

### Introduction

Estate planners have a number of tools available to them in planning for the transfer of assets that are expected to substantially appreciate in the future. One relatively common estate planning arrangement is for the grantor of a trust (where the trust is a “grantor trust” for income tax purposes) to sell assets to the trust. Commonly, a large part or all of the consideration for the sale is an installment note. For these purposes, we will refer to this as an “installment sale to a grantor trust” or “ISGT.” See, generally, Mulligan, “Sale to a Defective Grantor Trust: An Alternative to a GRAT,” 23 Estate Planning 3 (Jan. 1996).

Wealth Transfer Planning™ includes a concept memo (SmartContent which will offer advice as to whether a particular client should consider making such a sale) and an interactive process for the preparation of documents. By their very nature, ISGT transactions involve a risk of being re-characterized as a part sale, part gift transaction. This article suggests several ideas on how that risk might be reduced. This article also outlines the changes that WTP, a part of Interactive Legal’s “Legal Suite”, is in the process of implementing to its Irrevocable Trust, along with new interactive questions and documents to help accomplish the goal of reducing such a gift tax risk.

### Some Background about ISGTs

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

Similarly, because (under Rev. Rul. 85-13) the existence of the trust is ignored and the grantor is treated as still owning the trust property, interest due or paid on the note from the trust to the grantor is also not subject to income tax. In a typical transaction, the note bears the applicable Federal rate (AFR) of interest, which is relatively low and often much lower than market rates of returns. Under Code Sec. 7872, charging at least AFR interest on indebtedness between family members prevents a gift from being made by the extension of credit.

If the property sold to the ISGT does grow at a rate greater than the note’s AFR interest rate, value will accrue in favor of the trust, free of estate, gift and income tax. In addition, if the AFR thereafter drops, a new note carrying the lower (current) AFR may be substituted, generally with out adverse tax effects, for the “old” (higher AFR) note. See Blattmachr, Crawford and Madden, “How Low Can You Go? Some Consequences of

Substituting A Lower AFR Note for a Higher AFR Note,” Journal of Taxation (June 2008).

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

WTP suggests the consideration of several strategies aimed at reducing the risk of a gift, or at least reducing the risk of a relatively large gift, in an ISGT.

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

To reduce the risk of a gift occurring by having a sales price less than the sold property’s fair market value, WTP will provide a purchase or buy-sell agreement under which the grantor will agree to sell and the grantor trust will agree to buy a fractional interest in certain identified property for a specified price set forth in the purchase agreement or determined by an appraiser selected by the grantor and the trustees of the trust after the purchase agreement is executed.

First, to avoid the risk of a penalty under Code Sec. 6662 if it turns out the value used to determine the purchase price is not “correct,” the specified price set forth in the purchase agreement should be determined by an independent experienced appraiser. An alternative to the advance setting of the price by a qualified appraiser is to have the price determined by such an appraiser after the purchase agreement is signed. That way, neither of the parties knows when the agreement is signed what price will be, which some view as somewhat typical of what parties acting at arms’ length would use to determine a price (as not infrequently occurs in arms’ length buy-sell agreements among owners of a company).

In any event, the purchase agreement will provide that the portion, or fraction, of the asset(s) purchased will be the lesser of (1) the entire property (e.g., limited partnership units in a partnership, stock in a business or a tract of land) or (2) that fractional share of the property, the numerator of which is the specified price or value determined by the appraiser and the denominator of which is the fair market value, as finally determined for Federal gift tax purposes, of the entire property.

For example, assume limited partnership units are sold to the trust. The appraiser determines the value of all the units to be \$5,000,000. The trust will pay \$5,000,000, but in an attempt to reduce the risk of an unintentional gift, the purchase by the trust will be expressed as the lesser of (1) all of the grantor’s limited partnership units or (2) that fractional share of the units, the numerator of which is \$5,000,000 and the denominator

of which is finally determined fair market value of the units. If the fair market value of the units is finally determined to be \$5,000,000 or less, the trust will have purchased all of the units. If the fair market value is finally determined to be \$6,000,000, the trust will have purchased 5/6ths of the units.

