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Trusts and Other Techniques with Retained Interests: How to Motivate Your Clients to Consider Gifting

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Part I:

Lifetime Giving Revisited,

What's The Hold-Up?!?!

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I. Introduction & Overview

- On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Authorization and Jobs Creation Act of 2010, known as the "2010 Act."
- The 2010 Act increased and extended the federal estate and GST tax exemptions for two years, 2011 and 2012, and for the first time increased the federal gift tax exemption to $5,000,000 per person.
- The gift estate tax exemptions were indexed for inflation so that, in 2012, the exemption is $5,120,000 per person.
- The following chart shows the federal and state estate and gift GST tax exemptions for 2003 to 2013.

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YEAR	MA Exemption	Federal Estate & GST Tax Exemption	Federal Gift & GST Tax Exemption
2003	$700,000	$1 million	$1 million
2004	$850,000	$1.5 million	$1 million
2005	$950,000	$1.5 million	$1 million
2006	$1 million	$2 million	$1 million
2007	$1 million	$2 million	$1 million
2008	$1 million	$2 million	$1 million
2009	$1 million	$3.5 million	$1 million
2010	$1 million	No Federal Estate Tax	$1 million
2011	$1 million	$5 million	$5 million
2012	$1 million	$5.12 million*	$5.12 million*
2013	$1 million	$1 million	$1 million

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II. Impact of Giving

- **Federal:**
  - Removes future appreciation from estate (only)
  - Permanent savings if estate tax exemption falls back to $1,000,000 (no claw back)

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***See*: Form 706 & 709**

Sample Computations of Gift & Estate Tax Computations to Show Potential Claw-Back Using 2009 Forms

Form 709 (Gift)

		No Change in Exemption	**CLAWBACK**	**NO CLAWBACK**
Line 3	Amount of Gift	$5,000,000	$5,000,000	$5,000,000
Line 4	Tax on Gift (35%)	$1,750,000	$1,750,000	$1,750,000
Line 12	Unified Credit (Gift Tax on $5,000,000)	$1,750,000	$1,750,000	$1,750,000
Line 19	Gift Tax Due	– $0 –	– $0 –	– $0 –

706 Estate Tax Computation (Using 706, 9/09)

Line 3(a)	Total Assets at Death	– $0 –	– $0 –	– $0 –
Line 3(b)	State Death Tax Deduction	– $0 –	– $0 –	– $0 –
Line 3(c)	Taxable Estate	– $0 –	– $0 –	– $0 –
Line 4	Adjusted Taxable Gifts Made After December 31, 1976 (Other than Gifts that are Includible in the Decedent's Gross Estate)	$5,000,000	$5,000,000	$5,000,000
Line 5	Total	$5,000,000	$5,000,000	$5,000,000
Line 6	Tentative Tax (Assume 35%)	$1,750,000	$1,750,000	$1,750,000
Line 7	**Total Gift Tax Paid (or Payable)**	-$0-	– $0 –	$1,400,000
Line 8	Gross Estate Tax	$1,750,000	$1,750,000	$350,000
Line 9	Maximum Unified Credit ($1,000,000 x 35%) or ($5,000,000x 35%)	$1,750,000	$350,000	$350,000
Line 11	Allowable Unified Credit	$1,750,000	$350,000	$350,000
Line 16	**Tax Due (Line 8 minus Line 11)**	**$0**	**$1,400,000**	**$0**

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PLANNING NOTE:

- Give away
  1. Discounted Asset
  2. Assets likely to appreciate in the future
  3. Assets to be kept in the family

- Clawback not a problem

See *Pennell, 46th Annual Heckerling Institute on Estate Planning University of Miami School of Law – Recent Developments 2011*

See also:
H.R. 16: Sensible Estate Tax Relief Act of 2012

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- **Massachusetts:**
  - Permanent savings of $391,600 on a $5,000,000 gift

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III. Gift Giving Tax Considerations – The Basis Rules

(a) Compare the tax consequences of a step-up in basis attributable to inherited property vs. carryover basis in the case of lifetime gifts.

1) Basis of property acquired from the decedent.
   - A. IRC § 1014
   - B. IRC § 1014(b)
   - C. Exception

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2) Basis of Property Acquired by Gifts and Transfers in Trust §1015 – Carry Over

3) Increased Basis for Gift Taxes Paid

4) Gift Splitting

5) Holding Period
   - A. Inherited Property
   - B. Gifted Property

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EXAMPLE #1

- Assume single decedent with $5,000,000 in zero basis assets and is considering an irrevocable gift in 2012.
- Assume also that property will be sold shortly after death at a price equal to the fair market value on the date of death. Assume a combined capital tax rate of 20% (15% federal; 5% state)

	NO GIFT	GIFT
FMV	$5,000,000	$5,000,000
BASIS	0	0

SALE AFTER DEATH

SALE PRICE	$5,000,000	$5,000,000
BASIS	$5,000,000	$ 0
GAIN	$ 0	$5,000,000
TAX 20%	$ 0	$1,000,000
FEDERAL ESTATE TAX	$ 0	$ 0
STATE ESTATE TAX	$ 391,600	$ 0
INCOME TAX	$ 0	$1,000,000
TOTAL TAXES	$ 391,600	$1,000,000

Gift is a bad idea!

