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Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues

Jonathan G. Blattmachr

Mitchell M. Gans
Maurice A. Deane School of Law at Hofstra University

Diana S.C. Zeydel

FINAL REGULATIONS ON ESTATE TAX INCLUSION FOR GRATS AND SIMILAR ARRANGEMENTS LEAVE OPEN ISSUES

BY JONATHAN G. BLATTMACHR, MITCHELL M. GANS, AND DIANA S.C. ZEYDEL

Retained interests, whether in the form of an income interest, an annuity, or otherwise, will cause property to be included in the transferor's gross estate. Just how much of the transferred property, and the method by which that computation is made, is the subject of recently adopted final Regulations. Areas remain in which further guidance would be helpful.

JONATHAN G. BLATTMACHR is a partner in Milbank, Tweed, Hadley & McCloy, LLP, in New York City. MITCHELL M. GANS is a professor at Hofstra University School of Law in Hempstead, New York. DIANA S.C. ZEYDEL is a shareholder in the Miami office of the law firm of Greenberg Traurig, P.A. All three have previously written for THE JOURNAL.

Final Regulations (TD 9414, 7/11/08) affect the application of Sections 2036 and 2039 to "grantor retained interest trusts," which include grantor retained income trusts (GRITs), grantor retained unitrusts (GRUTs), grantor retained annuity trusts (GRATs), charitable remainder unitrusts (CRUTs), charitable remainder annuity trusts (CRATs), qualified personal residence trusts (QPRTs), and similar arrangements. The final Regulations are consistent with the Proposed Regulations issued in June 2007, but reserve for later Regulations or other pronouncements guidance in several important areas that commentators requested be covered.

These final Regulations, along with some planning options they may present and certain drafting issues they suggest, are discussed below. This article also examines Rev. Rul. 2008-35, 2008-29 IRB 116, which deals in part with the application of Section 2036 to "restricted management accounts."

BACKGROUND

Section 2036(a)(1) provides that if a decedent made a transfer and retained the right to the income from the property transferred, the property is included in the decedent's gross estate for federal estate tax purposes. The section applies only if the decedent retains the right to receive the income for life or for one of two other periods:

1. For a period that does not in fact end before the decedent's death, or
2. For a period not ascertainable without reference to the decedent's death.

For example, if the decedent retained the right to receive the income from the transferred property for life, Section 2036 applies. If the decedent instead retained the right to receive the income for a period of five years and died within the five-year period, Section 2036 would apply because the right was retained for a period that did not in fact end before death.

As explained in an article in THE JOURNAL about the Proposed Regulations,[1] neither the Code nor any prior Regulation addressed how Section 2036 should apply if the interest retained is something other than the right to the income from the property transferred, such as if the decedent retained the right to receive an annuity, i.e., a fixed amount payable annually, rather than an income interest. The Supreme Court, however, provided some guidance on this issue in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274, 1 AFTR2d 2151 (1958), and suggested that Section 2036 would not apply to such a payment if three conditions were satisfied:

1. The obligation to pay the annuity

is not chargeable solely to the transferred property.

2. The amount payable to the decedent is not dependent on the amount of the actual income the transferred property generates.

3. The transferees' obligation to make the annuity payments to the decedent is a personal one.

The implication therefore is that a decedent who makes a transfer and retains the right to receive an annuity should be treated, for purposes of Section 2036, as having retained the right to the income from the transferred property unless the three conditions are satisfied.

Nevertheless, even where a decedent has retained a right to the income from the transferred property, Section 2036(a) provides an exception to inclusion if the transaction constitutes a "bona fide sale for an adequate and full consideration."

FUNDAMENTAL RULES OF PROP. REGS. RETAINED

The final Regulations adopt the basic rules of the Proposed Regulations.

