

How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies?

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Although most estate planners are generally aware that annuities and income interests are interest rate sensitive while unitrust interests are not, the interplay of the various factors that enter the actuarial computations used to determine the value of an interest in property for gift tax purposes, when less than the entire interest may be transferred, are not always obvious.¹ The purpose of this article is to illustrate in table form the various actuarial elements that affect commonly used estate planning techniques such as a qualified personal residence trust (“QPRT”), a charitable remainder annuity trust (“CRAT”), a grantor retained annuity trust (“GRAT”), and a charitable lead annuity trust (“CLAT”).² Certain comparisons will also be made to self-cancelling installment notes, private annuities and installment sales to grantor trusts.³ This paper assumes the reader is familiar with the income and gift tax aspects of these structures, and focuses exclusively on the computational elements.⁴

Interests are at an historic low, as the Table below⁵ indicates. The section 7520⁶ rate tends to be higher than all of the short-term, mid-term and long term applicable federal rate (“AFR”) under section 1274, but that is not uniformly the case. There have been periods when the long term AFR exceeded the section 7520 rate. Similarly, in general, the short-term AFR tends to be lower than the mid-term AFR and the mid-term AFR tends to be lower than the long term AFR. However, in recent times we have had a so-called “inverted yield curve” when mid-term rates exceeded long term rates. These anomalies can provide estate planning opportunities. For example, when mid-term rates exceed long term rates, strategies such as installment sales that rely on the AFR rather than the section 7520 rate may be more attractive. On the other hand, when long term rates exceed the section 7520 rate, strategies such as GRATs and CLATs and even SCINs may be more beneficial than strategies that rely on interest rates at the AFR if one is primarily concerned with benefiting children.⁷ Of course, entering into a long term strategy that uses the AFR when long term AFR rates are relatively low allows one to lock

¹ See, generally, J. Blattmachr and D. Hastings, “Valuing Certain Split Interests,” 122 *Trusts & Estates* 27 (June 1983).

² All actuarial computations were performed using *Estate Planning Tools*, Stephen R. Leimberg & Robert T. LeClair, Brentmark Software, Inc. and *Tiger Tables*, Lawrence P. Katzenstein, or provided courtesy of specific computations performed by J.P. Morgan Private Bank.

³ See, generally, J. Blattmachr and D. Zeydel, “Playing the Tables: Current Developments in GRATs, SCINs. and Other Wealth Transfer Strategies,” 41st Annual Southern Federal Tax Institute (2006).

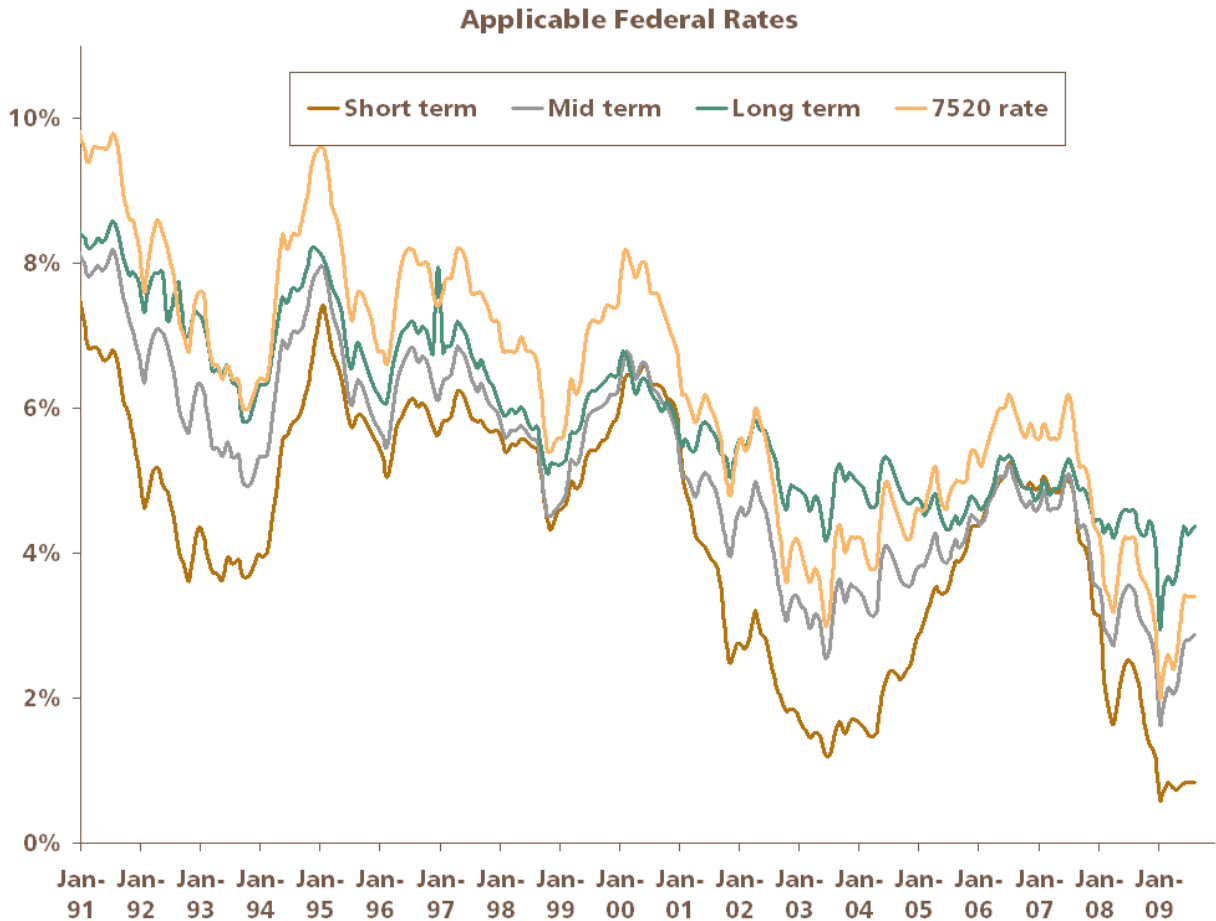
⁴ For background on the basic structure of QPRTs, GRATs, CLATs and CRUTs, see, generally, Blattmachr, Slade and Zeydel 836-2nd T.M. *Partial Interests--GRATs, GRUTs, QPRTs (Section 2702)*; Rosepink and Bradley, 865-2nd T.M., *Charitable Remainder Trusts and Pooled Income Funds*.

⁵ Source www.irs.gov.

⁶ All references to a “section” unless indicated to the contrary are to a section of the Internal Revenue Code of 1986, as amended.

⁷ This will not generally be true if one is interested in a dynasty type distribution that will ultimately benefit grandchildren or more remote descendants. Special rules apply to allocating generation-skipping tax exemption to a strategy in which the grantor has as retained interest (such as a GRAT) that is subject to the so-called “ETIP” or estate tax inclusion period rule under section 2642(f) and to CLATs under section 2642(e) which limit the effectiveness of allocating GST exemption to those types of trusts.

in the benefit of the lower rate, while preserving the opportunity to refinance at a lower mid-term rate when interest rates return to a normal yield curve.⁸



As a general matter, when interest rates are high, income interests are more valuable and annuity payments are less valuable. The right to receive all the income of a trust when the section 7520 rate is 10% is worth more than the right to receive all the income of a trust when the section 7520 rate is only 3.4%. Accordingly, strategies that rely on the value of an income interest, such as a qualified personal residence trust, may be less attractive when interest rates are low because the retained income interest will have a lower value, and consequently, the gifted remainder interest will have a higher value. On the other hand, the right to receive a fixed annuity payment of a certain amount will be worth more if the section 7520 rate is low. The right to receive \$100,000 at the end of each year for 10 years will be worth \$835,870 when the section 7520 rate is 3.4% and only \$614,460 when the section 7520 rate is 10%. Therefore, strategies that rely on the value of an annuity interest will be more attractive when the section 7520 rate is low, if the taxable gratuitous transfer is of the remainder interest, such as in a GRAT or a CLAT, and less attractive if the taxable transfer is of the annuity interest, such as in a CRAT. However, as the discussion in this paper demonstrates, these general principles do not

⁸ See J. Blattmachr, B. Crawford, E. Madden, “How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note,” *Journal of Taxation*, Vol. 109, No. 1, p.22 (2008) for a discussion of substituting a “new” note at the current AFR rate for an “old” note at the former AFR rate which has become greater than the current rate.

always tell the whole story, and must be analyzed in light of the particular planning and asset structure being used.

Qualified Personal Residence Trust

A qualified personal residence trust within the meaning of Treas. Reg. § 25.2702-5 is a structure under which an individual may transfer a remainder interest in a personal residence to family members at a reduced transfer tax cost. In the typical QPRT, a senior family member transfers a personal residence in trust, retaining the exclusive right to occupy the residence for a term of years and a contingent reversion under which the residence will revert to the transferor's estate if he or she dies within the term of years. The following table assumes a 10-year term QPRT created by a person age 65, 70 or 75 when the section 7520 rate is 3.4% (the rate for September 2009⁹), 6.0% or 8.0%.¹⁰ The values, expressed as a percentage of the retained interests, are shown separately and as a total. The excess of 100% over the percentage interest retained constitutes the portion of the transfer attributable to the remainder interest in the trust. The percentage assigned to the remainder interest multiplied by the current fair market value of the residence on the date of contribution to the QPRT would be the amount of the taxable gift.¹¹

10-Year QPRT

7520 Rate	Age 65			Age 70			Age 75		
	Income	Reversion	Total	Income	Reversion	Total	Income	Reversion	Total
3.40%	26%	18%	44%	25%	27%	51%	23%	39%	62%
6.00%	40%	16%	56%	38%	24%	62%	35%	35%	70%
8.00%	49%	14%	64%	47%	22%	69%	43%	32%	75%

Although the reversion is not nearly as interest rate sensitive as is the income interest, the reversion is very age sensitive.¹² Accordingly, it is the value of the reversion, not the income interest, that increases significantly the aggregate value of the retained interest for an older transferor. A 10-year QPRT for a 65 year old at a section 7520 rate of 8% will yield approximately the same taxable gift as a 10-year QPRT for a 75 year old at a section 7520 of 3.4%. For any age, of course, lower interest rates produce a lower aggregate value for the retained interests (and a higher taxable gift) than higher interest rates. Nevertheless, when interest rates are low, QPRTs may still be a viable strategy for an older settlor, particularly since wealthy individuals who are able to afford superior medical care tend to live longer, on average, than the IRS actuarial tables which are based upon the U.S. census, assume.

⁹ Rev. Rul. 2008-49, 2008-40 I.R.B. 811.

¹⁰ Because a QPRT will only be successful in removing the residence from the gross estate of the transferor if he or she lives until the end of the term of years (*see* I.R.C. §2036(a)(1)), a shorter retained term may be used for an older transferor. And the shorter term increases the amount of the gift, all other things being equal.

¹¹ No part of the gift qualifies for the gift tax annual exclusion under section 2503(a) because it is not a gift of a present interest.

¹² The reversionary interest will return the trust estate to the settlor if the settlor dies within the term of the QPRT. Thus, the value of the reversion depends upon the probability of the settlor's death within the fixed term. That probability is much higher for a 75 year old than for a 65 year old.

