# SALE TO AN IDIT FOR A PROMISSORY NOTE - THE BEST ESTATE PLANNING STRATEGY (GIMMICK) GOING

**by**

**Michael D. Mulligan**

February 2022

Lewis Rice LLC
600 Washington Avenue, Suite 2500
St. Louis, Missouri 63101
314-444-7600

TABLE OF CONTENTS

I. Introduction. ..... 1

II. Structure of Sale to IDIT Transaction. ..... 1

III. Avoiding IRC Secs. 2702 and 2036(a)(1). ..... 3

A. The Fidelity-Philadelphia Trust Co. Case. ..... 3

B. Guarantees to Create Cushion for Promissory Note. ..... 5

C. Possible Use of Incomplete Gift to Provide Cushion. ..... 6

D. Indications That IRS Recognizes Sale to IDIT Technique. ..... 8

IV. Powers Creating Grantor Trust Status In An IDIT. ..... 9

A. Spouse as a Beneficiary. ..... 9

B. Power to Borrow. ..... 10

C. Power of Disposition. ..... 10

D. Power to Substitute. ..... 11

E. Power to Pay Life Insurance Premiums. ..... 13

F. Actual Borrowing from a Trust. ..... 13

G. Turning Off Grantor Trust Status. ..... 14

V. Choice of Interest Rates. ..... 15

VI. Reporting Sale to IDIT on a Gift Tax Return. ..... 16

A. Running of Statute of Limitations on Gift Tax Return Precludes IRS From Challenging Values and Asserting Inclusion Under IRC Sec. 2036(a)(1). ..... 16

B. Conclusiveness of Legal Issues Under Treas.Reg.Sec. 20.2001-1(b) Should Preclude IRS From Asserting IRC Sec. 2036(a)(1). ..... 18

C. Guarantor Files Gift Tax Return. ..... 19

VII. Income Tax Consequences If Seller Holds IDIT's Promissory Note at Death. ..... 19

A. Tax Consequences of Sale to Nongrantor Trust. ..... 20

B. Tax Consequences of Sale to an IDIT. ..... 22

1. Gain Recognized at Death? ..... 23

2. Effect of Seller's Death on Basis of IDIT's Promissory Note. ..... 24

3. Effect of Seller's Death on Basis of Assets Purchased by IDIT. ..... 25

a. Change in Basis Under IRC Sec. 1012. ..... 25

b. Change in Basis Under IRC Sec. 1014(b)(1). ..... 26

4. Conclusions on Income Tax Consequences of Seller's Death. ..... 27

C. Effectiveness of "Basis Boosting" Strategy to Avoid Capital Gain at Death. 28

VIII. Discounting Value of Note in Subsequent Transfer Subject to Estate or Gift Tax – Basis Issues. 28

A. Proposed Regulations Under IRC 7872(i). 29

B. Loss or Absence of Basis. 30

IX. Use of Family Limited Partnerships in Sale to IDIT Transactions. 31

A. Sale to IDIT Can Avoid IRC Sec. 2036(a). 31

B. Indirect Transfer of Limited Partnership's Underlying Assets. 32

X. Sales of S Corporation Stock. 33

XI. Sale of Limited Partnership Interests or Non-Voting Interests in an LLC. 34

XII. Sale to IDIT Technique As An Alternative to the Standard Irrevocable Life Insurance Trust. 35

XIII. Structuring Sale to IDIT Transactions After the Tax Court's Decision in *Trombetta*. 37

A. Facts and Results in *Trombetta*. 37

B. Commentators' Response to *Trombetta*. 39

C. Comments on Recommendations. 40

1. Seller as Trustee. 40

2. Seed Capital. 42

3. Surrender All Interests in Business. 42

4. Arm's Length Transaction. 43

XIV. Sale in Exchange for an Annuity Payable Over Seller's Lifetime. 45

A. The 50% Probability of Survivorship Test. 45

B. Shortened Life Expectancy. 47

C. The Exhaustion Test. 49

1. Passing or Failing the Exhaustion Test. 49

2. Calculating the Special Factor. 50

3. Validity of Example 5. 50

4. Consequences of Failing the Exhaustion Test. 51

5. Coping with Failing the Exhaustion Test. 52

a. Risks of Accepting Results. 52

b. Additional Gift by Seller. 53

c. Guarantee by Beneficiaries. 53

d. Using A Guarantor Other Than a Beneficiary of the IDIT 54

D. Limiting Annuity to Shorter of Life or a Term of Years. 55
E. Another Individual as Measuring Life. 58
F. Convert a Note Into an Annuity. 58
G. Use of a Self-Canceling Installment Note (SCIN) – The *Davidson* Case. 59
1. Use of Tables Under I.R.C. Sec. 7520 for a Sale Governed by I.R.C. Sec. 7872. 60
2. *Davidson* and CCA 201330033. 60
3. Treas.Reg.Sec. 1.1275-1(j) and Use of Actuarial Tables Under I.R.C. Sec. 7520 in Valuing Annuity for Shorter of Life or a Term of Years. 62
XV. A Sale to a BIDIT Should Work as Well as a Sale to an IDIT. 62
A. Sale to a BIDIT. 62
1. Description of a BIDIT. 63
2. The BDOT and SGT. 64
B. The Parenthetical Exception - The *Wheeler* Case. 65
C. Gift Tax Return Reporting a Sale to a BIDIT. 68
D. Limited Partnership Cases - Substantial Non-Tax Purpose Required for a Bona Fide Sale. 69
1. *Strangi* and Its Progeny. 70
2. The *Powell* Case and IRC Sec. 2043(a). 72
3. Substantial Non-Tax Purpose Test Should Be Limited to Limited Partnership Cases. 73
E. Seller on Both Sides of the Transaction. 75
1. Receipt of Adequate and Full Consideration Establishes a Bona Fide Sale. 75
2. Fiduciary Responsibilities. 76
3. Standing on Both Sides of Transaction Not Sufficient as the Sole Ground for Finding No Bona Fide Sale. 77
XVI. Conclusion. 78

## I. Introduction.

It has been over twenty-five years since the article first discussing the sale to IDIT technique was published.[1] This article examines that technique, along with a number of variations, including a sale to an IDIT in exchange for an annuity which terminates upon the seller's death and the sale to a so-called BIDIT.

## II. Structure of Sale to IDIT Transaction.

The term an Intentionally Defective Irrevocable Trust ("IDIT") describes a particular type of trust. The existence of an IDIT apart from its grantor is recognized for estate, gift and generation-skipping tax purposes, but not for income tax purposes. Any uncompensated transfer to an IDIT constitutes a gift. The assets of an IDIT are not included in the estate of its grantor at death.

The position of the Internal Revenue Service ("IRS") is that an IDIT does not exist for Federal income tax purposes.[2] All income of an IDIT, including capital gain, is taxed directly to its grantor. A sale of appreciate property to an IDIT causes no recognition of gain. Interest on a promissory note paid by an IDIT to its grantor is not taxed to the grantor or deductible by the IDIT. For income tax purposes, such interest is ignored. An IDIT has the option to use the social security number of its grantor as its tax identification number.[3]

The sale to an IDIT technique involves a grantor establishing an IDIT and selling assets to the IDIT in exchange for the IDIT's promissory note. The IRS has asserted in litigation that IRC Sec. 7872 applies to a promissory note given in a sale transaction, and that if, pursuant to IRC Sec. 7872(f), a promissory note bears interest at the applicable Federal rate under IRC Sec. 1274, it has a gift tax value equal to its face amount. This position has been accepted by the Tax Court.[4] The sale to an IDIT is a mechanism by which equity can be converted into debt without income tax consequences.[5]

Under IRC Sec. 7872(f)(2)(A), the applicable Federal rate for a term loan is the rate in effect under IRC Sec. 1274(d) as of the date upon which the loan is made. IRC Sec. 1274(d)(2)

---

[1] Mulligan, *Sale to a Defective Trust: An Alternative to a GRAT*, 23 Est. Plan. No. 1, 3 (1996).

[2] Rev.Rul. 85-13, 1985-1 C.B.184.

[3] Treas.Reg.Secs. 671-4(b)(2)(i)(A) and 301.6109-1(a)(2)(i)(B).

[4] *Frazee v. Commissioner*, 98 T.C. 554 (1992); *Estate of True v. Commissioner*, 82 T.C.M 27 (2001), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004). *See also* Ltr. Ruls. 9408018 and 9535026.

[5] For an article advocating abolition of the grantor trust rules to foreclose this kind of planning see Rics, *I Dig It, But Congress Shouldn't Let Me: Closing the IDGT Loophole*, 36 ACTEC L.J. 641 (2010).

establishes a special rule for determining the applicable Federal rate for a sale or exchange. Under IRC Sec. 1274(d)(2), the applicable Federal rate is the lowest of the interest rates for the month in which there is a binding contract for the sale or exchange, and the two immediately preceding months. Because a lower interest rate on an IDIT's promissory note reduces the value of the seller's estate, it is tempting to make use of the IRC Sec. 1274(d)(2) exception when the applicable Federal rate for one of the two months preceding the month of sale is lower than the rate for the month of sale.

IRC Sec. 1274(d) is an income tax statute. As noted in the discussion with note 2, *supra*, the IRS takes the position that transactions between a grantor trust and its grantor are not recognized for income tax purposes. It is conceivable that the IRS might apply this position to assert that a sale to an IDIT is not a sale or exchange for purposes of IRC Sec. 1274(d)(2). In most cases, the variation in the interest rates over the three month period described in IRC Sec. 1274(d)(2) is unlikely to be substantial. It would seem advisable not to risk challenge by the IRS and use the applicable Federal rate for the month of sale and not either of the two preceding months.[6]

In the sale of difficult to value assets to an IDIT, the sales documents might describe the quantity of an asset being sold through the use of a formula expressing that quantity as a dollar amount rather than as a number or percentage of units *e.g.*, as $X worth if ABC, Inc. stock rather than XX number of shares of ABC, Inc. stock. Recent cases indicate that the courts might recognize the effectiveness of such a formula to eliminate any gift if the IRS successfully argues that the assets being sold to the trust have a greater per unit value than contemplated in the sale transaction.[7] In such event, the formula operates to reduce the number or percentage of units transferred so that the dollar amount transferred remains constant. If the effectiveness of the formula is recognized, the reduction in units transferred avoids a gift.

Similar to a grantor retained annuity trust, or GRAT, the sale to an IDIT technique produces an estate tax savings if the assets sold to the IDIT produce a total return (net income plus appreciation) which exceeds the interest on the IDIT's promissory note. In such case, the excess return is trapped inside the IDIT and excluded from the seller's estate. This result is easier to produce with an IDIT than with a trust which is a separate taxpayer. With an IDIT, the grantor pays all taxes due on income and capital gain generated by the assets of the IDIT. The IDIT's return on assets is not reduced by income tax liability.

---

[6] For a different point of view, see Hesch, Gassman and Denicolo, *Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, 36 T.M.Est., Gifts and Tr. J. No. 2, 128 (2011).

[7] *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008); *aff'd* 586 F.3d 1061 (8th Cir. 2009); *Petter v. Commissioner*, 98 T.C.M. 534 (2009), *aff'd* 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C.M. 2011-133 (2011); *Wandry v. Commissioner*, 103 T.C.M. 1472 (2012).

Although the grantor's payment of taxes on an IDIT's income can be viewed as an indirect transfer increasing the value of an IDIT, the IRS ruled in Rev.Rul. 2004-64[8] that such payment does not constitute a transfer subject to gift tax. Rev.Rul 2004-64 permits a grantor to pay taxes on income which is not in the grantor's estate without having such payment being treated as a gift.

The sale technique is particularly powerful when interests in a partnership, limited liability company or S corporation are sold to the IDIT. There is no income tax imposed upon such an entity. Rather, tax is imposed upon its owners. The seller of an interest in such an entity to an IDIT continues to be taxed on the portion of the entity's income attributable to that interest. If the entity makes a distribution to its owners for the payment of income taxes, that distribution is received by the IDIT. The IDIT can move funds to the seller by making payments on the promissory note, which has the effect of reducing, not just freezing, the value of the seller's estate.

The sale to an IDIT technique also produces favorable generation-skipping tax results. These favorable results can be illustrated by an example. A grantor may make a gift of $5,000.00 in cash to an IDIT, and then sell assets having a fair market value of $50 million to the IDIT in exchange for this IDIT's $50 million promissory note. The grantor/seller need only allocate $5,000.00 in GST exemption to the IDIT for the IDIT to have an inclusion ratio of zero. With that allocation, all of the excess return excluded from the grantor/seller's estate for Federal estate tax purposes is also insulated from generation-skipping tax. The significant point is this insulation is achieved without allocation of any additional GST exemption.

## III. Avoiding IRC Secs. 2702 and 2036(a)(1).

Two statutes to be avoided in a sale to an IDIT are IRC Secs. 2702 and 2036(a)(1). Each of these statutes produces an unfavorable tax result for certain retained interests in transferred property.

### A. The Fidelity-Philadelphia Trust Co. Case.

IRC Sec. 2702 provides that, for purposes of valuing a transfer to a trust for the benefit of a member of the transferor's family, any interest in the trust retained by the transferor is valued at zero unless it is a qualified interest defined in IRC Sec. 2702(b). IRC Sec. 2702 is the statutory basis for the GRAT.

A promissory note received in a sale to an IDIT would rarely, if ever, satisfy the requirements of IRC 2702 and the regulations issued under that statute. If the promissory note were deemed to be an interest in the IDIT, its value would be zero for gift tax purposes and the seller would be deemed to have made a gift to the IDIT equal to the fair market value of the property transferred to the IDIT in the sale transaction, unreduced by the amount due under the promissory note.

[8] 2004-2 C.B. 7.

IRC Sec 2702 was enacted as a part of the Omnibus Budget Reconciliation Act of 1990. There are no reported decisions on the issue of whether a promissory note received by a seller in a sale to IDIT transaction is a retained interest under IRC Sec 2702. There are cases under IRC Sec 2036(a)(1) involving sales. These cases should be relevant to IRC Sec 2702, since both IRC Secs. 2036(1)(1) and 2702 deal with the consequences of retained interests in transferred property. The IRS has applied the authorities under IRC Sec 2036(a)(1) in examining the treatment of a sale under IRC Sec 2702.[9]

IRC Sec. 2036(a)(1) includes in a decedent's gross estate a transfer (other than a bona fide sale for adequate and full consideration) under which the decedent retained the possession or enjoyment of, or the right to income from the transferred property. The United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith*,[10] established the tests for determining whether a sale providing for periodic payments of the purchase price is to be recognized as a sale and not treated as a transfer to which IRC Sec. 2036(a)(1) applies. Rev.Rul. 77-193.[11] applied the tests established by *Fidelity-Philadelphia Trust Co.* to a sale by the decedent, A, of timber rights to B for a series of unsecured promissory notes. One month after the sale to B, A conveyed the underlying real estate to C. One promissory note remained unpaid at the time of A's death. Rev.Rul. 77-193 held that the real estate was not includable in A's gross estate, stating:

> "In addition, since B's promise to pay for the timber rights is a personal obligation of B as transferee, the obligation is not chargeable to the transferred property, and the payments are wholly independent of whether or not the transferred property produces income for the transferee. Thus, no part of the transferred property is includable in the transferor's gross estate under section 2036(a)(1) of the Code. See the following footnote in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274, 280 (1958), 1958-1 C.B. 557, 559:
>
> `Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. E.g., *Estate of Sarah A. Bergan*, 1 T.C. 543, *Acq*. 1943 Cum.Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 1929, 35 F.2d 982, 68 Ct.Cl. 508; cf. *Welch v. Hall*, 1 Cir. 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.'
>
> "Accordingly, it is held that section 2036 of the Code does not apply . . ."

[9] Ltr. Rul. 9535026.

[10] 356 U.S. 274 (1958).

[11] 1977-1C.B. 273.

The first test enunciated by the Supreme Court in *Fidelity-Philadelphia Trust Co.* seems relatively easily satisfied. The interest rate in a sale to IDIT transaction is set pursuant to IRC Sec. 7872(f), and is not based upon the income generated by the assets sold to the IDIT.

The other two tests of *Fidelity-Philadelphia Trust Co.* should be satisfied if the IDIT has assets other than those sold to the IDIT in the sales transaction available to satisfy the promissory note. The other assets afford a cushion of equity to support the note. The IRS has indicated informally that other assets equal to or exceeding 10% of the promissory note should be a sufficient cushion.[12]

One method of creating the cushion is for the seller in the IDIT sale transaction to transfer to the IDIT assets having a value equal to or greater than 10% of the promissory note. This transfer would be subject to gift tax.

### B. Guarantees to Create Cushion for Promissory Note.

It appears possible to avoid a gift by the seller through use of a guarantee by one or more beneficiaries of the IDIT.[13] The guarantee could be for the cushion which is determined to be appropriate, e.g. 10% of the indebtedness. The seller's spouse could effect the guarantee, whether or not the spouse is a beneficiary of the IDIT. Any guarantor must have sufficient assets to make good on the guarantee.

Although beneficiary guarantees to furnish a cushion in a sale to IDIT transaction may avoid a gift by the seller, the gift tax consequences to a beneficiary making the guarantee are uncertain. There is authority that a gift occurs when a guarantee becomes a legally binding obligation of the guarantor.[14] Although not a certainty, it appears that the IRS would likely treat any gift as a gift by the guarantor to the IDIT rather than to the seller. Even though a payment on the guarantee would not be an addition to the IDIT itself, it would reduce the indebtedness of the IDIT to the seller.

Such a gift could have a number of unfavorable tax consequences. It could, for example, be treated as an addition to the IDIT causing the IDIT not to be wholly owned by the seller under the grantor trust income tax rules. If the guarantor is treated as making an addition to the IDIT by virtue of his or her guarantee, the addition could cause a portion of the IDIT to be includable in the guarantor's estate under IRC Sec. 2036(a)(1).

---

[12] Abbin, *[S]He Loves Me, [S]He Loves Me Not - Responding to Succession Planning Needs Through a Three Dimensional Analysis of Considerations to be Applied in Selecting From the Cafeteria of Techniques*, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1300.1 (1997).

[13] In Lt. Rul. 9515039, the IRS held that a guarantee was sufficient to avoid application of IRC Sec. 2036(a)(1) under the tests of *Fidelity-Philadelphia Trust Co.* so long as the beneficiary had sufficient assets to pay on the guarantee if required to do so.

[14] Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶119.4 [A][2] (1992).

If the guarantee is treated as a gift to the IDIT, it could also have generation-skipping tax consequences. If the guarantor is a beneficiary of the IDIT and the guarantee causes a portion of the IDIT to be included in the beneficiary's estate under IRC Sec. 2036(a) or 2038, the beneficiary would be precluded by the ETIP rules of IRC Sec. 2642 from allocating GST exemption to the IDIT during his or her lifetime. If the guarantor is the seller's spouse who is a beneficiary of the IDIT, the spouse would be precluded from allocating the spouse's GST exemption to the IDIT during his or her lifetime. In addition, the seller would not be able to allocate any GST exemption to the IDIT, because inclusion of any part of the IDIT in the spouse's estate creates ETIP for the seller.[15]

Potential problems with possible inclusion in the guarantor's estate and ETIP can be eliminated by drafting. A provision in the governing instrument could direct that no distribution is to be made to a guarantor from any asset or portion of an IDIT which is treated for estate, gift or generation-skipping tax purposes as having been added to the IDIT by the guarantor. Such a provision should be effective to cut off a guarantor from any beneficial interest in any portion of the IDIT deemed to have been added to the IDIT by the guarantee. The addition would be deemed to be a gift by the guarantor, but no portion of the IDIT would be included in the guarantor's estate. There would also be no ETIP precluding allocation of GST exemption by the grantor, or if the guarantor is the seller's spouse, by the seller.

There is also authority for the proposition that a gift occurs not when a beneficiary of an IDIT effects the guarantee, but rather when payment is made on the guarantee.[16] It can also be argued that a guarantee of a trust's liability by a beneficiary of the trust does not constitute a gift because it is given to enhance the beneficiary's own financial situation.[17] Risk of the guarantor being treated as making an addition by gift to the IDIT can be reduced by paying the guarantor a fee for the guarantee, e.g., .5% or 1% of the amount guaranteed, payable annually, so long as the guarantee continues in effect. It should be possible to eliminate the guarantee without unfavorable tax consequences if the value of the assets of the IDIT increases sufficiently to create an adequate cushion for the IDIT's note. As discussed in Section VI.C., *infra*, a guarantor should consider filing a gift tax return reporting the guarantee and taking the position that the guarantee is not a gift.

### C. <u>Possible Use of Incomplete Gift to Provide Cushion</u>.

An article suggests a strategy which the article asserts can be used to create a cushion for a sale to an IDIT for purposes of a sale without triggering a gift (the "Incomplete Equity Strategy

[15] IRC Sec. 2642(f)(4).

[16] Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, note 14, *supra*; August, *Planning Around Contingent Liabilities*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1802 (1992)

[17] Hatcher and Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts,* 92 J.Tax. No. 3, 152 (March 2000)

Article").[18] The Incomplete Equity Strategy Article suggests that an IDIT be structured to consist of two shares. Both shares are held for the benefit of the same beneficiaries, none of whom is the grantor of the IDIT. The provisions governing both shares are identical, except that the grantor retains a testamentary limited power to appoint one share (the "Limited Power of Appointment Share") to any appointee other than the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate. The grantor retains no such power over the other share of the IDIT (the "Non-Limited Power of Appointment Share"). The testamentary limited power keeps any transfer to the Limited Power of Appointment Share from being a completed gift for Federal gift tax purposes.

Noting that the grantor retains no right to reacquire property from either the Limited Power of Appointment Share or the Non-Limited Power of Appointment Share without consideration, the Incomplete Equity Strategy Article asserts that any transfer to the Limited Power of Appointment Share is complete for property law and trust law purposes. The Incomplete Equity Strategy Article states that it is only a provision of the Internal Revenue Code, i.e., the testamentary limited power of appointment, which treats the transfer to the Limited Power of Appointment Share as incomplete for Federal gift tax purposes. The Incomplete Equity Strategy Article suggests that transfers to the Limited Power of Appointment Share of an IDIT can be used to bolster the equity behind a promissory note given by the IDIT in a sale without a gift by the grantor.

Although the suggested strategy might be viewed as imaginative, the question is whether the strategy works as claimed by the Incomplete Equity Strategy Article. The objective of the Limited Power of Appointment Share is to make other assets available to satisfy a promissory note given by the IDIT to conform with the tests enunciated by the United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith* and by the IRS in Rev.Rul. 77-193. See Section III.A., *supra*.

Any assets which a grantor transfers to a Limited Power of Appointment Share remains includable in the grantor's estate under IRC Secs. 2036(a)(2) and 2038. Can assets which are included in a grantor's estate be used to avoid the application of IRC Secs. 2036(a)(1) and 2702 to assets sold to the IDIT in exchange for the IDIT's promissory note? The IRS might successfully assert that assets transferred to a Limited Power of Appointment Share and to a Non-Limited Power of Appointment Share constitute a single transfer all of which remain includable in the transferor's estate. In a "normal" sale transaction in which cushion for the IDIT's note is afforded by a gift to the IDIT or by beneficiary guarantees, a reduction in value of the assets composing the IDIT does not affect the value of the grantor's estate, so long as the other assets gifted to the IDIT or possessed by the grantor by the guarantor or guarantors are sufficient to cover such decrease in value. With the Limited Power of Appointment Share technique suggested by the Incomplete Equity Strategy Article, any decrease in the value of the Limited Power of Appointment Share produces an equal reduction in the value of the grantor's estate.

[18] Dunn, Such and Park, *The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts*, 34 Est.Plan. No. 2, 40 (Feb. 2007).

There is at least a reasonable possibility that the assets of a Limited Power of Appointment Share do not constitute "other assets" satisfying the test established by *Fidelity-Philadelphia Trust Co.* and Rev.Rul. 77-193. The Limited Power of Appointment Share strategy suggested by the Incomplete Equity Strategy Article should be considered risky. As noted in Section III.A., *supra*, the results are disastrous if IRC Sec. 2702 applies to the transaction.

### D. **<u>Indications That IRS Recognizes Sale to IDIT Technique</u>.**

There are no reported cases involving the sale to IDIT technique. The IRS has not officially pronounced upon the technique in a manner that can be relied upon by taxpayers. There are indications, however, that the IRS recognizes the effectiveness of the sale to IDIT technique.

*Estate of Marian Woelbing v. Commissioner*[19] and *Estate of Donald Woelbing v. Commissioner*[20] were two companion cases filed in the Tax Court. In those cases, the IRS asserted the applicability of IRC Sec. 2702 to a sale of non-voting stock of a closely held corporation by Mr. Woelbing to an IDIT in exchange for the IDIT's promissory note. The Woelbings were husband and wife. They both consented under IRC Sec. 2513 to treat any gift on the sale as having been made one-half by each of them. The IRS also asserted that the assets sold to the IDIT by Mr. Woelbing should be included in his Federal gross estate under IRC Secs. 2036 and 2038. In the *Woelbing* cases, the IRS also claimed that the stock sold to the IDIT had a value of $116.8 million on the date of sale, rather than the $59 million established as the purchase price in the sale transaction documents.

The *Woelbing* cases involved facts which were similar to those in *Karmazin v. Commissioner*[21]. *Karmazin* was a case filed in the Tax Court involving an asserted gift tax deficiency arising out of sales to IDITs. In *Karmazin*, the taxpayer sold limited partnership interests to two IDITs in exchange for the IDITs' promissory notes. The notes bore interest at the applicable Federal rate. The taxpayer made gifts of limited partnership interests affording a 10% cushion. The sales documents provided for the sale of limited partnership interests having a value equal to a fixed dollar amount, which amount equaled the face amount of the promissory notes given by the IDITs in the sale transactions. A discount of 42% was claimed on the gift tax return reporting the sale.

The case was settled on terms very favorable to the taxpayer. In the settlement, it was agreed that IRC Sec. 2702 did not apply. The sales were recognized, and it was agreed that the promissory notes had gift tax values equal to their face amounts. The discount produced by the limited partnership was agreed to be 37%, rather than the 42% claimed. Thus, the deficiency originally asserted by the gift tax examiner was reduced by 95%. These settlement terms were so favorable to the taxpayer that one commentary concluded that the IRS "was not serious" about

---

[19] Doc. No. 30260-13, filed December 26, 2013.

[20] Doc. No. 30261-13, filed December 26, 2013.

