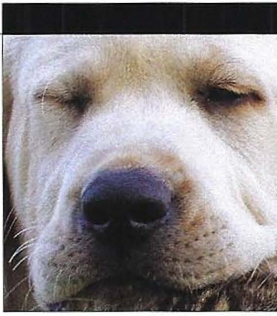

The Estate Planning Tsunami of 2020

In light of the current low interest rate environment, and the possibility that certain common estate planning techniques might be reduced or eliminated if a new presidential administration takes over in 2021, now is a good time to consider implementing strategies that would be likely targets for reform in the years ahead.

JONATHAN G. BLATTMACHR AND CARLYN S. MCCAFFREY

Now is a good time to encourage clients to consider implementing one or more currently available transfer tax planning techniques.[1] Depending on the outcome of the November federal elections, the current $11.58 million wealth transfer tax exclusion, which is scheduled to be cut in half in 2026, could undergo an earlier and more substantial reduction starting as early as 2021. Election results could also lead to an increase in transfer tax rates, statutory and regulatory elimination of a wide array of planning techniques available under current law, and a possible imposition of a tax on unrealized appreciation at death or carry-over basis.

The confluence of low interest rates, depressed asset values,[2] and the real possibility of a reduction in the availability of planning opportunities, is likely to cause a late-year rush of clients seeking to implement strategies designed to (1) take advantage of the current high exclusion levels and relatively low transfer tax rates; (2) assign valuation discounts to transferred assets; and (3) implement various techniques for shifting expected future increases to lower generations. Estate planners saw a similar phenomenon in the last months of 2012 when clients rushed to use the $5 million wealth transfer tax exclusion that was scheduled to be reduced to $1 million starting in 2013.

This article describes the principal planning techniques that are currently available, including those that have been the target of proposed reform for more than a decade, the risks individuals may face when they implement these techniques, and ways to reduce these risks.

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Available Estate Planning Techniques

The basics. An important goal of most estate tax planning techniques is the removal of existing wealth and expected future wealth from an individual's transfer tax base either without paying transfer taxes or by paying those taxes at lower rates than those that are expected to be in effect at the individual's death.

Existing current wealth can be removed from an individual's transfer tax base in one of the following ways:

1. Gifts.
2. Creation of grantor trusts.
3. Gifts or sales of fractional interests in property.
4. Sales of assets for lifetime annuities.

Expected future wealth can be diverted from an individual's transfer tax base by:

1. Gifts or sales of property expected to produce income or to increase in value.
2. Loans at interest rates lower than the rate of return the lender would expect to receive from his or her investment of the funds.
3. The use of devices that permit the shift of future investment return on assets retained by individuals.

Removing existing wealth from the transfer tax base. If the transfer tax exclusion remains the same, a gift will ordinarily not result in the removal of existing wealth from the donor's transfer tax base because the value of the gifted property at the date of the gift will be included in the donor's estate tax base as part of his or her adjusted taxable gifts. If, however, the gift is protected from gift tax by the currently high applicable exclusion amount allowed under Section 2010[3] and that exclusion amount is reduced before the donor's death, the gift should result in a tax-free removal of value from the donor's estate tax base to the extent of the reduction in the exclusion amount. The current exclusion is $11.58 million and can be double that amount if a donor's spouse is willing to treat one-half of the donor's gifts as having been made by him or her. Under current regulations, if the exclusion is reduced, the donor's estate will be able to use the exclusion amount the donor used against lifetime gifts if that amount is higher than the amount available at death.[4] In addition, if the donor is willing to pay gift tax, and if the donor lives for at least three years after the gift, the gift will have removed the amount of the gift tax from the donor's transfer tax base, effectively reducing a 40% transfer tax rate to 28.57%.[5]

Gifts made to grantor trusts, trusts deemed owned by their grantors under Section 671, have the potential for removing even greater amounts from the donor's transfer tax base because the donor will be obligated to pay income tax on the trust's income. If, for example, a donor creates a $10 million grantor trust that produces annual income for ten years at a 7% annual rate and that income is subject to tax, 50% at long-term capital gains tax rates and 50% at ordinary income tax rates, more than $3 million of additional value may have been removed from the donor's gross estate.

Arranging for the division of property into fractional interests, the value of which will be determined using various discounts, such as discounts for lack of marketability and lack of control, is another technique for removing value from a donor's transfer tax base. A donor who owns a $6 million parcel of real estate, for example, could give 1/3rd tenants-in-common interests in the parcel to trusts for each of the donor's children. Because fractional interests in real estate are difficult to market and because the owner of the fractional interest cannot compel the sale of the whole, the value of each of the gifts is likely to be substantially less than $3 million. If, for example, the appropriate valuation discount was 25%, the donor would have removed $1.5 million from his or her transfer tax base. Fractional interest discounts for investment assets are potentially achievable if they are transferred into an investment entity such as a limited liability company. Minority interests in the entity can then be given or sold to members of the donor's family or trusts for their benefit.

Depending on the outcome of the November federal elections, the current $11.58 million wealth transfer tax exclusion, which is scheduled to be cut in half in 2026, could undergo an earlier and more substantial reduction starting as early as 2021.

Finally, for individuals who have existing grantor trusts with substantial value and an expected life span less than the Service's mortality expectations, there is the possibility of selling assets to the trust

1 By transfer taxes, we refer to the estate, gift, and generation-skipping transfer taxes.

2 Although the S&P 500 Index had risen by more than 6% in 2020 by the end of August, the increase is largely attributable to increases in the stock prices of the five largest internet companies, which now make up about 26% of the index. The prices of more than half the stocks in the index have actually declined in 2020, many by 40% or more.

3 References to "Section" in this article refer to a section of the Internal Revenue Code of 1986, as amended (the "Code").

4 Reg. 20.2010-1(c) permits the estate of a decedent whose lifetime gifts were protected from gift tax by an applicable exclusion amount higher than the applicable exclusion amount in effect at his or her death to apply the sum of the exclusion amounts used against gift tax against his or her estate tax. References to "Reg" in this article refer to regulations under the Code promulgated by the IRS and the Treasury .

5 If the donor dies within three years of his or her gift, the amount of the gift taxes will be included in his or her gross estate under Section 2035(b).

6 An individual who is known to have an incurable illness or other deteriorating physical condition and has at least a 50% probability of dying within one year may not use the Service's assumed mortality expectations. Reg. 25.7520-3(b)(3). The sale to a grantor trust rather than a nongrantor trust will prevent the sale from tax recognition treatment and the treatment of a portion of each annuity payment as taxable income. Rev. Rul 85-13, 1985-1 CB 184.

in exchange for a lifetime annuity.[6] A 65-year old individual, for example, could sell $10 million worth of assets to a grantor trust that had at least $17 million of assets[7] in exchange for the right to receive an annual payment of $589,070. When the individual dies, the right to receive future payments terminates. If death occurs within the next several years, significant value will have been removed from the individual's transfer tax base.

Election results could also lead to an increase in transfer tax rates, statutory and regulatory elimination of a wide array of planning techniques available under current law, and a possible imposition of a tax on unrealized appreciation at death or carry-over basis.