In addition, the rare current economic circumstance when both interest rates and values are low might make a QPRT for a younger settlor attractive. A QPRT assumes that the potential “income” that could be earned on the residence is retained by the settlor for so long as the settlor is living during the QPRT term. Thus, the taxable gift to the remainder beneficiaries is reduced by the hypothetical “income” that is deemed consumed by the settlor during the term. This assumption is made regardless of whether the residence actually has income producing capacity at the section 7520 rate. In addition, the remainder value is assumed to appreciate at exactly the section 7520 rate. If the value of the residence is depressed so that it appreciates at a rate higher than the section 7520 rate, that excess appreciation will constitute a tax free gift to the remainder beneficiaries, if the settlor survives the term.

Charitable Remainder Annuity Trust

Under section 664(d), a CRAT must pay to one or more persons (other than charity) a sum certain of at least 5% and not more than 50% of the initial fair market value of all property placed in trust either for the lives of the individual measuring lives (who must be living at the time the trust is created) or for a term not to exceed 20 years. The value of the charitable remainder interest computed using the applicable section 7520 rate must be at least 10% of the initial fair market value of all property placed in trust. In addition, Revenue Ruling 77-374¹³ requires that the probability that the trust will exhaust before the remainder vests in charity must not exceed 5%. Thus, in the case of a life CRAT for an individual, if the probability is greater than 5% that the fund will be exhausted before the individual dies, the trust will fail to qualify for a charitable deduction.

Interest rates will affect the qualification of CRATs in at least two ways. In the case of a term of years CRAT, if interest rates are low, certain levels of annuity payments will cause the actuarial value of the remainder interest to fall below the 10% minimum requirement. In the case of a life CRAT, low interest rates will make it impossible for a CRAT with a younger life beneficiary to qualify for a charitable deduction because the minimum 5% payout will cause the CRAT to fail either or both the minimum 10% remainder requirement and the 5% probability of exhaustion test.

15-Year CRAT Value of Remainder Interest¹⁴

<u>7520 Rate</u>	<u>Payout</u>					
	<u>5%</u>	<u>6%</u>	<u>7%</u>	<u>8%</u>	<u>9%</u>	<u>10%</u>
<u>3%</u>	40%	28%	16%	4%	-7%	-19%
<u>5%</u>	48%	38%	27%	17%	7%	-4%
<u>7%</u>	54%	45%	36%	27%	18%	9%

¹³ 1977-2 C.B. 329.

¹⁴ Courtesy of J.P. Morgan Private Bank.

As the above table shows, the lower the section 7520 rate, the more rapidly a larger annuity payment will cause the remainder interest to fall below the required 10% minimum. (The reason is that it is assumed that the CRAT will grow annually at the section 7520 rate; the lower that rate the smaller the growth, meaning annually increasing erosion of the trust property by the fixed annuity payment.) It is interesting to note that, at a 3.4% section 7520 rate (the rate for September 2009), a life CRAT for a 30, 40 or 50 year old (which requires a minimum annuity payment of 5%) will also fail the minimum 10% remainder requirement. At a 3.4% section 7520 rate, a CRAT for the life of a 60 year old will fail the 5% probability of exhaustion test. Thus, a lower interest environment may make a charitable deduction for a life CRAT unavailable altogether as a planning strategy for a younger measuring life. It may also be noted that the probability of failure to meet the 5% probability of exhaustion test will increase if the number of annuitants exceeds one—such as a CRAT for a husband and wife.

The Table below, which was calculated under the prior 90CM Table, shows that because a CRAT must pay out at least 5% annually, a life CRAT for a 50 year old at 4% and a 60 year old at 3% will satisfy the 10% minimum remainder requirement, but will fail the 5% probability of exhaustion test. Life CRATs for younger measuring lives at lower interest rates will fail the 10% minimum remainder requirement.¹⁵

		7520 rate					
		3%	4%	5%	6%	7%	8%
		Payout	Payout	Payout	Payout	Payout	Payout
Age	30	5.0%	5.0%	5.1%	5.9%	6.7%	7.6%
	40	5.0%	5.0%	5.3%	6.2%	7.1%	7.9%
	50	5.0%	5.0%	5.6%	6.4%	7.3%	8.2%
	60	5.0%	5.3%	6.0%	6.8%	7.7%	8.5%
	70	5.5%	6.1%	6.8%	7.6%	8.3%	9.1%
	80	7.3%	7.9%	8.6%	9.2%	9.9%	10.7%
	90	10.8%	11.4%	12.0%	12.7%	13.3%	14.0%

There are certain transition rules that affect whether the new 2000CM Table may, or the old 90CM Table, must be used, and but if the valuation date occurs after June 30, 2009, the new mortality table must be used even if a prior month's interest rate is selected. There are some interesting effects under the new mortality tables because even though life expectancies are generally longer, at older ages there are fewer lives than under the prior table. The same phenomenon occurred in the transition from the 80CNSMT Tables and may simply reflect an improvement in the data available.¹⁶ This can mean that the result under the probability of exhaustion test can improve (that is, it is less likely, not more likely, that the trust will exhaust during the life of the annuitant) at certain ages.¹⁷ However, as a general rule, life expectancies are longer which means the probability of exhaustion is higher and the value of the remainder in a life CRAT will be smaller, and more likely to fail the 10% minimum requirement.

¹⁵ Courtesy of J.P. Morgan Private Bank.

¹⁶ See L. Katzenstein, "IRS Releases New Mortality Tables Effective May 1, 2009," presented at the Estate and Gift Tax Committee Meeting, ACTEC National Meeting, Summer 2009.

¹⁷ See L. Katzenstein, "IRS Releases New Mortality Tables Effective May 1, 2009," presented at the Estate and Gift Tax Committee Meeting, ACTEC National Meeting, Summer 2009.

Grantor Retained Annuity Trust

In a GRAT, within the meaning of Treas. Reg. §25.2702-3(b), the grantor of the trust retains the right to receive an annuity for a fixed term of years, following which the remainder will pass to the specified successor beneficiaries. The amount of the taxable gift of the remainder or successor interest is determined by subtracting the value of the retained annuity stream from the value of the property transferred to the trust. That value will include a stream of payments such that the annuity increases each year, but not by more than 20%. Thus, the greater the value of the annuity interest, the smaller the taxable gift. A lower interest rate increases the actuarial value of the retained annuity. The reason is that it is assumed that the GRAT will grow annually at the section 7520 rate; the lower that rate the smaller the growth, meaning greater erosion of the trust estate for a particular level of annuity payments. Thus, the same annuity payments will produce a lower taxable gift in at a lower interest rate. A GRAT provides the opportunity to deliver an almost gift tax free transfer to the remainder beneficiaries because the taxable gift is computed at the formation of the GRAT, and the actual performance of the assets contributed to the GRAT may far exceed the section 7520 rate used to determine the value of the remainder interest.

In general, GRATs are most efficient if the value of the remainder is small. That is most easily accomplished by requiring the annuity payments to be made for the entire term of the GRAT, to the grantor or if the grantor dies during the annuity term to the grantor's estate.¹⁸ The reason is that the value of the annuity stream retained by the grantor himself or herself must be calculated by "factoring" in the probability of the grantor's death during the term—if the grantor dies, he or she will no longer receive the annuity payments and there is always some probability of death during a term. However, the regulations now permit the value of the annuity interest payable to the grantor's estate also to be subtracted from the value of the property contributed to the GRAT in determining the value of the taxable gift.

From the foregoing discussion it would seem that a low interest rate environment (that is, a low section 7520 rate) would increase the probability of success for a GRAT. At first blush that would appear correct. Assuming one could predict a 10% annual return for property contributed to a 5 year GRAT, the actual GRAT remainder, which will pass to the successor beneficiaries would be much larger with a 3.4% section 7520 rate than with a 6% or 8% section 7520 rate.

¹⁸ This is known as a so-called "Walton GRAT" named for the case *Walton v. Comm'r*, 115 T.C. 589 (2000), *acq.* IRS Notice 2003-72, 2003-44 I.R.B. 964. See Treas. Reg. § 25.2702-3(e), *Examples 5 and 6*.

**\$1,000,000 Contribution to 5-Year GRAT
Zeroed Out/¹⁹20% Increasing Annual Annuity/10% Economic Growth
Future Value of GRAT Remainder**

<u>7520 Rate</u>	3.4%	6%	8%
<u>Remainder</u>	\$292,101	\$180,549	\$91,598

Suppose, on the other hand, that one could not forecast actual return (such as 10%) but only relative performance in excess of the section 7520 rate. Suppose one correctly forecasts a 2% annual growth in excess of the section 7520 rate that is used to determine the actuarial value of the remainder in the GRAT.

**\$1,000,000 Contribution to 5-Year GRAT
Zeroed Out/20% Increasing Annual Annuity
2% Economic Growth in Excess of §7520 Rate
Future Value of GRAT Remainder**

<u>7520 Rate</u>	3.4%	6%	8%
<u>Remainder</u>	\$79,131	\$86,039	\$91,598

The difference or variation in the values of the remainders is significantly less than where a fixed return (such as 10%) is forecast. And, in fact, the trend reverses and the remainder is forecast to be greater with a higher section 7520 rate because of the benefit of compounding at the higher absolute rate -- that is, at 10% (8% section 7520 rate plus 2% excess growth), rather than at 8% (6% section 7520 rate plus 2% excess growth) and rather than at 5.4% (3.4% section 7520 rate plus 2%). If the return in excess of the section 7520 rate were forecast to be a fixed percentage above the section 7520 rate, such as 25%, the spread among the remainder values becomes larger, but still favors a GRAT created when interest rates are higher.²⁰ Indeed, if all that can be forecast is relative performance, in the case of a short-term (e.g., 2 year) GRAT, the results of how much is transferred to the successor beneficiaries are almost interest rate neutral.

