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Grantor Retained Annuity Trusts (GRATs), Installment Sales to "Intentionally Defective" Grantor Trusts, Charitable Lead Annuity Trusts (CLATs), Qualified Personal Residence Trusts (QPRTs)

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I. <u>Using IRS Assumptions To Your Own Benefit with GRATs, Grantor Trusts, and Similar Techniques.</u>

All of the techniques discussed below take advantage of the interest-rate assumptions made by the Treasury. Each month, the Treasury publishes a set of rates. These rates are used to determine the present value of annuities, life interests, interests for a term of years, and remainder or reversionary interests. They reflect the I.R.S.'s assumption as to what assets can be expected to earn if invested on a particular date. These rates are at very low levels and have been throughout the last decade.

<u>Charitable Lead Trusts</u> and <u>GRATs</u> use the 7520 rate. The "Charitable Federal Midterm Rate" (also known as the CMFR or "7520 rate") calculated pursuant to I.R.C. Section 7520 (set at 120% of the mid-term Applicable Federal Rate (under Section 1274(d)(1)) rounded to the nearest two-tenths of one percent) for November 2018 is 3.6% (up from 3.4% in October and 2.6% in January). The lowest 7520 rate ever was 1.0% (January of 2013 and several months in 2012). The last time the 7520 rate topped 4% was in July of 2008. It was above 5% throughout 2006 and 2007 and was often above 7% or even 8% in the decade prior to 2008. These federal rates first began to float in 1988: Against the backdrop of interest rates from 1988-2018, 3.6% is still a favorable rate for the techniques discussed below.

<u>Installment sales</u> and <u>loans</u> use the applicable federal rate published each month by the Internal Revenue Service in accordance with Section 1274(d) of the Internal Revenue Code. The mid-term AFR for November 2018 (for loans with durations not exceeding nine years) is 3.04% and the long-term AFR (for loans exceeding nine years in duration) is 3.22% for November of 2018. The yield curve is so flat that many loans previously structured for a nine-year term with a balloon payment are now being structured as longer loans. The AFRs are tied to the yields of U.S. Treasury obligations, and therefore float over time. A few estate planners enjoy trying to predict what the new AFRs will be before they are announced.

GRATs, CLATs, and installment sales to children or to "intentionally defective" grantor trusts all depend in part for their success on the ability of particular assets to <u>out-perform these</u>

general interest rate assumptions over time. There are three different ways in which this is possible:

A. "Cherry Picking" Assets to Create One-Way Ratchets that Have the Chance to Outperform IRS Interest Rate Assumptions ("Immediate Arbitrage"). The IRS's assumed returns are the same for all asset classes, regardless of risk, and regardless of diversification. In reality, we know that some assets outperform others over time, and that in particular, there is a return premium demanded by those who invest in riskier investments such as small businesses. By placing more risky assets (such as small businesses or growth stocks) in estate planning vehicles, one creates the potential that the assets will actually appreciate more than the "average" investment that the I.R.S. looks at in calculating its rate assumptions. This potential can be maximized if the assets in question have a good track-record or are well-positioned for growth (for example, if the market for such securities is currently depressed, as in a bear market). Even in a down-economy, some businesses do extremely well, or can be expected to recover with the next business cycle. Many small businesses, farms, or even investment portfolios can be reliably forecast to generate a return (growth + income) exceeding 3.6% over a period of time.

RULE NUMBER 1: ***All of these techniques work well if funded with property which actually will generate growth + income (over the relevant time period) at a rate exceeding current IRS assumptions. Choosing the right asset is important.***

RULE NUMBER 2: ***Unless the transaction costs of so doing are prohibitive, it is better to create a separate vehicle for each distinct asset transferred. That way, your winners will not be offset by your losers. For example, 3 Single-asset GRATs are better than 1 3-asset GRAT, because your "losers" won't offset your "winners."***

RULE NUMBER 3: ***If the anticipated total return of an asset may be volatile, a series of 2-year GRATs may often be preferable to a single 10-year GRAT, because bad years will not drag down good years. Each two-year GRAT is a one-way ratchet, just as each single-asset GRAT is a one-way ratchet.***

Also, the mortality risk inherent in GRATs is greatly reduced for short-term GRATs.

Unless the transaction costs of so doing are prohibitive, it may therefore be better in many cases to utilize a series of "rolling" or "cascading"

2-year GRATs as opposed to a single 8 or 10-year GRAT.

However, with short-term GRATs, one loses the opportunity to lock in the current historically-low interest rates for a longer period of time.

B. Locking In Low Rates Over Time ("Temporally-Enhanced Arbitrage"). When a GRAT, CLAT, or Installment Sale to a Grantor Trust is initiated, the relevant published interest rate <u>then in effect</u> is locked in for the term of the GRAT, CLAT, or installment contract.

