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Estate Planning Developments and Techniques

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ESTATE PLANNING DEVELOPMENTS AND TECHNIQUES

by

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The authors wish to thank their partners and associates who contributed to this outline.

References in this outline to "sections" and "regulations" are to sections of the Internal Revenue Code of 1986, as amended, and Treasury regulations promulgated thereunder, unless otherwise indicated. References to the "IRS" are to the Internal Revenue Service.
I. SELECTED CURRENT DEVELOPMENTS OF INTEREST TO ESTATE PLANNERS

A. Marital Deduction.

1. **Shelfer v. Commissioner**, 103 T.C. No. 2 (1994). Because stub income was payable to remainderman instead of spouse, trust was not includible in the surviving spouse's estate even though QTIP deduction was claimed in first decedent's estate.

2. **Kurz v. Commissioner**, 67 T.C.M. (CCH) 2978 (1994). Five and five power was a general power of appointment over the bypass trust even though not exercisable unless the marital trust was exhausted.

3. Technical Advice Memorandum 9403005. Where the decedent bequeathed common stock in a closely held business to the credit shelter trust and the preferred stock outright to the surviving spouse, the stock should be treated as a single controlling block for gross estate purposes. However, for marital deduction purposes, the IRS ruled that the shares passing to the surviving spouse should be treated as a separate minority interest, citing **Ahmanson Foundation v. United States**, 764 F.2d 761 (9th Cir. 1981), and **Chenoweth v. Commissioner**, 88 T.C. 1577 (1987).

4. Private Letter Ruling 9409018. In reversing its earlier ruling in Private Letter Ruling 9113009, the IRS holds that loan guarantees will not defeat the allowance of the estate tax marital deduction. However, the new ruling is silent on the gift issues.

5. Private Letter Ruling 9418013. Applicable federal rate ("AFR") loans to sons from QTIP marital trust will not be deemed a distribution of all or part of the surviving spouse's qualifying income interest.

6. Private Letter Ruling 9420034. Where spouse will be entitled for life to all income generated by IRA principal whether held in the IRA or distributed to the QTIP marital trust, the spouse will have a qualifying income interest for life in the IRA which will qualify for QTIP treatment.
7. Private Letter Ruling 9437032. QTIP gift tax marital deduction treatment will be allowed for trust created by donor spouse for donee spouse for life where trust will continue for donor spouse's benefit following the death of the donee spouse.

B. Valuation.

1. **Evanson v. United States**, 30 F.3d 960 (8th Cir. 1994). Statute of limitations barring assessment of gift taxes does not preclude the IRS from revaluing the adjusted taxable gifts for estate tax purposes. This is consistent with **Levin v. Commissioner**, 986 F.2d 9 (4th Cir. 1993), cert. denied, 114 S.Ct. 66 (1994).

2. **Gillespie v. United States**, 23 F.3d 36 (2d Cir. 1994). Underwriting fees are not to be taken into account as part of a blockage discount in determining the value of stock in the decedent’s estate.

3. **Proctor v. Commissioner**, 67 T.C.M. (CCH) 2943 (1994). Estate tax charitable deduction for ranch was less than gross estate value because option to lease surface rights for grazing was granted to a third party under the decedent’s will.


5. Section 7520 Proposed Regulations, PS-26-93, 1994-28 I.R.B. 130. These proposed regulations specify the circumstances (for example, terminal illness with less than 50% chance of survival for more than one year) that preclude the use of the standard valuation tables.

6. Technical Advice Memorandum 9403002. Where the decedent owned one block of stock in a closely held business and had the power to alter the beneficial enjoyment over a second block held in trust, both blocks must be aggregated according to the IRS in determining the fair market value of the stock in the decedent’s gross estate.

7. Technical Advice Memorandum 9403005. Where the decedent owned a controlling interest block of stock, the control premium that is attributed to the decedent’s holdings is applicable in
determining the value of the decedent's entire holding for purposes of inclusion in the gross estate without reduction by reason of the fact that only a minority interest will pass to the surviving spouse; however, a minority discount is appropriate in valuing the portion of the decedent's stock holdings that passes to the surviving spouse for marital deduction purposes.

8. Technical Advise Memorandum 9432001. Stock held by parent at death was valued for estate tax purposes without reference to a block of stock in same corporation owned by son to whom the stock was bequeathed. Ruling cites Rev. Rul. 93-12, 1993-1 C.B. 202.

9. Technical Advice Memorandum 9436005. The fact that each of three 30% blocks of stock transferred has "swing vote" attributes is a factor to be taken into account in determining the fair market value of the stock.

C. Gifts:

1. Metzger v. Commissioner, ___ F.3d ___, 1994 WL 469868 (4th Cir. 1994). Noncharitable gifts in the form of checks are complete for federal gift tax purposes at the time of unconditional delivery and deposit of the checks even though the checks were actually honored by the drawee bank the next year.

2. Ridenour v. Commissioner, ___ F.3d ___, 1994 WL 511747 (4th Cir. 1994). Gifts made under a general power of attorney were not revocable as a matter of state law, and gifts were not part of the decedent/donor's gross estate. Virginia Code section 11-9.5 was found to have retroactive effect and not in conflict with Casey v. Commissioner, 948 F.2d 895 (4th Cir. 1991).

3. Notice 94-78, 1994-32 I.R.B. 15. Aggressive uses of charitable remainder trusts (for example, a two-year trust with an 80% unitrust amount where the sale of an appreciated asset takes place in the second year) will not be respected where the results are inconsistent with the purposes of the charitable remainder trust provisions. The IRS reserves the right to not respect the form of the transaction, to tax the gain to the donor, to question the tax-exempt status of the trust, and to impose sanctions (because the postponement of
the sale may constitute a use of trust assets for
the benefit of the donor).

4. Private Letter Ruling 9436042. The value of
excess contributions of "qualified appreciated
stock" carried over to years after 1994 will
continue to be based on the fair market value at
the time of contribution. All other private
letter rulings that have considered this issue
have reached the same result.

5. Private Letter Ruling 9415007. Where husband and
wife created a family limited partnership with
husband as general partner, gifts of limited
partnership interests will constitute present
interest annual exclusion gifts because each donee
will receive the immediate use, possession, and
enjoyment by virtue of the donee's ability to sell
his or her interest in the partnership to a third
party, subject to the right of first refusal
contained in the partnership agreement in favor of
the other partner.

D. Miscellaneous.

transferee liability purposes relating to gift
taxes payable on gifts, the IRS has an extra year
beyond the three-year statute of limitations to
make adjustments and look to the donees.

2. Arcadia Plumbing Trust v. Commissioner, 68 T.C.M.
(CCH) 699 (1994). Trust found to have associates
and business objective plus a majority of the
other four corporate characteristics, therefore
classified as an association taxable as a
corporation.

3. Private Letter Ruling 9413045. Where second-to-
die life insurance policies on the lives of
husband and wife were purchased in trusts created
by them and under which they served as trustees,
subsequent sale of the policies to a new
irrevocable trust having a third party as trustee
would not cause the life insurance to be
includible in the gross estate because the
transfers of the policies were for full and
adequate consideration in money or money's worth.
The new trust was structured as a grantor trust,
and the IRS ruled that amounts distributed by the
trust pursuant to its terms to reimburse the
taxpayers for tax payments made by them with
respect to the trust income would not be treated as a retention of the right to income. Finally, citing Jordahl v. Commissioner, 65 T.C. 92 (1975), the IRS found that the insured would not possess incidents of ownership in any insurance policy held in trust solely because the insured has the right to substitute assets of similar value for those policies.

4. Private Letter Ruling 9417005. IRS withdraws Private Letter Ruling 9240017 concerning the transfer of an option to a charitable remainder trust.

5. Private Letter Ruling 9422041. Beneficiary's status as owner under the grantor trust rules will not preclude a QSST election by the beneficiary.

6. Private Letter Ruling 9432017. Amendment in May of 1993 to a 1951 buy-sell agreement will not be a "substantial modification" that would cause loss of grandfathered status under the new Chapter 14 valuation rules. The amendment was adopted contingent on the receipt of a favorable letter ruling. The amendment changed the purchase price from 50% of book value to 75% of book value, changed the interest rate, and made other changes in the method of payment. The IRS held that the changes balanced out.

7. Private Letter Ruling 9438023. The exercise of a special power of appointment over a grandfathered generation-skipping trust to create a new trust for a lower generation for life will not be treated as an addition made after September 25, 1985 and will not cause a loss of the exemption from the generation-skipping transfer tax.

II. STRUCTURED VALUE TRANSFER TECHNIQUES TO CONSIDER

1. **Taxable Gifts.** Unified credit gifts are simple and result in the perfect freeze by shifting all future growth without paying any transfer taxes. Because gift taxes are calculated on a tax exclusive basis and because the dollars used to pay the gift taxes can be removed from the donor’s gross estate, lower transfer tax costs are involved.

2. **Valuation Discounts.** Proper structuring of the ownership of the asset or entity involved in the gift or freeze transaction to take advantage of
valuation discounts for undivided interests, minority interests, and other circumstances can enhance the leverage in the transaction. This is particularly true in view of Rev. Rul. 93-12, 1993-1 C.B. 202, holding that a minority discount will not be disallowed solely because the transferred interest, when aggregated with interests held by family members, would be part of a controlling interest.

3. **Chapter 14 Freezes.** Use of one of the techniques sanctioned by sections 2701 through 2704 can add certainty to the tax treatment of the structured value freeze. These include preferred stock recapitalizations, grantor retained annuity trusts and unitrusts (GRATs and GRUTs), and buy-sell agreements. Other techniques are qualified personal residence trusts (QPRTs), split-purchase annuity trusts (SPATs), and split purchases of residences. Grantor retained income trusts (GRITs) can continue to be used with nieces and nephews.

4. **Installment Sales.** A sale made in exchange for a long-term note can be a simple way to shift growth without being subject to Chapter 14. Installment sales can be used with any capital asset, and the note can be tailored to suit the client's needs as in Private Letter Ruling 8824043 where payment could be demanded on 367 days' notice. Under section 7872, the applicable federal rate is a safe harbor interest rate for income tax purposes, and, according to Frazee v. Commissioner, 98 T.C. 554 (1992), for gift tax purposes as well. At the holder's death, the note may be valued at less than face for estate tax purposes. See Regs. § 20.2031-4; Rev. Rul. 67-276, 1967-2 C.B. 321; and Friedberg v. Comm'r, 63 T.C.M. (CCH) 3080 (1992).

5. **Stock Redemptions.** This technique involves the transfer by a senior family member of a few shares in the C corporation to members of the next generation and a redemption by the corporation of the balance of the senior generation's stock in whole or in part for installments notes. Careful planning is required for exchange treatment under section 302(b) (and to avoid application of the section 318 family attribution rules) and to make sure the terms of the note do not cause it to be an applicable retained interest within the meaning of section 2701(b)(1) (for example, by inclusion of a conversion right on default).
6. **Private Annuities.** Use of a private annuity allows the seller to defer gain as with an installment note. However, at death there is no inclusion in the seller’s gross estate. In addition, if the seller dies before full basis recovery, the unreported gain disappears and a loss deduction can be claimed on the seller’s final income tax return for the unrecovered basis. See General Counsel Memorandum 39503 (June 28, 1985) which discusses the income tax treatment.

7. **Self-Cancelling Installment Notes.** A SCIN is a hybrid using the installment approach to determine the maximum payments to be made by the buyer and using the private annuity approach on cessation of payments if the seller dies early, thereby avoiding inclusion in the gross estate. See General Counsel Memorandum 39503 (June 28, 1985) and *Commissioner v. Frane*, 998 F.2d 567 (8th Cir. 1993), for a discussion of the income tax treatment.

8. **Loans and Guarantees.** Loans to family members and the personal guaranteeing or securing of their bank loans and other credit arrangements can provide them with the capital needed to invest in businesses, homes, and other appreciating assets. Structuring a gift loan under the safe harbor interest rate provisions of section 7872 is easy and can be understood by the client.

9. **Charitable Lead Trusts.** For a family that is otherwise charitably inclined, a lead trust offers the opportunity for substantial discounts in making taxable gifts. Combined with a private foundation, very few dollars need actually leave the control of the family.

10. **Split-Dollar Life Insurance.** Use of split-dollar life insurance arrangements, particularly with second-to-die policies owned by generation-skipping trusts, can provide significant leverage for the corporate dollars used to pay the premiums.
III. VALUATION ISSUES

A. Inherent Gain Discount.

1. The repeal of the General Utilities doctrine by the Tax Reform Act of 1986 has made it virtually impossible for a taxable corporation to sell or distribute appreciated assets without the realization of taxable gain.
   a. Prior law protected distributions to shareholders under certain liquidations. Sections 331, 337.
   b. Earlier law also insulated inherent gain from tax where appreciated property was used by a corporation to redeem stock under the protection of section 303. Section 311(d).

2. The step up in basis at death given to the stock of a corporation does not pass through to appreciated assets.
   a. Assets of the corporation are not considered to be assets of a shareholder for purposes of section 1014.
   b. The basis step up under section 1014 given to an interest in a partnership can be transferred to the underlying assets of the partnership through elections made available to the personal representative of the estate. Sections 732(d), 754.

3. The IRS position on this issue was generally upheld by the courts prior to the 1986 repeal of tax-free liquidations under section 337. 
   a. These decisions denied discounts for any inherent capital gains tax liability because a liquidation of the corporation was uncertain and because of the possibility that gain would be avoided or minimized in the event of a liquidation.
   b. This thinking contrasts somewhat with language in Rev. Rul. 59-60 which acknowledges that costs of liquidation merit

4. The IRS has recently reaffirmed its position that the inherent capital gain liability of a corporation cannot be considered in valuing its stock in the absence of evidence that a liquidation is actually contemplated. Tech. Ad. Memo. 9150001.

5. Also, the Tax Court in Estate of Ford v. Commissioner, 66 T.C.M. (CCH) 1507 (1993), with respect to the issue of liquidation costs of a closely held corporation, held that no discount is appropriate where the prospect of liquidation is merely speculative, citing favorably pre-1986 case law.

a. This position ignores the changes in the corporate income tax laws just noted and, in fact, Ford did not address the impact of the Tax Reform Act of 1986 on the pre-1986 cases.

b. The hypothetical and knowledgeable willing buyer would certainly recognize the reduction in the value of appreciated corporate assets if they are reduced to cash or distributed in a liquidation of the corporation.

c. In Obermer v. United States, 238 F. Supp. 29 (D.C. Haw. 1964) the taxpayer claimed a discount for the inherent capital gains tax on appreciated corporate assets in valuing the stock of a corporation and presented expert testimony that a buyer would consider this potential tax liability.

d. The District Court in Obermer expressly stated that the locked-in capital gains tax was a proper discount in valuing the stock and distinguished the earlier holding of the Tax Court in Cruikshank because no expert testimony was presented in Cruikshank on the effect of the tax liability on the value of the corporate stock.

e. Most recently, the Tax Court in Estate of Gray v. Commissioner, 66 T.C.M. (CCH) 254 (1993), accepted a discount in the value of an Albany, Georgia newspaper for impacted
capital gain tax liabilities based on expert testimony.

f. A discount for inherent capital gains on corporate assets is both logical and likely, but expert testimony will have to be presented to sustain a discount position in light of the current IRS stance on this issue.