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(6) Don’t forget the *Gallenstein* decision

A. How do you determine the basis of property inherited by a surviving spouse rather than children?

B. Memorandum In Support of Taxpayer’s Position

C. Don’t Forget the Estate of Gwynn – Does Property Have to be Inherited in Order to Obtain a Step-Up in Basis?

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IV. Eliminate Confusion Over the Various Three-Year Rules

(a) For federal and Massachusetts estate tax purposes, properties transferred within three years after date of death are not includible in the decedent's estate unless property transferred would have otherwise been an includible revocable transfer under IRC § 2036 (relating to transfers with retained interests), IRC § 2037, IRC § 2038, or IRC § 2042 (relating to life insurance), IRC § 2035(a)(1), (a)(2)

(b) Exception for transfers from revocable trusts

(c) Payment of Gift Taxes on Gifts Made by the Decedent or His Spouse Within Three Years of the Date of Death

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V. Discounts, Discounts, and More Discounts

a) *Lappo v. Commissioner*, T.C. Memo 2003-258:

Taxpayer gifted limited partnership interests in a partnership consisting primarily of marketable securities (principally municipal bonds) and certain parcels of Michigan real estate that was subject to a long term lease. The Tax Court allowed a 15% minority interest and a 24% marketability discount, computed as follows:

TOTAL NAV (NET ASSET VALUE) AS OF DETERMINATION DATE	$3,156,882
1% OF NAV	$ 31,569
LESS: 15% MINORITY INTEREST DISCOUNT	(4,735)
	$ 26,834
LESS: 24% MARKETABILITY DISCOUNT	(6,440)
FMV OF 1% INTEREST	$ 20,394
FMV OF 69.4815368% INTEREST	$1,417,006

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b) *Peracchio v. Commissioner*, T.C. Memo. 2003-280

Taxpayer formed limited partnership and transferred limited partnership interests to family members where the assets of the partnership consisted primarily of cash and marketable securities with a designated value of $2,013,765. The Tax Court allowed discounts of 6% for the minority interests and 25% for the marketability discount, computed as follows:

TOTAL NAV	$2,010,370
1% OF NAV	$ 20,104
LESS: 6% MINORITY INTEREST DISCOUNT	(1,206)
MARKETABLE VALUE	$ 18,898
LESS: 25% MARKETABILITY DISCOUNT	(4,725)
FMV OF 1% INTEREST	$ 14,173
FMV OF 45.47% INTEREST	$ 644,446
FMV OF 53.48% INTEREST	$ 757,972

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c) Revenue Ruling 93-12

The IRS will no longer deny discounts simply because transfers are made between family members understanding that there should be no aggregation of interest.

Example:

Decedent owns property, such as an LLC or an S corporation, worth $10,000,000 and gifts 20% to each of the 5 children. If the decedent dies, the asset would be worth $10,000,000. However, if the assets are transferred, the fair market value of the gift would be approximately $6,000,000, assuming a 40% discount. The question is what is the value of each 20% interest based upon the general rule that value is equal to the price of listed property to change hands assuming that a willing buyer and a willing seller and both parties had reasonable knowledge of all of the relevant facts and circumstances and neither party is under a compulsion to either buy or sell.

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d) Real Estate

The fair market value of fractional interests in real estate can range from a low of 17% to a high of 44%.

1. *Ludwick v. Commissioner*, T.C. Memo. 2010-104

Taxpayers, a married couple, separately transferred a tenancy in common interest in a vacation home to qualified personal residence trusts using a discount of 30% of net asset value ($7,250,000 x 50% x 70% = $2,537,500). The IRS was willing to allow a discount of 15% but in Tax Court argued that the discount should be no more than 11%. The Tax Court determined that a 17% discount would be appropriate relying on expert testimony as to how much a "partition" proceeding would cost.

In the case of a fractional interesting property, the value should be determined by reference to the "cost to partition" rather than using a "going concern" value.

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2. *Lefrak v. Commissioner*, T.C. Memo. 1993-526 (1993)

The Tax Court allowed a discount of 20% for lack of control and 10% for lack of marketability rejecting a cost of partition approach.

3. *Estate of Barge v. IRS*, 73 T.C.M. 2615 (1997)

The Tax Court allowed a 28% discount for an undivided interest in timberland noting that the Tax Court valued the land using a capitalization of income approach using a 10% capitalization rate.

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4. *Estate of Williams v. IRS*, 75 T.C.M. 1758 (1998)

The Tax Court allowed a 44% discount for a fractional interest of jointly owned real estate gifted to the donor's wife's niece finding that there should be a discount of 20% for lack of marketability and 30% for lack of control (44% in total net).

PLANNING NOTE

In TAM 199943003, the IRS agrees that the estimated cost to partition is only one method of determining the appropriate discount.

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e) Consider Promissory Notes

The gift tax value of a promissory note may be significantly less than the face amount of the note and perhaps forgiveness should be considered, although income tax ramifications of forgiveness should be considered if the note is not between a grantor and an intentionally defective grantor trust.

