immediate use, possession or enjoyment of property.[97] While gifts of limited partnership units have historically been treated as present interest gifts that qualify for the annual exclusion,[98] under certain circumstances the IRS and Tax Court have ruled to the contrary.[99] Accordingly, an individual should only consider making gifts of limited partnership units intended to qualify for the annual exclusion from gift tax after careful consideration of the issue with his or her tax advisor.

3. Are the valuation discounts valid?

The fair market value of a limited partnership interest is often significantly less than the proportionate fair market value of the underlying property held by the FLP. Most appraisers discount the value of the limited partnership interests to reflect the lack of marketability of the limited partnership interest and the limited partner's lack of control over the FLP. As previously

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[93] IRC Sec. 351(e)(1)(A).
[94] Treas. Reg. Sec. 1.351-1(c)(1).
[95] IRC Sec. 752(b).
[96] IRC Sec. 2503(b); *see also John W. Fisher et ux. v. United States*, No. 1:08-cv-00908(11 Mar 2010) where a district court determined that gifts of FLP interests were not present interests and therefore did not qualify for the Sec. 2503(b)(1) gift tax exclusion.
[97] Treas. Reg. Sec. 25.2503-3(b).
[98] Priv. Ltr. Ruls. 91-31-006 (Apr. 30, 1991); 94-15-007 (Jan. 12, 1994).
[99] In Technical Advice Memorandum 97-51-003 (Aug. 28, 1997), the partnership's partnership agreement provided the general partner with complete discretion to retain funds within the partnership for future partnership expenditures or for any reason whatsoever. The IRS determined that these partnership provisions effectively obviated the fiduciary duty ordinarily imposed upon general partners and concluded that because of the uncertainty of any income distributions to the limited partners, the limited partnership interests did not entitle the donees to the immediate use, possession or enjoyment of the income from their partnership interests, and gifts of such interests were not gifts of present interests. In Hackl v. Commissioner, 118 T.C. 279 (2000), the Tax Court held that the taxpayer's gifts of LLC membership units were not present interest gifts because the limited liability corporation's operating agreement prevented the donees from presently accessing any substantial financial or economic benefits as the donees had no right to distributions nor the right to unilaterally transfer such membership units.

mentioned, these discounts are oftentimes attacked by the IRS. For example, in Pierre v. Commissioner, T.C. Memo. 2010-106 (5/13/10), the court reduced a 36.5% valuation discount (for lack of marketability and control). Given the importance of the valuation discounts with FLP shares, please consult with an experienced appraiser.

The lack of marketability discount reflects the fact that a buyer would pay less for a limited partnership interest than the proportionate value of the underlying property because he or she would experience difficulties in attempting to sell the limited partnership interest, as there is no readily available market for selling limited partnership interests.

The lack of control discount reflects the fact that a buyer would pay less for a limited partnership interest than the proportionate value of the underlying property because he or she would have no control over the FLP. Without control, the limited partner would be unable to compel a liquidation of his or her interest and thus would not be able to access his or her proportionate interest in the FLP's property. This discount is available even if members of the limited partner's family control the FLP.[100]

E. Life Insurance Applications

A program of gifting or selling discounted interests in an FLP may certainly reduce the size of an individual's estate. Despite the reduction in one's estate, most ultra wealthy individuals will still have a taxable estate at death because they are unwilling to give away everything that they own prior to death. While the primary purpose of life insurance is death benefit protection, life insurance may provide the liquidity the estate needs to pay the resulting estate tax.

The general partner should not, however, own the policy on his or her own life. If the general partner owns the policy individually, the proceeds will be included in his or her estate and may be subject to estate tax. If the FLP is the owner and beneficiary of the policy, the general partner's estate will only include that portion of the policy proceeds that represent the general partner's proportional interest in the FLP, presuming that the FLP is structured to withstand the recent string of challenges by the IRS. Where proceeds are paid other than to the partnership, however, those amounts will likely be included in the insured-partner's estate. In light of the recent challenges by the IRS, however, life insurance should only be owned by an FLP after careful consideration by the individual's tax advisor. As an alternative, the use of a properly drafted and administered ILIT to own the policy may be considered to avoid the inclusion of the life insurance death benefit proceeds in the insured's estate.

[100] Rev. Rul. 93-12, 1993-1 C.B. 479.

VI. Installment Sale To An Intentionally Defective Irrevocable Trust (IDIT)

A. What is an installment sale to an intentionally defective irrevocable trust?

An installment sale to an intentionally defective irrevocable trust (IDIT) is a deferred sale arrangement between an individual and an irrevocable trust that allows an individual to make gift tax-free transfers of appreciated property and corresponding income to junior generations. In this arrangement, an individual sells property to an IDIT in exchange for an installment note payable over time. This type of deferred sale arrangement is oftentimes referred to as an IDIT Sale.

The following example illustrates the features of an IDIT Sale. Assume Father has a sizeable estate that includes a valuable clock manufacturing business and he has already used up the majority of his lifetime gift tax exemption amount. Father would like to transfer $10,000,000 of value in the business to his children, but he is reluctant to give up control and is reluctant to pay the gift tax involved with a gift of shares in the business to his children. A qualified appraiser has advised Father that if he recapitalizes the S-Corporation into voting and non-voting shares, assuming a 30 percent discount for lack of marketability and lack of control, Father could gift or sell $10,000,000 of value in the business to their children for a gift or sales price of $7,000,000.

Father establishes an IDIT and uses his remaining gift tax exemption amount to gift $700,000 of non-voting shares to the trust to "seed" the trust. Thereafter, Father sells $6,300,000 worth of non-voting shares to the trust on an installment sale basis. The note would bear interest at 2% (the Section 1274(d) long-term Applicable Federal Rate on the date of sale) and require equal payments of $701,357 per year for ten years. Regardless of when Father passes away, only the outstanding balance due on the note should be included in the survivor's taxable estate.

