ADVANCED TRUST AND ESTATE TAX PLANNING TECHNIQUES

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I. Advanced Estate Tax Techniques

A. Self-Canceling Installment Notes

1. Overview

A self-canceling installment note (a "SCIN") is in essence an installment note payable with reference to someone's life expectancy.[1] The use of the words "self-canceling" denotes the fact that the note is automatically canceled by its own terms on someone's death (i.e., once the seller dies, the buyer has no continuing obligation to keep making payments). SCINs are taxable much like other installment sales under Code Section 453.

2. Advantages of SCINs

SCINs enjoy many estate tax advantages, and also enjoy some income tax planning advantages. (There are certain nontax advantages as well. For example, the seller would not have to continue making payments past the term of the note. Compare this with a private annuity where the seller may have to make payments for a much longer period of time than the life expectancy of the transferor.)

a. Estate Tax

Any sale of property in exchange for a promissory note will accomplish an estate freeze. The taxpayer will own a promissory note which will never appreciate in value, and the assets sold (usually to an irrevocable trust) have been removed from the taxpayer's estate, including their subsequent appreciation.

SCINs take an estate freeze a step further. Promissory notes that are cancelled on death are not included in the decedent's estate.[2] This accomplishes not just the freeze of the estate at today's values, it actually reduces the value of the estate.

The cancellation clause must be a bona fide part of a contract, separately negotiated and paid for, and not simply a testamentary disposition.

This means that a seller in a SCIN transaction enjoys the same estate tax savings as the transferor in a private annuity. The transferred asset is removed from the seller's estate in exchange for the installment note that becomes worthless on death, and the future appreciation of the transferred asset is also transferred out of the estate.

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[1] Per GCM 39503, the term of a SCIN should always be less than the seller's life expectancy. If the term of the SCIN exceeds life expectancy, it is treated as a private annuity.
[2] Moss Est. v. Comm'r., 74 T.C. 1239.

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If the seller dies before reaching his life expectancy, the estate tax savings can be very significant. Keep in mind that the payments received by the seller on the installment note are includible in the seller's estate.

Example. George, age 40, sells an asset worth $5 million in exchange for a 35-year, self-canceling (on death of George) promissory note. George dies before he receives a single payment (he is run over by a milk truck). The entire $5 million asset is out of George's estate. If George survived for a few years, then whatever payments he would have received under the installment note and did not spend, would be included in his estate.

b. Securing the Note

SCINs can be secured. They can be secured with property, pledges or guarantees.[3] Securing a SCIN will not cause the entire amount of gain to be taxable in the year of sale.

c. Income Tax

i. Tax Consequences to Seller

SCINs are subject to the installment sale rules of Code Section 453. This means that if the transferor otherwise qualifies for the installment method (for example, if the transferor is a dealer, he does not qualify), that is how the sale of property in exchange for a SCIN will be taxed. The note has a maximum selling price and is treated by the Service as a fixed payment installment sale (although the note is really contingent).
A portion of each payment will be a return of basis, capital gain and ordinary income.

If the transferor dies before receiving all of the payments on the note, then his estate (on Form 1041) will be taxable on the unrecognized gain.[4]

Many commentators have argued that the transferor really has no unrecognized gain. A SCIN is not payable for life, but for a fixed term, and the parties also negotiate the possibility of the transferor dying before the expiration of the term – i.e., the transferor receives exactly what he bargained for, there is no unrecognized gain. Which means that SCIN payments are larger because of the risk premium, and the transferor already recognizes more gain.

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[3] Code Section 453(f)(3).
[4] Frane Est. v. Comm'r., 998 F. 2d 567 (8th Cir. 1993). In other circuits, including the 9th Circuit, taxpayer may still argue that the gain should be reportable on the last income tax return of the transferor.

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ii. Tax Consequences to Buyer

Interest payments made by the buyer on the promissory note may be deductible. Deductibility of interest depends on various factors, such as the identity of the buyer and the nature of the asset sold. If the buyer is a C corporation, interest should be fully deductible.

If the buyer is an individual, depending on the nature of the asset sold, interest may not be fully deductible due to various limitation imposed on the deductibility of investment interest and personal interest.

With respect to basis, the buyer will have basis in the acquired property equal to the stated maximum purchase price of the note (i.e., basis should equal fair market value of the property at the time of transfer). There will be no subsequent adjustments to basis.

3. Disadvantages of SCINs

a. Gift Tax

SCINs may have gift tax consequences if structured incorrectly. To determine whether a SCIN involves a gift, it is necessary to determine whether the value of the transferred property equals the value of the installment note.

The cancellation clause of a SCIN is technically a separately bargained for part of the contract. This means that first the terms of the note should be determined using the standard present value rules. Then, the terms need to be adjusted by the value of the cancellation clause.

The separately bargained for value of the cancellation feature is usually referred to as a risk premium. Because it is not possible to change the duration of the note, the risk premium is reflected through a higher principal amount or a higher interest rate.

Determining the proper interest rate hinges on first determining the value of the risk premium. This is based on the probability that the transferor will not survive to receive all scheduled payments. The probability of the transferor surviving to receive each payment is based on the mortality tables in Treas. Reg. Section 1.72-9 or the 90CM life expectancy. There is no clear guidance which life expectancy should be used. Because the regulations usually result in a longer life expectancy, that reduces the risk premium, and the use of the life expectancy in the regulations is therefore desirable.

4. Other

Because Code Section 453(e) applies to SCINs, a disposition of the assets by a related-party buyer within two years of the SCIN transaction would cause the seller to recognize all of the deferred gain.

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Finally, a SCIN would be inappropriate if the transferor would need to retain an income stream for life.

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B. Defective Grantor Trusts

"Grantor trust" is a term of art and refers to a trust defined in Code Sections 671-679. Sometimes grantor trusts are referred to as "defective grantor trusts" or "intentionally defective grantor trusts." Both of these terms are misnomers.

Some commentators have been referring to grantor trusts as defective. That implies that if a trust is a grantor trust that may result in some adverse consequences. As the reader will learn in this section, that is not necessarily so. As a matter of fact, certain advantages may be had from the grantor trust status. However, the term "defective grantor trust" has entered the common lexicon to refer to a trust that is grantor for income tax purposes but results in a completed transfer for estate and gift tax purposes.

What then is an "intentionally" defective grantor trust, or, in other words, an intentional grantor trust? This refers to the fact that the drafter of the trust intentionally structured the trust to qualify under Code Sections 671-679. The use of the term "intentionally" in this context is certainly a misnomer. Any grantor trust that is not so intentionally is a malpractice claim.

There is a lack of symmetry in the income and estate taxation of trusts. A transfer to an irrevocable trust can be treated simultaneously as both (i) a completed transfer for estate and gift purposes and (ii) an incomplete transfer for income tax purposes. Thus, it is possible to structure an irrevocable trust so that the assets of the trust will be excluded from the donor's estate at his death, while at the same time the trust will be a grantor trust for income tax purposes during the donor's lifetime. This may lead to certain estate and gift tax advantages.

Grantors commonly fund these trusts through the mechanism of an installment sale or a SCIN. This avoids any gift tax issues, and transfers, at the very least, the future appreciation of the asset, out of the grantor's estate. Using a SCIN, it is possible to transfer a lot more than just future appreciation out of the taxable estate, if the grantor dies prematurely.

When choosing between a SCIN and a defective grantor trust, the tax adviser must determine whether the client's objective is estate tax reduction, income tax reduction, or both.

If the sole objective is the reduction of the estate tax, then either structure can be used. If the objective is to also incorporate income tax planning, then a defective grantor trust cannot be used as the transaction will be ignored for income tax purposes.

1. Possible Benefits of Defective Grantor Trusts

There are several benefits to defective grantor trusts.

a. Income Tax Advantages

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Transactions between a grantor trust and its grantor are ignored - a grantor trust is a nonentity for income tax purposes. Consequently, transactions between the grantor and a grantor trust will be treated as income tax nonevents. The Service has ruled specifically on the issue of sales to defective grantor trusts and found these sales to be nonevents for tax purposes.[5] Additionally, all of the income, gain, deductions and losses of the trust are reported on the income tax return of the grantor, who is treated as the owner of those items.

For instance, a grantor's purchase of property from a grantor trust is not a realization event. This may be a major tax benefit.

Example. Consider a defective grantor trust, structured to avoid estate taxation at the grantor's death, holding $1 million in marketable securities, with a basis of zero. Pursuant to Code Section 1015, the trust's basis in its assets is the same as the grantor's basis at the time the trust was funded. Following the grantor's death, the basis of the trust assets will remain at zero (the assets of the trust are not part of the taxable estate).
To get a stepped up basis, the grantor can purchase the marketable securities owned by the trust with cash. Now, the grantor will own the securities and the trust will own cash. On death, the marketable securities now get a step-up in basis, and the basis of cash in the trust obviously does not change. Because the assets of this trust are not part of the donor's estate, the cash is not taxable on death of the donor. Thus, simply by switching assets with the trust, the grantor eliminated $1 million of capital gain, without any offsetting tax cost.

