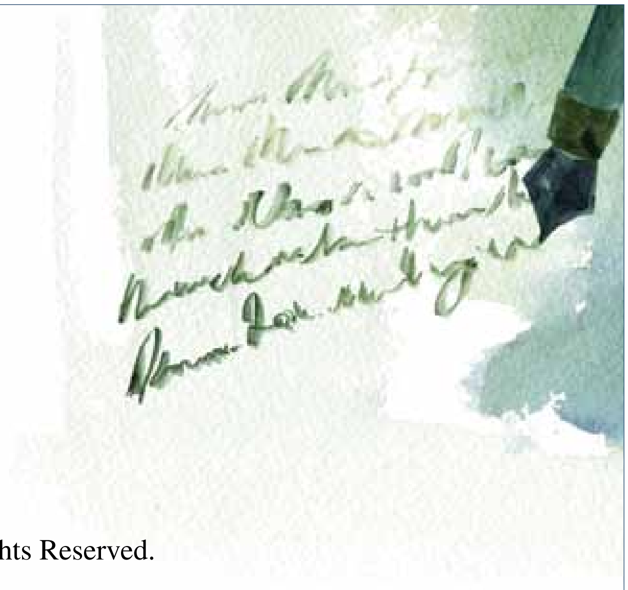

SAFETY NETS UPDATED

Gift Tax Safety Nets for Installment Sales Redux

Introduction

This article updates the earlier article on this topic. As that earlier article mentioned, one relatively common estate planning arrangement is for the grantor of a trust, which is a grantor trust with respect to him or her for income tax purposes, to sell assets to the trust, often for a note. This arrangement is often called an "installment sale to a grantor trust" or "ISGT." See, generally, Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 Estate Planning 3 (Jan. 1996). Wealth Transfer Planning offers a concept memo which will advise whether a particular client should consider making such a sale. This article presents some ideas on how to reduce the risk of a client making a gift by such a sale. It also explains the changes that WTP has make to its Irrevocable Trust and additional forms it will be offering to help accomplish the goal of reducing such a risk. It explains a new concept we have developed: An installment sale from a marital deduction trust to a non-marital deduction created for the same spouse.

Some Background about ISGTs

A sale, even of appreciated property, by a grantor to such a grantor trust is not, according to the IRS, subject to income tax because the grantor is treated as though he or she is "selling" the asset to himself or herself, which is not an income taxable event. See Rev. Rul. 85-13, 1985-1 CB 184.

Similarly, because under the revenue ruling the existence of the trust is ignored and the grantor is treated as still owning the trust property, interest due or paid on the note also is not subject to income tax. Usually, the note bears the applicable Federal rate (AFR) of interest which is relatively low and often much lower than market rates of returns. Under Code Sec. 7872, charging at least AFR interest on indebtedness between family members prevents a gift from being made by the extension of credit.

> **If the property sold in the ISGT does grow at a rate greater than the AFR interest rate that the note carries, value will accrue in favor of the trust free of estate, gift and income tax. In addition, if the AFR thereafter drops, a new note carrying the lower (current) AFR may be substituted, generally with out adverse tax effects, for the "old" (higher AFR) note. See Blattmachr, Crawford and Madden, "How Low Can You Go? Some Consequences of Substituting A Lower AFR Note for a Higher AFR Note," Journal of Taxation (June 2008).**

Four Ways to Reduce the Risk of a Gift in an ISGT

WTP will offer three ways in which the risk of a gift or of a relatively large gift may be reduced when a grantor sells an asset to a trust he or she has created for a note.

Defined Formula Sales Price. It seems that the Internal Revenue Code defines a gift as occurring to the extent that the value of property transferred exceeds the value of the property received in exchange. Code Sec. 2512. Hence, if the fair market value, as finally determined for Federal gift tax purposes, exceeds the amount the trust pays, the grantor would be treated as having made a gift to the trust unless the grantor can establish that the transaction was in the ordinary course of business within the meaning of Reg. § 25.2512-8, which often is challenging to do in a transaction between family members or entities on their behalf.

To reduce the risk of a gift occurring by a sales price below the sold property's fair market value, WTP will provide a purchase or buy-sell agreement under which the grantor will agree to sell and the grantor trust will agree to buy a fractional interest in certain identified property for a specified price set forth in the purchase agreement or determined an appraiser selected by the grantor and the trustees of the trust after the purchase agreement is executed. However, to avoid the risk of a penalty under Code Sec. 6662 if it turns out the value used to determine the purchase price is not "correct," the specified price set forth in the purchase agreement should be determined by an independent experienced appraiser. The alternative, as indicated, is to have the price determined by such an appraiser after the purchase agreement is signed--that way, neither of the parties knows when the agreement is signed what price will be, which some view as somewhat typical of what parties acting at arms' length would use to determine a price (as not infrequently occurs in arms' length buy-sell agreements among owners of a company).