The viability of such a formula price clause is not certain. Logically, there seems to be no reason why it should not be respected for tax purposes. See McCaffrey & Kalik, "Using Valuation Clauses to Avoid Gift Taxes," 125 *Trusts & Estates* 47 (October 1986). The United States Tax Court in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g*, 120 TC 358 (2003), refused to honor a formula price clause, but it seems to be based upon the ground that the formula, as the court construed it, did not specify that the fair market value aspect of the formula would be *as finally determined for Federal gift tax purposes*. The Court of Appeals for the Fifth Circuit did honor the defined formula provision although the court noted that the IRS had abandoned on appeal certain of its "policy" arguments about why formula price clauses should not be respect for tax purposes.

Hence, although not certain, expressing the purchase as a fraction the numerator of which is the purchase price and the denominator of which is the property's fair market value as finally determined for Federal gift tax purposes should reduce the risk of a gift occurring by reason of the trust paying less than the full fair market value of what it purchases.

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

The use of a defined value consideration certainly appears to reduce the risk of a part sale, part gift transaction. However, other consequences should be considered. First, no AFR note is being used in the sale. Using an AFR note produces an additional advantage if the property sold grows at a rate greater than the AFR. Of course, if the parties do not think the property will grow, at least over a reasonable time, at a rate greater than the AFR, then the issue of whether to make the sale for an installment note should be

reevaluated. Second, in order to accomplish the above described defined value consideration strategy, the trust must already have a marketable asset with a value well in excess of the appraised value of the property being sold to the trust by the grantor. In many cases, the trust will not have such an asset. Of course, the trust could borrow cash from the grantor, at the AFR, and use the borrowed cash to buy such a marketable asset. That would also permit the trust to “leverage” on the growth of the marketable asset purchased above the AFR (to the extent not transferred to the grantor in exchange for the property being sold by the grantor to the trust).

We believe that this strategy will be used infrequently in actual practice, and thus WTP does not currently offer such a defined value consideration provision but it seems that it would not be difficult for a skilled drafter and planner to implement it.

Division of Any Part Sale, Part Gift Transaction into Complete and Incomplete Portions. As discussed above, the sale by the grantor to the trust could result in a deemed gift. For example, if the sales price is lower than the transferred asset’s fair market value, the grantor will likely be treated by the IRS as having made a gift of the value difference. Additionally, a gift might be deemed to occur for other reasons.

To reduce the risk of a relatively significant gift being made, the trust can provide that any gift resulting from the sale will be divided into two parts. Ninety percent (90%) of such gift will be added to a trust for the benefit of the grantor and, as a result of the terms of that trust, will be an incomplete gift. Thus that 90% portion should not be subject to gift tax, although estate tax inclusion likely would occur as to that portion. The other 10% of any such gift will be added to the Lifetime Trust under the Irrevocable Trust with respect to which the gift would be complete.

While some might think that the entire 100% of any such gift should pass to the “incomplete gift” trust, the split into complete and incomplete gifts is to reduce the risk of the IRS contending that the incomplete portion should be ignored under *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944).

The IRS apparently reads that case as holding that any action to prevent the imposition of gift tax by formula or condition will be ignored. *Cf.* TAM 200245053 (not precedent). Instead, the trust agreement we suggest uses a different approach: any gift made after a specified date (which should be a date after the initial funding of the trust and prior to the date of the sale) is divided automatically into the 90% and 10% portions. Hence, any gift arising by reason of the sale would be subject to the above described 90% / 10% division. Although not certain, it seems that such a division, because it occurs automatically when the transfer is made and is not based upon any condition or formula, should not be subject to a “Procter” objection.

In any event, to reduce the risk of any significant taxable gift occurring by the sale to the trust by the grantor, the drafter will specify a date that will be (1) after the initial funding of the trust will occur (so all of the initial funding will be added exclusively to the Lifetime Trust created under the Irrevocable Trust and will constitute a completed

gift) and (2) before the sale will occur. The Irrevocable Trust will provide that any gift, made by any means, including by a bargain sale, after the date the drafter specifies, and whether complete or not, will be divided into the 90% and 10% portions, with the 10% portion also added to the Lifetime Trust and with the 90% portion added to a trust under the Irrevocable Trust for the benefit of the grantor that should not be a completed gift.