For example, in a Grantor Retained Annuity Trust or a Charitable Lead Annuity Trust, the annuity interest is valued as of the day of creation, even if it will last for 15 or 20 years. Thus, these annuity interests are valued (for tax purposes) based on the current interest rate assumptions. If one believes that is likely that, over time, interest rates will average out to something in excess of the current rates (as they certainly have at times, with the CMFR topping out at roughly 11% in 1990 and staying well above 5% from 1990 through 2001, for example), then one would find it beneficial to lock in these low interest rates, just as one would want to lock in a favorable mortgage rate by refinancing during such a low-interest rate environment.

<u>Even if one's assets do not outperform the market over time, the techniques set forth herein can be beneficial if the market as a whole will outperform the current interest rate assumptions over the term of the annuity or other interest to be created. Especially if a trust is funded near the bottom of a market cycle, there may be a good chance that this will occur.</u>

RULE NUMBER 4: ***In today's low-interest-rate environment, a relatively longer term GRAT or installment sale to a grantor trust will offer a greater opportunity for interest rate arbitrage. (Longer-term GRATs should perhaps be back-stopped with life insurance for the term of the GRAT; Sales to Grantor Trusts present less risk in this regard).***

C. Leveraging (1) and (2) by Using Partial Interests ("Valuation Arbitrage" and "Disappearing Value"). The benefits set forth above can be leveraged by funding the vehicle in question with a minority interest in an LLC, S Corporation, or other entity, if a qualified appraisal can be secured that attributes a significant discount to the value of the interest transferred for lack of control and lack of marketability. If the "fair market value" of an asset is less than the anticipated economic benefit from owning the asset over time, this leads to a "valuation arbitrage" that enhances the ability of the Trust to outperform IRS assumptions over time. Additionally, if the barriers to marketability subsequently disappear, then the "disappearing value" that escapes taxation may re-emerge down the road.

RULE NUMBER 5: ***When possible, consider funding a GRAT or Grantor Trust vehicle with <u>non-controlling interests</u>, such that an appropriate <u>valuation discounts</u> can be obtained. (This can be done, for example, by funding a trust with a 49% interest in a Corporation or LLC with a proper business purpose).***

RULE NUMBER 6: ***S Corporations and Partnerships are ideal candidates for sales to Grantor Trusts and GRATs.*** Minority interests in LLCs, Subchapter S Corporations, and FLPs are often the best assets to use for GRATS and similar techniques, because they will be making distributions to fund the owner's income tax payments with respect to the pass-through income generated by the entity. Interests in C Corporations work less well with short-term GRATs in particular, because their dividend rate will generally not suffice to allow the funding of GRAT payments in cash.

D. **Payment of Income Taxes by the Grantor ("Income Tax Burn").** GRATs and other trusts structured to be Grantor Trusts with respect to the Grantor provide an additional dimension of economic leverage, because the Grantor is responsible for paying income taxes on trust income. This payment of income taxes by the Grantor allows the trust assets to grow income-tax-free, which increases the effective rate of return inside the trust. Each tax payment by the Grantor regarding trust income is effectively a tax-free transfer of wealth by the Grantor to the trust beneficiaries. Because it is required by law, such payment of taxes does not trigger gift taxation.

RULE NUMBER 7: ***Always consider structuring an irrevocable trust as a Grantor Trust.***

E. **Removing Future Appreciation from the Grantor's Taxable Estate ("Estate Tax Freeze").** All of the techniques discussed in this Outline involve an estate tax freeze. Any appreciation in the value of the asset after the gift is made will escape federal estate and gift taxation. The earlier a donor starts using these techniques, the more powerful they can become, because the "income tax burn" and the freeze become more powerful with time, especially with an asset that appreciates in value (greater freeze) and produces significant taxable income (income tax burn).

RULE NUMBER 8: ***Encourage donors to consider these strategies sooner rather than later, where appropriate, to maximize the leverage.***

II. <u>Grantor Retained Annuity Trusts (GRATs)</u>

A. What is a GRAT?

1. A GRAT is an Inter-vivos Irrevocable Trust paying the Grantor an annuity, at least annually, for a fixed term of years.

   For example, Grantor might retain the right to a 10% annuity for 5 years.

2. The Annuity is equal to a percent of the fair market value of the assets placed in the Trust <u>on the date of its creation</u>. The value of this annuity is tied to the "frozen" fair market value on this date. (As opposed to a "Unitrust," in which the annual payment is tied to a revaluation of trust assets each year).

   If $1,000,000 in property were transferred to a GRAT, a 10% annuity for 5 years would pay Grantor $50,000 each year for 5 years.

3. If Grantor is living at the end of the term of years, what ever is left in the trust (remainder) is transferred to the beneficiaries named in the trust.