By using his remaining gift tax exemption to gift a portion of the non-voting shares to the IDIT and selling the remaining non-voting shares to the IDIT on an installment sale basis, Father was able to leverage his gifting capacity to freeze the value of the business and remove the value of the business at a discounted value, as well as any future appreciation, outside of his estate.

B. Why are IDIT Sales used?

1. An individual can transfer property to his or her intended beneficiaries without making a taxable gift.

If an IDIT Sale is properly structured, an individual can transfer property to his or her intended beneficiaries without paying gift tax or using his or her applicable lifetime gift tax exemption amount. A sale of property to an IDIT will not be considered a gift if the transferor receives full and adequate consideration in exchange for the transferred property.[101] Accordingly, the transferor should employ valuation experts to value the property so that it is sold for its fair market value. The transferor will not be making a gift to the trust if the fair market value of the property equals

[101] IRC Sec. 2512(b).

the fair market value of the note bearing interest at the applicable federal rate set forth in Section 1274(d).[102] On the transferor's death, only the outstanding balance of the note, if any, should be included in the transferor's gross estate.

The IDIT's property may be included in the transferor's gross estate if the IDIT does not have any funds or insufficient funds from which to make the installment payments. If the IDIT is under-funded, the IRS may consider the IDIT's promise to pay the installment note illusory and deem the sale to be a transfer to a trust with a retained interest. If the sale is disregarded, the IDIT property could be included in the transferor's gross estate under Section 2036(a)(1).[103] Accordingly, the transferor is encouraged to gift cash or property to the IDIT prior to the sale to "seed" the trust. If the IDIT Sale is successful, the transferor's gift of seed cash or property should be the only gift he or she makes to the IDIT.

2. An individual can freeze the value of the transferred property and pass all future appreciation to his or her intended beneficiaries without gift, estate or generation-skipping transfer tax consequences.

The value of the property transferred in an IDIT Sale is established at the time of sale. The installment payments are not adjusted to reflect changes in the value of the transferred property. Thus, any appreciation on the transferred property is excluded from the transferor's gross estate even if the transferor dies before full repayment of the balance due on the note.

3. An individual can make gift tax-free transfers to his or her beneficiaries equal to the annual income tax liability of the IDIT.

An IDIT may be specifically drafted to be a grantor trust for income (but not estate) tax purposes. If a trust is a grantor trust for income tax purposes, all income, deductions and credits attributed to income earned by the trust is attributed directly to the grantor.[104] This means that the grantor recognizes all the IDIT's income even though it is paid to the beneficiaries or accumulated in the IDIT. The IDIT property thus grows without a reduction to pay income taxes. The grantor's payment of income tax attributed to the IDIT is not considered a gift to the IDIT because the grantor is obligated to recognize the IDIT's income as his or her own income.[105] Thus, the grantor's recognition of the IDIT's income resembles a tax-free gift to the IDIT each year equal to the income tax liability of the IDIT. This tax-free transfer of additional wealth to the IDIT may be particularly important if an individual is using his or her annual exclusion gifts for other purposes and has exhausted his or her applicable lifetime gift tax exemption amount.

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[102] Frazee v. Comm'r., 98 T.C. 554 (1992).

[103] In a gift tax audit in 2000, the IRS challenged an IDIT Sale transaction where a taxpayer sold limited partnership interests to an IDIT. The IRS asserted that the partnership was a sham with no substantial economic effect and that the note attributable to the sale should be reclassified as equity and not debt. In 2003, the taxpayer challenged the IRS' assertions in Karmazin v. Commissioner (Tax Court Docket NO. 2127-03). The case was eventually settled with the IRS in October 2003. While the terms of the settlement were favorable to the taxpayer and the sale of the partnership units to the IDIT was respected as a bona fide sale, an individual considering an IDIT Sale should consult his or her tax counsel to discuss the appropriateness of this concept to a particular situation in light of possible challenges by the IRS.

[104] IRC Sec. 671 *et. seq.*

[105] Rev. Rul. 2004-64, IRB 7; Priv. Ltr. Rul. 95-43-049 (Aug. 3, 1995).

4. An individual can immediately, substantially reduce his or her gross estate by selling discounted interests to an IDIT.

Individuals utilize entities such as family limited partnerships, limited liability companies and corporations to transfer property to junior generations at a reduced transfer tax cost.[106] The transferor or his or her estate pays less gift, estate and GST tax because the fair market value of gifts of interests in these entities is usually significantly less than the proportionate underlying value of the property held by these entities.[107] Despite this, individuals rarely take immediate advantage of the potential discounts by making a current gift of their entire interest in the entity because individuals are reluctant to pay gift, estate or GST tax. Instead, individuals typically use their lifetime gift tax exemption amount to shelter an initial gift from gift tax (the seed amount) and transfer the balance of their interest in an entity over time through an annual exclusion gifting program.

An IDIT can increase the transfer of wealth to junior generations because an individual's entire interest in an entity can be sold to an IDIT (versus gifted) without gift or GST tax consequences. If the transferor dies shortly after the IDIT Sale, he or she may have greatly reduced his or her gross estate by virtue of the ability to discount the value of the asset in an IDIT Sale. Only the outstanding balance of the note, which is based upon the discounted value of the interest in the entity, should be included in the transferor's gross estate. Accordingly, the transferor could immediately reduce his or her gross estate by taking advantage of the lack of marketability and lack of control discounts through the sale of entity interests to an IDIT.