First, the amount included under Section 2036(a)(1) where an annuity interest is retained is determined by dividing the annuity amount by the Section 7520 rate for the month of death. The amount included in the case of a unitrust interest requires that the unitrust percentage first be converted to its equivalent income interest rate, taking into account the frequency of the unitrust payments. The equivalent income interest rate is then divided by the Section 7520 rate for the month of death to determine the percentage inclusion.[2]

Second, the final Regulations confirm that Section 2039 (relating to certain annuity payments or payments made pursuant to a contract, such as a pension plan) does not apply to cause estate tax inclusion in a GRAT, GRUT, GRIT, CRUT, or CRAT.[3]

WHERE FULL VALUE IS RETAINED

Although at least one commentator contended that Section 2036(a)(1) can apply only to the extent that an annuity or similar payment could not be paid from corpus (and, therefore, must be paid from income), the final Regulations do not adopt that position. The Preamble to TD 9414 explains:

"The IRS and Treasury Department believe, based upon the broad statutory language in section 2036, as well as its legislative history and relevant case law, that under section 2036, every type of lifetime interest in property (annuity, income, use or enjoyment of the transferred property, etc.) retained for the requisite time period constitutes the retained possession and enjoyment of the transferred property or the income therefrom, causing inclusion of the transferred property in the transferor's gross estate. This is true regardless of the extent to which the retained interest is paid from the income or the corpus of the transferred property."

Hence, the fundamental approach taken by the Proposed Regulations is confirmed—the portion of a trust, which provides for annuity or unitrust payments to the grantor, that is included in the grantor's estate is based on the amount of corpus that would be necessary, using the principles set forth in Section 7520, to produce income equal to the annuity or unitrust payment, whether the payment is from income or corpus, or both.[4]

Bona Fide Sale Exception

As mentioned above, there is an exception to the application of Section 2036 for a transfer for full and adequate consideration in a bona fide sale or exchange. A commentator contended that the exception should apply where a GRAT is structured so the value of the remainder is zero because, in such a case, the grantor will have received in promised annuity payments an amount equal to the value of the property transferred to the trust.[5] Thus, an argument had been made that Section 2036 should not apply to a zeroed-out GRAT on the basis of the bona fide sale exception.[6] In present-value terms, the grantor does not deplete the estate by creating a zeroed-out GRAT.

In *Wheeler*, 116 F.3d 749, 80 AFTR2d 97-5075 (CA-5, 1997), which involved the sale of a remainder interest, the Fifth Circuit invoked the bona fide sale exception and therefore rejected the Service's Section 2036 argument. It did so on the ground that, in present-value terms, no depletion in the decedent's estate had occurred by reason of the sale: the sum of (1) the present value of the retained income interest and (2) the selling price the decedent received for the remainder equaled the value of the assets the decedent had contributed to the trust.

While other courts had also taken the approach taken by *Wheeler* in the context of a sale of a remainder interest,[7] the Fifth Circuit itself, along with other courts, has reshaped the contours of the bona fide

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1 Gans and Blattmachr, "Treatment of GRATs Under the Section 2036 Proposed Regulations—Questions Remain," 107 JTAX 143 (September 2007).

2 TD 9414, 7/11/08, also declares obsolete Rev. Rul. 76-273, 1976-2 CB 268, and Rev. Rul. 82-105, 1982-1 CB 133, which had provided the rules for inclusion under Section 2036(a)(1) for charitable remainder unitrusts and annuity trusts.

3 See Reg. 20.2039-1(e).

4 In fact, Reg. 20.2036-1(c)(2) systematically deleted the word "income" from the phrase "other income interest" and substituted "other interest" to confirm the intention to capture all retained interests whether payable from income or corpus.

5 The value of the remainder in a charitable remainder trust (CRT) under Section 664 must be at least 10% of the value of the assets contributed to the trust. Nevertheless, the Preamble to TD 9414 says that the new Section 2036 Regulations may apply to any CRT whether or not it is a qualified one under Section 664. It is possible to create a nonqualified CRT with a zero value remainder where the grantor retains in annuity payments all the value transferred to the trust but provides for a secondary annuity interest in someone other than a charity after his or her interest in the trust ends. As indicated in the text, however, the Preamble states that Section 2036(a)(1) still would apply.