Reg. 20.2031-4 provides that the value of a note included a decedent's gross estate is presumed to be the amount of unpaid principal less accrued interest on the valuation date, unless the note is shown to have a lesser value or to be worthless. Discounts are appropriate attributable to uncollectability, lack of security, interest rates, and terms. The IRS and the courts have applied this Regulation to promissory notes between family members as well as notes between unrelated persons (even if money will be inherited enough to pay off the note and the cancellation of indebtedness is based on cash loans.). *Estate of Berkman v. Commissioner*, T.C.M. 1979-46; TAM 9240003

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VI. Consider Net Gifts – Revenue Ruling 75-52

To determine the gift tax due, divided the tentative tax by the rate of tax plus 1 to find the amount of the gift tax. The gift tax then is deducted from the value of the property to determine the amount of the net gift. Assume $10,000,000 in assets with no remaining exemption. Assume the gift tax rate is 35%. The actual gift tax will be $2,592,000 rather than $3,500,000. In this case, the gift tax would be $2,592,000 and the family would receive $7,408,000.

EXAMPLE #3

AMOUNT OF ASSETS	$10,000,000
TENTATIVE GIFT TAX (35%)	$ 3,500,000
NET GIFT TAX ($3,500,000 ÷ 1.35)	$ 2,592,000
AMOUNT TO FAMILY	$ 7,408,000

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Part 2:

Grantor Retained Annuity Trusts (GRAT) vs. Sale with Private Life Annuity

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I. GRAT

a) Description Of Technique

Donor transfers the property into a trust reserving the right to be paid an annuity every year until the term of the GRAT ends. The technique is governed by IRC § 2702, which was enacted in 1990 as part of Chapter 14 to eliminate a perceived abuse with grantor retained Income Trusts, in which property was given away and a "retained income interest" is retained, but no amounts were actually paid to the grantor.

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b) IRC § 2702 forces the use of an annuity rather than merely an income interest creating a special valuation rule.

c) IRC § 2702(a) provides that the value of the retained interest shall be zero unless the retained interest is a qualified interest.

d) A qualified interest is where a fixed annuity or a "unitrust" amount that must be paid every year. IRC § 2702(b)

This section does not apply to transfers between nieces and nephews, but only to transfers between family members defined as the Donor's spouse, ancestors and lineal descendants of the Donor and the Donor's spouse, and siblings of the Donor and their spouses (but not children of siblings). IRC § 2702(e) referring to IRC § 2704(c)(2).

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EXAMPLE

Assume a $10,000,000 asset. The grantor is age 60. The grantor is considering a 10 year GRAT.

May, 2011, IRC § 7520 Rate = 3.00% (120% Federal Mid-term AFR Rate). IRC § 2702(a)(2)(B)

FAIR MARKET VALUE	GRAT	GRIT
Fair Market Value	$10,000,000	$10,000,000
Annual Annuity	$1,000,000	$0
Present Value of Annuity Payments	$8,530,200	n/a
Gift	$1,469,800	$10,000,000

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e) Advantages:

- The value of the gift can be zeroed out following the case of *Walton v. Commissioner*, 115 T.C. 41 (2000). In *Walton*, Walmart stock worth $100,000,000 was transferred to a two-year GRAT with the first payment equal to $49,350,000 and the second annual payment in the amount of $59,220,000 for a total of $108,570,000. The value of the stock declined so that none of the wealth was transferred to the trust beneficiary at the end of the two year term. Even though no benefit was realized, the IRS assessed a taxable gift of $3,822,000 consisting of the Estate's contingent interest of $2,938,000 and the remainder interest $838,522. The Tax Court ruled in favor of the taxpayer.

- The amount of the gift can be adjusted by increasing the term of the retained interest or the amount of the annuity. In the prior example, an annuity for ten years of $1,249,328 would zero out the GRAT

- The valuation risk in a uni-trust can be eliminated in a GRAT since the amount of the annuity will adjust automatically if there is a valuation adjustment. Reg. 25.2702-3(c)(2)

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PLANNING NOTE

This advantage over outright gifts or sales to intentionally defective trusts has virtually been eliminated as a result of Wandry v. Commissioner, T.C. Memo. 2012-88. In Wandry, for the first time, the Tax Court approved a gift of LLC units at a value to be determined by an appraisal, subject to adjustment for the IRS audited return. The Tax Court held that the number of units transferred would be based on its decision and that no adjustment would be made for the dollar value of the gift. The exact language was as follows: "I hereby assign and transfer as gifts, a sufficient number of my units, as a member of LLC, so that the fair market value of such gifts for federal gift tax purposes, shall be as follows:

Name	*Gift Amount*
Kenneth D. Wandry	*$ 261,000*
Cynthia K. Wandry	*$ 261,000*
Jason K. Wandry	*$ 261,000*
Jared S. Wandry	*$ 261,000*
Grandchild A	*$ 261,000*
Grandchild B	*$ 11,000*
Grandchild C	*$ 11,000*
Grandchild D	*$ 11,000*
Grandchild E	*$ 11,000*
Total	*$1,099,000*

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Although the number of units gifts is fixed on the date of the gift, that number is based on the fair market value of the gifted units, which cannot be known on the date of the gift, but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (IRS). I intend to have a good faith determination of such value made by an independent third party professional experienced in such matters and appropriately qualified to make such a determination.