In any event, the purchase agreement will provide that the amount of the asset purchased will be the lesser of (1) the entire property (e.g., limited partnership units in a partnership, stock in a business or a tract of land) or (2) that fractional share of the property the numerator of which is the specified price or value determined by the appraiser and the denominator of which is the fair market value, as finally determined for Federal gift tax purposes, of the entire property. For example, assume the property sold will be the limited partnership units that are owned by the grantor in a limited partnership. The appraiser determines the value of all the units to be $5,000,000. The trust will pay $5,000,000, but in an attempt to ensure there is no gift, the trust will purchase the lesser or (1) all of the grantor's limited partnership units or (2) that fractional share of the units the numerator of which is $5,000,000 and the denominator of which is what is finally determined to be the fair market value of the units. If the fair market value of the units is finally determined to be $5,000,000 or less, the trust will have purchase them all. If the fair market value is finally determined to be $6,000,000, the trust will purchase 5/6ths of the units.

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The viability of such a formula price clause is not certain. Logically, there seems to be no reason why it should not be respected for tax purposes. See McCaffrey & Kalik, "Using Valuation Clauses to Avoid Gift Taxes," 125 Trusts & Estates 47 (Oct. 1986). The Court of Appeals for the Fifth Circuit in *McCord v. Commissioner*, 461 F.3d . (5th Cir. 2006), in reversing the Tax Court, did honor a formula price clause that the Tax Court did not honor apparently on the ground that the formula, as the court construed it, did not specify that the fair market value aspect of the formula would be *as finally determined for Federal gift tax purposes*. Although the Court of Appeals for the Fifth Circuit did honor the defined formula provision although the court noted that the IRS had abandoned on appeal certain of its "policy" arguments about why formula price clauses should not be respect for tax purposes.

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Hence, although not certain, it appears the having the portion of the property sold to the trust be determined by a price determined by an appraiser should reduce the risk of a gift occurring by reason of the trust paying the full fair market value for what it purchases.

Defined Value Consideration. An alternative to having the trust purchase a fractional share of the property being sold by the grantor may be to have the trust pay for the property using defined value consideration. The consideration would be a fractional share of a marketable (easy to value) asset the trust owns. For example, the appraiser determines that the fair market value of the property that the grantor intends to sell to the trust is $1,650,000. The trust then pays for that property by transferring to the grantor a fractional interest in an asset certainly worth more than the property the grantor is selling to the trust. For instance, the appraiser is certain that it would be irrational to contend that the property, which the appraiser has determined to be worth $1,650,000, is worth more than $3 million. Hence, the trust will pay for the property that grantor is selling with a marketable asset (e.g., a bond) having a current fair market value of at least $3 million, and will transfer to the grantor "that fractional share of the Bond, the numerator of which is $1,650,000 and the denominator of which is the fair market value of the Bond as of this date as finally determined for Federal gift tax purposes, and the parties agree that the Bond will be divided into separate ownership by the Grantor and the Trust at anytime at the direction either of them."

The use of such defined value consideration certainly appears to reduce the risk of a gift being made by the sale. However, there some other consequences that should be considered. First, no AFR note is being used in the sale. As mentioned above, using an AFR note produces an additional advantage if the property sold grows at a rate greater than the AFR. And, of course, if the parties do not think the property sold will not grow, at least over a reasonable time, at a rate greater than the AFR, it seems somewhat questionable whether the sale should be made, in most cases anyway. Second, the trust would have to have a marketable asset with a value well in excess of the appraised value of the property being sold to the trust by the grantor. In many cases, the trust will not have such an asset. Perhaps, the trust could borrow cash from the grantor, at the AFR, and could use the borrowed cash to buy such a marketable asset. That would permit the trust to "leverage" on the growth in the marketable asset purchased above the AFR (to the extent not transferred to the grantor in exchange for the property being sold by the grantor to the trust).

WTP does not currently offer such a defined value consideration provision but it seems that it would not be difficult for a skilled drafter and planner to implement it.

Division of Any Gift by Sale Divided into Complete and Incomplete Portions. The sale by the grantor to the trust could result in the grantor being deemed to have made a gift. For example, as explained above, if the sales price is lower than the sold asset's fair market value, the grantor likely could be treated by the IRS as having made a gift. A gift might be deemed to occur for another reason as well.

In any case, to reduce the risk of any relatively significant gift being made, the trust will provide that any gift made by the sale will be divided into two parts. Ninety percent (90%) of any gift made by the sale will be added to a trust under the trust agreement that will be for the benefit of the grantor and be an incomplete gift (which means that the 90% portion should not be subject to gift tax, although estate tax inclusion likely would occur). It will be an incomplete gift because it will be added to a trust under the Irrevocable Trust for the grantor. The other 10% of any gift will be added to the Lifetime Trust under the Irrevocable Trust with respect which the gift would be complete.