Similarly, interest payments on a note between a grantor trust and its grantor are not taxable to the grantor or the trust (same would apply to SCIN risk premium payments).[6] Further, the transfer of an installment note between a grantor trust and its grantor should not constitute a disposition for purposes of Code Section 453B.[7]

Grantor trusts are also entitled to all the deductions and exclusions that individual taxpayers enjoy. For example, a grantor is entitled to the Code Section 121 exclusion on the sale of a principal residence by a grantor trust.[8] A grantor is similarly entitled to the mortgage interest deduction with respect to real property owned by a grantor trust.
Because the grantor pays all the income taxes, the grantor trust is essentially tax exempt. Distributions to the beneficiaries of a grantor trust are income tax free; accumulations of income are also income tax free. These tax-free distributions and accumulations provide the beneficiaries with a substantial economic benefit. Moreover, and of great importance in many planning transactions, the grantor's payments of income taxes on grantor trust income do not constitute additional taxable gifts to the trust.

i. Playing with Basis

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[5] Rev. Rul. 85-13, 1985-1 C. B. 184.
[6] PLR 9535026.
[7] Rev. Rul. 74-613, 1974-2 C. B. 153.
[8] Rev. Rul. 85-45, 1985-1 C. B. 183.

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Because assets of a defective grantor trust are outside of the grantor's estate, the assets will receive no step-up in basis on the death of the grantor. Consequently, practitioners must carefully plan for this possible downside.

One way to negate the loss of basis step-up is to realize the gains of trust assets during the life of the settler, thus achieving basis step-up during the life of the grantor. This way, income taxes will be paid either by the grantor or by the grantor's estate, and not by the beneficiaries. Of course, at the end of the day, this really becomes a zero sum game.

A better way to negate the loss of a basis step-up is to either initially fund the trust with high-basis assets that would otherwise receive a basis step-down (i.e., built-in loss assets), or to sell low basis assets to the grantor in exchange for high basis assets like cash. Because the sale would be ignored for income tax purposes, it will simply result in an exchange of assets between the grantor and the trust.

Low basis assets will be transferred to the grantor and included in the grantor's taxable estate, receiving a basis step-up, and assets that require no step-up will be transferred to the trust and outside the estate.

Defective grantor trusts usually include a provision allowing the grantor to substitute trust assets for other property of equivalent value. This provision causes the trust to become a grantor trust and also allows the grantor to engage in the above tax planning.

ii. Using Installment Sales

It is important to understand why installment sales are frequently used as a mechanism to transfer assets to a defective grantor trust. If assets are simply contributed to the trust, that constitutes a gift, and therefore a transfer subject to the gift tax.

If assets are sold to the trust for adequate consideration, then there is no gift and no gift tax consequences. However, adequate consideration implies that the trust must pay consideration to the grantor in exchange for the asset sold to the trust. The trust may not have sufficient assets to pay such consideration. However, if the trust can pay the consideration over a period of time, especially with a deferred starting date, then the transaction avoids gift taxes, is ignored for income tax purposes, and is manageable from a practical standpoint.

iii. Payment of Taxes

The payment of income taxes by the grantor is an extremely important benefit of the defective grantor trust structure. The taxes are paid by the grantor from his own funds, depleting his taxable estate. If taxes were paid by the trust, it would deplete nontaxable assets. Additionally, the funds that would have been used by the trust to pay taxes remain invested and continue to appreciate outside of the grantor's taxable estate.

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It was relatively unclear for a long period of time whether payment of taxes by the grantor would constitute a gift to the trust. The Service, in Rev. Rul. 2004-64[9], clarified this issue as follows:

1. If the trust does not have any provisions permitting the trustee to reimburse the grantor for making income tax payments and the grantor pays taxes out of his own pocket, then no additional gifts are being made to the trust. The income tax is the legal obligation of the grantor who is taxed on the income of the trust.
2. If the trust requires reimbursement, then there are no additional gift being made by the grantor, but the entire trust corpus is includable in the grantor's estate.
3. If the trust provides the trustee with discretion in reimbursing the grantor for making tax payments, and there is no express or implied arrangement between the grantor and the trustee to that effect, then the payments of taxes will not be deemed a gift and the corpus of the trust will be excluded from the grantor's estate.

iv. Reporting Requirements

Grantor trusts report the grantor's share of trust income on a separate statement attached to Form 1041, and have the following options for their income tax reporting requirements: (i) they can use the method described in Treas. Reg. Section 1.671-4(a); (ii) they can file Forms 1099, indicating the grantor as the payee, and must furnish an information statement to the grantor. Foreign trusts are limited to clause (i).

b. Estate Tax Benefits

A defective grantor trust is a form of an estate freeze that avoids the application of Chapter 14. For estate tax purposes, the grantor transfers an asset to the irrevocable trust and out of the taxable estate, and in exchange takes back a promissory note. Because a promissory note can never appreciate in value (it will usually decline), the grantor froze the value of the taxable estate as of the date of sale to the trust.

c. Use with S Corporations

Grantor trusts qualify as S Corporation shareholders. As a general rule, a trust is not a permissible shareholder of S corporation stock.[10] However, Code Section 1361(c)(2)(A)(i) carves out an exception for grantor trusts. N.B. – The grantor should be treated as the owner of the entire trust, both income and principal. While there are other trusts that qualify to own S corporation stock (like QSSTs), grantor trusts are either to set up and administer.

2. Achieving Defective Grantor Trust Status

[9] 2004-27 IRB 7.
[10] Code Section 1361(b)(1)(B).

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What provisions should a trust contain so that a transfer of assets to the trust is complete for estate and gift tax purposes, but ignored for income tax purposes?

a. Power to Reacquire or Substitute Assets

Pursuant to Code Section 675(4)(C), a trust is a grantor trust if "any person" holds a power "in a nonfiduciary capacity…to reacquire the trust corpus by substituting other property of an equivalent value." A Code Section 675(4)(C) power retained by a grantor should not cause the trust property to be includible in the grantor's estate for estate tax purposes. Nor should the retained power prevent the grantor from having made a completed taxable gift to the trust.

b. Loans to Grantor

Pursuant to Code Section 675(2), if a nonadverse trustee is given the power to make loans to the grantor without adequate interest or security, the trust will be a grantor trust, unless the trustee holds the power to make loans to others under the same conditions. While loans without adequate interest may cause inclusion of trust assets in the grantor's estate, the power to loan without adequate security should not cause estate tax inclusion.

c. Power to Control Beneficial Enjoyment

Pursuant to Code Section 674(a), if the grantor's spouse (or any other third party) is a trustee and has the authority to add beneficiaries, the trust will be a grantor trust. Powers granted to the spouse are attributable to the grantor for income tax purposes, but not for estate and gift tax purposes (generally). For most taxpayers, using the spouse as the trustee is convenient and "safe." Accordingly, granting the spouse such a power should not prevent completed gift status for the trust nor should it trigger estate tax inclusion at the grantor's death.

d. Power to Distribute to Grantor's Spouse

Pursuant to Code Section 677(a), the grantor is deemed to own any portion of a trust, the income of which may be distributed to the grantor's spouse. Consequently, making the grantor's spouse a discretionary beneficiary of the trust will make it intentionally defective. The grantor trust status will end, however, if the spouse predeceases the grantor.

Making the grantor's spouse a beneficiary also has an important practical benefit. With the spouse as a beneficiary, the trustee can make distributions from the trust to the spouse, and the spouse would presumably share these distributions with the grantor. Thus, if the grantor needs access to the assets of the trust to maintain a certain standard of living, this can be achieved via the spouse-beneficiary without causing the inclusion of the assets in the grantor's estate.

e. Paying Life Insurance Premiums

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Code Section 677(a)(3) triggers grantor trust status as to the ordinary income of a trust if the trustee may pay from trust income premiums for insurance on the life of either the grantor or the grantor's spouse. Granting the trustee the ability to pay insurance premiums with trust income should not prevent transfers to the trust from being complete for either gift or estate tax purposes.

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C. GRATs

1. Understanding Section 2702

Whenever a grantor sets up a trust for the benefit of a family member, and the grantor retains an interest in the trust, Code Section 2702 applies to value the retained interest at zero. If the retained interest is valued at zero, then the remainder interest going to the family member has the same value as the asset contributed to the trust, and is fully subject to the gift tax.

For example, House gifts his motorcycle to an irrevocable trust. Wilson is the beneficiary of the trust, but House retains the right to use the motorcycle whenever he wishes, for the next 10 years. The value of the motorcycle is $15,000. What is the value of the gift made to the trust?

If Wilson is not House's family member, then the gift is computed as follows: determine the value of House's retained interest in the trust, and subtract that from the value of the asset transferred to the trust. A fairly straightforward calculation of the present value of the retained interest, using the annuity tables, gets us the value of the retained interest.

By using a trust with a retained interest, House can take an otherwise taxable gift, and reduce the gift portion significantly.