5. A transferor does not have to choose between estate tax exclusion and a step-up in income tax basis at death.

Under current law, property included in an individual's gross estate will receive a new income tax basis[108] equal to the fair market value of the property on the decedent's date of death.[109] For this reason, tax advisors often counsel their clients to retain low income tax basis property so that their heirs receive the benefit of a step-up in income tax basis at death. If the IDIT Sale is successful, the transferred property is not included in the transferor's gross estate and its income tax basis is not stepped-up to fair market value upon the transferor's death. This means the IDIT will recognize gain on the sale of any appreciated property transferred to the IDIT that the transferor's beneficiaries would not have recognized had the transferred property been included in the transferor's gross estate at death.

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[106] The use of discounted entities may be subject to challenge by the IRS. In recent years, the IRS has successfully challenged FLPs using Section 2036 where the taxpayer retained an express or implied benefit from the partnership or too much control over the partnership. The individual's tax advisor should be consulted about the use of discounted entities in conjunction with an IDIT Sale in a particular situation.

[107] Recently, the Tax Court ruled the step transaction doctrine applies to collapse the gift and sale, made within moments of each other, to each separate trust for valuation purposes, and to treat the transfers as an aggregate transfer of an interest in the LLC to each trust. *Pierre v. Commissioner*, T.C. Memo. 2010-106 (May 13, 2010) (Pierre II). Given this determination by the Court, individuals are advised to discuss this strategy and its potential implications with legal and tax counsel.

[108] IRC Sec. 1015, Rev. Rul. 77-413, 1977-2 C.B. 298.

[109] IRC Sec. 1014.

The benefit of estate tax exclusion, however, typically outweighs the benefit of a step-up in income tax basis. Property included in an individual's estate can be taxed at a federal rate of 40 percent. Nonetheless, if the IDIT grants the transferor the power to reacquire trust corpus by substituting other property of an equivalent value, the transferor could exchange cash or other high income tax basis property for low basis property held by the IDIT. Alternatively, the IDIT could distribute a portion of the IDIT property in kind to the transferor to satisfy its payment obligations under the note. With either method, appreciated property can be included in the transferor's gross estate, providing a step-up in income tax basis at death. If the IDIT is a grantor trust, neither method triggers the recognition of gain by the trust.[110]

6. The transferor can retain an interest similar to a life estate without causing the property to be included in his or her gross estate.

Most estate tax reduction techniques require an individual to give up all economic ties to property prior to death. An individual may be unwilling to part with the economic benefit of his or her property, particularly if the property represents a large portion of his or her net worth. The transferor can structure the IDIT Sale as a long-term installment sale so that he or she may receive an overall reduction in estate taxes without jeopardizing his or her financial security.

C. Appropriateness of an IDIT Sale

An IDIT Sale may be particularly attractive to an individual that wants to reduce his or her estate while minimizing the transfer taxes incurred on transfer made during life. This occurs because the only taxable transfer a transferor makes to the IDIT is the initial gift to seed the trust. The IDIT Sale is also attractive to individuals interested in passing wealth to skip persons[111] because GST tax is a tax on gifts – not sales. Thus, all the property sold to the IDIT (and its subsequent appreciation) can pass to the transferor's grandchildren and great-grandchildren free of GST tax. The transferor would only need to allocate GST exemption to (or pay GST tax on) the gift used to seed the trust.

Any individual with a large taxable estate that includes income producing or rapidly appreciating property should consider selling that property to an IDIT. Income producing property is the ideal type of property because the IDIT can use the property's income to make the installment note payments to the transferor. If the property produces a return in excess of the applicable federal rate (AFR), the arrangement should yield a positive transfer of wealth. This is true even if the property fails to appreciate over the grantor's lifetime because the IDIT will receive the benefit of the transferred income and only pay interest to the grantor at the AFR. Indeed, the arrangement will remove more wealth from the transferor's estate if the property also appreciates in value. Any appreciation in value accrues to the IDIT and its beneficiaries because the payments the IDIT must make to the transferor is based upon the sales price set at the time the parties entered into the sale arrangement.

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[110] Priv. Ltr. Rul. 95-35-026 (May 31, 1995), citing Rev. Rul. 85-13, 1985-1 C.B. 184.
[111] IRC Sec. 2613(a).

D. Common Questions About IDIT Sales

1. How is an IDIT structured as an intentionally defective grantor trust?

If a trust is defective for income tax purposes, the trust is ignored and the grantor is treated as the owner for income tax purposes. In an IDIT sale arrangement, this allows for (1) no gain or less to be recognized on the sale of property to the trust, (2) the grantor to pay all income taxes, and (3) interest paid by the IDIT to the grantor to not be taxable because the grantor is essentially paying himself or herself.

An attorney can draft a trust as a defective grantor trust by intentionally implicating one or more of the grantor trust rules which provides grantor status for income tax, but not estate tax purposes.[112] One or more of the following provisions should make a trust defective grantor trust without causing estate tax inclusion:

(a) Providing the trustee with the power to use trust income to pay life insurance premiums on the life of the grantor or the grantor's spouse without approval or consent by an adverse party;[113]

(b) Providing the grantor or another the power, in a non-fiduciary capacity, to reacquire trust corpus by substituting property of equivalent value;[114] and,

(c) Providing the trustee with the power to add beneficiaries other than the grantor’s after-born or after-adopted children.[115]

2. How do IDIT Sales compare to GRATs?

IDIT Sales and GRATs are both estate freeze techniques that provide an individual with a fixed sum in exchange for transferred property. While the techniques resemble one another, an IDIT Sale should yield a greater transfer of wealth than a comparable GRAT. This is based upon the following:

Superior Estate Tax Reduction. An IDIT Sale is superior to a GRAT in that the technique is successful regardless of whether the transferor outlives the term of the note. A GRAT, on the other hand, succeeds only if the grantor survives the GRAT term. If the grantor dies during the GRAT term, all or a portion of the GRAT assets are included in his or her gross estate.[116] If the transferor in an IDIT Sale dies before the note is repaid, only the outstanding balance of the note should be included in his or her gross estate.