Removing future wealth from the transfer tax base. A gift of property will remove all of the income and appreciation generated by the transferred property after the transfer from the donor's transfer tax base. A sale will accomplish the same thing, but only if the transferred property produces a rate of return greater than the rate of return generated by the cash or other property received as consideration for the sale. If the consideration is in the form of a note bearing one of the low interest rates permitted under Section 7872, the sale will likely have the effect of removing value.[8] A loan at a low Section 7872 interest rate to a family member or trust will have the same effect if the interest paid on the loan is less than the return the lender would have generated if he or she had not loaned the funds.

Finally, there are at least two forms of transfers that will remove some portion of the future investment return on transferred property from an individual's transfer tax base: an entity freeze transaction and a grantor retained annuity trust (a GRAT). An entity freeze transaction requires dividing the economic interests in an asset between an interest that will receive a fixed return with a small additional profit participation and an interest that will receive the balance of the return. The first interest is retained by the senior family member; the second interest is given or sold to other family members or the trusts for their benefit. A GRAT is a trust that is required to pay an annuity to its grantor for a specified number of years with the remaining property to be paid to the grantor's family members or a trust for their benefit. The annuity payable can be structured to have a value equal to or almost equal to the value of the property the grantor transferred to the GRAT. Its value will be determined using the rates established each month by the IRS under Section 7520. This rate is .4% in October 2020. Equivalent or nearly equivalent value permits use of this technique with few gift tax consequences. In each case, the investment return generated by the property, to the extent it exceeds the donor's share of the return, should pass free of transfer tax to family members or to trusts for their benefit.

Threatened Techniques

The outcome of the November elections is difficult to predict at this time. However, there is certainly a chance of a regime change in the federal government. Although, as with all other legislation, tax changes are a matter of political compromise, if there is a Democratic administration significant tax changes are likely to be proposed as part of a budget reconciliation act, which cannot be filibustered in the U.S. Senate. Even though significant tax changes may not be adopted, some changes almost certainly will occur. Those changes could well include reductions in the current exclusion amount as well as increased transfer tax rates.[9] Other changes that have been proposed by Democrat members of Congress and Demo-

[7] For this technique to work, there must be sufficient assets in the trust, including the assets contributed in exchange for the annuity, to pay the annuity for the duration of the donor's life if he or she lives to 110 using the assumption that the trust assets will be invested to earn a return equal to the rate prescribed under Section 7520 for the month in which the transaction takes place. Reg. 25.7520-3(b)(2). The Section 7420 rate in effect in September 2020 is .4%.

[8] Interest rates permitted under Section 7872 in September 2020 are .14% for loans of three years or less, .35% for loans of more than three years but no more than nine years, and 1% for loans of more than nine years.

[9] Many proposals are contained in S.309 introduced in 2019 by Senator Sanders. "Bernie Sanders's new plan to supercharge the estate tax, explained," available at https://www.vox.com/2019/1/31/18205294/bernie-sanders-estate-tax-99-percent.

[10] See https://taxfoundation.org/joe-biden-tax-plan-2020/.

[11] See https://taxfoundation.org/details-analysis-donald-trump-tax-plan-2016/.

[12] 81 FR 51413.

[13] FR Doc. 2017-22776 Filed 10-17-17.

[14] See discussion at ¶ 1304.5 in Blattmachr, "Adventures in Partial Interest Transfers: Avoiding the Legacy of Zero Valuation Under Section 2702," 45 Major Tax Planning – University of Southern California's Annual Institute of Federal Taxation ¶ 1300 (1993).

[15] Prop. Regs. 1.72-6(e) and 1.1001-1(j) would make the transfer of appreciated assets in exchange for a private annuity immediately taxable, as discussed in Josephs, "Watch Out for Private Annuities," J. Accountancy (July 1, 2008), but there would be no income generated if the obligor were a grantor trust as to the annuitant. Rev. Rul. 85-13, 1985-1 CB 184.

[16] See *Carlton*, 512 U.S. 26, 73 AFTR2d 94-2198 (1994).

[17] See Blattmachr, "The Right Answer: Put It All In Trust," Trust & Investments 16 (Sept/Oct 1998), republished in 10 NYSBA Elder Law Attorney 12 (Winter 2000).

crat candidates include the elimination of the income tax-free basis adjustment at death, the treatment of gifts and death as tax recognition events, and the inclusion of gifts and inheritances in gross income.[10] A continued Republican administration could also bring changes. President Donald Trump, for example, has called for an elimination of the tax-free basis adjustment at death, although he has also proposed the elimination of the estate tax.[11]

Proposals have also been made that would eliminate the effectiveness of GRATs by requiring the value of the taxable remainder of the trust be equal to at least 25% of the value of property contributed to it and requiring the annuity terms to be at least ten years but no longer than ten years after the estimated life expectancy of the trust's grantor. In 2016 during the Obama administration, the Treasury and the IRS published a notice of proposed rulemaking under Section 2704 relating to restrictions on the liquidation of an interest in a corporation or a partnership that significantly reduced the availability of minority and other fractional valuation discounts.[12] In 2017, during the Trump administration, the proposed regulations were withdrawn.[13] A Biden administration might reintroduce these rules.

Finally, some have proposed requiring the inclusion of a decedent's grantor trusts in his or her gross estate and subjecting the assets in a grantor trust to the gift tax if grantor trust status ends during the grantor's life. The use of grantor trusts has been a mainstay of estate tax planning for decades. Installment sales to grantor trusts,[14] GRATs, personal residence trusts, the use of private annuities,[15] and many other arrangements are all built on a platform of grantor trusts.

Options for Action Now

If any one or more of the changes described above is enacted or administratively implemented next year, the changes could be retroactive to the beginning of 2021 (if not before).[16] Because of this possibility, those individuals who have considered using any of the threatened techniques should consider implementing them before year end. Gifts made in 2020 should be protected by the current $11.58 million exclusion amount, should be subject to a 40% gift tax rate if a donor's cumulative gifts exceed the exclusion amount, and should be eligible for fractional interest discounts. Gifts of appreciated property should not be treated as tax recognition events. Also, a donor should be able to protect his or her transfers to a GRAT from gift tax no matter how small the value of the GRAT remainder. It is also possible that a rule subjecting grantor trusts to gift or estate tax enacted in the future might not apply to grantor trusts in existence at the time of enactment.

Use the Exclusion Amount and Make Taxable Gifts Now

Advantages and disadvantages. The easiest and most direct way for an individual to preserve the advantage of the current exclusion amount, favorable gift tax rates, and the ability to make gifts without triggering a tax realization event is to make gifts now to irrevocable grantor trusts,[17] both gifts that are protected by the exclusion amount and those that will attract a gift tax. Still, there are some drawbacks and practical difficulties. Gifts, for the reasons discussed below, could actually prove to be counterproductive. Even if gifts prove to be tax efficient, donors may be reluctant to lose control over assets that are given away and to lose the possibility of benefitting from them, and some donors may not have assets that they are willing to part with.

The potentially negative consequences of gifts and how to guard against them.

In general. Gifts can result in negative tax consequences for at least three reasons. First, the value of the property could decline. Second, if the gift is a gift of appreciated property and fails to appreciate sufficiently, the estate tax savings on the appreciation could be less than the income tax loss attributable to the basis step-up at death that would have been available if the gift had not been made. Finally, the estate of a New York domiciled decedent who dies within three years of making the gift may pay more total estate taxes as a result of making the gift than would have been due if the gift had not been made. Each of these possibilities is explained further below.