6 See Whitty, "Heresy or Prophecy: The Case for Limiting Estate Tax Inclusion of GRATS to the Annuity Payment Right," 41 Real Prop. Prob. & Tr. J. 381 (2006).

7 See Estate of D'Ambrosio, 101 F.3d 309, 78 AFTR2d 96-7347 (CA-3, 1996); Estate of Magnin, 184 F.3d 1074, 84 AFTR2d 99-5227 (CA-9, 1999).

sale exception where taxpayers have sought to invoke it in order to avoid Section 2036 inclusion in the case of a family limited partnership (FLP).[8] In this latter context, the courts have read the exception to require not only that the decedent receive full consideration but also that there be a non-tax purpose for forming the partnership.[9] Thus, even assuming that the formation of the partnership does not result in depletion in the decedent's estate, the exception is nonetheless unavailable unless a non-tax purpose is established.

The Preamble to TD 9414 explicitly rules out the availability of the bona fide sale exception in the context of a zeroed-out GRAT. According to the Preamble, a distinction must be made between a sale, on the one hand, and the retention of an interest in transferred property, on the other. In a sale, where both parties bring their own consideration to the transaction, the exception is available. With a retained interest, in contrast, the exception is unavailable.[10] Since in the case of a GRAT no party other than the grantor furnishes any consideration, the Preamble concludes that the exception cannot apply:

"There is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a third party. In the bona fide sale, there is a negotiation and agreement between two parties, each of whom is the owner of a property interest before the sale; each uses his or her own property to provide consideration to the other in exchange for the property interest to be received from the other in the sale. When the transferor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property to a third party in exchange for an annuity because there is no other owner of property negotiating or engaging in a sale transaction with the transferor. The transferor, instead, is transferring the property subject to a retained possession and enjoyment of, or right to, the income from the property. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death, the property is subject to inclusion in the grantor's gross estate under section 2036."

Even where a decedent has retained a right to the income, there is an exception if the transaction constitutes a bona fide sale for adequate and full consideration.

As a policy matter, this does make sense in that it appropriately creates some downside risk for the zeroed-out GRAT: if death should occur within the annuity period, Section 2036 applies.[11] Were this not the case, the zeroed-out GRAT would provide taxpayers with upside planning potential and no offsetting risk—thus inappropriately making the strategy even more attractive than it is under current law. Nonetheless, it is somewhat difficult to square the Preamble with the Fifth Circuit's depletion analysis in *Wheeler*. In short, just as the courts have sought to reshape the exception in the case of family partnerships by creating the requirement of a non-tax purpose, so, too, the Preamble seeks to make *Wheeler's* depletion analysis unavailable in the case of a GRAT.

Hence, it seems there is no advantage under Section 2036(a)(1) to "zeroing out" the remainder in a GRAT by having the value of the retained annuity payments equal the amount transferred to the trust.[12]

POTENTIAL APPLICATION TO PRIVATE ANNUITIES AND ISGTs

Although not certain, it does not seem that the foregoing statement in the Preamble would suggest that the IRS believes that property transferred in a private annuity arrangement, for example, would be included in the annuitant's gross estate. If the arrangement has a third party (even a family member) as the obligor, it seems it would fall under the three-part rule of *Fidelity-Philadelphia Trust Co. v. Smith* that effectively negates the application of Section 2036 (although a private annuity seems to entail little negotiation, as the tax law generally dictates what must be paid to the annuitant in order to avoid certain "adverse" gift and income tax consequences[13]). Even if the obligor is a trust or other fund, the regulatory requirement that the trust or other fund have significant assets in addition to those received from the annuitant for the

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8 See Estate of Strangi, 417 F.3d 468, 96 AFTR2d 2005-6895 (CA-5, 2005); Estate of Bigelow, 503 F.3d 955, 100 AFTR2d 2007-6016 (CA-9, 2007); Estate of Korby, 471 F.3d 848, 98 AFTR2d 2006-8115 (CA-8, 2006); Estate of Abraham, 408 F.3d 26, 95 AFTR2d 2005-2591 (CA-1, 2005); Estate of Bongard, 124 TC 95 (2005).