Nevertheless, if, after the number of gifted units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted units shall be adjusted accordingly so that the value of the number of units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermined by the IRS and/or a court of law."

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f) Disadvantages:

- The full value of the property transferred to the trust will be included in the grantor's estate if the grantor dies during the term. IRC § 2036(c); Regs. 20.2036-1(c)(2)
- The GRAT is not an effective generation skipping transfer technique since generation skipping transfer tax exemption cannot be allocated until the closing of the so-called estate tax inclusion period (ETIP), per section Regs. 25.2632-1(c)(3). (Any allocation of GST exemption to such property cannot be made before the close of the estate tax inclusion. IRC § 2642(f)(1).)

This means that in the case of the 10 year $10,000,000 GRAT, the value of the gift currently is $1,469,800, but if the property appreciates to $20,000,000 in 10 years and then is paid to grandchildren, a generation skipping tax will be imposed to the extent the transfer exceeds the generation skipping transfer tax exemption.

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Example:

FMV	$20,000,000
Less GST Exemption	$ 5,000,000
Taxable GST Termination	$15,000,000
GST Tax (35%)	$ 5,250,000

- The Donor (and no one else) is entitled to the Annuity during the term. Regs. 25.2702-3(d)(3)
- Additional contributions to the GRAT must be prohibited. Regs. 25.2702-3(b)(5)
- Commutation of the term interest must be prohibited. Regs. 25.2702-3(d)(4)
- Cannot use a Note or other debt interest to pay the annuity. Regs. 25.2702-3(d)(6)

See *Simches v. Simches*, 423 Mass 683 (1996) (A Massachusetts case in which a reformation proceeding permitted to change a QPRT remainder beneficiaries from grandchildren to children.)

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PLANNING NOTE

A GRAT will be an intentionally defective grantor trust so that the use of an asset to pay the annuity will not be considered a capital gain transaction. It is a transaction between the grantor and a grantor trust. Rev. Rul. 85-13

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g) Other Considerations:

- As a grantor trust, the grantor is taxed on the income generated by the GRAT.
- A GRAT is permissible with discounted assets
- To be successful, the rate of return must exceed the IRC § 7520 rate. (1.20% for the month of October, 2012)

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II. Sale of Assets to an Intentionally Defective Irrevocable Grantor Trust in Exchange for Either a Promissory Note or a Private Life Annuity

1. Using an Installment Note

a) Summary of Transaction

- Grantor establishes an irrevocable trust that is excluded from the estate for estate tax purposes.
- Income and principal may be payable to Donor's spouse and issue in trustee's discretion during the term.
- The trust can, and should be, set up for perpetuity or at least as long as the applicable state law of perpetuities permits
- The trust is a grantor trust for income tax purposes by including the power of substitution under IRC § 675(4)(C), which provides: "The grantor shall have the right to reacquire trust corpus by substituting property of an equivalent value."

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PLANNING NOTE

The provision has been approved by the Internal Revenue Service in connection with an intentionally defective trust where the IRS ruled that such a clause would not cause the trust assets to be includible in the decedent's estate under IRC § 2038 and IRC § 2041. Rev. Rul. 2008-22 as well as under IRC § 2042 (Rev. Rul. 2011-28) (relative to life insurance).

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•Generation skipping transfer exemption can be allocated at the time of the sale and the trust will forever be free of generation skipping transfer and can last literally forever.

•Consider using annual exclusion gifts to forgive the note and reducing the amount that needs to be paid back to the grantor by including Crummey trust provisions.

PLANNING NOTE

Crummey withdrawal powers does not change from the grantor to the beneficiaries under IRC § 678(a) by virtue of IRC § 678(b)

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•If working with an S corporation, recapitalize the S corporation with voting and nonvoting shares in a 9 to 1 nonvoting stock dividend.

•Determine the value of the nonvoting shares by taking into account applicable discounts for lack of marketability and lack of control.

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•The payment of principal which would otherwise be subject to the capital gain to the grantor is nontaxable since the transaction is between a grantor and a grantor trust. Rev. Rul. 85-13

•The payment of interest is not taxable to the grantor because it is a transaction between a grantor and a grantor trust. Rev. Rul. 85-13

•The grantor must pay the income taxes attributable to the income allocated to the IDGT. Rev. Rul. 2004-64

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PLANNING NOTE

Revenue Ruling 2004-64 provides that the independent trustee can reimburse the grantor each and every year for his or her incremental income tax.

•If income from the enterprise is insufficient to pay the note payment, then consider using either membership interests in an LLC or S corporation shares to pay amounts due under the note.

•Consider distributing low basis appreciated assets from the LLC (at least in the case of a partnership) to the trust, which can be used to repay the note on a non-discounted basis.