B. Appraisal Issues.

1. Appraisers are well aware of corrective measures taken by Treasury to limit the use of faulty and fraudulent appraisals to secure favorable tax results.

   a. Penalties are now imposed on persons who assist in the preparation or presentation of any portion of a return, affidavit, claim, or other document if that person knows (or has reason to believe) that the document will be used in connection with any material matter arising under internal revenue laws and would result in an understatement of the liability for the tax of another. Section 6701.

   b. The new rules relating to the substantiation of the value of property transferred to charity through qualified appraisals and qualified appraisers are well known in the appraisal community. Regs. § 1.170A-13(c).

   c. The Treasury may bar an appraiser from practicing before the IRS or the Treasury and may also decree that appraisals by an appraiser will have no probative effect in proceedings before the IRS or the Treasury.

   d. As a result, appraisers asked to take positions that may be unusual or aggressive will require substantial support from tax advisors.

2. Confidentiality issues are raised when appraisers are involved in sensitive valuation matters.

   a. Any appraisal secured by a taxpayer may be subpoenaed by the IRS. McKay v. United States, 372 F.2d 174 (5th Cir. 1967).
b. Until an appraiser’s position on the valuation issue is reasonably formulated, it may be wise to protect the appraisal process under the attorney work product doctrine. Hickman v. Taylor, 329 U.S. 495 (1947); see, Rule 26(b)(3) of the Federal Rules of Civil Procedure.

i. In order to keep the appraisal process within this doctrine, the appraiser should be employed by an attorney, receive instructions from that attorney, confer with the attorney before preparing a written appraisal, and be paid by the attorney.

ii. In short, until the appraisal process has been completed, the appraiser should be treated as a consultant to the attorney rather than an independent expert.

c. The information obtained by an appraiser from a party who is not before the court in a tax valuation proceeding cannot be considered privileged communication and will not be grounds for disqualification. Estate of Halas v. Comm’r, 94 T.C. 570 (1990).

C. The Buffalo Tool & Die Rule.


a. The court has now recognized that decisions which split the difference between parties encourage them to take extreme positions which frustrate the administrative settlement process.

b. The upshot is that a well tried and well presented case may result in a full victory rather than a compromise outcome.

2. Taxpayers have fared well under this principle. Estate of McGill v. Comm’r, 48 T.C.M. (CCH) 239 (1984); Estate of Gallo v. Comm’r, 50 T.C.M. (CCH) 470 (1985); Watts v. Comm’r, 51 T.C.M. (CCH) 60 (1985), aff’d, 823 F.2d 483 (11th Cir. 1987).
a. In Watts the issue was whether a partnership interest should be valued as an interest in a going concern or on the basis of its liquidation value. The case resulted in a complete win for the taxpayer.

b. The following comment from the Tax Court’s opinion is instructive:

"We have now come full cycle and, after weeks of preparation, days of trial, hundreds of pages of paper, thousands of dollars for lawyers, months of consideration by the Court and minutes reading the opinion, are back where the petitioner started on the Form 706. Perhaps this reemphasizes the wisdom of Buffalo Tool and Die Mfg. Co. v. Comm’r, supra."

3. The taxpayer can normally employ an appraiser contemporaneously with the relevant tax valuation date. Appraisals made at or near the date of valuation carry more weight than those made at a later period in time. First Republic Bank v. United States, 88-2 U.S.T.C. ¶13,786 (W.D. Tex. 1988).

4. Taxpayers can often utilize more qualified appraisers than the IRS, and payments are normally deductible for tax purposes. A number of cases illustrate the mismatch in appraiser quality that normally results in favorable decisions for taxpayers. Estate of Spruill v. Comm’r, 88 T.C. 1197 (1987); Mast v. Comm’r, 57 T.C.M. (CCH) 1355 (1989).

5. Contemporaneous appraisals are also valuable in locking up the value of adjusted taxable gifts, given the unfortunate results in Estate of Smith v. Commissioner, 94 T.C. 872 (1990).

D. Recoverable Costs.

1. Remember that a prevailing party may recover reasonable litigation costs (including attorneys’ fees) in tax controversies, as well as court costs, expert witness fees, various studies, reports, tests, and the like. Section 7430.

2. A number of rules apply to limit or deny an award of litigation or administrative costs, the most
important of which is the requirement that the prevailing party must have exhausted all administrative remedies within the IRS as a condition precedent to cost recovery. Section 7430(b)(1).

a. A party's administrative remedies are considered to have been exhausted only if the party participates in an appeals conference.

b. This requirement does not apply, however, unless the IRS makes available the opportunity for an appeals conference.

3. The bad news is that the maximum rate at which attorney's fees may be reimbursed is $75 an hour unless the court determines a higher rate as justified to reflect inflation. Section 7430(c)(1)(B)(iii).

a. H.R. 4210, the Taxpayer Bill of Rights II, passed by the House and Senate on March 20, 1992, would have increased attorney's fees to $110 an hour, but this legislation was vetoed by President Bush on the same day it was approved in the House and Senate.

IV. DISCOUNT FAMILY PARTNERSHIPS.

A. In General.

1. Family investment partnerships are typically formed for a variety of tax and nontax objectives.

2. Asset protection.

a. Gifts of limited partnership interests do not expose the underlying family capital to immature or spendthrift tendencies on the part of the donee(s).

b. Transfers of limited partnership interests are compatible with custodial donee arrangements.

c. Limited partnership interests are relatively secure against future matrimonial disputes.

d. The partnership format retains the investment assets within family parameters.
e. Many of these nontax objectives are achieved through transfer restrictions contained in the articles of partnership.

3. Financial benefits.
   a. Collective investing often secures opportunities foreclosed to individual family investors.
   b. Partnerships allow the investment of family capital to be entrusted to the most able managers in the family.


5. Tax advantages.
   a. Discounts for lack of marketability and minority interests are frequent characteristics of limited partnership interests.
   b. Gifts of undivided interests in the underlying assets are normally seen as a convenient and equitable means of transferring wealth to the next generation.
   c. Family partnerships can be created and liquidated without substantial tax hurdles. Sections 721, 736.
      i. Be careful to avoid the investment company rules upon formation. Section 721; Regs. § 1.351-1(c).
      ii. Income tax issues do arise whenever certain assets -- inventory and accounts receivable -- are present. Sections 736, 751.
      iii. Gifts of limited partnership interests in family partnerships will usually involve Chapter 14 issues.
B. Valuation Strategies.

1. Multiple discounts.
   a. Multiple discounts may be available if a tiered partnership structure is created, or if the underlying partnership assets may be discounted in addition to the outside partnership interests.
   b. Much of the overall discount may be absorbed by the illiquidity inherent in the underlying assets of the partnership, or in the first tier partnership interest.

2. Retroactive adjustments.
   a. It may be possible in certain situations to avoid inadvertent, or unintended, gifts by drafting for retroactive adjustments, if it is subsequently determined that the assumed values for property transferred into a family partnership, and the limited partnership interests taken back in return were, for any reason, incorrect.
   b. The IRS attacks adjustment clauses on the theory espoused in Commissioner v. Procter, 142, F.2d 824 (4th Cir. 1944), where the court refused to give effect to a provision in a trust agreement excluding any portion of a transfer in trust that was subsequently decreed by a court to be subject to gift tax. Cf., Harwood v. Comm'R, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986); Ward v. Comm'R, 87 T.C. 78 (1986).
   c. An IRS attack on a retroactive adjustment provision failed in King v. United States, 545 F.2d 700 (10th Cir. 1976).
      i. In this case, property was sold to a trust on an assumed value, but the transaction called for an adjustment in the principal amount of the installment sales note if the property was later revalued.
      ii. The King decision indicates that modifying the terms of the deal, rather than undoing the transaction altogether, may not be against public policy.
d. Adjustments expressly triggered by audits will be ignored by the IRS. Rev. Rul. 86-41, 1986-1 C.B. 300.

e. On the other hand, private letter rulings suggest that an adjustment triggered by an outside appraisal will be honored. Priv. Letter Rul. 8549005; see also, Priv. Letter Rul. 8611004.

f. Adjustment language can be drafted into the articles of partnership and also the express provisions of any assignment agreement. The adjustment provision should be triggered by later appraisal, not a subsequent IRS audit or court decision.

3. Cost issues.

a. The need for outside appraisal assistance (which costs money) depends upon the size of the transaction and the size of the claimed discounts.

b. Discount levels above 35% are risky and call for expert backup.

c. Discounts of 25%, or lower, are relatively safe.

d. Obviously, there is a gray area between 25% and 35%, as a practical matter.

e. Note the incompatibility between the special use valuation rules in section 2032A and the use of normal discounts. Maddux v. Comm’r, 93 T.C.M. (CCH) 228 (1989).

C. Chapter 14 Problems.

1. Section 2704 was enacted, according to clear legislative history, to thwart the results in Harrison v. Commissioner, 52 T.C.M. (CCH) 106 (1987), and Estate of Watts v. Commissioner, 51 T.C.M. (CCH) 60 (1985), aff’d, 823 F.2d 483 (11th Cir. 1987).

a. Both Harrison and Watts allow discounts at death for partnership interests retained by a
decedent in limited and general partnerships, respectively.

b. These discounts were triggered by the concept of lapsing values, since the recipient of former controlling or liquid general partnership interests received, as a result of the transfer, the economic rights to an interest that no longer contained control or any element of liquidity.

2. Section 2704(a).

a. Taxes the differential in value of a partnership interest between the moment before and the moment after death to the extent the differential is attributable to the lapse of voting or liquidation rights.

b. For example, following the death of the holder of a general partnership interest which allowed the holder to force a partnership liquidation and receive the liquidation value of the holder's interest in the underlying partnership assets, an assignee of the interest can no longer force the liquidation in the absence of a special provision in the articles of partnership allowing that action.

i. In other words, local law typically divests the recipient of a general partnership interest of the management and liquidation rights attributable to that interest.

ii. Limited partnership agreements usually treat the recipient as either an assignee, or, at best, a substitute limited partner without the rights formerly enjoyed by the deceased or transferring general partner.

c. The differential in value subject to tax under the new section 2704(a) rule will be roughly equivalent to the discounts formerly applied to the general and limited partnership interests of the decedents in the Harrison and Watts cases.

d. The lapse which is treated as a transfer under the statute is the lapse of a voting
right or a liquidation right. The liquidation right involved means a right or ability to compel the partnership to acquire all, or a portion, of the holder's interest in the entity. Regs. § 25.2704-1(a)(2) (iv)(v).

e. The following state law provisions applicable to limited partnerships that last for a set term are applicable to the analysis here:

i. Limited partners cannot withdraw from the partnership until it terminates.

ii. All partners have to agree to a dissolution of the partnership.

iii. If there is more than one general partner, no general partner unilaterally can force partnership dissolution by withdrawing.

iv. A general partner may be assessed damages for withdrawing before the end of the set term, and any effort to withdraw entitles the general partner to a repurchase of the general partnership (but not the limited partnership) interest at fair value, minus any damages caused by the early withdrawal.

v. The combination of these rules sets up the liquidity discount for limited partnership interests which are "locked in" until the end of the partnership term.

f. The interests of the senior members in a family limited partnership are typically allocated primarily to the limited partnership interests taken back when the partnership is formed, thereby allocating a relatively small portion of the underlying assets to the general partnership interests that may be subject to early withdrawal.

g. Whenever there are several general partners, none of them has a unilateral ability to liquidate the partnership unless the articles of partnership provide otherwise.
i. This means that several general partners contributing property to the limited partnership effectively lock themselves in with respect to the underlying assets allocable to limited, rather than general, partnership interests taken back upon formation of the entity.

ii. This is not unlike the result which occurs when three persons transfer an equal amount of property to a corporation in exchange for one-third of the outstanding stock of that entity; each gives up liquidity with respect to the transferred property and takes back an equal interest that is subject to the rights of others in the resulting corporation.

iii. No gift tax can be asserted under these circumstances because the exchange does not result in a transfer of property between the general partners in the limited partnership context or the equal stockholders in the corporate context. Regs. § 25.2511-1(h)(1); see, United States v. Gordon, 406 F.2d 332 (5th Cir. 1969).

3. Section 2704(b).

a. Enacted to prevent family partners from forming a partnership, restricting the interests to produce valuation discounts, transferring interests for estate planning purposes, and then liquidating the partnership when all estate planning objectives have been satisfied.

b. Operates by ignoring applicable restrictions in valuing interests in controlled family partnerships and corporations. This new rule was not, however, intended to eliminate fractionalization discounts that existed under prior law. Conf. Rept., H.R. 5835, 101st Cong. at 157 (Oct. 27, 1990).

c. The definition of an applicable restriction for this purpose is a limitation on the ability to liquidate the entity if it is more restrictive than the limitations than the
limitations normally applicable under state law. Regs. § 25.2704-2(b).

d. It seems clear that Congress did not intend to change existing case law for transfers of limited partnership interests in partnerships that exist for a set period of time.

e. When a general partner transfers limited partnership interests, no lapse will occur if the general partner does not have a unilateral right to liquidate the partnership and the transferee of the limited partnership interest either receives the economic rights of that interest as an assignee or becomes a substitute limited partner.

i. The lapse rule is covered in Regulations section 25.2704-1(f), Ex. 5.

ii. Neither an assignee of a limited partnership interest nor a substitute limited partner has the right, under state law, to force a liquidation of the partnership or require a purchase of their transferred limited partnership interests -- in short, normal state law restrictions, not section 2704(b) applicable restrictions, support the valuation discounts in question.

4. General thoughts.

a. The Chapter 14 rules apply to controlled family partnerships and corporations formed after October 7, 1990.

b. Note that this is a relatively new statutory scheme with new interpretative regulations, a risk that should be pointed out to the client in any case.

c. A good review of these discount family partnership valuation issues may be found in Eastland, "Family Limited Partnerships: Transfer Tax Benefits," 7 Probate & Property 59 (July/August 1993).

V. INSTALLMENT SALES

A. General Observations.

1. A current sale of property to younger family members (or trusts for their benefit) in exchange for an installment note remains an effective estate freeze technique.

   a. The sale avoids gift tax liability so long as the transfer is made in exchange for a note bearing an interest rate equal to the applicable federal rate ("AFR") published every month.

   b. The sale will fix the value of property retained by the Seller at the value of the note, thereby transferring future growth in the subject asset to younger generations; therefore, installment sales like all estate freeze transactions, are most effective for property currently at depressed values.