9 *Id.* For more on the family limited partnership aspects of the exception, see Korpics, "Qualifying New FLPs for the Bona Fide Sale Exception: Managing *Thompson, Kimbell, Harper,* and *Stone,*" 102 JTAX 111 (February 2005); Hatcher and Manigault, "The Tax Court's 'Practical Control' Test in *Bongard*: More Than FLPs Are in the Balance," 102 JTAX 261 (May 2005).

10 See Ray, 762 F.2d 1361, 56 AFTR2d 85-6496 (CA-9, 1985) (making a similar distinction).

11 See Gans, "GRIT's, GRAT's and GRUT's: Planning and Policy," 11 Va. Tax Rev. 761 (1992).

12 Several other issues arise with respect to such a zeroed-out GRAT. See Blattmachr and Zeydel, "Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth," Tax Management Memorandum, 1/23/06, Vol. 47, No. 2; BNA Tax Management, 3/16/06, updated and republished in 41 Ann. Heckerling Inst. on Est. Plan. (2007) (hereafter, "Blattmachr and Zeydel") for a discussion of these issues and potential drafting solutions to some of them.

13 See Rev. Rul. 69-74, 1969-1 CB 43, for a description of a private annuity. Proposed Regulations promulgated in 2006 would change the income taxation of private annuities in some cases. (See Lederman, "Proposed Regulations on the Tax Treatment of Private Annuities Would Generally Make Them Unattractive," 106 JTAX 175 (March 2007).) By their terms, when finalized the private annuity Regulations generally will be retroactive to the date the Proposed Regulations were issued (10/18/06). See also Hesch, Katzenstein, Lane, and McGrath, "A Holistic Analysis of Private Annuities," 59 U.S.C. Gould School of Law Fed. Inst. on Tax'n ¶ 1800 (Matthew Bender & Co., 2007).

annuity payments[14] may suggest that it too would fall under the *Fidelity-Philadelphia* "exception."

On the other hand, it could be argued that, because that regulatory requirement merely assures that the trust or fund will be able to pay the annuity until the annuitant reaches the age of 110 years, the Preamble to TD 9414 might indicate that the Service will take the position that the assets in a trust or other fund will be included in the annuitant's gross estate.

The portion included in the estate is based on the corpus necessary, using the principles of Section 7520, to produce income equal to the annuity or unitrust payment.

Perhaps a "safer" course would be to have one or more individuals or entities guarantee the annuity payments to the annuitant regardless of how long the annuitant lives. There is then some likelihood these guarantors would have to use their resources (and not the assets transferred by the annuitant in exchange for the promise to pay the annuity for life). This might help establish that the *Fidelity-Philadelphia* "exception" should apply, negating the application of Section 2036(a)(1). The guarantee by the individuals or entities, however, presupposes that there is a likelihood that the fund or trust will be exhausted, paying all of its income and corpus to make the annuity payments. It seems that as long as the person in charge of the trust or other fund is another person (e.g., the trustee of a trust) that has its own property (even if its origin is the annuitant), Section 2036 should not apply. But the matter does not appear certain.

Special valuation rules. Section 2702, in general, treats a retained interest in a trust as having a zero value, thereby causing the entire value of property transferred to a trust to be subject to gift tax. What the statement in the Preamble does not address is when or whether Section 2702 could apply where the interest retained (e.g., an annuity) does not fall under the statutory exception in Section 2702(b) for a retained annuity interest (e.g., GRAT) or unitrust interest (e.g., GRUT).[15]