When Wilson, the remainder beneficiary is a family member, Congress is concerned that House would use the trust arrangement to move a valuable asset into the trust, greatly minimize the gift tax, and retain the use and enjoyment of the asset. Consequently, Section 2702 was enacted to prohibit the above transaction when the remainder beneficiary of the trust is a family member.

a. Who Counts as Family

A "member of the transferor's family" is defined in Code Section 2704(c)(2) to include (1) the spouse, (2) any ancestor or lineal descendant of the transferor or transferor's spouse, (3) a sibling, or (4) a spouse of someone described in 2 or 3.

b. Retained Interest

For Code Section 2702 to apply, the settlor (or an applicable family member – see definition immediately above) must have retained an interest in the trust.

This covers whatever interest the settlor keeps in the asset transferred to the trust.

For example, Jim transfers the ownership of his car to a GRAT, and keeps for himself the right to drive the car on weekends. Because Jim used to own the car outright, he always had the right to drive the car on weekends. He has kept that right to himself, and therefore has retained an interest in the trust.

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Note that while the interest may be retained not only for the settlor of the trust but also for a family member (like a spouse or a child), the retention test is done at the level of the person who gets the interest.

For example, Betty transfers an asset to a trust, with income payable to her son for his life, and then to Julio, Betty's friend. Betty did not retain an interest for herself, and her son, for whom an interest was retained, did not own the asset prior to the transfer. This means that 2702 will not apply to a QTIP trust one spouse creates for another.

For the purpose of this test, an interest that may be retained includes a power over the trust which would cause any portion of the transfer to be treated as an incomplete gift.[11] An example of such a power would be the power to change the interest of an income beneficiary.

2. Exceptions to 2702

There are a number of exceptions that have been carved out to Code Section 2702, including an exception for incomplete gifts,[12] personal residence trusts,[13] charitable remainder trusts,[14] charitable lead trusts[15] and certain "qualified interests". Personal residence trusts and charitable trusts are discussed below.

We will focus on the so-called "qualified interest" exception which, as you will shortly find out, is the exception that covers a GRAT.

Code Section 2702(a)(2)(B) provides that Code Section 2702 shall not apply to a "qualified interest." A qualified interest is defined in Section 2702(b) as (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually (expressed as a fixed dollar amount or a fixed percentage of the trust corpus), and (2) any noncontingent remainder interest if all of the other interests in the trust are those described in (1) above. Thus, by definition, a qualified interest includes a qualified annuity interest (GRAT), this is where the annual dollar amount is fixed in advance, and a qualified unitrust interest (GRUT), this is where the percentage is fixed in advance and will be applied to the corpus of the trust on an annual basis. The requirements to qualify as a GRAT are stated in Treasury Regulations Section 25.2702-3(b) and (d), and the requirements to qualify as a GRUT are stated in Treasury Regulations Section 25.2702-3(c) and (d).

Note that 25.2702-(3)(d) has requirements that are common to both GRATs and GRUTs, which include the following: (1) the interest must be a qualified annuity or unitrust interest in every respect (i.e., an irrevocable right to receive a fixed amount or percentage annually, or the greater of the fixed dollar amount or of the percentage amount), (2) the qualified interest must be payable for a fixed term (can be life of the interest holder or a number of years or the shorter of

[11] Treas. Reg. Section 25.2702-2(a)(4).
[12] Code Section 2702(a)(3)(A)(i).
[13] Code Section 2702(a)(3)(A)(ii).
[14] Treas. Reg. Section 25-2702-1(c)(3)(i).
[15] Treas. Reg. Section 25-2702-1(c)(5).

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the two) and cannot be subject to a contingency, (3) distributions may not be made to anyone but the annuitant or unitrust recipient, (4) the term of the interest must be fixed, (5) the term holder's interest (the retained interest) may not be prepaid, and (6) debt obligations may not be used to satisfy the annual distribution requirement.

For a GRAT, the fixed dollar amount may be expressed as an actual dollar amount to be paid each year, or as a percentage of the initial trust corpus. In either case, the dollar amount can be increased or decreased from year to year. If the payments are increased, then each year's payment cannot exceed 120 percent of the prior year's payment.

For example, the settlor transfers assets to a GRAT and retains the right to receive $100 in Year 1, $120 in Year 2 and $150 in Year 3. Only the payments to be received in Years 1 and 2 are qualified annuity interests and can be counted to reduce the gift amount to the remainderman. Of the Year 3 payment, only $144 (120 percent of the Year 2 payment) is qualified.

The settlor may also reserve the right to receive the greater of the annual payment (the annuity amount) or the income of the trust. Only the annual payment is counted toward calculating the gift value of the remainder.[16] Further, the settlor may be reimbursed by the trustee for any federal income tax paid by the settlor attributable to trust income in excess of the annuity amount, but the amount reimbursed is not taken into account in calculating the gift value of the remainder.[17]

GRUTs are similar to GRATs in all respects, except when it comes to calculating the annual distribution. In a GRUT, the annual distribution is a percentage of the assets of the trust at the time of the distribution. The percentage itself is fixed at the time the GRUT is created. Similar to a GRAT, the percentage amount can be increased from year to year, subject to the 120 percent rule discussed above.

While you are going through these rules and exceptions, please keep in mind why it is important to qualify the annuity distributions from the trust. If the distributions are not qualified, then they are ignored in calculating the value of the remainder interest, which increases that value and increases the gift tax. The value of the remainder interest is equal to the value of the assets transferred to the trust less the present value of the qualified interest retained by the settlor. The present value of the retained interest is determined using the retained term, the annual payment and the 7520 rate.

3. Calculating the Gift Tax

On a transfer of an asset to a GRAT or a GRUT, the gift, for gift tax purposes, is the value of the remainder interest. The value of the remainder interest is calculated by subtracting the value of the qualified retained interest from the value of the assets transferred to the trust.

[16] Treas. Reg. Section 25-2702-3(b)(1)(iii).
[17] PLR 9352007.

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The value of the qualified retained interest is determined under Code Section 7520 using a present value calculation. The discount rate used in the calculation is 120 percent of the applicable federal midterm rate in effect for the month of the transfer. You would then use the applicable annuity table to determine the factor for an annuity retained for life or a term of years. A retained interest includes an interest payable to the grantor of the trust, and payable to the grantor's estate on his death.

The remainder interest has no minimum. For example, in the famous Walton case[18] the remainder interest was .003 percent. That was determined to be within the scope of the regulations. There is at least one TAM (200245053) which states that the remainder interest should be at least 1 percent of the assets contributed to the trust, but there appears to be no authority for that position and taxpayers routinely create GRATs that have a small or a zero value remainder interest. A GRUT, mathematically, cannot have a remainder interest as small as zero.

If the remainder interest is zero, that means that the retained interest is equal to the value of the assets transferred to the trust. So, for example, $100 is transferred into the trust, the grantor retains an annual distribution of $20. Assume that statistically, that distribution is expected to return to the grantor the entire $100 over his lifetime. That means that statistically, the remainder interest is worth zero. What is the benefit of a remainder interest being valued at zero?

The benefit is realized when assets that are expected to significantly appreciate in value are transferred to the trust. Today, the asset is valued at $100, and based on the retained annual distributions, the remainder interest is zero. But if tomorrow the $100 asset becomes worth $1,000, the grantor still gets his $20 per year, and whatever is left goes to the remaindermen. The remaindermen may therefore receive a significant distribution from the trust, without subjecting the transfer to any gift or estate taxes.

To the extent the remainder interest has any value, it constitutes a gift of a future interest and is not protected by the annual exclusion.

4. Estate Tax

If the grantor predeceases the term of the trust, inclusion of the trust corpus in the grantor's estate is required by Code Section 2036(a)(1).[19] The portion of the GRAT or GRUT included in the estate is that portion of the trust corpus necessary to provide the retained payment (as a perpetual annuity) applying the 7520 rate. This generally causes the entire corpus (or close to it) of the GRAT to be included in the estate.

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[18] Walton v. Comr., 115 T.C. 589 (2000).

[19] Prior to the 2008 regulations, inclusion was also required by Code Section 2039. Treas. Reg. Sections 20.2036-1(c)(20(i) and 20.2039-1(e).

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To avoid the inclusion of the trust corpus in the grantor's estate, the practitioner should consider (i) selling the remainder interest at least three years prior to death, and/or (ii) creating short-term "rolling" GRATs.

5. Income Tax

GRATs and GRUTs are treated as grantor trusts, because of the interest the grantor retains in the trust.[20] Because of the grantor trust treatment, transactions between the grantor and the trust are ignored, there is no adjustment to the basis of the assets transferred to the trust and the grantor remains taxable on the income generated by the trust.

Because it is the grantor and not the trust that is taxed on the trust's income, any grantor trust allows assets to appreciate income tax free for the benefit of the remaindermen.