   <u>Note</u>: If assets in the Trust fail to generate the income required to make the annuity payments, some or all of the corpus may have to be distributed back out to the Grantor to satisfy the annual annuity payments, reducing or eliminating the benefits of the technique (but leaving Grantor no worse off than if he had done nothing).

4. If Grantor dies before the end of the term of years, some portion of or all of the trust property will be included in Grantor's estate. With "zeroed out" GRATs, all of the trust property is usually included in the Estate in this event.

5. If the Annuity paid to Grantor is a "qualified annuity" under IRC Sec. 2702(b)(1), then the amount of the gift is the fair market value of the assets less the present value of the annuity retained by the Grantor.

6. The annuity value is calculated using IRC Sec. 7520 and the Applicable Federal Rates (AFR) in effect for the month the gift to the GRAT is made.

7. The AFR rate for November 2018 is 3.6%.

B. Technical Requirements for a "Qualified Annuity" Under I.R.C. Section 2702(a)(2)(B)

1. Must be a fixed and irrevocable payment made at least annually. Should be structured as a percentage of the initial fair market value of the assets transferred to the GRAT. <u>See</u> Treas. Reg. 25.2702-3(b).

2. *Payment of the Annuity by a Note* is NOT permitted. Treas. Reg. 25.2702-3(b)(1)(i). The trust document should expressly prohibit the use of notes or similar financial arrangements for making the annuity payments.

On the other hand, a trustee can probably borrow money from an unrelated 3rd party to make the annuity payments. See 65 Fed. Reg. 52587,53588 (September 5, 2000).

3. *Timing of Payments* – Payments can be made on a calendar year basis or on the anniversary of the annuity and must be made at least annually. Payments must be prorated for a short tax year. Treas. Reg. 25.2702-3(b)(3). Using the anniversary date is usually optimal. Payments may be delayed up to 105 days past the anniversary date each year, but may not be paid early.

4. Term of the GRAT can be any number of years. The longer the term the smaller the annual annuity payment, but the greater the chance that the Grantor dies during the term of the GRAT. The IRS has approved GRATs as short as 2 years. See PLR 9239015 (June 25, 1992).

5. There are many technical requirements that must be met in the trust instrument for this technique to work. See generally Reg. § 25.2702-3. Care must be taken to follow all of the various technical prescriptions in the regulations in establishing such a trust.

C. The Gift Tax Consequences of a GRAT

1. *Transfers of assets to a* GRAT is a taxable gift to the extent the fair market value of the assets transferred exceed the value of the annuity interest retained by the Grantor, determined under the actuarial tables in IRC §7520. (A GRAT is not a present interest and so the annual exclusion exemption cannot be used).

   a. The longer the term of the annuity interest, the higher the value of the retained annuity interest, and the lower the actuarial value of the remainder interest.
   b. The higher the reserved annuity rate, the higher of the retained annuity interest, and the lower the value of the remainder interest.
   c. The lower the current 7520 rate on the date the GRAT is created (3.6% in November 2018), the lower the tax-value of the remainder interest.

2. *Zeroed-Out GRAT.* The annuity rate and the term of the trust can be adjusted so that the value of the grantor's retained annuity interest equals or approximates the value of the property transferred to the GRAT, such that the "tax" value of the remainder interest approximates zero. There is essentially no gift tax related to the establishment of a zeroed-out GRAT, and no unified credit is consumed.

3. *Walton v. Commissioner, 115 T.C. 589 (2000); acq. Notice 2003-72.*

In _Walton_:

a. Grantor established two substantially equal GRATS, each for a 2 year term, and funded the trusts with Wal-Mart stock. Grantor was to receive an annuity amount from each trust equal to 49.35% of the initial trust value for the 1st year of the trust and 59.22% of the initial value for the 2nd year of the trust. If the grantor died during the two year term, the remaining GRAT payments would be made to her estate with the balance of the GRAT property being paid to the remainder beneficiaries at the end of the two year term.

b. The GRAT payments were designed to result in no gift on the creation of the GRAT under the position that the grantor's mortality need not be considered in valuing the remainder. The grantor reported the gift of the remainder interest on a gift tax return with a value of zero. The Wal-Mart stock did not perform as expected, and all of the property was distributed to the grantor to satisfy the annuity. Nothing was left to distribute to the remainder beneficiaries. The IRS sought to impose gift taxes on the transfer.

c. IRS contended that zeroed-out GRATS were not possible because the possibility of the grantor's death during the term reduced the value of the retained interest resulting in a taxable gift at the time of the transfer of assets to the trust.

d. Tax Court held that the grantor's retained annuity interest should be valued as an annuity for a term of years rather than as an annuity for the shorter of a term of years or the grantor's life.

e. As a result of Walton, GRATS can be created where an annuity equals the value of the transferred property.

f. What a zeroed-out GRAT essentially does is transfers the excess appreciation of the trust assets (beyond the 3.6% 7520 Rate) tax-free to the remainder beneficiaries.