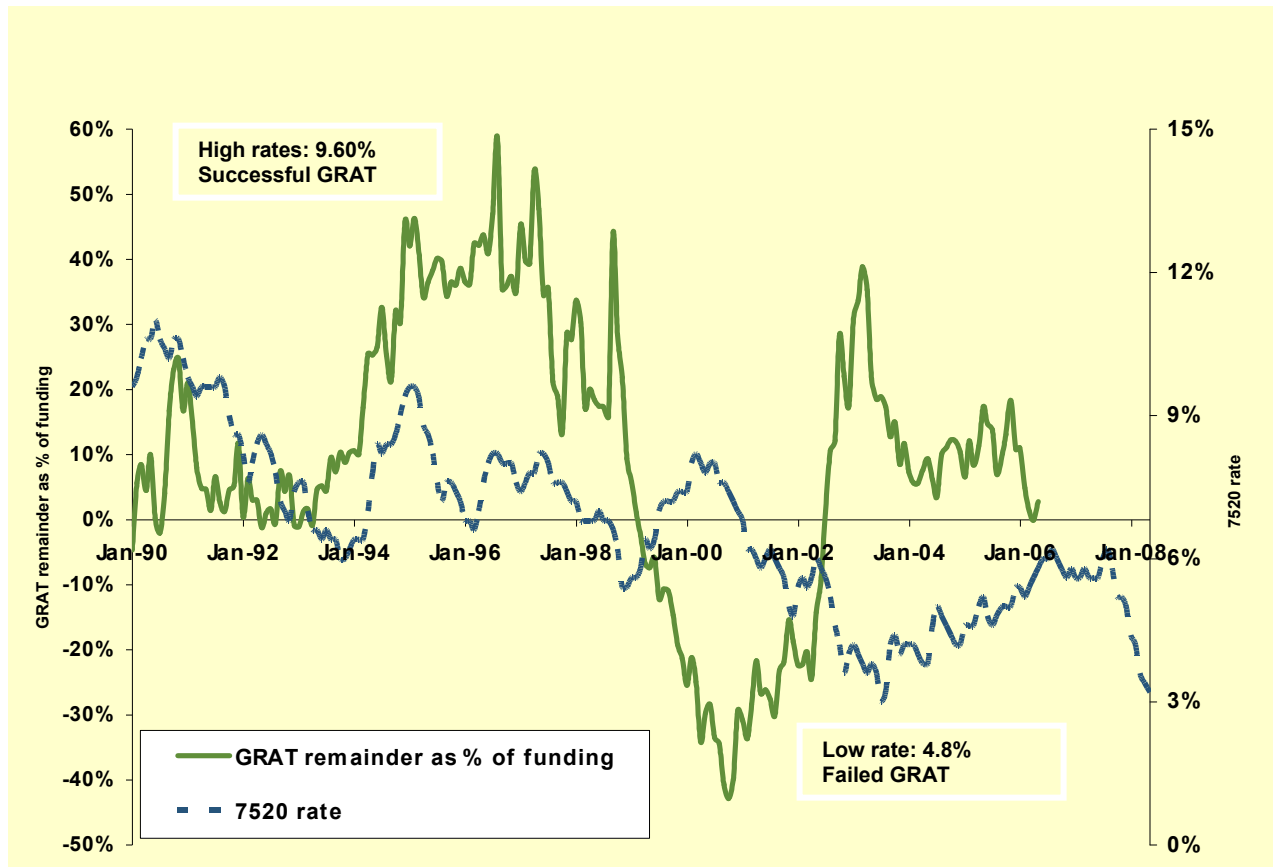
¹⁹ Some commentators believe that absolute “zeroing out” the value of the remainder of a GRAT has certain risks associated with it, although near zeroing out should be possible, particularly if appropriate savings language is included in the governing instrument. See J. Blattmachr and D. Zeydel, *GRATs vs. Installment Sales to IDGTs: Which Is the Panacea or Are They Both Pandemics?*, 41st Annual Heckerling Institute on Estate Planning, 2007. In all cases, the modeling assumes a “Walton” style GRAT where annuity payments will continue to the grantor’s estate if the grantor dies during the GRAT term.

²⁰ In the case of forecast performance in excess of the section 7520 rate of 25% for a 5-year GRAT with annuity payments that increase by 20% each year, the remainders at section 7520 rates of 3.8%, 6% and 8% are \$37,122, \$63,756 and \$91,598, respectively.

**\$1,000,000 Contribution to 2-Year GRAT
Zeroed Out/20% Increasing Annual Annuity
2% Economic Growth in Excess of §7520 Rate
Future Value of GRAT Remainder**

<u>7520 Rate</u>	3.4%	6%	8%
<u>Remainder</u>	\$32,189	\$32,861	\$33,349

It turns out that the prediction that the performance of a short term GRAT is interest rate neutral is correct. Computations prepared by one financial institution²¹ show that, if one assumes a 2-year GRAT is created at the beginning every month since section 7520 rates were available (and structured so that using the applicable section 7520 rate for that month, the annuity payments are actuarially equal to the value of the property contributed to the GRAT) and if the assets of the GRAT were invested in an S&P 500 Index Fund, the probability that remainder would be positive is virtually uncorrelated to the section 7520 rate.



Instead, a regression analysis prepared by the same financial institution showed (based upon historical market performance) that the probability that a 2-year GRAT remainder is

²¹ See computations performed by J.P. Morgan Private Bank for ACTEC Summer Meeting 2008, “Estate Planning in a Low Interest Rate, Down Market: Making Lemonade Out of Lemons.”

positive would be 66% percent dependent on asset performance in the first year, 33% dependent on asset performance in the second year and only 1% dependent on the section 7520 rate.²²

It can also be demonstrated that so-called short term “rolling” GRATs, meaning a series of 2-year GRATs in which each annuity payment received by the grantor is contributed to a new 2-year GRAT, will outperform a single longer term GRAT. For example, a series of 2-year rolling GRATs that continue so that all GRATs terminate by the end of 10 years will, on average, deliver greater wealth to the remainder beneficiaries than a single 10-year GRAT. This is true notwithstanding the fact that rolling GRATs must suffer the potential fluctuation in section 7520 rates during the 10 year period. The reason is in part that the performance of a 2-year GRAT is essentially interest rate neutral, as shown above. But an additional reason is the fact that in a longer term GRAT periods of appreciation may be offset by periods of depreciation. In contrast, with two-year rolling GRATs, if the assets depreciate, the first annuity payment (which will exceed 50% of the GRAT assets) will be contributed to a new GRAT that resets the annuity taking into account the currently depressed value. The new GRAT, with depressed value assets, may have an increased chance of succeeding, if assets recover. Thus, a rolling GRAT strategy has an improved chance of success because it will increase the likelihood of capturing volatility. If assets decline, a substantial portion of the depressed value assets will be returned to the grantor for re-GRATING. If those assets rebound, the excess value will be captured for the remainder beneficiaries.

Given the benefits of capturing volatility as early as possible, one potential strategy, particularly if one believes that market performance is unusually volatile at the present time, is to structure the annuity payments to decrease rather than increase during the GRAT term. Treas. Reg. §25.2702-3(b)(1)(ii)(A) permits the stated annuity amount to increase by 20% each year, but contains no prohibition on decreases. Suppose the annual GRAT annuity payments are structured to be 90% of the fair market value of the assets contributed to the GRAT, as finally determined for federal gift tax purposes, in the first year, and whatever amount is necessary to zero-out or near zero-out the taxable gift in the second year.²³ If the assets have increased significantly in value in the first year, that excess value will remain in the GRAT with only a small remaining annuity payment due. On the other hand, if the assets have declined dramatically, the depressed value assets will be substantially distributed to the grantor for “re-GRATING”. One might also consider more frequent annuity payments in especially volatile environments. If larger and earlier payments are beneficial, more frequent payments may also be beneficial. Of course, it would behoove the estate planner to obtain some projections from a experienced financial institution to test these hypotheses in a particular case.

Another possibility, and one that would overcome the arbitrariness of the GRAT annuity payment date, is to use a power of substitution under section 675(4)(C) to capture the volatility in a GRAT. Private letter ruling 200846001 allowed the taxpayer to exercise a power of substitution over a GRAT without negative gift tax effects. The power of substitution in the

²² *Id.*

²³ Note, however, that in PLR 200846001, the IRS ruled favorably on a 2-year GRAT but the annuity payments to the grantor were less than 50% of the fair market value of the property contributed to the GRAT and the remainder value exceeded 10%. It is unknown whether these facts were necessary in order for the taxpayer to obtain a favorable ruling, but those requirements are consistent with the limitations on structuring a CRAT annuity if one wishes to obtain a charitable deduction for the remainder interest (see discussion of CRATs *supra*). To take these uncertainties into account, a word formula approach should be used to set the annuity payments in a GRAT not only to avoid a payment that is too large, but also to avoid a remainder that is too small.

private letter ruling was held in a fiduciary capacity, but a power of substitution that complies with the requirements of Revenue Ruling 2008-22²⁴ should have the same effect because it requires that the trustee have a fiduciary duty to ensure that the property substituted for the trust property be of equivalent value. The strategy would be for the taxpayer to exercise the power of substitution when the assets have reached what in the taxpayer's view is a peak value in order to preserve that enhanced value for the benefit of the GRAT remainder beneficiaries. The power of substitution might also be effectively used to rescue the assets of an "underwater" GRAT in order to re-GRAT those assets at their currently depressed value using a lower section 7520 rate (which will increase the value of the annuity) thereby enhancing the opportunity effectively to capture a future upswing in the value of the underlying assets.

Consideration might also be given to a longer term GRAT, particularly if one is of the view that GRATs as an estate planning strategy may have a limited shelf life.²⁵ The negative of a longer term GRAT is that death within the term of the GRAT will likely cause a substantial portion, if not all, of the assets of the GRAT to be included in the grantor's gross estate for Federal estate tax purposes.²⁶ The probability of death within the term of a GRAT can be estimated using the 2000CM mortality tables which are based upon the 2000 census, and those probabilities are shown in the Table below.

Probability of Death Within a Term of Years

	<u>Age of Grantor</u>		
<u>Length of Term</u>	<u>50</u>	<u>60</u>	<u>70</u>
<u>2 years</u>	.9%	2.2%	4.9%
<u>5 years</u>	2.5%	6.1%	13.7%
<u>10 Years</u>	6.4%	14.6%	32.1%
<u>15 years</u>	12.1%	26.3%	53.9%

Another possible source of these probabilities, and perhaps a more accurate one, is the Life Table for the total population published by the National Center for Health Statistics, which shows the probability of survival for a term.²⁷

²⁴ 2008-16 I.R.B. 796.

²⁵ Note that the Green Book published by the Department of the Treasury in May 2009 proposes a minimum term of ten years for GRATs created after the date of enactment, which would seem to require legislation, as opposed to an amendment to the Treasury Regulations.

²⁶ See Treas. Reg. §20.2036-1(c).

²⁷ Life table for the total population: United States, 2004; National Center for Health Statistics; Centers for Disease Control and Prevention; www.cdc.gov/nchs.

		GRAT term		
		2 years	5 years	10 years
Current age	30	100%	99%	99%
	40	100%	99%	97%
	50	99%	97%	94%
	60	98%	94%	87%
	70	95%	87%	71%
	80	89%	71%	41%
	90	74%	42%	11%

The risk of death would typically be slightly higher for a male and slightly lower for a female.²⁸ In addition, statistics have shown that wealthier individuals tend to live longer, potentially reducing even further the risk of death within the term for the typical client who would consider creating a GRAT. Accordingly, for a relatively younger client, when interest rates are very low, a longer term GRAT may be a viable estate planning alternative, particularly if other techniques, such as employing a substitution power, are used to capture asset volatility thereby simulating the performance of a series of shorter term GRATs without the risk of fluctuations in the section 7520 rate.

The Tables below show the probability that a GRAT will be successful if the section 7520 rate is 2.0% (the rate in February 2009), or alternatively, 6.0% using the National Center for Health Statistics probabilities of survival.²⁹

Section 7520 rate is 2.0%

		GRAT term		
		2 years	5 years	10 years
Current age	30	77%	87%	93%
	40	77%	87%	92%
	50	77%	86%	89%
	60	76%	83%	82%
	70	74%	77%	67%
	80	69%	62%	39%
	90	57%	37%	11%

²⁸ Computations performed using *Estate Planning Tools*, Stephen R. Leimberg & Robert T. LeClair, Brentmark Software, Inc.

²⁹ Courtesy of JP Morgan Private Bank. Growth portfolio has an expected return of 9.8% and an expected volatility of 13.1%.

Section 7520 rate is 6.0%

		GRAT term		
		2 years	5 years	10 years
Current age	30	62%	68%	74%
	40	62%	67%	72%
	50	61%	66%	70%
	60	61%	64%	65%
	70	59%	59%	53%
	80	55%	48%	31%
	90	46%	29%	8%

It is interesting to note that the probability of success of a GRAT is higher with a longer term for a relatively younger grantor, although this is probably not a fair comparison because the longer term includes the benefit of compounding for the longer period. As discussed above, studies have shown that a rolling GRAT strategy, where each annuity payment from a 2 year GRAT is contributed to a new 2 year GRAT, and that process is continued for a 10 year period, has a superior result to a single 10 year GRAT.³⁰ Nevertheless, it does seem that a longer term GRAT for a relatively younger grantor is a statistically viable strategy to accomplish gratuitous wealth transfer, particularly in a low interest rate environment. And it may be enhanced if combined with the other strategies, such as asset substitution, described above. In the case of a single GRAT, the crossover point appears to be about age 70, when using a 10 year term has a materially depressing effect on the probability of success of the GRAT. It may be that these statistics influenced the recommendation in the Green Book³¹ to require a 10 year term for GRATs.