Superior Multi-Generational Transfers. GRATs are rarely used to transfer property to grandchildren because a grantor cannot leverage his or her GST tax exemption with a GRAT. The selected term of a GRAT is an ETIP and the grantor cannot allocate his or her GST tax exemption during an ETIP. Thus, the grantor must wait until he or she no longer retains an interest in the

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[112] IRC Sec. 671 *et. seq.*
[113] IRC Sec. 677(a)(3).
[114] IRC Sec. 675(4)(c).
[115] IRC Sec. 674(c).
[116] Treas. Reg. Sec. 20.2036-1(c)(2)(i).

GRAT to make the allocation.[117] Accordingly, the grantor cannot allocate his or her GST tax exemption until years after the gift, when the property held in the GRAT may have drastically appreciated in value. IDIT Sales, on the other hand, are excellent arrangements to transfer wealth to grandchildren and other skip-persons. If properly structured, the transferor will only need to allocate his or her GST tax exemption to the gift of the seed property. Thus, the sale can occur between the transferor and the IDIT with minimal allocation of GST tax exemption, even if the IDIT beneficiaries are grandchildren or other skip-persons. The IDIT Sale may preserve family wealth by allowing property to pass through several generations without any estate or GST tax.

Potentially Lower Applicable Federal Rate. An installment note bears the AFR short-term, mid-term or long-term, depending upon the term of the note.[118] The present value of the GRAT annuity payment is based upon 120 percent of the federal mid-term rate of Section 1274(d) (the 7520 rate).[119] Accordingly, an individual's beneficiaries may retain more wealth with an IDIT Sale than a successful GRAT because of the potentially lower interest rate imposed on the transaction.

While an IDIT Sale compares favorably to a GRAT in most respects, the lack of an established body of law interpreting the arrangement is a downside. GRATs are governed by the rules set forth in Section 2702 and the corresponding Treasury Regulations. IDIT Sales are not governed by any clear body of law. Rather, an IDIT Sale is structured and the corresponding tax consequences determined by careful application of several tax principles. Thus, even though IDIT Sales are not governed by any clear body of law, the IDIT Sale strategy is a generally accepted estate planning technique.

3. How is the transferor taxed on the sale of property to the IDIT?

The sale of the property by the transferor should not be a taxable event. If the property is sold for its fair market value, the transferor should not be making a gift of any part of the transferred property. Additionally, the transferor should not recognize gain or loss on the sale of property to the IDIT if the IDIT is set up as a grantor trust.[120]

4. How should the transferor structure the IDIT Sale to avoid the implication of Section 2036(a)(1)?

The IDIT Sale should be structured to avoid categorizing the sale as a transfer with a retained interest that causes estate inclusion. If the IDIT is underfunded, the IRS could consider the IDIT's promise to pay the installment note illusory and deem the sale to be a transfer to a trust with a retained interest. Accordingly, the transferor must gift cash or property to the IDIT prior to the sale to seed the trust. Some commentators have suggested that a gift of 10 to 15 percent of the total value of the property that will be sold to the IDIT is sufficient to seed the trust.

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[117] *Id.*
[118] Frazee v. Comm'r., 98 T.C. 554 (1992), Priv. Ltr. Rul. 95-35-026 (May 31, 1995).
[119] IRC Sec. 7520.
[120] Rev. Rul. 85-13, 1985-1 C.B. 184.

5. Who can serve as trustee of the IDIT?

Any competent adult, other than the transferor, can serve as trustee of the IDIT. While it may be possible to draft the IDIT to allow the transferor to serve as trustee without causing inclusion of the IDIT's property in the transferor's estate, the transferor should not serve as trustee if the IDIT may hold life insurance on the transferor's life. The transferor's powers as trustee would constitute an incident of ownership causing inclusion of the insurance policy proceeds in the transferor's gross estate under Section 2042. Additionally, the life insurance producer should not serve as the trustee. A life insurance producer who is paid a commission on the sale of a life insurance policy represents both his or her personal interest and the interests of the trust, creating a conflict of interest.

E. Life Insurance Applications

A wealthy individual may drastically reduce the value of his or her estate by selling property to an IDIT. Nonetheless, he or she will probably still have a taxable estate at his or her death because few individuals give away everything that they own prior to death. Although the primary purpose of life insurance is death benefit protection, life insurance may be an important part of the wealth transfer plan because it can provide the estate with the liquidity it needs to pay any resulting estate tax.

An IDIT that permits the trustee to purchase life insurance on the grantor's life can serve as an attractive alternative to an irrevocable life insurance trust (ILIT). An ILIT, if set up and administered properly, prevents policy proceeds from being included in an insured's gross estate. The grantor may, however, prefer to use an IDIT to exclude policy proceeds from his or her estate because he or she can save the time and legal fees associated with administering another trust.

The grantor may also prefer an IDIT to an ILIT because the IDIT may allow him or her to use annual exclusion gifts or his or her lifetime gift tax exemption amount for other gifting purposes. If the grantor establishes a separate ILIT to hold a policy insuring his or her life, he or she would need to make taxable gifts to the ILIT so that the trustee could pay the policy premiums. While the typical IDIT grantor can probably afford the gifts of premium payments to an ILIT, he or she may be better served by allowing the IDIT to use its own income to own and pay for the policy. If the IDIT pays the policy premiums (using income generated by the IDIT's assets), the grantor will not need to make a gift to the trust that would require the use of his or her annual exclusion gifts, lifetime gift tax exemption amount or pay a gift or GST tax.