The IRS acquiesced in this decision in Tax Notice 2003-72 (Nov. 3, 2003).

Thus, in theory, if Bill Gates changed his mind on the whole "use his money to save the world" idea, he could pass his entire interest in Microsoft to his children via a GRAT without incurring a single dollar of estate tax or even dipping into his unified credit. (He would, of course, receive significant annuity payments back from the GRAT, which would be includable in his estate, but he could use those liquid assets to save the world and obtain a charitable deduction).

Planning Point: Usually, the term and annuity payments will be "optimized" such that that there is a very small taxable gift. The GRAT is then disclosed on a gift tax return which starts the statute of limitation running. Full and adequate disclosure is essential, including a qualified appraisal for non-marketable assets.

D. The Estate Tax Consequences of a GRAT

A GRAT only succeeds if the Grantor survives the annuity term.

1. *If the Grantor Survives Trust Term.* If the grantor is living at the end of the trust term, any property remaining in the GRAT passes to the remainder trust beneficiaries free of gift and estate tax.
2. *If the Grantor Dies During Trust Term.* If the grantor dies during the trust term, some portion or all of the trust property will be included in the grantor's gross estate for estate tax purposes. With zeroed-out GRATs, all or almost all of the trust assets will generally be included in the Grantor's estate in this event. In other words, the Grantor will be back where he started, with all assets transferred to the GRAT in his estate. Grantor will have lost the opportunity to utilize a different plan that doesn't have mortality risk (for example, an installment sale to a grantor trust), and will be out the transaction costs of setting up the GRAT. Otherwise, Grantor isn't harmed, he just hasn't accomplished anything.

   There are two ways to backstop the plan to moderate or eliminate the mortality risk:

   a. Careful planning can be done so that the annuity payments and the remainder interest pass to the surviving spouse or a trust for the surviving spouse in a way that qualifies for the marital deduction if the Grantor dies prematurely. This would defer estate taxes until the surviving spouse dies, make the surviving spouse's unified credit available to shelter such gifts, and potentially give the surviving spouse the chance to engage in additional planning to avoid estate taxation altogether.
   b. Life insurance (second-to-die in many cases) is used to back-stop the mortality risk.
   c. Even if a GRAT fails, the family will generally be no worse off than if they had done nothing. The estate taxes will generally be no different than if the family had never created a GRAT and the Grantor had simply retained the property until his or her death. The primary exception to this would pertain to a situation in which the Grantor is survived by his or her spouse and the marital deduction was not preserved with respect to the GRAT.

E. The Income Tax Attributes of a GRAT (and Opportunities Presented)

GRATs are structured to be grantor trusts, and to make doubly certain that they are wholly grantor trusts, we generally include a substitution power. The following favorable income tax results are achieved because of this grantor-trust status:

1. No gain or loss is recognized on the creation of the GRAT, because the grantor is deemed to have transferred the assets to himself or herself for income tax purposes.

2. Payment of the annual annuity is ignored for income tax purposes since the grantor is deemed to have it paid to himself or herself.

3. Income and capital gains generated by the GRAT assets are taxable to the grantor whether or not distributed to him or her.

4. If the grantor funds the trust with appreciated property, the distribution of such property in satisfaction of the annuity will not cause the grantor to recognize gain.

F. What are Rolling GRATS, and When Might They Be Preferable to a Single, Long-Term GRAT?

Instead of creating a single long-term GRAT, the grantor sometimes creates a series of GRATS, often called “rolling” or “cascading” GRATS. The rolling GRATS work as follows:

1. The Grantor creates a GRAT for a short term such as 2 years.

2. The annuity payment in year 1 from the first GRAT is used to fund the second GRAT also for a 2 year term.

3. The annuity payments in year 2 of GRAT 1 and year 1 of GRAT 2 are used to create the third GRAT

4. and so on, for as long as desired.

   a. *Advantages of Short-Term GRATS.*
      i. Risk of death during the term of the GRAT is minimized. Death in Year 4 would not impact GRATs that terminated in year 2 or year 3. In this way, each year, an incremental amount is placed beyond the reach of the estate tax if the Grantor dies prematurely. The one way ratchet keeps ratcheting at the end of each GRAT.
      ii. The risk that a year or two of poor performance during the term of the GRAT will adversely affect the overall the overall benefit of the GRAT is minimized.

   See “GRATS on a Roll”, Julie K. Kwon & Daniel J. Lowey, Trusts and Estates, June 2005, page 33. Writers assert that rolling trusts will generate higher investment return over time than longer term GRATS; *See also* “Rolling Short-term GRATS Are (Almost) Always Best,” David Weinreb and Gregory Singer, Trusts and Estates, August 2008, page 18.

   b. *Disadvantages of Short-Term GRATS.*
   Risk that the Section 7520 rate will increase.
      i. Change in the tax law may prohibit later GRATS (existing GRATs would probably be grandfathered).
      ii. Additional transaction costs in doing a series of short-term GRATS.
      iii. Additional appraisal costs, if non-marketable assets are used for funding.