After the retained term expires, the trust may remain a grantor trust, if properly drafted. It is often desirable to preserve the grantor status of the trust to allow the trust to accumulate assets income tax free. See the discussion of intentionally defective grantor trusts to determine how to keep a trust grantor for income tax purposes without causing estate tax inclusion.

[20] Code Section 673.

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D. Residence Trusts

1. Overview

Residence trusts are used to transfer a grantor's residence out of the grantor's estate at a low gift tax value. Once the trust is funded with the grantor's residence, the residence and any future appreciation of the residence is excluded from grantor's estate.

Personal residence trusts ("PRTs") are irrevocable split interest trusts. The transfer of the residence to the trust constitutes a completed gift. The split interest character of the trust is as follows: the grantor retains the right to live in the house for a number of years, rent-free, and then the remainder beneficiaries of the trust become fully vested in their interest. PRTs are similar by nature to other types of retained interest trusts, like GRITs, GRATs and GRUTs.

Generally, if the grantor retains an interest in the trust, then for estate and gift tax valuation purposes, his retained interest as valued at zero.[21] However, if the retained interest is "qualified" within the meaning of Code Section 2702(b), its value is determined under Code Section 7520.[22]

The value of the retained interest, as will be explained in more detail below, is important for gift tax purposes. Because the transfer of the residence to the PRT is a completed gift, it is desirable to minimize the value of the gift. The gift is valued as the fair market value of the residence, less the value of the retained interest. Consequently, if the remainder interest is valued at zero, the taxable gift equals the fair market value of the residence. If the remainder interest is valued under Code Section 7520, its value will be greater than zero, and the gift value is minimized.

Code Section 7520 values the remainder interest using the term of the trust, the life expectancy of the grantor and the 7520 rate in effect for the month of the transfer. The longer the term of the trust and the higher the 7520 rate, the lower the value of the gift. The age of the grantor also matters. If the grantor is older, there is a greater likelihood that the grantor will die during the term of the retained interest (when a contingent reversion is retained by the grantor).

The regulations under Code Section 2702 allow two types of qualified trusts: personal residence trusts and qualified personal residence trusts ("QPRTs"). Of the two, QPRTs are more widely used because they possess a greater degree of flexibility.

a. Personal Residence

A personal residence is one of the following: (i) the principal residence of the grantor; (ii) one other residence of the grantor; or (iii) an undivided fractional interest in either.[23] Up to two

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[21] Code Section 2702(a)(1) and (a)(2)(A).
[22] Code Section 2702(a)(2)(B).
[23] Treas. Reg. Section 25.2702-5(b) for PRTs and 25.2702-5(c) for QPRTs. Refer to Code Section 1034 for the definition of a personal residence, and Code Section 280A(d)(1) for one other residence.

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residences may be transferred into residence trusts, and one must be the primary residence.[24] The other residence, usually a vacation home, may be rented by the grantor a portion of the time, but the grantor must live in the vacation home for more than the greater of 14 days or 10 percent of the number of days rented.[25]

b. Mortgages

Personal residences that are mortgaged may be transferred to a residence trust.[26] To the extent the residence is encumbered, the value of the property transferred will be reduced for gift tax purposes.

As mortgage payments continue to be made by the grantor, additional gifts are made to the remaindermen. To avoid this result, many practitioners do not take mortgages into account when valuing the residence for gift tax purposes. While this practice is common, there is no authority to support it.

2. Personal Residence Trusts

To escape valuation under Code Section 2702 (i.e., retained interest valued at zero), a PRT must comply with the following two primary requirements: (i) the trust may hold only one residence which must be used as the grantor's personal residence during the term of the trust;[27] and (ii) the trust may not allow the sale of the residence during the term of the trust.[28] Additionally, following the expiration of the residence term, sale to grantor or grantor's spouse is also prohibited.[29]

The inability to sell the residence is a major restriction on the flexibility of a PRT and usually makes QPRTs more desirable. PRTs do not, however, have many other technical restrictions that QPRTs are subject to.

3. Qualified Personal Residence Trusts

Similar to PRTs, QPRTs must comply with certain requirements to avoid valuation under Code Section 2702. The QPRT requirements are as follows: (i) income must be distributed to the grantor at least annually;[30] (ii) no distributions of principal may be made to any person other than

[24] Treas. Reg. Sections 25.2702-5(a)(1) and 25.2702-5(b)(1). N.B. The limitation is on the number of residences, not on the number of trusts that a grantor may have. This is important when fractional interests are transferred.
[25] Code Section 280A(d)(1).
[26] Treas. Reg. Section 25.2702-5(b)(2)(ii) and 25.2702-5(c)(2)(ii).
[27] Treas. Reg. Section 25.2702-5(b)(1).
[28] Treas. Reg. Section 25.2702-5(b)(1).
[29] Treas. Reg. Section 25.2702-5(b)(1).
[30] Treas. Reg. Section 25.2702-5(c)(3).

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the grantor;[31] (iii) only one personal residence may be held in the trust, but as discussed below, certain other assets may be held in the trust, as well;[32] (iv) to the extent the trust hold cash in excess of the amount allowed, such cash must be distributed at least quarterly;[33] (v) the QPRT status will cease if the residence is no longer used in such capacity.[34]

QPRTs are permitted the following: (i) the residence may be sold, but not to the grantor or the grantor's spouse (the residence may pass to the grantor's spouse without any consideration at the end of the term);[35] (ii) if the residence is sold, the trust may continue holding the sale proceeds, so long as the cash is held in a separate bank account;[36] (iii) cash may be added to the trust, and then held in a segregated bank account, for the payment of certain expenses connected with the residence;[37] (iii) the trust may permit improvements to be added on to the residence;[38] and (iv) the grantor's interest may be converted into an annuity, if the trust contains provisions required by Treasury Regulations Section 25.2702-3 for a qualified annuity interest.[39]

If the residence is sold and the trust retains the cash, then the trust must provide that it will terminate as a QPRT with respect to the cash, no later than the earlier of: (i) the date that is two years after the date of sale; (ii) the termination of grantor's interest in the trust; or (iii) the date on which a new residence is acquired by the trust.[40] If the QPRT status of the trust terminates as to the cash, then the cash comes back into the grantor's estate.

4. Income Tax Aspects of Residence Trusts

A residence trust (PRT or QPRT) will remain a grantor trust during the grantor's retained term.[41] Grantor status is important, because it will allow the grantor to take mortgage interest and property tax deductions, and will also avail the grantor of the Code Section 121 gain exclusion.[42]

Following the expiration of the residence term, the grantor status of the trust usually ceases, unless the trust is drafted in a manner to make the trust intentionally grantor following the expiration of the term. This may be advantageous if the trust holds a vacation home and the grantor wishes to deduct mortgage interest and expenses associated with that home.

5. Estate and Gift Tax Aspects of Residence Trusts

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[31] Treas. Reg. Section 25.2702-5(c)(4).
[32] Treas. Reg. Section 25.2702-5(c)(5).
[33] Treas. Reg. Section 25.2702-5(c)(5)(ii)(A)(2).
[34] Treas. Reg. Section 25.2702-5(c)(7)(i).
[35] Treas. Reg. Section 25.2702-5(c)(5)(ii)(C) and Treas. Reg. Section 20.2702-5(c)(9).
[36] Treas. Reg. Section 25.2702-5(c)(5)(ii)(C).
[37] Treas. Reg. Section 25.2702-5(c)(5)(ii).
[38] Treas. Reg. Section 25.2702-5(c)(5)(ii)(B).
[39] Treas. Reg. Section § 25.2702-5(c)(8)(ii).
[40] Treas. Reg. Section 25.2702-5(c)(7).
[41] Code Section 677(a)(1).
[42] See Rev. Rul. 85-45, 1985-1 C. B. 783; PLRs 9118017, 8313025 and 199912026.

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If a grantor dies during the retained term of a residence trust, the full value of the trust property is included in the grantor's estate under Code Section 2036(a)(1) (because the grantor retains the right to possess or enjoy the property). If the grantor retains a reversionary interest during the retained term of the trust, the value of the residence is included in the grantor's estate under Code Section 2033.

However, it is usually prudent to include in a QPRT a contingent reversionary interest during the retained term of the trust. If the grantor dies during the retained term, the residence is included in the grantor's estate whether or not there is a reversionary interest. But, if there is a reversionary interest, the age of the grantor now comes into the valuation of the retained interest. Because now there is a possibility that the grantor will die within the retained term and the remainder beneficiaries will then receive nothing, the value of the retained term increases and the value of the remainder interest decreases (only the transfer of the remainder interest is subject to the gift tax, so it is beneficial to decrease its value).

Following the expiration of the retained term, the residence is no longer included in the grantor's estate; provided that the grantor is not a beneficiary of the trust and does not have the right to rent the residence for less than fair market value.

6. Practical Considerations

Clients are frequently concerned that following the expiration of the residence term, (i) they would have to commence making rent payments to the trust to continue living in their home; (ii) the kids could kick them out of the home; and (iii) the trust would cease being a grantor trust, causing the loss of the Code Section 121 exclusion. These fears are either unfounded or can be easily planned for.