[21] Tax Ct. Dock. No. 2127-03.

its IRC Sec. 2702 contentions.[22] The *Woelbing* cases were also settled on terms favorable to the estates. From the stipulated decisions entered in March of 2016, it is clear that the IRS abandoned its IRC Secs. 2036, 2038 and 2702 arguments in both cases.[23]

The IRS has recognized the sale to IDIT technique in two private letter rulings.[24] The author's office has been involved in more than fifty audits involving gift tax returns reporting sales to IDITs. In none of those audits was the basic structure of the sale challenged. None of the examining agents in those audits asserted that IRC Sec. 2702 was applicable. Generally, the only issue in the audits was the value of the assets sold to the IDIT. The author's experience is that the IRS recognizes the sale to IDIT technique. Although the issue bears watching, the *Woelbing* and *Karmazin* cases do not seem to indicate an official IRS position that sales to IDITs are to be challenged.

## IV. **Powers Creating Grantor Trust Status In An IDIT**.

IRC Secs. 671-677 create a number of opportunities to create a trust which violates the grantor trust income tax rules without causing the trust to be included in the grantor's estate.[25] This result is made easier to achieve by IRC Sec. 672(e), which provides that, for purposes of the grantor trust rules, the grantor is treated as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest, or who thereafter became a spouse of the grantor. In the latter case, grantor trust status exists only with respect to periods after such individual became the grantor's spouse.

### A. **Spouse as a Beneficiary**.

Under IRC Secs. 677(a)(1) and (2), grantor trust status exists with respect to any portion of a trust whose income without the approval or consent of an adverse party may be distributed to the grantor or the grantor's spouse or accumulated for future distribution to the grantor's spouse. If the spouse is trustee of the IDIT and inclusion in the spouse's estate is avoided

---

[22] Covey and Hastings, *Recent (2003) Developments in Transfer and Income Taxation of Trusts and Estates*, 38th Ann. Philip E. Heckerling Inst. on Est. Plan. ¶ 129 (2004).

[23] Aucutt, *Parties Settle Closely Watched Tax Court Cases Involving Defined Value Clauses*, L1S1 Estate Planning Newsletter #2419 (May 24, 2016).

[24] Ltr. Ruls. 9436006 and 9535026. However, see Letter Rul. 9251004 which involved the right to receive annual payments on a promissory note received from a trust in exchange for the transfer of stock in a transaction described as a "sales/gift." The IRS held that the right to receive annual payments on the note constituted a retained right to receive trust income, causing the transferred stock to be included in the transferor's estate.

[25] For excellent articles on grantor trusts, see Zaritsky, *Open Issues and Close Calls - Using Grantor Trusts in Modern Estate Planning*, 43 U. Miami Heckerling Inst. on Est. Plan. ch. 3 (2009); Akers, Blattmachr and Boyle, *Creating Intentional Grantor Trusts,* 44 Real Prop., Tr. and Est. L.J. 207 (2009); Blattmachr, Gans and Lo *A Beneficiary as Trust Owner: Decoding Section 678,* 35 ACTEC J. 106 (2009).

through the use of an ascertainable standard under IRC Secs. 2041(b)(1)(A), grantor trust status exists under IRC Secs. 677(a)(1) and (2). There is no provision in IRC Secs. 677(a)(1) and (2) comparable to IRC Sec. 2041(f)(1)(A) creating an exception for an ascertainable standard.

### B. Power to Borrow.

A power to borrow income or principal of the trust in the grantor without regard to adequate interest or security will achieve wholly grantor trust status under IRC Sec. 675(2). By virtue of IRC Sec. 672(e), grantor trust status is also achieved if the grantor's spouse possesses such power. Grantor trust status does not result, however, if the power to lend without adequate security exists in a trustee (other than the grantor or the grantor's spouse) under a general lending power to make loans to any person without regard to interest or security.

A power to borrow without adequate security should not have any estate tax significance, because the exercise of the power has no impact on the size of the grantor's estate. Any borrowing of funds from the trust is offset by an indebtedness to the trust.

IRC Sec. 675(2) also confers grantor trust status if the grantor retains the right to borrow without adequate interest. A power to borrow from a trust without interest could be considered to be a retained right "to the possession or enjoyment of, or the right to the income from" the trust within the purview of IRC Sec. 2036(a)(1). It would appear to be unwise to use a retained right in the grantor to borrow without interest as a means of achieving grantor trust status.

### C. Power of Disposition.

IRC Sec. 674(a) treats the grantor as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. At first blush, violation of IRC Sec. 674(a) appears to be an easy method of achieving grantor trust status. There are, however, a number of exceptions to the broad general rule of IRC Sec. 674(a).

For example, the rule of IRC Sec. 674(a) does not apply if the power of disposition is exercisable only with the approval or consent of an adverse party. Trustees who are also beneficiaries are likely adverse parties precluding grantor trust status under IRC Sec. 674(a).[26]

If the grantor or the grantor's spouse is to act as a trustee and if the grantor's or the spouse's power to make distributions of income and principal is limited by an ascertainable standard, such standard will not prevent the grantor from being treated as the owner of the income portion of the trust. IRC Sec. 674(d), which creates an exception to IRC Sec. 674(a) for a power exercisable by a trustee or trustees to distribute, apportion or accumulate income which is limited by an ascertainable standard, does not apply if the grantor or the grantor's spouse living with the grantor is acting as a trustee. On the other hand, the ascertainable standard

[26] See Treas.Reg.Sec. 1.672(b)-1(b). In addition, IRC Sec. 674(c) excepts powers held by independent trustees from the general rule of IRC Sec. 674(a).

precludes the grantor from being treated as the owner of the corpus portion of the trust, even if the grantor or the grantor's spouse is acting as a trustee. See IRC Sec. 674(b)(5)(A).

Insulation from grantor trust status under IRC Secs. 674(b)(5)(A), (c) and (d) is not available if any person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive income or corpus, except where such action is to provide for after-born or after-adopted children. Grantor trust status under IRC Secs. 674(b)(5)(A), (c) and (d) can be achieved by giving a party the power to add beneficiaries to the trust.[27] The grantor should not be the one possessing the power to add beneficiaries. If held by the grantor, such power would cause inclusion of the trust in the grantor's estate under IRC Secs. 2036(a)(2) and 2038(a)(1). The power to add beneficiaries should likewise not be given to an existing beneficiary of the trust. The IRS might argue that an existing beneficiary's interest is adverse to the exercise of the power, making the power to add beneficiaries ineffective.[28]

### D. Power to Substitute.

The power to substitute assets causes grantor trust status under IRC Sec. 675(4)(C). Under IRC Sec. 675(4)(C), grantor trust status is created if any person has a power to reacquire trust corpus by substituting other property of an equivalent value.

Commentators have suggested that retention by the grantor of the power to substitute assets in a nonfiduciary capacity so as to fall within IRC Sec. 675(4)(C) might cause trust assets to be included in the grantor's estate. The concern was that the power to substitute might be considered a power to designate the persons to possess or enjoy property or the income therefrom under IRC Sec. 2036(a)(2) or a power to alter, amend, revoke or terminate within the meaning of IRC Sec. 2038(a)(1).[29]

Rev.Rul. 2008-22[30] alleviates some concern on this point. In Rev.Rul. 2008-22, a U.S. citizen D established an irrevocable trust for the benefit of D's descendants, naming T as trustee. The Ruling states that the governing instrument prohibits D from serving as trustee. The governing instrument also grants D the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person acting in a fiduciary capacity, to acquire any property of the trust by substituting other property of equivalent value. Rev.Rul. 2008-22 holds that the grantor's power to substitute does not cause assets of the trust to be included in the grantor's estate under IRC Sec. 2036 or 2038. The Ruling states that this result is reached so long as the trustee has a fiduciary obligation (either under local law or the terms of the governing

---

[27] See Treas.Reg.Secs. 1.674(b)-1(b)(5)(iii), Example (1) and (d)-2. See also Ltr.Ruls. 200030018 and 200030019 which held that the power to add charities as beneficiaries created grantor trust status.

[28] See Treas.Reg.Sec. 1.674(d)-2(b).

[29] See, e.g., Horn, *Avoiding and Attracting Grantor Trust Treatment,* 24 ACTEC Notes 204, 224-225 (1998).

[30] 2008-16 IRB 796.

instrument) to ensure that the properties acquired and substituted by the grantor are, in fact, of equivalent value, and so long as the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries.

Rev.Rul. 2008-22 does not indicate whether the IRS attaches any significance to the fact that the governing instrument prohibited the grantor from acting as trustee. It may be that the IRS does not believe that this point is significant. However, such an assumption would appear risky. An IRS agent auditing an estate tax return could very well assert that the grantor's inability to act as trustee is a necessary prerequisite to the conclusion reached in Rev. Rul. 2008-22, and that a grantor with a power to substitute serving as trustee causes inclusion. The most that can be said favorably is that the Ruling doesn't address the issue. It would appear wise not to reserve in the grantor a power to substitute under authority of Rev.Rul. 2008-22 if the grantor is to serve as a trustee.[31]

A draftsperson may seek to avoid any possibility of inclusion under IRC Sec. 2036(a)(2) or 2038(a)(1) by conferring the power to substitute on a person other than the grantor. IRC Sec. 2041 is the only statute which could create estate tax inclusion in another person, and a power to substitute property with other property of equal value does not cause inclusion under IRC Sec. 2041.[32]

IRC Sec. 675(4)(C), by its express terms, applies to "any person" holding the power to substitute assets. However, IRC Sec. 675(4)(C) uses the word "reacquire" in describing the transactions to which the statute applies. It has been suggested that only the original grantor of a trust can "reacquire" trust assets, and that conferring the power to substitute on a person other than the grantor or the grantor's spouse does not insure grantor trust status..[33] To state that the power to "reacquire" can only be held by the grantor and not another person is simply incorrect. A nongrantor who has previously exercised a right to substitute could "reacquire" an asset given in exchange for the previously substituted asset. It is not reasonable to suggest that IRC Sec. 675(4)(C) only applies to a nongrantor who has previously exercised a power to substitute as opposed to one who has not previously exercised such power.

Although the statutory language of IRC Sec. 675(4)(C) could be more precise by the use of a word other than "reacquire", the fact that the statute by its terms expressly applies to "any person" renders dubious any assertion that it applies only to grantors. The clear reference to "any person" would seem more than enough to overcome any uncertainty created by the word "reacquire." Similarly, by virtue of IRC Sec. 672(e), a power to substitute in the grantor's spouse should confer grantor trust status, even if the spouse has not contributed assets to the trust

---

[31] See Mulligan, *Power to Substitute in Grantor Does Not Cause Inclusion, With A Significant Caveat*, 109 J. Tax. No. 7, 32 (July 2008).

[32] Treas.Reg.Sec. 20.2043-1(a).

[33] See Horn, *Avoiding and Attracting Grantor Trust Treatment*, note 29, *supra*.

which the spouse can "reacquire." The IRS has concluded in private letter rulings that a power to substitute conferred upon a nongrantor results in grantor trust status.[34]

### E. Power to Pay Life Insurance Premiums.

At first blush, it would appear that IRC Sec. 677(a)(3) affords an easy way to create grantor trust status in a manner that has no estate or gift tax consequences. That statute treats the grantor as the owner of any portion of a trust whose income, without the consent of an adverse party, may be used to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse. On its face, the language of IRC Sec. 677(a)(3) would appear to create grantor trust status if a trust instrument expressly authorizes the use of trust income to pay premiums on policies insuring the life of the grantor or the grantor's spouse. There are, however, cases decided under the predecessor of IRC Sec. 677(a)(3) which hold that the grantor is only taxed on income actually used to pay premiums.[35] It seems advisable not to rely solely on IRC Sec. 677(a)(3) to create grantor trust status.

### F. Actual Borrowing from a Trust.

IRC Sec. 675(3) creates grantor trust status with respect to any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. Grantor trust status is not created by a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor (or, under IRC Sec. 672(e), the grantor's spouse), and other than a related or subordinate trustee subservient to the grantor.

The language of IRC Sec. 675(3) referring to the beginning of the taxable year is obscure. That language has been held to create grantor trust status for an entire calendar year if at any time during such year a loan described in the statute is outstanding.[36]

IRC Sec. 675(3) can be construed as affording a simple method of obtaining grantor trust status for an entire trust. It is possible to construe the statute as creating grantor trust status for an entire trust if the grantor borrows even a *de minimis* amount from the trust. However, the cases indicate that this is not the correct reading of the statute, and that borrowing *de minimis* amounts from the trust does not cause the whole trust to be a grantor trust.[37]

---

[34] See, e.g., Letter Ruls. 9011052, 9026036 and 9037001.

[35] *Moore v. Commissioner*, 39 B.T.A. 808 (1939), *acq*. 1939-2 C.B. 25; *Rand v. Commissioner*, 40 B.T.A. 233 (1939), *aff'd* 116 F.2d 929 (8th Cir. 1941), *cert. denied*, 313 U.S. 594 (1941), *acq*. 1939-2 C.B. 30; *Iversen v. Commissioner*, 3 T.C. 756 (1944); *Weil v. Commissioner*, 3 T.C. 579 (1944), *acq*. 1944 C.B. 29.

[36] *Mau v. U.S.*, 355 F. Supp. 909 (D. Hawaii 1973); Rev.Rul. 86-82, 1986-1 C.B.253.

[37] *Benson v. Commissioner*, 76 T.C. 1040 (1981); *Bennett v. Commissioner*, 79 T.C. 470 (1982).

### G. Turning Off Grantor Trust Status.

It is possible that at some point the continuing obligation to pay taxes on IDIT income may become burdensome to the grantor. It would generally seem advisable for the governing instrument to contain a mechanism for turning off grantor trust status. Turning off grantor trust status would cause the income of the IDIT to be taxed to the trust or its beneficiaries.

If one of the devices used to create grantor trust status is granting the power to an individual to add to the beneficiaries eligible to receive distributions from the IDIT pursuant to IRC Secs. 674(b)(5)(A), (c) and (d), such individual could be granted the power to terminate such power. The individual could also be empowered to terminate any other powers which are utilized to create grantor trust status. If such individual is not the grantor and has no beneficial interest in the IDIT, the individual's possession or exercise of the power to terminate grantor trust status should not have any adverse estate or gift tax consequences.

It would seem advisable to pay off any promissory note given by the IDIT to its grantor in a sale transaction before grantor trust status is turned off. There is a risk that turning off grantor trust status while the promissory note is outstanding would be treated as a sale causing realization of gain to the extent that the amount due on the promissory note exceeds the income tax basis of the assets held by the IDIT. With the loss of grantor trust status, the trust becomes a taxpayer separate from its grantor. At that time, it is treated for income tax purposes as having received assets from its grantor at the same time it issues its promissory note. The trust's receipt of assets simultaneously with its issuance of the note could be treated as a sale. [38]

If there is not sufficient cash to satisfy the note, the note could be paid in kind. Because the IDIT will continue to be a grantor trust when the note is paid, there will be no gain on that payment, even if appreciated assets are used to pay off the note.

Generally, the grantor trust rules of IRC Sec. 671-677 operate on a year-to-year basis.[39] It might be possible for grantor trust status to be eliminated in one year and reinstated in another. For example, a grantor may be comfortable with paying taxes on dividend and interest income derived from assets previously sold to an IDIT, but may be uncomfortable with paying taxes on a substantial capital gain incurred if those assets are sold. In such an instance, it would be desirable to be able to turn off grantor trust status for the year in which the assets are sold and then turn grantor trust status back on in subsequent years after the sale is completed.

There does not appear to be any authority on this issue. There is reason to be concerned that the IRS might simply not recognize an attempt to toggle grantor trust status off or on from year to year. The IRS might simply take the position that a power which is capable of being reinstituted is never actually turned off, and that the existence or nonexistence of grantor trust

---

[38] Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J.Tax. No. 3, 149 (2002). At note 8, the article points out that there is no direct authority on this issue.

[39] See, e.g., Treas.Reg.Sec. 1.671-3(a)(3) which defines the portion of a trust treated as owned by the grantor under certain circumstances for "the taxable year in question."

status is not to be determined from year to year. If accepted, this argument would cause the grantor to be taxed in years in which it was thought that the IDIT was no longer a grantor trust. Worse yet, it is possible that the IRS might assert that the IDIT never was a grantor trust. Without any authority on the question of whether grantor trust status can be changed from year to year, it would seem preferable that any turn off of grantor trust status, once effected, be permanent.

## V. <u>Choice of Interest Rates</u>.

Under IRC Sec. 1274(d), the Federal short-term rate applies to a promissory note with a term of not over three years, the Federal mid-term rate applies to a promissory note with a term of over three years but not over nine years, and the Federal long-term rate applies to a promissory note with a term exceeding nine years.

In structuring the promissory note in a sale to IDIT transaction, the inclination in every case might be to lock in the long-term interest rate for an extended period of time. This inclination is likely to be strongest when the Federal long-term rate is comparatively low by historical standards. The term of the notes in Ltr. Rul. 9535026 was twenty years. The term of the note in Ltr. Rul. 9436006 was twenty-five years. Selecting the long-term rate over a long period of time is beneficial if the applicable Federal rate increases in the future. If the applicable Federal rate decreases, it appears that the promissory note can be renegotiated at the lower prevailing rate without gift tax consequences, so long as the note provides for prepayment of interest and principal without penalty.[40] Before automatically selecting the long-term rate, however, the current long-term rate should be compared with the current mid-term rate. Consideration should also be given to how long the note is likely to remain outstanding.

Even if the Federal long-term rate does not exceed the mid-term rate by much, it still may be preferable to utilize the mid-term rate in those instances in which there is a good chance that the promissory note will be paid off within nine years. For example, a seller may not be expected to live much longer than nine years. Alternatively, it may be anticipated that assets sold to the IDIT will be liquidated within nine years. In such event, the promissory note might be paid off, and the cash received in payment of the note placed in a limited partnership or other entity to produce valuation discounts in the manner discussed in Section IX, *infra*. The interests in the entity might then be sold to the IDIT at a discounted value, producing a reduction in the value of the seller's estate. This reduction in value would be in addition to any reduction achieved in the original sale. It has been the experience of the author that promissory notes given in sale to IDIT transactions rarely remain outstanding for nine years. That experience might change in a period of consistently rising interest rates.

---

[40] Blattmachr, Crawford and Madden, *How Low Can you Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J.Tax No. 7, 22 (July 2008); Harrington, *Question and Answer Session*, 38th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1216 (2004); Zeydel, *Estate Planning in a Low Interest Rate Environment*, 36 Est. Plan. No. 7, 17 (July 2009).

In some cases, it may be useful to calculate the breakeven interest rate in considering whether to use the mid-term rate rather than the long-term rate. The "breakeven interest rate" can be computed by choosing a term for a hypothetical note which is to bear interest at the applicable Federal long-term rate. It is then assumed that a note with the same face amount as the hypothetical note and bearing interest at the current mid-term rate has a term of nine years. After nine years, it is assumed that this note is renegotiated into a new note with a term which ends at the same time as the term of the hypothetical note. The "breakeven interest rate" is the rate which produces the same results as produced with the hypothetical note. If the decision is made to use the mid-term rate, prevailing rates can be monitored during the term of the IDIT's promissory note. If it appears that interest rates are likely to exceed the breakeven interest rate, the note can be renegotiated at the prevailing applicable Federal rate to lessen the damage. The possibility of renegotiating a note at any time during its term makes the selection of the mid-term rate less of a risk.

## VI. Reporting Sale to IDIT on a Gift Tax Return.

If no gift tax return is filed reporting a sale, there is no time limit on the IRS's ability to challenge that sale and assert a gift tax liability.[41] Similarly, during the seller's lifetime, there is no certainty that an IDIT has an inclusion ratio of zero for generation-skipping tax purposes.[42]

### A. Running of Statute of Limitations on Gift Tax Return Precludes IRS From Challenging Values and Asserting Inclusion Under IRC Sec. 2036(a)(1).

A gift tax return might be filed reporting a sale to IDIT transaction, and taking the position that the sale is not a gift because the value of the IDIT's promissory note is not less than the value of the assets sold to the IDIT.[43] If the gift tax return adequately discloses the sale transaction, the IRS cannot assert otherwise for any purpose after the three-year statute of limitations has elapsed.[44] A timely filed gift tax return can also be used to establish conclusively the value of property for purposes of allocating GST exemption.[45] Although reporting a sale transaction risks a possible audit, it would generally seem that reporting a sale is to be preferred.

In addition to precluding the IRS from asserting gift tax liability and establishing values for purposes of allocation of GST exemption, the running of the statute of limitations should also prevent the IRS from asserting that the assets sold to the IDIT are includable in the seller's estate as a transfer with retained interest under IRC Sec. 2036(a)(1). There is an exception to inclusion under IRC Secs. 2036(a), 2037 and 2038(a) afforded by identical language contained within parentheses in all three of these statutes. Under this parenthetical exception, the statutes do not

---

[41] IRC Sec. 6501(c)(9).

[42] Treas.Reg.Sec. 26.2642-5(b).

[43] Treas.Reg.Sec. 301.6501(c)-1(f)(4).

[44] IRC Secs. 2001(f), 2504(c) and 6501(c)(9).

[45] IRC Sec. 2642(b)(1).

apply to any transfer constituting "a bona fide sale for an adequate and full consideration in money or money's worth." Satisfying the parenthetical exception makes any of the three statutes inapplicable even if there is a retained interest or power which would otherwise cause inclusion. A question arises as to whether the passage of the three year statute of limitations on a gift tax return adequately disclosing a sale transaction has any impact on the availability of the parenthetical exception to avoid possible inclusion under IRC Sec. 2036(a)(1).

The parenthetical exception has two requirements. There must be (i) a bona fide sale, and (ii) adequate and full consideration. In the case of a sale to an IDIT for a promissory note, the "bona fide sale" requirement would seem easily satisfied so long as the formalities with respect to the sale are observed. A true sale to a party different from the seller has, in fact, taken place. Passage of the statute of limitations on a gift tax return adequately disclosing a sale to an IDIT which reports a gift of zero should establish "adequate and full consideration" under the parenthetical exception.

IRC Sec. 2001(f) provides that if the time has expired under IRC Sec. 6501 within which a gift tax may be assessed "… the value thereof shall, for purposes of computing the tax under this chapter, be the value as finally determined for purposes of chapter 12." This language does not indicate that there is any exception to the rule that gift tax value is determinative for estate tax purposes. On the contrary, the statute appears to establish a rule that applies with respect to any aspect of the process involved in computing estate tax. The question of whether adequate and full consideration was received for a transfer which might be included in the gross estate under IRC Sec. 2036(a)(1) is a part of that process. The preamble to the Final Regulations on adequate disclosure contains the statement that the Final Regulations "preclude adjustments with respect to all issues related to a gift once the gift tax statute of limitations expires with respect to that gift."[46]

A number of commentators have concluded that IRC Sec. 2001(f) does not operate to establish adequate and full consideration under the parenthetical exception[47], primarily under authority of Treas. Reg. Sec. 20.2001-1(b)[48]. That Regulation states that gift tax value is

---

[46] T.D. 8845.

[47] S*ee The Beneficiary Grantor Trust*, Practical Drafting page 10471 (July 2011); Bramwell, *Considerations and Consequences of Disclosing Non-Gift Transfers*, 116 J. Tax. 19 (Jan. 2012); Culp, Hattenhauer & Mellen, *The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust*, 44 ACTEC L.J. 63 (Winter 2019).

[48] Treas. Reg. Sec. 20.2001-1(b) provides as follows:

*Adjusted taxable gifts and Section 2701(d) taxable events occurring after August 5, 1997.* For purposes of determining the amount of adjusted taxable gifts as defined in Section 2001(b), if, under Section 6501, the time has expired within which a gift tax may be assessed under Chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) with respect to a gift made after August 5, 1997, or with respect to an increase in taxable gifts required under Section 2701(d) and §25.2701-4 of this chapter, then the amount of the taxable gift will be the amount as finally determined for gift tax purposes under Chapter 12 of the

conclusive for purposes of determining adjusted taxable gifts. The commentators construe Treas. Reg. Sec. 20.2001-1(b) as applying solely for purposes of determining adjusted taxable gifts. They also express the view that ascertaining the correct amount of adjusted taxable gifts is a different issue than determining whether IRC Secs. 2036(a)(1) applies to a transfer.

Although Treas. Reg. Sec. 20.2001-1(b) can be read to imply that its rule applies only to the determination of adjusted taxable gifts, it does not expressly state such to be the case. It is possible that Treas. Reg. Sec. 20.2001-1(b) is intended to be an expression of how the rule applies to the determination of adjusted taxable gifts without addressing how the expiration of the gift tax statute of limitations applies to other issues, e.g., the determination of whether adequate and full consideration was received for purposes of the parenthetical exception.

On the other hand, it may be an intention of the Regulation to restrict its application solely to the determination of adjusted taxable gifts. If so, this intent would seem to be more restrictive than the rule established by the language of IRC Sec. 2001(f), the applicable statute. In the event of a conflict between the Regulation and the statute, the statute prevails.

If the foregoing analysis is correct, adequate disclosure of a sale to an IDIT which has language in the governing instrument making a gift complete for gift tax purposes will start the gift tax statute of limitations to run. Once that statute has run, a conclusion in the return that consideration received in the sale was sufficient to avoid any gift should also be conclusive on the question of adequate and full consideration under the parenthetical exception.[49]

### B. Conclusiveness of Legal Issues Under Treas.Reg.Sec. 20.2001-1(b) Should Preclude IRS From Asserting IRC Sec. 2036(a)(1).

Treas.Reg.Sec. 20.2001-1(b) also precludes the IRS from raising legal issues relating to the gift once the statute of limitations has run.[50] That Regulation is another basis upon which an

---

Internal Revenue Code and the amount of the taxable gift may not thereafter be adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

[49] Such a conclusion is consistent with the Fifth Circuit's decision in *Wheeler v. U.S.*, discussed in Section XV.B., *infra*, that full and adequate consideration for gift tax purposes constitutes and establishes full and adequate consideration for estate tax purposes.

[50] Treas.Reg.Sec. 20.2001-1(b) provides:

> For purposes of determining the amount of adjusted taxable gifts as defined in section 2001(b), if, under section 6501, the time has expired within which a gift tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) with respect to a gift made after August 5, 1997, or with respect to an increase in taxable gifts required under section 2701(d) and §25.2701-4 of this chapter, then the amount of the taxable gift will be the amount as finally determined for gift tax purposes under chapter 12 of the Internal Revenue Code and the amount of the taxable gift may not thereafter be adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating

adequately disclosed sale should thwart any attempt by the IRS to include assets sold to an IDIT in the seller's estate under IRC Sec. 2036(a)(1) after the three-year statute of limitations has run.