G. Other Planning Options with GRATs

1. GRATs may also be graduated, such that the annual payout increases annually by as much as 20%. Regs. § 25.2702-3(b)(1)(ii). Unless the assets are illiquid or a flat payout is preferred for other operational reasons, a graduated GRAT will often produce superior tax results. By back-end-loading the annuity payments, the GRAT assets stay in the trust longer and have the potential to generate higher cumulative tax-sheltered growth.

2. Often, a husband and wife will each do a GRAT simultaneously, especially if longer-term GRATs are utilized. This hedges one's bets, as a single premature death only causes half of the plan to fail. Alternatively, if one spouse is healthier or younger than the other, it may be optimal to have that Spouse create the GRAT.

3. Waiting up to 100 days after an anniversary date presents some planning options. First, an additional 100 days of appreciation or income may be earned, which is significant for short GRATs. Second, valuation may shift during this period, which may present opportunities. (105 days is the actual limit, but I prefer not to cut it too close, so I always tell my clients 90 or 100 days.)

4. If a GRAT is underwater, consider having the Grantor repurchase the security for cash, so that the Grantor can start fresh with a new GRAT. The first GRAT will fail, but a new opportunity is created for a fresh GRAT to succeed. This does not require a substitution power, but a substitution power is not a bad idea for most GRATs.

5. One disadvantage to using a GRAT is that assets passing to the remainder beneficiaries from the GRAT will not receive a step-up in basis at the death of the Grantor. Because capital gains rates are lower than estate tax rates at present, this is presently a good trade-off.
   However, it may be possible to have the Grantor repurchase appreciated assets from the GRAT shortly prior to its termination. This would make the appreciated assets available for a step-up in basis at death, or potentially for contribution to a charitable remainder trust or qualified charity.

H. Advantages of a GRAT vis-à-vis an Installment Sale to a Grantor Trust?

1. Unlike a sale to a grantor trust, zeroed-out GRATs require no use of the unified credit (tax-free amount) upon formation. *This is less of a concern for most clients with exemptions now at $11,180,000 and indexed to inflation, but for a billionaire it might be.*

2. If a GRAT is "zeroed out," no unified credit is used up, and no gift taxes end up being paid, <u>even if the value of the assets transferred is later adjusted on audit</u>.

The lack of audit risk is a distinct advantage over sales to grantor trusts, where adjustments in value can result in gift tax, although Wandry clauses can mitigate that risk for sales and gifts to grantor trusts.

3. GRATs have statutory support. Sales to defective trusts do not. There is less unquantifiable risk related to a GRAT.

4. GRATs are simpler to explain to clients and easier for clients to understand.

I. Disadvantages of GRATs vis-à-vis Installment Sales to Grantor Trusts?

1. If Grantor dies during the annuity term, all (or at least most) Trust property is included in Grantor's gross Estate.

2. Unlike sales to grantor trusts, GRATs cannot be effectively and easily used to shelter generation-skipping transfers to grandchildren from the GST tax. Some planners have developed advanced strategies aimed at circumnavigating this limitation, but when funding a dynasty trust or a generation-skip, GRATs are a less attractive option.

III. Installment Sales to Grantor Trusts

A. Installment Sales Generally: The Basic Concept

1. In an installment sale, property is sold for fair market value in exchange for a note payable over time.

2. To avoid gift tax treatment under IRC Section 7872, the seller must charge the buyer annual interest at least equal to the relevant AFR set forth in I.R.S. tables on a monthly basis. See Frazee v. Commissioner, 98 T.C. 554 (1992). These rates are different depending on the term (length) of the installment contract. The required rate is the appropriate rate on the date the installment contract is signed. The interest rate is then locked in for the term of the contract. The lower the applicable interest rates at the time of creation, the less interest the buyer will have to pay to the seller over time.

3. Because the numbers in the interest rate tables are at present quite low, there are currently advantages to a parent selling property to a child on an installment basis, especially if the installment contract is structured as a series of “interest only” payments with a balloon payment at the end of the installment term. These advantages are:
   a. Value Freeze: The property can be transferred without tax for its current fair market value, rather than the fair market value at the time of death, which may be greater.
   b. The child will have to pay relatively little interest over time.
   c. The parent will generate relatively little interest income over time.

d. If the property sold on an installment contract can earn income or appreciate at a rate exceeding the current interest rate assumptions (between 3 and 5 percent depending on the term of the contract), wealth can be transferred to the buyer from the seller free of estate and gift tax. (Any remaining obligation on the note that secures the installment contract will be a part of the transferor's estate).