2. Installment sales can occur with stock of a subchapter S corporation.

   a. Sales of such stock to a trust can be structured so long as the trust is properly divided into separate trusts for each beneficiary. Section 1361(d)(3).

      i. Each separate trust must have only one current income beneficiary.

      ii. Any corpus distributed during the beneficiary's life can be distributed only to that beneficiary.

      iii. The beneficiary's income interest must terminate at the earlier of the beneficiary's death or termination of the trust.

      iv. Upon termination of the trust during the beneficiary's life, the trust assets must be distributed to the beneficiary.

   b. Alternatively, the trust purchasing subchapter S stock can be structured as a grantor trust. Section 1361(c)(2)(A)(i).
i. Grantor trust status can be changed opportunistically according to the transferor's ability (or desire) to further "leverage" the transfer tax savings by assuming the trust's income tax obligations.

a. Consider inclusion in the trust of an administrative power under section 675 which can be waived or released by the grantor or trustee.

b. Alternatively, if the trustee is given certain discretionary powers, the addition or removal of independent trustees can be used to change the grantor trust status of a trust under section 674.

ii. The ability to repeatedly "opt in" and "opt out" of grantor trust status has not been fully tested in the courts.

3. A transaction at fair market value will allow the seller to postpone gain, although a basis step up otherwise available under section 1014 will be lost.

a. Treatment of the transferor's gain under the installment method is available even if the note is secured. This probably is not the case with a sale in exchange for a private annuity. *Bell v. Comm'r*, 60 T.C. 469 (1973); *212 Corp. v. Comm'r*, 70 T.C. 788 (1978); cf. *Stern v. Comm'r*, 64 T.C.M. (CCH) 1 (gain recognized ratably if private annuity unsecured).

b. For reasons discussed below, providing security for the note may help prevent recharacterization of the installment sale as a transaction subject to section 2036.

4. The members of the purchasing younger generation may be able to deduct interest paid on the note as investment interest (to the extent of their investment income). Section 163(d).

5. At the transferor's death, the note may be valued at less than its face value. Regs. § 20.2031-4;

B. Applicable Federal Rate Issues.

1. If section 1274 applies to an installment sale between the transferor and the trust, the note issued in favor of the transferor must bear AFR interest to avoid both imputation of interest and an unintended gift tax.

   a. The AFR is defined in section 1274(d) and in Proposed Regulations section 1.1274-6. The AFR is published monthly by the Treasury in a published revenue ruling.

   b. A short-term AFR applies to debt instruments of up to three years maturity; a mid-term AFR applies to debt instruments with maturities longer than three years but not over nine years; a long-term AFR applies to debt instruments with a term of more than nine years.

   c. The basic AFR rate is expressed as an annual rate based on semi-annual compounding but equivalent rates based on annual, quarterly, and monthly compounding are also published.

   d. It may not be possible to analyze an installment obligation which requires partial payments prior to maturity simply by reference to the short-term, mid-term, or long-term rates, i.e., should the same AFR apply to the principal payment due in year two and the principal payment due in year 10?

   i. The taxpayer may elect to use the AFR applicable to the final principal payment date. Prop. Regs. § 1.1274-6(d)(1).

      a. This may require an inappropriately high AFR in the case of a "steep" yield curve when long-term rates are considerably higher than short-term rate).

      b. However, it may work to the taxpayer's advantage in the case of an "inverted" yield curve in which long-term rates are lower than short-term rates.
ii. Separate tables are available to determine the appropriate AFR for "self-amortizing" or level principal obligations. Prop. Regs. § 1.1274-6(d)(2).

iii. Finally, a present value approach, using an AFR applicable to each principal payment, is available. Prop. Regs. § 1.1274-6(d)(3).

2. Sales to grantor trusts.

a. Section 1274(c)(1) provides that the statutory rules apply to any debt instrument given in consideration for the sale or exchange of property.

i. Proposed regulations provide that the term "sale or exchange" means any transaction treated as a sale or exchange "for tax purposes." Prop. Regs. § 1.1274-1(a)(1).

ii. The statute, therefore, will not apply to a transaction between a grantor and grantor trust unless it constitutes a sale or exchange for federal income tax purposes.

b. In Rev. Rul. 85-13, 1985-1 C.B. 184, the IRS ruled that a transfer of property by the trustee of a grantor trust to the grantor of the trust is not recognized as a sale for federal income tax purposes.

i. In that ruling, the grantor, A, funded a trust with stock with a basis of $20x and subsequently bought the stock, then worth $40x, from the trust in exchange for a promissory note for $40x. When A later sold the stock to an unrelated party for $50x the IRS ruled that A's basis in the shares received from the trust was equal to $20x "because the basis of the shares was not adjusted during the period that [the trustee] held them."

ii. The IRS ruled that A was considered to be the owner of the promissory note held by the trust and that the transfer from the trust to A was not recognized as a sale.
for federal income tax purposes because A is both the maker and owner of the promissory note.

c. The IRS specifically declined to follow a contrary decision involving similar facts, Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), because of its "position of treating the owner of an entire trust as the owner of the trust’s assets." Id. If the IRS applied this interpretation of the grantor trust rules to section 1274, it presumably would hold that a sale between a grantor and a grantor trust should not be considered a sale or exchange of property for purposes of section 1274(c)(1).

d. No reported authority has considered the applicability of Rev. Rul. 85-13 to section 1274. Analogous cases and rulings applying Rev. Rul. 85-13 to other situations, however, suggest that the statute would not apply to a note between a grantor and his grantor trust.

i. In Rev. Rul. 87-61, 1987-2 C.B. 219, the IRS ruled that the section 1491 excise tax on transfers of appreciated property by United States citizens or residents to foreign trusts did not apply at the time of a transfer by a grantor to a foreign grantor trust but rather applied at the time that the grantor ceased to be the owner of the trust.

ii. In Rev. Rul. 88-103, 1988-2 C.B. 304, the IRS ruled that if a taxpayer’s property is involuntarily converted into money and the taxpayer’s grantor trust, rather than the taxpayer, purchases replacement property, the purchase can qualify the taxpayer’s gain for nonrecognition under section 1033. Citing Rev. Rul. 85-13, the IRS held that "[w]hether replacement property is purchased by the grantor or by the grantor’s trust is of no consequence for purposes of Section 1033."

iii. See also, Rev. Rul. 90-7, 1990-1 C.B. 153 (certificate holder in investment trust classified as grantor trust does not
recognize gain or loss when the certificates are exchanged for a proportionate share of the trust's assets).

e. The IRS and the courts have not always held consistently that a grantor trust has no independent tax significance.

i. The leading case in which the IRS successfully argued that a grantor trust should be accorded separate entity status is *W & W Fertilizer Corp. v. United States*, 527 F.2d 621 (Ct. Cls. 1975), cert. denied, 425 U.S. 974 (1976). In *W & W Fertilizer Corp.*, the question presented was whether a grantor trust or its grantor was the owner of stock for purposes of section 1371(a)(2), which provided that a subchapter S corporation could have as shareholders only individuals and estates. The Court of Claims recognized the trust as a separate entity owning the shares in large part because Regulations section 1.1371-1(e) explicitly provided that a grantor trust did not qualify as a subchapter S corporation shareholder.


3. The transferor and the trustee of the trust may later want to renegotiate the interest rate payable on the note as the AFR changes through a replacement note bearing interest at the AFR in effect when the renegotiation occurs.

a. Obviously, if the transferor desires to further leverage the transfer tax advantages
of the installment sale transaction, he will only renegotiate the loan when the AFR decreases in order to reduce the trust's interest payments.

b. No authority supports or contradicts the ability of the transferor and the trustee of the trust to renegotiate the terms of the note on such an opportunistic basis.

i. The transaction should not be subject to challenge as a gift loan under section 7872 because the use of the AFR at any point in time will prevent characterization of the replacement note as evidencing a gift loan.

ii. The opportunistic renegotiation of the interest rate theoretically could be challenged under an extension of Dickman v. United States, 465 U.S. 330 (1984), although it clearly does not fall within the facts or theory of that case.

iii. On the other hand, a renegotiation feature cannot be built into the original note. If the AFR at the time of the sale is 6%, a note bearing interest monthly at a rate equal to "the lesser of 6% or the AFR prevailing each month" clearly would be subject to section 1274 adjustment. Variable rate notes are governed by separate rules. See Regs. § 1.7872-3(e).

iv. It is advisable to avoid an upfront agreement to renegotiate only when rates decline.

C. Dispositions of Installment Obligations.

1. Lifetime dispositions.

a. A transfer (or cancellation) of the installment obligation by the transferor will trigger gain. Section 453B(a). This rule applies even to the gift of an installment obligation. Rev. Rul. 79-371, 1979-2 C.B. 294.

b. A renunciation by a grantor of powers which cause a trust to be classified as a grantor trust is treated as a transfer of ownership
of the trust assets by the grantor to the trust, which, upon such renunciation, becomes a "separate taxable entity, independent of its grantor." Regs. § 1.1001-2(c), Ex. 5; see also, Madorin v. Comm'r, 84 T.C. 667 (1985).

2. Modifications.

a. Most modifications to installment obligations do not constitute taxable dispositions.

i. In Private Letter Ruling 8932011 modifications to a note did not substantially change the rights of the seller and did not constitute a taxable disposition of the installment obligation where: (i) payments of principal and interest on the unpaid balance of the note were reduced retroactively; (ii) simple interest was increased from 9% to 10%; (iii) a new quarterly payment was added based on a percentage of cash flow from the property; and (iv) a clause was added recognizing the seller's right to use part of the property sold.

ii. In Rev. Rul. 82-122, 1982-1 C.B. 86, the IRS ruled that the substitution of a new obligor coupled with an increase of the note interest rate was not a taxable disposition.

b. A taxable disposition is deemed to have occurred, however, if substantial modifications of the installment obligation are made and the rights of the seller are materially changed.

i. In Rev. Rul. 82-188, 1982-2 C.B. 90, the IRS ruled that a disposition occurred when the obligor substantially increased the face amount of its outstanding installment obligation in consideration for the taxpayer's waiver of his right to convert the obligation into common stock of the debtor corporation.

ii. In Rev. Rul. 87-19, 1987-1 C.B. 249, the IRS ruled that a bondholder's waiver of an otherwise automatic interest rate adjustment clause, such that the
bondholder received a lower rate of interest in exchange for the debtor’s satisfaction of requirements necessary for the bond to be tax exempt, was a material change resulting in a taxable disposition under section 1001.

3. In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the subject taxpayer, a savings and loan, sold mortgage participation interests to another financial institution in exchange for substantially identical mortgage participation interests.

   a. The Supreme Court held that the exchanged properties were materially different because the participation interests exchanged by the taxpayer were derived from loans made to different obligors and secured by different homes. The Court therefore allowed the taxpayer to recognize losses on the transaction under section 1001.

   b. Although Cottage Savings did not deal with the modification of a debt instrument, the case suggests that parties to a debt instrument should be able to adjust certain terms of their instrument without the modification rising to the level of a deemed exchange.

4. In 1992 the IRS responded with proposed (non-exclusive) regulations under section 1001 dealing with modifications of debt instruments. Only "significant" modifications result in a taxable exchange.

5. Proposed regulations -- definition of modification.

   a. The proposed regulations apply whether a modification is accomplished by an actual change of instruments or by an alteration of the original instrument. Prop. Regs. § 1.1001-3(b).

   b. A modification includes any alteration in any legal right or obligation of the issuer or a holder of a debt instrument. Prop. Regs. § 1.1001-3(c)(1).
c. An alteration that occurs by the operation of the original terms of the instrument is not a modification. Prop. Regs. § 1.1001-3(c)(2)(i). For example, if the interest rate is to be "reset each 49 days by a remarketing agent based on an objective standard," the resets do not alter any legal right or obligation and therefore are not modifications. Prop. Regs. § 1.1001-3(d), Ex. 1.

d. A party's exercise or waiver of a right under the instrument is not a modification if it arises "by operation of the original terms [and] is unilateral." Prop. Regs. § 1.1001-3(c)(2)(i). For example, if the issuer is entitled to reduce the interest rate from 9% to 8% in the event it attains a specified credit rating, an exercise of this right is not a modification. Prop. Regs. § 1.1001-3(d), Ex. 4.

i. An exercise of a right is not unilateral in three circumstances:

a. where it "creates a right in the other party to alter or terminate the instrument." Prop. Regs. § 1.1001-3(c)(2)(i)(A)(1);

b. if it "requires consent of the other party, unless that consent may not be unreasonably withheld." Prop. Regs. § 1.1001-3(c)(2)(i)(A)(2); or

c. if it requires "consideration, unless the amount of consideration is fixed as the issue date." Prop. Regs. § 1.1001-3(c)(2)(i)(A)(3).

ii. A waiver is not unilateral if it represents a "settlement of terms among the parties." Prop. Regs. § 1.1001-3(c)(2)(i)(B). For example, a workout is a modification even if it consists only of a reduction of the interest rate or stated principal. Generally, a waiver is a settlement if the waiving party receives a benefit (other than the mere enhancement of goodwill or reputation) from the other party to the instrument.
e. No modification results from a "temporary failure of the issuer to perform its obligations under an instrument, including a delay in payment." Prop. Regs. § 1.1001-3(c)(2)(ii). Also, "an agreement by the holder to temporarily stay collection or waive an acceleration clause or similar default right is not a modification." Id.

f. Generally, an alteration resulting "in an instrument or property right that is not debt for federal income tax purposes" is a modification even if it occurs pursuant to the instrument's original terms. Prop. Regs. § 1.1001-3(c)(3). However, an exercise of a right to convert debt into stock of the issuer is not a modification if the conversion right is included in the instrument's original terms.