PLANNING NOTE

This will not work in the case of an S corporation because of Code Section 311(b). The trust's basis is a carryover basis since no taxable gain was recognized at the time of the sale. Consider using a self-cancelling installment note or a private annuity.

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PLANNING NOTE

If possible, work with Limited Liability Companies and Limited Partnerships to avoid any built in gain problem or possible gain on the distribution of appreciated property from the company to its owners. See, IRC § 311(b), which provides: that the distribution of appreciated property from a corporation (including an S corporation) will be considered a sale for fair market value and a distribution of the proceeds.

- Fund/Seed the trust with an amount equal to 10% above the assets being purchased." (There is no statutory or regulatory basis for this, but seems to be an accepted standard.) See, Petter v. Comm., T.C. Memo. 2009-280 (Defined value formula permitted in a case where 10% seed money was used.)

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PLANNING NOTE

With a a $5,000,000 lifetime giving exemption, this could equate to a sale of $50,000,000 in stock. This would be the equivalent of an $80,000,000 company on a discounted basis.

- Determine whether to use one of the following techniques:

1. An installment note (FMV of Note included in Donor's estate)
2. A self-cancelling installment note see, *Frane v. Comm.*, 998 F.2d 567 (8th Cir. 1993) (FMV of Note not included in Donor's estate.)
3. A private life annuity See, GCM 39503; Rev. Rul. 86-72

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•Determine applicable interest rate using applicable federal rate, which is as follows for the month of October, 2012:

Term	Applicable Rate	Annual Rate
3 years or less	federal short term rate	0.23%
4 to 9 years	federal midterm rate	0.93%
9 years or greater	long term rate	2.36%

See, *Frazee v. Comm.*, 98 T.C. 554 (1992)

IRC § 1374(d)

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•Prepare amortization schedule and be sure cash flow from enterprise is sufficient to pay the principal.

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•Obtain solid valuation and to minimize valuation adjustments, consider using a formula purchase price. See, *Petter v. Comm.*, T.C. Memo. 2009-280 (The Donor gifted to a trust as seed money before the sale of LLC units equal to 10% of the value of the total units held in the trust after the sale.) See, also, *Knight v. Comm.*, 115 T.C. 506 (2000) (A gift was made to children in an amount equal to those number of FLP units having a value of $300,000.); *McCord v. Comm.*, 461 F.3d. 614 (5th Cir. 2006); *Estate of Christiensen*, 586 F.2d. 1061 (8th Cir. 2009) Aff'g. 130 T.C. (Formula value allocations between trusts permitted.) *Wandry v. Comm.* TC. Memo 2012-88.

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•Avoid IRC § 2036 problems by having automatic wire transfers to make a distribution of funds to the owners and then a corresponding payment of the promissory note by the trust.

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2. Consider Using a Self-Cancelling Installment Note

a) No amount attributable to the note is includible in the decedent's estate.

b) At the time of the sale, a premium must be built in to either the interest rate or the principal payment. (This could be a disadvantage if death does not occur within the anticipated term.)

c) Gain may be recognized at the time of decedent's death since trust no longer will be a grantor trust.

See: *Frane v. Comm*. 998 F.2d 567 (8th Cir. 1993)

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3. Using a Private Annuity

Advantages:

1) The property will not be included in the annuitant's estate at death.

2) No present gift by transferor/annuitant if the present value of the annuity equals the fair market value of the property on the date of the transfer. Rev. Rul. 69-74. (If there is a gift, none of the basis needs to be allocated to the gift portion.)

3) Income tax treatment to transferor/annuitant is determined under annuity rules of IRC § 72. Therefore, a portion of each payment will be a return of capital, capital gain (if capital gain property is transferred) and ordinary income (unless sale is to an IDGT, in which case these rules are inapplicable).

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4) Annuitant is no longer responsible for management and is guaranteed (unsecured) a stream of income for life.

5) There will be no income in respect of decedent (IRD) at death either to the estate or the obligor under IRC § 691(c).

6) Neither IRC § 2701 nor IRC § 2702 should apply since the private annuity is a sale or exchange.

7) Can be used for marketable securities.

PLANNING NOTE:

Number 3 is inapplicable if sale is to an IDGT.

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Disadvantages:

1) The promise to pay must be unsecured *Bell v. Commissioner*, 60 T.C. 469 (1973); *212 Corp. v. Commissioner*, 70 T.C. 788 (1978). If secured, gain is recognized immediately. G.C.M. 39503.

2) Health of the annuitant not considered unless death is imminent. G.C.M. 39503. In *Harrison v. Commissioner*, 115 T.C. 13 (2000), the Tax Court denied the credit in the control of a simultaneous death of H and W in a plane crash. Each had left the survivor a life estate with a provision in the Will that the other spouse was deemed to have survived. The estate could not use the actuarial tables since death was imminent.

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Part 3:

Qualified Personal Residence Trust (QPRT vs. Home Security Trust)

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a) INTRODUCTION TO QPRT

- This is similar to the GRAT, but no amount is required to be paid pursuant to the terms of the QPRT. Regs. 25.2702(5)(c)
- This is an exception to the IRC § 2702 rules for a home and a second home.
- Very ineffective for allocation of generation skipping transfer tax exemption since the ETIP rules apply. IRC § 2642(f)(3), (4); Reg. 26.2632-1(c)(2)
- Ineffective if the property has a mortgage since the payment of mortgage represents an addition to the trust.