The Regulations under Section 2702 spell out detailed requirements in order for these exceptions to apply (such as prohibiting commutation or prepayment of the retained interest).[16] Such provisions are not typically incorporated in private annuity arrangements. In light of the statement in the Preamble, it may be prudent to incorporate these requirements in a private annuity arrangement, although arguably Section 2702 should not apply where the obligor under the arrangement has independent property that is liable to pay the annuity.[17]

It even is possible that the Preamble statement indicates that the IRS would take the position that a sale to a trust in exchange for a note[18] could cause the purchasing trust to be included in the grantor's estate under Section 2036 if the note owed to the grantor-seller is outstanding at his or her death. It would seem that the Preamble's apparent construction of the bona fide sale exception as requiring the purchaser to possess sufficient property to make the purchase independent of the property acquired in the sale is overbroad. Indeed, if the trust has assets in addition to those purchased, it would seem that the *Fidelity-Philadelphia* exception should apply, negating the application of the section.[19] Although not certain, that also would seem to block the application of Section 2702.[20]

POOLED INCOME FUNDS

A pooled income fund, defined in Section 642(c)(5), is a trust (although it need not be a trust under local law) maintained by a public charity, and which pays its income to one or more beneficiaries who have contributed (or for whom contributions have been made) to the trust. The remainder of the trust is irrevocably payable to or for the public charity that maintains the fund. A special type of charitable income tax deduction is permitted to the trust under Section 642(c)(3) and the contributors also are entitled to a deduction under Section 170 for the value of the remainder interest irrevocably transferred to the charity.

A commentator suggested that the Service explain the impact of the final Section 2036 Regulations on pooled income funds that have been in existence for more than three years compared to ones that have not been in existence for at least that time. The amount of the charitable deduction allowed to an individual for a contribution to a pooled income fund depends on the fund's estimated rate of return to the individual income beneficiaries, which in turn depends on whether the fund has been in existence for more than three years or for a shorter period.

As the Preamble to TD 9414 points out, however, whether the pooled income fund is mature or new the individual beneficiaries are in fact entitled to all of the fund's income. Thus, the maturity of the fund does not determine whether Section 2036(a)(1) applies. Rather, because all income must be paid to the contributor, the section will apply to any grantor entitled to income from the fund at death.

Indeed, the final Regulations add new Example 5 to Reg. 20.2036-1(c)(2)(iii), which explains that the amount included in the grantor's gross estate under Section 2036(a)(1)

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14 Reg. 25.7520-3(b)(2)(i).

15 Technically, the annuity and unitrust rules of Section 2702(b) are not exceptions but a special rule which, in essence, functions as an exception to the general "zero value" rule of Section 2702(a).

16 See Reg. 25.2702-3.

17 This is discussed in detail in Blattmachr and Zeydel, *supra* note 12.

18 That is, an installment sale to a grantor trust (ISGT). See generally Blattmachr and Zeydel, *supra* note 12, for a detailed description of such a sale and citations to articles that discuss it.

19 This is discussed in detail in Blattmachr and Zeydel, *supra* note 12.

20 This also is discussed in detail in Blattmachr and Zeydel, *supra* note 12.

is the FMV at the grantor's death[21] of the unit (or units) in the fund from which the grantor was entitled to the income. The final Regulations, however, do not provide any guidance as to how that FMV is determined. It would seem to be a pro rata portion of the entire fund—that is, if the grantor was entitled to 3% of the income from the fund at death, 3% of the FMV of the fund would be included in the gross estate under Section 2036(a)(1), although that is not spelled out in detail. Of course, if there is no successor to the grantor's interest in the fund, there would be no estate tax generated, presumably, by the inclusion, although it could have indirect ramifications for estate tax purposes.[22]

CHARITABLE REMAINDER IN A PERSONAL RESIDENCE OR FARM

Section 170(f)(3)(i) effectively permits a charitable deduction for the value of a donation to charity of a remainder interest in a personal residence or farm in which the donor retains the right to use the property until death (or for a term of years). Although a commentator asked that the final Regulations cover the "implications" for the charitable deduction if such a remainder has been transferred to charity but, on account of the retained use for life, is included in the donor's gross estate under Section 2036, the final Regulations do not address that issue. Example 2 has been added to Reg. 20.2036-1(c)(1), however, to confirm that, if the transferor transferred a personal residence to a third person while retaining the right to use the personal residence for life or for a term of years, and if the transferor died during that term, the FMV of the residence on the date of death is includable in the transferor's gross estate under Section 2036.