Once the residence term ends, the grantor would no longer be a beneficiary of the trust and would no longer be able to live in the house rent-free. Consequently, the grantor should commence making rent payments. These payments will not be deductible by the grantor and will be taxable to the trust. A bad result.

There are two ways to avoid that. One is to name the spouse of the grantor as the beneficiary of the trust. This would allow the spouse to live in the house rent-free, and would allow the grantor to live with the spouse, also rent-free.

A better way is to name a defective grantor trust as the beneficiary of the residence trust. This would avoid the adverse tax treatment of the rent payments from the grantor to the trust (the payments will be ignored as they are being made to a grantor trust), and would allow the grantor to continue to qualify for Code Section 121 exclusion. A further benefit can be garnered by naming the grantor's spouse as the beneficiary of the defective grantor trust. This would also allow the spouses to live in the house rent-free, in addition to the income tax benefits.

Many clients are concerned that their children, once the residence term expires, would be able to kick them out of the house. If that is a concern, then the children should only be the

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beneficiaries of the trust, not the trustees. Only the trustee may have such power. Also, if the children are such a concern, the parents should think twice about disclosing the existence and the nature of the trust to the children.

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E. Family Limited Partnerships

In the arena of estate tax planning, family limited partnerships ("FLPs") are commonly used to minimize the value of the gross estate by applying various valuation discounts to the partnership interests owned by a taxpayer. Initially, the Service attacked FLPs by challenging the valuation discounts. Having lost a number of cases, the Service shifted its attack to Code Section 2036.

It is important to understand that as a technical matter, there is no such thing as a "family" limited partnership or a "family" limited liability company. State statutes provide for limited partnerships and LLCs only. The term "family" is simply a descriptive term used to describe limited partnerships and LLCs set up in a family setting. Consequently, from a tax standpoint, FLPs are simply tax partnerships and are analyzed as such.

1. Code Section 2036

Code Section 2036(a)(1) provides that a decedent's estate includes transferred property if the decedent retained possession/enjoyment or right to income with respect to the transferred property. Code Section 2036(a)(2) provides that a decedent's estate includes transferred property if the decedent retained control over the property to direct its beneficial enjoyment. Bona fide sales for fair market value are excluded.

The purpose of Code Section 2036 is to prevent avoidance of the estate tax by lifetime transfers that are testamentary in nature (and if transfer is testamentary, it should be subject to the estate tax).

2. Court Cases on 2036

The U.S. Supreme Court decision in Byrum,[43] was the foundation for all the subsequent FLP cases. The decedent transferred 70 percent of corporate stock to a trust with corporate trustee, but retained the right to vote the shares. The corporation had unrelated shareholders (30 percent) and operated an active business. Because the trustee and corporate directors owed fiduciary duties to the other shareholders, the decedent retained no control that would cause inclusion under Code Section 2036.

In Estate of Schauerhamer,[44] the decedent, after being diagnosed with cancer, established three limited partnerships. The decedent and her child were the general partners, with the decedent being the managing general partner. Over the years, decedent assigned (gifted) limited partnership interests to the child.

[43] 408 U.S. 125 (1972).
[44] T.C. Memo 1997-242.

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Although the FLPs had bank accounts, all income generated by the FLPs was deposited into the decedent's bank account. Funds in the decedent's account were used to pay her personal expenses, and no records were maintained to track partnership and personal expenses.

These facts lead the court to conclude that there was an implied understanding between the decedent and her children that the decedent will retain economic benefits of the property transferred to the FLPs. As a result, the assets transferred to the FLPs were included in the decedent's estate.

In Estate of Reichardt,[45] the decedent, after being diagnosed with terminal cancer, formed an FLP. The decedent acted as the general partner and transferred limited partnership interests to his children.

The tax court noted that in transferring the property to the FLP, the decedent merely changed its legal title. The decedent continued to deposit partnership income into his personal account, and paid personal expenses out of the partnership's account. The decedent continued to live rent-free in the house transferred to the FLP.

The court further noted that as the general partner, the decedent owed a fiduciary duty to the limited partners that would ordinarily preclude a finding of continued possession and enjoyment. But given that the limited partners did not object to the way the decedent dealt with the FLP, the court found an implied agreement between the decedent and his children that the decedent would continue to enjoy the property transferred to the partnership.

In Estate of Harper,[46] the court found that the decedent was commingling funds with the FLP (the bank account for the FLP was opened three months after its formation, and prior to that, funds were deposited into the decedent's account), the FLP was making disproportionate distributions to the decedent, and no books were kept for the FLP. This indicated that the partners did not really view the FLP as a separate legal entity, suggesting an implied agreement among the partners that the decedent would retain possession and enjoyment over partnership assets.

Although the decedent's son was acting as a general partner and owed a fiduciary duty to all the partners, he always acted in response to the particular needs of the decedent. The court concluded that the FLP was more like the decedent's estate plan, than an arm's-length joint venture among partners.

In analyzing whether the transfer of assets to the FLP was "a bona fide sale for an adequate and full consideration in money or money's worth" the court noted that the decedent merely changed the form in which he held beneficial interest in the transferred assets. Because contributing the assets to the FLP did not change the underlying pool of assets (no other partners contributed any

[45] 114 T.C. No 9 (2000).
[46] T.C. Memo 2002-121.

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assets), and there was no increased profit potential, the FLP constituted a circuitous recycling of value.

In Estate of Thompson,[47] prior to the formation of the FLP the children agreed that the decedent would be taken care of, financially, regardless of the tax structure implemented. The decedent proceeded to transfer almost all of his assets to the FLP, and retained enough to live on for two years. Following the contribution of the assets to the FLP, the investment portfolio did not change. Because the children contributed little and cash flow distributed to specific partners was tracked to the assets contributed by such partners, there was no pooling of assets. Further, the FLP was not conducted in a business-like manner (repayment of the loans made by the FLP to family members was not enforced).

The court concluded that there was an implied understanding that the decedent will retain possession and enjoyment over the assets and that the transfer was not bona fide for adequate consideration.

In the Third Circuit decision affirming Thompson, the court held that arm's-length bargaining is not a prerequisite to the bona fide sale defense. The court also focused its analysis on the existence of an operating business and the nontax business objectives in setting up the FLP. It noted that a "good faith" transfer to a family limited partnership must provide the transferor "some potential for benefit" other than the potential estate tax saving.

In Kimbell,[48] the 96-year old decedent formed and FLP two months prior to death. She owned the 99 percent limited partnership interest, and 50 percent of the LLC that acted as the general partner. The ownership percentages had led the district court to conclude that the decedent not only stood on both sides of the transaction, the decedent was both sides of the transaction. This precluded the possibility of a bona fide sale.

In analyzing whether there was an implied agreement that the decedent would retain possession and enjoyment over FLP's assets, the district court noted that as the sole limited partner the decedent had the power to remove the LLC and appoint herself as the general partner. The partnership agreement also provided that the general partner owed no fiduciary duty to the partnership or to any other partner. Thus, the decedent could appoint herself as the general partner and distribute the assets to herself, without any constraints.

The Fifth Circuit overturned the district court's finding in favor of the government and allowed the taxpayer to claim a 49 percent valuation discount. The Fifth Circuit decision focuses on whether the transfer of assets to the partnership was a bona fide transfer for full and adequate consideration.

The court noted that a tax saving motive alone does not trigger the application of Code Section 2036. Apparently, according to the Fifth Circuit, tax planning motives are fine, if the transaction

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[47] T.C. Memo 2002-246, aff'd by Turner v. Com'r, 382 F.3d 367 (3d Cir 2004). Turner is the same case as Thompson, with Thompson being the decedent, and Turner being the executor of Thompson's estate.
[48] 244 F. Supp. 2d 700 (N.D. Tex. 2003), vac'd and rem'd 371 F. 3d 257 (5th Cir. 2004).

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is otherwise a real business transaction. When a transaction is between family members there is higher scrutiny to determine whether it is a sham or a disguised gift. Transactions are scrutinized by looking at objective facts (what actually happened and how), and not what the taxpayer is saying they intended.

The Fifth Circuit found a number of "positive facts:" (i) decedent retained sufficient assets outside the FLP, (ii) there was no commingling, (iii) partnership formalities were observed, (iv) assets transferred included working interests in oil and gas which required active management (11 percent of all assets in the FLP), and (v) there were several nontax business reasons for the transfer: increasing family wealth, continued collective operation of family assets, and asset protection.

The court also noted that although fiduciary duties were waived in the partnership agreement that may have been ineffective under state law, as they may have been nonwaivable, and duties of loyalty and care were not waived.

In analyzing whether the bona fide sale exception applied, the Kimbell court used the two- part test adopted in Harper, and followed in Thompson and Strangi. First, was the transaction an arm's-length sale? Second, was full and adequate consideration paid?