VII. Private Annuity

A. What is a private annuity?

In a typical private annuity arrangement, an individual (the transferor) transfers property to another individual or entity (the transferee) in exchange for an unsecured promise to a stream of income for the transferor's lifetime. If the transferee is concerned that the transferor may outlive his or her life expectancy, the arrangement can be structured as a private annuity for a stated term that is at least equal to the transferor's life expectancy. Private annuities are most commonly used by a senior generation family member with a shorter than average life expectancy to transfer appreciated property to the junior generation.

For example, assume that Mom, a 70-year-old woman, has a sizeable estate. Mom's only heir is Son, a financially secure 45-year-old man. Mom would like to give Son the apartment complex that he currently manages and she owns. Mom, however, has already used her lifetime gift tax exemption amount and does not want to pay gift tax on the transfer to Son. Son would like to purchase the apartment complex but is unable to finance an outright purchase.

Under a private annuity arrangement, Son buys the apartment complex from Mom for its fair market value. In exchange, Son combines his own funds with the income that the apartment complex generates to make annuity payments to Mom for the duration of her life. The annuity payments should have a fair market value equal to the fair market value of the apartment complex. Given that Mom is selling the apartment complex to Son for its fair market value, Mom is not making a gift to Son and should not have to pay any gift tax upon the sale of the apartment complex. At Mom's death, the apartment complex will not be included in Mom’s estate (because she already sold it) and, thus, would not be subject to estate tax.

B. Why are private annuities used?

1. The transferor can remove property from his or her estate without incurring gift, estate or GST tax liability.

If structured properly, the transferor will not be making a taxable gift when he or she transfers the property to the transferee in exchange for the private annuity. The transferred property should be excluded from the transferor's estate regardless of when he or she dies because the annuity payments terminate upon his or her death.

2. The transferor can freeze the value of the transferred property and pass all future appreciation to his or her intended beneficiaries.

The annuity payment is based upon the value of the transferred property at the time that the parties entered into the arrangement. It is not subsequently adjusted to reflect any increase or decrease in the value of the transferred property. Thus, the transferor will, at a minimum, reduce his or her gross estate by the amount that the transferred property appreciates after the date of the transfer.

3. The transferor can retain an interest similar to a life estate without causing the property to be included in his or her gross estate.

Most estate tax reduction techniques require an individual to give up all economic ties to property prior to the transferor's death. This is problematic if an individual is unwilling to part with the economic benefits of property. The private annuity arrangement may provide an individual with an overall reduction in estate taxes without jeopardizing his or her financial security because the transferor receives an annuity stream for life.

4. The junior generation can finance the purchase of property over time.

The junior generation may possess the requisite maturity to manage property (e.g., the family's closely held business), but lack the financial means to purchase the property outright. The private annuity arrangement may allow the transferee to purchase property over the transferor's lifetime.

C. Appropriateness of a Private Annuity

As with any technique, an individual's circumstances will dictate whether a private annuity is appropriate in a given situation. A private annuity may be appropriate if the proposed transferee is able to withstand the financial burden of making the annuity payments to the transferor. This may be particularly important to an individual if the property he or she intends to transfer represents a sizeable portion of his or her total net worth. This is the case because most private annuities are unsecured arrangements. Another important consideration is the asset being transferred; the transfer of a substantially appreciated asset in exchange for a private annuity may not be desirable because all the gain in the asset will be recognized on the date of the exchange. For more details on taxation upon the sale of a property for a private annuity, please see discussion in Section D.1.

A private annuity may be a great bargain for a transferee if the transferor is in poor health because the annuity payments are determined using life expectancy tables (as opposed to the transferor's actual life expectancy). This means that a transferee will pay less for the transferred property if the transferor dies prematurely. If, however, there is a greater than 50 percent probability that the transferor will die within one year, the Treasury Regulations mandate that the annuity factor reflects the actual life expectancy of the individual. Accordingly, there is rarely an advantage to entering into a private annuity arrangement if the transferor is terminally ill.

In the ideal situation, an individual will exchange income producing and rapidly appreciating property for the annuity. Property that produces a substantial income stream will ease the transferee's financial burden because he or she may combine the property's income with his or her own resources to make the annuity payments. The transferor may then remove a greater amount of wealth from his or her estate if the transferred property appreciates because annuity payments to the transferor are fixed at the time the parties entered into the private annuity arrangement.

A private annuity is not recommended where the transferee does not have an independent source of income from which to make the annuity payments. If the transferee does not have a separate source of income when the parties enter into the private annuity arrangement, the transferred property may be included in the transferor's estate because the IRS could classify the private annuity as a trust arrangement wherein the transferor retains an interest for life.[121]

D. Common Questions About Private Annuities

1. How is the transferor taxed on the sale of the property and upon receipt of the annuity payments?

As stated previously, the transferor should not be treated as making a gift of any part of the transferred property. Historically, the transferor only immediately recognized gain on the sale of appreciated property if the private annuity was secured; if the arrangement was unsecured, the transferor recognized any gain over his or her life expectancy.[122] However, in 2006, the IRS made significant changes to the taxation of private annuity arrangements in Proposed Regulations Sec. 1.72-6(e). The Proposed Regulations put the transferor in the same position that he or she would have been in had the property been sold for cash and the cash used to purchase the annuity. As a result, the entire amount of any gain must be recognized at the time of the exchange, regardless of whether the transaction is secured or not.