Charitable Lead Annuity Trust

A CLAT usually is a longer term strategy than is a GRAT. One reason for that is the GRAT will “fail” if the grantor dies during the annuity term; a CLAT generally will not.³² A CLAT, therefore, has the potential to benefit from “locking in” a long-term low interest rate at inception. In a CLAT, property is placed in trust usually for a period of years during which a fixed amount is paid to charity each year with the remainder at the end of the term passing to non-charitable beneficiaries. A CLAT created during lifetime may be structured as a grantor trust within the meaning of section 671 or as a non-grantor trust.³³ If the CLAT is a grantor trust, the grantor will be taxed on all the income of the CLAT during the term (and without the benefit of an annual income tax charitable deduction for the annuity payments made to charity). However, the grantor will obtain a current income tax deduction for the actuarial value of the charitable interest in the CLAT upon creating the CLAT, which can be used to the extent

³⁰ J. Blattmachr, D. Zeydel & R. Weiss, "Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth," 26th Annual Southern California Tax and Estate Planning Forum and 32nd Annual Notre Dame Tax and Estate Planning Institute, October 2006

³¹ The Green Book was published by the Department of the Treasury in May 2009.

³² See Treas. Reg. §20.2036-1(c)(1).

³³ See Rev. Proc. 2007-45, 2007-25 I.R.B. 89 (confirming the use of a grantor trust CLAT and using a substitution power within the meaning section 675(4)(C) held by a person other than the donor, the trustee or other disqualified person within the meaning of section 4946(a)(1) as the means to confer grantor trust status).

allowable under the normal rules applicable to charitable gifts under section 170, subject to recapture if the grantor dies during the CLAT term.³⁴ If the value of the charitable annuity interest is so large that it equals the value of the property placed in trust, the CLAT is said to be “zeroed out”—that is, the value of the taxable remainder will be zero because the entire value of the property contributed to the CLAT will qualify for the gift tax charitable deduction under section 2522. In that case, any assets that remain in the trust at the end of the CLAT term will pass to the remainder beneficiaries free of gift tax.

Low interest rates will make the actuarial value of the annuity interest in a CLAT more valuable, thereby increasing the chances of a positive remainder and a tax free gift. For example, if the actual annual return during the charitable annuity term were 10%, the future value of the remainder interest in a \$1,000,000 zeroed-out, 20 year CLAT would be \$2,733,714 if the section 7520 rate is 3.4%, but only \$1,734,265 if the section 7520 rate is 6%. (The reason is that the annuity will need to be much higher with a higher section 7520 rate in order to zero-out the remainder.) On the other hand, if the actual relative annual performance is 2% above the section 7520 rate, then the future value of the remainder would be only \$457,332 for a 3.4% section 7520 rate as opposed to \$671,429 for an 6% section 7520 rate. That may seem counterintuitive because it means that compounding at a higher rate (that is, at an 6% section 7520 rate plus 2% rather than a 3.4% section 7520 rate plus 2%) helps, and more than offsets, the higher 7520 rate (which would require a larger annuity payment to reduce the actuarial value of the remainder to zero and thus might seem to make it more difficult to have a successful CLAT.)

It seems accurate to conclude though that because a CLAT is a longer term strategy, a higher average performance can be projected, and that performance would be forecast regardless of the section 7520 rate at the commencement of the CLAT. In addition, unlike a GRAT, it seems that value will be ascribed to annuity payments to charity from a CLAT even for increases in excess of 20% a year so long as the annuity payments are determinable at the inception of the CLAT.³⁵ In a CLAT that is structured as a grantor trust, high escalation appears greatly to improve the likelihood of a positive outcome.

Assume, for example, that a 20-year zeroed-out CLAT created every month from January 1926 to May 1989 were invested in an S&P 500 index fund. Assume also for this purpose (because we do not have section 7520 rates for that period) that the section 7520 rate is 6% for each CLAT and the annuity payment to charity were escalated annually by 50% (meaning each subsequent year’s annuity payment would be one and half times the amount of the payment for the prior year). In simulations run by one financial institution,³⁶ 92% of the CLATs would be successful, meaning at least \$1 would be delivered to the remainder

³⁴ See section 170(f)(2)(B).

³⁵ See Rev. Proc. 2007-45, 2007-25 I.R.B. 89 *Annotations for Paragraph 2, Payment of Annuity Amount, of the Sample Trust in Section 4.* (“CLATs are not subject to any minimum or maximum payout requirements. The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer may be ascertained at the time of the transfer to the trust.”) See Treas. Regs. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), and 25.2522(c)-3(c)(2)(vi)(a).

³⁶ Courtesy of J.P. Morgan Private Bank.

beneficiary. Indeed, the median remainder value would have been 547% of the starting value of the CLAT -- a very impressive result.

In a low interest rate environment, such as a 3% section 7520 rate, historical analysis favored longer terms and higher escalation. It is of interest to note that, from an historical perspective, if a higher section 7520 rate were assumed (such as 10%), the best structure is more difficult to determine. For a longer term, higher escalation appears preferable, but for a shorter term it seems that a somewhat lower escalation is preferable.

**Median Remainder Value as Percent of Initial Funding
Grantor Zeroed Out CLAT
Section 7520 Rate is 10%
Historical Investment in S&P 500 Index Fund³⁷**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	18%	23%	34%	31%
<u>15 years</u>	43%	66%	69%	64%
<u>20 Years</u>	50%	149%	219%	226%
<u>25 years</u>	37%	251%	465%	494%

During current conditions, many do not expect future market performance to be as robust as it has been over certain recent years. The question then becomes what structure should be adopted for a CLAT created at this time. In the simulations prepared by one financial institution, the trends based on expected future performance (as of about 6 months ago) clearly favored high acceleration in lower section 7520 rate environments. The escalation column indicates the percentage increase in the annuity payment over the payment due in the prior year. (Thus, 100% escalation means the payment doubles each year.) In a 20 year CLAT initially funded with \$1,000,000, that translates to a payment of \$1.93 in year 1 and a payment of \$1,014,128.57 in year 20, in order to zero out the value of the remainder.

Charitable Payouts	Year	Annuity Escalation				Difference between 0% and 100%
		0%	20%	50%	100%	
	1	72,285	9,427.6	293.1	1.93	72,282.61
	2	72,285	11,313.2	439.7	3.87	72,280.68
	3	72,285	13,575.8	659.5	7.74	72,276.81
	4	72,285	16,291.0	989.3	15.47	72,269.07
	5	72,285	19,549.2	1,483.9	30.95	72,253.59
	10	72,285	48,644.6	11,268.4	990.36	71,294.18
	15	72,285	121,043.2	85,569.1	31,691.52	40,593.03
	20	72,285	301,194.2	649,790.3	1,014,128.57	(941,844.03)

³⁷ Courtesy of J.P. Morgan Private Bank.

Suppose that we assume a hypothetical portfolio with an expected return of 8.6% with 15% volatility. Fifteen percent volatility means that there is a 68% chance the actual return will be one standard deviation higher or lower than the expected return (between -6.4% and 23.6%) and a 95% chance the actual return will be two standard deviations higher or lower than the expected return (between -21.4% and 38.6%). The Table below shows that the median future value of a grantor CLAT improves with longer terms and higher escalation. Indeed, the most successful CLAT is expected to deliver a tax free benefit to the remainder beneficiaries that is 468% of the original value contributed to the CLAT. Thus, if the CLAT were funded with \$1,000,000, \$4,680,000 would be delivered to the remainder beneficiaries gift tax free at the end of a 25 year term, in the median case.

Median Future Value of CLAT Remainder as a Percentage of Initial Contribution
Grantor Zeroed Out CLAT
Section 7520 Rate is 3%
8.6% Expected Return/15% Volatility³⁸

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	45%	57%	68%	75%
<u>15 years</u>	88%	122%	144%	154%
<u>20 Years</u>	157%	230%	267%	279%
<u>25 years</u>	261%	404%	453%	468%

Nevertheless, if the section 7520 rates are high, then high escalation of the annuity retards CLAT performance with respect to its remainder interest. The probability of a successful CLAT (that is, one that has a positive remainder) is lower with higher escalation in a higher interest rate environment. In addition, if the section 7520 rate is higher, longer term CLATs may be expected to be less beneficial than shorter term CLATs.

³⁸ Courtesy of J.P. Morgan Private Bank.

**Probability of Positive Remainder
Grantor Zeroed Out CLAT
Section 7520 Rate is 10%
8.6% Expected Return/15% Volatility³⁹**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	29%	28%	27%	27%
<u>15 years</u>	25%	23%	23%	22%
<u>20 Years</u>	23%	20%	20%	20%
<u>25 years</u>	21%	18%	17%	16%

In fact, in the median case, the remainder for all the above CLATs will be zero because the expected return of 8.6% is less than the section 7520 rate of 10%, causing the CLATs to exhaust before the remainder vests at least 50% of the time.

Given the current highly unpredictable market environment, it certainly seems wise to reduce, to the greatest extent possible, the annuity payments to be made at least for the first several years of the CLAT. Substantial payments in the early years of a CLAT coupled with market losses will almost certainly result in the entire trust estate being delivered to the charitable beneficiary because the value of the trust would erode so much in the early years that the trust would be unable to recover. Therefore, a CLAT created today would seem to require that the grantor have substantial charitable intent rather than just a desire to use a CLAT to increase the amount of property that may be transferred to the chosen objects of his or her bounty free of gift and estate tax. The charts set forth above were based on forecasts made several months ago when market conditions seemed more predictable and were certainly better. It would be appropriate for any individual who has been considering using a CLAT to have any forecasts made in light of recent developments in the economy before proceeding.

The assumed portfolio in the preceding charts had an expected return of 8.6% and volatility of 15%. What happens to the expected performance of a grantor CLAT if a slightly more conservative or a slightly more aggressive portfolio is used? The charts below assume that Portfolio A has an expected return of 8.5% and volatility of 10.2% while Portfolio B has an expected return of 12.2% and volatility of 19.07%, similar to the historical performance of the S&P 400. What effect do these changes in investment strategy have on the expected outcome of a CLAT?

³⁹ Courtesy of J.P. Morgan Private Bank.

**Probability of Positive Remainder
Grantor Zeroed Out CLAT
Section 7520 Rate is 3%
Portfolio A⁴⁰**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	92%	93%	94%	95%
<u>15 years</u>	95%	97%	97%	94%
<u>20 Years</u>	97%	98%	99%	99%
<u>25 years</u>	98%	99%	99%	100%

**Probability of Positive Remainder
Grantor Zeroed Out CLAT
Section 7520 Rate is 3%
Portfolio B⁴¹**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	87%	88%	89%	90%
<u>15 years</u>	90%	93%	94%	94%
<u>20 Years</u>	93%	96%	96%	97%
<u>25 years</u>	95%	97%	98%	98%

The charts above show that at an assumed low section 7520 rate of 3%, the probability of a positive remainder is slightly negatively affected by employing the more aggressive portfolio. But that negative effect is probably less than one might have assumed. On the other hand, the value of the median remainder in those CLATs that have a positive remainder is substantially enhanced by employing a more volatile portfolio.