The first test is satisfied if the decedent actually parted with her interest in the transferred assets and the partnership interest received in exchange is of roughly equivalent value, so that the estate of the decedent is not depleted. The recycling test referred in almost all the cases discussed above must also be applied in testing this prong. In Kimbell, the Fifth Circuit found no recycling of value because, (i) the taxpayer retained sufficient assets outside the FLP, (ii) all partnership formalities were satisfied, (iii) assets included working oil and gas interests which require active management, and (iv) various nontax business reasons existed.

The court noted that lack of negotiations between family members is not a compelling argument when value determined by objective factors, such as an appraisal.

To find full and adequate consideration, the following three factors must be satisfied: (i) were partnership interests credited to each partner proportionate to the fair market value of the assets contributed by each partner; (ii) were capital contribution properly credited to the partners' capital accounts; and (iii) would the partnership liquidate per positive capital accounts? Thus, the first prong focuses on whether there is a capital shift on the formation of the FLP, and the other two focus on whether capital accounts are properly maintained as required in Code Section 704(b).

All the tests were deemed satisfied in Kimbell.

The court rejected the government's argument that the FLP was a sham because each child contributed only $20,000. There is no requirement under partnership law that a partner must own a certain minimum interest in the partnership for it to be respected.

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In Estate of Strangi,[49] the decedent created an FLP with a corporate general partner and funded it primarily with marketable securities and cash. The decedent owned 99 percent of limited partnership interests and 47 percent of the general partner, with the children owning the remainder. At the time the FLP was established, Mr. Strangi was of an advanced age and died two months following the formation of the FLP. Additionally, the decedent transferred 98 percent of his wealth to the FLP, paid personal expenses out of the FLPs account, contributed his personal residence to the FLP but did not pay rent (rent was accrued on the partnership books).

The tax court concluded further that the decedent, through his attorney-in-fact (his son-in-law) controlled the FLP, the decedent's children obtained no meaningful economic interest in the FLP, and the children never objected when the FLP spent large sums of money on decedent's personal expenses. Although the distributions were always made pro rata, they were made only when requested by the decedent.

The court concluded that the decedent retained possession/enjoyment of the transferred assets.

The court also engaged in analysis under Code Section 2036(a)(2) – did the decedent retain the right to control the transferred assets. Generally, because general partners have a fiduciary duty to the limited partners, no such control can be found. The court concluded that because this partnership was not established in a bona fide business setting, there was no fiduciary duty.

The court further concluded that the bona fide sale for adequate consideration exception did not apply, because the partners did not engage in meaningful negotiations in setting up the partnership, and the partnership did not engage in business operations or have a substantial nontax business purpose. The court did conclude that the transfer of assets to the partnership was for full and adequate consideration because the partnership formalities were respected.

The Estate of Stone[50] is one of the few taxpayer victories in the 2036 arena. Prior to the formation of the FLP, the decedent's children were engaged in litigation with each other. The FLP was formed as a way to get the kids to stop fighting. The partnership agreement was extensively negotiated, with each child represented by own counsel. Partnership formalities were respected, there was no commingling of assets, capital accounts of all partners were properly credited, distributions were always made pro rata, and the decedent retained sufficient assets outside the partnership to live on the rest of her life.

The partnership continued to conduct an active business, with the children actively participating in the management.

The tax court found that the transfers of assets to the FLP were bona fide, arm's length and for full and adequate consideration. Consequently, the court had no need to engage in the retained possession/enjoyment analysis.

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[49] T.C. Memo 2003-1454; 417 F. 3d 468 (5th Cir. 2005).
[50] T.C. Memo 2003-309.

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In Estate of Abraham,[51] the decedent was of an advanced age and had severe health problems. She was under a court appointed guardianship, with the children acting as guardians. With the permission of the probate court, the children proceeded to implement an estate plan, including setting up an FLP.

The negative fact was that the FLP would always first make distributions to the decedent to satisfy her support and maintenance needs, and then to the other partners, and the children were not engaged in the management of the FLP. The good facts were that the children were represented by independent counsel, and the decedent survived for 14 months.
The bona fide sale exception did not apply because although each child paid $160,000 for their interest in the FLP, the valuations of the interests received by the children "would not hold up" according the decedent's own appraiser. Consequently, the taxpayer could not establish a transfer for full and adequate consideration.

In Hillgren,[52] the decedent, suffering from numerous mental ailments, committed suicide five months following the formation of the FLP. The tax court noted that the facts were very similar to Harper: commingling of funds and disregard of the partnership form. Additional "negative" facts included payment by the FLP of the decedent's personal expenses (according to the court, the partnership was supposed to pay the decedent's living expenses), lack of independent counsel in establishing the partnership, titles to assets were never transfers to the partnership and the certificate of formation for the partnership was not filed until the estate tax audit, and partnership bank account was not opened until after the decedent's death. Partnership assets were included in the decedent's estate under Code Section 2036(a)(1).

It is interesting to note that in Hillgren the valuation discount survived the 2036 challenge. The assets transferred to the FLP were subject to a business loan agreement between the FLP and one of the children. The business loan agreement obligated the "child" to provide certain services to the FLP in exchange for certain rights to the properties and 25 percent of any sale proceeds. This business loan agreement sufficiently tied up the decedent's assets to warrant a valuation discount.

Hillgren is a great reminder that FLPs are not the only way to obtain valuation discounts. Although in Hillgren the FLP was disregarded under the 2036 analysis, the valuation discount claimed on the estate tax return survived the challenge.

In Estate of Bongard,[53] to facilitate raising capital for a venture, stock of a corporation was transferred to a holding company to facilitate investment, and then interests in the holding company were transferred to an FLP. The court found that the transfer to the holding company had a business purpose, but the transfer to the FLP did not.

[51] T.C. Memo 2004-39.
[52] T.C. Memo 2004-46.
[53] 124 T. C. Memo 8 (2005).

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Decedent exercised "practical control" over the FLP, because he had sole authority to redeem shares of the holding company and in fact did so several times. This demonstrated an implied agreement for decedent to retain possession/enjoyment.

The Bongard decision provides an excellent summary of all the recent 2036 cases. It also further clarifies the bona fide sale test by providing that: "In the context of family limited partnerships, the bona fide sale for adequate and full consideration exception is met where the record establishes the existence of a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred."[54]

In Estate of Bigelow,[55] court found an implied agreement that decedent would retain enjoyment and income from the property, and no nontax reason existed. The decedent contributed her residence to the FLP, but remained liable on the mortgage.

The "bad facts" were as follows: the children contributed less than 1 percent interests; the partnership paid the mortgage but did not reflect the payments in the decedent's capital account; the decedent transferred substantially all her assets to the FLP and the partnership had to pay her personal expenses.

Because the transferred residence continued to secure the decedent's debts (the mortgage), there was an implied agreement that she retained economic benefit of the assets transferred to the FLP. Because, no business purpose for the FLP was found, the transfer was not bona fide. Because capital accounts were not properly maintained, the transfer was not for full and adequate consideration. Because the management of the property remained the same following its contribution to the FLP, it constituted a mere recycling of value. There was also no pooling of assets as the children contributed virtually nothing.

Estate of Mirowski,[56] is the latest pro-taxpayer decision by the Tax Court. The decedent transferred $62 million worth of cash, securities and IP to an LLC. She retained $7.5 million of assets in her own name. She was initially the sole member of the LLC, but then assigned interests in the LLC to her three daughters. She died four days later from unanticipated causes (i.e., LLC and assignments were not intentional, last-minute pre-death planning).

The tax court characterized the transfers of assets to the LLC as bona fide and arm's length, because of significant nontax reasons (business purpose) for funding the LLC. The decedent wanted the three daughters to work closely together, and created the LLC for joint ownership and management of the underlying assets.

Citing the holding of Bongard, the Tax Court held that because the transfers were supported by a business purpose and the decedent received an interest in the LLC proportionate to the value of

[54] *Id.* at 39.
[55] 89 T.C. M. 954 (2005).
[56] T.C. Memo 2008-74 (2008).

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assets she contributed (here the decedent was the sole member, so easy to satisfy), the transfer came under the "bona fide and arm's length" exception to 2036(a).

The court in Mirowski ignored the "bad facts" set out by the numerous cases cited above. For example, the court ignored the fact that the decedent was dependent on LLC assets to maintain her standard of living (see Kimbell, implying a retained right to income), and ignored non-pro rata distributions made to the decedent (see Strangi).

3. Structuring FLPs

Based on the information available to the author anecdotally, the IRS looks for the following when auditing FLPs: (i) compliance with all technical requirements and partnership formalities, and (ii) whether the decedent left sufficient assets outside the FLP so that, while alive, they could continue living off those remaining assets without impacting their lifestyle. If the FLP was established within six months of death, the IRS may usually compromise on 0-15 percent valuation discount. If more than six months, and the FLP holds active business assets, a 35-40 percent discount, and if passive assets, 25-30 percent.