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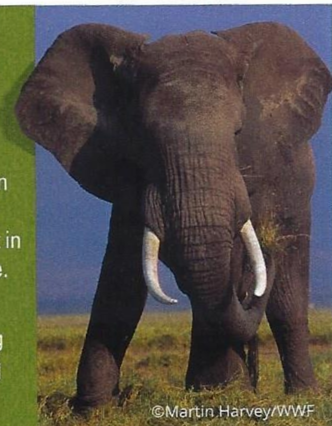
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The value of the gifted property declines. A decedent's estate tax is calculated on an estate tax base that consists of his or her taxable estate and his or her lifetime taxable gifts that are not included in his or her gross estate. Lifetime taxable gifts do not

An important goal of most estate tax planning techniques is the removal of existing wealth and expected future wealth from an individual's transfer tax base either without paying transfer taxes or by paying those taxes at lower rates than those that are expected to be in effect at the individual's death.

remove the value of the gifted property from the decedent's estate tax base. All taxable gifts are included in the decedent's estate tax base either as adjusted taxable gifts or as gifts included in the gross estate. As a result, if the value of gifted property declines between the date of the gift and the date of death, the decedent's estate tax will be more than it would have been if the gift had not been made.

Consider the following example:

Example 1.
Donor (D) makes a gift of $11.58 million worth of the common stock of X to a trust for her children in 2020 in order to use all of her remaining exclusion amount. D has made no prior gifts. She pays no gift tax. D dies in 2024 when the X stock is worth only $4 million. She has a taxable estate of $10 million. D's estate tax base is the sum of her adjusted taxable gifts and her taxable estate or $21.58 million. Assume that the exclusion amount has not been reduced and is $13,000,000 in 2024. Her estate tax would be calculated as shown in Exhibit 1.

If D had not made the gift, D's estate tax base would have been only $14,000,000, and her estate taxes only $400,000. The gift in this example cost the estate more than $3 million additional taxes. D's gift would have saved estate taxes only if the exclusion amount had declined to $5,284,500.

An income tax basis step-up would be more valuable than estate tax savings. Most property included in a decedent's gross estate receives a new income tax basis equal to fair market value at death (or at the alternate valuation date).[18] Property given during life does not unless the property is included in the decedent's gross estate.

A lifetime gift generates estate tax savings only on the income and appreciation it generates after the gift is made. If there is no investment return, there is no estate tax savings. When a donor gives appreciated property, unless the property generates a positive investment return before death, the loss of the basis adjustment will create a net tax disadvantage to the donor's beneficiaries.

Consider the following example:

Example 2.
The income tax basis of the $11.58 million worth of X stock given by D in Example 1 was $1 million before the gift. The X stock was worth $12.58 million when D died. The gift saved D's beneficiaries estate tax of $400,000 – 40% of the $1 million appreciation. Assume that the trust that holds the X stock is in the top federal income tax bracket. When the stock is sold, the trust will pay tax of 23.8% on the gain or $2,756,040. The gift has cost the family additional taxes of $2,356,040. If the gifted X stock had been included in D's taxable estate, the estate would have paid additional estate taxes of $400,000 but would have saved income taxes of $2,756,040.[19]

The donor is domiciled in New York and dies within three years of the gift. New York estate tax is imposed on gifts made by New York domiciliaries within three years of death.[20] Because there is no similar provision of the federal estate tax law, the additional New York estate tax seems not to be deductible for federal estate tax purposes. As a result, the combined federal and New York estate tax on the gift could be as high as 56% rather than 49.6%.

Consider the following example:

Example 3.
D, the Donor described in Example 1, died two years after making the gift of the X stock. When D died, the value of the X stock was $11.58 million. D was a domiciliary of New York. D's estate tax is calculated as shown in Exhibit 2.

If D had not made the gift, D's federal estate tax would have been only $2,832,160. The additional federal estate tax is caused by the fact that the New York estate tax

[18] Section 1014.

[19] The following formula may be used to determine the amount of total investment return a gifted appreciated asset must generate to offset the potential income tax cost of the loss of basis step up at the death of the donor:

$X = ((E)(V) - (I)(B)) \div (E-I)$

In this formula, the letter E means the highest combined federal and state estate tax rate applicable in the year of the donor's death to the estates of decedents who die domiciled in the donor's state of domicile. The letter I means the highest combined federal and state income tax rate applicable to the transferee's long-term capital gains. The letter V means the value of the transferred asset as finally determined for federal gift tax purposes. The letter B means the basis of the transferred asset for federal income tax purposes.

[20] N.Y. Tax Law sec. 954(a)(3).

[21] State estate taxes imposed on property included in the gross estate are deductible under Section 2058.

attributable to the gifts made within three years of D's death may not be deductible for federal estate tax purposes because the gifted property is not included in D's federal gross estate.[21]

Guarding against the potentially negative consequences of gifts. There are at least three ways of guarding against the potentially negative consequences of gifts. First, a gift can be structured in a manner that permits a donee to disclaim it and return the property to the donor. Second, a gift can be made to a trust that could be protected from gift tax by an election by the donor under Section 2056(b)(7) (a "QTIP"). Finally, the terms of the trust to which a donor has made a gift could give a person other than the donor the power to give the donor a testamentary power that would cause the trust property to be included in his or her gross estate.

Disclaimers. A donor could make a gift to the trustees of a trust the trust instrument of which contains a provision that (i) gives one of the beneficiaries the power to disclaim his or her interest in the trust and (ii) provides that if the beneficiary makes a disclaimer within nine months of the gift, the trust property would be returned to the donor. If a disclaimer is made within nine months of a gift, the disclaimer is effective under local law, the beneficiary received no benefit from the trust, and the property is returned to the donor as a result of the disclaimer, Section 2519 will treat the gift for federal gift tax purposes as if it had not occurred. If, during the nine-month period, the value of the gifted property declined or it became apparent that the exclusion amount was not likely to be reduced, the beneficiary might see the tax benefit of a disclaimer and might exercise his or her right to disclaim. Of course,

EXHIBIT 1
Calculation of estate tax if Donor is not a New York domiciliary

Taxable Estate	$10,000,000
Adjusted Taxable Gifts	$11,580,000
Estate tax base	$21,580,000
Tentative tax	$8,577,800
Applicable exclusion amount	$13,000,000
Unified credit	$5,145,800
Net federal estate tax	$3,432,000

EXHIBIT 2
Calculation of estate tax if Donor is a New York domiciliary

Value of estate assets	$10,000,000
Gross estate	$10,000,000
Deduction for NY estate taxes	$1,067,600
Federal taxable estate	$8,932,400
Adjusted taxable gifts	$11,580,000
Estate tax base	$20,732,400
Tentative tax	$8,150,760
Applicable exclusion amount	$11,580,000
Unified credit	$4,577,800
Net federal estate tax	$3,572,960
New York taxable estate	$21,580,000
New York estate taxes	$2,919,600
Total estate taxes	$6,492,560

this approach requires that the donor rely on the person with the power to disclaim to do so.

Gifts to QTIPs. When a donor makes a gift to a trust that is eligible for QTIP treatment, the donor, if his or her spouse is a U.S. citizen, retains the power to decide whether the gift will be taxable or not and can exercise that power at any time between the date of the gift and the date the donor's gift tax return is due. When the gift tax return is filed, if it is timely filed, the donor can make an election under Section 2523(f) to treat the gift as eligible for the marital deduction. If, for example, a gift is made in November 2020, the donor can wait until October 15, 2021 to decide whether the gift will be a taxable gift. If, with the value of hindsight, the donor concludes that the gift should be treated as a nontaxable gift because, for example, the value of the gifted property has declined significantly, the donor can make a QTIP election and protect the gift from gift tax by the marital deduction.