⁴⁰ Courtesy of J.P. Morgan Private Bank.

⁴¹ Courtesy of J.P. Morgan Private Bank.

Median Future Value of CLAT Remainder as a Percentage of Initial Contribution⁴²
Grantor Zeroed Out CLAT
Section 7520 Rate is 3%
Portfolio A⁴³

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	50%	62%	72%	79%
<u>15 years</u>	93%	126%	148%	158%
<u>20 Years</u>	161%	234%	270%	282%
<u>25 years</u>	266%	407%	455%	469%

Median Future Value of CLAT Remainder as a Percentage of Initial Contribution
Grantor Zeroed Out CLAT
Section 7520 Rate is 3%
Portfolio B⁴⁴

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	94%	114%	132%	143%
<u>15 years</u>	190%	248%	288%	306%
<u>20 Years</u>	360%	499%	568%	587%
<u>25 years</u>	635%	932%	1021%	1045%

Indeed, the median value of the remainder for a 25-year CLAT with 100% escalation in payments more than doubles with the more volatile portfolio, even though the likelihood of a positive remainder is reduced by only 2% points from 100% to 98%. This might be a risk well worth taking on. The results contradict the conventional wisdom that in a longer term strategy a more conservative portfolio improves the outcome. Although the likelihood of success does improve with a more conservative portfolio, that improvement is modest when compared to the degree to which the level of success is negatively affected. Of course, there will be a crossover

⁴² Median value is computed only for those CLATs that have a positive remainder. Thus, if only 95% of the CLATs have a positive remainder, the median value is computed only for 95% of the CLATs.

⁴³ Courtesy of J.P. Morgan Private Bank.

⁴⁴ Courtesy of J.P. Morgan Private Bank.

point when taking on additional risk will reduce the likelihood of success more significantly. This means there is no substitute for running multiple projections before determining the appropriate investment strategy.⁴⁵

In a higher interest rate environment, the choice of portfolio will have an even more dramatic effect. The charts below assume the section 7520 rate is 10% when assets are invested in a grantor CLAT. The probability of a positive remainder is dramatically reduced, but is significantly improved by the use of a more aggressive portfolio. The probability of a positive remainder at a 3% section 7520 rate for a 100% escalating CLAT invested in Portfolio A is 100%, whereas the probability of a positive remainder at a 10% section 7520 rate falls to 16%. On the other hand, if the CLAT is invested in Portfolio B, the probability of a positive remainder fall from 98% to only 55.9%, a nearly 40% improvement in the odds.

**Probability of Positive Remainder
Grantor Zeroed Out CLAT
Section 7520 Rate is 10%
Portfolio A⁴⁶**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	29%	28%	27%	27%
<u>15 years</u>	25%	23%	23%	22%
<u>20 Years</u>	23%	20%	20%	20%
<u>25 years</u>	21%	18%	17%	16%

⁴⁵ If the CLAT will not be a grantor CLAT or is a testamentary CLAT, the payment of income taxes on the taxable income of the trust not distributed to charity on an annual basis will need to be taken into account, and will likely change the composition of the optimal portfolio. If the CLAT payments are highly escalating, it may mean that a different investment strategy is needed in the earlier years, as opposed to the later years when the payments to charity will begin to exceed the likely taxable income of the CLAT.

⁴⁶ Courtesy of J.P. Morgan Private Bank.

**Probability of Positive Remainder
Grantor Zeroed Out CLAT
Section 7520 Rate is 10%
Portfolio B⁴⁷**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	51.3%	52.2%	52.9%	53.4%
<u>15 years</u>	51.7%	53.1%	53.9%	54.6%
<u>20 Years</u>	51.9%	53.6%	54.9%	55.7%
<u>25 years</u>	52%	54.5%	55.4%	55.9%

The median future value of the CLAT remainder as a percentage of the initial contribution, for the CLATs with a positive remainder, also improves dramatically with a more aggressive portfolio. At a 10% section 7520 rate only 16% of the 25-year CLATs with 100% escalation invested in Portfolio A are predicted to have a positive remainder, and of that 16%, the median projected value is 219% of the initial funding. On the other hand, 55.9% of the CLATs invested in Portfolio B are expected to have a positive remainder, and of those CLATs the median remainder value is projected to be 907% -- more than 3 times higher. Thus, in order to offset starting a CLAT when interest rates are high, it appears that one must take a more aggressive investment approach in order to have any reasonable chance of a positive outcome for the remainder beneficiaries.

⁴⁷ Courtesy of J.P. Morgan Private Bank.

**Median Future Value of CLAT Remainder as a Percentage of Initial Contribution
Grantor Zeroed Out CLAT
Section 7520 Rate is 10%
Portfolio A⁴⁸**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	22%	28%	33%	36%
<u>15 years</u>	39%	51%	64%	71%
<u>20 Years</u>	64%	95%	115%	122%
<u>25 years</u>	97%	158%	205%	219%

**Median Future Value of CLAT Remainder as a Percentage of Initial Contribution
Grantor Zeroed Out CLAT
Section 7520 Rate is 10%
Portfolio B⁴⁹**

<u>Length of Term</u>	<u>Escalation</u>			
	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>10 years</u>	67%	81%	95%	106%
<u>15 years</u>	127%	174%	216%	233%
<u>20 Years</u>	225%	348%	436%	464%
<u>25 years</u>	398%	694%	853%	907%

The foregoing result might seem a bit startling. But, the important lesson is that there is no one answer to determining the optimal investment strategy for an estate planning arrangement. The specific economic environment and the particular structure of the arrangement must be taken into account. And alternative scenarios should be compared to determine the effects on probability and degree of success.

⁴⁸ Courtesy of J.P. Morgan Private Bank.

⁴⁹ Courtesy of J.P. Morgan Private Bank.

SCINs and Private Annuities

A self-cancelling installment note (“SCIN”) and a private annuity also benefit from a low interest rate environment. A 10-year SCIN in September 2009 in the original principal amount of \$1,000,000 that cancels upon the earlier death of a 60 year old will have a risk principal premium⁵⁰ of approximately \$47,228 if the section 7520 rate is 3.4%, and approximately \$281,425 if the section 7520 rate is 6.0%. In addition, market interest payments for the 10-year term will be calculated on the increased balloon principal payment due at maturity equal to \$1,000,000 plus the risk premium. Accordingly, the total payments due will be significantly higher when interest rates are high. An interesting phenomenon is that if one accepts the IRS’s apparent method of actuarial computation for a SCIN,⁵¹ in the current environment where the long term applicable federal rate exceeds the section 7520 rate, for a younger measuring life the risk principal premium may be reduced to zero. A SCIN for a 50 year old in September 2009 when the long term AFR is 4.38% would produce no principal or interest premium. Therefore, a 10-year to 25-year SCIN for a 50 year old in September 2009 could be structured as an interest only arrangement with a balloon payment of principal at the end of the period, and cancel upon early death without additional cost.

In the case of a private annuity, a higher interest rate means not only a larger annuity payment, but the additional amount due will be added to the taxable portion of the annuity payment. Thus, a private annuity sold in September 2009 for \$1,000,000 in cash due for the life of a 60 year old when the section 7520 rate is 3.4% would require an annual annuity payment of \$69,047, \$27,753 of which would be taxable and \$42,194 of which would not be. If the section 7520 rate is 6.0%, the taxable portion increases to \$48,202. The non-taxable portion would remain the same.

It appears that the use of a SCIN will avoid inclusion of any portion of an installment note in the estate of the holder⁵² It is important to note that the foregoing computations make certain assumptions about the proper way to value a SCIN. Although quite a bit has been written about SCINs,⁵³ many basic questions remain. Among the unanswered questions is how to determine the increase in the note on account of the cancellation possibility.⁵⁴ This increase

⁵⁰ A risk principal premium is generally an additional sum, above the original amount borrowed, due at maturity. In general, the risk premium in a SCIN is the additional amount (above the amount borrowed plus market interest) that the obligor must pay to reflect the probability of the economic benefit to the obligor resulting from the fact that the obligation is cancelled upon the death of the measuring life prior to maturity. The risk premium may be expressed as a higher than market interest rate or as additional principal due. In the latter case, market interest (typically the AFR determined under section 1274(d)) will be due not only on the original principal (\$1,000,000 in the example in the text) but also on the additional principal amount constituting the risk premium.

⁵¹ Both the NumberCruncher software and TigerTables produce the result described.

⁵² See *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq in result*, 1981-1 C.B. 2; and *Costanza v. Commissioner*, 320 F. 3d 595 (6th Cir. 2003), *rev’g*, T.C. Memo 2001-128, for examples of SCINs.

⁵³ See, generally, H. Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms (WGL)*; J. Hesck & E. Manning, “Beyond the Basic Freeze: Further Uses of Deferred Payment Sales,” 34th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Chapter 16 (Matthew Bender & Company 2000); E. Wojnaroski, *Private Annuities and Self-Canceling Installment Notes*, BNA Tax Mgt. Portfolio, 805-2d; S. Rapkin, “Freezing Estates with Private Annuities and Self-Canceling Installment Notes,” 12 *Jl of Taxn of Investments* 33 (August 1994); S. Banoff & M. Hartz, “Sales of Property: Will Self-Canceling Installment Notes Make Private Annuities Obsolete?,” 59 *Taxes* 499 (August 1981). See also IRS General Counsel Memorandum (“GCM”) 39503 (May 7, 1986).

⁵⁴ Indeed, it does seem certain whether it matters for gift tax purposes anyway that the principal of the note is increased or the interest due under the note must be increased to reflect the cancellation feature.

is sometimes called the SCIN or mortality premium. No developed law specifically states how this premium is to be determined, although at least one commentator says “it is important to use sound actuarial principles in establishing the premium for any self-canceling feature in the note between family members,”⁵⁵ and the IRS has stated that the “value of the installment obligation and the property sold must be *substantially* equal.”⁵⁶

Presumably, the mortality premium will be based upon the probability that the measuring life will die before payment is due. If that chance is 50%, then the value of the note would be twice what the sales price of the property was. Generally, the probability is determined by reference to standard mortality tables. Unfortunately, there are many such tables. Although many estate planners are familiar with Table 90CM which has been promulgated under section 7520, the mortality feature of private annuities⁵⁷ has been based on Tables promulgated under section 72 and not section 7520. This might suggest that the 2000CM Table should not be used for a SCIN especially when the IRS in GCM 39503 states that if the term of the note exceeds the seller’s life expectancy the arrangement should be viewed as a private annuity or, if it is shorter, as an installment sale; and in doing so the IRS refers the Tables under section 72.⁵⁸ Hence, it is uncertain what mortality table should be used to determine the premium for a SCIN. It may seem that the “safer” route to follow would be to use that table that produces the largest premium, at least where the purchaser is a trust. After all, a trustee, as such, cannot make a gift.⁵⁹ However, it seems possible that a beneficiary of the trust might be treated as making a gift if the trust “overpays” for the property, such as by using a premium higher than required.⁶⁰ It also seems possible that the IRS would assert any overpayment to be evidence of a retained interest, perhaps leading to inclusion of the trust property under section 2036. This issue would appear to pose a more significant risk when a

See, generally, H. Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms*, *supra*, at ¶ 12.04[3][e].