Summarizing the above cases on 2036, practitioners should focus on the following when setting up FLPs:

1. Partnership formalities and technical requirements should be observed. This includes filing all required documents with the secretary of state's office, executing the partnership agreement, opening a bank account, keeping books and records.
2. Once the partnership agreement is drafted, it should be respected by the partners, and all partnership operations and dealings by partners with each other should be in compliance with the partnership agreement.
3. Taxpayers should never commingle personal and partnership assets. Partnership income should be deposited into the bank account of the partnership, and the partnership should never pay the personal expenses of the partners. If the partnership does pay a partner's personal expenses, it should be treated, on the partnership books and for tax purposes, as a distribution to the partner.
4. The partnership must properly keep its books and records, and maintain capital accounts in accordance with Code Section 704(b). Kimbell suggests that if parents and kids join their investment portfolios in an FLP to have a more balanced portfolio, to qualify for minimum investment opportunities, to reduce the costs of administration, there will be a valid pooling purpose.
5. The partnership must make distributions proportionately.
6. There must be some nontax business reason(s) for establishing the partnership. Partnership agreement should properly document the business purpose(s) of the partnership. Actual business purposes considered and approved by FLP decisions include: asset protection, centralized management, training the next generation – succession planning with retained control by the older generation, consolidation and economies of scale, providing a single investor for SEC purposes.

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7. Partners must transact business with the partnership at arm's length. This includes documenting all transactions between partners and the partnership, and following through on the economics of the transactions – i.e., if a loan was extended, it should be repaid.
8. General partners should not waive fiduciary obligations to the limited partners.
9. If possible, the partnership should operate an active business. The active business does not need to comprise all of the assets of the FLP. In Stone it was 2 percent of FLP's assets and in Kimbell, 11 percent.
10. The client should not transfer all or substantially all of their assets to the partnership.
11. Legitimate negotiations and separate counsel used in forming the partnership are helpful outside the Third and the Fifth Circuits. It would be particularly helpful if such negotiations were documented. An example would include letters exchanged by the partners or their counsel negotiating management and voting rights, etc.
12. Children should participate in the management of the partnership. This will help to support the pooling of assets argument and the succession planning purpose of the partnership. Children, if possible, should have more than a *de minimus* interest in the partnership, although that requirement was dismissed in Kimbell. Per Stone, parents can gift assets to the children, who can then in turn contribute the assets to the partnership.

Of course, it is not enough for the practitioner to structure the transaction correctly, the client also needs to be educated about how the partnership should be operated, what formalities need to be observed. The client needs to understand that they should deal with the partnership as if they were engaging in a standard joint venture transaction with nonfamily members.

4. The "Gift-on-Formation" Attack

In M. W. Senda,[57] the Eight Circuit Court of Appeals held that transfer of assets to an FLP can be a gift on formation. This caused the taxpayer to be treated as if gifts were made to the children directly, causing such gifts to be taxable on the full value of the underlying assets, without any valuation discounts.

The Sendas transferred $3.5 million of their MCI stock to an FLP (for simplicity, the second FLP set up by the Sendas is being ignored in this discussion). Each of the three kids got a 0.01 percent LP interest. The FLP interests where then gifts to the kids.

The court analyzed whether the Sendas gifted to their children the stock of MCI or partnership interests. A valuation discount could be had only if the court concluded that partnership interests were gifted.

Because the transfers were close in time, it was difficult to determine which transfer took place first, the transfer of MCI stock to the FLP, or the transfer of partnership interests to the children. Sendas could not present any conclusive evidence that they transferred stock to the FLP, before the FLP was transferred to the children.

[57] 433 F. 3d 1004 (8th Cir. 2006), aff'g T. C. Memo 2004-160.

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Sendas maintained no corporate formalities for the partnership and no books or records. The Eight Circuit utilized the step transaction doctrine to determine that the children were first made partners of the partnership, and then the stock was gifted to the partnership.

In Strangi, transfers were not held to be gifts on formation because the contributing partner (parent) received a continuing partnership interest in return for the contribution, all of the contributions were properly reflected on the capital accounts, and the value of the other partners' (childrens') interests was not enhanced by the taxpayers' contributions. It was helpful that in Strangi the children transferred something of value to the FLP.

To avoid the Senda result, taxpayers should transfer assets to the partnership in exchange for a capital account equal to the value of the assets, and then gift their capital accounts to the children. The parent, following the contribution, must remain a partner in the partnership. It is also important to document the sequence of the transfers and to separate the transfers in time.

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F. Unified Credit

Prior to 2013, planning with the unified credit focused on being able to take advantage of the unified credits available to both spouses. In a marital situation, if one spouse leaves everything to the surviving spouse on death, such transfer will not trigger a transfer tax, because the unlimited marital deduction will apply.[58] Consequently, unified credit planning was tied into the marital deduction planning.

Because the American Taxpayer Relief Act of 2012 made the unused unified credit of the first-to-die spouse automatically portable to the surviving spouse, the intent of planning with the unified credit has shifted. The planning now focuses on whether there is a need to engage in the traditional unified credit planning (like using the A-B trust approach), or whether reliance on the automatic portability is sufficient.

1. Marital Deduction

The taxable estate is determined by subtracting allowable deductions from the gross estate. The estate tax marital deduction is a deduction from the gross estate for property passing to the spouse in a qualifying form (generally, if the transfer is in a form of a terminable interest, it does not qualify).[59]

There are two ways to pass property to a surviving spouse: outright, or through a trust mechanism. The marital deduction is allowed for any property that will be subject to the estate tax on the death of the surviving spouse. This certainly applies to property passing to the surviving spouse outright.

When the transfer is via a trust, a trust may be structured in such a way so that the property will not included in the surviving spouse's estate (i.e., the surviving spouse's interest in such property will terminate prior to death because of the passage of time or because of some contingency). A terminable interest in an asset will not qualify for the marital deduction if: (i) another interest in the same property passed from the decedent to a beneficiary other than the surviving spouse for less than full consideration, and (ii) that beneficiary will enjoy and possess the property after the surviving spouse's interest terminates. A common example of this would be leaving the surviving spouse a life-estate in an asset, with the remainder interest going to the kids. An exception is carved out for certain life-income only interests (a QTIP trust).[60]

The purpose of a marital deduction transfer is usually to take advantage of each spouse's unified credit. Because a transfer of all property by one spouse to another will be entirely exempted from the estate tax due to the unlimited marital deduction, the unified credit of the first to die spouse will be lost. The unified credit is applied only when there is an estate tax. The marital deduction will reduce the taxable estate to zero, never triggering any tax in the first.

[58] Code Section 2056.
[59] Treas. Reg. Section 20.2056(b)-1(b).
[60] Code Section 2056(b)(7).

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a. A-B Trusts Prior to 2010

Prior to the 2010 Tax Relief Act, if Husband and Wife had a taxable estate of $2 million, the transfer of the entire $2 million to the surviving spouse on the first death was be shielded by the marital deduction, with no transfer tax payable on the first death. However, on the second death, the transfer tax will be computed on the full $2 million.

Utilizing a bypass trust, the spouses can leave $1million directly to the children on the first death, and $1 million to the surviving spouse. The $1 million left to the children on first death will be shielded by the unified credit of the first to die, and the second million will be shielded by the unified credit of the second to die. This is the common reason for drafting an *inter-vivos* trust in the A-B format (sometimes referred to as an AB trust).

The bypass trust (with children as beneficiaries) will allow the surviving spouse to (i) be the trustee of that trust; (ii) distribute to anyone other than the surviving spouse without any restrictions; and (iii) distribute to the surviving spouse subject to an ascertainable standard (health, education, support and maintenance).

Marital deductions can also be utilized in larger estates where the property owned by the two spouses is disproportionate. The purpose of the marital deduction in these circumstances is to equalize the two estates, lowering the overall effective tax rate.

Transfers to a surviving spouse will qualify for the marital deduction if: (i) if the decedent and surviving spouse were legally married (as opposed to common law marriage) at the time of death; (ii) the surviving spouse is a U.S. citizen; and (iii) the property constitutes a deductible interest – included in the gross estate, not deductible under Code Section 2053 or 2054, and is not a terminable interest (goes to the surviving spouse unconditionally).

b. Drafting the A-B Formula

Allocating assets between the A and the B trusts is often done by means of a formula. Using a formula, as opposed to a specific bequest, allows for flexibility to anticipate changes in the estate tax laws.

There is no set way of drafting the formula. The common sense approach is to avoid the estate tax on the first death, which means that the amount allocated to the credit shelter trust should not exceed the amount that would be sheltered by the unified credit. The remainder defaults to the marital deduction trust. However, care should be taken not to allocate all of the assets to the credit shelter trust, or, with some formulas, all, or the bulk of the assets to the marital deduction trust.

If the estate is very large, it would be more important to equalize the decedent's and survivor's estates to minimize the marginal tax rate.

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Generally, the planning buckets for allocating between the marital deduction and the credit shelter trusts are as follows: (i) both estates less than one spouse's unified credit (allocation not very important); (ii) both estate less than both spouses' unified credits (allocation was important prior to 2010 to ensure both credits got utilized – credit shelter trust gets fully funded, rest goes to the marital deduction trust; important in 2011 and 2012 if estate is expected to grow significantly by the time of the second death); and (iii) both estate are in excess of both spouses' unified credit (focus on using both unified credits and equalizing the estates).