It seems appropriate that guidance be provided with respect to the impact on the charitable deduction for a gift to charity of a remainder interest in a farm or residence, as the commentator requested. Because the property would be included in the transferor's estate (as Example 2 confirms), it could generate estate tax that could be apportioned to the property if there were a second life tenant.

Suppose a wife gives a remainder interest in her residence to charity, retaining a life estate for herself and for her husband if he survives her. Whether or not the husband survives, the home will be included in her gross estate. It is possible that, if he survives her, the life estate she created for her husband in the residence might cause the home included in her estate to qualify for the estate tax marital deduction (for example, by election under Section 2056(b)(7) as QTIP property). Equally possible, however, is that it might not—the executor might fail to make the election or the husband might not be a U.S. citizen (meaning the marital deduction would be allowed pursuant to Section 2056A only if the home were placed in a qualified domestic trust). Hence, estate tax could be due on the value of the home when the wife dies and that tax could be apportioned to the home. That would reduce the amount that would pass to charity when the husband later dies.

In an analogous situation, the IRS concluded in Rev. Rul. 82-128, 1982-2 CB 71, that a trust does not qualify as a charitable remainder trust described in Section 664 unless the instrument requires that, in order for a successor unitrust or annuity interest to take effect, taxes be paid from another source. Although the Preamble dismisses the commentator's request by saying that the "calculation of the charitable deduction is beyond the scope of these final regulations," it seems a reasonable request, especially in light of that Revenue Ruling.

The same comment could be made with respect to a pooled income fund where some individual will succeed to the contributor's interest in the fund when the contributor dies. Indeed, in light of Rev. Rul. 82-128, it may be appropriate to have any person who would succeed to an interest in a pooled income fund or a farm or residence, the remainder of which has been contributed to charity, to agree to be responsible for any estate tax due on the interest at the grantor's death.

ALTERNATE VALUATION ISSUES

Under Section 2032, in some instances the executor may elect to value the decedent's estate for federal estate tax purposes on the alternate valuation date, which usually is six months after death. A commentator requested guidance on how the alternate valuation rules would work, including how payments made between date of death and the alternate valuation date are to be taken into account. For example, to what extent, if any, are payments to the grantor's estate from a GRAT added back to the value on the alternate valuation date?[23]

The Preamble acknowledges that the Section 7520 rate in effect on the alternate valuation date is used to determine the amount of the trust included in the estate but contends that all other issues more properly should be addressed by Regulations under Section 2032. Perhaps, consistent with Example 2 of Reg. 20.2036-1(c)(2)(iii), annuity payments to the estate, if made in kind from the assets of the GRAT, might be ignored under Section 2036 and Section 2032, and the entire GRAT as constituted on the date of death, taking into account only sales of assets or distributions out of the gross estate during the alternate valuation peri-

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21 Or, by implication, on the alternate valuation date if elected under Section 2032.

22 For example, it could affect whether the executor may elect special-use valuation for certain real property under Section 2032A and whether the executor may elect to defer the payment of estate tax pursuant to Section 6166. Also, if the public charity that maintained the fund lost its status as a charitable organization described in Section 2055 before the grantor died, it may be that no charitable deduction would be permitted for the interest in the pooled income fund included in the grantor's estate.

23 The same issue is raised with respect to GRUTs, CRATs, CRUTs, and pooled income funds. In each illustration in the Regulations, the issue is avoided because it is stated that the executor does not elect alternate valuation.

od, would be valued on the alternate valuation date.[24]

It would have been helpful to have the matter resolved by final Regulations but it seems that is unlikely to occur even when the Proposed Regulations under Section 2032 become final, because those Proposed Regulations do not address the issue directly.[25] It also is unfortunate that the Section 2036 final Regulations provide no example where the executor elected alternate valuation.