Under IRC Sec. 2702(a)(2)(A), if the promissory note received from an IDIT in a sale transaction were a "retained interest," it would be valued at zero. The result would be that the note would not cause any reduction in the value of the assets transferred to the IDIT for gift tax purposes, and the seller would be treated as making a gift of that value. Passage of the limitations period on a gift tax return which adequately discloses a sale and reports $0 gift precludes the IRS from asserting otherwise. It follows that the promissory note received in the sale must have value. If the promissory note is not valued at zero, it cannot be a "retained interest" under IRC Sec. 2702(a)(2)(A). If the note is not a "retained interest" under IRC Sec. 2702(a)(2)(A), it should not be treated as a retention of the interests described in IRC Sec. 2036(a)(1).

### C. Guarantor Files Gift Tax Return.

If guarantees are used to create a cushion or equity in the IDIT for the sale in the manner described in Section III.B., *supra*, a guarantor should consider filing a gift tax return. That return would take the position that the guarantee does not constitute a gift for Federal gift tax purposes. If the statute of limitations runs on that return, it should preclude the IRS from asserting otherwise. If the guarantor is a beneficiary of the IDIT, it should also preclude the IRS from arguing that the guarantee causes a portion of the IDIT to be included in the guarantor's estate under IRC Sec. 2036 or 2038, or that the guarantor's contribution to the IDIT taints it for generation-skipping tax purposes. While not expressly covered by Treas.Reg.Sec. 20.2001-1(b), it is to be hoped that the IRS could not, if precluded by Treas.Reg.Sec. 20.2001-1(b) and Treas.Reg.Sec. 25.2504-2(b) from asserting that the guarantee is an addition to the IDIT for estate and gift tax purposes, argue that the guarantee constitutes an addition to the IDIT for income tax purposes, causing it to cease being a wholly grantor trust.

## VII. Income Tax Consequences If Seller Holds IDIT's Promissory Note at Death.

There is one issue regarding the sale to IDIT technique which has generated more discussion than any other. That issue is whether the seller's death while holding a promissory note received on the sale of appreciated property to an IDIT causes gain to be recognized on the note.[51]

---

> to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

Treas.Reg.Sec. 25.2504-2(b) establishes an identical rule for gift tax purposes in valuing gifts made in preceding calendar periods.

[51] *See* Nicholson, *Sale to a Grantor Controlled Trust: Better Than a GRAT?* 37 BNA Tax Mgmt. Memo. 99 (1996); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation* - 1996, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶120. 2E (1997); Practical Drafting, pp. 4833-4835 (1997); Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est.,

The possibility exists that the IDIT's loss of grantor trust status as a result of the seller's death causes a sale to be deemed to occur under the rationale of *Madorin v. Commissioner*.[52] In *Madorin* and the other authorities cited in note 52, *supra*, an individual transfers a tax shelter to a wholly-grantor trust. When the tax shelter is about to produce phantom income, the grantor renounces the powers which cause grantor trust status in an effort to have the phantom income taxed to the trust rather than the grantor. The cited authorities hold that the loss of grantor trust status upon the grantor's renunciation is to be treated as a transfer of the shelter to a newly-formed non-grantor trust, which is a disposition causing the grantor to recognize income.

The commentators cited in note 51, *supra*, disagree on whether the *Madorin* rationale applies when the IDIT's loss of grantor trust status is the result of the seller's death. The commentators also disagree on the effect, if any, of the seller's death on the income tax basis of the promissory note. Finally, there is disagreement regarding the effect of the seller's death on the basis of the assets sold to the IDIT.

### A. <u>Tax Consequences of Sale to Nongrantor Trust</u>.

Before attempting to address these disputes, it is useful to examine the consequences of a sale to a nongrantor trust, both during the seller's lifetime and at the seller's death. It is also useful to examine the tax consequences of the disposition of appreciated property subject to indebtedness, such disposition occurring either during the property owner's lifetime or at the property owner's death. There is no dispute about the tax consequences of such a sale or disposition.

<u>Example 1</u>. <u>Sale to a Nongrantor Trust</u>. Assume that an individual sells land held for investment for more than one year with a basis of $200,000 and a current fair market value of $2 million to a nongrantor trust established for the benefit of seller's descendants. The sale is in exchange for the trust's promissory note. The note provides for annual payments of $100,000 in principal over a term of twenty years, plus interest accrued at the time of each principal payment at the long term applicable Federal rate under IRC Sec. 1274. These facts can be summarized as follows:

---

Gifts and Tr. J. No. 1, 3 (1999); Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J.Tax No. 1, 49 (2001); Aucutt, *Installment Sales to Grantor Trusts*, 4 Bus. Entities, No. 2, 28 (2002); Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, note 38, *supra*; Hodge, *On the Death of Dr. Jekyll - Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at Grantor's Death*, 29 Tax Mgmt. Est., Gifts and Trust J., No. 6, 275 (2004); Peebles, *Death of an IDIT Noteholder*, 144 Tr. & Est. No. 8, 28 (2005); Cantrell, *Gain is Realized at Death*, 149 Tr. & Est. No. 2, 20 (2010); Gans and Blattmachr, *No Gain at Death*, 149 Tr. & Est. No. 2, 34(2010).

[52] 84 T.C. 667 (1985). *See also* Treas.Reg.Sec. 1.1001(c), Example (5) and Rev.Rul. 77-402, 1977-2 C.B. 222.

| | | |
|---|---|---|
| Fair market value | = | $2 million |
| Basis | = | $200,000 |
| Annual Payments of Principal | = | $100,000 |

The seller in this example realizes a capital gain of $1,800,000. The sale qualifies for installment treatment under IRC Sec. 453. The installment method permits the seller to defer recognition of gain ratably over the term of the promissory note. Upon receipt of each payment, the seller recognizes a $90,000 long term capital gain[53], and is taxed at ordinary rates on interest received. As a result of the purchase, the nongrantor trust's income tax basis in the purchased land is $2 million, i.e., the face amount of the promissory note.

If the seller dies after having received ten installment payments, the $1 million in principal payments remaining due on the note is included in the seller's Federal gross estate. Because the promissory note is income in respect of a decedent ("IRD"), the promissory note does not acquire a new income tax basis under IRC Sec. 1014 by virtue of the seller's death.[54] IRD is defined as amounts to which a decedent was entitled at death as gross income, but which were not properly includable in computing the decedent's taxable income.[55] The distribution of the promissory note to a beneficiary entitled to receive it under the seller's Will is not a disposition causing gain to be recognized.[56] The beneficiary is permitted to report gain on the sale under the installment method. The trust's basis in the land continues to be $2 million.

Assume the seller's Will cancels the note. The cancellation does not affect the inclusion of the promissory note in seller's estate. The cancellation is treated as a disposition causing the full $900,000 in remaining gain to be taxed to the decedent's estate.[57] Again, the trust's $2 million basis in the land is not changed.

<u>Example 2</u>. <u>Gift or Bequest/Devise of Encumbered Asset</u>. Owner owns commercial real property with a basis of $2 million and a current fair market value of $8 million. The property is subject to a mortgage of $7,500,000 received as a loan from a bank. These facts can be summarized as follows:

| | | |
|---|---|---|
| Fair market value | = | $8 million |
| Mortgage | = | $7,500,000 |
| Basis | = | $2 million |

---

[53] IRC Sec. 1222.

[54] IRC Sec. 691(a)(4).

[55] Treas.Reg.Sec. 1.691(a)-1(b).

[56] IRC Sec. 453B(c).

[57] IRC Sec. 691(a)(5). Because the trust is a related party, the remaining gain cannot be less than $900,000. See IRC Sec. 491(a)(5)(B).

If owner makes a gift of the property, the owner is treated as having sold the property for the $7,500,000 liability shifted to the donee, recognizing a gain of $5,500,000 ($7,500,000 - $2 million) on the transfer.[58] This is true even if the indebtedness is nonrecourse and even if the indebtedness exceeds the fair market value of the property.[59]

On the other hand, if the owner dies, a devise of the land subject to the indebtedness is not an income realization event under authority of the United States Supreme Court's decisions in *Crane v. Commissioner*[60]. The owner's estate does not recognize gain on the transfer of land to the beneficiary entitled to receive it under the Will. If the indebtedness is recourse, the full $10 million fair market value of the property is reported on Schedule A of the owner's Federal estate tax return, and the indebtedness is listed separately on Schedule K as a deduction.[61] If the loan is nonrecourse, the net value of the property is reported on Schedule A.[62] In either event, under *Crane*, the beneficiary's income tax basis in the property is its fair market value on the owner's date of death or alternate valuation date, whichever is applicable.[63]

In *Crane*, a surviving spouse inherited an apartment building at her husband's death. The apartment building was encumbered by nonrecourse indebtedness which was exactly equal to the Federal estate tax value of the building. Rather than treating the transfer of the building as a sale for an amount equal to the liability (which would have caused the spouse's income tax basis in the building to be determined under the predecessor of IRC Sec. 1012), the Supreme Court indicated that the surviving spouse's basis in the building was to be determined under the predecessor of IRC Sec. 1014, unreduced by the indebtedness.

### B. Tax Consequences of Sale to an IDIT.

Assume that the trust posed in Example 1 is an IDIT, but that the other facts of the example remain the same. Under the rationale of Rev.Rul. 85-13, the sale is ignored for income tax purposes even though it is recognized for estate and gift tax purposes. The seller recognizes no gain when payments are made on the note. The IDIT is not deemed to exist for income tax purposes. The seller is taxed individually on any income earned by the assets held by the IDIT, but is not separately taxed on the interest payments made by the IDIT on the note. The IDIT takes the seller's $200,000 basis in the land.

---

[58] Treas.Reg.Sec. 1.1001(e).

[59] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[60] 331 U.S. 1 (1947).

[61] Instructions for Form 706, Dept. of the Treasury, Internal Revenue Service, pp. 36-37 (Rev. Sept. 2022).

[62] *Id.*

[63] IRC Sec. 1014(a).

### 1. **Gain Recognized at Death?**

All of the commentators cited in note 51, *supra*, agree with the consequences described in the immediately preceding paragraph. Those commentators also agree that since the IDIT is to be considered as coming into existence for income tax purposes at the seller's death, the IDIT's assets should be treated for income tax purposes as transferred to the IDIT on the seller's death. The commentators agree that for income tax purposes the promissory note also comes into existence at the seller's death.

The commentators who conclude that the seller's death causes gain to be realized come to that conclusion because the transfer of assets to the IDIT and the coming into existence of the promissory note occur simultaneously at the seller's death. Because these events occur simultaneously, these commentators believe they should be treated as a sale of the IDIT's assets under the *Madorin* rationale. Some express the view that the sale can be regarded as occurring immediately before the seller's death.[64]

If the seller's death is a taxable event under the *Madorin* rationale, the consequences are the same as those set forth on seller's death in Example 1. Although any payments received on the promissory note by the seller during seller's lifetime have no income tax consequence, gain is realized to the extent that amounts remaining due on the note exceed the seller's basis in the note at death. If the deemed sale at the seller's death qualifies for installment treatment, gain is recognized as payments are received by the seller's successor in interest. If the deemed sale does not qualify for installment treatment,[65] the gain is reported on the seller's final income tax return,[66] and the income tax payable on that gain is a debt deductible for Federal estate tax purposes under IRC Sec. 2053.

The position that the *Madorin* rationale should not apply to cause gain on the promissory note to be realized at the seller's death rests on the principle that transfers at death generally do not cause realization of income.[67] This is true even if an identical transfer during lifetime would cause income to be realized. The exception created by IRC Sec. 453(B)(c) for the transfer of an installment obligation at death, discussed in Section VII.A., *supra*, is an example of the principle that transfers at death generally do not cause a realization of income, and is an exception to the

---

[64] See e.g. Covey, *Recent Developments Concerning Estate, Gift and Income Taxation -* 1996, note 51, *supra*.

[65] For example, IRC Sec. 453(k)(2) provides that installment treatment is not available for the sale of marketable securities.

[66] Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, note 51, *supra*.

[67] This general proposition was recognized in CCA200923024.

general rule established by IRC Sec. 453(B)(a) that the disposition of an installment note causes recognition of gain on the note.[68]

The commentators who conclude there is no realization at death believe that the Supreme Court's decision in *Crane* is direct authority for their position. As noted in the discussion of Example 2, *supra*, the transfer during the transferor's lifetime of property subject to an indebtedness which exceeds the transferor's basis in the property is deemed to be a sale causing gain to be recognized. Under *Crane*, there is no sale and no recognition of gain if the transfer occurs as a result of the transferor's death.

The commentators who conclude that death causes gain to be recognized find no basis in the authorities cited at note 52, *supra*, for concluding that such authorities apply only to the termination of grantor trust status during the grantor's lifetime.[69] These commentators also believe that *Crane* is not authority for the proposition that there is no recognition of gain on the seller's death. For example, one commentator states that the issue in *Crane* was the amount of income which the surviving spouse should recognize when she sold the building while it remained subject to the nonrecourse mortgage. Noting that the mortgage was equal to the fair market value of the building, this commentator observes that the surviving spouse's basis in *Crane* would have been the same whether she was viewed as having received the building by inheritance or by purchase for the amount of the nonrecourse indebtedness. The commentator further states that the court in *Crane* did not discuss whether the building was acquired by inheritance or by sale.[70]

These comments appear to give insufficient weight to the Supreme Court's reference in *Crane* to the predecessor to IRC Sec. 1014 rather than the predecessor of IRC Sec. 1012 in discussing the surviving spouse's basis in the building. The Court's reference to the predecessor to IRC Sec. 1014 rather than the predecessor IRC Sec. 1012 may not be a "discussion," but it should not simply be ignored. The Court clearly did not view the distribution of the building to the spouse in *Crane* as a sale.

### 2. <u>Effect of Seller's Death on Basis of IDIT's Promissory Note</u>.

One's view on the effect of the seller's death on the income tax basis of the IDIT's promissory note depends upon one's opinion on whether or not the seller's death causes gain to be realized. If one believes that the seller's death causes gain to be realized, then the results are the same as described in the discussion of Example 1, *supra*. Because gain on the promissory

---

[68] For other examples of situations in which there are no income tax consequences to a transfer at death, see Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, note 38, *supra*. For a list of situations in which death produces income tax consequences, see Peebles, *Death of an IDIT Noteholder*, note 51, *supra*.

[69] See, e.g., Cantrell, *Gain is Realized at Death*, note 51, *supra*.

[70] *Id*.

note is IRD, the basis of the promissory note would not be stepped up to its fair market value on date of death or alternate valuation date.

If gain is not realized on the seller's death, then the promissory note is not IRD. Because the IDIT is a grantor trust, no payments on the promissory note during the seller's lifetime can constitute taxable income to the seller. The absence of IRD results in the promissory note acquiring a new income tax basis under IRC Sec. 1014 equal to the value at which it is included in the seller's gross estate. Note that reporting the note on the seller's estate tax return at a discounted value risks converting what would have been tax free amounts due under the note into ordinary income under the market discount rules of IRC Secs. 1276-1278.

### 3. **Effect of Seller's Death on Basis of Assets Purchased by IDIT**.

If one believes that seller's death causes gain to be realized under the *Madorin* rationale, it is because a purchase and sale is deemed to occur at seller's death. Because the IDIT's assets are viewed as having been acquired by purchase, those assets acquire a new income tax basis at the seller's death under IRC Sec. 1012 equal to what is treated as the purchase price.

One would expect that a person who is of the view that death is not a realization event would also conclude that the seller's death does not cause any change to the IDIT's basis in the assets which it purchased from seller. If the seller's death is not believed to be a realization event, it is consistent to conclude that the seller's death does not bring about any change in the basis of the IDIT's assets. Several commentators who do not believe that the seller's death is a realization event have also expressed the view that the seller's death causes no change in the IDIT's basis.[71] There is a consistency in this view which is conceptually appealing. There are, however, other commentators who, while believing that the seller's death does not cause realization of gain, nevertheless believe that the seller's death causes a change in the income tax basis of the IDIT's assets.

#### a. **Change in Basis Under IRC Sec. 1012**.

The authors of one article (herein "Messrs. Manning and Hesch") express the view that the seller is to be regarded as transferring assets to the IDIT at death when the IDIT's grantor trust status for income tax purposes terminates. That transfer is in exchange for the promissory note, and, in their view, constitutes a sale requiring basis to be adjusted under IRC Sec. 1012 even though under *Crane* there is no realization of gain.[72]

Messrs. Manning and Hesch recognize that their opinion that the basis of the IDIT's assets should be adjusted under IRC Sec. 1012 seems inconsistent with their view that no gain is

---

[71] Aucutt, *Installment Sales to Grantor Trusts*, note 51, *supra;* Peebles, *Death of an IDIT Noteholder*, note 51, *supra*.

[72] Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, note 51, *supra*. See also Hodge, *On the Death of Dr. Jekyll - Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at Grantor's Death*, note 51, *supra*.

realized at the seller's death. Even though under *Crane* there is no realization of gain, they still view the seller's death as causing a simultaneous deemed transfer of assets to the IDIT and the deemed issuance of the promissory note. These two events, which are treated as occurring simultaneously, together with the fact that the IDIT actually gave the promissory note to the seller during the seller's lifetime in exchange for the assets purchased, should in their view cause the note to be treated as given for such assets at seller's death. Such treatment makes IRC Sec. 1012 applicable to determine the IDIT's basis in the assets.

The effort by Messrs. Manning and Hesch to address the inconsistency of their position is thought-provoking. In this author's view, however, the inconsistency should not be accepted as correct unless it is inescapable, i.e., unless there exists no other reasonable analysis or explanation that avoids the inconsistency.

This author does not believe that the inconsistency is inescapable. In this author's view, *Crane* should be regarded as establishing that there is no sale by the seller or purchase by the IDIT. If there is no realization of gain, that is because there is no purchase. This view also seems more consistent with the rationale of Rev.Rul. 85-13. Under that rationale, a wholly grantor trust does not exist apart from its grantor for income tax purposes. Under Rev.Rul. 85-13, the income tax consequences of a sale between an IDIT and its grantor during the grantor's lifetime are not suspended or delayed. The sale is treated as not occurring. Not applying IRC Sec. 1012 at the seller's death is more consistent with this treatment.

Without *Crane*, perhaps it would be appropriate to treat the simultaneous transfer of assets to the IDIT and the IDIT's issuance of the promissory note at the seller's death as a purchase and sale. However, just because two events occur simultaneously does not mean that they are actually one event. With the treatment of the transaction in *Crane* as a background, a better conceptual result is produced if IRC Sec. 1012 is not viewed as applicable, just as the predecessor to IRC Sec. 1012 was not considered applicable by the Supreme Court in *Crane*.

**b. Change in Basis Under IRC Sec. 1014(b)(1).**

The authors of another article (herein "Messrs. Blattmachr, Gans and Jacobson") believe that the IDIT's assets acquire a new income tax basis under IRC Sec. 1014 upon the seller's death even though the assets of the IDIT are not included in the seller's gross estate for Federal estate tax purposes.[73] Messrs. Blattmachr, Gans and Jacobson express the view that a step up in basis under IRC Sec. 1014(b)(1) does not, by the express terms of the statute, require estate tax inclusion as a prerequisite for a basis step up. The statutory language only requires that an asset be acquired from a decedent by "bequest, devise, or inheritance." Because an IDIT is not recognized to exist for income tax purposes during the grantor's lifetime under the rationale of Rev.Rul. 85-13, assets titled in the name of an IDIT at the time of the grantor's death should be viewed for income tax purposes as passing to the IDIT by "bequest, devise, or inheritance" at the grantor's death when the IDIT loses its grantor trust status and becomes a separate taxpayer.

[73] Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, note 38, *supra*.

Messrs. Blattmachr, Gans and Jacobson recognize that their view on the applicability of IRC Sec. 1014(b)(1) to increase the basis of assets held by an IDIT at the death of its grantor is unconventional. The conventional view is for the basis of an asset to be changed under IRC Sec. 1014, it must be included in an individual's gross estate. Messrs. Blattmachr, Gans and Jacobson concede that Treas.Reg.Sec. 1.1014-2(a)(1) and the 1954 legislative history appear to contemplate that IRC Sec. 1014(b)(1) applies only to property passing under a decedent's Will or under the laws of intestacy, i.e., through a probate estate, where the property is included in the Federal gross estate. They note that IRC Secs. 1014(b)(2) and (3) make IRC Sec. 1014 applicable to certain lifetime trusts which constitute grantor trusts for income tax purposes. While conceding that their construction of IRC Sec. 1014(b)(1) makes IRC Secs. 1014(b)(2) and (3) unnecessary, they reject the proposition that IRC Sec. 1014(b)(1) applies only to assets passing through a probate estate. They point out that IRC Secs. 1014(b)(1), (2) and (3) were enacted before Rev.Rul. 85-13 was issued. At the time of enactment of IRC Secs. 1014(b)(1), (2) and (3), it was not at all clear that transactions between a grantor trust and its grantor should be disregarded for income tax purposes. As a result, according to Messrs. Blattmachr, Gans and Jacobson, Congress would not have known that the rules created by IRC Secs. 1014(b)(2) and (3) were already covered by IRC Sec. 1014(b)(1).

A problem with the construction given IRC Sec. 1014(b)(1) by Messrs. Blattmachr, Gans and Jacobson is that Treas.Reg.Sec. 1.1014-2(a)(1), in describing property which passes by "bequest, devise, or inheritance," mentions only two ways such passing occurs. One is by the decedent's Will, and the other is by the laws of intestacy. Both of these methods occur only with a probate administration. Treas.Reg.Sec. 1.1014-2(a)(1) was itself issued prior to Rev.Rul. 85-13. At the time Treas.Reg.Sec. 1.1014-2(a)(1) was issued, it was not clear that assets held in a grantor trust should be viewed, for income tax purposes, as passing to the trust upon the grantor's death. If the consequences of grantor trust status were not clarified until the issuance of Rev.Rul. 85-13, it seems improper to use the conclusions of Rev.Rul. 85-13 in construing the language of Treas.Reg.Sec. 1.1014-2(a)(1). IRC Sec. 1014(b)(1) and Treas.Reg.Sec. 1.1014-2(a)(1) should be construed as requiring an actual probate administration and not as referring to a deemed transfer at the grantor's death which exists only as a result of Rev.Rul. 85-13. It is this author's view that IRC Sec. 1014(b)(1) does not apply to adjust the basis of assets held by an IDIT at the death of its grantor.[74]

#### 4. <u>Conclusions on Income Tax Consequences of Seller's Death</u>.

Summarizing, in this author's opinion, the death of a seller holding an IDIT's promissory note is essentially an income tax nonevent. Specifically, this author believes that, under *Crane*, there is no realization of gain on the seller's death. This author also believes that the IDIT's promissory note held by the seller at death acquires a new income tax basis equal to its Federal estate tax value in the seller's gross estate. Finally, this author believes that the income tax basis of the assets held by the IDIT at the seller's death does not change.

This author recognizes that these opinions are not shared by many respected commentators. He believes, however, that they represent the best analysis of what occurs at the

---

[74] See CCA 200937028 which reaches this same conclusion.

seller's death, applying the principles of *Crane*, Rev.Rul. 85-13 and the other authorities discussed in this Section VII.

### C. **Effectiveness of "Basis Boosting" Strategy to Avoid Capital Gain at Death.**

Two of the authors of the Incomplete Equity Strategy Article discussed in Section III.C., *supra*, have written another article in which they propose a strategy which they state reduces the risk that income tax is triggered when a seller of appreciated property to an IDIT in exchange for the IDIT's promissory note dies before the note is paid off (the "Basis Boosting Article").[75] The Basis Boosting Article points to the uncertainty which exists on whether the seller's death before the note is paid off has income tax consequences. It states that resolution of the question might depend upon whether assets sold to the IDIT are deemed transferred to the IDIT immediately before or immediately after the seller's death. If before, the assets are not treated as owned by the seller at death and acquire no step-up in basis. If those assets are to be considered as exchanged for the IDIT's note at the seller's death, gain is recognized, according to the Basis Boosting Article, because the basis of the IDIT's assets is less than the face amount of the note.

The Basis Boosting Article suggests that this possible result can be avoided if the seller transfers additional assets to the IDIT which have a basis sufficient to increase the basis of all assets of the IDIT to a total no less than the face amount of the promissory note. The Basis Boosting Article claims that because the face amount of the note does not exceed the IDIT's basis in its assets, no gain is recognized at the seller's death.

The Basis Boosting Article suggests that the seller retain a power over assets which the seller adds to the IDIT which avoids any gift on such addition. For example, the seller might retain the power to revoke the addition. The retained power may, however, keep the strategy suggested by the Basis Boosting Article from succeeding. Assets over which the seller has retained a power which avoids a gift will cause those assets to be included in the seller's estate at death. By being included in the seller's estate, such assets will acquire a new basis at the seller's death. As a result, the transfer of those assets might be viewed as occurring "after" the seller's death, and the basis of such assets might not be considered basis of the IDIT at the time of the seller's death. If the recognition of gain at the seller's death is actually a problem, the remedy suggested by the Basis Boosting Article does not appear to be a solution.

## VIII. **Discounting Value of Note in Subsequent Transfer Subject to Estate or Gift Tax – Basis Issues.**

The applicable Federal rate is generally well below the prevailing market interest rate for arm's length loan. It might seem inconsistent after using the applicable Federal rate to establish the fair market value of an IDIT's promissory note at its face amount in a sale to IDIT transaction to then, in a subsequent transfer of the note which is subject to estate or gift tax, discount the note below face amount. IRC Sec. 7872(i) appears to be an attempt to deal with this issue.

---

[75] Dunn and Park, *Basis Boosting: How to Avoid an Income Tax Problem in Sales to Grantor Trusts*, 145 Tr. & Est. No. 2, 22 (Feb. 2007).

IRC Sec. 7872(i)(1)(A) directs the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the provisions of IRC Sec. 7872 in certain circumstances, including disposition of the lender's or borrower's interest in an IRC Sec. 7872 loan. Such regulations are to adjust the provisions of IRC Sec. 7872 when, because of such circumstances, the provisions of IRC Sec. 7872 do not carry out its purposes.

IRC Sec. 7872(i)(2) provides that, under regulations prescribed by the Secretary of the Treasury, any loan which is made with donative intent and which is a term loan is to be taken into account for purposes of chapter 11 (dealing with estate tax) in a manner consistent with IRC Sec. 7872(b). IRC Sec. 7872(b) deals with the transfer which is considered to be made from lender to borrower in the case of a low-interest term loan.

### A. **Proposed Regulations Under IRC 7872(i).**

Proposed Regulations were issued in 1986 under authority of IRC Sec. 7872(i). These Proposed Regulations have not been finalized.