For the latter situation, the practitioner should also take into account the age disparity between the two spouses. Allocating assets to the surviving spouse will gain a significant estate tax deferral if the surviving spouse is considerably younger.

Practitioners should also always recall that assets allocated to the B trust will escape the estate tax but will also not receive a basis step up on the second death.

Here are the most frequently used types of formulas for A-B allocation:

Pecuniary Formula.

This is a bequest phrased as a specific dollar amount or a specific formula. It is not uncommon to find a living trust that allocates $625,000 to the B trust (an old exemption amount). Because the exemption amounts are constantly changing (at least over the past 10 years), pecuniary formulas do not work well for most estates.

Fractional Formula.

This formula allocates to the marital (A) trust the minimum amount necessary to avoid the estate tax or allocates to the bypass (B) trust the amount equal to the exclusion amount. Both approaches are fairly popular but neither is perfect. For example, if the client has an estate of $5 million on the first death, the latter approach would allocate the entire $5 million to the B trust. Given that the current spousal exemption is $10 million, such an allocation is unnecessary and may complicate the life of the surviving spouse.

Disclaimer.

With a disclaimer approach, all of the assets are left to the surviving spouse, who is given the option of disclaiming some or all of the assets. The disclaimed assets will then be automatically diverted into the bypass trust (or the QTIP trust discussed below). Disclaimers eliminate the need to predict the future. The surviving spouse, within 9 months of death, can disclaim the amount that is deemed best at such time, fine tuning the allocation formula. If the surviving spouse does not consult with her advisors within 9 months of death, the disclaimer approach will not work.

c. A-B Trusts in 2013 and Beyond

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One of the more interesting features of the American Taxpayer Relief Act of 2012 is to provide for the automatic portability of the unused unified credit of the first-to-die spouse. To a large extent this eliminates the need for an A-B trust. Now, all of the assets can go to the surviving spouse on the first death, get shielded by the unlimited marital deduction, and the full $5 million exemption of the deceased spouse will be available to the surviving spouse on the second death. Only the unused exemption of the last deceased spouse is usable. This means that if Wife 1 dies and Husband remarries, and then Wife 2 dies, only the unused exemption of Wife 2 will be usable when Husband dies.

Even though a married couple automatically has a $10 million exemption available to them (index for inflation), an A-B trust may still be useful in some cases. The unused exemption of the deceased spouse does not get indexed for inflation and does not get adjusted to reflect to the appreciation of and income from the assets passed to the survivor. This could mean that a couple with a $7 million estate on the first death that does not have an A-B trust, may wind up with a $14 million estate on the second death, with $4 million subject to tax. If, however, on the first death $5 million was allocated to the B trust, then on the second death $10 million would be in the B trust and not subject to tax, and $4 million in the A trust would be covered by the surviving spouse's exemption.

The significant disadvantage of allocating assets in the A-B fashion as opposed to relying on the portability of the unused exemption is that the assets in the B trust will not get a step up in basis on the second death. In the above example, the $10 million in the B trust avoid the estate tax but do not receive a basis step up. This is very frequently the choice that has to be made in estate planning: an asset is either in the taxable estate and then receives the basis step up and is subject to the estate tax, or is not in the taxable estate, does not receive a basis step up and is not subject to the estate tax.

Portability of the unused exemption does not apply to the GST exemption, and a non-marital GST-exempt trust should be created on the first death.

In practice, this author believes that estates under $7 million on the first death will opt to rely on the portability of the exemption and get the basis step up (unless the surviving spouse is much younger), and taxable estates will opt for allocating the maximum possible amount to the B trust. The difficult decision will be for estates between $7 and $10 million on the first death.

d. QTIP (A-B-C) Trust

"QTIP" stands for "qualified terminable interest property." A QTIP trust is a trust for the benefit of the surviving spouse which meets the requirements described below (these trusts are sometimes referred to as A-B-C trusts, with the C trust being the QTIP). It will qualify for the marital deduction to the extent that the decedent or his executor elects. The trust must be held for the benefit of the surviving spouse during her lifetime; at her death, it can pass to persons chosen by the decedent. The people who will receive the property after the surviving spouse's death are called the "remainder beneficiaries."

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Contrast the QTIP with the A-B trust planning. In a living trust drafted in the A-B format, the share qualifying for the marital deduction passes to the surviving spouse outright and free of trust, without any conditions or restrictions. In a living trust drafted in the A-B-C format, the marital deduction property passes into a trust for the benefit of the surviving spouse. The trust must then satisfy the QTIP requirement for the deduction to apply. QTIP trusts are commonly used when the decedent does not trust the surviving spouse or wants to protect the surviving spouse. A QTIP trust is a wonderful asset protection device and should be considered even if the estate is not large enough to call for an A-B division.

The benefit of the QTIP trust is that it allows the decedent's executor the flexibility to choose, with knowledge of the facts existing after the decedent's death, whether it is best to qualify all, any part, or none of the property for the marital deduction. The QTIP trust also assures that any property left in the trust on the surviving spouse's death goes to the decedent's chosen beneficiaries, rather than a second husband or other person outside the family. It can also provide protection from subsequent divorcing husbands and creditors of the surviving spouse during her lifetime.

To qualify as a QTIP trust, the trust must (i) provide that the surviving spouse receives all income of the trust for her life, payable at least annually;[61] (ii) no one but the surviving spouse can receive distributions during her lifetime (i.e., no power to appoint to anyone other than the surviving spouse – which means that even surviving spouse cannot make lifetime gifts); and (iii) the executor must make an irrevocable QTIP election on the estate tax return (that means the property will be included in the surviving spouse's estate).[62] It is a good practice to include in the will instructions for the executor with respect to making a QTIP election. The election puts the interests of the surviving spouse at odds with the remainder beneficiaries, and it is best to absolve the executor from the inherent liability both by providing clear instructions regarding the election and by specifically stating that the executor is absolved from liability with respect to the election (as to beneficiary challenges and estate tax consequences).

Additional consideration should be given to including a spendthrift clause in the trust. A spendthrift clause will make the trust interests to which it applies nonassignable, thereby providing creditor protection for beneficiaries. Omitting the clause will provide flexibility to make tax-motivated (and other) gifts of trust interests.

e. Disclaimer Trust

As an alternative to the QTIP election by the executor, or as an additional post-death planning strategy, the surviving spouse may be granted the right to disclaim some or all of the assets to which the QTIP election would otherwise apply. Assets disclaimed would then be diverted to a non-QTIP trust and would not qualify for the marital deduction.

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[61] Code Sections 2056(b)(7)(B)(i), 2056(b)(7)(B)(ii)(I).

[62] Code Sections 2056(b)(7)(B)(i), 2056(b)(7)(B)(ii)(II) and 2056(b)(7)(B)(v). However, the surviving spouse can assign her interest in the trust to the children, if the trust is not a spendthrift trust.

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For estate tax planning purposes, a goal of the QTIP trust is to equalize the estates of the two spouses, getting them into the lowest possible marginal estate tax rate. Disclaimer planning is used to accomplish the same result, and allows the surviving spouse to fine tune on the first death which assets will be taxable on the first death and which on the second death.

N.B. Disclaimers are not advisable for all clients. They generally have to be made within nine months of the date of death. Often clients will not consult with their CPA or lawyer for quite some time following death, and they may run out of time to disclaim. We recommend disclaimers only to the more sophisticated or better organized clients.

f. QDOT

No deduction is allowed for property passing to a surviving spouse who is not a citizen of the United States.[63] It does not matter whether the decedent was a U.S. citizen, or whether the surviving spouse is a resident of the U.S.

The exception to this rule applies when assets otherwise qualifying for the marital deduction are transferred to the qualified domestic trust.

A QDOT is a trust that (i) requires at least one trustee be a U.S. citizen or domestic corporation; (ii) provides that no distribution of principal may be made unless the above trustee has the right to withhold the tax imposed by Code Section 2056A (in simple terms, the estate tax that would have applied to the distribution if the distribution was included in the decedent's estate); (iii) is elected by the executor, on the estate tax return, to be treated as a QDOT; and (iv) if the value of the assets passing to the trust exceeds $2 million, requires at least one U.S. trustee to be a bank, or to furnish a bond.[64] The regulations also place restrictions on ownership of assets outside of the U.S.

2. Outright Gift

In certain circumstances, an outright gift or bequest to the surviving spouse may be preferable. For example, it is preferable to leave the principal residence to the surviving spouse outright, to allow the surviving spouse to later qualify for the Code Section 121 exclusion. An irrevocable trust (such as a marital deduction trust) will not qualify for Code Section 121.

[63] Code Section 2056(d)(1).
[64] The last requirement is promulgated in Proposed. Treas. Reg. Section 20.2056A-2(d)(1).

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Jacob Stein's published works include:

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