SPLIT-INTEREST CHARITABLE TRUSTS

Under Section 7520(a), a taxpayer may choose to value a deductible charitable interest in a split-interest transfer (that is, one where there are charitable and noncharitable interests, as in a pooled income fund or a charitable remainder trust) using the month of transfer or either of the two preceding months. Also, Reg. 20.7520-2(a)(2) provides that, if the executor elects alternate valuation, the executor may value the charitable interest using the Section 7520 rate for the month in which the alternate valuation date occurs or either of the two months preceding such alternate valuation date.

A commentator asked for guidance on how the election under Section 7520 to value the charitable interest in either of the two preceding months affects the amount included in the grantor's gross estate where the grantor is, for example, receiving an annuity or unitrust payment from a charitable remainder trust. The response in the Preamble seems confusing and that confusion is exacerbated by Example 3 in Reg. 20.2036-1(c)(2)(iii).

The Preamble states: "The choice as to the monthly interest rate to be used to determine the portion of trust corpus includible in [the decedent's] estate and the value of [the decedent's child's] continuing annuity interest present no issues under section 2036, and are addressed by section 7520." But neither Section 7520 nor its Regulations addresses how much is included in the grantor's gross estate.

It seems logical that whatever Section 7520 rate is used to determine the charitable deduction (which under the last sentence of Section 7520(a) also must be used to value all of the interests, including the noncharitable interests in the trust), the same interest rate should be used to determined what is included in the gross estate under Section 2036(a)(1). Otherwise, a different amount could be included in the grantor's gross estate than the amount of the combined charitable and noncharitable interests in the trust.

The Preamble does not foreclose that, and perhaps could be read as suggesting that result. But whatever the Preamble may be intending to relate, Example 3 of Reg. 20.2036-1(c)(2)(iii) presents confusion on the issue. In the example, the grantor died retaining a unitrust interest in a charitable remainder trust. The example states, in part, that "D's executor does not elect to use the alternate valuation date and, *as a result*, D's executor does not choose to use the section 7520 interest rate for either of the two months prior to D's death." (Emphasis added.) The use of the phrase "as a result" suggests that the executor is foreclosed in using the Section 7520 rate for either of the two months prior to the decedent's death. But that is contrary to the Code and Regulations.[26]

One clarification made by Example 3 is that, in determining the amount included, one must make an adjustment for the timing of payments from a charitable remainder trust. That is, a stated payout rate (e.g., a 5% unitrust payment) must be adjusted to take into account when during the year it is paid, as explained in Reg. 1.664-4(e)(3).

TERM OF YEARS CRTs

In response to requests for guidance, the final Regulations add a sentence to each of Examples 1 and 3 in Reg. 20.2036-1(c)(2), dealing with charitable remainder trusts in which the grantor retained payments for a term of years and died during such term. The examples conclude that inclusion occurs in such cases essentially as it would had the payments from the charitable remainder trusts been for life. That seems the correct conclusion because, as explained above, Section 2036(a)(1) applies if the interest is "retained for his life or for any period not ascertainable without reference to his death *or for any period which does not in fact end before his death.*" (Emphasis added.)

INCREASING ANNUITY PAYMENTS

Guidance was requested where the annuity payment from a GRAT is to increase and the grantor dies during the annuity term. Although the Preamble acknowledges such guidance "would be helpful and appropriate," it is stated that this area needs further consideration. It also will be

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24 This approach would appear to be supported by Prop. Reg. 20.2032-1(f)(3), which in general prohibits changes in value due to post-death events, other than market conditions, and provides in part: "The term post-death events includes, but is not limited to, a reorganization of an entity (for example, corporation, partnership, or limited liability company) in which the estate holds an interest, a distribution of cash or other property to the estate from such entity, or one or more distributions by the estate of a fractional interest in such entity."