Prop.Reg.Sec. 20.2031-4 refers to Treas.Reg. 20.7872-1 for special rules governing the estate tax value of gift loans made after June 6, 1984. Prop.Reg.Sec. 20.7872-1 provides that the estate tax value of a gift term loan is the lesser of: (i) the unpaid stated principal, plus accrued interest; or (ii) the sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death. Prop.Reg.Sec. 20.7872-1 further provides that no discount is allowed based upon evidence that the loan is uncollectible, unless the facts concerning collectability of the loan have changed significantly since the time the loan was made. The last sentence of Prop.Reg.Sec. 20.7872-1 provides that the Proposed Regulation is to apply "with respect to any term loan made with donative intent after June 6, 1984, regardless of the interest rate under the loan agreement, and regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made."

Prop.Reg.Sec. 20.7872-1 is clearly designed to establish the rule envisioned by IRC Sec. 7872(i)(2). It is not clear what constitutes a "loan made with donative intent." One might speculate that a loan to a family member which bears interest at the applicable Federal rate, but which is lower than prevailing market rates, might be considered to have been with donative intent.

The other proposed regulations issued in 1986 under IRC Sec. 7872(i) deal with the valuation for gift and income tax purposes of a below-interest loan. Those proposed regulations contain no language similar to Prop.Reg.Sec. 20.7872-1, dealing with a transfer subject to gift tax of an existing note evidencing a term loan.[76]

---

[76] Prop.Reg.Sec. 25.2512-8 provides that a note given in exchange for the purchase of property in a sales transaction which is bona fide, at arm's length and free from any donative intent is to be valued in accordance with Treas.Reg.Sec. 1.1012-2. Prop.Reg.Sec. 1.1012-2(b)(1) provides that the value of a debt instrument issued by a buyer to a seller which has adequate stated interest under IRC Sec. 1274(c)(2) is its issue price, i.e., its face amount.

Although it might be argued that if formally promulgated, Prop.Reg.Secs. 20.2031-4 and 20.7872-1 would preclude discounting a note given in a sale to IDIT transaction on the seller's estate tax return, absent significant changes in collectability. Those regulations have not been adopted as final regulations and, thus, do not satisfy the requirements of IRC Sec. 7872(i)(2) to be effective. Proposed Regulations are accorded little, if any, deference.[77] There is not even a proposed regulation dealing with the gift tax value in a subsequent inter vivos transfer of a note governed by IRC Sec. 7872. In the absence of final regulations satisfying the requirements of IRC Sec. 7872(i), it would seem that it is permissible in a subsequent transfer subject to estate or gift tax to claim discounts in valuing notes originally valued at face under IRC Sec. 7872.

**B. <u>Loss or Absence of Basis</u>.**

Although it may be possible to claim a valuation discount upon a subsequent transfer of a promissory note which is subject to estate or gift tax, doing so produces unfavorable consequences. As noted in Section VII.B.2., *supra*, reporting an IDIT's promissory note at a discounted value on a seller's estate tax return converts principal payments on the note into ordinary income under the market discount rules. The note acquires an income tax basis limited to its discounted value. Payments on the note in excess of that value are taxed as ordinary income.

Transferring an IDIT's promissory note in a transfer subject to gift tax likely creates even greater basis issues. When the note is transferred to a transferee which is not a disregarded entity for income tax purposes, the note comes into existence for income tax purposes. Since the transferee does not give anything in exchange for the note, it does not appear that the note has any basis in the transferee's hands.[78] A promissory note is not the equivalent of cash and its issuance, without more, does not give it basis. As a result, any payments of principal to the transferee on an IDIT's promissory note would appear to be taxed as ordinary income.

---

Prop.Reg.Sec. 25.2512-4 refers to Treas.Reg.Sec. 25.7872-1 for valuation rules in the case of gift loans made after June 6, 1984. Prop.Reg.Sec. 25.7872-1 provides that if a taxpayer makes a gift loan within the meaning of Prop.Reg.Sec. 1.7872-4(b) that is a term loan, the excess of the amount loaned over the present value of all payments which are required to be made under the loan agreement is treated as a gift from the lender to the borrower.

[77] *State Farm Mutual Ins. Co. v. Commissioner,* 130 T.C. No. 16 (2008); *Perano v. Commissioner,* 130 T.C. No. 8 (2008); *Southland Royalty Co. v. U.S.,* 91-1 U.S.T.C. ¶50, 083 (Ct. Clc. 1991); *Madden v. Commissioner*, 57 T.C.M. 84 (1989).

[78] A partner's basis in a partnership has been held not to be increased by the contribution of the partner's promissory note to the partnership absent an increase in the partnership liabilities allocated to the contributing partner. *See Leonard Oden*, TC Memo. 1981-184, *aff'd* in an unpublished opinion 679 F.2d 885 (4th Cir. 1982); *Vision Monitor Software, LLC*, TC Memo. 2014-182. For the same result with respect to the contribution of a note to a corporation C, *Velma W. Alderman*, 55 T.C. 662 (1971).

## IX. Use of Family Limited Partnerships in Sale to IDIT Transactions.

There are numerous cases in which the courts have recognized that limited partnerships or other entities can be utilized to produce estate and gift tax valuation discounts.[79] Assets such as cash and marketable securities might be contributed to a limited partnership in exchange for limited partnership interests. If the limited partnership produces valuation discounts, the limited partnership interests can be sold to an IDIT for a smaller promissory note than would be received if the seller sold the underlying assets to the IDIT. The result is an immediate reduction in the value of the seller's estate without gift tax consequences.[80]

The IRS has had success in asserting the application of IRC Sec. 2036(a) in cases in which individuals have owned limited partnership interests or interests in limited liability companies at death.[81] In these cases, the courts do not find that the existence of the limited partnership should be disregarded. Rather, the courts have found that the decedents in those cases retained the enjoyment of or right to income from the assets transferred into the limited partnerships or the power to designate the persons who shall possess or enjoy such assets or income, causing IRC Sec. 2036(a) to be applicable. The applicability of IRC Sec. 2036(a) renders irrelevant the effect which the strictures caused by a limited partnership have on value. Under IRC Sec. 2036(a), transferred assets are included in the estate as though the transfer had never taken place. The transferred assets are included at their underlying value.

### A. Sale to IDIT Can Avoid IRC Sec. 2036(a).

IRC Sec. 2036(a) is an estate tax statute. The cases applying IRC Sec. 2036(a) to limited partnership interests held at death do not apply to the gift tax valuation of limited partnership interests transferred during lifetime. The sale to IDIT technique permits limited partnership interests to be disposed of during lifetime, taking advantage of valuation discounts. If the sale transaction is structured to avoid IRC Sec. 2702 and if the value of the limited partnership interests sold to the IDIT does not exceed the face amount of the promissory note received in the sale, the limited partnership interests are removed from the estate without any gift being made. As discussed in Section III.A., *supra*, if the sale avoids IRC Sec. 2702, it should also avoid IRC Sec. 2036(a)(1) at death. The result is a reduction in the value of the estate with the IDIT's promissory note taking the place of the limited partnership interests.

One test used by the courts in applying IRC Sec. 2036(a)(1) is whether a decedent has placed most of his or her assets in a limited partnership. If so, the courts frequently conclude that the decedent must have anticipated receiving distributions from the limited partnership in order to pay living expenses. This test should be rendered irrelevant if limited partnership interests are sold to an IDIT for the IDIT's promissory note following the structure suggested in Sections II. and III.B., *supra*. With that structure, the note should not constitute a retained interest to which

---

[79] Akers, Aucutt and Nipp, *Estate Planning Current Developments*, Item 26 (December 2021). www.bessermertrust.com/for-professional-partners/advisor-insight.

[80] *Id.* at Item 26(e).

[81] *Id.* at Item 26(f).

IRC Sec. 2036(a)(1) applies, irrespective of what portion of an individual's estate has been contributed into the limited partnership. The sale to IDIT technique permits a greater portion of an individual's estate to be involved in the limited partnership planning than is the case when an individual simply retains a limited partnership interest until death.

### B. **Indirect Transfer of Limited Partnership's Underlying Assets.**

The IRS has asserted in a number of cases with some success that a transfer of interests in a limited partnership, or other entity such as a limited liability company, in reality constituted a transfer of the underlying assets held by the entity for which no valuation discount was allowable. The IRS has made this argument in at least one case in which the limited partnership interests were transferred before assets were conveyed into the limited partnership.[82] The IRS has also made this argument when the sequence of funding an entity and transferring interests in the entity is uncertain.[83]

A difficulty with a number of the cases from a planning perspective is that the opinions in those cases indicate that it may not be sufficient simply to demonstrate that the transfer to the entity took place prior to the transfer of interests in the entity.[84] These cases suggest that a period of time must pass between the date of contribution of assets to the entity and the date of transfer of interests in the entity. According to these cases, the time which passes must be sufficiently long to result in the original contributor to the entity bearing a material economic risk that asset values would change between the date of contribution and the date of transfer, given the nature of the assets placed in the entity. In cases involving transfers of limited partnership interests in limited partnerships holding marketable securities, periods of six days[85] and eleven days[86] were held sufficient. Following the rationale of *Senda*, courts have held that no discount was allowable when funding an LLC with real estate, cash and securities[87] and cash alone[88] was contemporaneous with the gifts of LLC interests.

---

[82] *Shepherd v. Commissioner*, 115 T.C. 374 (2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002); *Estate of Malkin v. Commissioner*, 98 T.C.M. 225 (2009).

[83] *Senda v. Commissioner*, 88 T.C.M. 8 (2004), *aff'd* 433 F.3d 1044 (8th Cir. 2006).

[84] *Holman v. Commissioner*, 130 T.C. 170 (2008), *aff'd on other grounds* 601 F.3d 763 (8th Cir. 2010); *Gross v. Commissioner*, 96 T.C.M. 187 (2008); *Linton v. U.S.* 638 F. Supp. 2d 1277 (D.C. Wash. 2009), *aff'd in part, rev'd in part, and remanded* 630 F.3d 1211 (9th Cir. 2011); *Heckerman v. U.S.*, 2009-2 U.S.T.C. ¶ 60,578 (W.D. Wash. 2009).

[85] *Holman v. Commissioner*, note 84, *supra*.

[86] *Gross v. Commissioner*, note 84, *supra*.

[87] *Linton v. U.S.*, note 84, *supra*.

[88] *Heckerman v. U.S.*, note 84, *supra*.

The courts' discussion of economic risk and passage of time between funding and transfer is disturbing. A legitimate question is what does economic risk associated with the underlying assets held by an entity have to do with the issue of whether a gift consists of those assets or the interests in the entity in which they are held. If economic risk is the test, it would seem that no discount should be allowable with respect to a transfer of interests in a limited partnership whose only asset was a non-interest-bearing checking account. A gift of interests in an entity holding real estate would seem to require months between funding and gifting.

Focusing on economic risk or the passage of time between funding and gifting ignores the property interests which pass to a donee. What actually passes to a donee ought to be what is valued for gift tax purposes. Hopefully, all of the discussion of economic risk will ultimately be determined to have no bearing when there is no doubt that funding preceded transfer, and when other formalities regarding the entity have been observed. Until that time, to preserve valuation discounts, practitioners would be advised to allow at least several days to pass between funding of an entity and the transfer of interests in the entity.

## X. <u>Sale of S Corporation Stock</u>.

So long as the grantor is a citizen or a resident of the U.S., the grantor trust status of an IDIT qualifies it to be a shareholder of an S corporation.[89] Prior to a sale to an IDIT, an S corporation might be reorganized by having the shareholders surrender their existing voting common shares for new common stock. One percent of the new stock might be voting, and 99% of the new stock might be nonvoting. A corporation is not treated as having more than one class of stock, thus making the corporation ineligible to be an S corporation, solely because of differences in voting rights among the shares of common stock.[90] The shareholder might retain the voting stock, and sell the nonvoting stock to an IDIT in exchange for the IDIT's promissory note.

This suggested reorganization and sale arrangement produces several favorable results. It allows for a minority interest discount in valuing the shares sold to the IDIT. It should also permit the shareholder to retain the vote associated with the old voting common stock without having the nonvoting shares included in the shareholder's estate under IRC Sec. 2036(b). IRC Sec. 2036(b) applies when a shareholder has transferred stock of a controlled corporation, but has retained the right to vote the transferred shares.[91] The statute should not be applicable to the

---

[89] IRC Sec. 1361(c)(2)(A)(i).

[90] IRC Sec. 1361(c)(4).

[91] Under IRC Sec. 2036(b), the retention of the right to vote, directly or indirectly, shares of stock of a controlled corporation is considered to be a retention of the enjoyment of transferred property for purposes of IRC Sec. 2036(a)(1). A corporation is a controlled corporation if at any time after the transfer of the shares and during the three year period ending on the date of the decedent's death, the decedent owned (with the application of the attribution rules of IRC Sec. 318) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock.

suggested reorganization and sale arrangement because the arrangement does not result in the shareholder retaining the right to vote shares of transferred stock. The stock which is transferred is nonvoting. The voting stock is retained, not transferred.[92]

Unlike C corporations, S corporations are not separately taxed at the entity level. Income available for dividend payments to shareholders is not reduced by taxed imposed on the corporation. In addition, shareholders of an S corporation are taxed directly on the corporation's income, whether or not that income is distributed by the corporation to the shareholders. Income attributable to shares of S corporation stock held by an IDIT is taxed to the IDIT's grantor. S corporations commonly pay dividends to provide funds for shareholders to pay taxes on S corporation income. If shares have been sold to an IDIT, it is the IDIT which receives the dividends, not the grantor. Since the grantor is not a beneficiary of the IDIT, these funds can be passed through to the grantor for the payment of taxes only by making payments on the promissory note.

Frequently, the dividends received by the IDIT and paid to the grantor on the promissory note will exceed the interest accruing on the promissory note. This occurs for several reasons. One reason is that the applicable Federal rate is generally lower than prevailing market rates. Another reason is that the valuation discount allowable in valuing the nonvoting stock for purposes of the sale effectively increases the stock's rate of return. Payments in excess of interest on a promissory note reduce the principal amounts due under the promissory note, and, consequently, the seller's estate. Because there is no separate tax imposed on an S corporation, more fund are available for payments on the promissory note than with a sale of C corporation stock. If the S corporation is particularly profitable, the reduction in the principal amount due on the promissory note can be dramatic. S corporation stock is generally an excellent candidate for a sale to IDIT transaction.

## XI. Sale of Limited Partnership Interests or Non-Voting Interests in an LLC.

The beneficial results possible with the sale of non-voting S corporation stock can also be produced with a business operated as a limited partnership or a limited liability company which has elected to be taxed as a partnership or an S corporation, and not a C corporation. With a limited partnership or such an LLC, there is no separate tax imposed at the entity level.

If a voting interest in an LLC represents a minority interest, it is not necessary to convert such interest into a non-voting interest to produce a minority interest valuation discount. In addition, the seller can retain the right to vote that interest as trustee of the IDIT without concern about the possible application of IRC Sec. 2036(b) to cause the interest to be included in his or her estate. By its express terms, IRC Sec 2036(b) applies only to the retained right to vote transferred stock of a corporation, not a transferred interest in an LLC. This result should also be

[92] Prop.Reg.Sec. 20.2036-2(a)(3) adopts this analysis. It states that if a person who owns 100% of the voting and nonvoting stock of a corporation transfers the nonvoting stock, that person is not to be treated as having retained the enjoyment of the property transferred merely because of the voting rights in the stock retained.

true even if the LLC has elected to be taxed as a corporation. Even with such an election, the interest being transferred is not corporate stock. Structurally the entity continues to be an LLC.

## XII. Sale to IDIT Technique As An Alternative to the Standard Irrevocable Life Insurance Trust.

An Irrevocable Life Insurance Trust ("ILIT") is the traditional estate planning device which is used to eliminate insurance from an insured's estate. Practitioners commonly use so-called Crummey withdrawal powers (after the Ninth Circuit's decision in *Crummey v. Commissioner*[93]) to qualify funds added to the ILIT to pay premiums for the gift tax annual exclusion. The Crummey power grants beneficiaries of an ILIT the right to withdraw additions to the ILIT for a period of time, e.g., thirty days. If the Crummey power is not exercised within the specified time, the power lapses and the trustee can utilize the added funds for premium payments.

The IRS takes the position that for a Crummey power to be recognized, a beneficiary holding a Crummey power must have a beneficial interest in the trust other than the power itself.[94] Crummey withdrawal powers given to persons holding contingent remainder interests have been recognized.[95]

A lapsed power does not constitute a gift by the beneficiary of the trust if the lapsed amount does not, during any calendar year, exceed the greater of $5,000 or 5% of the value of the assets out of which the withdrawal power could be satisfied.[96] The "hanging" Crummey power is frequently used to permit use of the maximum per donee annual exclusion without violating the "5 & 5" limit of IRC Sec. 2514(e). With a hanging power, a beneficiary's withdrawal power lapses in any calendar year only up to the 5 & 5 limit. Any excess of that limit remains open and exercisable until its lapse does not constitute a gift by the beneficiary under IRC Sec. 2514(e).

An individual may wish to acquire substantial amounts of life insurance with premiums in excess of annual exclusion gifts which could be covered by Crummey withdrawal powers in a conventional ILIT. Even with a hanging Crummey power, there might not be a sufficient number of persons to whom the individual is willing to grant beneficial interests in the ILIT to cover premium payments completely. Conversely, there may be a sufficient number of Crummey power donees, but the individual may prefer to make gifts of cash or other assets which can be used immediately, rather than using Crummey powers to make annual exclusion

---

[93] 397 F.2d 82 (9th Cir. 1968). *See also* Rev. Rul. 73-405, 1973-2 C.B. 321; Rev. Rul. 81-7, 1981-1 C.B. 474; *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *acq. in result* 1992-2 C.B. 1; AOD 1996-010.

[94] *See, e.g.,* Ltr. Ruls. 8727003, 9045002, 9141008, 9628004 and 9731004.

[95] *Estate of Cristofani v. Commissioner*, note 93, *supra*; AOD 1996-010, note 93, *supra*; *Estate of Kohlsaat v. Commissioner*, 73 T.C.M. 2732 (1997).

[96] IRC Sec. 2514(e).

gifts which do not confer an immediate financial benefit on the donees. Such an individual might consider alternatives to the standard ILIT.

One alternative might be an IDIT to which assets have been sold. The IDIT might own and be named as beneficiary of the life insurance. Funds in the IDIT, including income from assets which have been sold to the IDIT, might be used to pay premiums on the insurance. So long as the IDIT has sufficient funds to pay premiums, there is no need to make gifts to the IDIT for the payment of premiums. If the IDIT has an inclusion ratio of zero for generation-skipping tax purposes, use of funds of the IDIT to pay premiums results in the death benefit being protected from generation-skipping tax without allocation of additional GST exemption.

If the grantor is to act as a trustee of the IDIT, provisions should be included in the governing instrument which preclude the grantor from possessing any incidents of ownership with respect to insurance on his or her life which would cause inclusion under IIC Sec 2042. Powers constituting incidents of ownership over the insurance might be allocated to a co-trustee.

Alternatively, insurance might be held in a separate ILIT of which a party other than the insured is trustee. The IDIT's governing instrument might include provisions specifically authorizing its trustee to make premium payments on behalf of the ILIT directly to the insurer.

If held by the grantor as trustee of the IDIT, a discretionary power to determine whether and to what extent to pay premiums on insurance held by a separate ILIT likely constitutes a power over the IDIT causing inclusion under IRC Secs. 2036(a)(2) and 2038(a)(1). This is true even though the same discretion does not create IRC Sec. 2036(a)(2) or 2038(a)(1) issues if the insurance constituted an asset of the IDIT.[97] Application of IRC Secs. 2036(a)(2) and 2038(a)(1) can be avoided by eliminating any discretion in the grantor regarding premium payments. For example, the trustee of the ILIT might be granted authority to direct the grantor, as trustee of the IDIT, to make payments which the grantor is obligated to follow. In addition to applying if a decedent holds a proscribed power acting alone, both statutes also apply if a decedent holds such a power acting "in conjunction with any other person". This condition for application of those statutes would not exist if the trustee of the ILIT alone possesses the power to determine what amount of any premium is to be borne by the IDIT.

Since the IDIT's payment of premiums is not a gift, Crummey powers are not needed to qualify any such payment for the gift tax annual exclusion. Provisions might be included in the governing instrument of the ILIT that it's Crummey provisions are not to apply to any premium payments by the IDIT or any distribution to the ILIT from the IDIT to pay premiums. If all premiums on insurance held by the ILIT are funded by an IDIT which has a inclusion ration of 0 for generation-skipping tax purposes, the death benefit received by the ILIT will be exempt from generation-skipping tax without any allocation of GST exemption to the ILIT.

---

[97] As noted in Section XIII.C.1., *infra*, administrative powers, including the power to invest trust assets, do not cause inclusion under IRC Sec. 2036(a)(2) or 2038(a)(1), so long as such powers are not overbroad and are subject to judicially enforceable limitations.

## XIII. Structuring Sale to IDIT Transactions After the Tax Court's Decision in *Trombetta*.

The decision of the Tax Court in *Estate of Trombetta v. Commissioner*[98] generated a great deal of commentary. Various commentators have made numerous suggestions regarding steps to be taken for a sale to an IDIT transaction to be successful. The commentary was a reaction to the Tax Court's analysis and justification for its decision in *Trombetta*.

### A. Facts and Results in *Trombetta*.

In *Trombetta*, the decedent transferred two highly leveraged rental properties to a trust which she had established, the terms of which provided her with an annuity. The annuity was to continue for one hundred eighty months, which the decedent retained the power to reduce. Decedent remained personally liable on the indebtedness after the rental properties were transferred into the trust.

Under the terms of the trust, decedent was to receive $75,000 for the first twelve-month period of the annuity term, with a four percent increase at the beginning of each successive twelve-month period. If the income of the annuity trust exceeded the amounts due the decedent as annuity payments, the trustees could distribute the excess income to the decedent or accumulate it in the annuity trust. The trust instrument provided that the decedent intended her retained annuity in the trust to be a qualified interest under IRC Sec. 2702(b)(1).

The decedent and three of her children were named as trustees of the trust. The decedent retained fifty percent of the trustees' voting rights, and the co trustees split the remaining voting rights. The decedent's three children who were acting as co-trustees each personally guaranteed payment of the annuity amounts due the decedent.

The trust was prohibited from making any distributions to the decedent after the term of the annuity payments had expired. The trust itself would terminate upon the later to occur of the decedent's death or the expiration of the annuity term. Upon termination, the trust was to be distributed to the decedent's children or grandchildren.

The decedent reported her transfer of the rental properties on a gift tax return, reducing the value of the gift by the value of her retained annuity interest. In subsequent years, the trust made payments of varying amounts to the decedent. During the term of the annuity payments, decedent reduced that term from one hundred eighty to one hundred fifty six months. The decedent died several months after the expiration of the shortened annuity term. At the decedent's death, there was a balance due her resulting from the underpayment of annuity amounts. After the decedent's death, the unpaid balance due the decedent was paid to the decedent's estate, together with interest. The decedent's children who were co-trustees never made any payments to the decedent under their guarantees.

The Tax Court held that because of the decedent's retained interests in the rental properties, they were included in her gross estate under IRC Sec. 2036(a)(1). The court held that

---

[98] 106 T.C.M. 416 (2013).

IRC Sec. 2036(a)(1) applied by virtue of IRC Sec. 2035(a) because the decedent's shortening of the annuity term constituted a transfer occurring within three years of her death.

The court rejected the estate's argument that the decedent received adequate and full consideration for her transfer under the parenthetical exception in IRC Sec. 2036 for bona fide sales. The court noted that the value of the annuity payments which the decedent reserved was less than the value of the rental properties which she transferred to the trust.

The court also concluded that no bona fide sale, in terms of an arm's length transaction, had occurred. There was no meaningful negotiation or bargaining with the decedent's co-trustees or beneficiaries of the trust. According to the court, the decedent, as sole beneficiary of the trust and the sole transferor, formed the transaction, funded the trust and essentially stood on both sides of the transaction. The court found that there were no legitimate and significant non-tax reasons for establishing the trust. It noted that the decedent transferred the properties into the trust on the advice of her estate planning counselors, and that her actions with respect to the trust were consistent with an estate plan rather than a legitimate business.

The estate argued that the decedent wished to reduce her responsibilities in the management of the rental properties. The court noted, however, that the trust agreement did not preclude the decedent from participating as a trustee in managing the properties and that the decedent had, in fact, continued in managing the properties after the trust was established. The court concluded that the decedent retained de facto control over the transferred properties and that, consequently, the decedent retained an IRC Sec. 2036(a)(1) interest in the properties.

The court also noted that the trust instrument provided that income in excess of the annuity payments could be distributed to the decedent at the discretion of the trustees, and that the decedent held fifty percent of the trustees' vote. In addition, because the properties were conveyed to the trust subject to the mortgages upon which the decedent remained liable, the court found that the decedent received an economic benefit when the trust made payments on the mortgages. According to the court, the decedent impliedly maintained the same enjoyment of the rental properties and their income stream as she had before she transferred them into the trust.

The court rejected the estate's argument that under the Supreme Court's decision in *Fidelity-Philadelphia Trust Co.*, the decedent retained an interest in the annuity and not in the rental properties. While noting that the decedent formally structured the transaction as an annuity obligation and did not calculate the amount of the annuity payments on the basis of the trust's income, her conduct showed that her transfer was more akin to a transfer with a retained interest than a sale for an annuity. Payments were made to her solely out of trust income. The court noted that the co-trustees were never called upon to pay under their guarantees when income was insufficient to fund the annuity payments in full. The court held that the tests established by the *Fidelity-Philadelphia Trust Co.* case were not satisfied. According to the court, the amounts distributed to the decedent were based upon the trust's income and were derived solely from the property which the decedent transferred to the trust.

### B. **Commentators' Response to *Trombetta*.**

The court's technical analysis in *Trombetta* can be criticized.[99] For example, it used implied powers which it found were retained by the decedent as a basis for its conclusions. Implied retained interests are a sufficient basis for inclusion under IRC Sec. 2036(a)(1), but only ascertainable and enforceable powers cause inclusion under IRC Sec. 2036(a)(2).[100]

The principal source of difficulty for the estate in *Trombetta* was the provision in the trust instrument authorizing the trustees to distribute excess income to the decedent. An implied understanding between the decedent and her children acting as trustees was sufficient to cause inclusion under IRC Sec. 2036(a)(1). At a minimum, the court's litany of other justifications in its decision is unnecessary.

There has been a good deal of commentary on the Trombetta decision.[101] Commentators have recommended a number of steps which should be considered in structuring sale to IDIT transactions. In addition to taking steps designed to satisfy the tests of *Fidelity-Philadelphia Trust Co.*, the suggestions include the following:

1. The IDIT should have an independent trustee, not the seller or the seller's spouse. The seller should also not possess any direct or indirect decision making authority with respect to the IDIT.