6. Proposed regulations -- definition of "significant" modification.

a. A change in yield is not significant unless it increases or decreases the annual yield by more than 25 basis points. Prop. Regs. § 1.1001-3(e)(1)(ii).

b. An extension of an instrument on a maturity date is a significant modification if the date is delayed by more than five years or 50% of the original term, whichever is less. Prop. Regs. § 1.1001-3(e)(2)(ii). Any other deferral of a payment is significant if it is material. Prop. Regs. § 1.1001-3(e)(2)(i). For example, if a bond requires interest to be paid annually, but several years into the bond's term the holder agrees to permit interest for the succeeding four years to be deferred and paid simultaneously with the fifth succeeding year's interest, such deferral of interest is material even if the deferred interest bears interest at a rate such that the yield is not affected. Prop. Regs. § 1.1001-3(g), Ex. 4.

c. A partial prepayment is not a significant modification, but any modification in the terms of the remaining portion may be significant. Prop. Regs. § 1.1001-3(e)(2)(iii).
d. The addition or elimination of a right in the issuer to call the instrument or a right of the holder to put the instrument to the issuer is significant if the call or put has significant value when it is added or deleted. Prop. Regs. § 1.1001-3(e)(2)(iv). Similarly, a modification of a call or put is significant if the value of the call or put changes "significantly" as a result of the amendment.

e. A change in obligor is usually a significant modification unless the change occurs in a transaction to which section 381(a) applies and the new obligor is the acquiring corporation. Prop. Regs. § 1.1001-3(e)(3)(i).

f. However, a change in the obligor is not significant, regardless of the circumstances, if the obligation is without recourse. The addition of an obligor is not significant unless it is intended to circumvent the foregoing rules. Prop. Regs. § 1.1001-3(e)(3)(ii).

g. No significant modification results from a subordination of a debt instrument to other debt of the issuer. Prop. Regs. § 1.1001-3(e)(3)(v). On the other hand, the addition or material alteration of a guarantee or other form of credit enhancement on a nonrecourse instrument is a significant modification. Prop. Regs. § 1.1001-3(e)(3)(iii). An addition or modification of a guarantee or other credit enhancement to a recourse instrument is not significant "unless the guarantor or credit enhancement provider is, in substance, substituted as the obligor on the debt instrument and the change is intended to circumvent the rules regarding a change in obligor."

h. Changes in the collateral for a recourse obligation are never significant modifications. Prop. Regs. § 1.1001-3(e)(3)(iv). Generally, a change in the collateral securing a nonrecourse obligation is a significant modification if a substantial portion of the collateral is released or replaced with other property and the release or replacement is not pursuant to
the instrument’s original terms. However, such a change is not significant if the collateral is fungible or otherwise of a type where the particular unit pledged as security are unimportant. Also, adjustment and improvements of the collateral for a non-recourse obligation are not significant.

i. A modification is significant if it changes a debt instrument into an instrument that is not debt for federal tax purposes. Prop. Regs. § 1.1001-3(e)(4)(i).

j. A change in the interest rate from variable to fixed, or vice versa, is not a modification if it is pursuant to the original terms of the instrument. However, if it is a modification, any one of the following changes is significant:

i. A change of a fixed rate instrument to a variable rate instrument for a contingent payment obligation;

ii. A change of a variable rate instrument to a fixed rate obligation or a contingent payment obligation; or

iii. A change of a contingent payment obligation to a variable or fixed rate instrument. Prop. Regs. § 1.1001-3(e)(4)(ii).

k. A modification is significant if it changes a recourse obligation into a nonrecourse obligation or vice versa. Prop. Regs. § 1.1001-3(e)(4)(iv). However, the IRS is weighing the possibility of adding an exception for a change from recourse to non-recourse based upon the adequacy of the collateral securing the loan.

7. Testamentary dispositions.

a. The transfer of an installment obligation at death is not a taxable disposition. The remaining unreported gain from the obligation constitutes income in respect of a decedent, and is reported only as payments under the obligation are received by the estate or beneficiaries. Section 691(a)(4); Regs. § 1.691(a)-5(a).

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b. Taxable gain is triggered, however, if the installment obligation is transferred at death to the obligor. Section 691(a)(5).

c. Of course, a transfer of the obligation by the estate or the beneficiaries also triggers gain.

d. In Rev. Rul. 76-100, 1976-1 C.B. 123, the IRS ruled that the grantors of a trust who transferred an installment obligation to the trust were treated as owners of the entire trust and that the deferred gain represented by the installment obligation was income in respect of a decedent.

e. In *Sun First National Bank of Orlando v. United States*, 607 F.2d 1347 (Ct. Cls. 1975), withdrawing 587 F.2d 1073 (Ct. Cls. 1978), the subject grantor transferred stock to a grantor trust, which later sold the stock for cash and promissory notes and reported the gain on the sale on the installment basis pursuant to section 453. The trustee realized the capital gain as income and paid most of the income to the grantor, as income beneficiary. The grantor died before the notes were fully paid. When the Tax Court upheld the IRS's determination that the property of the trust was includible in the grantor's estate under section 2036, the grantor's estate filed a refund claim asserting that the gain on the sale of the notes paid after her death was income in respect of a decedent so that the recipient of such income (i.e., the trust) was entitled to a deduction under section 691(c) for estate tax paid on that income. The IRS rejected the refund claim on the grounds that the gain on the notes was not income in respect of a decedent.

i. The Court of Claims held that because the grantor was viewed as the owner of the installment obligations for federal tax purposes, those notes were "acquired by" the trust by reason of the death of the decedent. Implicitly, the court concluded that the notes, though owned for federal income tax purposes by the grantor during her life, passed to the trust upon the grantor's death.
ii. A dissenting opinion observed that this transfer occurred "(as if by magic)... by some unexplained method, which was not by a testamentary bequest or any other known or proven conveyance."

f. Neither Sun First National Bank nor Rev. Rul. 76-100 considered the case of an installment note executed by a grantor trust in favor of its grantor. In Sun First National Bank, the subject note was executed by the trustee of a grantor trust in favor of a third party. In Rev. Rul. 76-100, the subject note was executed by a third party in favor of the grantor and transferred to the trust. Nonetheless, the reasoning of the majority in Sun First National Bank, which held that section 691(a)(4) applies upon the passing (to use the dissent's term, "as if by magic") of a note from the grantor to the trust at the death of the grantor, suggests that the death of a grantor holding a note executed by his grantor trust would result in recognition of income in respect of a decedent.

8. Self-cancelling notes.

a. Self-cancelling installment notes were favored vehicles under prior law.


ii. Arguably, no income tax resulted from the cancellation provision when it was triggered. Miller v. Usry, 160 F.Supp. 368 (W.D. La. 1958).

b. The addition of sections 453B(f) and 691(a)(5) by The Installment Sale Revision Act of 1980 reversed the income tax result just noted.

i. Whenever an installment obligation is cancelled or otherwise becomes unenforceable, the obligation is treated as if it were disposed of in a transaction other than a sale or
exchange, and, if the obligor and obligee are related, the fair market value of the obligation cannot be less than the face amount. Section 453B(f).

ii. An installment obligation transferred at death is excluded from this recognition rule, unless the obligation is transferred by bequest, devise, or inheritance to the obligor or is cancelled by the personal representative of the estate. Sections 453B(c), 691(a)(5).

c. In *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992), the Tax Court held that gain was recognized upon the death of the holder of an installment note which was automatically cancelled upon death by the express terms of the note.

i. Here, the subject transferor sold property to his four children in exchange for a 20-year installment note at a time when his life expectancy exceeded 20 years.

ii. In fact, however, the transferor lived to receive only two installments and recognized income on those installments as if he lived the entire 20 years.

iii. The Tax Court held that the cancellation of the notes resulted in taxable gain to the decedent/transferor under section 453B. However, the Court of Appeals, citing section 691(a), held that the cancellation of the installment obligation must be treated as a disposition of the obligation by the decedent's estate causing it to recognize income in respect of a decedent. *Comm'r v. Estate of Frane*, 998 F.2d 567 (8th Cir. 1993).

iv. The Tax Court rejected the taxpayer's argument that the self-cancellation clause in the notes created a "contingency" affecting the total purchase price to be paid for the stock and that the obligation therefore was not cancelled within the meaning of either
section 453 or section 691. The Court of Appeals affirmed this portion of the Tax Court's judgment.

v. The appellate decision is consistent with Rev. Rul. 86-72, 1986-1 C.B. 253, and General Counsel Memorandum 39503, both of which held that section 691(a)(5) applies when the payee of a self-cancelling installment note dies.

d. This decision causes inevitable comparisons between installment sales and private annuity transactions.

i. Both transactions eliminate assets from the gross estate of the seller.

ii. Self-cancelling notes can be secured, but a secured private annuity forfeits any deferral by the seller. *Bell v. Comm'r*, 60 T.C. 469 (1973); *212 Corp. v. Comm'r*, 70 T.C. 788 (1979).

iii. If the fair market value of the property transferred in either transaction exceeds the present value of the obligation received, a gift tax liability is incurred. Rev. Rul. 69-74, 1969-1 C.B. 43; Gen. Coun. Mem. 39503.

iv. For income tax purposes, the purchaser of property in exchange for a private annuity is not entitled to an interest deduction, even though the annuity payment may in fact reflect either an actual or imputed interest factor.

v. Unlike the installment sale situation, there is no postdeath realization of income by the holder of an annuity contract, although his basis in the property is adjusted.

vi. The parties should not use an unfunded trust to purchase the property in a private annuity transaction. If such a trust is used, the transaction will be characterized as a gift to the trust with a reserved life estate, rather than as an annuity, and the value of the trust property will be included in the gross
estate. *Lazarus v. Comm'r*, 58 T.C. 854 (1972), *aff'd*, 513 F.2d 824 (9th Cir. 1975); *LaFargue v. Comm'r*, 73 T.C. 40 (1979); Rev. Rul. 68-183, 1968-1 C.B. 308. The same issue can arise for installment sales as well (see the discussion in Paragraph D, *infra*).

vii. In the installment sale, the basis of the purchaser should equal the purchase price of the property, including any premium paid for a cancellation feature. This provides an advantage over the private annuity transaction where obligor’s basis is adjusted if the annuitant dies prematurely.

e. The question is whether a self-cancelling installment note transaction still compares favorably with a private annuity despite the taxpayer’s loss in *Estate of Frane* with respect to the income tax liability incurred upon cancellation of the note.

i. Each transaction eliminates assets from the gross estate, except to the extent the seller or annuitant fails to expend the payments received.

ii. Each transaction freezes the value of the property in question and passes any appreciation in the asset sold to the next generation.

iii. Unlike a private annuity, an installment sale can be secured without jeopardizing installment reporting of gain.

iv. Unlike a private annuity, an installment sale can be structured with flexibility, since self-cancelling installment notes do not require substantially constant annual payments; principal need not be payable until future dates, and interest may be accrued.

v. From the purchaser’s standpoint, the self-cancelling installment note is superior to a private annuity transaction because of his ability to deduct interest on the installment note (to the extent of investment income) and, presumably, his
ability to claim a cost basis in the asset purchased.

D. Potential Recharacterization of Sale As a Transfer With Retained Interest.

1. The IRS has attempted to recharacterize sales of property to trusts in exchange for fixed annuity payments as transfers with a retained life interest for purposes of sections 677 and 2036. These cases involve transactions analogous, though not identical, to installment sale transactions and therefore merit careful attention.

a. Treatment of the trust as a grantor trust under section 677 may not always be problematic. In fact it may be desirable as a means of further "leveraging" the transfer tax consequences of the transaction by having the grantor pay the younger generation's income tax liability.

b. On the other hand, inclusion of the trust property in the transferor's estate under section 2036 obviously would defeat the purpose of the freeze.

c. The Supreme Court has made the IRS's task a difficult one. In Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274 (1958), it held that an irrevocable assignment of rights in life insurance policies combined with a retention of annuity contracts issued in conjunction with the policies did not subject the proceeds of the life insurance policies to inclusion under the predecessor to section 2036. In an oft-cited footnote, the Court observed that:

"Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. . . . In these cases, the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments
is not determined by the size of the actual income from the transferred property at the time the payments are made."
356 U.S. at 277, n.8 (citations omitted).

d. As a result, the IRS has been unable successfully to recharacterize a sale-annuity transaction as a transfer with a retained life interest unless (i) it can point to a substantial link between the income produced by the transferred asset and the annuity payments made to the transferor or (ii) the transfer is illusory because the transferor retains control over the transferred property.

2. Pro-IRS recharacterization cases.

a. Cases involving a link between the transferred assets and the retained annuity.

i. In Lazarus v. Commissioner, 513 F.2d 824 (9th Cir. 1975), aff'q, 58 T.C. 854 (1972), the subject grantor nominally funded an offshore trust and sold stock of a corporation wholly owned by the grantor to the trust in exchange for an annuity payable during the joint lives of the grantor and his wife. As part of a prearranged plan, the trust then sold the transferred stock to the issuing corporation in exchange for a note which yielded exactly as much as the annual annuity payments. The court held that under section 677 the grantor's income included the purported annuity payments because the transfer of stock to the trust in consideration for the annuity payments was in fact a transfer subject to a reserved income interest, rather than a sale. The factors relied upon by the court included that:

a. The trust had no assets other than the nominal sum with which it was initially funded and the note received as consideration for its sale of the stock;
b. The note was nonnegotiable and could not be assigned, so the annuity payments could only be paid from interest on the note;

c. The yield of the note was exactly equal to the annual annuity payment;

d. The corpus of the trust was to remain intact for ultimate distribution to the trust beneficiaries in exactly the same way as it would have had the transaction been structured as a transfer in trust with a reserved income interest;

e. The arrangement did not involve a down payment, interest on the deferred purchase price, or security for the purchase price; and

f. There was a substantial disparity between the fair market value of the stock transferred and the actuarial value of the annuity payments.

ii. In Schwartz v. Commissioner, 9 T.C. 229 (1947), the subject decedent transferred property to her children in exchange for an annuity of $7,000 per year. The children immediately contributed the property to a trust in which the decedent was given a life interest. When the income of the trust property was less than $7,000, the children did not pay the difference between the $7,000 and the amount of the income to the decedent. The Tax Court therefore held that the property was includible in the decedent's gross estate under the predecessor of section 2036.

iii. See also, Samuel v. Commissioner, 306 F.2d 682 (1st Cir. 1962), where section 677 was applied to grantor who, as trustee of a trust, did not make annuity payments in years in which trust income was insufficient.
b. Retained control cases.

i. In *Bixby v. Commissioner*, 58 T.C. 757 (1972), the subject grantors established a series of off-shore trusts and sold stock to the trusts in exchange for annuities. The Tax Court held that the income of the trust was taxable to the grantors under section 677 because the grantors retained control over the trust property through an advisory committee on which they could serve.

ii. See also, *Holland v. Commissioner*, 47 B.T.A. 807 (1942), where purported sale of stock to children disregarded for purposes of section 2036 where stock held by decedent as security, decedent retained voting rights, children not permitted to sell or assign stock, and decedent retained "salary for life" but performed no services to corporation.