The reason the system does not have 100% of any gift made by the sale be added to the incomplete gift trust for the grantor is to reduce the risk of the IRS contended that the transfer to the incomplete gift trust should be ignored under *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756

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(1944). The IRS apparently reads that case as holding that any action to prevent the imposition of gift tax by formula or condition will be ignored. Cf. TAM 200245053 (not precedent). Instead, the trust agreement uses a different approach: any gift made after a specified date (which should be before the sale occurs) is divided automatically into the 90% and 10% portions. (Hence, by the time the sale occurs, any gift arising by reason of the sale should be subject to the 90%/10% division.) In other words, when the sale occurs, the 90%/10% division of any gift involved in the sale should apply. Although not certain, it seems that such a division, because it occurs automatically when the transfer is made and is not based upon any condition or formula, should not fall under the Proctor case.

In any event, to reduce the risk of any significant taxable gift occurring by the sale to the trust by the grantor, the drafter will specify a date that will be (1) after the initial funding of the trust will occur (so all of the initial funding will be added exclusively to the Lifetime Trust created under the Irrevocable Trust and will constitute a completed gift) and (2) before the sale will occur. The Irrevocable Trust will provided that any gift, made by any means, after the date the drafter specifies, including by a bargain sale, and whether complete or not, will be divided into the 90% and 10% portions, with the 10% portion also added to the Lifetime Trust and with the 90% portion added to a trust under the Irrevocable Trust for the benefit of the grantor that should not be a completed gift.

For example, if it is anticipated that the initial funding will be on March 1, 2009 and the sale will be on May 1, 2009, the date specified might be April 1, 2009. Hence, any gift made to the trust after April 1, 2009 (such as by a bargain sale) would be divided into the 90%/10% portions with the 90% portion going into the incomplete gift trust and 10% into the Lifetime Trust (which should render the 10% portion a completed gift). Hence, only 10% of the gift element made in the bargain sale should be a taxable gift (and potentially subject to gift tax).

<u>Disclaimer of Gift Element.</u> One of the ways that a gift may be prevented from occurring after a transfer is made is if the beneficiary makes a qualified disclaimer of the property transferred under Code Sec. 2518. That section provides that if the beneficiary disclaims a transfer within nine months and certain other conditions are met, the property will be treated as though it never was transferred.

Although the IRS took the position in Estate of *Christiansen v. Commissioner*, - -F. 3d-- (8th Cir. 2009), that qualified disclaimers may not be under Code Sec. 2518 in certain ways (e.g., a disclaimer, in general, may not by effected through a tax-driven word formula, such as producing a certain charitable deduction described in terms of the tax result sought to be achieved by the disclaimer), the Tax Court and the Court of Appeals for the Eighth Circuit rejected that. Hence, it seems that if the principal beneficiary of a trust disclaims property transferred to the Irrevocable Trust and, if a result of the disclaimer, the property reverts to the grantor, then no gift should be deemed made.

Therefore, WTP provides an Irrevocable Trust that provides, if a sale will made to it by the grantor, that, if the individual identified as the Principal Beneficiary disclaims any gift made to the trust, the property will revert to the grantor. This provision should allow the identified Principal Beneficiary to make a disclaimer under Code Sec. 2518 with respect to any portion of the property sold to the trust that would constitute a gift and, as a result, should prevent any portion of the transfer from constituting a gift because it will revert to the grantor/seller.

WTP also offers a form of disclaimer under which the Principal Beneficiary of the trust may make the disclaimer.

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Alternative to Sale by Grantor: Sale by Grantor's Spouse

An alternative to the grantor selling assets to a grantor trust that the grantor creates is to have the spouse of the grantor sell the assets to the trust if the grantor's spouse is a beneficiary of that trust. The trust for the spouse may be structured so the sale should not result in the spouse being deemed to make a gift because the trust would be structured so even a direct gift by the spouse to the trust would not be complete under the principles set forth in Reg. § 25.2511-2. For example, if the selling spouse is the only beneficiary of the trust for life (or is a beneficiary with the power to veto distributions to others during his or her lifetime) and holds a special power of appointment exercisable at death, any gift by that spouse to that trust by any means (including a bargain sale) would not subject to gift tax because the gift would be incomplete. And as long as there is no gift by the selling spouse, no part of the trust should be included in his or her gross estate because he or she is not the grantor of the trust. Hence, if some type of gratuitous transfer occurs by reason of the sale, such as where the asset is sold for less than its fair market value, the gratuitous transfer should not be a completed gift and, as a result, no taxable gift should be deemed paid and, therefore, no gift tax should be payable— however, in that case, some portion of the trust may be included in the decedent's estate under Code Sec. 2036(a)(2) and/or 2038 (and *see, also*, Code Sec. 2043). WTP defaults certain answers to the Irrevocable Trust form so that any gift made by the spouse by a sale to the trust should be an incomplete gift.