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•No step-up for GST purposes in the case of a child who dies after creation of the trust since the "deceased parent exception" is measured at the time the gift is complete.

•The property will be included in the Donor's estate if the Donor dies during the term of the trust. IRC § 2036(a)(1)

•The QPRT (and any residual grantor trust) must prohibit the reacquisition of the property by the Donor. Regs. 25.2702-5(c)(9)

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b) INTRODUCTION TO HOME SECURITY TRUST

- As an alternative consider transferring outright over a number of years the property to an irrevocable intentionally defective grantor trust using Crummey withdrawal notices.
- If the value of the property exceeds $5,000,000, have the grantor take back a promissory note.
- The property must be rented by the grantor for fair rent in order to avoid estate tax inclusion.

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•The payment of rent to the IDGT is income tax free.

•The receipt of payments under the installment note are income tax free.

•The trust takes a carryover basis so consider having the grantor repurchase the property before death for cash so the decedent dies with low basis property to take advantage of a step up in basis.

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PLANNING NOTE

This provision is so important that it is prohibited to be included in the terms of a qualified personal residence trust or in any trust into which the property flows after the termination of the qualified personal residence trust. See Reg. 25.2702-5(c)(9)

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Part 4:

Consider Using A Domestic Asset Protection Trust

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- In most states, the settlor cannot be a beneficiary, otherwise the assets in the trust are included in the decedent's estate. Ware v. Gulda, 331 Mass. 68 (1954); State Street Bank & Trust Company v. Reiser, 7 Mass. App. 663 (1979); Rev. Rul. 76-103; Rev. Rul. 77-378

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•Consider using a state which has repealed the self-settled rule, such as New Hampshire, Rhode Island, or Delaware (and also repealed the rule of perpetuities).

•Such a trust requires that the trustee be a resident of the applicable state.

•All statutes also allow the appointment of a trust advisor who is responsible for telling the trustee where to invest the assets (and when and if to make distributions).

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Part 5:

So, What's the Hold-Up?

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EXAMPLE

Assume Grantor is 65 years old with a life expectancy of 83, wants $200,000 per year to cover living expenses, and is willing to gift away $5,000,000 or more, but wants to keep the "income."

- Compare a gift to a Domestic Asset Protection Trust with a part gift-part sale for a Private Life Annuity

		Part Gift-Part Sale	
	No Private Life Annuity	With Private Life Annuity	Part Gift-Part Sale to Maximize Exemption
Grantor's Gifting Exemption	$5,000,000	$5,000,000	$5,000,000
Tentative Gift	$5,000,000	$1,779,532	$5,000,000
Sale Portion	$-0-	$3,220,468	$3,220,468
Gifting Exemption Used	$5,000,000	$1,779,532	$5,000,000

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LACK OF CONTROL AND CONCERN ABOUT LOSS OF INCOME AND ACCESS TO THE FUNDS GIFTED.

Consider Using a Lifetime Credit Shelter Trust

1) As to loss of control, based on the case of a business and/or rental real estate, use a limited liability company or an S corporation with voting and nonvoting shares and give away nonvoting shares and keep the voting shares.

2) In the case of a couple, have one spouse create a lifetime credit shelter trust where income and principal is payable to the class consisting of the donor's spouse and the donor's issue of all generations. No marital deduction would be allowable should an intervivos marital deduction be utilized since the intent is to make it a completed gift couple this with the nonvoting shares so that the asset being transferred to the irrevocable credit shelter trust would be the nonvoting shares. As long as the couple stays married, income and principal can be reallocated to the grantor's generation.

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Planning Note:

The trust should provide that, in the event of a divorce, the term "spouse" would exclude the divorcing spouse since this is considered an act of independent significance that would not cause the trust assets to be includible in the decedent's gross estate. Rev. Rul. 80-255; Estate of Tully v. U.S. 78-1 US Tax Cases (CCH ¶ 13.228 (ct.ct 1978)

Consider having husband and wife each establish an irrevocable credit shelter trust for each other. The trust would be a grantor trust at least as to income under Section 677, but probably should be a wholly grantor trust by including a provision under Section 675(4)(c) to reacquire trust corpus by substituting property of an equivalent manner.

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•Will this technique avoid the reciprocal trust technique?

In *United States v. Grace*, 395 U.S. 316 (1969), the husband and wife created trusts for each other which were identical, created at the same time and the trust were of equal value. After the first spouse died, the IRS sought to include in the decedent's estate assets that had been transferred to her irrevocable trust. The question according to the Court was "whether the trust created by the settlors placed each other in approximately the same objective economic position as they would have been if each had created his own trust with himself rather than the other as life beneficiary." The reciprocal trust doctrine can be avoided if the two trusts are not substantially identical.