3. Pro-taxpayer recharacterization cases.

a. As a general rule, courts have rejected the IRS’s efforts to recharacterize sale-annuity transactions structured so that either: (i) the annuity payments are not tied to the yield of the transferred asset or (ii) the transferor does not retain control over the transferred assets inconsistent with his status as an annuitant-creditor.

i. For example, in *LaFarque v. Commissioner*, 73 T.C. 40 (1979), *rev’d in part and aff’d in part*, 689 F.2d 845 (9th Cir. 1982), the subject grantor, "pursuant to an overall plan," nominally funded a trust and then transferred assets to the trust in exchange for annuity payments. The court held that the transaction was not a sale or exchange for an annuity but instead a transfer with a reserved life estate for purposes of section 677, focusing on the facts that:
a. The creation of the trust and the sale were part of the same prearranged plan;

b. The trust was funded only with the property transferred in exchange for the annuity so the grantor could look only to the transferred property itself for her annuity payments;

c. No effort was made to determine the cost of a comparable commercial annuity;

d. The actuarial value of the annuity was less than the fair market value of the transferred property; and

e. The grantor treated herself as beneficial owner of the property, as evidenced by her direct receipt of dividends on some of the transferred stock for three years after the trust was funded, and her failure to assert penalties when annuity payments were delayed.

ii. The Court of Appeals reversed, holding that the formal agreement between the parties concerning the transfer of property to the trust established the grantor’s status as a creditor of the trust. It found that the fact that the actuarial value of the annuity was less than the fair market value of the transferred property simply established that there was a gift element to the transaction.

a. It also argued that the stock which paid dividends directly to the decedent after the trust was funded represented only a small fraction of the trust property, and that other transferred property was properly treated as belonging to the trust rather than the grantor.
b. The court distinguished Lazarus, supra, because the annuity payments in the present case were not a mere "conduit" for the income of the trust property, as evidenced by the use of trust principal, in some years, to make annuity payments.

ii. In Becklenburg v. Commissioner, 273 F.2d 297 (7th Cir. 1959), the decedent contributed 26.78% of the assets of a trust in exchange for a $10,000 annuity. The court held that the annuity payments did not result in inclusion of the trust property in the decedent's estate under the predecessor to section 2036 because the payments were not restricted to trust income and were not limited to the transferred property. The court focused, in part, on the fact that the corpus of the trust was in fact distributed to the decedent.

iii. Similarly, in Cain v. Commissioner, 37 T.C. 185 (1961), the court respected the characterization of a transfer of stock to a corporation in exchange for an annuity as a sale because: "It is clear that the decedent divested herself of all title to and control over the stock, and [the transferee corporation], entered into immediate and complete possession of the property. Furthermore, there is no evidence that the monthly installments were chargeable to the transferred stock or that the payments were in any way related to the potential or expected earnings of the . . . shares specifically or to the profits of [the corporation], generally. To the contrary, the obligation was fixed and dependent solely upon the singular obligation of [the corporation]." 37 T.C. at 188.

iv. In Stern v. Commissioner, 747 F.2 555 (9th Cir. 1984), the appellate court reversed a Tax Court opinion recharacterizing transfers of stock to a foreign trust in exchange for an annuity as transfers with a retained life interest. The court distinguished Bixby,
supra, on the basis that the transferor maintained no active management control over the transferred property.

b. In conclusion, if the transferor sells property to a trust previously funded with substantial property in exchange for a note having a value equal to the value of the transferred property, the sale should not be characterized as a transfer with a retained life interest for purposes of sections 677 or 2036 so long as (i) the note is payable from all property of the trust, rather than the transferred property; (ii) the note is payable from trust principal as well as trust income; (iii) the transferor retains no control over the trust property; and (iv) the transferor enforces his rights, as a creditor of the trust, to his payments under the note.

c. In addition, it would be helpful to structure the transaction so that the transferor receives a down payment and security for the purchase price of the transferred assets, so long as such security is not limited to the transferred assets themselves.

E. Availability of Installment Method for Holding Companies With Holding Publicly Traded Securities.

1. An important exception to the availability of the installment method may apply to family businesses which serve as holding companies for publicly traded securities.

a. Section 453(k)(2)(A) provides that use of the installment method otherwise permitted by section 453(a) is not allowed in the case of an installment obligation arising out of the sale of stock or securities which are traded on an established securities market. The statute provides that the IRS may provide for the application of this subsection in whole or in part for transactions in which the rules of this subsection otherwise would be avoided through the use of related parties, pass-thru entities, or intermediaries.

b. No regulations have been promulgated pursuant to this statutory authority. The legislative history of section 453(k) states that the regulations should apply to sales of a
taxpayer's interest in a wholly owned corporation which owns publicly traded securities. S.Rep. No. 313, 99th Cong., 2d Sess. 133 (1986). On the other hand, the legislative history provides that Congress did not intend the regulations to deny the use of the installment method where the taxpayer cannot directly sell, or cause the sale of, publicly traded stock or securities.

c. Therefore, if the taxpayer sells an interest in a partnership or corporation holding publicly traded stock to a grantor trust, the ability to use the installment method upon a subsequent sale triggered by termination of grantor trust status or the transferor's death will depend on the extent to which the transferor could control or liquidate the limited partnership.

i. The taxpayer's control or ability to liquidate presumably could, theoretically, be determined either at the time of the initial transfer, or at the time of the termination of the grantor trust status, or the taxpayer's death, as the case may be.

ii. Because under the principles of Rev. Rul. 85-13, 1985-1 C.B. 184, no sale occurs for federal income tax purposes at the time of an initial transfer of property by a grantor to a grantor trust, it is likely that the grantor's control would be measured for purposes of section 453(k) either at the time of the termination of grantor trust status, or the transferor's death, whichever occurs first.

2. Apparently, however, the IRS will decline to apply the "pass thru" rule of the flush language of section 453(k) until regulations are issued. See Tech. Ad. Mem. 9306001.

VI. LOAN TRANSACTIONS NOT INVOLVING SALES

A. Applicable Internal Revenue Code Provisions.

1. Section 163(d). An individual's interest deduction for investment interest is limited to the net investment income for the year.
2. Section 163(h)(1). The personal interest of an individual is nondeductible.

3. Section 163(h)(3). Qualified residence interest is deductible.

4. Section 451(a). In the case of an individual taxpayer on the cash method, interest income is taxable in the year of receipt and not when accrued.

5. Section 7872. Most gift loans (that is, those with donative intent and having below-market interest rates) are subject to rules that treat the foregone interest as being transferred from the lender to the borrower and retransferred by the borrower to the lender on the last day of the calendar year.

   a. The interest imputation rules of section 7872 can be avoided by charging the applicable federal rate ("AFR") in the case of a demand loan or in the case of a term loan by charging sufficient interest so that the present value of all payments due under the loan equal or exceed the amount loaned. Section 7872(e)(1).

   b. For gift loans between individuals where the aggregate amount outstanding does not exceed $10,000, section 7872 does not apply as long as the loan is not directly attributable to the purchase or carrying of income-producing assets. Section 7872(c)(2).

   c. If an individual borrower's net investment income for any year does not exceed $1,000 and the individual lender's loans to the borrower do not exceed $100,000, there is no imputation of income to the lender, but the lender is deemed to have made a gift transfer as to the foregone interest. If the borrower's net investment income exceeds $1,000, the amount treated as being retransferred is limited to the borrower's net investment income for the year. Section 7872(d)(1).

(1) This exception does not apply where one of the principal purposes of the interest arrangement is the avoidance of any federal tax. Section 7872(d)(1)(B).
(2) This exception also does not apply if the borrower can control the timing of the receipt of investment income and actually does manipulate the timing to accelerate or defer the receipt of investment income (for example, with the dividends of a closely held corporation). Prop. Regs. § 1.7872-8(c)(3).

(3) For taxable years beginning on or after January 1, 1993, capital gains are generally excluded from the calculation of investment income. Section 163(d)(4)(B); section 13206(d) of The Omnibus Budget Reconciliation Act of 1993.

d. Husband and wife are treated as one person. Section 7872(f)(7).

(1) This applies to the husband and wife on the lending side as well as the borrowing side.

(2) It appears this may prevent a husband and wife from electing split-gift treatment under section 2513 for the amounts deemed transferred under section 7872.

e. Generally, the section 7872(f)(8) exception for loans subject to section 483 or section 1274 will apply to loans given in the sale or exchange of property even if the rules of section 483 or section 1274 do not apply by reason of exceptions or safe harbor provisions. Prop. Regs. § 1.7872-2(a)(2)(ii).

f. For estate tax valuation purposes, the applicable federal rate at death is used in valuing a loan made with donative intent, and no discount is allowed on the note for uncollectibility unless the facts have changed significantly since the time the loan was made. Prop. Regs. § 20.7872-1.

B. Recent Cases and Rulings Relating to Loan Transactions.

1. Flandreau v. Commissioner, 994 F.2d 91 (2d Cir. 1993). Loans to family members followed by
contemporaneous loans back to the original lender in identical amounts were not treated as bona fide debts for purposes of section 2053.

2. *Gatto v. Commissioner*, 1 F.3d 826 (9th Cir. 1993). No interest deduction was allowed under section 163 for interest paid by the grantor/borrower to a trust/lender on loans made by the trust to the grantor immediately upon receipt of the gift. The court held that the grantor/borrower had done nothing more than donate to the trust a promise to make a gift of money in the future.

3. Rev. Rul. 86-17, 1986-1 C.B. 377. To simplify the computation of foregone interest with respect to below-market demand loans that are outstanding for the entire calendar year, a blended annual rate is published with the July applicable federal rates.

4. Private Letter Ruling 9418013. Applicable federal rate ("AFR") loans to sons from QTIP marital trust will not be deemed a distribution of all or part of the surviving spouse's qualifying income interest.

C. Examples of Uses of Loan Transactions.

1. Enhanced Annual Gift Program. Facts: Grandparents with 12 grandchildren and 18 great grandchildren are making $20,000 annual gifts and paying tuition but want to do more to minimize growth in their estates through appreciation and accumulation of income. Solution: Under the $10,000 de minimis rule, each grandparent loans $5,000 interest free to each of these descendants, for a total of $300,000.

2. Loan to Child for Business. Facts: Divorced daughter needs capital to start a design business with her son. The daughter has a roll-over IRA, a home, alimony, and a few thousand dollars in savings. The grandson has no assets of any consequence. Solution: Father makes two $100,000 interest-free demand loans, one to his daughter and one to the grandson. As long as neither has net investment income in excess of $1,000 a year, there is no imputation.

3. Loan to Child for House. Facts: Son needs $750,000 for the downpayment on a new home. Son is the remainderman of a charitable lead trust that terminates in 1999. Solution: In September
of 1993 father lends son $750,000, secured by a second mortgage on the home, with interest only payable at 5.25% per quarter. The note matures on December 31, 1999.

4. Loan to Avoid Taxable Gift. Facts: Mother has used unified credit and wants to advance funds to her daughter and son-in-law on a nongift basis to allow them to support their lavish lifestyle without being forced to dispose of their valuable works of art. Solution: Mother loans $1,500,000 to daughter and son-in-law for a demand note providing for interest at the lowest rate necessary to avoid the imputation of interest under any provision of the Internal Revenue Code. The note provides that to the extent accrued interest is not paid each December 31, it will be compounded and added to principal.

5. Loan to Grantor Trust. Facts: Grandmother is the grantor of an intentionally structured grantor trust that owns insurance on her life for the collective benefit of her grandchildren. She prefers to fund the trust in some manner other than through gifts that require the allocation of part of her GST exemption. Solution: Grandmother makes annual loans to the trust and charges interest at the applicable federal rate. By being treated as the owner of the trust for income tax purposes, the interest she receives should be nontaxable; and by charging a safe harbor interest rate, there should be no element of a gift in the transaction.

6. Use of Testamentary Charitable Remainder Trust. Facts: Husband is the holder of a number of notes from his children where the interest has been compounding for years. Children own sufficient insurance on his life to allow them to repay the notes and all accrued and compounded interest at his death. Husband wants to avoid having his estate pay income taxes on all the accrued and compounded interest. Solution: Husband creates a charitable remainder trust under his will for the benefit of his wife and directs his executor to fund the trust with the note proceeds received from the children in such a manner as the interest, which is income in respect of a decedent, will be passed out to the tax-exempt charitable remainder trust.
VII. PERSONAL GUARANTEES

A. Private Letter Ruling 9113009. Following the logic of Dickman v. Commissioner, 465 U.S. 330 (1984), the IRS has held in Private Letter Ruling 9113009 (subsequently reversed as to the estate tax marital deduction disallowance in Private Letter Ruling 9409018) that a guarantee in favor of a family member results in a present taxable gift.

1. The 1991 ruling does not advise how to value the gift resulting from the guarantee itself. Query whether the proper measure of the gift is what a bonding company would charge.

2. The ruling also holds that an additional gift would result if the guarantor is required to make payment upon default.

3. The ruling approves the use of back-to-back loans even though they are substantively the same as loan guarantees. As long as the second loan has adequate stated interest as required by section 7872, there is no gift and no imputation of foregone points or finance charges.

B. Unanswered Questions. Assuming the guarantee is a gift, there are many unanswered questions.

1. Is the gift a future interest or a present interest gift?

2. To what extent is the value of the gift influenced by the net worth of the borrower?

3. If the guarantee is with respect to a loan to a corporation in which the guarantor is a minority shareholder, is there a gift? What if the other shareholders also guarantee the loan, but their net worth is not substantial?

4. If the guarantor is the controlling shareholder of a corporation whose loan he guarantees, is there a gift to the minority shareholders? If so, does a minority interest discount apply to the gift guarantee?

5. How does the practitioner handle the gift tax reporting requirements? Potential penalties?
6. Can multiple gifts result from the same guarantee (for example, where the loan guarantee is extended)?

VIII. IRA/QTIP ARRANGEMENTS

A. The Problem.

1. Estate planning for IRAs initially appeared to require some unhappy choices between income tax planning and estate disposition objectives.

   a. In order to achieve maximum income tax deferral, an account owner was seemingly required to name his or her spouse as the beneficiary of any death benefits payable from the account.

      i. The account owner was then able to elect distributions over the longest possible time frame, which was either a fixed term of years equal to the combined life expectancies of the account owner and his or her spouse, or their life expectancies as recomputed annually. Sections 408(a)(6), 401(a)(9).

      ii. The applicable life expectancies are determined using the expected return multiples in Regulations section 1.72-9, Table VI.

   b. In order to assure an estate tax deduction for the value of the account at death, it appeared necessary to give the surviving spouse an unlimited power of withdrawal from the account.

      i. This unlimited power of withdrawal satisfies the dual marital deduction requirements that all income be distributable currently to the spouse and that the spouse have a general power of appointment. Regs. §§ 20.2056(b)-5(f)(a), 20.2056(b)-5(g)(1) and (5).

2. Designating the spouse as the beneficiary and granting the spouse an unlimited power of withdrawal obviously placed the spouse in control of the ultimate disposition of the IRA arrangement.
3. However, the issuance of proposed regulations governing distributions from IRA accounts and a published revenue ruling dealing with IRAs, and the marital deduction disclose an alternative for account owners who wish to postpone distributions for income tax reasons but retain control over the ultimate disposition of the account principal. Rev. Rul. 89-89, 1989-2 C.B. 231; See generally, Lanier, "Qtipping IRAs" 4 Probate & Property 35 (March/April 1990).

a. The alternative is to name a QTIP trust as the beneficiary of the IRA account.

b. This technique requires careful attention to the technical requirements of the minimum distribution regulations for IRAs and the marital deduction rules relating to qualified terminable interest property.

c. Care must be taken in drafting the necessary beneficiary designation for the IRA document and the QTIP marital trust agreement.

d. In some cases, appropriate amendments must be incorporated into the governing instrument for the IRA arrangement.

B. Minimum Distribution Requirements.

1. The proposed regulations interpreting the minimum distribution requirements of section 401(a)(9), which were published in 1987, clarify that a trust may be the designated beneficiary of qualified plans and IRAs if certain conditions, set out in the proposed regulations are met. Prop. Regs. § 1.401(a)(9)-1, Q&A D-5 and D-2.

a. The trust must be a valid irrevocable trust under state law (or a trust which would be valid if it had a corpus). It is unclear whether a testamentary trust can meet this requirement, and it is safer to name an inter vivos trust as the beneficiary.

b. The beneficiaries of the trust must be identifiable or, if the beneficiaries are members of a class capable of expanding or contracting, it must be possible to identify the beneficiary with the shortest life expectancy.
c. A copy of the trust instrument must be provided to the plan. Presumably this requirement may be satisfied in the case of an IRA by giving copies of the trust instrument both to the custodian or trustee of the account and to the account owner.