The use of grantor trusts has been a mainstay of estate tax planning for decades. Installment sales to grantor trusts, GRATs, personal residence trusts, the use of private annuities, and many other arrangements are all built on a platform of grantor trusts.

The disadvantage of this approach, from the standpoint of tax efficiency, is that trust income will be required to be paid to the beneficiary spouse for life even if the gift is treated as a taxable gift. The income will increase the value of the spouse's estate, causing more estate tax than if the gift had been made without the income requirement. The disadvantage can be reduced by avoiding investments in assets that produce a high level of current income.

Power to grant a testamentary power of appointment. The terms of the trust agreement could give a person other than the donor or a beneficiary of the trust a power to give the donor a testamentary power of appointment over the trust principal, but not income, and to revoke that power at any time. The power holder would, by conferring the testamentary power on the donor, be able to cause the inclusion of the gift in the donor's gross estate. The power holder's power would be exercisable only at a time when he or she reasonably believed, based on current circumstance, that the inclusion of the gift in the donor's gross estate would be likely to reduce future combined estate and income taxes. If the testamentary power were granted, the trust property would be included in the donor's gross estate under Section 2038 at its date of death value. It would no longer be included in the donor's estate tax base as an adjusted taxable gift at its date of gift value.[22] Also, the basis of the property would be adjusted to its date of death value. The power conferrable on the donor does not have to be a significant power. The power, for example, to merely change the time of enjoyment of trust property should be sufficient.[23]

The existence of the power to grant a testamentary power over principal to the donor should not cause inclusion in the donor's gross estate if the power is never conferred; until the power is conferred, the donor does not have a power. Section 2038 does not apply to a power the exercise of which on the date of the decedent's death is subject to a contingency beyond his or her control.[24] Although Section 2036 does apply to powers subject to contingencies beyond the decedent's control, it does not apply to powers over property that do not affect the enjoyment of income received or earned during the decedent's life.[25] The testamentary power that can be conferred by the power holder would be limited to a power over trust principal, and

22 Section 2001(b).

23 *Lober*, 346 U.S. 335, 44 AFTR 467 (1953).

24 Reg. 20.2038-1(b).

25 Reg. 20.2036-1(b)(3).

26 Sections 2035(a) and 2038(a).

27 D should not be a trustee of the Family Trust in order to avoid the possible application of the conclusion in *Powell*, 148 TC 392 (2017), that a decedent's right to amend a limited liability agreement with the consent of all the other members was a retained interest within the meaning of Section 2036(a)(2).

28 A noncumulative return is not a qualified payment within the meaning of Section 2701. If D wants the economic security of a high cumulative return, D could elect under Section 2701(c)(3)(C) to treat the cumulative return as a non-qualified payment.

29 The interest in excess profits is suggested in order to more clearly show that the Class A interests are equity interests rather than debt.

30 The Supreme Court in *Dickman*, 465 U.S. 330, 53 AFTR2d 84-1608 (1984), concluded that the holder of an interest-free demand note who fails to demand repayment is making a continuing gift of the amount of the forgone interest. The Tax Court in *Snyder*, 93 TC 529 (1989), refused to apply the *Dickman* rationale to the holder of shares of noncumulative preferred stock who declined to exercise her right to require the corporation to redeem her shares.

31 Because of the put right exercisable at D's death, the Class A interests should be worth at least $9,900,000 at her death if the assets of L are worth at least that amount despite the fact that the preferred return is likely less than a market rate of return. It is possible that the value could be higher depending on (1) the extent to which the preferred return has actually been paid and is likely to continue to be paid; (2) the rates of return attainable on fixed income securities at the time of her death; and (3) the value of the right to 2% of the profits in excess of the preferred return.

would not apply to any income earned after the gift.

If, after conferring the testamentary power, circumstances changed so that gross estate inclusion was no longer desirable, the power holder could simply revoke the power. If a decedent relinquishes a Section 2038 power within three years of his or her death, the property that was subject to the power will be included in his or her gross estate to the same extent that it would have been included if the power had not been relinquished.[26] The three year rule does not apply to the decedent's powers that were terminated without any action by the decedent.

Retaining the possibility of benefitting from gifted assets. Techniques that enable a donor to make transfers using his or her currently available exclusion amount while retaining an interest in or the possibility of reacquiring an interest in the gifted property include (i) transferring an interest in an entity such as a partnership, while retaining an interest in the entity that is treated as having a zero value under Section 2701 (an "Intentionally Defective Preferred Interest"), and (ii) transferring property to trusts from which the donor or the donor's spouse may receive future distributions.

The intentionally defective preferred interest. An intentionally defective preferred interest in an entity is an equity interest that entitles its holder to distribution rights that are not qualified interests within the meaning of Section 2701. If an individual acquires such an interest in an entity at the same time that his or her children or trusts for their benefit acquire junior interests in the entity, or if he or she transfers junior interests in the entity while retaining the preferred interest, the preferred interest will be treated as having a zero value. As a result, the individual will be treated under Section 2701 as having made a gift to the holders of the junior interests equal to the value of the preferred interest.

Consider the following example:

Example 4.
D creates an irrevocable trust for the benefit of her children and transfers property worth $1.1 million to the trustees.[27] D and the trustees form a limited liability company (L) with two classes of membership interests, Class A and Class B. The holders of Class B interests hold all the voting rights. Class A members have no voting rights. The holders of the Class A interests are entitled to an annual noncumulative preferred return from L's profits of 1% of the value of their capital accounts[28] plus 2% of the amount of L's profits in excess of the profits needed to fund the preferred return.[29] The holder of the Class A interests have the right to require L to redeem the Class A interests for an amount equal to the capital account associated with the interest at any time.[30] L has the right to redeem the Class A interests at the death of D for an amount equal to the capital account associated with the interests. The holders of Class B partnership interests are entitled to all other partnership income and gains. The trustee of the Family Trust transfers property worth $1,100,000 to L for all of L's Class B interests. D transfers property worth $9,900,000 to L for all of L's Class A interests.

D's transfer of property worth $9,900,000 to L will be treated as a taxable gift by her, even though D will retain full access to the property for the rest of her life. If D retains the Class A interests until death, they will be included in D's gross estate under Section 2033 at a value of at least $9,900,000 if the value of L itself is at least that amount.[31] The interest should receive a date of death basis under Section 1014. The amount on which C's tentative estate tax is computed under Section 2001(b)

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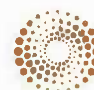
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will be reduced by $9,900,000, the amount by which C's taxable gifts were increased by the application of Section 2701, but not in excess of the value of the Class A interests included in C's gross estate.[32] As a result, D's estate tax should be no higher than it would have been if D had made an outright gift of $9,900,000.

The intentionally defective preferred interest technique permits a donor to use her available exclusion amount without relinquishing her interest in the property. There is a risk, however, that the regulations that permit a decedent's estate to use the higher of the exclusion amount available at death or the exclusion amount used during the decedent's life may not be available to the extent that the decedent's lifetime gifts are included in his or her taxable estate rather than included in his or her adjusted taxable gifts. The preamble to Reg. 20.2010-1(c) – the regulation that permits the use of the higher exclusion – indicates that the IRS and Treasury may consider making this change.[33] If this change occurs, the holder of the interest should be able to avoid the result by making a gift of the interest shortly before death.