2. To the extent possible, have the purchasing IDIT funded with assets the transfer of which is "old and cold." If there is no "old and cold" trust, gifts of "seed capital" should be effected earlier in time than the sale, perhaps in a different tax year, to avoid aggregation with the sale.

3. If an interest in a closely held business is being sold to the IDIT, the seller should dispose of any voting interest in the business, and should resign as an officer, director or manager of the business.

---

[99] Gans & Blattmachr, *Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. Tax 226 (May 2014).

[100] *U.S. v. Byrum*, 408 U.S. 125 (1972). Although *Byrum* was legislatively overruled by the enactment of IRC Sec. 2036(b), the decision remains "good law" to the extent not expressly modified by that statute. Rev.Rul. 81-15, 1981-1 C.B. 457; *Daniels v. Commissioner*, 68 T.C.M. 1310 (1994).

[101] See Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies*, 49 U.Miami Philip E. Heckerling Inst. on Est. Plan., ¶605.3 (2015); Gans & Blattmachr, *Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. Tax 226 (May 2014); Johnson, Hesch and Wojnaroski, *Recent Tax Court Cases Offer Guidance for Planners When Structuring Private Annuities and Self-Cancelling Installment Notes (SCINs)*, 39 T.M. Est., Gifts and Tr. J. 210 (2014); Esterces, *Tips for Structuring Private Annuities After Trombetta*, 41 Est. Plan. No. 7, 11 (2014).

4. There should be arm's-length negotiations to arrive at the purchase price and other terms of sale, with the trustee of the IDIT and its beneficiaries being represented by separate counsel.

### C. **Comments on Recommendations.**

Many of the recommendations are a response to the observations made in the *Trombetta* opinion. One objective of the commentators' recommendations is to eliminate, except for the IDIT's promissory note, any interaction between the seller and the assets which the seller has conveyed to the IDIT. The concern is that any interaction might cause the IRS to ignore the sale and assert that the assets conveyed to the IDIT are to be included in the seller's gross estate. Uncertainty exists on the extent to which interaction must cease because, unlike the GRAT, there are no regulations or other rules issued by the IRS governing how a sale to an IDIT transaction is to be structured.

Many clients will find at least some of the recommendations unpalatable. For example, most business owners will balk at the suggestion that they should surrender control of a business when they are selling interests in the business to an IDIT. Many clients will be discouraged by the prospect of having independent counsel represent the IDIT and its beneficiaries, and that the sales price for the assets sold to the IDIT is to be arrived at through arm's-length negotiations. Many sellers also prefer to be trustee of the IDIT. A question arises as to whether the failure to follow some or all of the recommendations will cause a sale to an IDIT transaction to fail.

#### 1. **Seller as Trustee.**

So long as a trust does not contain stock described in IRC Sec. 2036(b)(2) or insurance on the grantor's life which could be included in the grantor's estate under IRC Sec. 2042, a grantor of a trust can serve as trustee of that trust without causing the assets of the trust to be included in the grantor's estate.[102] Administrative powers, such as the power to invest and the power to allocate receipts and disbursements between income and principal, do not cause estate tax inclusion under IRC Sec. 2036(a)(2) or 2038(a)(1), so long as the powers are not overbroad and are subject to judicially enforceable limitations.[103] A power retained by the grantor of a trust to distribute income or principal to trust beneficiaries does not cause inclusion, if the power is limited by a definite external standard. Cases have held IRC Secs. 2036(a)(2) and 2038(a)(1) inapplicable when grantors have retained the right to distribute assets to provide for "illness,"

---

[102] Bisignano, *When the Only One You Trust is Yourself – Drafting and Planning With Self Trusteed Irrevocable Nongrantor Trusts*, State Bar of Texas – Advanced Drafting: Estate Planning and Probate Course (October, 2006).

[103] *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), *acq.* 1973-2 C.B. 3; *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971), *non acq.*, 1978-2 C.B. 3; *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968); *Estate of Peters v. Commissioner*, 23 T.C.M. 994 (1964); *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of King*, 37 T.C. 973 (1962), *non acq.* 1963-1 C.B. 5; *Miller v. United States*, 325 F. Supp. 1287 (E.D.Pa. 1971).

"infirmity," "disability," "sickness," "accident" or other "emergency" affecting a trust beneficiary, and also to provide for a beneficiary's "health," "support," "maintenance", "welfare," "happiness" and "comfort."[104] Although the IRS contends otherwise, it appears that the definite external standard which will accomplish exclusion under IRC Secs. 2036(a)(2) and 2038(a)(1) is less restrictive than the ascertainable standard described in IRC Sec. 2041(b)(1)(A). The safest rule to follow, however, is to utilize only the ascertainable standard set forth in IRC Sec. 2041(b)(1)(A) to avoid an argument with the IRS.

Even if a grantor has retained no beneficial interest in the IDIT, the ability given creditors under state law to reach the trust to satisfy the grantor's legal obligation to support a beneficiary of the trust may cause the trust to be included in the grantor's estate. If the grantor as trustee has discretion to satisfy legal support obligations out of the trust, the trust is included in the grantor's estate.[105] If the grantor is to act as a trustee, the governing instrument should expressly preclude the grantor from making use of trust assets to satisfy the grantor's legal support obligations.

In spite of the authorities cited in notes 104 and 105, *supra,* and many practitioners hesitate to name the grantor as a trustee of an irrevocable trust which is designed to be excluded from the grantor's gross estate. For example, in the Bisignano article cited in note 102, *supra*, the author, who is a well-known and highly regarded estate planning attorney, asserted that the more he researched the law on the point, the more convinced he became that there was little to fear in utilizing self-trusteed trusts, and that "self-trusteed trusts can indeed be successfully drafted so long as the draftsman is careful." In spite of this conclusion, the author goes on to state that "third-party trustees should be the norm and self-trusteed trust the exception." It is not clear why this should be the case. Mr. Bisignano gives no reasons in his article for this statement.

Given the general reluctance to name the grantor as trustee as evidenced by the Bisignano article, it is not surprising that commentators have suggested that the seller should not act as trustee of the IDIT in a sale transaction. The *Trombetta* court's statement that the decedent was on both sides of the transaction in that case increases their reluctance. Courts in other cases have described taxpayers as being on both sides of a transaction in reaching decisions adverse to the taxpayer. While *Trombetta* refers to the grantor of a trust being on both sides of the transaction, that fact was just one of a number of justifications that the court used in reaching its result. A trustee has fiduciary responsibilities. The existence of those responsibilities should preclude adverse results in a sale transaction in which the seller is the trustee of the IDIT so long as the transaction is otherwise structured properly.[106]

---

[104] *Estate of Budd*, 49 T.C. 468 (1968); *Estate of Pardee*, 49 T.C. 140 (1967), acq. 1973 2 C.B. 3; *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of Weir*, 17 T.C. 409 (1951); *Estate of Kasch*, 30 T.C. 102 (1958), acq. 1958 2 C.B. 6; *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); Rev.Rul. 73-143, 1973 1 C.B. 407.

[105] *Estate of McTighe*, 36 T.C.M. 1655 (1977); *Estate of Pardee*, 49 T.C. 140 (1967), *acq*. 1973 2 C.B. 3; Rev.Rul. 59-357, 1959 2 C.B. 212; Rev.Rul. 70-348, 1970 2 C.B. 193.

[106] See the discussion in Section XV, *infra* on being on both sides of a transaction.

### 2. **Seed Capital**.

The suggestions regarding the transfer of seed capital to the IDIT arise from concern that seed capital which is transferred to an IDIT as a part of a sale transaction may not constitute other assets under the test of *Fidelity-Philadelphia Trust Co.* Commentators having this concern point out that the transfer in *Trombetta* was a part gift/part sale occurring simultaneously, and the court held *Fidelity-Philadelphia Trust Co.* inapplicable. Ltr.Rul. 9251004, discussed in note 24, *supra*, is also cited for the proposition that assets transferred to an IDIT as the gift portion of a part gift/part sale do not constitute other assets under *Fidelity-Philadelphia Trust Co.*

A problem with this analysis is that the *Trombetta* opinion discusses *Fidelity-Philadelphia Trust Co.* in connection with the children's guarantees, not their mother's gift to the annuity trust. The court basically found the children's guarantees to be illusory, because they were never called upon by their mother. The *Trombetta* opinion does not discuss *Fidelity-Philadelphia Trust Co.* in connection with the decedent's gift to the annuity trust. Similarly, it is difficult to see how Ltr.Rul. 9251004 can be viewed as authority for the proposition that assets gifted to an IDIT in a part gift/part sale transaction cannot serve as other assets under *Fidelity-Philadelphia Trust Co.* when the Ruling itself makes no reference to that case.

Neither *Trombetta* nor Ltr.Rul. 9251004 should be viewed as authority for the proposition that assets gifted to an IDIT as a part of a sale cannot serve as other assets under *Fidelity-Philadelphia Trust Co.* This is especially true if the assets being sold and those being gifted are delineated in the transaction documents.

Commentators who express concern about a gift occurring simultaneously with a sale qualifying as other assets prefer the use of an "old and cold" trust, i.e. a trust with assets which were clearly transferred into the trust independent of the sale. If there is no such trust, the commentators suggest delaying the sale for some time after the gift is made to the trust. If possible, it is suggested that the sale occur in a year different than the gift. As a practical matter, it is difficult to see how the passage of one year cures any problem if it is clear by the relatively small amount gifted to the new trust as compared to the sale that the gift and sale actually are a part of the same plan. If the gift and sale are truly related, it is difficult to see how the passage of time has the effect of separating them from one another.

### 3. **Surrender All Interests in Business**.

The suggestion that a seller of an interest in a closely-held business should give up other interests in the business would seem unnecessary under the United States Supreme Court's decision in *U.S. v. Byrum*.[107] In *Byrum*, the decedent transferred stock in closely-held corporations to an irrevocable trust for the benefit of his children, retaining the right to vote the transferred stock. The right to vote the transferred stock, together with other stock owned by the decedent, gave the decedent a majority vote in each corporation. The Supreme Court held that the decedent's retention of the right to vote did not constitute a retention of the enjoyment of the transferred stock within the meaning of IRC Sec. 2036(a)(1). The court also held that the

[107] Note 100, *supra*..

decedent's retention of the right to vote the stock was not an ascertainable and legally enforceable power to control the corporations necessary to bring about inclusion under IRC Sec. 2036(a)(2).[108] The court held that the decedent's ability to continue to control the payment of dividends from the corporations, by virtue of his power to vote, was not sufficient control to cause the transferred stock to be included in the decedent's estate under IRC Sec. 2036(a)(2). It would seem that *Byrum* settled the indirect control concerns expressed by the commentators who suggest that a seller of interests in a business to an IDIT should break off all contact with the business. Under *Byrum*, the powers to run a business are not those which generate inclusion under IRC Sec. 2036(a)(2).

#### 4. **Arm's Length Transaction.**

Commentators' suggestions about arm's length negotiations and separate counsel are intended to structure a sale to an IDIT transaction as an arm's length transaction. Courts review intrafamily transactions with special scrutiny. This does not mean, however, that a sale to an IDIT will be recognized only if it is an arm's length transaction.

In *Estate of Thompson v. Commissioner*,[109] the Third Circuit held that the assets which a decedent had transferred into a limited partnership were includable in the decedent's estate under IRC Sec. 2036(a)(1). In addressing the parenthetical exception to the application of that statute for a "bona fide sale for an adequate and full consideration," the court's opinion contains an extensive discussion of intrafamily and arm's length transactions:

> The Commissioner argues that there was no "bona fide sale" in this case because decedent "stood on both sides of the transaction" as transferor and a limited partnership of the family partnerships. The Commissioner's position is supported by several cases which have concluded that a "bona fide sale" requires an arm's length bargain. *See, e.g., Bank of New York v. United States*, 526 F.2d 1012, 1016 (3d Cir. 1975) ("[T]he value of the claim settled by the estate may not be deducted if the agreement on which the claim was based was not bargained at arm's length.); *Harper*, 83 T.C.M. at 1653 (denying the §2036 exception, in part, where there was no "arm's length bargaining because decedent "stood on both sides of the transaction"); *Strangi*, 85 T.C.M. at 1343 (finding no bona fide sale where "decedent essentially stood on both sides of the transaction"). As a practical matter, an "arm's length" transaction provides good evidence of a "bona fide sale," especially with intrafamily transactions. . . .
>
> That said, however, neither the Internal Revenue Code nor the governing Treasury Regulations define "bona fide sale" to include an "arm's length transaction." Treasury Regulation 20.2036 1(a) defines "bona fide sale for adequate and full consideration" as a transfer made "in good faith" and for a price that is "adequate and full equivalent reducible to a money value." 26 C.F.R.

---

[108] See the discussion on the continuing validity of *Byrum* in note 100, *supra*.

[109] 382 F.3d 367 (3d Cir. 2004).

§20.2036-1(a) (referring to 26 C.F.R. §20.2043 1(a)). Based in part on an interpretation of this regulation, the Court of Appeals for the Fifth Circuit concluded a "bona fide sale" only requires "a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange." *See Kimbell*, 371 F.3d at 265. The court reasoned:

> [J]ust because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide. A transaction that is a bona fide sale between strangers must also be bona fide between members of the same family. In addition, the absence of negotiations between family members over price or terms in not a compelling factor in the determination . . . particularly when the exchange value is set by objective factors.

*Id.* at 263 (discussing *Wheeler*, 116 F.3d 749 (internal citations omitted).

We similarly believe a "bona fide sale" does not necessarily require an "arm's length transaction" between the transferor and an unrelated third-party. Of course, evidence of an "arm's length transaction" or "bargained-for exchange" is highly probative to the §2036 inquiry. But we see no statutory basis for adopting an interpretation of "bona fide sale" that would automatically defeat the §2036 exception for all intra-family transfers. *Wheeler*, 116 F.3d at 655 ("Unless and until the Congress declares that intrafamily transfers are to be treated differently . . . we must rely on the objective criteria set forth in the statute and Treasury Regulations to determine whether a sale comes within the ambit of the exception to section 2036(a).").

We are mindful of the mischief that may arise in the family estate planning context. As the Supreme Court observed, "the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used." *Comm'r v. Culbertson*, 337 U.S. 733, 649, 69 S.Ct. 1210, 93 L.Ed. 1659 (1949). But such mischief can be adequately monitored by heightened scrutiny of intra-family transfers, and does not require a uniform prohibition on transfers to family limited partnerships. *See id.* ("[T]he existence of the family relationship does not create a status which itself determines tax questions, but is simply a warning that things may not be what they seem."); *Kimbell*, 371 F.3d at 265 ("[W]hen the transaction is between family members, it is subject to heightened scrutiny.")[110]

---

[110] 382 F.3d at pp. 381-2.

## XIV. Sale in Exchange for an Annuity Payable Over Seller's Lifetime.

A person whose life expectancy is shortened by illness may anticipate not having any extended period of time for the standard sale to an IDIT to produce a significant estate tax savings. For such an individual, a modification to the standard sale might be considered. The modified technique is a sale to an IDIT in exchange for an annuity which terminates at the seller's death. The modified technique is a variation of a long-established estate planning strategy, a sale in exchange for a private annuity.[111] The annuity payments terminate at death, leaving nothing additional to be taxed in the annuitant's estate. A sale to an IDIT for an annuity for life presents issues which do not exist with a sale in exchange for a promissory note. This Section XIV discusses those issues and potential solutions in dealing with them. It also identifies situations in which use of a sale to an IDIT in exchange for an annuity for life might be utilized, and compares a sale for an annuity to a sale for a so-called self-cancelling installment note, or "SCIN".

### A. The 50% Probability of Survivorship Test.

Treas.Reg.Sec. 25.7520-3(b)(3) establishes a taxpayer friendly rule in planning for an individual who, because of illness, has an actual life expectancy that is shorter than predicted by the IRS's actuarial tables. Under Treas.Reg.Sec. 25.7520-3(b)(3), the mortality component prescribed under I.R.C. Sec. 7520 may not be used to determine the present value of an annuity, income interest, remainder interest or reversionary interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this rule, an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year. Treas.Reg.Sec. 25.7520-3(b)(3) further provides that if the individual survives for 18 months or longer after the date the gift is completed, the individual is presumed to have not been terminally ill at the date the gift was completed unless the contrary is established by clear and convincing evidence. If the IRS mortality tables are not to be used in valuing an interest under I.R.C. Sec. 7520 because an individual is considered to be terminally ill, Treas.Reg.Sec. 25.7520-3(b)(4) provides that the value of the interest is to be determined taking into account the individual's actual life expectancy.[112]

The 50% probability of survivorship test established by Treas.Reg.Sec. 25.7520-3(b)(3) is frequently not difficult to satisfy. Even a person who is terminally ill will, according to his or her treating physicians, often have greater than a 50% probability of living one year. Treas.Reg.Sec. 25.7520-3(b)(3) affords planning opportunities for an individual afflicted with an illness which shortens life expectancy, but the probability is less than 50% that the individual's death will occur within one year. If the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3) is met, the

[111] A private annuity has been described as the most talked about but least frequently used strategy in estate planning. Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 Columbia L. Rev. 2 (March 1977).

[112] *See also* Treas.Reg.Secs. 1.7520-3(b)(3), 20.7520-3(b)(3) and the Examples at Treas.Reg.Secs. 1.7520-3(b)(4), 20.7520-3(b)(4) and 25.7520-3(b)(4).

IRS mortality tables under I.R.C. Sec. 7520 are binding, even if it is conceded that the individual's actual life expectancy is substantially shorter than predicted by those tables.[113] Even in cases in which an early death is virtually certain, it is frequently possible to satisfy the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3). An example illustrates planning possibilities.

Example. Assume that an individual is 75 years of age at his or her nearest birthday. Assume that because of illness, the individual has a life expectancy shorter than predicted by the IRS mortality tables, but satisfies the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3). Assume that the individual sells assets having a value of $10 million to an IDIT in exchange for an annuity payable on each anniversary of the date of sale over the individual's lifetime. If the I.R.C. Sec. 7520 rate for the month of sale is 2%, the factor under I.R.C. Sec. 7520 for determining the present value of the annuity is 9.5385.[114] Utilizing this factor, an annuity of $1,048,382.87 per year has a present value of $10 million ($10 million ÷ 9.5385). If the individual sells the $10 million in assets to an IDIT in exchange for an annuity of $1,048,382.87 per year for life, the sale transaction will not have any gift tax consequence (assuming the exhaustion test, discussed Section XIV.C., *infra*, does not apply).

If the individual dies on the fourth anniversary of the sale, the individual will have received a total of $4,193,531.48 ($1,048,382.87 x 4) in annuity payments.[115] The result is that the individual's estate is reduced by $5,806,468.52 ($10 million - $4,193,531.48), without even

---

[113] For a case illustrating planning possibilities using the actuarial tables under I.R.C. Sec. 7520 see *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43.

[114] All of the factors utilized in this article were derived through the use of NumberCruncher, a product of Leimberg & LeClair, Inc., and rounded to the nearest hundredth at each step. Computations for the figures appearing in Tables I, II and III were performed manually. The figures appearing in the columns Amount of Gift and Additional Amount Needed to Avoid Gift of Table IV, V and VI were calculated in the manner directed by Treas.Reg.Sec. 25.7520-3(b)(2)(i) and Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v). The figures shown as Amount of Gift in Tables VII and VIII were derived through the use of NumberCruncher. The figures shown as Additional Amount Needed to Avoid Gift in Tables VII and VIII were determined through a computer created spreadsheet. Note that the calculations appearing in this Section XIV are drawn from an article which was originally published in 2016. That article used the mortality data appearing in Table 2000CM, which was derived from results of the Year 2000 census. The calculations have not been recalculated for this Article using Table 2010CM, which is derived from the Year 2010 census. Although use of Table 2010CM would change the numbers which appear, *infra*, it would not change the analysis or conclusions of this Section XIV.

[115] In valuing annuity, unitrust and income interest payable for an individual's life, the I.R.C. Sec. 7520 tables assume that payments will be made for a partial year of survivorship. To comply with this, the sale agreement should provide for a pro rata payment for a partial year and not terminate the seller's right to payment on the anniversary of the sale immediately preceding the seller's death.

considering any income from or appreciation in the value of the $10 million which would have been included in the individual's estate but for the sale.

The sale transaction in the Example produces a better result with a lower I.R.C. Sec. 7520 rate than is produced with a higher rate. This is because the value of the right to receive a fixed annuity decreases as the assumed interest rate increases.

The 2% I.R.C. Sec. 7520 rate assumed in the Example is close to the historically low rates over the last few years. A 6% rate is more representative of the I.R.C. Sec. 7520 rate in effect during normal economic times. Assuming an I.R.C. Sec. 7520 rate of 6% in the Example, the factor for calculating the present value of the annuity payable to the individual for life is 7.3052, resulting in an annuity amount of $1,368,887.92 ($10 million ÷ 7.3052). If the individual survives to receive four payments, the individual will receive a total of $5,475,551.68 ($1,368,887.92 x 4), and the reduction in the estate is $4,524,448.32 ($10 million - $5,475,551.68) as opposed to the $5,806,468.52 reduction in the value of the estate achieved with an I.R.C. Sec. 7520 rate of 2%. The results of assumed 2% and 6% I.R.C. Sec. 7520 rates are summarized in Table I.

**TABLE I**

**Reduction in Value of Estate Assuming Individual in Example Dies After 4 Payments**

| Assumed I.R.C. Sec. 7520 Rate | 2% | 6% |
|---|---|---|
| Annual Amount Having Present Value Of $10 Million | $1,048,382.87 | $1,368,887.92 |
| Total Received After Four Years | $4,193,531.48 | $5,475,551.68 |
| Reduction in Value of Estate | $5,806,468.52 | $4,524,448.32 |

If the continuation of the right to receive annuity payments is based upon the life of an individual, the amount payable to the individual includes a premium to compensate for the possibility that the individual may die prematurely. The amount of the premium is calculated actuarially based upon the data contained in Table 2000CM. Table 2000CM is a mortality table commencing with a population of 100,000 in year one. It traces the number of the survivors of that initial population in each of the subsequent years through year 110. In year 109, 11 of the original 100,000 individuals remain alive. In year 110, all are deceased.

### B. <u>Shortened Life Expectancy</u>.

Because of the premium, an annuity based upon life should not be used if the annuitant is likely to survive to or beyond his or her life expectancy. Table II and Table III illustrate this point. Table II shows the amounts that would be received by the individual in the Example posed above if the sale were effected in exchange for an annuity for life as compared to the amounts received under a standard promissory note. The Table shows the results if the seller dies on the 4$^{th}$, 8$^{th}$, 12$^{th}$ and 16$^{th}$ anniversary of the sale. It is assumed that interest on the promissory note is payable annually on the anniversary date of the note and that the annuity is payable annually. In Table II, the interest rate assumed for both the promissory note and the annuity is 2%, even though the I.R.C. Sec. 1274(d) rate is likely to be lower than the I.R.C. Sec.

7520 rate.[116] Assuming the same interest rate means that the difference in results in Table II is attributable solely to the annuity premium compensating for the possibility of premature death. Table III contains the same analysis as Table II, except that the interest rate on the promissory note and the annuity is assumed to be 6%.

**TABLE II**
**COMPARISON OF LIFE ANNUITY**
**AND INTEREST ONLY PROMISSORY NOTE – INTEREST = 2%**

Annual Annuity Payment = $1,048,382.87
Annual Interest Payment on Promissory Note = $200,000

| (1) Number of Years | (2) Total Annuity Payments Received | (3) Total Interest Payments Received Plus Face Amount of Promissory Note | (4) Excess of (3) over (2) |
|---|---|---|---|
| 4 | $4,193,531.48 | $10,800,000.00 | $6,606,468.52 |
| 8 | $8,387,062.96 | $11,600,000.00 | $3,212,937.04 |
| 12 | $12,580,594.44 | $12,400,000.00 | ($180,594.44) |
| 16 | $16,774,125.92 | $13,200,000.00 | ($3,574,125.92) |

**TABLE III**
**COMPARISON OF LIFE ANNUITY**
**AND INTEREST ONLY PROMISSORY NOTE – INTEREST = 6%**

Annual Annuity Payment = $1,368,887.92
Annual Interest Payment on Promissory Note = $600,000

| (1) Number of Years | (2) Total Annuity Payments Received | (3) Total Interest Payments Received Plus Face Amount of Promissory Note | (4) Excess of (3) over (2) |
|---|---|---|---|
| 4 | $5,475,551.68 | $12,400,000.00 | $6,924,448.32 |
| 8 | $10,951,103.36 | $14,800,000.00 | $3,848,896.64 |
| 12 | $16,426,655.04 | $17,200,000.00 | $773,344.96 |
| 16 | $21,902,206.72 | $19,600,000.00 | ($2,302,206.72) |

Tables II and III show similar results. Initially, there is a substantial reduction in the value of the estate produced by the sale in exchange for a life annuity as compared to that produced by a sale in exchange for a standard interest only promissory note. This result changes

[116] Under I.R.C. Sec. 7520(a)(2), the I.R.C. Sec. 7520 rate is 120% of the Federal mid-term rate under I.R.C. Sec. 1274(d)(1). The Federal mid-term rate is for periods over 3 years but not over 9 years. It is conceivable that the long-term rate under I.R.C. Sec. 1274(d)(1) could exceed the I.R.C. Sec. 7520 rate. The long-term rate under I.R.C. Sec. 1274(d)(1) is for periods in excess of 9 years.

with the passage of time. Under Table 2000CM, an individual 75 years of age has a life expectancy of just over 11 years. Both Table II and Table III illustrate that as the seller survives beyond his or her life expectancy, the sale for a life annuity causes an increase in the value of the seller's estate over that resulting from a sale for an interest only promissory note.

### C. **The Exhaustion Test.**

The premium which shores up the value of annuity payments conditioned upon survivorship has a significant impact on the sale for an annuity for life transaction. The premium causes the exhaustion test established under Treas.Reg.Sec. 25.7520-3(b)(2)(i) to be a factor which must be taken into account in structuring a sale to an IDIT in exchange for an annuity for life.

#### 1. **Passing or Failing the Exhaustion Test.**

Treas.Reg.Sec. 25.7520-3(b)(2)(i) provides that a standard I.R.C. Sec. 7520 factor may not be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will or other governing instrument is to ensure that the annuity will be paid for the entire defined period.