The proposed regulations provide that if an annuity contract is issued (either by commercial or private parties) in exchange for property other than money: (1) the amount realized by the seller/annuitant in the exchange will be fair market value, as determined under section 7520, of the annuity contract at the time of exchange; (2) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and (3) for purposes of determining the initial investment in the annuity contract, in situations where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract will be equal to the fair market value of the property exchanged for the annuity contract.

The proposed regulations are generally effective for exchanges of property for an annuity contract after October 18, 2006. However, the effective date was delayed until April 18, 2007 for transactions in which (1) the issuer of the annuity contract is an individual; (2) the obligations under the annuity contract are not secured, either directly or indirectly; and, (3) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

2. Do the Original Issue Discount rules apply to private annuities?

The Original Issue Discount (OID) rules, a complex set of rules imputing ordinary income to a lender, may apply to a particular private annuity arrangement.[123] Accordingly, an individual's attorney and tax advisor should review the OID rules to determine their applicability to a particular private annuity arrangement.

[121] Lazarus v. Comm'r., 513 F.2d 824 (9th Cir. 1975), *aff'g*. 58 T.C. 854 (1972), *acq.*, 1973-2 C.B. 2.
[122] *Id.*
[123] Treas. Reg. Sec. 1.1275-1.

E. Life Insurance Applications

While the primary purpose of life insurance is death benefit protection, life insurance can be an important part of the transferor's wealth transfer plan that includes a private annuity. Life insurance can provide liquidity for the estate, equalize the inheritance among family members and ensure the continued payments to the transferor if the transferee dies prematurely.

Additionally, even though a private annuity may reduce the transferor's estate, he or she will probably still have a taxable estate at his or her death, because few individuals give away everything that they own prior to death. In this regard, life insurance is an important part of the wealth transfer plan because it provides the estate with the liquidity it needs to pay the resulting estate tax.

Likewise, if the property transferred in the private annuity arrangement is a significant part of the transferor's estate, the transferor may need to purchase life insurance to prevent disinheriting family members who are not parties to the private annuity arrangement. This situation typically arises where a private annuity is used to pass a family business to the children who are actively participating in the business where the business is the major asset of the transferor's estate. Life insurance proceeds can equalize the inheritance among family members who do not participate in the family business.

Finally, in the typical private annuity arrangement, a senior family member is the transferor and the junior family member is the transferee. While it is statistically unlikely that the transferee will predecease the transferor, it is a possibility. If the transferee predeceases the transferor, the transferee's estate will be responsible for the annuity payments to the transferor. Accordingly, the transferee, transferee's spouse or the trustee of an irrevocable life insurance trust should consider owning a policy insuring the transferee's life to provide funds to continue the annuity payments to the transferor. This may be particularly important if the transferor is relying upon the annuity payments as a significant part of his or her income.

VIII. Self-Canceling Installment Note (SCIN)

A. What is a self-canceling installment note?

A self-canceling installment note (SCIN) is a deferred payment arrangement whereby an individual transfers property to another individual or entity in exchange for payments for a specified term. The transferee's payments to the transferor will not exceed the transferor's life expectancy because the note contains a self-cancellation clause triggered by the transferor's death. In other words, the note is cancelled at the death of the transferor and no further payments are due.

For example, assume Mother, a 70-year-old woman, wants to transfer her cleaning service business (currently worth $2,000,000) to Son. Although Mother would otherwise bequeath the business to Son at her death, she believes that she can transfer more wealth to Son if she sells the business to Son today using a SCIN because the repayment obligation is cancelled by her death. Mother and

Son realize that if Mother lives longer than her normal life expectancy Son may overpay for the transferred business. This is the case because, if Mother lives longer than expected, Son could pay much more than the value of the business of $2,000,000 because the SCIN must include a risk premium. The term risk premium refers to the amount that compensates Mother for the possibility that her death may cancel the installment obligation. Despite having to pay a risk premium, Son is nevertheless willing to enter into the SCIN arrangement because Mother is relatively unhealthy. Son believes that through the SCIN arrangement he will pay less than $2,000,000 for the business.

Mother and Son enter into a ten-year SCIN arrangement. The discount rate on the date of the sale is 2.0%; the no-risk-premium market interest rate on the date of the sale is 2.0%.[124] Based on these assumptions, the principal risk premium to compensate Mother for the possibility that she may die before receiving full repayment of the $2,000,000 obligation is $304,373.31. Thus, the principal of the note is $2,254,373.31. If Mother dies at the end of year two, Son will have only paid $536,541[125] to Mother for the cleaning service business and Mother will have removed the business and all the corresponding income and appreciation from her estate without paying any gift or estate tax.

In this situation, the SCIN yields a positive transfer of wealth. Son will have paid Mother less than $2,000,000 for the business as long as Mother does not live beyond year seven when the total payments are $1,798,990. If, however, Mother lives until the end of the ten-year term, Son will have paid Mother $2,502,354 for the business that was valued at $2,000,000 on the date of sale – an overpayment of $502,354.

B. Why are SCINs used?

1. The transferor can remove property from his or her estate without incurring gift, estate or GST tax liability.

If properly structured, a SCIN allows an individual to transfer property to his or her beneficiaries without gift or estate tax consequences. The transferor will not be making a taxable gift to the transferee if the fair market value of the SCIN that he or she receives is substantially equal to the fair market value of the property transferred.[126] The value of the SCIN can only be substantially equal to the fair market value of the property transferred if the interest factor imposed or the principal amount due includes an adequate risk premium that compensates the transferor for the possibility that his or her death might cancel the installment obligation.[127] To prevent an inaccurate calculation of the risk premium, a valuation expert should determine the appropriate interest rate premium or principal risk premium.