⁵⁵ H. Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms*, *supra*, at ¶ 12.04[3][a][i] (footnote omitted). But note that GCM 39503, *supra*, states, in part, “there is no requirement that the actuarial tables are to be used in determining the gift taxation of [an] installment sale.”

⁵⁶ GCM 39503, *supra* (emphasis added). Although not quite as explicit, *Costanza v. Commissioner*, *supra*, seems consistent with the substantially equal value statement in the GCM. It seems relatively clear that GCMs are not binding upon the IRS. *See, e.g., Morganbesser*, 984 F.2d 560 (2d. Cir. 1993) (acknowledging that GCMs have no precedential value, but they are “helpful in interpreting the Tax Code when ‘faced with an almost total absence of case law’”; the court assumed that “the IRS would insist upon a uniform interpretation” of the statute in question and if there's no case law on point, it is arguably permissible to use GMCs to “instruct the court on how the IRS itself” interprets a certain statute); *cf. Stichting*, 129 F.3d 195 (D. Colum. 1997) (holding that GMCs “have no precedential value”) and *Tupper*, 134 F.3d 444 (1st Cir. 1998) (“GCMs do not establish precedent, and taxpayers cannot cite GCMs as authority against the United States in litigation.” Instead, they “may be looked to as a research tool by any interested court or party, but they are not authority in this court.”).

⁵⁷ *See* Rev. Rul. 69-74, 1969-1 C.B. 43, for a description of a private annuities. But note that proposed regulations promulgated in 2006 would change the income taxation of private annuities in some cases. By their terms, these final regulations would be retroactive to the date the proposed regulations were issued. *See, generally*, J. Hesch, L. Katzenstein, N. Lane & K. McGrath, “A Holistic Analysis of Private Annuities,” 59 USC Gould School of Law Fed. Inst. on Taxn ¶ 1800 (Mathew Bender & Co. 2007).

⁵⁸ GCM 39503, *supra*.

⁵⁹ *See* Treas. Reg. § 25.2511-1(g)(1); *Saltzman v. Commissioner*, 131 F.3d 87 (2d. Cir. 1997), *rev'g*. T.C. Memo 1994-641.

⁶⁰ *See, generally*, J. Blattmachr, M. Gans & S. Heilborn, “Gifts By Fiduciaries By Tax Options and Elections”, 18 *Probate & Property* (November/December 2004) No. 6; republished in *Digest of Tax Articles* (March 2005); *cf.* Rev. Rul. 84-105, 1984-2 C.B. 197.

SCIN is used because one is anticipating that death might occur when the obligation is still outstanding.

In *Dallas v. Commissioner*,⁶¹ the Tax Court concluded that two installment obligations payable by each of two trusts created by the taxpayer for the primary benefit of his children should be construed as self-cancelling installment notes. The taxpayer was 78 years old at the time the notes were issued and the notes had a face value of \$2,232,000. The court concluded that after taking the risk premium into account, the notes had a fair market value of only \$1,687,704. It appears that in arriving at that value, the IRS relied on the 90CM Table.⁶²

A somewhat similar question is what interest rate should be used to determine the premium. Although a special interest rate is prescribed under section 483(d) for a sale reportable under the installment sales provisions of that section, no sale will be deemed to occur under that (or any other income tax) section because a sale to a grantor trust is ignored for income tax purposes.⁶³ In an installment sale to a grantor trust, generally, the so-called AFR is used as determined under section 7872, which applies for income, gift and estate tax purposes. However, private annuities use the so-called section 7520 rate (which is 120% of the mid-term AFR determined under section 7872 rounded to the nearest even two-tenths of one percent). Section 7520 applies for purposes of determining “the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest.” A sale, even an installment sale, is not any such interest. However, GCM 39503 suggests, in some cases, that an installment sale will be treated as a private annuity. Accordingly, it appears uncertain which interest rate should be used. Both the GCM and *Costanza v. Commissioner*⁶⁴ indicate that unlike a private annuity, a SCIN need not be “exactly” for equal worth of the property purchased. Hence, perhaps any IRS “approved” table and rate can be used. It appears that in *Dallas*, however, the discount rate used was in fact the then applicable section 7872 rate and not the section 7520 rate. On the other hand, it might be worthwhile noting that several “commercial” actuarial calculation programs use the 2000CM Table and the section 7520 interest rates in doing calculations with respect to SCINs.

Another question is under what circumstances a particular mortality table may not be used on account of the particular health profile of the measuring life. Treas. Reg. § 25.7520-3(b)(3) provides that the standard mortality table may not be used if the death of the measuring life is imminent (essentially, that the measuring life is afflicted with a medical condition so that the probability of surviving for at least one year is not at least 50 percent). But, as indicated above, where a SCIN is not treated as an annuity, it is questionable whether any part of section 7520 or its regulations applies as that section is limited to “any annuity, any interest for life or a

⁶¹ T.C. Memo. 2006-212.

⁶² It appears that the IRS performed its computation in two parts, calculating the value of the right to receive interest on the note (the terms of which called for interest at 6%) and the right to the balloon principal payment at the end of the 5 year term separately. The annual midterm AFR at the time the notes were issued in November 1999 was 6.08%. The section 7520 rate was 7.4%. The discount on the notes in *Dallas* resulting from the risk premium can be computed virtually to the penny using commercial software that would apply the 90CM Table, if the then section 7872 (AFR) of 6.08% is used as the discount factor, taking into account that the note itself called for interest payments at a 6% rate. The risk premium would have been much higher if the section 7520 rate of 7.4% had been used. Anecdotally, other practitioners report that the IRS actuaries use the AFR and not section 7520 to determine the discount factor for a SCIN.

⁶³ Rev. Rul. 85-13, 1985-1 C.B. 184.

⁶⁴ 320 F. 3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo 2001-128.

term of years, or any remainder or reversionary interest.”⁶⁵ A SCIN (unless, as was done in GCM 39503, treated as a private annuity) seems to be none of those.

In Rev. Rul. 80-80,⁶⁶ the IRS used a “so remote as to be negligible” test for determining the chance of survival for at least a year (understood to be a 1 in 20 of survival for at least one year). Certainly, that revenue ruling has been usurped by Treas. Reg. § 25.7520-3(b)(3) with respect to “any annuity, any interest for life or a term of years, or any remainder or reversionary interest.” But the Rev. Rul. test may be the correct test for a SCIN. Note also that GCM 39503 states, in part, “there is no requirement that the actuarial tables are to be used in determining the gift taxation of [an] installment sale. Thus, the taxpayer’s particular health status may be considered . . .” In any case, it would seem more prudent to use a SCIN only if the regulatory test for survival applies rather than the revenue ruling test, and even perhaps actual life expectancy would need to be taken into account.

If use of standard mortality tables is denied as a result of the probability of the premature death of the seller, it may be that there is little downside consequence. At least under Treas. Reg. § 25.7520-3(b)(3), the seller would be deemed to have made a gift, the calculated risk premium having been too low. But the note presumably would not be included in the seller’s estate and overall the result may be better than if a non-SCIN note had been used. In any case, as with a private annuity, the “best seller for whom a SCIN should be used, from a purely tax standpoint, is one whose actuarial life expectancy greatly exceeds his or her real life expectancy. The risk premium[,] in this situation, is based on the actuarial life expectancy, but relatively few payments are made during the seller’s lifetime.”⁶⁷

Although there may be significant income tax consequences to the payments under the SCIN as well as its cancellation, it seems there is none if the buyer is a grantor trust.⁶⁸ Hence, if the parties are reasonably confident that the seller will die earlier than forecast pursuant to appropriate mortality tables, making the note issued by the grantor trust to effect the installment sale to a grantor trust transaction a SCIN will enhance the estate planning results.

What About an Installment Sale to a Grantor Trust?

In a typical installment sale to a grantor trust, a grantor trust purchases assets from its grantor for an installment note. The note usually provides for payments of interest only for a period of time followed by a balloon principal payment at maturity. The interest rate is generally determined by the applicable federal rate under section 1274, rather than the higher section 7520 rate.⁶⁹

⁶⁵ See H. Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms*, *supra*, at ¶12.04[3][a][ii], suggesting the Treas. Reg. § 25.7520-3(b)(3) test should be used for a SCIN, citing to Priv. Ltr. Rul. 2005-51-013 for support for that suggestion although acknowledging it “involved life estates, rather than a SCIN.” Although claiming the Priv. Ltr. Rul. “is still relevant” despite that distinction, it fails to explain how or why.

⁶⁶ 1980-1 C.B. 194.

⁶⁷ See H. Zaritsky, *Tax Planning for Family Wealth Transfers: Analysis with Forms*, *supra*, at ¶12.04[3][a][ii]; J. Hesch, L Katzenstein, N. Lane & K. McGrath, *supra*.

⁶⁸ Rev. Rul. 85-13, *supra*.

⁶⁹ The section 7520 rate is the mid-term AFR times 1.2 and rounded to the nearest even two-tenths of one percent. It is possible that the short-term AFR or long-term AFR could be greater than the section 7520 rate.

With the current economic downturn, individuals who have implemented an installment sale to a grantor trust may find that the transaction is “underwater”. An underwater sale means one where the fair market value of the asset purchased by the trust and not used to pay off the installment note has fallen below the outstanding principal due on the installment note.. Several possible transactions might be considered when faced with this situation.

One possibility would be to lower the interest rate on the installment note to a current market rate.⁷⁰ This simple step can have a surprisingly beneficial effect on the outcome. In the Table set forth below, it is assumed that a 10-year installment sale to a grantor trust was put in place when average rates of return were 8% and the AFR interest rate on the note was 5%. It is further assumed that the grantor trust is funded with initial or seed capital of \$1,000,000 and the asset sold to the grantor trust is an interest in an entity with an underlying net asset value of \$9,000,000 but which would be valued with a 30% discount from underlying net asset value so that the initial principal on the installment note is \$6,300,000 (that is, 70% of \$9 million). In the first four years the assets grow at the rate of 8% and an interest payment of \$315,000 (5% of \$6,300,000) is made each year. In the fifth year after the sale, there is a drop in the value of the underlying assets by 40%. Thereafter, average annual returns drop to 4%. In the case where the parties make no adjustments to the arrangement, on a net asset value basis, the transaction fails and substantial seed capital is lost as the Table below demonstrates (where the value of the remainder at the end of \$505,901.05 is less than the initial or seed capital of \$1,000,000).

Installment Sale to Grantor Trust
Assume 8% Annual Growth Years 1-4, 40%
Decline in Year 5 and 4% Annual Growth Thereafter
Seed Capital \$1MM, Sale of \$9MM Discounted 30%, AFR on Note 5%

1	\$ 10,000,000.00	\$ 800,000.00	\$ (315,000.00)	\$ 10,485,000.00
2	\$ 10,485,000.00	\$ 838,800.00	\$ (315,000.00)	\$ 11,008,800.00
3	\$ 11,008,800.00	\$ 880,704.00	\$ (315,000.00)	\$ 11,574,504.00
4	\$ 11,574,504.00	\$ 925,960.32	\$ (315,000.00)	\$ 12,185,464.32
5	\$ 12,185,464.32	\$ (4,874,185.73)	\$ (315,000.00)	\$ 6,996,278.59
6	\$ 6,996,278.59	\$ 279,851.14	\$ (315,000.00)	\$ 6,961,129.74
7	\$ 6,961,129.74	\$ 278,445.19	\$ (315,000.00)	\$ 6,924,574.93
8	\$ 6,924,574.93	\$ 276,983.00	\$ (315,000.00)	\$ 6,886,557.92
9	\$ 6,886,557.92	\$ 275,462.32	\$ (315,000.00)	\$ 6,847,020.24
10	\$ 6,847,020.24	\$ 273,880.81	\$ (6,615,000.00)	\$ 505,901.05

Suppose that the parties agree to reduce the interest rate on the installment note to the assumed current AFR of 3%. This simple strategy allows the transaction to succeed, at least on a net asset value basis, to deliver some additional assets to the remainder beneficiaries above the seed capital, as reflected in the table set forth below, where the value of the remainder at the end of \$1,188,357.69 is greater than the initial or seed capital of \$1,000,000.