Under Treas.Reg.Sec. 25.7520-3(b)(2)(i), if the amount of the fixed annuity payment does not exceed the effective I.R.C. Sec. 7520 rate at the date of the transfer, the corpus is assumed to be sufficient to make all annuity payments. In such case, the standard applicable I.R.C. Sec. 7520 factor may be used to calculate the present value of the annuity. This is true whether the annuity payments are to be made for a term of years or the life of one or more individuals.

If the fixed annual payment exceeds the applicable I.R.C. Sec. 7520 rate, Treas.Reg.Sec. 25.7520-3(b)(2)(i) directs how it is to be determined whether or not the exhaustion test is satisfied. If the fixed annuity is payable for a definite period of years, the annual amount is to be multiplied by the Table B term certain annuity factor under Treas.Reg.Sec. 25.7520-1(c)(1) for the number of years of the definite term. Table B contains actuarial factors used in determining the present value of an interest for a term of years. If the fixed annuity is payable for the life of one or more individuals, the annuity amount is to be multiplied by the Table B annuity factor for the excess (in years) of 110 over the age of the youngest individual.

If the computation in either of the two preceding paragraphs produces a figure which exceeds the value of the limited fund, the annuity arrangement fails the exhaustion test. The consequence is that a standard I.R.C. Sec. 7520 annuity factor may not be used to determine the present value of the annuity. Rather, it is necessary to compute a special I.R.C. Sec. 7520 annuity factor that takes into account the exhaustion of the fund.[117]

---

[117] Treas.Reg.Sec. 25.7520-3(b)(2)(i) is a gift tax regulation. *See also* Treas.Reg.Secs. 1.7520-3(b)(2)(i) and 20.7520-3(b)(2)(i) which are identical to Treas.Reg.Sec. 25.7520-3(b)(2)(i) and apply respectively for income and estate tax purposes.

### 2. **Calculating the Special Factor**.

Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) illustrates how the special factor is to be calculated in a postulated factual situation. In Example 5, a donor who is 60 years of age and in normal health transfers property worth $1 million to a trust which is to make an annual payment of $100,000.00 to a charitable organization for the life of the donor. At the donor's death, the remainder is to be distributed to the donor's child. The I.R.C. Sec. 7520 rate is stated to be 6.8%. After calculating that the proposed annuity payments do not satisfy the exhaustion test, Example 5 states that if a trust earns the assumed 6.8% I.R.C. Sec. 7520 rate, it will only be able to make 17 annual payments in full and will be exhausted after making a partial 18$^{th}$ payment of $32,712.72. As a result, for purposes of determining the present value of the distribution to charity, the Regulation requires the provisions governing the annuity payments to be recharacterized as a distribution to charity of $67,287.28 ($100,000.00 - $32,712.72) per year for the donor's life or, if shorter, for a period of 17 years, plus a distribution of $32,712.72 per year for the donor's life or, if shorter, for a period of 18 years. The present value at an I.R.C. Sec. 7520 rate of 6.8% of an annuity of $67,287.28 per year payable for 17 years or until the prior death of a person age 60 is $597,013.12 ($67,287.28 x 8.8726). At the same 6.8% interest rate, the present value of an annuity of $32,712.72 per year payable for 18 years or until the prior death of a person age 60 is $296,887.56 ($32,712.72 x 9.0756). Thus, the present value of the annuity payable to charity in Example 5 is $893,900.68 ($597,013.12 + $296,887.56). The conclusion in Example 5 means that of the $1 million originally placed in the trust, only $893,900.68 qualifies for the charitable deduction, resulting in a taxable gift equal to $106,099.32 ($1 million - $893,900.68).

### 3. **Validity of Example 5**.

The conclusion of Example 5 does not appear harsh. The gift is approximately 10.6% of the $1 million placed in the trust. Nevertheless, some commentators have asserted that Treas.Reg.Sec. 25.7520-3(b)(2)(i) is invalid, because of the assumption in the Regulation that the individual whose life is used to establish the term of the annuity might live until the age of 110 years.[118] According to the commentators, this assumption should result in a conclusion that all assets of the trust in Example 5 will be distributed to charity. Under this analysis, the amount of the charitable deduction in Example 5 should be equal to the full $1 million placed in the trust.

The calculations prescribed by Example 5 of I.R.C. Sec. 7520-3(b)(2)(v) are based upon assumptions that are standard in the use of IRS tables under I.R.C. Sec. 7520. It is assumed that the assets in the trust produce a net return equal to the applicable I.R.C. Sec. 7520 interest rate, and that the assets of the trust do not appreciate or depreciate in value. Based upon those assumptions, a projection is made as to when the trust will be depleted. The factors for a life annuity under I.R.C. Sec. 7520 assume that annuity payments will be made as long as the person who is the measuring life remains alive. Under the exhaustion test, the time during which

---

[118] Katzenstein, *Turning the Tables: When Do the IRS Actuarial Tables Not Apply?*, 37th Ann. U. Miami Philip E. Heckerling Inst. On Est. Plan. Ch. 3 (2003); Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies?*, 49th Ann. U. Miami Philip E. Heckerling Inst. On Est. Plan ¶606 (2015).

annuity payments are made is not assumed to extend beyond the time that computations project the trust to run out of assets.

Rather than being invalid, the exhaustion test as promulgated by Treas.Reg.Sec. 25.7520-3(b)(2)(i) and Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) actually appears quite rational. I.R.C. Sec. 7520(a) provides that the value of any annuity shall be determined under tables prescribed by the Secretary. I.R.C. Sec. 7520(b) provides that I.R.C. Sec. 7520 shall apply for purposes of any provisions specified in the Regulations. Because Congress has delegated authority to fill in gaps in I.R.C. Sec. 7520, the Regulations under that statute are legislative regulations which are given controlling weight unless arbitrary, capricious or manifestly contrary to the statute.[119] It seems unlikely that the courts will find Treas.Reg.Sec. 25.7520-3(b)(2)(i) and Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) to be invalid.[120]

#### 4. **Consequences of Failing the Exhaustion Test.**

The impact of failing the exhaustion test can be illustrated using the facts of the Example, i.e. a 75 year old individual selling assets having a value of $10 million to an IDIT in exchange for an annuity payable over the seller's lifetime. As noted above, the factor at an assumed I.R.C. Sec. 7520 rate of 2% for computing an annuity for the life of an individual 75 years of age is 9.5385, producing an annuity of $1,048,382.87 per year. Under the assumptions of Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v), a fund of $10 million produces an annuity of $1,048,382.87 per year for 10 years and a final payment in the 11th year of $724,648.58. The present right to receive this annuity is determined by adding two sums, i.e., the present value of the right to receive $724,648.58 for a period of 11 years or the seller's prior death and the present value of the right to receive $323,734.29 ($1,048,382.87 - $724,648.58) per year for a period of 10 years or the seller's prior death. At an I.R.C. Sec. 7520 rate of 2%, the factor for 11 years or the seller's prior death is 7.4847 which, when multiplied by $724,648.58, produces a present value of $5,423,777.23. The factor for an annuity payable for 10 years or the seller's prior death is 7.0762 which, when multiplied by $323,734.29 produces a present value of $2,290,808.58. This figure, when added to $5,423,777.23, produces a sum of $7,714,585.81. The seller's gift under the exhaustion test is $2,285,414.19 ($10,000,000.00 – $7,714,585.81).

As noted above, the factor for an annuity for the life of an individual 75 years of age at an assumed I.R.C. Sec. 7520 rate of 6% is 7.3052, resulting in an annuity of $1,368,887.92 per year. Under the assumptions of Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v), a fund of $10 million at an I.R.C. Sec. 7520 rate of 6% produces an annuity of $1,368,887.92 per year for a period of 9 years and a final payment in the 10th year of $1,234,282.09. At an I.R.C. Sec. 7520 rate of 6%, the factor for an annuity of 10 years or the seller's prior death is 5.9064, which when multiplied by $1,234,282.09 ($1,368,887.92 – $134,605.83) produces a present value of $7,290,163.74. The factor for an annuity payable for 9 years or the seller's prior death is 5.5937,

---

[119] *Chevron v. National Resources Defense Council*, 467 U.S. 837 (1984).

[120] For an excellent discussion of this issue and the exhaustion test generally, *see* McGrath, *Private Annuity Sales and the Exhaustion Test*, 31 T.M.Est., Gifts and Tr. J. 167 (July/Aug. 2006).

which, when multiplied by $134,605.83, produces a present value of $752,944.63. This figure, when added to $7,290,163.74, produces a sum of $8,043,108.37. The seller's gift under the exhaustion test is $1,956,891.63 ($10,000,000.00 - $8,043,108.37).

Under Treas.Reg.Sec. 25.7520-3(b)(2)(i), the exhaustion test is passed if the assets in the IDIT have a value equal to the product obtained by multiplying the annuity amount by the Table B term certain annuity factor for a term equal to 110 years minus the annuitant's age. For an individual who is 75 years of age (an assumed term of 35 years), the factor is 24.9986 and an assumed I.R.C. Sec. 7520 interest rate of 2% for which the annuity is $1,048,382.87 per year, producing a value of $26,208,104.01 (24.9986 x $1,048,382.87). At an I.R.C. Sec. 7520 rate of 6% (for which the annuity is $1,368,887.92), the factor is 14.4982, producing a value of $19,846,410.84 (14.4982 x $1,368,887.92).

At an assumed I.R.C. Sec. 7520 rate of 2%, the $26,208,104.01 in value in the IDIT needed to avoid a gift under the exhaustion test is $16,208,104.01, or approximately 162%, in excess of the $10 million involved in the sale. At an assumed I.R.C. Sec. 7520 rate of 6%, the total $19,846,410.84 in value needed to avoid a gift under the exhaustion test is $9,846,410.84, or over 98%, in excess of the $10 million involved in the sale. These results are summarized in Table IV.

**TABLE IV**
**ANNUITY FOR LIFE**
**COMPARISON OF GIFT UNDER EXHAUSTION TEST**
**WITH AMOUNT NEEDED TO AVOID GIFT**

| Assumed I.R.C. Sec. 7520 Rate | Annuity Amount | Amount of Gift | Additional Amount Needed To Avoid Gift |
|---|---|---|---|
| 2% | $1,048,382.87 | $2,285,414.19 | $16,208,104.01 |
| 6% | $1,368,887.92 | $1,956,891.63 | $9,846,410.84 |

### 5. <u>Coping with Failing the Exhaustion Test</u>.

Table IV illustrates that the gift tax consequences of failing the exhaustion test are modest. On the other hand, the value required to avoid a gift is substantial. There are two factors operating to reduce the amount of the gift on failing the exhaustion test. The first factor is that the gift is based upon present values discounted for the passage of time. Exhaustion does not occur until sometime in the future, and the amount of the gift represents the present value of the future projected shortfall in annual annuity payments. The second factor is that when the shortfall occurs, many in the population in Table 2000CM who were alive at age 75 years have died, and the significance of deaths after that point is reduced. For example, of the 64,561 individuals which Table 2000CM shows alive at age 75, 34,471 remain alive 10 years later at age 85, or 53.4%. The impact of mortality is reduced by the time exhaustion occurs.

#### a. <u>Risks of Accepting Results</u>.

Because the amount of a gift resulting from failing the exhaustion test is relatively small, the temptation might be simply to accept that result and report the gift under Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) on the seller's gift tax return. The gift would frequently be

covered by the seller's unused gift and estate tax applicable exclusion amount. Even if the gift generates a gift tax, the amount of gift tax would be small compared to the potential estate tax savings which the transaction might ultimately produce. A problem with this tactic is that it increases risk under I.R.C. Secs. 2036(a)(1) and 2702.

Accepting the gift tax result under Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) does not only produce a gift, it also eliminates any cushion of other assets designed to satisfy the second and third tests of *Fidelity-Philadelphia Trust Co*. described in Section II.B., *supra*. Without a cushion which satisfies these tests, the sale is likely to be treated as a transfer with a retained interest under I.R.C. Sec. 2036(a)(1), causing the assets sold to the IDIT to be included in the seller's estate. As noted above in Section II.B., *supra*, if I.R.C. Sec. 2036(a)(1) applies, the sale is also likely to be treated as a transfer to a trust with a retained interest under I.R.C. Sec. 2702. If the annuity is valued at zero, the seller makes a gift of the full value of the assets transferred to the IDIT in the sale transaction. Simply accepting the consequences of Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) does not appear to be an acceptable alternative.

**b. Additional Gift by Seller.**

A gift by the seller of additional amounts to cover both the amounts needed to avoid the exhaustion test and to provide at least a 10% cushion is impractical. Even if the seller has sufficient assets to make such a gift, incurring a gift tax on a gift of the magnitude of the amounts appearing in Column 4 of Table IV and a further 10% cushion is unlikely to be acceptable.

**c. Guarantee by Beneficiaries.**

The discussion in Section II.B., *supra*, points out that in a standard sale in exchange for an IDIT's promissory note, personal guarantees by beneficiaries are frequently used to provide the 10% cushion. As noted in that discussion, there is authority for the proposition that a guarantee in a standard sale does not constitute a gift unless and until a payment is made on the guarantee. It would seem to be difficult to come to the same conclusion if a life annuity rather than a standard promissory note is received in a sale to an IDIT transaction. With a standard sale, there is no equivalent to the exhaustion test. There is not the same potential for a shortfall in a sale for a standard promissory note as there is with a sale in exchange for an annuity for life. With a sale to an IDIT in exchange for a standard promissory note, it is possible to take the position that a guarantee is not a gift. With Treas.Reg.Sec. 25.2520-3(b)(2)(i) and Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v), assuming they are valid, there is no question about the gift. It would seem that the effect of a guarantee is not to eliminate the gift, but merely to shift the person treated as making the gift from the seller to the guarantor.

In addition to any guarantee which is used to avoid failing the exhaustion test, it would seem that there should also be at least a 10% cushion (i.e. 10% of the purchase price in the sale transaction) to satisfy the second and third tests under *Fidelity-Philadelphia Trust Co.* If this 10% cushion is afforded through the use of a guarantee, it should be possible for the guarantor to take the position on a gift tax return that the guarantee affording the 10% cushion does not constitute a gift under the authorities discussed in the materials referenced in note 23, *supra*, even if the guarantor reports the guarantee given to avoid failing the exhaustion test as a gift.

As illustrated by Table IV, the amount of a gift resulting from failing the exhaustion test is modest. The gift tax consequences of a guarantee sufficient to avoid a gift by the seller under the exhaustion test might be acceptable to a beneficiary. If the IDIT is to be exempt from generation-skipping tax, steps should be taken to permit the guarantor to allocate sufficient GST exemption to reduce the inclusion ratio of the gift to zero. A point to be considered is that interests and powers conferred upon a guarantor who is a beneficiary of the IDIT might result in the gift being treated as a transfer with retained interests or powers causing inclusion in the beneficiary's estate under either or both of I.R.C. Secs. 2036 and 2038. If so, the interests and powers would result in ETIP under I.R.C. Sec. 2642(f), precluding allocation of the beneficiary's GST exemption to cover the gift. This result can be avoided with a provision in the instrument governing the IDIT that a beneficiary is not to possess any interest or power with respect to any assets or portion of the IDIT of which the beneficiary is transferor for Federal estate and gift tax purposes.

Although a beneficiary's guarantee of the amount needed to avoid failing the exhaustion test likely constitutes a gift for Federal gift tax purposes, it should not constitute a gratuitous transfer for purposes of the grantor trust rules under I.R.C. Sec. 671, et seq. Treas.Reg.Sec. 1.671-2(e)(2)(i) provides that a transfer may be considered a gratuitous transfer causing application of the grantor trust income tax rules "without regard to whether the transfer is treated as a gift for gift tax purposes." The purpose of the grantor trust income tax rules is to preclude grantors from utilizing trusts to shift income away from themselves. In the case of a guarantee, there is no transfer which has any possibility of shifting income. A beneficiary's guarantee should have no impact on the IDIT's status as a grantor trust taxable entirely to the seller.

**d. Using A Guarantor Other Than a Beneficiary of the IDIT.**

It would seem possible to structure a guarantee so that it is given without gift tax consequences. An existing trust which is not includable in any individual's Federal gross estate, if such a trust exists, might be a candidate as the guarantor. To be valid, any guarantee must be within the powers conferred upon the trustees of the existing trust. If there are beneficiaries of the existing trust who are also beneficiaries of the IDIT, the provisions of the existing trust governing distributions to beneficiaries may be broad enough to authorize the existing trust's guarantee. For example, provisions in the existing trust might authorize distributions directly or indirectly to or for the benefit of trust beneficiaries.

The provisions governing distributions from an existing trust may not be broad enough to permit that trust to effect a guarantee without compensation. Nevertheless, the provisions governing management and investment under most trust instruments should generally be broad enough to permit trustees to effect a guarantee in exchange for a fee.

If an unrelated individual or a corporation, limited liability company or other entity which is owned by unrelated parties is willing to effect a guarantee in an arm's length agreement in exchange for a fee, it should be possible to structure that guarantee so as to avoid a gift under the exhaustion test without adverse gift tax consequences to the guarantor or its owners. Treas.Reg.Sec. 25.2512-8 provides that any transaction which is bona fide, at arm's length and free from any donative intent is considered to be made for an adequate and full consideration in

money or money's worth, and thus is not subject to gift tax. If Treas.Reg.Sec. 25.2512-8 applies, the adequacy of consideration received for the guarantee is not relevant. The guarantee simply does not constitute a gift.

### D. Limiting Annuity to Shorter of Life or a Term of Years.

Although the gift tax consequences of a beneficiary's guarantee of an amount sufficient to avoid the exhaustion test may be manageable, there is a significant obstacle to the use of guarantees to avoid the exhaustion test. For a guarantee to be effective, the guarantor must have sufficient wherewithal to pay on the guarantee. As illustrated by Column 4 of Table IV, *supra*, the amounts which must be available to avoid the exhaustion test are substantial. It may be a challenge to find a guarantor with sufficient resources to support a guarantee in a sale in exchange for an annuity for life.

A possible solution to this practical problem is to structure the annuity so that less value is needed to avoid a gift under the exhaustion test so that the resources required of the guarantor to support the guarantee are reduced. One method of achieving this reduction is to eliminate from the possible term of the annuity years which have little impact on the amount of the gift under the exhaustion test. As noted above in Section VII.E., *supra*, the inability to pay an annuity for the years in which the individual would be very elderly has little gift tax consequence because few of the original 100,000 persons in Table 2000CM live to advanced ages. The amount required to avoid a gift in a later year under the exhaustion test is much greater than the amount of the gift which results if the exhaustion test is not satisfied for that year. Eliminating these years from consideration has little impact upon the effectiveness of the transaction to reduce estate taxes, but has a substantial effect in reducing the amounts which must be made available to avoid failing the exhaustion test.

Elimination of later years can be achieved by structuring the term of the annuity to continue for the shorter of the seller's lifetime or a fixed term. Table V illustrates the use of a number of different fixed terms under the hypothetical facts posed in the Example, i.e., a sale of assets having a fair market value of $10 million by an individual 75 years of age. The sale in Table V is for an annuity payable over the shorter of the seller's lifetime or a specified term of 6 years, 12 years, 15 years or 20 years. Table V assumes an I.R.C. Sec. 7520 rate of 2%. For comparative purposes, Table V also restates the amounts from Table IV for an annuity payable for life with no term of years limitation. Table VI shows the results with the same hypothetical facts as Table V, but at an assumed I.R.C. Sec. 7520 rate of 6%.

TABLE V
ANNUITY FOR SHORTER OF LIFE OR TERM OF YEARS AT 2%
COMPARISON OF GIFT UNDER EXHAUSTION TEST
WITH AMOUNT NEEDED TO AVOID GIFT

| Years | Annuity Factor | Annuity Amount | Gift Under Exhaustion Test | Additional Amount Needed To Avoid Gift |
|---|---|---|---|---|
| 6 | 4.9171 | $2,033,719.06 | $1,061,912.71 | $1,391,673.94 |
| 12 | 7.8444 | $1,274,794.76 | $1,812,920.86 | $3,481,337.03 |
| 15 | 8.6576 | $1,155,054.52 | $2,036,790.49 | $4,841,642.04 |
| 20 | 9.3237 | $1,072,535.58 | $2,224,702.05 | $7,537,458.28 |
| Life Annuity (No Term Limit) | 9.5385 | $1,048,382.87 | $2,285,414.19 | $16,208,104.01 |

TABLE VI
ANNUITY FOR SHORTER OF LIFE OR TERM OF YEARS AT 6%
COMPARISON OF GIFT UNDER EXHAUSTION TEST
WITH AMOUNT NEEDED TO AVOID GIFT

| Years | Annuity Factor | Annuity Amount | Gift Under Exhaustion Test | Additional Amount Needed To Avoid Gift |
|---|---|---|---|---|
| 6 | 4.3405 | $2,303,882.04 | $1,013,884.22 | $1,328,879.16 |
| 12 | 6.4007 | $1,562,329.12 | $1,644,165.87 | $3,098,254.88 |
| 15 | 6.8774 | $1,454,037.86 | $1,804,910.69 | $4,121,906.50 |
| 20 | 7.2166 | $1,385,694.09 | $1,926,894.92 | $5,893,772.64 |
| Life Annuity (No Term Limit) | 7.3052 | $1,368,887.92 | $1,956,891.63 | $9,846,410.84 |

Column 1 of Tables V and VI lists the number of years of the specified term. Column 2 is the special factor for calculating the value of an annuity payable for the shorter of the life of an individual 75 years of age or the specified number of years. The factor listed in Column 2 is calculated pursuant to the methodology outlined in Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v). Column 3 is the annuity amount which, based upon the factor in Column 2, produces an annuity having a present value of $10 million. This amount is determined by dividing $10 million by the factor listed in Column 2. Column 4 is the gift under the exhaustion test calculated in the manner prescribed by Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v). Column 5 represents the total amount needed to avoid a gift under the exhaustion test. In the case of a guarantee, Column 5 is the net worth which the guarantor must have at the time of the guarantee for the guarantee to be effective in order to avoid a gift under the exhaustion test.

Referring to Table V and Table VI, the smallest gift is produced with a six year maximum term. A six year maximum term also produces the closest correlation between the gift under the exhaustion test and the amount needed to avoid that gift. With a six year maximum

term, however, the annuity amount payable to the seller becomes so large that the sale transaction is likely to produce little reduction in the value of the seller's estate.

Of the terms illustrated in Tables V and VI, the 20 year maximum term produces the smallest annuity amount payable to the seller. A maximum term of 20 years does not produce a significant reduction in the gift made under the exhaustion test as compared to the gift with an annuity for life with no maximum term. Tables V and VI both show, however, that a 20 year maximum term has a significant impact in reducing the amount needed to avoid a gift under the exhaustion test.

Frequently, placing a maximum term close to the seller's life expectancy will be viewed as a means of harmonizing the variables involved in a sale to an IDIT for an annuity. As previously noted, under Table 2000CM, an individual who is 75 years of age has a life expectancy of approximately 11 years. Tables V and VI show the results of a maximum term of 12 years and illustrate how a maximum term which is approximately equal to the seller's life expectancy seems to harmonize different considerations in an acceptable fashion. With an assumed I.R.C. Sec. 7520 rate of 2%, the annuity amount is $1,274,794.76, while the amount needed to avoid a gift under the exhaustion test is $3,481,337.03, or approximately 34.8% of the $10 million sold to the IDIT. If the seller dies on the fourth anniversary of the sale, the seller would have received annuity payments totaling $5,099,179.04, producing a reduction in the estate of $4,900,820.96 ($10 million - $5,099,179.04). With an assumed I.R.C. Sec. 7520 rate of 6%, the annuity amount is $1,562,329.12, while the amount needed to avoid a gift under the exhaustion test is $3,098,254.88. If the seller dies on the fourth anniversary of the sale, the seller will have received annuity payments totaling $6,249,316.48, producing a reduction in the estate of $3,750,683.52 ($10 million - $6,249,316.48).

As the I.R.C. Sec. 7520 rate increases, the size of the annuity payments becomes an increasingly important consideration. At a 6% I.R.C. Sec. 7520 rate, the amount of the annuity is much greater than at the 2% rate. Because of these larger payments, the results at a 6% I.R.C. Sec. 7520 rate are not as beneficial as with an I.R.C. Sec. 7520 rate of 2%. Although the amount of the annuity payments increases as the I.R.C. Sec. 7520 rate increases, the amount needed to avoid a gift under the exhaustion test decreases. As a result, in structuring the annuity sale, the practitioner may wish to provide for a longer term when the annuity transaction is effected in periods of higher interest rates (e.g. 6%) as opposed to a sale when the I.R.C. Sec. 7520 rate is lower (e.g. 2%). The figures appearing in Table VI for a maximum term of 15 years illustrate this point. These figures might be compared to the figures in Table V for a sale for the maximum term of 12 years.

If a seller satisfies the 50% survivorship test of Treas.Reg.Sec. 25.7520-3(b)(3), it is the exhaustion test that produces the greatest problems in successfully effecting a sale to an IDIT in exchange for an annuity. Each situation in which a sale to an IDIT for an annuity might be considered presents its own set of facts. It is not possible to devise a uniform structure which fits all situations. It would seem, however, that placing some upward limit on the term of the annuity payments is almost certainly to be preferred over an annuity for life with no maximum term. In the vast majority of cases with an annuity for life with no maximum term, it would seem that the amounts needed to avoid a gift under the exhaustion test are simply not available. In most cases, the amounts available to avoid a gift under the exhaustion test are limited. Frequently, the

amounts available to avoid a gift under the exhaustion test will impact what maximum term is selected.[121]

### E. Another Individual as Measuring Life.

There is a disadvantage with a sale to an IDIT for an annuity based upon the seller's life. If the seller dies within a short time of the sale, the IDIT loses grantor trust status for income tax purposes. The ability to shift value to the IDIT and its beneficiaries by the grantor paying income taxes is lost.

A married couple can avoid this result. If one spouse is ill, the healthy spouse might effect the sale to an IDIT established by the healthy spouse in exchange for an annuity which is based upon the life of the spouse who is ill. There is nothing in I.R.C. Sec. 7520 or the Regulations thereunder or in any other authority which indicates that it is impermissible for one spouse to effect a sale to an IDIT in exchange for an annuity which uses the other spouse as the measuring life rather than the life of the spouse effecting the sale. Specifically, the annuity might be payable for a period of years or the earlier death of the spouse who is ill. If the annuity payments cease upon the death of such spouse, the IDIT continues to be a grantor trust for income tax purposes.