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[124] The calculations contained in this example were obtained using NumberCruncher software, Leimberg & LeClaire, Inc. The assumptions are as follows: a 2.0% discount rate (the 7520 rate on the date of the sale); a 2.0% no-risk-premium market interest rate (the long-term AFR on the date of sale); Son's initial down payment is $50,000; Mother's cost basis of $10,000; and a $600,000 recapture amount (IRC Secs. 1245 or 1250).
[125] The calculation based on the repayment schedule for a level-principal SCIN with a principal risk premium obtained using NumberCruncher software, Leimberg & LeClaire, Inc.
[126] Gen. Couns. Mem. 39, 503 (May 7, 1986).
[127] Estate of Buckwalter v. Comm'r., 46 T.C. 805 (1966).

The fair market value of the balance of an installment note is typically included in the transferor's gross estate at his or her death.[128] However, if the installment note includes a self-cancellation clause, the transferee's duty to repay the balance on the note is cancelled by the transferor's death. Accordingly, the value of the property transferred in the SCIN transaction should be excluded from the transferor's gross estate at his or her death.[129]

2. The transferor can freeze the value of the transferred property and pass all future appreciation to his or her intended beneficiaries.

The SCIN technique is an estate freezing technique because the sale price is established on the date of the sale. The installment payments are based on the fair market value of the transferred property on the date the parties entered into the SCIN arrangement and are not adjusted to reflect changes in the value of the transferred property. Even if the transferor lives until such time that he or she receives the maximum sales price for the transferred property, the SCIN can allow him or her to reduce the gross estate by the amount by which the transferred property appreciates after the transfer.

3. The transferor can retain an interest similar to a life estate without causing the property to be included in his or her gross estate.

A properly structured SCIN may reduce an individual's estate without risking his or her financial security because the transferor can retain a stream of income until the earlier of his or her receiving the maximum sales price or his or her death. Most estate tax reduction techniques require an individual to relinquish all economic ties to property prior to death to remove property from one’s gross estate.

C. Appropriateness of a SCIN

SCINs and private annuities are typically appropriate in the same types of situations.[130] The transferor's health is the primary factor to consider in deciding to structure a sale as a private annuity, SCIN or traditional installment sale. If the transferor is in poor health, but not terminally ill, a SCIN may maximize the transfer of wealth by minimizing the wealth transferred back to the transferor.

An individual may prefer to structure an intra-family sale as a SCIN rather than a private annuity if he or she is selling appreciated property to the transferee. Unlike a private annuity, with a SCIN the gain on the sale is not recognized upfront, but rather it is recognized as the installment payments are received. On the other hand, the transferor may not receive installment sale treatment and thus need to structure the arrangement as a private annuity (and not a SCIN) if the transferor is a dealer in property, or is selling depreciable property or marketable securities to the transferee. However, these factors are not an issue if the private annuity or SCIN sale occurs between the transferor and

[128] IRC Sec. 2033.

[129] Estate of Costanza, 320 F.3d 595 (6th Cir. 2003), *rev’g and* rem’g Estate of Costanza v. Comm’r., T.C. Memo. 2001-128 (June 2001); Estate of Moss v. Comm'r., 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2, Gen. Couns. Mem. 39, 503 (May 7, 1986).

[130] See discussion on Private Annuity on page 37.

a defective grantor trust. A sale to a trust that is defective for income tax purposes is essentially treated as a sale to oneself (*see the discussion on grantor trusts)*. Accordingly, the transferor should not recognize any gain or loss on the exchange of appreciated property with a defective grantor trust.[131]

D. Common Questions About SCINs

1. How is the transferor taxed on the sale of the property and upon receipt of the installment payments?

The transferor reports gain over the period of the note assuming the receipt of the maximum sales price.[132] If the transferor dies before receiving the maximum sales price, his or her estate will recognize any previously unreported taxable gain.[133]

Installment sale treatment is not available for the sale of stock traded on an established securities market and may not be available for dealers in property or sales of depreciable property.[134] If installment sale treatment is unavailable and the transferor is to immediately recognize any gain on the sale, he or she should enter into the SCIN with a defective grantor trust because no gain or loss is recognized in a transaction between a grantor and a defective grantor trust.[135]

2. How is the transferee taxed if he or she sells the transferred property?

In a SCIN arrangement, the transferee's income tax basis in the transferred property equals the full face value of the SCIN exchanged for that property.[136] This means that highly appreciated property can be sold by the transferee without recognizing the gain that the transferor would have recognized had he or she sold the property prior to the SCIN sale.

E. Life Insurance Applications

While the primary purpose of life insurance is death benefit protection, life insurance can be an important part of the transferor's wealth transfer plan that includes a SCIN. It may be needed to ensure the continued payments to the transferor if the transferee dies prematurely, to provide liquidity for the estate and to equalize the inheritance among family members.

The transferee or transferor should consider purchasing a policy insuring the transferee's life to provide funds to continue the payments to the transferor. In the typical SCIN arrangement, a senior family member is the transferor and the junior family member is the transferee. While unlikely, the transferee could predecease the transferor. If the transferee predeceases the transferor, the transferee's estate will be responsible for the installment payments to the transferor.

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131 Rev. Rul. 85-13, 1985-1 C.B. 184.
132 Gen. Couns. Mem. 39, 503 (May 7, 1986).
133 Estate of Frane v. Comm'r., 998 F.2d 567, (8th Cir. 1993).
134 IRC Secs. 453(k)(2)(a), 453(b)(2) and 453(g)(2).
135 Rev. Rul. 85-13, 1985-1 C.B. 184.
136 Gen. Couns. Mem. 39, 503 (May 7, 1986).