2. The foregoing requirements must be satisfied as of the later of the time the trust is designated as the beneficiary or the required beginning date for distributions under the regulations, which is generally April 1 of the year after the account owner reaches age 70 1/2.

3. If more than one person has an interest in a trust which is named as the beneficiary of an IRA, the person whose life expectancy is shortest will be used in calculating the minimum distributions payable from the account. Prop. Regs. § 1.401(a)(9)-1, Q&A D-6.

a. For a typical QTIP trust, providing benefits for the spouse for life and then to younger generation beneficiaries, the spouse’s life expectancy generally will be shorter than the life expectancies of any of the potential remainder beneficiaries.

b. A distribution method based on the spouse’s life expectancy may therefore be selected in these cases.

C. QTIP Requirements.

1. Rev. Rul. 89-89, 1989-2 C.B. 231, provides that a QTIP election can be made with respect to an IRA of which the beneficiary is a trust.

a. The account owner described in this ruling selected a distribution option requiring the payment of all income from the undistributed portion of the IRA by the close of each calendar year and also requiring the distribution of the corpus of the IRA in equal annual installments over the life expectancy of the spouse.

b. The provisions of the trust and state law required that all income from the trust be payable currently to the spouse, including both the income distributed to the trust from the IRA and income earned on the corpus of
the marital trust. The installment payments of corpus from the IRA were treated as corpus by the recipient trust and accumulated.

c. No person had the power to appoint trust principal to anyone other than the spouse.

2. In ruling that a QTIP election could be made with respect to the IRA, the IRS observed that the trust was a "mere conduit" for payment of the IRA income to the spouse and concluded that the spouse had a qualifying income interest as required by section 2056(b)(7)(B) even though the IRA income was payable in the first instance to the trust rather than directly to the spouse.

a. Private Letter Ruling 9204017 holds that an individual retirement annuity qualified for the marital deduction under the special annuity rules of section 2056(b)(7)(C), even though payable to a QTIP trust, where the terms of the trust required the redistribution of the annuity payments within the calendar year of receipt.

b. The trust also provided that no taxes or trust expenses, including trustee’s fees, were to be allocated to those payments.

D. Drafting Considerations.

1. Using the above authorities to justify the designation of a QTIP trust as the beneficiary of an IRA requires drafting appropriate provisions in the beneficiary designation instrument for the IRA account, the QTIP trust itself and, sometimes, the governing instrument of the IRA.

2. The beneficiary designation form should name a trust satisfying the requirements of the proposed regulations previously outlined.

a. The trust should be a valid trust under state law (presumably an inter vivos trust).

b. The trust should also have as beneficiaries the spouse and others who are either named or ascertainable, with the spouse being the beneficiary whose life expectancy is the shortest.
3. Assuming the spouse is the beneficiary with the shortest life expectancy, the spouse's life expectancy may be used in making a distribution election, in accordance with the minimum distribution requirements of section 401(a)(9) and regulations thereunder, to distribute the account over a fixed period either within the combined life expectancies of the account owner and the spouse or over the life expectancies of the owner and spouse as recomputed annually.

4. Since installment methods of distribution do not automatically require the distribution of all income, the instrument should further require the distribution of an amount equal to all of the income of the IRA in any year in which the income is greater than the installment distribution otherwise payable.

   a. The importance of satisfying the all income requirement is underscored by the position taken by the IRS in Technical Advice Memorandum 9220007, involving an IRA naming as beneficiary a QTIP trust.

   b. The IRA plan document contemplated, and the account owner apparently elected, a form of installment distribution, but no attempt was made during the owner's lifetime to require the distribution of all income from the IRA to the marital trust following his death.

   c. Since the installment distribution method did not ensure the distribution of all income on a current basis from the IRA, the IRS held that the spouse was not entitled to receive a qualifying income interest for life as required of QTIP arrangements by section 2057(b)(7)(B)(ii).

   d. The attempt by the trustees of the QTIP trust to cure the problem by electing to take additional distributions equal to the amount of the income of the IRA was ineffective, according to the IRS, because the resulting income interest did not "pass from the decedent" as required by section 2056(b)(7)(B)(i).

   e. The provisions of the marital trust giving the spouse the right to require that all trust property be made productive of income
also did not cure the income entitlement problem. The IRS concluded that the IRA was not an asset of the QTIP trust.

f. In contrast, Private Letter Ruling 9052015 held that an IRA qualified for QTIP treatment where the account was payable in installments over the spouse's life expectancy. This holding should not be relied upon, however. The favorable conclusion in the ruling was seemingly based on representations that the installment payments would always be greater than the "projected" trust income.

5. The QTIP trust should, consistent with Rev. Rul. 89-89, supra, contain the following provisions:

a. The trust should require that all income received from the IRA be redistributed by the trustee to the spouse in the year of receipt.

b. In light of the importance of the "mere conduit" analysis in Rev. Rul. 89-89, and the stated facts in Private Letter Ruling 9204017 that taxes and trust expenses were not to be charged to the annuities passed through the trust, the trust should provide that all taxes, fees, and expenses otherwise chargeable against income received from the IRA must be charged instead to trust principal.

c. The trust should also require the trustee to exercise discretionary powers as beneficiary of the IRA so as to insure that all income of the IRA will be paid on a current basis to the trust, if the election of the account owner to that effect is not fully binding on all parties.

i. The binding effect on the beneficiary of a distribution election made by the deceased account owner is questionable under the terms of many IRA governing instruments.

ii. A trust provision requiring the trustee to exercise powers so as to insure the current distribution of all income would seem to be a prudent precaution. See Priv. Letter Rul. 9229017, approving an IRA for QTIP treatment where both the IRA...
distribution election and the terms of
the trust required the current
distribution of all income in a
consistent manner. See also, Priv.
Letter Rul. 9043054 for a similar result.

6. Consideration should also be given to whether the
governing instrument of the IRA is consistent with
the beneficiary designation and distribution
provisions outlined above.

a. Many IRA governing instruments do not
contemplate that a trust may be named a
beneficiary of the account and do not,
therefore, contemplate that the person whose
life expectancy is used in calculating
distributions may differ from the person who
actually receives the distributions and
exercises beneficial powers.

b. Consideration should be given in such cases
to amending the governing instrument.

i. Such an amendment may cause the governing
instrument to lose the benefit of
existing IRS determinations as to the
qualified status of the IRA.

ii. Many financial institutions serving as
custodian or trustee of IRAs obtain group
determination letters covering all
accounts created under their master or
prototype plans. Modification of the
terms governing the accounts may cause
these rulings to cease to apply.

c. The account document should also be reviewed
to verify that it permits distributions
consistent with the approach recommended
above. One of the problems with the IRA
considered in Technical Advice Memorandum
9220007, discussed above, may have been that
it did not clearly permit payments of income
in excess of the amounts resulting from an
installment distribution election.
IX. FINAL QTIP REGULATIONS

A. The Proposed QTIP Regulations.

1. The IRS issued the proposed regulations under sections 2044, 2056, 2207A, 2519, 2523, and 6019 of the Internal Revenue Code on May 21, 1984.

2. Following the issuance of the proposed regulations, the IRS received numerous comments from various groups and individuals and there were several changes to the law dealing with the federal estate tax marital deduction.

B. The Final QTIP Regulations.

1. The IRS issued the final regulations on March 1, 1994, nearly 10 years after the issuance of the proposed regulations and more than 12 years after the enactment of section 2056(b)(7).

2. The final regulations reflect written comments received by the IRS and changes to the law made by:

   a. The Deficit Reduction Act of 1984;

   b. The Tax Reform Act of 1986;

   c. The Technical and Miscellaneous Revenue Act of 1988;

   d. The Omnibus Budget Reconciliation Act of 1989;

   e. The Revenue and Reconciliation Act of 1990; and


C. Summary of Changes.

1. The final regulations make the following changes or additions to the original proposed regulations:

   a. Availability of installment payment of estate taxes under section 6166;

   b. Guidance on evidence required to rebut the presumption that the first deceased spouse's
estate or the donor spouse claimed a marital deduction;

c. Changes dealing with the term "specific portion;"

d. Clarification as to who is responsible for making the QTIP election with respect to property not in the executor's possession;

e. Availability of a protective QTIP election under limited circumstances;

f. Continuation of the position that an income interest does not qualify as a qualifying income interest if the income interest is contingent on the executor's election of QTIP treatment;

g. Elimination of the example allowing QTIP treatment for an annuity purchased by an executor pursuant to the decedent's direction;

h. Clarification concerning the treatment of annuities;

i. Clarification concerning the division into separate trusts of a single marital trust over which a partial QTIP election was made;

j. Addition of provisions dealing with "stub" income;

k. Clarification as to when a charitable remainder trust may qualify for the QTIP election;

l. Reflection of the addition of section 2056(b)(9) and 2523(h) which deny a double deduction for the same property for the same decedent;

m. Elimination of the transitional rules for computing the amount of the allowable estate tax marital deduction for decedents dying from 1977 to 1981;

n. Changes to the rules concerning the "net gift" treatment of a disposition of a qualifying income interest in property subject to a QTIP election;
o. Revisions of the examples dealing with the transfer of a portion of an income interest in a trust subject to a partial election to reflect the application of section 2702;

p. Revisions concerning the timing of a QTIP election on a gift tax return;

q. Addition of examples dealing with an inter vivos QTIP where the donor retains a secondary income interest; and

r. Revisions dealing with the marital deduction and a noncitizen spouse.

2. In addition, the IRS has requested comments in the following areas:

a. The application of the Energy Policy Act of 1992 to the treatment of certain annuities; and

b. Whether the unitrust or annuity interest in a charitable remainder trust qualifies as a qualifying income interest for life in view of the amendments made by the Energy Policy Act of 1992.

D. Applicability of Section 6166.

1. The proposed regulations did not mention whether the installment payment of estate taxes under section 6166 would be available for business interests included in the surviving spouse’s estate under section 2044.

2. The final regulations include a reference to section 6166 to clarify that property included in the surviving spouse’s gross estate under section 2044 is treated as passing from the surviving spouse upon the surviving spouse’s later death for purposes of determining whether the surviving spouse’s estate is eligible to pay the estate tax liability in installments under section 6166.

E. Evidence Required to Rebut Presumption of QTIP Election.

1. The final regulations include guidance to taxpayers on the evidence that is required to rebut the presumption that property in which the surviving spouse had a qualifying income interest
for life was deducted by the first deceased spouse’s estate under section 2056(b)(7) or by the donor spouse under section 2523(f) in determining the estate or gift tax liability.

2. Under the final regulations, if a marital deduction is taken on either the estate or gift tax return with respect to the transfer which created the qualifying income interest, it is presumed that the deduction was allowed for purposes of section 2044. To avoid the inclusion of property in the surviving spouse’s estate, the executor of the surviving spouse’s estate must establish that the deduction was not taken for the transfer that created the qualifying income interest.

3. One example given in the final regulations of evidence rebutting the presumption is the executor producing a copy of the estate or gift tax return filed with respect to the transfer by the first spouse or the first spouse’s estate establishing that no deduction was taken under section 2523(f) or section 2056(b)(7). Another example cited is the executor establishing that no return was filed because the value of the estate was below the threshold requirement for filing.

F. Specific Portion.

1. Several changes were made regarding the definition of the term "specific portion" as used in sections 2056(b)(5), 2056(b)(7), 2523(e), and 2523(f).

2. In general, a spousal interest qualifies for the marital deduction under section 2056(b)(5) or section 2523(e) if the spouse receives an income interest with respect to the entire interest in property or a "specific portion" of the entire interest, coupled with a general power of appointment over the entire corpus or a specific portion of the entire corpus.

3. Similarly, an interest is eligible for the qualified terminable interest property election under section 2056(b)(7) or section 2523(f) if the spouse receives an income interest in the entire interest or a specific portion of the interest.

4. In Northeastern Pennsylvania National Bank and Trust Company v. United States, 387 U.S. 213 (1967), the Supreme Court held that for purposes
of section 2056(b)(5) a right to receive a specified periodic payment ($24,000 per year) from a trust also constitutes a right to receive the income from a specific portion of the trust corpus (that is, the pecuniary amount of corpus based upon the assumed rate of return used in the regulations that would generate the periodic payment). In reaching this conclusion, the Court invalidated Regulations section 20.2056(b)-5(c) to the extent it precluded characterization of the specific periodic payment as a right to income from a specific portion of trust corpus.

5. In Estate of Alexander v. Commissioner, 82 T.C. 34 (1984), which was affirmed without opinion by the 4th Circuit, the Tax Court held that a power of appointment over a pecuniary amount of trust corpus constituted a power of appointment over a "specific portion" of the trust property, thus qualifying the property for the marital deduction under section 2056(b)(5).

6. The proposed regulations provide a definition of the term "specific portion" that conforms to the Supreme Court's decision in Northeastern Pennsylvania National Bank.

7. The Energy Policy Act of 1992 amended section 2056(b) and section 2523(e) and (f) to limit the term "specific portion" to refer to a portion determined only on a fractional or percentage basis. These amendments are generally effective in the case of estates of decedents dying after October 24, 1992 (the date of enactment of the Energy Policy Act of 1992) and to gifts made after that date, subject to certain transitional rules.

8. The final regulations adopt the definition in the proposed regulations of "specific portion" as a fractional or percentage interest. Under the final regulations, a partial interest in property is treated as a specific portion of the entire interest if the rights of the surviving spouse in income and the spouse's general power of appointment constitute a fractional or percentage share of the entire property interest. The surviving spouse's interest must reflect its proportionate share of the increase or decrease in the value of the entire property interest to which the spouse's income rights and the general power of appointment relate.
9. This rule applies to decedents dying after October 24, 1992 if property passes to the spouse pursuant to a will executed before October 24, 1992 and either the spouse was under a mental disability to change the disposition or the spouse dies before October 24, 1995. Accordingly, an estate plan with an Alexander-type of marital disposition must be amended before October 25, 1995.

10. The IRS has requested comments on the application of the Energy Policy Act of 1992 to the treatment of annuities as described in the last sentence of section 2056(b)(7)(B)(ii).

G. Definition of an Executor.

1. Regulations section 20.2056(b)-7(b)(3) has been revised to clarify that an executor who is appointed, qualified, and acting within the United States within the meaning of section 2203 is responsible for making the QTIP election, even with respect to property not in the executor’s possession.

2. If there is no executor appointed, the person in actual or constructive possession of the qualifying income interest property may make the election.

3. If there is no executor acting within the United States, the person in actual or constructive possession may also make the election with respect to other property not in the actual or constructive possession of that person. For example, if there is no executor acting, the trustee of an inter vivos trust that is included in the gross estate of the decedent may make the election for property not only in the trust but also outside the trust (notwithstanding that the property is not in the trustee’s possession).