4. Of course, a traditional installment sale has some downsides vis-a-vis an option contract providing for sale out of one's estate:
   a. it will generate some taxable income to the seller in the form of interest income (or gift tax or use of unified credit if interest is not paid) that is avoided with an option contract arrangement;
   b. such a sale results in the recognition of capital gain (assuming the property is low-basis property), although this gain can be spread over the life of the contract. This capital gain would be avoided if an option contract were used instead, and the property were sold from the estate after death. In other words, the tax-free step-up in basis that would be available if the asset were held until death is lost with this technique.

5. Whether the advantages of an installment sale outweigh the downsides depend on many factors, including:
   a. Income tax bracket of the seller (and perhaps also income tax bracket of buyer);
   b. Seller's potential gift and estate tax liability;
   c. Whether the asset can be expected to appreciate significantly (or generate significant income) over time;
   d. Whether (in the case of a farm, for example) there is a need to solidify the "on-farm heir's" control over and ownership in the farm,
   e. Whether the on-farm heir has any immediate plan for selling the farm.

6. Right now, in some situations, because of the low interest rate environment, consider discussing the installment sale as a viable alternative to standard "options to purchase" or "rights of first refusal," with farm clients, especially where the on-farm heir is worried about future family disputes and wishes to solidify his ownership and control over the land in which he is investing both cash and labor and on which he relies for his livelihood.

B. Installment Sales to Grantor Trusts

1. A more sophisticated version of the installment sale employs a sale to a special trust known as a "grantor" trust, or more specifically as an "intentionally defective grantor trust."

2. Such a trust is irrevocable. It cannot be changed or revoked by the Grantor.

3. Such a trust is ***effective*** for Estate and Gift Tax purposes (such that property in such a trust is outside the Grantor's estate at death, and such that gifts to such a trust are completed gifts for estate tax purposes) (similar to insurance trusts, for example).

4. Such a trust is ***Ineffective*** or "***defective***" for Income Tax purposes, such that (1) transfers for value between the grantor and the trust are ignored for income tax purposes, and (2) all income earned by the trust on trust assets is taxable to the Grantor.

5. ***In other words, the trust is recognized for gift and estate tax purposes, but ignored for income tax purposes during Grantor's life.*** This can be done because of a disjunction in the way the I.R.S. looks at Trusts for income tax purposes (Sections 671-679 of the Internal Revenue Code) and the way the I.R.S. looks at Trusts for estate and gift tax purposes (see I.R.C. §§ 2036-2042). Certain provisions in a trust instrument (for example, a retained power for the Grantor to substitute property of equal value in a non-fiduciary capacity, if crafted very carefully, or a power for a non-adverse (non-related and non-subordinate) party to loan the Grantor funds without adequate security) will render the Trust "ineffective" for income tax purposes, but not for estate and gift tax purposes. This technique is built on that divergence.

6. The Trustee can probably be given the discretion (but not the obligation) to reimburse the Grantor for taxes paid with respect to Trust income as long as this provision does not result in state law subjecting the trust property to the Grantor's creditors, *see* Rev. Rul. 2004-64. but I have never included such a provision.

C. **ADVANTAGES VIS-À-VIS STRAIGHT INSTALLMENT SALE.**
Selling property to an intentionally-defective grantor trust has several advantages over a straight installment sale to one's children or grandchildren. These include the following:

1. During the Grantor's life, the Grantor pays the income tax on all income earned by the Trust assets, because it is a "Grantor Trust." This payment of taxes can be seen as an additional transfer to the trust beneficiaries that is free from gift tax and estate tax.

2. Additionally, the interest earned by the Grantor is not taxable income, because (due to the "grantor" status of the trust) it is effectively paid by the Grantor to himself, and thus not recognized for income tax purposes.

3. Unlike a straight installment sale, no capital gain is recognized at the outset of the installment contract, because the Seller (Grantor) and Buyer (the "Grantor Trust") are the same person, and the transfer is thus not a recognition event. *See* Rev. Rul. 85-13. A Grantor can therefore sell assets to his or her Grantor Trust without recognizing any capital gains taxation.

D. The installment sale can be set up as a series of annual "interest only" payments followed by a balloon payment of the principal. If the property sold to the Trust can earn a return that greatly exceeds the standard IRS "applicable federal rates", the Trust can effectively pay for the property it has purchased with the cash-flow it receives from the purchased property. Moreover, any growth in value of the property sold to the Trust is out of the Grantor's estate. If at some point it becomes beneficial for the Trust to prepay some or all of the principal (for example, if the courts clarify that Grantor's death will trigger capital gains if the note is still outstanding at that time), the Trustee will be free to do so.