While a SCIN can reduce the transferor's estate, he or she will probably still have a taxable estate at his or her death because few individuals give away everything that they own prior to death. Life insurance is an important part of the wealth transfer plan because it provides the estate with the liquidity it needs to pay the resulting estate tax.

If the property transferred in the SCIN arrangement is a significant part of the transferor's estate, the transferor may need to purchase life insurance to prevent disinheriting family members who are not parties to the SCIN. Life insurance proceeds can aid the grantor in equalizing the inheritance among family members.

IX. Combination Techniques

A. Super GRAT, Super IDIT Sale, Super Private Annuity and Super SCIN

FLPs, Limited Liability Companies (LLC) and S-Corporations are entities that may be discounted to reflect the lack of marketability of the interest and the limited partner, member or shareholder's lack of control over the entity. While an individual can realize significant transfer tax savings with a GRAT, IDIT Sale, private annuity or SCIN, he or she can greatly enhance the effectiveness of these techniques by gifting or selling discounted interests in an entity to the GRAT, IDIT, or in a private annuity or SCIN arrangement. The value of an interest in these entities can be substantially less than the value of the underlying property held by these entities.[137]

Assume Father, a 60-year-old man, wants to give Son his apartment complex valued at $5,000,000. He is reluctant to make an outright gift because he has exhausted his lifetime gift tax exemption amount and the gift would trigger $2,000,000 in gift tax at his or her marginal gift and estate tax rate of 40 percent.[138] Thus, Father gifts the apartment complex to a GRAT, retaining an annuity interest of eight percent for five years, and providing for the remainder to go to Son. Father's annuity interest reduces the value of the gift to Son to $3,323,520, which triggers $1,329,408 in gift tax.

While Father's gift to the GRAT is less than an outright gift, the gift would be significantly less if Father first contributed the apartment to an FLP. Assuming a 30 percent combined discount for lack of marketability and lack of control, the discounted value of the limited partnership units Father gifts to the GRAT is $3,500,000. If Father retains the same annuity interest of eight percent for five years, his or her retained interest reduces the value of the gift to Son to $2,326,464, which triggers $927,709 in gift tax. The combination of the FLP and GRAT saves Father an additional $448,675 in gift tax.[139]

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[137] The use of discounted entities may be subject to challenge by the IRS. In recent years, the IRS has successfully challenged FLPs using Section 2036 where the taxpayer retained an express or implied benefit from the partnership or too much control over the partnership. The individual's tax advisor should be consulted about the appropriateness of discount entities in a particular situation.
[138] This calculation was obtained using NumberCruncher software, Leimberg & LeClaire, Inc.
[139] These calculations assume a 5% Section 7520 Rate on the date of Father's gift, trust income and growth of 0%, and were calculated using NumberCruncher software, Leimberg & LeClaire, Inc.

The savings illustrated in the prior example may be realized with any of the intra-family gift or sale techniques discussed in this pocket guide, other than a QPRT.[140] It is important to remember, however, that the use of discounted entities can also be subject to challenge by the IRS. In a 2000 gift tax audit, the IRS challenged an IDIT Sale involving the sale of limited partnership interests at a discount, asserting that the partnership was a sham with no substantial economic effect and that the note attributable to the sale should be reclassified as equity rather than debt. While the case settled and the sale of the partnership units to the IDIT was respected as a bona fide sale, the client's tax advisors should be consulted about the appropriateness of discounted entities in a client's particular situation.

B. Private Annuity, SCINs and IDITs

If a private annuity or SCIN is an appropriate estate planning tool for an individual, he or she should consider selling the property to an IDIT established for the benefit of his or her beneficiaries' as opposed to selling the property directly to the beneficiaries.

Added flexibility is one reason to consider this combination technique. The transferor will not recognize gain on the sale of property in exchange for a private annuity or SCIN if the sale is made to a grantor trust.[141] Thus, this combination technique can provide the transferor with the flexibility to secure a private annuity arrangement or sell property that is ineligible for installment sale treatment without causing immediate recognition of any gain inherent in the transferred property. Another reason to consider using the IDIT in combination with the private annuity or SCIN is that the transferor is obligated to recognize all the trust's income.[142] This means that the property sold to the IDIT may grow without a reduction to pay income taxes.

The transferor should also consider this technique if he or she would like to choose the time and manner of the distribution of the transferred property to the beneficiaries. If the transferor sells the property outright, he or she will have no control over the time and manner of distribution of the property because the transferees will own the property outright. However, if the transferor sells the property to a trust, then he or she controls the time and manner of distribution of the transferred property among his or her beneficiaries.

[140] An individual cannot gift discounted units in an entity to a QPRT. A QPRT may only hold the grantor's personal residence and limited and specific amounts of cash. Treas. Reg. Sec. 25.2702-5(c)(5).
[141] Rev. Rul. 85-13, 1985-1 C.B. 184.
[142] IRC Sec. 671 *et. seq.*

X. Conclusion

To maximize the transfer of wealth, ultra wealthy individuals need to develop a wealth transfer plan. The life insurance and the intra-family gift and sale techniques discussed here should be considered as part of that plan. No one technique is right for everyone. The need for income and control may favor the use of certain techniques, whereas the health and financial stability of certain family members may favor the use of others.

Ultimately, an individual's facts and circumstances will determine the estate planning technique (or combination of techniques) used to transfer wealth. It will also determine the amount and type of life insurance needed to pay the resulting estate and GST tax, equalize inheritances among family members and for any transfer tax savings that may be lost if an individual lives too long or dies unexpectedly.

For additional questions, feel free to contact Pacific Life's Advanced Designs Unit at
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