Trusts from which the donor's spouse or the donor may receive future distributions

Domestic asset protection trusts (DAPTs). The concerns of a grantor about loss of all future access to the property he or she transfers to a trust may be alleviated if the terms of the trust permit the trustee to make distributions to the grantor. The power of the trustee of a trust to make distributions from the trust to the grantor should not, by itself, cause the grantor's transfers to the trust to be incomplete for gift tax purposes.[34] In the absence of retained enjoyment pursuant to an express or implied understanding with the trustee, the trust property should not be included in her gross estate under Section 2036 even if she actually receives distributions.[35]

If, however, the grantor's creditors can compel the trustee to use trust property to pay the grantor's debts, it is likely that the grantor's gift to the trust will be incomplete[36] and that the trust assets will be included in his or her gross estate under either or both of Sections 2036(a)(1) or 2038.[37]

A trust that gives its trustee the power to make distributions to its grantor is generally referred to as a "self-settled trust." The Uniform Trust Code, which has been adopted in some form in 34 states and the District of Columbia,[38] provides that during the life of the grantor of a self-settled trust, his or her creditors can reach the maximum amount held in the trust that can be distributed to or for his or her benefit regardless of her motivation for creating the trust.[39] Other states that have not adopted the Uniform Trust Code have statutes that have been construed to have the same effect.[40] Section 548(e) of the U.S. Bankruptcy Code pulls into the bankruptcy estate any property transferred to a self-settled trust or similar device if the transfer was made to hinder, delay, or defraud a creditor and a bankruptcy proceeding is commenced within ten years of the transfer.[41]

Of the 34 states that have adopted the Uniform Trust Code, ten have statutes that, under certain circumstances, permit grantors to have beneficial interest in the trusts they have created without subjecting trust assets to the claims of the grantor's creditors. An additional nine states have created similar laws. Trusts which include their grantors as potential beneficiaries created in the states that protect their assets from the claims of their grantor's creditors are frequently referred to as domestic asset protection trusts ("DAPTs").[42]

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[32] Reg. 25.2701-5. In the absence of Section 2701, the Class A interests would have been valued at $9,900,000 because the holder had the power to require L to redeem them for that value.

[33] RIN 1545-B072, ¶ 6 (2017).

[34] *Herzog*, 116 F.2d 591, 26 AFTR 169 (CA-2, 1941), *aff'g* 41 BTA 509 (1940); Reg. 25.2511-2(b); Rev. Rul. 77-378, 1977-2 CB 347.

[35] *Estate of German*, 7 Cls. Ct. 641, 55 AFTR2d 85-1577 (1985); *In re Uhl's Estate*, 241 F.2d 867, 50 AFTR 1746 (CA-7, 1957).

[36] *Outwin*, 76 TC 153 (1969); *Paolozzi*, 23 TC 182 (1954), *acq.* 1962-1 CB 4; Rev. Rul. 76-103, 1976 CB 293.

[37] *Estate of Paxton*, 86 TC 785 (1986).

[38] The states that have adopted the Uniform Trust Code are Alabama, Arizona, Arkansas, Colorado, Connecticut, District of Columbia, Florida, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont ,Virginia, West Virginia, Wisconsin, and Wyoming. Uniform Laws Commission Acts, https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d

[39] Unif. Trust Code § 505(a)(2), Unif. Law Comm'n (2000, with subsequent amendments). This provision of the Uniform Trust Code was based on a similar provision in the Restatement of Trusts. Restatement (Second) of Trusts § 156(2).

[40] For example, New York law has long provided such a rule. New York EPTL 7-3.1 says "A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator." In some jurisdictions, the rule arose under common law. See also *De Rousse v. Williams*, 181 Iowa 379 (1917) and *Everett v. Peyton*, 167 NY 117 (1901). The extent to which New York EPTL 7-3.1 would actually permit creditors to reach the assets in a discretionary trust with multiple beneficiaries is not clear. In *Herzog*, 116 F.2d 591, 26 AFTR 169 (CA-2, 1941), *aff'g* 41 BTA 509 (1940), the Court of Appeals of the Second Circuit concluded that the predecessor of New York EPTL 7-3.1 would not be so construed. In a later case, *Vanderbilt Credit Corp. v. Chase Manhattan Bank, NA*, 100 A.D.2d 544 (2d Dep't, 1984), construed the section to apply to a trust from which the trustee could make distributions to the grantor, but, in that case, the grantor was the only current beneficiary.

[41] 11 U.S. Code section 548. This provision should not cause inclusion in the gross estate of the grantor if his or her motive for creating and funding the trust was to minimize estate taxes rather than to hinder, delay, or defraud a creditor.

[42] The states that have DAPT laws are Arizona, Connecticut, Delaware, Hawaii, Indiana, Michigan, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and

Grantors who want to retain the possibility of access to the assets in the trusts they create should consider using trustees resident in a state that has adopted a DAPT law and creating them in conformity with that state's DAPT law requirements. If the trust's creator is also a resident of that state and there is no express or implied understanding with the trustee that assets will be distributed to the grantor, the grantor's gifts to the trust should be complete, and the trust assets should not be included in his or her gross estate under Sections 2036(a)(1) or 2038.[43] Grantors who are not residents of a DAPT state may not have that same protection. For example, in *In re Huber,*[44] the U.S. Bankruptcy Court held that the assets in a trust governed by Alaska law would not be protected from the claims of the grantor's creditors. In that case, virtually all connections of the trust (grantor, trustees who had almost total control, location of assets) were outside Alaska and the grantor had been receiving regular trust distributions.[45]

To the extent practical and acceptable to the client, the majority of the trust's contacts should be with a DAPT state, including trustees, trust protectors, advisors, etc.[46] If the grantor is not a resident of a DAPT state, it would be difficult to avoid the contact with his or her state that the grantor's residence provides. One solution might be to give the trustee the power to distribute to another trust of which the grantor is a beneficiary rather than the power to distribute directly to the grantor.

The easiest and most direct way for an individual to preserve the advantage of the current exclusion amount, favorable gift tax rates, and the ability to make gifts without triggering a tax realization event is to make gifts now to irrevocable grantor trusts, both gifts that are protected by the exclusion amount and those that will attract a gift tax.

Hybrid domestic asset protection trusts and special power of appointment trusts. Another approach is to avoid naming the trust's grantor as a beneficiary of the DAPT when it is created, but to include a provision that permits another person to add the grantor as a beneficiary after a period of time (perhaps, after the running of the statute of limitations under the laws of the state of the grantor for fraudulent conveyances or for more than ten years, the years specified in section 548(e) of the Bankruptcy Code, mentioned above).

It is not certain that this approach would prevent a court from determining the trust is subject to the claims of the grantor's creditors. For example, in *Iannotti v. Commissioner of New York State Department of Health,*[47] the court held that a trust would be subject to the claims of the grantor's creditors because the "trust protector" could add the grantor as a beneficiary. It is possible the court reached this conclusion because it determined the trust protector was a fiduciary.