⁷⁰ See J. Blattmachr, B. Crawford, E. Madden, “How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note,” *Journal of Taxation*, Vol. 109, No. 1, p.22 (2008).

Installment Sale to Grantor Trust
Assume 8% Annual Growth Years 1-4, 40% Decline in Year 5 and 4% Growth Thereafter
Seed Capital \$1MM, Sale of \$9MM Discounted 30%
AFR on Note 5% -- Reset to 3% Year 6

1	\$ 10,000,000.00	\$ 800,000.00	\$ (315,000.00)	\$ 10,485,000.00
2	\$ 10,485,000.00	\$ 838,800.00	\$ (315,000.00)	\$ 11,008,800.00
3	\$ 11,008,800.00	\$ 880,704.00	\$ (315,000.00)	\$ 11,574,504.00
4	\$ 11,574,504.00	\$ 925,960.32	\$ (315,000.00)	\$ 12,185,464.32
5	\$ 12,185,464.32	\$ (4,874,185.73)	\$ (315,000.00)	\$ 6,996,278.59
6	\$ 6,996,278.59	\$ 279,851.14	\$ (189,000.00)	\$ 7,087,129.74
7	\$ 7,087,129.74	\$ 283,485.19	\$ (189,000.00)	\$ 7,181,614.93
8	\$ 7,181,614.93	\$ 287,264.60	\$ (189,000.00)	\$ 7,279,879.52
9	\$ 7,279,879.52	\$ 291,195.18	\$ (189,000.00)	\$ 7,382,074.70
10	\$ 7,382,074.70	\$ 295,282.99	\$ (6,489,000.00)	\$ 1,188,357.69

Suppose instead that the parties arrange to prepay the note without having to use a discounted asset, meaning that underlying assets of the entity (an interest in which was purchased in the installment sale) are used to repay the obligation, rather than an interest in the entity itself which is discounted in value.⁷¹ Suppose the seller then contributes the proceeds received in satisfaction of the original note to a different entity and sells an interest in that entity back to the trust for another note bearing the then current AFR interest. Assume that the interest sold also is valued with a 30% discount and that the applicable federal rate on the new note is 3%. Notwithstanding the somewhat conservative assumption that average rates of return for the balance of the 10 year period will drop to 4%, it appears that, because the 3% interest rate on the note is less than the assumed 4% rate of return and because the transaction is able to “capture” a 30% discount, the results are beneficial even if the new installment sale is very short term, as demonstrated in the chart set forth below.

Installment Sale to Grantor Trust
Assume 8% Annual Growth Years 1-4
40% Decline in Year 5 and 4% Growth Thereafter
Seed Capital \$1MM, Sale of \$9MM Discounted 30%
AFR on Note 5% -- Repay in Year 5

1	\$ 10,000,000.00	\$ 800,000.00	\$ (315,000.00)	\$ 10,485,000.00
2	\$ 10,485,000.00	\$ 838,800.00	\$ (315,000.00)	\$ 11,008,800.00
3	\$ 11,008,800.00	\$ 880,704.00	\$ (315,000.00)	\$ 11,574,504.00
4	\$ 11,574,504.00	\$ 925,960.32	\$ (315,000.00)	\$ 12,185,464.32
5	\$ 12,185,464.32	\$ (4,874,185.73)	\$ (6,615,000.00)	\$ 696,278.59

⁷¹ This strategy will have less risk if the initial installment sale to the trust was reported as a non-gift by making adequate disclosure on a timely filed gift tax return. See Treas. Reg. §301.6501(c)-1(f)(2).

**Restart Freeze @30% Discount with Repayment Amount of \$6.3MM
4% Growth and Reset Note to 3%**

			\$	\$
6	\$ 6,996,278.59	\$ 279,851.14	(132,300.00)	7,143,829.74
			\$	\$
7	\$ 7,143,829.74	\$ 285,753.19	(132,300.00)	7,297,282.93
			\$	\$
8	\$ 7,297,282.93	\$ 291,891.32	(132,300.00)	7,456,874.24
			\$	\$
9	\$ 7,456,874.24	\$ 298,274.97	(132,300.00)	7,622,849.21
			\$	\$
10	\$ 7,622,849.21	\$ 304,913.97	(4,542,300.00)	3,385,463.18

This would indicate that locking in a low interest rate for a longer period will accomplish substantial wealth transfer, even if rates of return are assumed to be conservative. Therefore, although it may be difficult to motivate individuals to engage in planning when property values are low, the opportunity for wealth transfer may be substantial. In a stable marriage situation, the concern about moving assets to a trust may be partially offset by making the spouse a discretionary beneficiary of the trust so that assets could be retrieved by discretionary distributions to the spouse.⁷² In addition, regardless of the other arrangements used to cause the trust to be a grantor trust, giving the spouse a discretionary beneficial interest in the entire trust will cause the trust to be a wholly grantor trust under sections 676 and 677.

It is interesting to note that the economic performance of an installment sale trust may be favorably compared to an escalating CLAT particularly in a low interest rate environment.

⁷² Indeed, the spouse could be defined as the person to whom the grantor is married to and living with at the time in question, without that causing the trust assets to be included in the estate of the grantor. See Rev. Rul. 80-255, 1980-2 C.B. 272. In addition, it seems that the grantor himself or herself could be a discretionary beneficiary of the trust without causing estate tax inclusion if the trust is created in a jurisdiction (such as Alaska or Delaware) where creditors of the grantor may not attach the assets of the trust. See, e.g., *Estate of German v. Comm'r*, 7 Ct. Cl. 641 (1985); Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

**Probability of Positive Remainder
Grantor Zeroed Out CLAT
9 Year CLAT
8.6% Expected Return/15% Volatility⁷³**

	<u>Escalation</u>			
<u>7520 Rate</u>	<u>0%</u>	<u>20%</u>	<u>50%</u>	<u>100%</u>
<u>3%</u>	90%	92%	93%	93%
<u>5%</u>	79%	80%	81%	82%
<u>7%</u>	59%	61%	61%	62%
<u>10%</u>	30%	29%	28%	28%

**Probability of Positive Remainder
9 Year Installment Sale to Grantor Trust
8.6% Expected Return/15% Volatility⁷⁴**

<u>Midterm AFR</u>	<u>0%</u>
<u>2.50%</u>	95%
<u>4.17%</u>	87%
<u>5.83%</u>	74%
<u>8.33%</u>	46%

Of course there are a number of distinctions between a CLAT and a grantor trust that participates in an installment sale to a grantor trust. First, all the CLAT annuity payments are made to charity, but the payments in the installment sale return to the grantor and presumably will eventually pass to the grantor's beneficiaries. In addition, it is likely that generation-skipping transfer tax exemption would be allocated to the purchasing trust in an installment sale which cannot be effectively done with a CLAT,⁷⁵ thereby dramatically improving the leverage of the GST exemption (if the installment sale is "successful"). But one potential advantage of the CLAT is that there appears to be no real limit on the term of the trust (as there needs to be with a GRAT because the death of the grantor during the annuity term will cause all or a portion of the GRAT to be included in the grantor's gross estate for Federal estate tax purposes), and the longer the low interest rate can be locked in the better the economic results are likely to be. In the one private letter ruling⁷⁶ that analyzed most aspects of an installment sale to a grantor

⁷³ Courtesy of J. P. Morgan Private Bank.

⁷⁴ Courtesy of J.P. Morgan Private Bank.

⁷⁵ See section 2642(e).

⁷⁶ PLR 9535026 (not precedent under I.R.C. §6110(k)(3)).

trust, it appears that the IRS required that the note not extend beyond the life expectancy of the grantor in order to rule favorably.

Consider Restructuring Existing Estate Planning to Provide Additional Leverage

Although there will be psychological hurdles to engaging in estate planning when clients feel less wealthy, consideration should be given to the opportunities that may exist to improve the performance of existing estate planning structures. One significant opportunity is to convert existing family trusts from a non-grantor trust to a grantor trust within the meaning of section 671. Revenue Ruling 2004-64⁷⁷ confirms that the payment of income tax by the grantor of a trust that is treated as wholly owned by the grantor for federal income tax purposes under section 671 does not constitute a taxable gift by the grantor to the trust. Yet, the ability to enhance the value of a trust by the income tax liability on its assets effectively permits the trust to compound income tax free. Income tax free compounded affords a trust the same economic performance as a retirement plan or a charitable remainder trust, without any distribution requirements. Over time, the wealth transfer that can be accomplished is very substantial, and may become even more substantial in the future if ordinary income tax and capital gains rates increase.

Several methods may be available to convert a trust from a non-grantor trust to a grantor trust. One method might be to apply to court for a modification or reformation of the trust.⁷⁸ Another might be to relocate the trust to a State that has legislation or State common law permitting so-called “decanting” of trusts, which is the act of a trustee contributing the assets of the original trust to a new trust with differing terms.⁷⁹

Florida appears to have the earliest case authorizing decanting of a trust. In *Phipps v. Palm Beach Trust*,⁸⁰ the Supreme Court of Florida held that a trustee with absolute discretion to distribute the principal of a trust among a class of beneficiaries, has the lesser power to distribute the principal of the trust into a new trust for a member of the class of beneficiaries, rather than making the distribution directly to the beneficiary. The *Phipps* case appears to consider the trustee’s absolute discretion over distributions of principal to be in the nature of a special power of appointment, and expressly held that the trustee’s power of appointment could be exercised in further trust. In *Phipps*, the purpose of decanting was to give the primary beneficiary of the trust a testamentary power of appointment over the trust estate that would permit an appointment in favor of the beneficiary’s spouse.

Typically, the beneficiaries of the second trust may include only beneficiaries of the first trust. However, consistent with the discretionary authority to distribute principal to one but not all beneficiaries, from which the authority to decant derives, it is not required that every beneficiary of the first trust also be a beneficiary of the second trust. The exercise of the power usually cannot reduce any fixed income, annuity or unitrust interest in the assets of the first trust. This limitation preserves the tax effects of the first trust (such as with respect to a marital deduction trust required to pay all income to the surviving spouse) and also preserves the intentions of the settlor with respect to required income distributions. Such dispositive concerns, as opposed to tax concerns, could be regarded as misplaced to the extent that an

⁷⁷ 2004-2 C.B. 7.

⁷⁸ See, e.g., F.S. 736.04113 and 736.04115. See also F.S. 736.0412 dealing with non-judicial modification.

⁷⁹ See, e.g., AK Stat. §13.36.157; 12 Del C. §3528; F.S. 736.04117; NY EPTL §10-6.6(b)

⁸⁰ 142 Fla. 782 (1940)

outright distribution of principal to one or more beneficiaries would by definition defeat any fixed income interest. Yet, the concern that the notion of decanting has the potential to defeat the dispositive intention of the settlor is typically raised in the legislative process, and frequently resolved by the determination to preserve income-type interests because they may also have potential tax sensitivity.