Treasury Regulations governing charitable lead trusts identify persons whose lives may be used to define the term of a charitable lead trust. Under these Regulations, permissible lives are limited to the donor, the donor's spouse and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in I.R.C. Sec. 170, 2055 or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.[122] Even if these Regulations applied to a sale to an IDIT for an annuity, the seller's spouse is a permitted measuring life. However, these Regulations are limited in their application to charitable lead trusts, and do not apply to a sale to an IDIT for a life annuity. No regulation or other authority by its terms limits the identity of the persons whose lives might be used in a sale to an IDIT for a life annuity. Indeed, there does not appear to be any regulation or other promulgated IRS authority which would preclude the use of a complete stranger as the measuring life in a sale to an IDIT for an annuity based upon an individual's life.

### F. Convert a Note Into an Annuity.

A seller may have previously effected a sale to an IDIT in exchange for a promissory note. If the seller's health deteriorates after the original sale and a balance remains due on the promissory note, it should be possible for the seller to exchange the promissory note for an

---

[121] See Section XIV.G.3., *infra*, for a discussion of the possible use by the IRS of Treas.Reg.Sec. 1.1275-(f) to assert that an annuity for the shorter of life or term of years is not an annuity to which the 50% probability of survivorship test of Treas.Reg.Sec. 25.7520-3(b)(3) applies.

[122] *See* Treas.Reg.Secs. 20.2055-2(e)(2)(vi)(A) and 25.2522(c)-3(c)(2)(vi)(A) for charitable lead annuity trusts, and 20.2055-2(e)(2)(vii)(A) and 25.2522(c)-3(c)(2)(vii)(A) for charitable lead unitrusts.

annuity based upon the seller's life. Exchanging a promissory note for an annuity would be similar in concept to renegotiating a promissory note given by an IDIT in a sale transaction when the applicable Federal rate decreases after the sale. A lower interest rate on the promissory note results in less interest being paid to the seller and a reduction in the seller's estate. Most commentators believe that an IDIT's promissory note can be refinanced at the applicable Federal rate in force in the month of refinancing without unfavorable transfer tax consequences, so long as the promissory note authorizes prepayment without penalty.[123]

It would seem that a promissory note could be exchanged for an annuity without unfavorable transfer tax consequences. The exchange would not constitute a gift by the seller so long as the annuity received for the promissory note had a value under I.R.C. Sec. 7520 equal to the balance of interest and principal due on the promissory note as of the date of the exchange. The seller would need to satisfy the 50% survivorship test of Treas.Reg.Sec. 25.7520-3(b)(3) as of the date of the exchange. In computing the annuity payments to be made to the seller, the interest rate used should be I.R.C. Sec. 7520 rate for the month in which the exchange occurs.

Following the rationale of the discussion in Section IX, *supra*, if a seller who has effected a sale to an IDIT in exchange for the IDIT's promissory note has a spouse whose health deteriorates, it should be possible for the seller to exchange the IDIT's promissory note for an annuity based upon the life of the spouse who is ill.

### G. Use of a Self-Canceling Installment Note (SCIN) – The *Davidson* Case.

The Self-Cancelling Installment Note, or SCIN, is another device which might be used when the seller's life expectancy is shortened by illness. A SCIN generally takes the form of an ordinary installment note which provides for periodic payments at specified intervals, *e.g.*, annually, semi-annually, quarterly or even monthly. Unlike an ordinary installment note which remains due if the seller dies, a SCIN provides that the obligation to make further payments ceases at the seller's death. Any outstanding obligation which is canceled at the seller's death is not included in the seller's gross estate.[124] The balance due on the SCIN at the seller's death escapes Federal estate tax.

Many of the considerations which arise with the use of an annuity for life payable by an IDIT also arise with the use of a SCIN. The issuance of CCA 201330033 and the arguments made by the IRS in the case of *Estate of Davidson v. Commissioner*[125] raise the question as to whether the annuity for life should be preferred over the SCIN. Specifically, the question is

---

[123] Blattmachr, Crawford and Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J.Tax No. 7, 22 (2008); Harrington, *Question and Answer Session*, 38th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1216 (2004); Zeydel, *Estate Planning in a Low Interest Rate Environment*, 36 Est. Plan. No. 7, 17 (2009).

[124] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980) *acq. result* 1981-1 C.B.2; *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003).

[125] Docket No. 13748-13.

whether the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3) applies to a SCIN as it does to an annuity based upon life. The answer to this question is uncertain.

### 1. **Use of Tables Under I.R.C. Sec. 7520 for a Sale Governed by I.R.C. Sec. 7872.**

I.R.C. Sec. 7520(b) provides that I.R.C. Sec. 7520 is not to apply for purposes of part I of subchapter D of chapter 1 or any other provision specified in regulations. Treas.Reg.Sec. 25.7520-3(a)(7) provides that I.R.C. Sec. 7520 does not apply for purposes of I.R.C. Sec. 7872.[126]

The extent to which Treas.Reg.Sec. 25.7520-3(a)(7) precludes application of I.R.C. Sec. 7520 to I.R.C. Sec. 7872 is not clear. It may be that the intent of Treas.Reg.Sec. 25.7520-3(a)(7) is only to emphasize that the interest rate under I.R.C. 7520 is not to apply to I.R.C. Sec. 7872 transactions, and that Treas.Reg.Sec. 25.7520-3(a)(7) does not preclude use of the actuarial tables under I.R.C. Sec. 7520 to sales in which the interest rate is determined under I.R.C. Sec. 7872. However, the language of Treas.Reg.Sec. 25.7520-3(a)(7) is not so limited. Treas.Reg.Sec. 25.7520-3(a)(7) can be construed as making the actuarial tables under I.R.C. Sec. 7520 and the 50% test of Treas.Reg.Sec. 25.7520-3(b)(2)(i) inapplicable to a sale to an IDIT transaction in which the interest on the promissory note bears interest at the rate specified under I.R.C. Sec. 7872. An advantage to the 50% test under I.R.C. Sec. 25.7520-3(b)(2)(i) is that if the seller satisfies the 50% test, the IRS is bound to use the actuarial tables under I.R.C. Sec. 7520 in determining the seller's life expectancy, even if it is conceded that the seller's actual life expectancy is substantially shorter than predicted by the tables. To avoid possible application of Treas.Reg.Sec. 25.7520-3(a)(7), it would seem that the interest rate prescribed by I.R.C. Sec. 7520 should be used with a SCIN in a case in which the 50% test of Treas.Reg.Sec. 25.7520-3(b)(2)(i) is important. The SCINs in *Davidson*, discussed *infra*, bore interest at the I.R.C. Sec. 7520 rate.

The IRS's official position appears to be that even if an interest rate under I.R.C. Sec. 7520 is used, I.R.C. Sec. 7520 does not apply to a SCIN, for the reason that a SCIN is a promissory note and not an annuity, interest for life or a term of years, or a remainder or a reversion. See CCA 201330033. That CCA was issued in connection with the *Davidson* case.

### 2. ***Davidson*** **and CCA 201330033.**

The Tax Court pleadings in the *Davidson* case reveal that William Davidson was the President, Chairman and Chief Executive Officer of Guardian Industries Corp. and a former owner of the Detroit Pistons. In December of 2008 and January of 2009, at the age of 86, he entered into a number of gift and sale transactions, including two large sales for SCINs. Shortly after the transactions, he was diagnosed with a terminal illness and died on March 13, 2009, before receiving any payment on the SCINs. In the notice of deficiency, the IRS asserted gift, estate and generation-skipping tax deficiencies in excess of $2.8 billion. An important issue in the case is whether the SCINs constituted valid consideration for the sales. According to the

[126] *See also* Treas.Reg.Secs. 1.7520-3(a)(7) and 20.7520-3(a)(7).

IRS mortality tables under I.R.C. Sec. 7520, the decedent's life expectancy was 5.8 years at the time of the transaction. The decedent's physician wrote a letter on October 20, 2008 indicating that the decedent maintained an active exercise schedule and was working. The physician expressed the view that the decedent was in good health commensurate with his age group, and participated in a healthy life style, exercise regimens and activities which required keen mental rigor. The physician wrote a similar letter on December 16, 2008. Four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS, expressed the view that in January 2009 the decedent had greater than a 50% probability of living at least one year.

The IRS's position in the *Davidson* case is expressed in CCA 201330033, as follows:

> We do not believe that the §7520 tables apply to value the notes in this situation. By its terms, §7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in §25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

The case was settled. On July 6, 2015, the Tax Court entered a stipulated decision with the IRS agreeing to a total $152 million increase in the estate's combined gift, estate and generation-skipping tax liability. Given the settlement of *Davidson*, it remains uncertain whether the rules of I.R.C. Sec. 7520 can be applied to a SCIN. This uncertainty is frequently of critical importance. If the tables apply, an estate need only demonstrate that an individual has greater than a 50% probability of living more than one year in order to be able to take advantage of the conclusive presumption of life expectancy established by Treas.Reg.Sec. 25.7520-3(b)(3). If the tables do not apply, this conclusive presumption is not available, and the individual's actual life expectancy is used. If an individual is ill at the time of the sale, use of the individual's actual life expectancy could significantly reduce the value of the SCIN and result in a substantial gift.

Since the payments for a life annuity can be structured in a way that is very similar to a promissory note or SCIN, there would seem to be no reason from a non-tax viewpoint to favor one over the other. Given the IRS's position that a SCIN does not qualify for the 50% test under Treas.Reg.Sec. 25.7520-3(b)(3), it would seem that practitioners contemplating sale transactions terminating at death should choose a life annuity over a SCIN, at least until the law on this issue is clarified.

### 3. **Treas.Reg.Sec. 1.1275-1(j) and Use of Actuarial Tables Under I.R.C. Sec. 7520 in Valuing Annuity for Shorter of Life or a Term of Years.**

An article states that Treas.Reg.Sec. 1.1275-1(j) supports the IRS's position in *Davidson* and CCA 201330033 that the actuarial tables under I.R.C. Sec. 7520 do not apply to a SCIN.[127] The purpose of Treas.Reg.Sec. 1.1275-1(j) is to define an "annuity" which is not considered to be a debt instrument subject to the OID rules. While not specifically addressing the issue, the discussion in the article evidences its authors' belief that the IRS could also use Treas.Reg.Sec. 1.1275-1(j) to assert that I.R.C. Sec. 7520 does not apply to an annuity payable for the shorter of life or a term of years. The argument would be that the term of years prevents distributions from increasing commensurately with the longevity of the annuitant. For at least two reasons, the IRS should not be able to use Treas.Reg.Sec. 1.1275-1(j) in this fashion.

First, as noted above, Treas.Reg.Sec. 1.1275-1(j) expressly states its purpose. That purpose does not include what qualifies or does not qualify under I.R.C. Sec. 7520. Secondly, IRS Publication *Actuarial Values, Book Aleph*, Publication 1457 (7-1999), which contains examples illustrating the use of the actuarial tables under I.R.C. Sec. 7520, includes as examples the use of the tables to determine factors for life and a term of years. It is difficult to see how the IRS could successfully argue that I.R.C. Sec. 7520 does not apply to value an annuity payable for the shorter or life or a term of years when its own publication illustrates the use of the tables under I.R.C. Sec. 7520 for such an annuity.

## XV. **A Sale to a BIDIT Should Work as Well as a Sale to an IDIT.**

A variant of the standard sale to an IDIT technique is the sale to what can be called a Beneficiary Intentionally Defective Irrevocable Trust ("BIDIT") in exchange for the BIDIT's promissory note. In the standard sale to an IDIT, the seller establishes the trust. The trust instrument has no provisions which would cause assets which the seller transfers to the IDIT to be included in the seller's Federal gross estate. This is not the case with a BIDIT. A BIDIT is established by a grantor other than the seller. The seller is granted interests and powers which would typically cause assets which the seller transfers to the BIDIT to be included in the seller's estate. It appears that the sale to an IDIT technique "works" and is actually recognized as effective by the Internal Revenue Service ("IRS"). With a sale to a BIDIT, that same conclusion presently cannot be reached with the same level of confidence. This Section XV. compares the sale to a BIDIT with the sale to an IDIT, and seeks to demonstrate that the sale to a BIDIT should also be a successful estate planning strategy.

### A. **Sale to a BIDIT.**

Although a sale to a BIDIT is structurally similar to a sale to an IDIT, there are differences between the two types of transactions.

---

[127] Crotty, Hesch, Wojnaroski, Jr., and Gassman, *IRS Position Puts More Skin in the Game of Using SCINs*, 41 Est.Plan. No. 1 3 (Jan. 2014).

### 1. Description of a BIDIT.

With a BIDIT, a party might establish a trust for the benefit of an individual beneficiary and the beneficiary's descendants. The beneficiary will be the seller in the sales transaction. The governing instrument might name the individual beneficiary as trustee, and authorizes the trustee to make distributions of income and principal of the BIDIT to the beneficiary and the beneficiary's descendants living from time to time for health, support, maintenance or education. The trust instrument could also prohibit the trustee from making any distribution which satisfies any legal obligation of the trustee, including the obligation to support a descendant. The trust might continue for the beneficiary's lifetime. The beneficiary might be granted a testamentary power to appoint any assets of the trust at death to any appointee of the beneficiary's selection, other than the beneficiary, the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.

Because the beneficiary as trustee is precluded from using assets of the BIDIT to satisfy claims of the beneficiary's creditors and because the trustee's power to make distributions to himself or herself is limited by an ascertainable standard related to health, support, maintenance or education, the powers which the beneficiary possesses as trustee during his or her lifetime do not constitute a general power of appointment.[128] Although the testamentary power of appointment is broad, because permissible appointees exclude the beneficiary, the beneficiary's creditors, the beneficiary's estate, or the creditors of the beneficiary's estate, the testamentary power does not constitute a general power of appointment.[129] Thus, any assets of the trust which cannot be traced, directly or indirectly, to a transfer by the beneficiary are not included in the beneficiary's Federal gross estate.

The grantor might gift up to $5,000 to the BIDIT and grant the individual beneficiary a power to withdraw that contribution which, if not exercised, lapses after a period of time, e.g., 30 days. So long as the grantor is not taxed under any of the grantor trust rules subpart E, [130] such power causes the beneficiary to be treated as the owner of the trust. While the power is outstanding, the beneficiary is treated as the owner under IRC Sec. 678(a)(1). After the power has lapsed, the beneficiary is treated as the owner under IRC Sec. 678(a)(2). Because the lapse does not exceed the $5,000 or 5% limits of IRC Sec. 2014(e), the lapse of the power of withdrawal is not considered to be a gift by the beneficiary. In addition, because the $5,000 or 5% limits of IRC Sec. 2041(b)(2) are not exceeded, the lapse of the power to withdraw is not considered a release causing the lapsed amount to be included in the beneficiary's estate by virtue of the beneficiary's retained interests and powers with respect to the lapsed amount.

At this point, the situation with respect to the BIDIT is the same with respect to the beneficiary as with an IDIT and its grantor. The BIDIT is recognized to exist for Federal estate tax purposes. The grantor's $5,000 contribution is excluded from the beneficiary's Federal gross

---

[128] Treas. Reg. Secs. 20.2041-1(c)(1)(b) and 20.2041-1(c)(2).

[129] Treas. Reg. Sec. 20.2041-1(c)(1)(b).

[130] IRC Sec. 678(b).

estate. For income tax purposes, the BIDIT is not recognized to exist separate and apart from the beneficiary.[131] As with an IDIT and its grantor, the beneficiary can sell appreciated assets to the BIDIT without recognizing gain. The beneficiary is taxed individually on all income generated by the BIDIT's assets. The beneficiary's payment of tax on such income is not considered to be a gift by the beneficiary to the BIDIT.[132]

With an IDIT, the 10% cushion can be created by the grantor/seller making a gift of additional assets to the IDIT. This option is not available with the BIDIT described above, because the interests and powers possessed by the beneficiary/seller which the beneficiary/seller gifts to the IDIT would cause inclusion under IRC Secs. 2036(a) and 2038(a). One method of dealing with this problem is to add a provision in the governing instrument which precludes the beneficiary from having any interest or power with respect to any assets which the beneficiary transfers to the BIDIT for less than an adequate and full consideration. Such a provision would cause any gift by the beneficiary to be a completed gift for Federal gift tax purposes. The gifted assets would, however, be available to satisfy the promissory note to the beneficiary in the same way that gifted assets are available to satisfy a promissory note given on the sale of assets to an IDIT. If this method is utilized, care must be taken not to commingle any assets gifted by the beneficiary, together with any income from such assets, with other assets of the BIDIT.

Another method of providing a cushion for the promissory note is for beneficiaries of the BIDIT other than the beneficiary/seller to guarantee at least 10% of the amounts payable under the promissory note. All of the discussion in Sections II and IV, *supra*, with respect to guarantees by beneficiaries of an IDIT is applicable to guarantees by beneficiaries of a BIDIT.

#### 2. The BDOT and SGT.

There are two other types of trusts that have been suggested as alternatives to the BIDIT. One such other type of trust has been called a "Beneficiary Deemed Owner Trust" or "BDOT."[133] The other has been called a "Spousal Grantor Trust" or "SGT."[134]

The BDOT is a trust with respect to which a beneficiary is treated as owner under IRC Sec. 678. The BDOT grants the beneficiary the continuing right to withdraw annually all of the net taxable income of the BDOT, i.e., dividends, interest and taxable income allocated to principal, such as capital gain. The power can be satisfied out of the entire income or corpus of the trust. The beneficiary's withdrawal power lapses in each year to the extent it is not exercised.

---

[131] Rev. Rul. 85-13, 1985-1 C.B. 184.

[132] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[133] Eastland, *Best Estate Planning Techniques Under TCJA - Part 4: BDOT*, 45 Est. Plan. 19 (September 2018).

[134] Culp, Hattenhauer and Mellen, *The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust*, 44 ACTEC L.J. 63 (Winter 2019).

The reference in IRC Sec. 678(a)(1) to "income" is to taxable income, not accounting income. Because the beneficiary's withdrawal power extends to the taxable income of the entire trust, the effect of the withdrawal power is to make the BDOT a wholly grantor trust. All of its income, both accounting income and capital gain income, is taxed to the beneficiary. It is contemplated that the beneficiary will withdraw annually any taxable income in excess of the $5,000 or 5% limits of IRC Secs. 2041(b)(2) and 2514(e). The 5% limit is 5% of the value of the entire trust. Any lapsed amounts remain in the BDOT excluded from the beneficiary's Federal gross estate.

A stated advantage of the BDOT over the BIDIT is that the grantor can make a substantial gift to the trust, all of which is treated as owned by the beneficiary for income tax purposes under IRC Sec. 678(a)(1). With a BIDIT, the initial gift does not exceed $5,000. The greater initial funding possible with the BDOT means that there is equity in the trust to support any note given by the BDOT in purchasing assets from the beneficiary, giving the sale more of the attributes of an arm's length transaction than exists with a BIDIT which is funded only with a maximum of $5,000. The equity also satisfies the test enunciated by the United States Supreme Court in *Fidelity-Philadelphia Trust Co. v. Smith* that assets in addition to those purchased be available to satisfy the trust's promissory note.[135]

An SGT is similar to an IDIT. One spouse establishes the SGT of which the other spouse is a beneficiary and which is a grantor trust treated as owned by the spouse establishing the SGT (and who is not a beneficiary of the SGT). The beneficiary spouse who is not treated as the owner of the trust under the grantor trust rules sells assets to the SGT in exchange for its promissory note. Gain on the sale of appreciated assets is avoided not because the SGT is treated as owned by the selling spouse under the grantor trust income tax rules, but rather by application of IRC Sec. 1041. That statute provides that no gain or loss is recognized on a transfer of property to, or in trust for the benefit of, the transferor's spouse. IRC Sec. 1041 applies because the assets which the beneficiary spouse sells to the SGT are treated as sold to the grantor spouse by virtue of the SGT's grantor trust status. IRC Sec. 1041 does not apply to interest on the SGT's promissory note, and such interest is taxable to the selling spouse. If the SGT has investment income, it may be entitled to an offsetting deduction for the interest paid.[136]

### B. The Parenthetical Exception - The *Wheeler* Case.

An IDIT contains no express provisions in the governing instrument which cause assets in the IDIT to be included in the grantor/seller's estate for Federal estate tax purposes. The exact opposite is the case with a BIDIT. The provisions of the BIDIT cause any assets which the beneficiary gifts to the BIDIT to be included in the beneficiary's estate. The theory upon which the sale to BIDIT transaction rests is that the beneficiary's sale of assets to the BIDIT falls within the parenthetical exception rendering the retained interests and powers irrelevant. This result is achieved only if the beneficiary's transfer of assets to the BIDIT constitutes a bona fide sale for an adequate and full consideration.

---

[135] *See* discussion at note 7, *supra*.

[136] IRC Sec. 163(d).

The purpose of the parenthetical exception is to ensure that the estate is replenished for the value by which it may have been reduced because of the transfer.[137] Because the estate and gift tax rules for valuing transferred assets permit discounting, adequate and full consideration is deemed to have been received so long as the consideration received for a transferred interest is at least equal to the estate and gift tax value (after any discounts) of the assets transferred. That the value sufficient to avoid a gift on the sale should also mean that adequate and full consideration has been received for purposes of the parenthetical exception.

This point is illustrated by the Fifth Circuit's decision in *Wheeler v. U.S.*,[138] which is a leading case involving the parenthetical exception. In *Wheeler*, the decedent sold a remainder interest in a farm to his two adopted sons several years before his death. The decedent reserved a life estate in the farm. The actuarial tables at Treas. Reg. 25.2512-5(A) were used to determine the purchase price, which the sons paid for the remainder interest by their promissory note. Applying IRC Sec. 2043(a), the IRS determined that the decedent's gross estate should include the date of death value of the farm, less the amount of the sons' promissory note. The District Court accepted the IRS's argument, finding under authority of a number of prior cases[139] that to be applicable, adequate and full consideration of the parenthetical exception required that the value received by the decedent must be equal to the value of the underlying property and not the actuarial value of the remainder interest.

Following the Third Circuit's decision in *D'Ambrosio v. Commissioner*,[140] the Fifth Circuit held that the value of the remainder interest constituted adequate and full consideration under the parenthetical exception. The Fifth Circuit stated that the decedent received adequate and full consideration for gift tax purposes, and thus should also be considered to have received adequate and full consideration for purposes of the parenthetical exception. The Fifth Circuit's opinion contains the following:

> To the extent the "bona fide" qualifier in section 2036(a) has any independent meaning beyond requiring that neither transfers nor the adequate and full consideration for them be illusory or sham, it might be construed as permitting legitimate, negotiated commercial transfers of split-interests that would not otherwise qualify as adequate consideration using the actuarial table values set forth in the Treasury Regulations to qualify under the exception. Such a result comports with the same construction the term is given in the gift tax regulations. The gift tax regulations prevent an "ironclad" operation of the gift tax statute from transforming every bad bargain into a gift by the losing party. [*Citations omitted.*] Accordingly, the term "bona fide" preceding "sale" in section 2036 is

---

[137] *Commissioner v. Wemyss*, 324 U.S. 303 (1945); *Merrill v. Fahs*, 324 U.S. 308 (1945).

[138] *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997).

[139] *Gradow v. U.S.*, 897 F.2d 516 (Fed. Cir. 1990); *Pittman v. U.S.*, 878 F. Supp. 833 (E.D.N.C. 1994).

[140] 101 F.3d 309 (3rd Cir. 1996), cert. denied 520 U.S. 1230 (1997).

> not, as the government seems to suggest, an additional wicket reserved exclusively for intrafamily transfers that otherwise meet the Treasury Regulations' valuation criteria. The government implicitly asserts that the term "bona fide" in section 2036(a) permits the IRS to declare that the same remainder interest, sold for precisely the same (actuarial) amount but to different purchasers, would constitute adequate and full consideration for a third party but not for a family member. This construction asks too much of these two small words. In addition to arguing that "adequate and full consideration" means different things for gift tax purposes than it does for estate tax purposes, the government would also have us give "bona fide" not only a different construction depending on whether we are applying the gift or estate tax statute, but also different meanings depending upon the identity of the purchaser in a section 2036(a) transaction. We do not believe that Congress intended, nor do we believe the language of the statute supports, such a construction.[141]
>
> * * *
>
> . . . Here the sons parted with real money in the form of a fully secured, conventional real estate lien note on which each had entire personal liability; the purchase price of the remainder interest was the uncontested fair market value of the ranch discounted by the actuarial factor set forth in the government's own regulations; Melton received not only the principal amount due under the note, but also interest income generated by the note prior to its assignment to The Melton Company; no payments were missed, the note was never in danger of default, and it was *in fact* paid off in full, principal and interest, by January 1988, more than three years before Melton's death; although there were no negotiations concerning the purchase price, it is patent that, at the time of the transfer, a third party would have been ill-advised to pay more than its actuarial value; . . . This was a bona fide sale.[142]

Under the Fifth Circuit's opinion in *Wheeler*, the bona fide sale requirement of the parenthetical exception is satisfied if consideration for a transfer is, in fact, received by the transferor. When the consideration actually received by the transferor is adequate and full, both requirements of the parenthetical exception are satisfied and IRC Sec. 2036(a) is not applicable. Additionally, under *Wheeler*, adequate and full consideration for gift tax purposes is also adequate and full consideration for estate tax purposes.[143]

---

[141] 116 F.3d at pp. 763-764.

[142] 116 F.3d at p. 770.

[143] *See also Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004).

### C. **Gift Tax Return Reporting a Sale to a BIDIT.**

The discussion in Section VI., *supra*, suggests that a sale to an IDIT might be disclosed on a gift tax return which reports no gift because the value of the promissory note is at least equal to the value of assets purchased. If the return adequately discloses the sale, the IRS cannot assess a gift tax on the sale once the three year statute of limitations has elapsed. Further, as observed in that discussion, the return should also establish the existence of adequate and full consideration for purposes of the parenthetical exception. It would be beneficial if the same result could be achieved by filing a gift tax return adequately disclosing a sale to a BIDIT.

A beneficiary's retained interests and powers over assets which the beneficiary transfers to the BIDIT described in Section XIV.A.1., *supra*, causes any gift by the beneficiary to be incomplete.[144] Reporting an incomplete gift does not start the limitations to run.[145] Without dealing with the incompleteness issue, it does not appear possible to achieve finality by adequately disclosing a sale to a BIDIT on a gift tax return.

It has been suggested that the incomplete gift issue can be avoided by reporting the sale to a BIDIT as a "non-gift completed transfer" under Treas. Reg. Sec. 301.6501(c)-(1)(f)(5).[146] That Regulation provides that if a transfer adequately disclosed on a gift tax return is reported as a completed gift, the statute of limitations for assessing gift tax on the transfer will run, even if the transfer is later determined to be an incomplete gift. Treas. Reg. Sec. 301.6501(c)-(1)(f)(5) also states that "…once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included." The suggestion is that if the sale to a BIDIT is reported as a completed gift on a gift tax return, the quoted language precludes the IRS from including the assets sold to the BIDIT in the seller's Federal gross estate.