I always (or almost always) structure my installment notes so that there is some principal paid in addition to interest, to avoid any argument that there is no intent that the note principal will be paid, but I seldom use straight or mortgage-style (constant payment) amortization, opting for the flexibility that a balloon structure (without prepayment penalty) provides.

The long-term AFR [over nine years] is 3.22% for November 2018, and the mid-term AFR [3-9 years] is 3.04% for November 2018.

E. Like a GRAT, works particularly well if funded with minority interest in a pass-through entity such as an LLC, FLP, or S. Corp. A good appraisal from a competent and respected qualified appraiser is paramount.

F. ADVANTAGES VIS-À-VIS GRAT.

The sale to an intentionally defective trust has several advantages vis-a-vis GRATs, discussed below. These include:

1. Grantor need not survive the term, and Jonathan Blattmachr has written convincingly that death during the term of the note should not cause capital gains recognition, *See* Blattmachr on income Taxation of Estates and Trusts § 4.7.2 (2010).

2. Effective tool for Generation-skipping transfers. Can be the funding vehicle for a dynasty trust set up in a state with no rule against perpetuities and no state income tax (such as South Dakota or Alaska).

3. If the mid-term rate applies (3-9 year term), the applicable interest rate will be lower than that used for GRATs (discussed below) by 20%. (If the long-term rate applies (over a 9 year term), the applicable interest rate may actually be slightly higher than the rate used for GRATs (as is currently the case), depending on the yield curve. That is not the case in November of 2018, because the yield curve is flat).

4. Same Trust can engage in multiple (serial) installment purchases from the Grantor. This is a vehicle that can be used again and again in the right situation. You can build much more complexity around this chassis.

5. Prepayment of the promissory note is allowed, as is refinancing to extend the term, and the note can be back-end loaded to a greater extent than a GRAT if desired. The installment contract technique is infinitely more flexible than a GRAT.

6. A grantor trust that purchases assets on installment contract can be a great vehicle for owning life insurance, see Rev. Rul. 2007-13, and private letter rulings suggest that Crummey rights of withdrawal are not inconsistent with a wholly grantor trust. See PLR 200606006; PLR 200603040; PLR 200729005, *but be careful to also review* I.R.C. § 678(b) and Revenue Ruling 81-6.

G. DISADVANTAGE VIS-À-VIS GRAT:

1. Riskier-----less settled law surrounding this technique, subject to creative IRS challenges.

2. Generally requires a significant taxable seed gift to a trust. Probably cannot be "zeroed out," as a GRAT can, although some folks attempt to do this using guarantees from beneficiaries in lieu of a seed gift, but this has always given me the willies, so I have not done so.

IV. Charitable Lead Annuity Trusts ("CLATs")

Charitable Lead Trusts (CLTs) can be either inter vivos or testamentary trusts, and can take either the form of an annuity (CLAT) or a unitrust (CLUT). This outline focuses on Charitable Lead Annuity Trusts (CLATs), which are the charitable equivalent of a GRAT. In either an inter vivos or testamentary CLAT, the Trust provides for an annuity interest for a term of years (or a lifetime) being paid to a tax-exempt charity or charities (the "lead interest"), with the remainder passing to a designated individual or individuals (generally the Grantor's children) at the end of the annuity term. See Reg. 20.2055-2(e)(2)(vi) & (vii) & Reg. 25.2502(c)(3)(c)(2)(vi) & (vii).

A. A CLAT can be particularly advantageous when interest rates are low. Like GRATs, CLATs are trusts with annuity and remainder beneficiaries. As with a GRAT, the remainder beneficiaries are usually the Grantor's children. Unlike a GRAT, the annuitant of a CLAT is necessarily a charity. CLATs (and all Charitable Lead Trusts) are generally subject to the rules applicable to private foundations.

B. With this technique, a Trust is established to pay an annuity to a designated charity or charities for a term of years. At the end of the annuity term, the assets remaining in the Trust pass to the remainder beneficiary, usually the Grantor's children.

C. The value of the gift to the children upon formation of the CLAT is the value of the assets transferred less the actuarial value of the charitable annuity interest. The value of the charitable annuity interest is related to the length of the term of the charitable interest (i.e., 10 years), the rate of the annual annuity (i.e., 7%), and the applicable 7520 Charitable Federal Mid-term Rate (CFMR) on the date of formation. The creator of a CLAT has the option of using the 7520 rate for the current month or for either of the preceding two months, with the lowest rate providing the lowest taxable remainder gift. As such, this plan again works well if the assets transferred to the Trust can out-perform the IRS rate, and this is most likely to be the case in a low interest rate environment, such as we currently are experiencing.

D. CLATs work particularly well if the Grantor is making annual gifts to Charity anyway, as this technique simply allows the Grantor to use those annual gifts to pass some money down to the next generation tax-free. It effectively leverages the Charitable gifts to make a transfer of assets at the end of the charitable term to the children.