Greater protection might be obtained by giving a third party, not a trustee, other fiduciary, or beneficiary, a limited power of appointment that is broad enough to include the grantor, a special power of appointment trust.[48] The laws of many states permit a trustee who has the power to distribute trust property to a beneficiary to distribute the property to a trust of which the beneficiary of the original trust is a beneficiary even if the trust has different terms and even if the recipient trust instrument gives the beneficiary a broad power of appointment that could be exercised in favor of the grantor.[49]

Wyoming. See https://www.oshins.com/state-rankings-charts for a chart comparing the different DAPT laws.

[43] See Ltr. Rul. 9837007 (June 10, 1998), holding that gifts by an Alaska resident to an Alaska DAPT were completed gifts and Ltr. Rul. 200944002 (July 15, 2009), holding that assets given to an Alaska DAPT would not be included in the gross estate of the Alaska resident grantor.

[44] 493 Bkrptcy. Rptr. 798 (Bkrptcy. DC Wash, 2013). See Blattmachr et al., "Avoiding the Adverse Effects of *Huber*," Trusts & Estates 20 (July 2013).

[45] See also, discussion in Blattmachr, Shenkman & Gassman, "Toni 1 Trust v. Wacker: Reports of the Death of DAPTs for Non-DAPT Residents Is Exaggerated," LISI Asset Protection Newsletter 362 (Mar. 16, 2018).

[46] A foreign asset protection trust may also be considered. It is beyond the scope of this article to discuss the use of foreign trusts in detail, but their use raises certain issues that are not raised with a domestic trust, including the possibility of the treatment of the grantor's death as an income tax recognition event. See Section 684; *cf. In re Lawrence*, 251 Bkrptcy. Rptr. 630 (DC Fla., 2000) (incarceration for failure to return assets in a foreign trust to the U.S.; impossibility defense rejected). This possibility may not be a concern for a donor who is seeking to protect a trust from inclusion in his or her gross estate and is not seeking to avoid creditor claims.

[47] 725 NYS 2d 866 (2001). Note that the decision does not recite all of the relevant facts. They can be gleaned only by reviewing all of documents submitted in connection with the proceedings.

[48] See O'Connor, Gans and Blattmachr, "SPATs: A Flexible Asset Protection Alternative to DAPTs," 46 Estate Planning 3 (Feb. 2019) for a more detailed discussion of SPATs.

[49] See, e.g., S.D. Codified Laws § 55-2-15.

Spousal lifetime access trusts. Some donors have sufficient confidence in their spouses to feel comfortable transferring assets to trusts of which their spouses are beneficiaries. As long as the motive for the transfer is the reduction of estate taxes, rather than a motive to hinder, delay, or defraud creditors, the trust should be free from the claims of creditors. If creditors cannot reach the trust assets, the grantor's transfer should be complete for gift tax purposes and excludable from the grantor's gross estate, unless the trust terms mandate the use of the trust property to discharge the obligation of the grantor to support his or her spouse.[50]

If an individual has no assets that he or she is willing to part with or has only highly appreciated assets but wants to make gifts now before a possible change in the tax law, consideration should be given to borrowing the funds to use to make the gifts.

By creating a trust for a spouse, a donor is likely to be able to continue to benefit from the property through the spouse without concern of estate tax inclusion.[51] In fact, if the beneficiary spouse has a power of appointment (or is later granted one by a decanting or otherwise[52]), the beneficiary spouse could exercise it in favor of a trust for the donor spouse. Unless the IRS (or a creditor) could show an understanding that the beneficiary spouse would exercise it in this manner, the existence of the power should not cause inclusion in the gross estate of the grantor.[53] If the power is exercised, for additional protection, any trust the beneficiary spouse creates for the donor spouse should probably have a trustee resident in a state that has DAPT legislation and should comply with that state's DAPT statute.[54]

The matter is more complicated if each spouse creates a trust for the other. Dual trusts raise the risk of application of the "reciprocal trust" doctrine under which a person (A) is treated as the grantor of a trust for A's benefit that was actually created by another person (B) if A, in consideration of B's creation of the trust for A, created a trust for B. The application of this doctrine potentially increases the risk of exposure to estate tax.[55] The parameters of how different the trusts for the spouses must be to avoid the doctrine have not been determined. Although one case[56] held the doctrine did not apply when one spouse gave a lifetime special power of appointment to the other spouse and no power of appointment was granted to the other, greater protection would be obtained if the trusts are created at different times, with different trustees, with different assets, and under the laws of different jurisdictions.[57] One spouse might create a trust for the other spouse and delay advising the beneficiary spouse of the creation of the trust to reduce the risk of any claim of an implied understanding.[58] Extra protection could be obtained if the trust is created in a DAPT jurisdiction because, if the decedent is a mere discretionary beneficiary with no power to control the beneficial enjoyment of the property, there should be no estate tax inclusion if the creditors of the beneficiary cannot attach the trust assets.[59]

Making gifts without parting with assets. *Gifts made with borrowed funds.* If an individual has no assets that he or she is willing to part with or has only highly appreciated assets but wants to make gifts now before a

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[50] See discussion in Gans & Blattmachr, "Another Look at Spousal Lifetime Access Trusts," Leimberg Estate Planning Newsletter 1387 (Dec. 18, 2008); but *cf.* Merrick & Goodwin, "The Good, Bad and Ugly of Spousal Access Trusts," Leimberg Estate Planning Newsletter 1334 (Aug. 20, 2008).

[51] See *Gutchess*, 46 TC 554 (1966), *acq.* 1967-1 CB 2.

[52] Zeydel & Blattmachr, "Tax Effects of Decanting-Obtaining and Preserving the Benefits," 111 J. Tax'n 288. (Nov. 2009).

[53] *Cf.* Rev. Rul. 2004-64, 2004-2 CB 7.

[54] See Rothchild et al., "IRS Rules Self-Settled Alaska Trust Will Not Be Grantor's Estate," 37 Estate Planning 3 (Jan. 2010).

[55] *Estate of Grace*, 395 U.S. 316, 23 AFTR2d 69-1954 (1969). See also, Slade, "The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Application in Current Estate Planning," Tax Mgt Estates, Gifts & Trusts (May 1992); Steiner & Shenkman, "Beware of the Reciprocal Trust Doctrine," Trusts & Estates 14 (2012).

[56] *Estate of Levy*, TCM 1983-453.

[57] See suggestions in Blattmachr, Gans & Zeydel, "Supercharged Credit Shelter Trustsm," 21 Probate & Property 52 (Jul./Aug. 2007).

[58] The reciprocal trust doctrine was developed under common law and later applied to the tax law. See *De Rousse v. Williams*, 181 Iowa 379 (1917), and *Everett v. Peyton*, 167 NY 117 (1901). *Lehman*, 109 F.2d 99, 24 AFTR 198 (CA-2, 1940), cert. denied, 310 U.S. 637 (1940).

[59] See Ltr. Rul. 200944002 (not precedent) discussed in Rothchild, note 54, *supra*.

[60] *Copley's Estate*, 194 F.2d 364, 41 AFTR 705 (CA-7, 1952), *aff'g* 15 TC 17 (1950), *acq.*, 1965-2 CB 4; *Harris*, 178 F.2d 861, 38 AFTR 1235 (CA-2, 1949), *rev'd on other grounds*, 340 U.S. 106, 39 AFTR 1002 (1950); Rev. Rul. 84-25, 1984-1 CB 191.

[61] "A written release or promise, hereafter made and signed by the person releasing or promising, shall not be invalid or unenforceable for lack of consideration, if the writing also contains an additional express statement, in any form of language, that the signer intends to be legally bound." 33 P.S. § 6.