Estate of Levy v. Commissioner, 46 T.C.M. 910 (1983) (one trust gave broad inter vivos special power of appointment and the other did not); Letter Ruling 200426008 (citing and apparent acceptance of Levy). The factual differences between the trusts included (a) power to withdraw specified amounts after one son's death, and (b) separate powers of appointment, effective at specified times, to appoint trust principal among an identified class of beneficiaries.

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In *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977), the reciprocal trust doctrine was applied to Section 2036(a)(2) and 2038. In Exchange *Bank & Trust Company of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984), TAM 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with right to distribution powers). To the contrary, see, *Estate of Green v. Commissioner*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

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CAVEAT

If the reciprocal trust doctrine applies, the value to be included in either grantor's estate cannot exceed the value of the smaller trust. *Estate of Cole v. Commissioner*, 140 F.2d 636 (8th Cir. 1944).

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How to Establish (Not So Reciprocal Trusts)

•In the case of the husband's trust:

- •the wife will be a trustee together with a child (Mario)
- •the terms will be income and principal payable to the surviving spouse for health, education, support, and maintenance and such other amounts as the trustee, other than the surviving spouse determines
- •there will be no limited power of appointment and, upon death, the assets will be divided into as many equal shares as there are children designated as beneficiaries.

•In the case of the wife's trust:

- •all income is going to be payable to the spouse
- •principal is payable to the spouse in the discretion of the trustee other than the spouse
- •include a limited power of appointment and, in default of the appointment the assets will be divided into as many equal shares as there are children then living and children then deceased leaving issue then living.

PLANNING NOTE:
Spouse can be sole trustee as long as his or her right to principal is limited to an ascertainable standard. IRC § 1041

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Part 6:

S Corporations

66

•**Qualified S Corporation Shareholders**

In connection with a gift giving program, it is extremely important that the S election be preserved since in all likelihood a trust will be the donee, it is important to be sure the trust is structured to be an eligible S corporation shareholder both during the life of the donor as well as thereafter.

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•**Applicable Code Sections**

IRC § 1361 provides that an S corporation must have only so-called eligible S corporation shareholders and generally must be an individual or one or more trusts as set forth in IRC § 1361(c)(2). Pursuant to this section, an eligible S corporation shareholder is as follows:

1.A trust, all of which is treated as owned as an individual who is a citizen or resident of the United States (meaning a wholly grantor trust). IRC § 1361(c)(2)(A)(i)

2.A trust which was a wholly owned trust immediately before the death of the deemed owner and which continues in existence after such death, but only for the two year period beginning on the date of the deemed owner's death. IRC § 1361(c)(2)(A)(ii)

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3. A trust with respect to stock transferred to it pursuant to the terms of a Will, but only for the two year period beginning on the day on which such stock is transferred to it. IRC § 1361(c)(2)(A)(iii)

4. An electing small business trust (ESBT). IRC § 1361(c)(2)(A)(v)

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In addition to the foregoing, IRC § 1361(d) provides for a so-called qualified subchapter S trust. A qualified subchapter S trust is a trust which, according to the terms of the trust, satisfies the following requirements:

i. all trust income must be distributed currently to a single income beneficiary;

ii. the current income beneficiary must be a U.S. citizen or resident;

iii. the trust instrument must provide that during the life of the current income beneficiary, there may be only one income

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iv. the trust must restrict principal distributions made during the income beneficiary's life to the current income beneficiary;

v. the trust instrument must provide that the beneficiary's income interest will terminate upon the earlier of the beneficiary's death or the trust's termination; and

vi. the trust instrument must provide that if the trust terminates during the current income beneficiary's lifetime, all trust assets must be distributed to the current income beneficiary.

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PLANNING NOTE

In general, a QTIP trust will satisfy this requirement. In the case of a lifetime credit shelter trust, it will be a wholly grantor trust, provided the power to reacquire trust assets pursuant to Section 675(4)(c) is included.

PLANNING NOTE

In addition to the foregoing, a QSST election must be made by the current income beneficiary with respect to each subchapter S corporation in which the trust has an interest. This must be made within 60 days after the date the trust receives the S corporation stock.

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•Income Tax Treatment

In the case of a qualified subchapter S trust, the single beneficiary is treated as the owner and will be taxed on all income attributable to the S corporation pursuant to IRC § 1361(d)(1)(B), which provides:

"For purposes of Section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which a QSST election is made." IRC § 1361(d)(2)

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•Electing Small Business Trusts

An ESBT is defined as any trust excluding QSSTs provided such trust (1) does not have a beneficiary, any person other than an eligible individual, an estate (or certain tax exempt organizations), (2) no interest in such trust was acquired by purchase, and (3) an election was made to have it treated as an ESBT.