H. Protective QTIP Election.

1. Paragraph (c) of Regulations section 20.2056(b)-7 provides limited circumstances under which a protective QTIP election is recognized for estate tax purposes.

2. The protective election will be recognized only if at the time the estate tax return is filed a bona fide issue is presented the resolution of which is uncertain at the time the federal estate tax
return is filed, that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive.

3. Because of changes made to Schedule M of Form 706, the IRS considered it unnecessary to provide for a protective election for a trust that fails to meet the requirements of section 2056(b)(5).

4. Once made, the protective election is irrevocable and cannot be revoked. If a protective election is made on the basis that a bona fide question exists regarding the inclusion of an asset in the gross estate and it is later determined that the asset is includible, the protective election becomes effective with respect to the asset and cannot thereafter be revoked.

5. There is no provision for a protective gift tax QTIP election. The IRS considered a protective gift tax QTIP election but rejected it because of the perceived absence of a need for such an election.

I. Income Interest Contingent on QTIP Election.

1. The final regulations continue the position that an income interest does not qualify as a qualifying income interest if the income interest is contingent on the executor's election of QTIP treatment.


3. In Estate of Robertson and Estate of Clayton, the appellate courts found that under section 2056(b)(7)(B), qualified terminable interest property is defined as property for which an election is made. Thus, qualification of property for QTIP treatment is always contingent on the executor's election.

4. The IRS continues to assert that if the substantive rights and interests the spouse receives in trust property are dependent upon the
executor’s post-death exercise of discretionary authority, the rights and interest received by the spouse cannot properly be characterized as qualifying as of the time of death, nor can the rights and interest received by the spouse be characterized as passing from the decedent to the spouse, as required under section 2056(a).

5. The IRS believes that the appellate court’s position is inconsistent with the fundamental principle that qualification of an interest in property for the marital deduction is determined as of the date of death.

J. No Marital Deduction for Direction to Purchase Commercial Annuity.

1. The proposed regulations had an example where an executor pursuant to a decedent’s direction purchased a commercial annuity that qualified for the QTIP election. The final regulations did not adopt this example.

2. According to the IRS, the example is in conflict with section 2056(b)(1)(C) that provides that a marital deduction is not allowed with respect to any terminable interest if the interest is to be acquired by the executor for the surviving spouse pursuant to the direction of the decedent.

K. Division into Separate Trusts after Partial QTIP Election.

1. Regulations section 20.2056(b)-7(b) provides that a marital trust that qualified for QTIP treatment may be divided into separate trusts to reflect a partial election with respect to the trust if authorized by the governing instrument or local law.

2. This provision has been clarified to provide that the severance of the trust must occur no later than the termination of the period of estate administration.

3. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.

4. The provision has been further clarified to indicate that, although the severed trust must be
funded based on fair market values as of the date of division, the trust need not be funded with a pro rata portion of each asset.

L. Treatment of "Stub" Income.

1. The final regulations make it clear that the income accruing between the last date income was distributed to the surviving spouse and the date of the surviving spouse’s death is not required to be distributed to the surviving spouse or to the surviving spouse’s estate.

2. This stub income is included in the estate of the surviving spouse under section 2044.

3. Until Congress codifies the handling of stub income, draftsmen should continue to provide for stub income to go to the surviving spouse’s estate in view of Shelfer v. Commissioner, 103 T.C. No. 2 (1994), which held that QTIP treatment was not proper where the stub income went to the remainderman.

M. Treatment of Annuities.

1. Section 1941 of the Energy Policy Act of 1992 amended section 2056(b) to add subparagraph (10) to define the term "specific portion" to only include a portion determined on a fractional or percentage basis. This provision was effective for decedents dying on or before October 24, 1992.

2. For estates of decedents dying on or before October 24, 1992, a surviving spouse’s lifetime annuity payable from a trust or other assets is treated as a qualifying income interest.

3. There is a transitional rule for property passing pursuant to a will or revocable trust executed on or before October 24, 1992 for decedents dying before October 24, 1995.

4. The 1992 amendment to section 2056(b)(7)(B)(ii) stated that an annuity shall be treated in a manner similar to an income interest in property to the extent provided in regulations. The IRS has invited comments on the application of this provision to the treatment of annuities.
N. Charitable Remainder Trusts.

1. Regulations section 20.2056(b)-8 has been revised to provide that a charitable remainder trust may qualify for the marital deduction under section 2056(b)(7) in situations where the surviving spouse is the only noncharitable beneficiary of the charitable remainder trust.

2. If the surviving spouse is the only noncharitable beneficiary of a charitable remainder annuity or unitrust, section 2056(b)(1) does not apply to the interest in the trust. Accordingly, the value of the interest passing to the spouse qualifies for a marital deduction under section 2056(b)(8) and the value of the remainder interest qualifies for a charitable deduction under section 2055. No QTIP election may be made with respect to this property. (No election is necessary in any event.)

3. If the surviving spouse is not the only noncharitable beneficiary, the trust may come within the annuity transitional rules and the spousal annuity or unitrust may qualify under Regulations section 20.2056(b)-(7)(e) as a qualifying income interest. If the decedent dies after October 24, 1992, and the surviving spouse is not the only noncharitable beneficiary of a charitable remainder trust, the question is whether future regulations will treat the annuity in a manner similar to an income interest in property (the amendment made by the Energy Policy Act of 1992).

O. Right of Recovery of Estate Taxes in the Case of QTIP Property.

1. If the gross estate includes QTIP property by reason of section 2044 (the surviving spouse has died and the QTIP property is includible in the surviving spouse’s estate), the estate of the surviving spouse is entitled to recover from the person receiving the property the amount of federal estate tax attributable to that property.

2. Failure of an estate to exercise a right of recovery is treated as a transfer for federal gift tax purposes of the unrecovered amounts from the persons who would benefit from the recovery to the persons from whom the recovery could have been obtained. A delay in the exercise of the right of recovery may be treated as an interest-free loan.
with appropriate gift tax consequences under section 7872.

3. These provisions do not apply to the extent that the surviving spouse's will provides that a recovery shall not be made or to the extent that the beneficiaries cannot otherwise compel recovery. If the surviving spouse gives the executor discretion to waive the right of recovery and the executor waives the right, no gift occurs.

P. Disposition of Income Interest.

1. The proposed QTIP regulations treated the section 2519 gift of an income interest as a net gift. If the surviving spouse transferred all or part of the spouse’s income interest in QTIP property, the spouse was making a gift under section 2519. Under section 2207A(b) a spouse has the right to recover from the persons receiving the transferred property any gift tax imposed on the transfer. In determining the amount of the gift under section 2519, the value of the transfer is reduced by the amount of the gift tax reimbursement.

2. The final regulations delete the reference in Regulations section 25.2519-1(c) treating the transfer as a net gift. The IRS anticipates that the issue regarding net gift treatment will be the subject of subsequent proposed regulations and requests comments on this issue.

Q. Gift Tax QTIP Election.

1. The final regulations reflect the changes made to section 2523(f)(4)(A) by the Tax Reform Act of 1986 that allow the gift tax QTIP election to be made on or before the date prescribed for filing a gift tax return, including extensions.

2. This reflects the cure of the problem of extending income and gift tax returns and not being able to make a QTIP election.

R. Denial of Double Deduction.

1. The final regulations make it clear that the value of an interest in property may not be deducted for federal estate tax purposes more than once with respect to the same decedent.
2. Where the decedent transfers a life estate in a farm to the surviving spouse with a remainder to charity, the entire property is treated as passing to the spouse if a QTIP election is made. No part of the value of the property will qualify for a charitable deduction under section 2055.

S. Changes Made Because of Chapter 14.

1. Two examples that were in the proposed regulations were changed to reflect the enactment of Chapter 14.

2. Examples 4 and 5 under Regulations section 25.2519-1(g) were revised to include a reference to section 2702. In those examples, the surviving spouse makes a gift of 40% of the surviving spouse interest in a QTIP trust where a partial QTIP election had been made. The final regulations referred to section 2702 and states that the surviving spouse's retained income interest would be valued at zero under that section, thereby increasing the section 2519 gift.

T. Changes to Inter Vivos QTIP Regulations.

1. The final regulations made several changes to the proposed regulations under section 2523.

2. The final regulations make it clear that no marital deduction is allowed with respect to a gift for transfers to a spouse who is not a citizen of the United States at the time of the transfer.

3. Example 9 to Regulations section 25.2523(f) makes it clear that a QTIP election may not be made for an income interest following the donor's income interest.

4. Example 10 to Regulations section 25.2523(f) makes it clear that the donor may reserve an income interest following an income interest given to the donor's spouse. The income interest given to the donor's spouse will qualify for QTIP treatment under section 2523(f). Under the facts of Example 10, the donor died before the spouse and no portion of the trust corpus was includible in the donor's gross estate because of the donor's retained interest in the trust.
U. Rejected Comments.

1. The IRS rejected the comment suggesting that an inter vivos transfer in trust where the donor retains an income interest and the spouse receives the right to trust income on termination of the donor's preceding life income interest should qualify for QTIP treatment under section 2523(f).

2. The IRS still refuses to allow the surviving spouse to have a lifetime power of appointment over QTIP property.

X. CHARITABLE LEAD TRUSTS

A. General Description of a Charitable Lead Trust.

1. A charitable lead trust is the reverse of a charitable remainder trust. With a charitable lead trust, the charitable interest precedes or "leads" the remainder interest which generally passes to the donor's descendants.

2. A charitable lead trust offers a way to benefit charity while keeping the capital in the family without the need for "wealth replacement" techniques.

3. The qualifying charitable lead interest may either be in the form of an annuity interest or a unitrust interest and may be created during lifetime or at death.

4. Although qualified charitable lead trusts are not as strictly regulated as charitable remainder trusts, many sections of the Internal Revenue Code must be considered.

B. Primary Uses of Charitable Lead Trusts.

1. Because all types of split-interest charitable trusts result in a shifting of a part of a family's income or wealth to charity, charitable lead trusts are best suited for families that have a true desire to benefit charity.

2. Leverage for transfer tax purposes is available through a gift or estate tax charitable deduction for the annuity or unitrust interest.
charitable lead trust with an asset such as a limited partnership interest that has a good cash flow but can be discounted for transfer tax purposes.

C. **Type of Charitable Lead Trusts.**

1. Charitable lead annuity trust -- A fixed dollar amount or fixed percentage of the initial net fair market value is payable to one or more charitable organizations for the term of the trust.

2. Charitable Lead Unitrust -- A fixed percentage of the net fair market redetermined annually is payable to one or more charitable organizations for the term of the trust.

3. Nonqualifying or Common Law Lead Trust -- The income or other interest payable to charity is in a form other than a guaranteed annuity or unitrust interest that is not a completed gift. If structured to avoid section 2702 (for example, gift of the remainder to a nonfamily member), the remainder value may be smaller than with an annuity or unitrust interest.

4. Inter Vivos vs. Testamentary -- The principal difference is a carry over of basis when the trust is created during lifetime.

5. Grantor vs. Nongrantor -- Grantor trust structure is not common but can be used as a sophisticated income tax planning tool and in estate planning situations where intentional grantor trust treatment is desired.

6. Term of Years vs. Life or Lives -- These can generally be mixed and matched in any fashion without the strictures that apply to charitable remainder trusts.

D. **Applicable Internal Revenue Code Sections.**

1. Section 170(f)(2)(B). No income tax charitable deduction is allowed for the charitable lead interest unless it is in the form of a guaranteed annuity or unitrust interest and the grantor is treated as the owner of such interest for purposes of section 671.
2. Section 642(c). The charitable lead trust is allowed an unlimited income tax charitable deduction for amounts of gross income paid to charity.

3. Section 644. If a trust sells an appreciated asset within two years of its transfer to the trust, a special tax is payable by the trust equal to the income tax the donor would have paid had the donor sold the asset.

4. Section 2055(e)(2)(B). No estate tax charitable deduction is allowed for the charitable lead interest unless it is in the form of a guaranteed annuity or unitrust interest.

5. Section 2522(c)(2)(B). No gift tax charitable deduction is allowed for the charitable lead interest unless it is in the form of a guaranteed annuity or unitrust interest.

6. Section 2642(e). The inclusion ratio for a charitable lead annuity trust is adjusted by increasing the numerator by interest using the same rate used to determine the charitable deduction.

a. Consequently, in a charitable lead annuity trust it may be best to delay allocating GST exemption until the end of the lead interest. Query whether an amended notice of allocation is permissible to "recover" excess GST exemption where the exemption is allocated at the outset and upon application of section 2642(e) there would be an over allocation.

b. In a charitable lead unitrust, the GST exemption can be precisely allocated at the outset when the trust is created, and opportunities for leverage exist because the amount of the allocation necessary to produce a zero inclusion ratio is the calculated value of the remainder for gift and estate tax purposes.

7. Section 4947(a)(2). As a split-interest trust, a charitable lead annuity or unitrust is subject to the private foundation rules of sections 508(e) and 4941 through 4945.

8. Section 4947(b)(3)(A). Sections 4943 and 4944 (excess business holdings and jeopardy
investments) do not apply to a charitable lead annuity or unitrust if all the income interest (and none of the remainder interest) is payable to charity and the charitable deduction amount is not more than 60% of the value of the trust.

9. Section 7520. This section sets forth the special rules to be used in valuing annuities, life estates, and interests for a term of years.

a. Fluctuations in the section 7520 rate have little effect on unitrust interests. However, if the unitrust payout rate is lower than the section 7520 rate, the unitrust will produce a larger charitable deduction than an annuity trust because the excess of the assumed return over the payout rate is deemed to cause an increase in the trust assets against which the unitrust payout will be calculated.

b. Low section 7520 rates increase the value of a lead annuity interest (giving a greater charitable deduction) and reduce the taxable remainder.

c. High section 7520 rates decrease the value of a lead annuity interest (giving a smaller charitable deduction) and increasing the taxable remainder.

d. Conversely, in a charitable remainder trust, higher section 7520 rates produce a greater charitable deduction through a larger remainder value, and lower rates produce a smaller charitable deduction.

E. Cases and Rulings Relating to Lead Trusts.

1. Rebecca K. Crown Income Charitable Trust v. Commissioner, 8 F.3d 571 (7th Cir. 1993). Amounts in excess of the annuity specified in the trust agreement are not deductible under section 642(c) even though the amounts are not in commutation of future amounts and may be within the overall annuity obligation when considered in the aggregate.

2. The Ann Jackson Family Foundation v. Commissioner, 15 F.3d 917 (9th Cir. 1994). Distributions from a charitable lead trust to a private foundation are not includible in the distributable amount of the
private foundation for purposes of the minimum payout requirements of section 4942. Regulations section 53.4942(a)-2 was found to be invalid and inconsistent with the 1981 amendment to section 4942. Query whether the same logic might apply to invalidate Regulations section 53.4940-1(d)(2) concerning the character of distributions from a lead trust to a private foundation for purposes of the excise tax on net investment income.