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

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

Although the IRS took the position in *Estate of Christiansen v. Commissioner*, 130 T.C. No. 1 (2008), that qualified disclaimers under Code Sec. 2518 may not be implemented in certain ways to achieve a particular specific result (e.g., the IRS position that it is against public policy to allow a disclaimer which, by a tax-driven word formula, would be a disincentive to the IRS upon audit because, for example, increases in the value of assets on audit would increase, dollar for dollar, the charitable deduction), the Tax Court rejected that position. Hence, it seems that if the principal beneficiary of a trust disclaims property transferred to the Irrevocable Trust and, if a result of the disclaimer, the property reverts to the grantor, then no gift should be deemed made.

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

WTP also will be offering a form of disclaimer under which the Principal Beneficiary of the trust may make the disclaimer.

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

An alternative to the grantor selling assets to a grantor trust that the grantor creates is to have the spouse of the grantor sell the assets to a trust of which the spouse is a beneficiary but not the grantor. The trust for the spouse may be worded so the sale

should not result in the spouse being deemed to make a gift because the trust would be structured so even a direct gift by the spouse to the trust would not be complete under the principles set forth in Reg. § 25.2511-2. For example, if the selling spouse is the only beneficiary of the trust for life (or is a beneficiary with the power to veto distributions to others during his or her lifetime) and holds a special power of appointment exercisable at death, any gift by that spouse to that trust by any means (including a bargain sale) would not be subject to gift tax because the gift would be incomplete. And as long as there is no gift by the selling spouse, no part of the trust should be included in his or her gross estate because he or she is not the grantor of the trust.

On the other hand, if the sale transaction does involve some type of gratuitous transfer (such as where the asset is sold for less than its fair market value), the gratuitous portion of the transfer should not be a completed gift. As a result, no taxable gift should be deemed to have occurred and therefore no gift tax should be payable. However, in that case, some portion of the trust may be included in the decedent's estate under Code Sec. 2036(a)(2) and/or 2038 (and *see, also*, Code Sec. 2043). WTP will default certain answers to the Irrevocable Trust form so that any gift made by the spouse by a sale to the trust should be an incomplete gift.

A sale by the spouse of the grantor to the trust is treated as a sale by that spouse to the grantor, because the existence of the trust is ignored under Rev. Rul. 85-13. Since the selling spouse is treated as selling the asset to his or her spouse (the grantor of the trust), and since sales between spouse are not subject to income tax, there should be no income tax on the sale. Code Sec. 1041.

However, Code Sec. 1041 does not completely foreclose all income tax effects of transactions between spouses. For example, if the trust pays the selling spouse (who is not the grantor) for the purchased property by issuing an interest bearing note, the interest paid or imputed will be included in the gross income of the grantor and be deductible by the grantor's spouse to the extent specified in Code Sec. 163. As long as the asset purchased from the trust is an investment asset, the interest should be investment interest, deductible by the selling spouse to the extent of investment income. If the grantor and the grantor's spouse file a joint income tax return, the income from the interest and the deduction for it likely will "cancel" out.

Nonetheless, there will be other consequences. For example, the adjusted gross income of the couple will increase, potentially leading to other consequences on a joint income tax return. For example, increasing the adjusted gross income raises the threshold in deducting charitable contributions under Code Sec. 170. On the other hand, it may increase the amount of certain itemized deductions that will be reduced under Code Sec. 68. Thus, even though the sale by the spouse of the grantor, combined with a special power of appointment, should foreclose any deemed taxable gift, all additional consequences should be considered.

Further, state and local income tax consequences should be considered. For instance, in some jurisdictions, certain itemized deductions (including that for investment interest paid) may be disallowed or limited.

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

### Summary and Conclusions

An ISGT may be a very effective estate tax planning strategy. There is, however, a risk that the IRS may claim a gift has been made by such a sale. To reduce that risk, WTP is modifying its irrevocable trust form (the trust to which the sale is made), the goal being to reduce the risk of a large inadvertent gift. In addition, WTP will be offering a purchase (buy-sell) agreement incorporating a formula defined purchase price. Such a formula approach should further reduce the risk of an inadvertent gift by reason of the ISGT. Finally, WTP will be offering a disclaimer and renunciation form by which the purchasing trust's Principal Beneficiary may disclaim any gift made to the trust as a consequence of the sale to the trust by the grantor.