Read closely, the quoted language of the Regulation does not support this suggestion. That language states only that interests and powers which cause a transfer to be incomplete are disregarded. Ignoring only those interests or powers which prevent a transfer from being complete does not necessarily preclude that transfer from being included in the transferor's estate. For example, if a transferor's interest in the income from assets which a transferor has transferred to a BIDIT is sufficient to permit the transferor's creditors to reach that income to satisfy claims against the transferor, those assets are includable in the transferor's gross estate under IRC Sec. 2036(a).[147] Ignoring interests and powers which make the transfer incomplete does not change this result.

---

[144] Treas. Reg. Sec. 25.2511-2.

[145] Treas. Reg. Sec. 301.6501(c)-1(f)(5).

[146] Oshins, Brody, Hesch & Rounds, *A Gift from Above: Estate Planning on a Higher Plane*, 150 T&E 17 (Nov. 2011).

[147] Treas. Reg. Sec. 20.2036-1(b)(2).

There is another method of dealing with the incomplete gift issue, which is likely to be more successful than the non-gift completed transfer approach. That other method is to include language in the governing instrument suggested in Section XIV.A.1., *supra*, which provides that a beneficiary is not to have any beneficial interest in or any testamentary power of appointment over any assets which the beneficiary transfers to the BIDIT for less than a full and adequate consideration. Such a provision would cause any gift by a beneficiary to be a completed gift for Federal gift tax purposes. A gift tax return adequately disclosing a sale to a BIDIT containing such a provision which takes the position that the sale did not constitute a gift because of the value of the assets sold did not exceed the value of the BIDIT's promissory note should preclude the IRS from challenging that position once the statute of limitations has run. Further, for the reasons stated in Section IV, *supra*, the gift tax return should also conclusively establish the existence of adequate and full consideration for purposes of the parenthetical exception.

### D. <u>Limited Partnership Cases - Substantial Non-Tax Purpose Required for a Bona Fide Sale</u>.

Recently, there have been a substantial number of reported cases involving the parenthetical exception. Most of these cases involved the question of whether or not valuation discounts were available for interests in a limited partnership or limited liability company included in a decedent's Federal gross estate. In many of these cases, an individual transferred marketable securities or other liquid assets into a limited partnership or an LLC in exchange for limited partnership interests or non-voting membership interests in the LLC. It is asserted that the Federal estate tax value of such interests is less than the value of the assets transferred into the entity, i.e., that the value of the individual's Federal gross estate is reduced below what it would have been had the transfer not taken place. The IRS asserts that the assets which the individual contributed into the entity are included in the gross estate under IRC Sec. 2036(a) or 2038(a), or both, because of interests or powers retained or possessed at death. Essentially, the IRS's position is that the existence of the entity is ignored. The individual's estate typically argues that even if interests or powers exist, inclusion is avoided by virtue of the parenthetical exception. Specifically, the estate argues that the transfer of assets into the entity in exchange for interests in the entity constituted a bona fide sale for adequate and full consideration. [148]

The cases have uniformly held that the receipt of partnership interests proportionate to a partner's contribution to a partnership constitutes adequate and full consideration.[149] The applicability of the parenthetical exception thus depends upon whether the transfer of assets into the limited partnership constitutes a bona fide sale. The cases involving this issue require a

---

[148] Most of the decided cases involve limited partnerships rather than LLCs. For convenience, this article frequently refers to limited partnerships without mentioning LLCs. The considerations involved in applying IRC Secs. 2036(a) and 2038(a) to limited partnership interests and non-voting interests in an LLC are the same.

[149] *Estate of Harper*, 83 T.C.M. 1644 (2002); *Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004); *Estate of Thompson v. Commissioner*, 382 F.3d 367 (3d Cir. 2004); *Estate of Bigelow v. Commissioner*, 503 F.3d 955 (9th Cir. 2010).

substantial non-tax reason or purpose justifying the formation of a limited partnership as a pre-requisite for finding the existence of a bona fide sale.

### 1. *Strangi* and Its Progeny.

Estate *of Strangi v. Commissioner*[150] is an early case in which the IRS asserted that IRC Sec. 2036(a) applied to cause assets transferred into a limited partnership to be included in the transferor's gross estate. In *Strangi*, the decedent, through his attorney-in-fact, transferred assets to a limited partnership interest in exchange for a 99% limited partnership interest. Seventy-five percent of the transferred assets constituted cash and marketable securities. The decedent was in ill health at the time the partnership was formed and died just over two months later.

In a regular opinion written by Judge Cohen,[151] the Tax Court rejected the IRS's contention that the existence of the limited partnership should be ignored for lack of economic substance or a business purpose. The Tax Court's opinion expressed skepticism regarding the existence of non-tax motives for the partnership. Nevertheless, noting that formalities were followed and that the limited partnership changed the relationship between the decedent, his heirs and actual and potential creditors, the Tax Court held that the limited partnership had sufficient substance to be recognized for Federal estate tax purposes.

The Tax Court in *Strangi* rejected a number of other arguments by the IRS, including the argument that the underlying assets of the partnership should be included in the decedent's gross estate under IRC Sec. 2036(a). The IRS first asserted the applicability of that statute in a motion filed in the Tax Court fifty-two days prior to trial. In filing that motion, the IRS reversed the position it had previously taken in a number of private letter rulings. In these rulings, the IRS held IRC Sec. 2036(a)(2) did not apply to a general partner's power to control distributions from a limited partnership because of the fiduciary duty a general partner owes the other partners.[152] The Tax Court denied the IRS's motion to amend because it considered the motion untimely.

On appeal, the Fifth Circuit affirmed all of the Tax Court's holdings other than its conclusion regarding IRC Sec. 2036(a). It remanded the case with directions to the Tax Court that it consider the IRS's 2036(a) claim.[153]

Back in the Tax Court, one argument made by the estate was that the parenthetical exception rendered IRC Sec. 2036(a) inapplicable. The Tax Court rejected this argument in a

---

[150] 115 T.C.M. 458 (2000), *aff'd in part and rev'd in part*, *Gulig v. Commissioner*, 293 F.3d 279 (5th Circuit 2002), *on remand*, 85 T.C.M. 1331 (2003), *aff'd* 417 F.3d 468 (5th Circuit 2005).

[151] 115 T.C.M. 458.

[152] See, e.g., Ltr. Ruls. 9546006; 9415007; 9332006; 9310039; 9131006; 8611004.

[153] 293 F.3d 279.

memorandum opinion by Judge Cohen,[154] who was also the author of the Tax Court's 2000 regular opinion in *Strangi*.

The Estate proffered five different non-tax reasons for the decedent's transfer of assets into the limited partnership. These reasons were: (i) deterring potential tort litigation by the decedent's former housekeeper; (ii) deterring a potential will contest suit; (iii) persuading a corporate executor to decline to serve; (iv) creating a joint investment vehicle; and (v) permitting centralized, active management of working interests.[155] Judge Cohen rejected each of these rationales as a sufficient non-tax purpose justifying the formation of the partnership.

The Fifth Circuit affirmed this determination upon finding that it was not clearly erroneous.[156] According to the Fifth Circuit, the bona fide sale requirement of the parenthetical exception could be satisfied only by a demonstration that the "transfer was objectively likely to serve a substantial non-tax purpose…"[157]

After its success in *Strangi*, the IRS has used IRC Sec. 2036(a) as the only basis upon which it challenges valuation discounts for limited partnership interests included in a decedent's Federal gross estate. In cases after *Strangi*, courts have generally replicated the methodology adopted by Judge Cohen in her 2003 memorandum opinion. After finding that there is a retained interest or power sufficient to cause inclusion under IRC Sec. 2036(a), the courts consider whether inclusion is avoided by virtue of the parenthetical exception. In determining whether the parenthetical exception applies to avoid IRC Sec. 2036(a), courts have considered whether there is a sufficient non-tax purpose justifying a limited partnership's existence. If no substantial non-tax reason for the limited partnership is found to exist, the courts find that the assets contributed by a decedent into a limited partnership are included in the decedent's gross estate as though owned by the decedent.[158] Paradoxically, searching for a substantial non-tax purpose as a test for inclusion under IRC Sec. 2036(a) involves the same analysis in which Judge Cohen declined to engage while rejecting the IRS's business purpose and economic substance argument in her first *Strangi* opinion.

---

[154] 85 T.C.M. 1331.

[155] 417 F.3d at p. 480.

[156] 417 F.3d 468.

[157] 417 F.3d at p. 479.

[158] In Item 26f of *Estate Planning Current Development*, note 79, *supra*, the authors list 37 cases involving limited partnerships or limited liability companies. Fourteen of those cases held that IRC Sec. 2036(a) was not applicable by virtue of the parenthetical exception. Twenty-three cases held for inclusion under IRC Sec. 2036(a). Further, the authors categorize 2 of the 23 cases as partial wins for the estates.

### 2. The *Powell* Case and IRC Sec. 2043(a).

The courts uniformly followed the methodology outlined in the preceding paragraph until the Tax Court's decision in *Estate of Powell v. Commissioner*.[159] In a plurality decision joined in by eight of the seventeen judges participating in the case (with two judges concurring in result), the Tax Court held that assets contributed to a limited partnership were includable in the decedent's Federal gross estate.

In *Powell*, the decedent's son, acting under a durable power of attorney, contributed assets of the decedent into a limited partnership in exchange for a 99% limited partnership interest. After the limited partnership was formed, the decedent's son, again acting under the durable power, transferred the 99% limited partnership interests into a charitable lead trust. The validity of the transfer to the charitable lead trust was in doubt, because the durable power of attorney only authorized annual exclusion gifts to the decedent's issue. The decedent died seven days after the limited partnership interests were transferred to the charitable lead trust. In granting the IRS's motion for summary judgment, the judges joining in the plurality opinion held that the transfer of the decedent's assets to the limited partnership was subject to a retained right to designate under IRC Sec. 2036(a)(2). The Tax Court plurality held IRC Sec. 2036(a)(2) applied because the decedent, in conjunction with all of the other partners, could dissolve the partnership. The plurality further held that IRC Sec. 2036(a)(2) was not avoided by the transfer to the charitable lead trust even if it was assumed that such transfer was valid. Because the transfer occurred within three years of the decedent's death, IRC Sec. 2035 caused IRC Sec. 2036(a)(2) to continue to apply even though the decedent no longer held the limited partnership interests at death.

The Tax Court's analysis of the application of IRC Sec. 2036(a)(2) in *Powell* might be questioned. A limited partner has no power to participate in the management or distributions from the partnership. It is the first case in which any court has applied IRC Sec. 2036(a)(2) to hold for inclusion when the decedent did not hold a general partnership interest. It would seem that if the Tax Court's analysis is in *Powell* is correct, the taxpayer should never have won a single limited partnership estate tax case. Any partnership can be dissolved by agreement of all of its partners. Treas. Reg. Sec. 20.2038-1(a)(2) provides that IRC Sec. 2038(a) does not apply if a decedent's power could be exercised only with the consent of the parties having an interest (vested or contingent) in the transferred property. Although there is no similar provision in the Regulations under IRC Sec. 2036(a)(2), there is no reason why the rule established by Treas. Reg. Sec. 20.2038-1(a)(2) should not also apply to that statute.

After finding for inclusion under IRC Sec. 2036(a)(2), the plurality opinion in *Powell* then engaged in an extended discussion on the interaction of IRC Sec. 2036(a)(2) with IRC Sec. 2043(a). The latter statute applies when consideration is received for a transfer, but the consideration is not adequate and full. According to the plurality opinion, the amount included in the estate under IRC Secs. 2036(a) and 2043(a) in limited partnership cases is the date of death value of the assets transferred to the limited partnership, reduced by the value of limited partnership interests received in exchange for such transfer, the received interests being valued as

[159] 148 T.C.M. 18 (2017).

of the date of the transfer. Further, according to the plurality, the limited partnership interests held by the decedent at death is separately included in the estate under IRC Sec. 2033 at its date of death value. The effect of this interaction among IRC Secs. 2036(a), 2043(a) and 2033 is to include in the estate the excess of the date of death value of the transferred assets (reduced by the date of transfer value of the limited partnership interests received) over the date of death value of the limited partnership interests received.

In *Powell*, the parties stipulated that the value of the assets transferred to the limited partnership was also their value as of date of death. Because of that stipulation, the net value actually included in *Powell* was the amount of the discount produced by the limited partnership. In footnote 7 of its opinion, the plurality notes that its view of the interaction of IRC Secs. 2036(a), 2043(a) and 2033 produces the possibility of double inclusion if the value of the transferred assets increases between date of transfer and date of death. This is because the appreciation in the value of the transferred assets is included under IRC Secs. 2036(a) and 2043(a), and is also included in determining the date of death value of the limited partnership interests included in the gross estate under IRC Sec. 2033.

The seven judges joining in the concurring opinion in *Powell* rejected the plurality's analysis of IRC Secs. 2036(a), 2043(a) and 2033, noting that the issue had not been argued or briefed by either party. The concurring opinion notes that all prior cases applying IRC Sec. 2036(a) to limited partnerships ignored the existence of the limited partnership. According to the concurring opinion, limited partnership interests held at death should be regarded as having no distinct value, being an "alter ego" of the assets transferred to the limited partnership in exchange for such interests.

#### 3. Substantial Non-Tax Purpose Test Should Be Limited to Limited Partnership Cases.

A thoughtful article[160] analyzes *Powell* in the context of examining the propriety generally of using IRC Sec. 2036(a) as the basis for deciding whether a limited partnership interest is to be recognized as effective to produce valuation discounts. The article contrasts how courts have applied the parenthetical exception's bona fide sale test in limited partnership cases as compared to how they apply it in non-partnership cases. Citing *Wheeler*,[161] the article observes that in conventional analysis, even if a sale were tax driven, the parenthetical exception applied to avoid double inclusion when the decedent received a substitute asset equal in value to the asset transferred. The article criticizes the courts' rejection of what it describes as a "more appropriate methodology" for closing down tax driven limited partnerships, i.e., that limited partnerships formed for the sole purpose of avoiding the estate tax should be disregarded.

In addition to finding fault with the courts' indifference to *Wheeler* and rejection of the "more appropriate methodology," the article points to a number of unfavorable consequences

---

[160] Gans and Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (Winter 2017).

[161] See note 138, *supra*.

resulting from the use of IRC Sec. 2036(a) in limited partnership cases. One problem is the possibility of double taxation referred to in footnote 7 of the plurality's opinion in *Powell*. The article also points out that under the tests which have been developed in the jurisprudence under IRC Sec. 2036(a), a partnership formed without any non-tax justification will in some instances nevertheless be recognized. For example, a partnership whose sole purpose is to avoid estate taxes will not be ignored under IRC Sec. 2036(a)(1) if no distributions are made from the partnership and if the decedent retains sufficient assets outside of the partnership upon which to live. In such a case, there is no evidence of a retained income interest causing IRC Sec. 2036(a)(1) to apply. The article observes that "…having chosen section 2036, the courts are left with the complications such as those that surfaced in *Powell*."[162]

In *Estate of Trombetta v. Commissioner,* discussed in Section XIII.A., *supra*, the Tax Court appears to have recognized issues created by the courts' use of the substantial non-tax reason test to decide limited partnership cases. In *Trombetta*, the estate argued against inclusion of the GRAT in the decedent's estate under IRC Sec. 2036(a)(1) on the grounds that the parenthetical exception applied. According to the estate, the decedent established the trust for an assured income stream and to avoid managing the properties she transferred to the trust. The estate argued that these purposes for establishing the trust constituted legitimate and significant non-tax reasons making the parenthetical exception applicable. The Tax Court found that the significant non-tax reason test should be limited in application to limited partnership cases:

> Although a number of other cases have applied the "legitimate and significant nontax reasons" standard to determine whether a bona fide sale exception was satisfied, all of the cases applied the standard in the context of a transfer to a family limited partnership. [Citations omitted.] Decedent transferred the Tierra Plaza and Black Walnut Square properties to a grantor trust, not a family limited partnership. Decedent's transfers are not comparable to a transfer to a family limited partnership, particularly given that no other individual received a present interest in the annuity trust. We are not persuaded and are unable to find that decedent's transfers to the annuity trust are sufficiently similar to a transfer to a family limited partnership to apply the "legitimate and significant nontax reasons" standard.[163]

Given the conceptual difficulties that have arisen in applying IRC Sec. 2036(a) and the non-tax purpose test in limited partnership cases, it would be understandable if the courts were to reconsider that application. With the number of decisions that have been based upon IRC Sec. 2036(a), such a development seems unlikely. At the very least, however, the courts should limit the use of the non-tax purpose test to limited partnership cases and not extend it to a case involving the applicability of the parenthetical exception to a sale to a BIDIT.

---

[162] 42 ACTEC L.J. at p. 275.

[163] *Id.* at p. 422.

## E. Seller on Both Sides of the Transaction.

There are cases in which the courts have expressed as a justification for applying IRC Sec. 2036(a) the assertion that a decedent "stood on both sides of the transaction." A number of those cases involve limited partnerships.[164] In these cases, the courts have made the observation that a decedent has stood on both sides of the transaction in holding that the exchange of assets for interest in a limited partnership or other entity did not constitute a bona fide sale. In the cases in which this observation is made, the decedent or someone acting on the decedent's behalf was the controlling voice as to the structure of the limited partnership and the rights and responsibilities of the various partners, and there was little or no evidence of engagement by the other partners in the formation of the limited partnership.

### 1. Receipt of Adequate and Full Consideration Establishes a Bona Fide Sale.

The statement has also been made in cases which did not involve limited partnerships. *Estate of Trombetta v. Commissioner*, discussed in Section XIII.A., *supra*, involved a transfer of assets to a trust in exchange for an annuity payable over a specified term. The court held that the annuity constituted a retained interest causing the assets transferred to the trust to be included in the decedent's estate under IRC Sec. 2036(a)(1). Among the grounds given by the court for this holding was that the decedent stood on both sides of the transaction:

> [The decedent's attorney] and decedent determined how the entire estate plan would be structured and operated and what property would be contributed to which vehicle. Decedent, as the sole beneficiary and the sole transferor, formed the transaction, fully funded the annuity trust, and essentially stood on both sides of the transaction.[165]

In another article, the authors identified in note 160, *supra*, analyze the decision in *Trombetta*.[166] One point the article discusses is the Tax Court's suggestion that a lack of meaningful negotiation (i.e., being on both sides of the transaction) renders the parenthetical exception unavailable. The article comments that the *Trombetta* court's discussion of the decedent being on both sides of the transaction was not necessary to its decision, because the value of the annuity exceeded the value of the assets which the decedent transferred to the trust. That excess value was reported on a gift tax return. Irrespective of whether the transaction

---

[164] *See*, *e.g.*, *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005); *Estate of Erickson v. Commissioner*, 93 T.C.M. 1175 (2007); *Estate of Turner v. Commissioner*, 102 T.C.M. 214 (2011); *Estate of Liljestrand v. Commissioner*, 56 T.C.M. 1598 (2011); *Estate of Strangi v. Commissioner*, 85 T.C.M. 1331, *aff'd* 417 F.3d 468 (5th Cir. 2005).

[165] 106 T.C.M. at p. 421.

[166] *Gans and Blattmachr, Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. Tax. 227 (2014).

constituted a bona fide sale, the requirements of the parenthetical exception were not satisfied because the decedent had not received adequate and full consideration.

The article also notes that the above quote from the *Trombetta* opinion can be construed as requiring an arm's length transaction for a sale to be bona fide under the parenthetical exception. The article states that an arm's length negotiation should not be required if a decedent has received adequate and full consideration in a sale. Echoing the view of the parenthetical exception expressed by the court in *Wheeler*, the article observes that it makes no sense as a policy matter to require inclusion under IRC Sec. 2036(a) if in fact full consideration was received.

**2. Fiduciary Responsibilities.**

A trustee has fiduciary responsibilities which should be and have been recognized as distinguishing an individual acting in his or her individual capacity. A good illustration of this point is the case of *Goodman v. Commissioner*.[167] The decision in *Goodman* was rendered after the Fifth Circuit's affirmance of the Tax Court's decision in *Rushing v. Commissioner*.[168] In *Rushing*, the seller sold corporate stock to a trust for the benefit of his children after the corporation had adopted a plan of liquidation. The stock was sold in exchange for the trust's installment obligation. The IRS challenged the transaction, asserting that the taxpayer was not entitled to installment treatment and should be taxed immediately on the sale. The Fifth Circuit rejected the IRS argument and held that the taxpayer was entitled to installment treatment, emphasizing in its opinion that the trust had an autonomous corporate trustee which was independent of the taxpayer.

In *Goodman*, the taxpayers sold apartments to trusts of which they were trustees for installment notes the day before the trusts sold the apartments to an unrelated party. The Tax Court rejected the IRS's arguments that installment sale treatment should be denied. In distinguishing other cases involving taxpayers participating in transactions with themselves as trustees, the court stated that the fact that taxpayers were trustees was not the basis for the holdings in those cases:

> Considering our holdings in a number of other cases, we conclude that the fact that a seller of property is the trustee of the trusts to which the property is sold, standing alone, does not cause the same to lack substance or bona fides, or the seller to constructively receive the income from the sale received by the trusts. The crucial factor is whether the trustee was acting solely as trustee and in the best interests of the trusts in making the purchase and sale of the property.
>
> In our view, under the facts here present, [the taxpayers] did not have control over the proceeds of the sale or control over making the sale to Cathedral

[167] 74 T.C.M. 684 (1980)

[168] 441 F.2$^{d}$ 593 (5$^{th}$ Cir. 1971), *aff'g* 52 T.C.M. 888 (1969).

except in their capacity as trustees, which was a capacity distinct and apart from their capacity as individual sellers of the property.[169]

Although the beneficiary/seller of a BIDIT continues to possess substantial interests and powers with respect to any assets which he or she sells to the BIDIT, the beneficiary/seller no longer has absolute control over those assets. Under the terms of the BIDIT, the beneficiary/seller as trustee is limited to distributions for health, support, maintenance or education. As trustee, the beneficiary/seller has fiduciary duties to the other beneficiaries of the BIDIT. In states with statutes similar to Section 813 of the Uniform Trust Code, the beneficiary/seller, as trustee, is required to notify qualified beneficiaries of the BIDIT's existence, the identity of the settlor, the right to request a copy of the trust instrument and the right to receive annual reports.[170] The trustee is also obligated to send annual reports to the permissible distributees who do not waive the right to receive them and to other beneficiaries of the BIDIT who request them.[171] The duty to notify and provide annual reports cannot be overridden by the trust instrument.[172]

There is a distinction between full control that exists with outright ownership and a beneficiary/seller's interests and powers under a BIDIT. Those differences caused the Tax Court to reach the conclusions it did in *Goodman* in spite of the Fifth Circuit's emphasis in *Rushing* on the existence of an independent corporate trustee. As in *Goodman*, what should ultimately count is that the fiduciary duties which the law imposes upon a trustee should be sufficient to overcome an assertion that the seller in a BIDIT transaction is on both sides of the transaction.

#### 3. Standing on Both Sides of Transaction Not Sufficient as the Sole Ground for Finding No Bona Fide Sale.

While *Trombetta* and a number of the other cases cited in note 63, *supra,* refer to the grantor of a trust being on both sides of the transaction, that fact was just one of a number of justifications that the courts used in reaching a result adverse to the taxpayer. In no case has being on both sides of the transaction been the only ground upon which no bona fide sale has been found to exist. In *Estate of Stone v. Commissioner*[173] and *Estate of Purdue v. Commissioner*,[174] the courts found that the decedents were on both sides of the transaction, but that the parenthetical exception nevertheless applied to avoid inclusion under IRC Sec. 2036(a).

---

[169] 74 T.C.M. at pp. 708-709. The decision in *Rushing* and its progeny led to the enactment of IRC Sec. 452(e) that disallows installment treatment in sales to a related party if the buyer disposes of the purchased property within two years.

[170] Uniform Trust Code Sec. 813(b)(3).

[171] Uniform Trust Code Secs. 813(c) and (d).

[172] Uniform Trust Code Secs. 105(b)(8) and (9).

[173] 103 T.C.M. 1237 (2012).

[174] 110 T.C.M. 627 (2015).

In *Stone* and *Purdue*, the courts found that the parenthetical exception applied because of the existence of substantial non-tax reasons for the formation of the entities in those cases.

The excerpt from the Third Circuit's opinion in *Estate of Thompson v. Commissioner*, appearing in Section XIII.C.4., *supra*, specifically addressed and rejected the IRS's contention that the decedent in that case was "on both sides of the transaction". The Third Circuit's analysis in *Thompson* of what constitutes a bona fide sale corresponds with the Fifth Circuit's analysis in *Wheeler*. That analysis rejects both sides of the transaction as a basis for finding no bona fide sale as long as there is an actual exchange in which consideration is received by the seller. The BIDIT should be viewed as having sufficient characteristics that distinguish it from the seller, so that an exchange between distinct parties has taken place. A bona fide sale occurs even though the seller might superficially be said to be on both sides of the transaction.

There are a number of factors which make a sale to either an IDIT or a BIDIT appealing as a planning technique to reduce Federal estate taxes. Because of the grantor trust income tax status of both the IDIT and the BIDIT, no gain is recognized on the sale of appreciated assets to either type of trust. In addition, the seller's continued payment of income taxes on assets sold to either an IDIT or a BIDIT without gift tax consequences causes a reduction of the seller's Federal gross estate. The ability to use strategies to discount the gift tax value of what is sold (and, consequently, the value of the seller's estate) is another appealing factor. These factors which make the sale to either an IDIT or a BIDIT attractive as a planning technique should have no bearing on the determination of whether a sale to either an IDIT or a BIDIT constitutes a bona fide sale for an adequate and full consideration. The question should not be is there a reason why a seller would want to engage in a sale to a BIDIT, but, under *Thompson* and *Wheeler*, rather whether a sale involves a true exchange of assets for a consideration.

As noted in Section III.D., *supra*, the IRS appears to recognize the sale to an IDIT technique even when the seller is trustee of the IDIT. A seller on both sides of the transaction does not invalidate a sale to an IDIT. It should likewise not be a sufficient basis standing alone to invalidate a sale to a BIDIT.

## XVI. Conclusion.

The sale to IDIT technique appears to have developed into a reliable estate planning strategy which can be utilized in different circumstances and with a variety of different types of assets, including limited partnerships, S corporations and life insurance. Although questions remain about certain aspects of the technique, overall it appears to have withstood the test of time. Although this conclusion cannot presently be reached with the same degree of certainty regarding the sale to a BIDIT, that technique also seems to be conceptually sound.

4895-9824-6921.3