3. *Rifkind v. United States*, 84-2 U.S.T.C. ¶ 13,577 (Cls. Ct. 1984). The decedent’s ability to participate as an officer and director of a foundation in the selection of charitable recipients of grants from the foundation, which was funded with income from a charitable lead trust created by the decedent, constituted a section 2036(a) retained power to control the enjoyment of the trust property and caused inclusion of the trust in the gross estate.

   a. A similar problem can arise where a trustee is given a power (for example, selection of the charities to receive the lead interest) that, if held by the grantor, would have caused inclusion in the gross estate. See *McCabe v. United States*, 475 F.2d 1142 (Ct. Cl. 1973), where there was clear evidence that the trustee, in making supposedly discretionary distributions, was acting under the control of the transferor.

   b. Refer to Private Letter Ruling 9331015 for suggested provisions that can be used to avoid section 2036(a) problems.

   c. If the charitable lead trust is created by a corporation, the charitable deduction should not be jeopardized because its directors are involved in selecting the charitable recipients. See Private Letter Ruling 9350009 concerning the funding of a private foundation by a corporation.

4. *Boeshore v. Commissioner*, 78 T.C. 523 (1982). The charitable lead unitrust interest may be preceded in time by a private lead unitrust interest without losing the deduction for the charitable interest. The court found Regulations section 20.2055-2(e)(2)(vii)(g) to be invalid. But see Action on Decision 1987-003 (June 15, 1987) (acquiescence in result only) where the Internal
Revenue Service states that it will continue to apply the regulations in circumstances presenting the potential for abuse or a risk the charity will not receive its interest.

5. Rev. Rul. 72-552, 1972-2 C.B. 525. The value of property transferred during lifetime to a charitable organization is includible in the decedent's gross estate under section 2036(a) where the decedent was an officer and director of the organization that had authorized the decedent and another as officers to select the charitable recipients.

6. Rev. Rul. 78-101, 1978-1 C.B. 301. The failure to designate specific charitable recipients of a charitable lead unitrust interest does not disqualify the interest for a charitable deduction where the trustee has the power to select the recipients.

7. Rev. Rul. 83-75, 1983-1 C.B. 114. The distribution by a trust of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a charitable organization results in a taxable gain to the trust. The trust is entitled to a charitable deduction under section 642(c) equal to the amount of gain recognized upon the distribution.

8. Rev. Rul. 88-27, 1988-1 C.B. 331. A charitable lead annuity interest does not qualify as a guaranteed annuity interest where the trustee has the discretion to commute and prepay the charitable interest before the expiration of the specified term of the trust. This result obtains even where the instrument states that the rate of commutation is equal to the rate used to compute the original charitable gift tax deduction taken by the grantor. Query whether paying the unpaid annuity installments on an accelerated basis, without a discount, is permissible.

9. Rev. Rul. 88-82, 1988-2 C.B. 336. No charitable deduction is allowable for the lead interest where any excess earnings are distributable to the remaindermen. However, excess earnings may be accumulated for future distribution to the remaindermen without being subject to sections 4943 and 4944 if the lead interest does not violate the 60% test.

F. Examples of Uses of Lead Trusts.

1. **Unified Credit Gift Through Segregation of Portion of Portfolio.** Facts: Widower with one child and a modest estate consisting largely of a blue chip portfolio wants to make provision for his church and university and use a portion of his unified credit to remove future growth from his gross estate. Solution: Create a simple inter vivos charitable lead annuity trust with high basis common stocks and naming daughter as trustee. Pay fixed amount annually to each charity for grantor's life. Instruct broker to issue checks once a year.

2. **Leverage of Unified Credit.** Facts: Estate owner wishes to make the most effective use of his unified credit at death and does not mind making his children wait to receive their inheritances. Solution: Create a testamentary charitable lead unitrust for a term of years and let the children designate the charitable recipients.

3. **Leverage of GST Exemption.** Facts: In addition to making the most effective use of his unified credit, the estate owner wishes to maximize the advantages of his GST exemption. Solution: Create a testamentary charitable lead unitrust for a term of years with the grandchildren as remaindermen.

4. **Reduction of Estates Taxes.** Facts: Estate owner wishes to reduce estate taxes and is willing to have his children's receipt of their inheritances deferred for an extended period. Solution: Create a testamentary charitable lead unitrust for a term of years commencing at the death of the estate owner, or at the surviving spouse's death in the case of a marital trust.

5. **Source for Funding Donor Advised Fund.** Facts: Individual wishes to support a community foundation by creating a donor advised fund for his family. Solution: Create an inter vivos or testamentary charitable lead annuity or unitrust designated to provide the community foundation with lead trust payments that in the aggregate...
will create an appropriately funded donor advised fund.

6. **Substitute for Private Foundation.** Facts: 
Husband and wife like the idea of a private foundation as a vehicle for lifetime charitable giving but do not want the capital to be lost by the family. Solution: Create an inter vivos charitable lead annuity or unitrust with one spouse as grantor and the other as trustee. The trustee spouse makes the lead payments to the family's favorite charities periodically during the year just as could be done through a private foundation.

7. **Source for Funding Private Foundation.** Facts: 
Family has existing private foundation, and parents desire to enhance its endowment without depriving the children of their ultimate inheritances. Solution: Create an inter vivos charitable lead annuity or unitrust for a relatively short term with the family foundation as the charitable recipient.

8. **Funding Family Charitable Giving.** Facts: Parents and children annually give substantial amounts to various charitable organizations and intend to continue this pattern, and parents wish to make taxable gifts to shift growth from their gross estates but do not want to sacrifice their cash flow and existing standard of living. Solution: Create a long-term inter vivos charitable lead unitrust with parents income-producing assets and with children as trustees.

9. **Widow’s Gift of Marital Trust Assets.** Facts: 
Widow with independent wealth and ability to make a lifetime withdrawal or appointment of the marital trust created by her husband desires to use his assets to establish an endowment in his memory at his university while removing growth in the assets from her gross estate. Solution: Create an inter vivos charitable lead annuity or unitrust with a payout rate and term to give the university the necessary endowment amount.

10. **Rate Arbitrage or Reduction of Large Unusual Gain.** Facts: Taxpayer anticipates being in a lower bracket in future years and desires to use charitable planning to reduce his taxes without depriving his family of the underlying assets. Solution: Create an inter vivos grantor
charitable lead annuity or unitrust, with a payout rate and term suitable to the grantor, and structured as a grantor trust.

11. **Art Collection.** Facts: Widow with large art collection desires to use the collection to provide an endowment to her university and to reduce her estate taxes. Solution: Create a testamentary charitable lead annuity trust, with the children as trustees, authorizing the trustees to satisfy the annuity by distributing to the university art objects in kind that can be sold by the university to produce cash to fund the endowment.

12. **Closely Held Stock.** Facts: Father wishes to transfer future growth in family's C corporation to his children while at the same time benefiting the family's friendly charity. Solution: Create an inter vivos charitable lead annuity trust that will not be subject to section 4943, will be funded with cash and stock, and will be authorized to distribute stock in kind to the charity in satisfaction of the annuity obligation, after which the charity could offer the stock to the corporation for redemption.

13. **Double Discounts for Closely Held Stock.** Facts: Father wishes to give minority-interest stock in the family's C or S corporation to his children and is willing to postpone their receipt of the shares and to allow the dividends to benefit charity. Solution: Create an inter vivos charitable lead annuity or unitrust (structured as a grantor trust if S stock is involved) funded with a certain amount of cash in addition to the stock. For gift tax purposes there are double discounts -- first, discounts for minority interest and lack of marketability; and second, for the value of the charitable lead annuity or unitrust interest. The cash in the trust, as augmented by dividends, can be used to pay the charitable lead interest, and the stock at its appreciated value will pass to the children upon termination of the trust.

14. **Tax-Exempt Bonds.** Facts: Owner of tax-exempt bonds wishes to use these bonds to obtain a current income tax deduction. Solution: Create an inter vivos charitable lead annuity or unitrust structured as a grantor trust that will provide the grantor with a current income tax deduction.
equal to the annuity or unitrust value and without having taxable income to report in future years.

15. **Corporate Lead Trust.** Facts: Corporation has "unwanted" appreciated assets that would generate corporate level tax if sold or distributed to shareholders. Solution: Create a charitable lead annuity or unitrust for a term of years and structure trust as a grantor trust if circumstances warrant. Offers opportunities to avoid the General Utilities tax and to shift growth outside the corporation if the remainder interest is assigned to the shareholders.

16. **Leverage for Spouse’s Poor Health.** Facts: Husband and wife wish to create charitable lead trust as part of their gift program. Wife is younger than husband and is in poor health but can be expected to live for more than one year. Solution: Create a charitable lead annuity or unitrust to continue for the wife's life. A larger charitable deduction will be available than if based on husband’s life, and the remainder will likely become possessory at a much earlier time.

17. **Leverage for Unrelated Person’s Poor Health.** Facts: Estate owner wishes to create a charitable lead trust with significant leverage. Solution: Create an inter vivos charitable lead annuity or unitrust for the life of a younger person with a significantly reduced life expectancy (for example, a person with AIDS) who can be expected to live at least one year.

18. **Avoiding Private Foundation Rules.** Facts: Childless business owner wishes to give stock in family corporation to a charitable lead trust (for the ultimate benefit of his nephew) that can, without self-dealing, sell all or a portion of the stock back to the company or to the grantor if the nephew decides to leave the business. Solution: Create a nonqualifying lead trust for the nephew, avoiding section 2702. The trust will not be a section 4947(a)(2) split-interest trust subject to the section 4941 self-dealing rules on any sale of the stock because no gift tax charitable deduction is allowable.

19. **Avoiding High State Income Taxes.** Facts: Individual lives in a state that has high state income taxes and already has more charitable deductions being carried forward than he can use.
Solution: Create a charitable lead annuity or unitrust as a nongrantor trust, thereby removing the income from his returns, both federal and state, and effectively getting a 100% deduction and doing the tax authorities out of significant dollars.

20. **Cascading Lead Trusts.** Facts: An investor with many entrepreneurial investments, and who is otherwise willing to have the investments go to charity, wishes to use zeroed-out GRAT techniques to produce a benefit without transfer tax for his children if one or more of the investments have outstanding growth. Solution: Create a series of charitable lead annuity trusts having staggered or "cascading" termination dates.

**XI. SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS**

**A. Tax Considerations.**

1. The general rules governing the tax treatment of split-dollar arrangements are found in Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110, 1966-1 C.B. 12, both of which predate section 7872. However, the IRS has continued to issue favorable private letter rulings on both collateral assignment and endorsement method arrangements with both employees and shareholders. See, for example, Private Letter Rulings 9037012 and 9318007.

2. In view of the liberal position of the Internal Revenue Service in Technical Advice Memorandum 9323002, allowing the designated owner of the policy to be changed by submission of a supplementary application without triggering the three-year rule of section 2035, considerable flexibility is available to design trust ownership arrangements while a split-dollar plan is being implemented.

3. In the case of a controlling shareholder who assigns his rights, it is imperative to structure things as described in Situation 3 of Rev. Rul. 76-274, 1976-2 C.B. 278, in order to avoid attribution of corporate incidents of ownership and the result in *Estate of Dimen v. Commissioner*, 72 T.C. 198 (1979).

4. Rev. Rul. 78-420, 1978-2 C.B. 67, discusses the income and gift tax consequences where the
employee's spouse is the owner. The amount of the gift because of the employer's premium payment is the value of the insurance protection provided by the employer (that is, the P.S. 58 cost or the insurer's yearly term rate). Technical Advice Memorandum 8206014 is an example of how not to structure split-dollar insurance with the spouse of an insured who was the 100% shareholder.

5. In "equity" split-dollar, there is no clear authority that the build up will not be taxed to the employee currently as an "other benefit" under Rev. Rul. 66-110 or on a deferred basis at rollout under section 83. However, most insurance professionals install these leveraged arrangements on the assumption, which is probably correct, that all forms of split-dollar arrangements have been sanctioned by the IRS in Rev. Rul. 66-110 and any change in this position would be prospective only.

6. A rollout has the risk of being treated as a transfer for value under section 101(a)(2) in an endorsement method arrangement. Use of the "undocumented" collateral assignment method can minimize this potential problem.

7. If the equity build up is subject to income tax, parallel gift tax treatment should follow under the theory of Rev. Rul. 78-420.

8. In an S corporation shareholder split-dollar agreement where each shareholder must reimburse the corporation to the extent its payment confers an economic benefit (that is, for example, the P.S. 58 cost), the split-dollar agreement does not create more than one class of stock within the meaning of section 1361(b)(1)(D) because the arrangement does not alter rights to distribution and liquidation proceeds. See, for example, Private Letter Ruling 9331009. A stronger position probably exists where the insureds are shareholder/employees (and not just shareholders) as in Private Letter Ruling 9248019 which cites Rev. Rul. 91-26, 1991-2 C.B. 185, dealing with the payment of accident and health insurance premiums on behalf of shareholder/employees.

B. Examples of Uses of Split-Dollar Insurance.

1. Benefits for Nonshareholder Children. Facts: Father has four children, only two of whom are shareholder/employees of the family business and
economically advantaged. Father wants all four children to receive a minimum amount of second-to-die insurance benefits to help with liquidity needed for death taxes and wants the two nonshareholder children to receive additional amounts in the nature of bequests at the death of the survivor of father and mother. Solution: Father causes corporation to enter into employer-pay-all split-dollar agreements with all four children providing joint coverage on father and mother, but with the nonshareholder children having substantially more coverage. Father reports the P.S. 38 economic benefit on his W-2 and treats the same amount as part of his annual exclusion gifts to the children.

2. Substitute for Other Benefits for Key Employee. Facts: Key employee of a family S corporation has asked for stock options or other arrangements to enhance the assets available to his family at his death or retirement. Controlling shareholder is willing to issue stock or grant stock options but is not willing to commit the corporation to mandatory buy-sell obligations. Solution: Key employee creates an irrevocable Crummey trust with his wife as trustee and life beneficiary to enter into an employer-pay-all split-dollar agreement with the corporation. Trust applies for and becomes the owner of a variable life policy on the key employee's life, corporation pays the premiums, key employee reports the P.S. 58 economic benefit on his W-2, and key employee treats the economic benefit amount as annual exclusion gifts to the Crummey power holders.

3. Generation-Skipping Planning for Controlling Shareholder/Employee. Facts: Chief executive officer is the largest shareholder of a closely held corporation that will likely go public in a few years. Officer is concerned about his estate's lack of liquidity and the limitations of Rule 144 and is receptive to the leverage offered by split-dollar concepts. Solution: Officer creates a generation-skipping trust for his grandchildren and their descendants to last for the perpetuities period. The trust applies for and becomes the owner of second-to-die insurance on the life of the officer and his wife. The split-dollar agreement with the employer corporation calls for the trust to contribute the P.S. 38 amount each year toward the premiums. The officer will make gifts each year of the P.S. 38 amount to the trust and will allocate a portion of his GST exemption to the gifts.

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