[62] Section 2053(c)(1)(A).

[63] 1984-1 CB 191.

[64] For a more detailed discussion of this technique, see Bramwell, "Donative Promise Can Lock in 2012 Gift Tax Exemption," 39 Estate Planning 3 (Aug. 2012).

[65] On account of the uncertainty of any requirement for the value of the annuity stream retained, it has been suggested that a word formula be used to describe the annuity and the term for which it is retained. See discussion in Blattmachr & Zeydel, The Forty-First Annual Philip E. Heckerling Institute on Estate Planning, Chapter 2, at ¶ 202.3.

possible change in the tax law, consideration should be given to borrowing the funds to use to make the gifts. Individuals with significant assets are generally able to negotiate loans from financial institutions at favorable interest rates. In some cases, individuals who are beneficiaries of trusts will be able to borrow funds from the trusts at favorable interest rates, the assets that he or she wishes to retain.

Gifts of promises to make gifts. An enforceable promise to make a gift in the future made without full and adequate consideration in money or money's worth is treated as a taxable gift despite the fact that the promisor has not parted with any assets.[60] The enforceability of a promise to make a gift is determined under applicable state law. To be enforceable, the promise should generally be supported by consideration, but that consideration need not be financial. A promise to pay a sum of money in the future to a child's trust in exchange, for example, for that child's promise to read at least one good book a month should be sufficient. However, there is an exception to the required consideration rule in Pennsylvania. Under Pennsylvania law, a written promise is enforceable despite the absence of consideration if the writing states that the promisor intends to be legally bound.[61]

A promised gift will not remove any assets from the promisor's gross estate if the promisor does not make the promised payment on a date before death. No deduction will be available for the debt because the promise was not based on full and adequate consideration in money or money's worth.[62] Rev. Rul. 84-25,[63] however, will permit the removal of the amount of the promised gift from the promisor's adjusted taxable gifts. Unless Reg. 20.2010-1(c) is amended to reach a different result, the removal of the gift from the promisor's adjusted taxable gifts should not prevent a claim on the promisor's estate tax return that the estate is entitled to use the higher exclusion amount available on the date the gift was promised.

Promised gifts should not be split with a spouse under Section 2513. Splitting will result in an adjusted taxable gift for the splitting spouse. The adjustment to the promisor's adjusted taxable gifts provided by Rev. Rul. 84-25 is limited to the promisor and does not extend to the splitting spouse. If a promised gift is split, there should be a definite plan to pay the obligation before the promisor's death.[64]

Use Techniques that Permit Shifting Future Investment Returns Without Making Taxable Gifts

Grantor retained annuity trusts

In general. Under Section 2702, a donor is treated, for gift tax purposes, as transferring the entire value of property the donor has transferred to a trust (or trust equivalent) for the benefit of members of his or her family, undiminished by the value of the interest in the trust he or she retained unless, subject to a few small exceptions or special rules, the property is a personal residence or the interest retained is a unitrust or annuity interest. Reg. 25.2702-3 sets forth detailed requirements that must be satisfied to qualify a retained annuity for "qualified" annuity" treatment. A trust that satisfies these requirements is commonly called a "grantor retained annuity trust" or a "GRAT."

Most estate planners believe that the value of the annuity can be designed to approach or possibly equal the value of the entire property transferred to the trust. If this approach is used, the value of the gift caused by the creation and funding of the GRAT will be extremely small.[65] The value of the gifted remainder in the GRAT is determined by subtracting from the value of the transferred assets the discounted value of the stream of required annuity payments. Because the discount rate established under Section 7520 is only .4% in October 2020, the amount of the annuity payments required to produce a remainder interest worth only .1% of the transferred property is quite low. For example, if $10 million worth of assets is transferred in September 2020 to a five-year GRAT, the annual payments, if a constant amount, need be only $2,082,694 to produce a remainder interest worth $10,000.

Successful GRATs: growth above the Section 7520 rate. Because the value of the taxable remainder can be quite small, GRATs provide a sig-

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nificant opportunity to shift future investment return out of the gross estate of the grantor. However, in order to be successful, the growth and income of the assets once contributed to the trust must exceed the interest rate applicable to value the retained annuity in the GRAT. The greater the growth and income, the better the estate tax result.[66]

Amount included in gross estate if grantor's death occurs during term. If the grantor dies during the retained annuity term, all or a portion of the assets in the GRAT will be included in his or her estate for federal estate tax purposes.[67] The amount included is the lesser of the entire value of the trust or an amount equal to the amount of the annuity divided by the Section 7520 rate in effect at the grantor's death.

Short-term GRATs. Some have suggested that GRATs should be structured as short-term GRATs and that the grantor transfer the annuity payments as received into new GRATs of similar duration. Although the regulations do not specifically authorize short-term GRATs, there is no reported instance in which the IRS has successfully challenged a GRAT based on its short duration.[68] Not only does a short-term GRAT reduce the mortality risk, it also reduces the possibility that a poor investment performance during one year will adversely affect good performances in prior years. For example, suppose a GRAT is funded with $1 million and is to pay the grantor $330,000 per year for three years. The value of the assets doubles in value in the first year to $2 million. After the trustee pays the first year annuity of $330,000, the trust will be worth $1,670,000. There is no further appreciation in the second year. At the end of the second year the trustee again pays the $330,000 annuity leaving the trust with $1,340,000 at the beginning of the third year. It appears that the GRAT will be tremendously successful. But if the trust declines by 80% in the third year, it will have only $268,000 at the end of that year, not enough to pay the annuity. Nothing will be available to transfer to the remainder beneficiaries. If the GRAT had been a two-year GRAT (paying, for example, $500,000 each year as an annuity) and experienced the same assumed 100% growth in the first year and no growth in the second year, $1 million would pass to the successor beneficiaries. For this reason, short term GRATs, with the grantor-annuitant rolling the annuity payments received into other short term GRATs, likely should be preferred.

There are legislative proposals, which, if enacted, would impose gift tax on short-term GRATs. If it seems likely that such legislation is about

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to be enacted, the grantors of existing GRATs may want to purchase assets from their GRATs and use these assets to create long-term GRATs that may not be affected by the legislation if created and funded before the effective date of the legislation.

Asset splitting GRATs. Another useful strategy is the creation of separate GRATs for different assets. For example, funding a GRAT with two different securities will prevent negative returns in one security from diminishing the benefit of positive returns in the other.

Although there is a possibility that the IRS might attempt to require that two or more GRATs funded at the same time with the same terms and the same beneficiaries be combined, there is no reported instance in which the IRS has taken this position. The Service's attempt in 1983 to enforce a regulation for which there was no statutory authority that treated separate trusts as a single trust for income tax purposes failed.[69] Section 643(f) now permits this treatment for income tax purposes. In the absence of specific authority under the transfer tax law, such an attempt should not be successful. In order to diminish the risk of a successful argument that the multiple trusts are treated as one,[70] consider funding the GRATs at different times and providing different durations and payouts and different successor beneficiaries.