A sale by the spouse to the grantor trust is treated as a sale by him or her to the grantor of the trust because the existence of the trust is ignored under Rev. Rul. 85-13. Therefore, the spouse is treated as selling the asset to his or her spouse (the grantor of the trust) and sales between spouse are not subject to income tax. Code Sec. 1041.

However, that section does not foreclose income tax effects from occurring by other transactions between spouses. For example, if the trust pays the spouse for the property by issuing a note which bears interest, the interest paid or imputed will be included in the gross income of the grantor and be deductible by the grantor's spouse to the extent specified in Code Sec. 163. As long as the asset purchased from the trust is an investment asset, the interest should be deductible by the spouse as investment interest which is deductible to the extent of investment income. If the grantor and the grantor's spouse file a joint income tax return, the income from the interest and the deduction for it

likely will "cancel" out. Nonetheless, there will be other consequences. For example, the adjusted gross income of the couple will increase which may have consequences on their joint income tax return. For example, increasing the adjusted gross income raises the threshold in deducting charitable contributions under Code Sec. 170. On the other hand, it may increase the amount of certain itemized deductions that will be reduced under Code Sec. 68. All additional consequences should be considered when determining if the sale should be by the spouse rather than by the grantor which, as stated, should foreclose any taxable gift being deemed made. Also, state and local income tax consequences should be considered. For instance, the New York income tax law, certain itemized deductions (including that for investment interest paid) are disallowed or limited.

In any case, even if the spouse will make the sale, the purchase (buy-sell) agreement between that spouse and the grantor trust will provide for a defined formula purchase.

It seems virtually certain that no income is recognized when the grantor of the grantor trust who whom the grantor has sold assets to the trust for a note dies. See, generally, Blattmachr, Gans & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death", *Journal of Taxation*, September 2002, Page 149; CCA 200923024. For different reasons, it seems that there should be no income

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recognition when either of the spouses dies where one spouse has sold assets for a note to a trust which is a grantor trust to the other spouse. One reason is that there has been no sale by reason of Code Sec. 1041. Although the substitution of a new obligor on a note may result in realization of gain or loss, Reg. § 1.1001-3(e)(4)(ii) provides there is no gain by such reason if the note is non-recourse (that is, the liability to pay the note falls only on the property pledged for the note). Hence, to reduce the risk of any gain the note should be made non-recourse.

Further Alternative Sale from Marital Trust to Non-Marital Trust

Another alternative to the grantor selling assets to a grantor trust the grantor creates is to have one spouse create a lifetime marital deduction trust for the other spouse and also create a non-marital deduction trust for the same spouse and then have the marital deduction trust sell assets for an AFR note to the non-marital deduction trust. (The spouse for whom the marital deduction trust is created must be a US citizen as no marital deduction is allowed for gift tax purposes if the spouse is not a US citizen.) Transfers of any amount of property can be made to the marital deduction trust without gift tax (provided the property does not constitute a terminable interest under Code Sec. 2523(b).) Both trusts will be grantor trusts with respect to the same grantor (that is, the spouse who created the trust).. for whom the created spouse of the grantor sell the assets to the trust if the grantor's spouse is a beneficiary of that trust. Hence, there will be no gain, by reason of Rev. Rul. 85-13, upon the sale and no risk of gain upon the death of the grantor.

The marital deduction trust should be a general power of appointment trust described under Code Sec. 2523(e) rather than a QTIP trust under Code Sec. 2523(f) so there is no risk of Code Sec. 2519 applying when the sale from the marital deduction trust occurs. (Under Code Sec. 2519, the beneficiary spouse is treated as making a gift of corpus in the trust if he or she transfers an interest in the trust income.) The non-marital deduction trust should be structured, as described above, so that, even if the spouse who is the beneficiary of the marital deduction trust is treated as making a gift when the sale is made from the marital deduction trust to the non-marital deduction trust, that gift was be incomplete.

Summary and Conclusions

An ISGT may be a very effective estate tax planning strategy. There is, however, a risk that the IRS may claim a gift has been made by such a sale. To reduce that risk, WTP has modified its irrevocable trust form, which will be the purchasing trust, to attempt to reduce the risk of any relatively large gift being made. In addition, WTP offers a purchase (buy-sell) agreement that has use a formula defined purchase amount which also should eliminate the risk of any gift being made by the purchase. WTP also provides a disclaimer and renunciation form by which the purchasing trust's Principal Beneficiary may disclaim any gift made to the trust by the sale to it by the grantor. Moreover, two other alternatives are offered: a sale to the grantor trust by the grantor spouse; and a sale from a marital deduction trust to a non-marital deduction trust, both of which will be grantors trusts with respect to the spouse who created them.

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