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•Income Tax Treatment for the ESBT

The income tax on the ESBT share is computed without any deductions, including the deduction for distribution to beneficiaries, other than a deduction for administrative expenses or state or local income taxes that are allowed, such that the income of the ESBT share is taxed at the highest individual rate on all items of income, loss, or deduction. IRC § 641(d)(2)

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Exhibit A

Test Case:
Sale of Non-Voting Shares to Defective Trust

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Test Case
SALE OF NON-VOTING SHARES TO DEFECTIVE TRUST
Estate Planning Analysis

ASSUMPTIONS

FMV of Asset		10,000,000
Cash Flow		2,000,000
Interest Rate (October 2012)		2.36%
Term of Note		15
Annual Payment		504,502.31
Growth of Assets		10.0%
Tax Liability		25.0%
Defective Trust Share of Cash Flow	99%	1,980,000

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CALCULATION OF FAIR MARKET VALUE AND SALES PRICE

Cash Flow				2,000,000
Multiple				5
FMV of Asset				10,000,000
Shares				100
Price Per Share				100,000
Lack of marketability discount	-	25%		(25,000)
				75,000
Lack of control discount	-	15%		(11,250)
Discounted Share				63,750
Multiplied by interests to be sold	X	99		6,311,250
Total sale price			$	**6,311,250**

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	NOTE		CASH FLOW	
YEAR	TOTAL PAYMENT	2.36% INTEREST	PRINCIPAL	BALANCE
-	-	-	-	-
				$6,311,250.00
1	$504,502.31	$148,945.50	$355,556.81	$5,955,693.19
2	$504,502.31	$140,554.36	$363,947.95	$5,591,745.24
3	$504,502.31	$131,965.19	$372,537.12	$5,219,208.12
4	$504,502.31	$123,173.31	$381,329.00	$4,837,879.12
5	$504,502.31	$114,173.95	$390,328.36	$4,447,550.76
6	$504,502.31	$104,962.20	$399,540.11	$4,048,010.65
7	$504,502.31	$95,533.05	$408,969.26	$3,639,041.39
8	$504,502.31	$85,881.38	$418,620.93	$3,220,420.46
9	$504,502.31	$76,001.92	$428,500.39	$2,791,920.07
10	$504,502.31	$65,889.31	$438,613.00	$2,353,307.07
11	$504,502.31	$55,538.05	$448,964.26	$1,904,342.81
12	$504,502.31	$44,942.49	$459,559.82	$1,444,782.99
13	$504,502.31	$34,096.88	$470,405.43	$974,377.56
14	$504,502.31	$22,995.31	$481,507.00	$492,870.56
15	$504,502.31	$11,631.75	$492,870.56	$0.00

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DEFECTIVE TRUST-UNDISCOUNTED

FMV ASSETS	10.0% TAXABLE INCOME	PAYMENT	END OF YEAR
-	-	-	-
			$9,900,000.00
$9,900,000.00	$1,980,000.00	$504,502.31	$11,375,497.69
$11,375,497.69	$2,178,000.00	$504,502.31	$13,048,995.38
$13,048,995.38	$2,395,800.00	$504,502.31	$14,940,293.07
$14,940,293.07	$2,635,380.00	$504,502.31	$17,071,170.76
$17,071,170.76	$2,898,918.00	$504,502.31	$19,465,586.45
$19,465,586.45	$3,188,809.80	$504,502.31	$22,149,893.94
$22,149,893.94	$3,507,690.78	$504,502.31	$25,153,082.41
$25,153,082.41	$3,858,459.86	$504,502.31	$28,507,039.96
$28,507,039.96	$4,244,305.84	$504,502.31	$32,246,843.50
$32,246,843.50	$4,668,736.43	$504,502.31	$36,411,077.62
$36,411,077.62	$5,135,610.07	$504,502.31	$41,042,185.38
$41,042,185.38	$5,649,171.08	$504,502.31	$46,186,854.15
$46,186,854.15	$6,214,088.19	$504,502.31	$51,896,440.02
$51,896,440.02	$6,835,497.00	$504,502.31	$58,227,434.72
$58,227,434.72	$7,519,046.70	$504,502.31	$65,241,979.11

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TAXPAYER'S ESTATE ANALYSIS

NOTE REC	ANNUAL PAYMENT	25.0% TAX LIAB	NET ESTATE
-	-	-	-
$6,311,250.00			$6,311,250.00
$5,955,693.19	$504,502.31	$495,000.00	$5,965,195.50
$5,591,745.24	$504,502.31	$544,500.00	$5,551,747.55
$5,219,208.12	$504,502.31	$598,950.00	$5,124,760.43
$4,837,879.12	$504,502.31	$658,845.00	$4,683,536.43
$4,447,550.76	$504,502.31	$724,729.50	$4,227,323.57
$4,048,010.65	$504,502.31	$797,202.45	$3,755,310.51
$3,639,041.39	$504,502.31	$876,922.70	$3,266,621.00
$3,220,420.46	$504,502.31	$964,614.96	$2,760,307.80
$2,791,920.07	$504,502.31	$1,061,076.46	$2,235,345.92
$2,353,307.07	$504,502.31	$1,167,184.11	$1,690,625.28
$1,904,342.81	$504,502.31	$1,283,902.52	$1,124,942.60
$1,444,782.99	$504,502.31	$1,412,292.77	$536,992.53
$974,377.56	$504,502.31	$1,553,522.05	($74,642.17)
$492,870.56	$504,502.31	$1,708,874.25	($711,501.38)
$0.00	$504,502.31	$1,879,761.68	($1,375,259.37)

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