Given the breadth of typical decanting statutes, it would seem that the exercise of the power to decant in order to add provisions necessary to convert a trust from a non-grantor trust to a grantor trust that are otherwise without dispositive effect ought to be reasonably non-controversial. For example, the new trust could simply add a power in the grantor to substitute assets of equivalent value within the meaning of section 675(4)(C). That power, perhaps thought by some to present a substantial risk of estate tax inclusion of the assets, appears significantly less problematic since the issuance of Rev. Rul. 2008-22.⁸¹ Another possibility is to change the identity of the trustees from independent trustees to trustees who are related and subordinate parties but are not otherwise beneficiaries of the trust.⁸²

Extending the duration of a trust will also enhance the wealth transfer and asset protection opportunities for the trust beneficiaries, particularly if the trust is simultaneously converted to a grantor trust. A trust scheduled to terminate at a stated age will likely accumulate substantially less value than a lifetime trust that is also a grantor trust. Moreover, a trust that terminates in favor of its beneficiary will immediately become subject to the claims of the beneficiary's creditors, potentially diluting significantly the wealth transfer achieved. There appears not to be a restriction on distributing to a second trust that eliminates one or more fixed principal distributions or extends the termination date of a trust. Decanting to extend the duration of a trust can also permit the trustee to continue a trust that is protected from generation-skipping transfer tax.⁸³

Another possible strategy would be to take advantage of a client's enhanced GST exemption, currently \$3.5 million. If values are depressed, it may be advantageous to allocate unused GST exemption to an existing trust using a so-called late allocation.⁸⁴ One may elect to value the assets as of the first day of the month in which the allocation is made, or to value the assets on the date the allocation is made by filing a Form 709 that is late with respect to the date of transfer.⁸⁵ If a client has previously created trusts some of which are exempt from

⁸¹ 2008-16 I.R.B. 796.

⁸² See section 674 and section 672(c) for the extent to which discretionary authority over trust distributions held by related and subordinate trustees will cause a trust to be treated as owned by its grantor for federal income tax purposes.

⁸³ Compare Treas. Reg. §26.2601-1(b)(4)(i)(E) *Example 1* (express authority granted in a trust instrument to appoint in further trust without the approval or consent of any beneficiary permitted the trustee to extend the duration of the trust within the scope of that express authority without losing the GST exempt status of an irrevocable trust created prior to the effective date of Chapter 13) with *Example 2* (decanting in favor of a new trust under a decanting statute enacted after the original trust became irrevocable and requiring the consent of all parties was a modification but did not shift a beneficial interest in the trust to a beneficiary in a lower generation).

⁸⁴ See Treas. Reg. 26.2632-1(b)(4)(ii).

⁸⁵ It is not clear whether a late allocation can be made to a transfer in the immediately preceding taxable year if the Form 709 for that year is not yet due. The regulations refer to a "late allocation" as one that is made on a return filed after the due date for a timely return with respect to the transfer. *Id.* Suppose a transfer is made in trust in December 2008, and the taxpayer wishes to allocate all of her enhanced GST exemption to the trust as of January 1, 2009. There does not appear to be a policy reason why this should

generation-skipping transfer tax and some of which are not, it may be appropriate to consider a sale of assets between trusts. If both trusts are grantor trusts, or can be made to be grantor trusts, there will be no income tax consequence to such a sale. And when interest rates are low and values are depressed, the leverage provided by moving assets to a transfer-tax free environment using a long term, low interest note may be substantial over time.

The purpose of the foregoing discussion is not to provide an exhaustive list of the opportunities, but simply to point out that even if a client feels constrained in engaging in additional estate planning, a review of existing estate planning structures might present the opportunity for a number of possible wealth transfer enhancements without parting with large sums of additional capital.

Overcoming Planning Inertia

Notwithstanding the opportunities, clients are unlikely to be motivated to engage in substantial lifetime estate planning when interest rates are low and values are depressed. Frequently, a client's sense of self relates directly to his or her standing in his or her society and within the family as the one who owns and controls the wealth. That identity may already have been substantially shaken by the current economic crisis. For many clients, this may be the first time they have had to contemplate lifestyle changes because portfolio values and returns have fallen so dramatically. Further dilution by current wealth transfers may be psychologically unacceptable.

One method to overcome the psychological and economic impediments to current wealth transfer planning is the use of trusts. A trust as the recipient of a current wealth transfer affords many important flexibilities. The client can, within the constraints of Revenue Ruling 95-58,⁸⁶ control the identity of the trustee without adverse estate or gift tax effects. A properly drafted trust will provide the trust beneficiaries with asset protection and thereby avoid the dissipation of family wealth. Asset protection can be accomplished by including spendthrift provisions in the trust instrument. But a wholly discretionary trust will likely provide similar asset protection so long as the beneficiaries are not able to control distributions to themselves by powers of withdrawal or because they are serving as trustees without limitations, either under local law or the governing instrument, on distributions in favor of themselves.⁸⁷ Distributions from a trust can be made entirely discretionary, and it will be exceptionally unlikely that any beneficiary can contest the trustee's exercise of discretion to constrain distributions as an abuse of discretion.⁸⁸

In view of the foregoing, one possible method for a settlor to keep indirect access to a lifetime trust is for the settlor to include his or her spouse as a discretionary beneficiary. Such a structure should not, by itself, give the spouse the right to demand distributions from the trustee. However, for so long as the settlor and his or her spouse remain married and living together, the trustee could make distributions for the spouse's benefit that would indirectly benefit the settlor, thus providing an element of financial security. The trust could be drafted so as to include the

not be permitted as a late allocation, and certainly the additional \$1.5 million of GST exemption that became available in 2009 cannot be allocated any earlier than 2009.

⁸⁶ 1995-2 C.B. 191.

⁸⁷ See, e.g., F.S. 736.0504(2)(b) which provides that a wholly discretionary trust does not permit creditors of a beneficiary to attach the assets of the trust prior to distribution.

⁸⁸ See, e.g., *Sarasota Bank & Trust Co. v. Rietz*, 297 So. 2d 91 (FL 2nd DCA 1974) ("A trustee's exercise of its discretion is not subject to control by the court except to prevent an abuse of discretion.")

spouse that the settlor is married to from time to time. In addition, if the settlor becomes divorced and the trust is settled in a State that permits self-settled trusts without adverse effects (see discussion below), the settlor could be introduced as a discretionary beneficiary. The ability to become a trust beneficiary upon divorce should not be considered a retained interest in the trust because divorcing one's spouse would be deemed a fact of independent significance.⁸⁹

But more important, the client can choose to settle the trust in a State with so-called asset protection legislation.⁹⁰ In general, a trust created for the settlor's own benefit is available to the settlor's creditors to the extent of the settlor's beneficial interest.⁹¹ If the settlor's interest is discretionary, the trust will be deemed available to the settlor to the maximum extent of the trustee's ability to make discretionary distributions in the settlor's favor. Such discretion will have the collateral negative consequence of making the transfer to the trust incomplete for federal gift tax purposes, as well as includible in the settlor's gross estate for federal estate tax purposes.⁹²

Whether the assets of a self-settled trust are available to the settlor's creditors should depend upon the law of the State that governs the trust. In *Estate of German v. U.S.*,⁹³ the decedent, who was not a resident of Maryland, settled trusts governed by Maryland law which provided that during her lifetime the trustees had the power in their absolute and uncontrolled discretion to pay to or apply for the benefit of the grantor all or any part of the income or principal as the trustees should determine for any reason whatsoever, including the termination of the trust, with the written consent of the trust's remainder beneficiary. The court concluded that under Maryland law, the trusts would not be available to the grantor's creditors because distributions to the grantor would require that the grantor obtain the consent of an adverse beneficiary. Because the government could not establish that the trusts were available to the decedent's creditors at the time of her death under Maryland law, the government's motion for summary judgment for inclusion of the trusts in the decedent's gross estate was denied. More recently, the IRS has ruled that a self-settled trust in a State that does not permit creditors of the settlor to access the trust will result in a completed gift to the trust for federal gift tax purposes.⁹⁴ The IRS refused to rule on whether the trust would be includible in the settlor's gross estate, but the gift tax ruling is encouraging and should foreclose an adverse estate tax ruling unless the IRS could demonstrate an implied understanding sufficient to cause inclusion under section 2036 or 2038.

Accordingly, one potential structure that may be satisfactory is to settle the trust in a State that generally prohibits the settlor's creditors from accessing the trust and either restricting distributions to the settlor's spouse during a healthy marriage, or restricting distributions to the settlor to economic circumstances unlikely to occur prior to death, but nevertheless providing coverage for the "rainy day." Another possibility is to afford the settlor a full discretionary interest from inception, with the additional authority to remove and replace independent trustees, coupled with the ability of a trust protector to remove the settlor as beneficiary. Such a

⁸⁹ *Estate of Tully v. U.S.*, 208 Ct. Cl. 596 (1976); Rev. Rul. 80-255 1980-2 C.B. 272.

⁹⁰ See, e.g., Alaska Stat § 34.40.110; Del. Code Ann. tit. 12, §§3570-3576.

⁹¹ See, e.g., *In re Lawrence*, 251 B.R. 630 (S.D. FL 2000), *aff'd*, 279 F.3d 1294 (11th Cir. 2002) ("Florida and federal bankruptcy law both prohibit individuals from setting up self-settled spendthrift type trusts and maintaining the benefits of and the ability to significantly control same, while keeping the assets away from creditors.")

⁹² See Rev. Rul. 76-103, 1976-1 C.B. 293; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Outwin v. Commissioner*, 76 T.C. 153 (1981); *Estate of Uhl v. Commissioner*, 25 T.C. 22 (1955).

⁹³ 7 Ct. Cl. 641 (1985),

⁹⁴ PLR 9837007 (not precedent).

removal power should not be within the reach of section 2035(a),⁹⁵ even if the settlor were construed to have retained an interest in the trust because the settlor is not making a transfer of his or her interest, instead the settlor's interest is being extinguished by an independent third party. Perhaps the protector's authority could be limited to the circumstance that the settlor's death has become imminent. Last, would be to confer the discretionary interest with no ability to remove the settlor on the basis that either it accomplishes the estate planning while providing the necessary financial comfort or, if it does not, the gift in trust would be deemed incomplete, avoiding current gift tax, with the collateral consequence that the property is includible in the settlor's gross estate as if the settlor had not engaged in lifetime planning.

Conclusion

Lower interest rate environments definitely provide certain estate planning opportunities. Motivating a taxpayer when he or she does not feel wealthy or financially secure may be an obstacle to having him or her implement estate planning arrangements. Strategies that do not involve substantial or long term transfers of wealth might prove the most attractive to such an individual. In addition, strategies that transfer wealth in trust so that the trustee may directly or indirectly benefit the grantor will provide greater comfort. Restructuring planning that has already been implemented to enhance the after tax benefits might be particularly attractive as no new wealth transfer would be involved. A failed prior strategy might be renewed to advantage, and depressed values might even make direct gifts an attractive and highly leveraged opportunity.

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⁹⁵ Section 2035(a) includes in the gross estate of a decedent property that would have been includible in the decedent's gross estate under sections 2036, 2037, 2037 or 2042, but for the decedent transfers for less than full and adequate consideration in money or money's worth of the retained power or interest causing estate tax inclusion within three years of the decedent's death.