E. With a Non-Grantor CLAT (or testamentary CLAT), the Grantor will receive no income tax deduction upon the creation of the CLAT, but the CLAT (a complex trust for income tax purposes) will receive an annual deduction for the value of the lead payments made to the charity each year. Because those annuity payments will generally exceed the trust's taxable income, the trust will in most cases avoid income taxation once it has been funded, absent significant capital gains recognition events. A Grantor CLAT, on the other hand, generates a charitable deduction for the Grantor at the time of its creation, but the grantor will have to pay income taxes on the Trust income each year.

Non-Grantor CLATs are particularly good options for people who can't fully utilize the income tax charitable deduction in the year a gift is made, or who anticipate income being earned in excess of I.R.S. assumptions. For many donors, a GRAT coupled with an outright gift to charity will be preferable to an inter vivos CLAT.

Possible uses:

1. In a "zero estate tax plan." After the tax-free amount goes to my children, I direct the residue to a zeroed-out 20-year CLAT, with the remainder also payable to my children.

2. Lifetime Non-Grantor CLAT (where the charitable deduction is foregone). Then there is no annual income that the Grantor has to report (the CLAT reports the income but is entitled to an off-setting charitable deduction to the extent of the annual payments to the charity). Because the transfer to Donor's ultimate beneficiaries is reduced by the charitable income interest, it is possible to make the gift at a reduced gift tax cost, or even with no gift (a zeroed out CLAT). All appreciation is also protected. *This use is likely less common now that exemptions exceed $11M, as income tax*

deductions may be more valuable to most clients than estate tax avoidance when charitable gifts are made during life.

F. Although the transfer to the ultimate remainder beneficiary (i.e., children) is delayed until the end of the charitable annuity term, no estate or gift tax is due at that time if the gift is zeroed out, and as such it offers a tremendous hedge for a person with a large estate and a desire to avoid any estate tax.

G. This is not a plan that works well for generation-skipping transfers, because the inclusion rate is not determined until the lead interest has terminated. <u>See</u> I.R.C. Section 2642(e).

<u>Note</u>: A charitable lead ***unitrust*** (or CLUT) is a viable generation-skipping vehicle, because the inclusion ration for a CLUT is determined at the time the CLUT is established. However, a CLUT is generally not able to provide the same tax advantages as a CLAT, especially in a low interest rate environment, and the taxable gift to the remainder beneficiaries of a CLUT can never be zeroed out.

H. Special care must be taken if a CLAT's annuity interest is to be distributed to a Private Foundation, in that the IRS has taken the position that if the Donor is on the Board of such Foundation, the Donor will not be considered to have given up dominion and control of the property. <u>See</u> <u>Rifkind</u>, 5 Ct. Cl. 362.

I. Given the complications of the private foundation rules, funding CLATs with interests in entities such as FLPs or (especially) S Corporations can raise difficult issues.

<u>V. Qualified Personal Residence Trusts</u>

A. Like a GRAT (or more precisely, like a GRIT) but owning a house. The term interest is "all income plus use of the house" rather than an annuity amount.

1. Grantor retains the tight to use the home for a term of years and to receive any income earned by the QPRT. This retained right (and the estate's reversionary interest if the Grantor's death prior to the end of the QPRT term), reduce the value of the gifted contingent remainder interest. This calculation involves both mortality factors and an interest rate factor related to the time value of money, and tied to the 7520 CMFR. *However, the economics are reversed, and QPRTs are more tax-efficient when interest rates are higher*.

2. As with a GRAT, the Grantor must survive the term of years for estate tax benefits to accrue. (*See* IRC § 2036(a)(1)).

3. Additional leverage is available if QPRTs are funded with fractional interests in the residence (Valuation Discount Should Apply).

4. After the QPRT term ends, the Grantor must rent the home from the kids (or trust benefitting the kids) if continued use is desired. Grantor's spouse, however, could be the beneficiary of the trust receiving the property at the end of the QPRT term, and could use house rent-free, if desired.

5. It is often best if the QPRT remainder passes to a Grantor Trust (to avoid income tax on rental payments to the trust for Kids after QPRT term ends).

6. Qualified appraisal and gift tax return will be required to substantiate the gift and initiate a three-year statute of limitations.

7. Numerous technical requirements exist. Complications arise if improvements or additions are made to the house after the QPRT is created, or if the house is sold during the QPRT term. There are solutions to all of these issues, but they involve increased complexity. Natalie Choate's book is our Bible with respect to all of these issues.

8. Unlike a GRAT or a CLAT, a QPRT cannot be zeroed out.

9. Each Spouse can do QPRTs with a different residence, and vacation homes are eligible.

10. A house with significant appreciation potential, owned by a young and healthy client is an ideal candidate for a QPRT (or multiple QPRTs).