Declining annuity payment GRATs. Another structure that might be considered to increase the chances of successful GRATs is the use of steeply declining annuity payments. Initially, many estate planners thought it would be best to start with low annuity payments and increase them to enable more assets to remain in the GRAT, so that more future growth would inure to the benefit of the remainder beneficiaries. The Treasury apparently became aware of this possibility and issued regulations that limit the benefit of increasing annuity payments to 20% annually.[71] There is, however, no limitation on declining annuity payments.[72] Declining annuity payments can produce the greatest opportunity for the growth above the Section 7520 rate to be removed from the grantor's gross estate.

Because the value of the taxable remainder can be quite small, GRATs provide a significant opportunity to shift future investment return out of the gross estate of the grantor.

Consider, for example, a GRAT funded with $1 million which provides for an annuity equal to $990,000 at the end of the first year and $15,000 at the end of the second year. If the investment performance at the end of the first year is poor, the GRAT will essentially fail; at the end of the first year, all or substantially all of the trust assets will be returned to the grantor. The grantor can then contribute the returned property to a new short-term GRAT. If the trust has good investment performance (e.g., the trust is worth $1,300,000 at the end of the first year), the $990,000 annuity will be paid to the grantor at the end of the first year, who can contribute that payment to a new GRAT and $295,000 will be transferred to the successor beneficiaries (that is, the $310,000 remaining in the GRAT after the $990,000 annuity paid at the end of the first year reduced by the remaining $15,000 annuity due for the second year), assuming no further change in value in the GRAT assets.

The 99-year GRAT.[73] All or a substantial portion of the assets in the GRAT will be included in the gross estate of the grantor if death occurs while he or she is still entitled to annuity payments from the trust. However, the amount included is limited to the value of the trust assets at the grantor's death (or on the alternate valuation date under Section 2032, if applicable) of an amount equal to the annuity payable at death divided by the Section 7520 rate in effect at the grantor's death. If the Section 7520 rate is higher at death than when the GRAT was created, or if the value of the assets in the trust increases significantly, the value of assets included in the gross estate could be less, perhaps significantly less, than the initial value of the contribution to the trust. The possibility of excluding a portion of the GRAT assets is increased with long-term GRATs.

For example, suppose a GRAT was funded in August 2020 with $1 million when the Section 7520 rate

66 See discussion in Bloomberg Tax Management Portfolio 836-2d.

67 Reg. 20.2036-1(c)(2).

68 The GRATs that were the subject of the successful taxpayer challenge to the validity of one of the examples that originally appeared in the Reg. 20.2702-3 regulations were two-year GRATs. *Walton*, 115 TC 589 (2000).

69 *Stephenson Trust*, 81 TC 283 (1983).

70 Under Section 643(f), two trusts may be treated as one for income tax purposes if, among other conditions, the trusts had a primary purpose to reduce income taxes. There is no comparable rule for gift tax purposes.

71 Reg. 25.2702-3(b)(1)(ii).

72 See Example 3 in Reg. 25.2702-3(e).

73 This idea was first developed by Turney P. Berry of Wyatt, Tarrant & Combs, LLP, Louisville, KY.

was .4% and provided an annuity of $12,250 per year for 99 years. The value of the gift of the remainder would be about $200. If the grantor dies when the Section 7520 rate is 3%, the amount included in the gross estate would be $12,250/.03, or only $408,333; if rate were 5% the includable amount would be only $245,000. If the rate were 5% and the trust were still worth $1 million, $755,000 would be transferred estate tax free. In fact, if the Section 7520 rate is greater than 1.225% at the grantor's death, less than $1 million would be included in the grantor's gross estate (but never more than the value on the grantor's date of death or alternate valuation date).

If interest rates rise significant before death, the grantor could sell his or her entitlement to the remaining annuity payments for a price equal to the annuity divided by the then Section 7520 rate. If the sale were made to a trust that is treated as owned by the grantor, no income would be caused by the sale.[74] If the grantor lives for at least three years after the sale, no portion of the GRAT should be included in his or her gross estate.

Split-purchase annuity trusts

In general. Section 2702, which causes the value of interests retained in certain trusts to be subject to gift tax, applies to so-called split purchases, such as the acquisition by a parent of a life estate in an asset when a member of his or her family (such as a child) acquires the remainder. This application is referred to as the "joint purchase rule."[75] If, for example, a parent acquires a life interest in an asset as part of the same transaction in which the parent's child acquires a remainder interest, the parent will be treated as having acquired both interests and having transferred the remainder interest to the child in exchange for the price the child paid for the remainder interest. The zero value rule of Section 2702(a) will apply to treat the parent as having made a gift to the child of the value of the life interest. However, if the interest acquired by the parent is in the form of a qualified annuity interest, the rule that assigns a zero value to the parent's interest will not apply. A joint purchase should be done within a trust structure to facilitate compliance with the GRAT regulations. Two taxpayers (perhaps a parent and child or a parent and a grantor trust held for the child) would each contribute funds to a trust. Their contributions would be in proportion to the relative values of the interests of each in the trust. Such a trust arrangement is often referred to as a split purchase annuity trust.

The split purchase annuity trust offers significant advantages over a conventional GRAT.

Advantages of the split purchase annuity trust. The split purchase annuity trust offers significant advantages over a conventional GRAT. First, although a GRAT might be successful even if the grantor dies soon after the GRAT is created, except in the case of a long-term GRAT, it is not likely to achieve success. As a result, many estate planners do not suggest GRATs to clients with diminished life expectancies even if death is not imminent because of the mortality risk. If, however, the remainder beneficiary of a GRAT paid full value for the remainder interest, Section 2036 should not apply to the GRAT if the term holder dies before the term expires.[76]

Second, if Section 2036 does not apply to a split purchase annuity trust, it should be possible for the senior family member to acquire an annuity payable for life without concern over gross estate inclusion of anything other than the present value of the right to receive the remaining annuity payments.[77] The acquisition of an annuity payable for life may be important to individuals who want to achieve estate tax planning goals but who are reluctant to surrender interests in assets.

Summary and Conclusions

Tremendous opportunities for estate tax planning are available to individuals who wish to reduce the wealth transfer tax burden their families may otherwise face. Motivating individuals to consider this planning may be difficult to accomplish. Still, estate planners should advise their clients of the opportunities appropriate for them to consider. Not only may significant taxes be saved but structures may be implemented that may allow the client to continue to benefit from the assets transferred. ■

[74] See Rev. Rul. 85-13, 1985-1 CB 184; Reg. 1.1001-2(c), Example 5.

[75] Section 2702(c)(2).

[76] *Cf. Kimbell*, 371 F.3d 257 (CA-5, 2004); *Magnin*, 184 F.3d 1074 (CA-9, 1999); *Wheeler*, 116 F.3d 749 (CA-5, 1997); *Estate of D'Ambrosio*, 101 F.3d 309 (CA-3, 1996), rejecting earlier conclusions reached by the Courts of Appeals for the Federal Circuit and the Tenth Circuit (*Gradow*, 897 F.2d 516 (CA-F.C., 1990); *Allen*, 293 F.2d 916 (CA-10, 1961)) that Section 2036 will apply to an individual's transfer of property with a retained term interest unless the consideration she receives for the transfer augments her estate by an equivalent amount. See also, Ltr. Rul. 9515039 (Jan. 17, 1995).

[77] Normal actuarial principles under Section 7520 may not be used if death is imminent but, even if it is not imminent, planners may forego using a GRAT for life or even for a term because the GRAT assets will not have had sufficient time to outperform the Section 7520 rate which must be paid, along with the original value of the trust corpus, to the grantor. Reg. 20.7520-3(b)(3).