25 Comments on Proposed Regulations under Section 2032 submitted by the American College of Trust and Estate Counsel on 7/22/08; see "Trust and Estate Lawyers Recommend Changes to Proposed Regs on Alternate Valuation Method Election," 2008 TNT 156-14.

26 Reg. 20.7520-2(a)(2) provides, in part: "If any part of the property interest transferred qualifies for an estate tax charitable deduction under section 2055 or 2106, the executor may compute the present value of the transferred interest by use of the section 7520 interest rate for the month during which the interest is transferred or the section 7520 interest rate for either of the 2 months preceding the month during which the interest is transferred. Paragraph (b) of this section explains how a prior-month election is made. The interest rate for the month so elected is the applicable section 7520 interest rate. If the executor elects the alternate valuation date under section 2032 and also elects to use the section 7520 interest rate for either of the 2 months preceding the month in which the interest is transferred, the month so elected (either of the 2 months preceding the month in which the alternate valuation date falls) is the valuation date."

helpful to provide guidance where the payments are to decrease, a technique likely to be used by many taxpayers as that may be the most efficient way to structure GRATs.[27]

WALTON-TYPE GRATs

Many GRATs and GRUTs are drafted as a trust for a fixed term of years (a term GRAT or a term GRUT) and provide for continuing payments to the grantor's estate if the grantor dies within the term, consistent with Reg. 25.2702-3(e), Example 5, in order to reduce the value of the taxable gift of the remainder interest.[28] The actuarial value of the right to receive post-death annuity payments might be includable in the grantor's gross estate under Section 2033. Nevertheless, Example 2 of Reg. 20.2036-1(c)(2) indicates, as does the Preamble in explaining that example, that the amount from a GRAT included under Section 2036(a)(1) does not depend on whether payments continue to be made after the grantor's death to the estate.

This is logical, because the inclusion under Section 2036 is the portion of the trust needed to support the annuity payments as if they were an income interest. The actuarial tables assume that the trust will earn at the Section 7520 rate each year, so the inclusion is of the portion of the principal that, under the tables, would support the annuity payments in perpetuity. It therefore would seem that the separate inclusion under Section 2033 of the annuity payments payable to the estate would be an impermissible "double counting."

It is likely, based on the "divide the payment due the grantor by the Section 7520 rate" approach for inclusion set forth in the Regulations, that the entire amount in a GRAT will be included in the grantor's gross estate under Section 2036(a)(1) because GRATs typically are short term (to avoid the risk of death during the annuity term triggering the application of the section) and the rate, as a percentage of value contributed to the trust, is large, in order to produce a very small value of the remainder that almost always will constitute a taxable gift.[29]

EXAMPLE: A taxpayer creates a GRAT that provides for her to receive two annual annuity payments on the anniversary of the creation of the trust equal to 53% of the value of the assets contributed to the trust. Even if the grantor dies when the Section 7520 rate is 11% (the highest it has ever been), the property in the trust would have to have grown by more than 480% in order for any of it to be excluded from the grantor's gross estate if she dies during the annuity term.[30]

Because no more than the amount in the trust at the grantor's death may be included in the gross estate under any estate tax inclusion provision, the treatment of post-death annuity (or unitrust) payments due the grantor's estate likely will be unimportant in almost all cases. Nevertheless, because some GRATs may be long-term with relatively low annuity payments, which may well result in some portion of the trust not being included under Section 2036(a)(1), it will be appropriate for guidance to be developed on the treatment of post-death payments required to be made to the grantor's estate, especially if those payments increase from year to year.

EXAMPLES AND THEIR PRINCIPLES

Example 2 of Reg. 20.2036-1(c)(1)(ii) involves a property owner who transfers her home to her child, retaining the right to use the residence for a term of years, and who dies during that term. The example concludes the entire value of the home is included in the transferor's estate and illustrates that Section 2036(a)(1) may apply to an outright transfer during life (as opposed to one in trust, for example) and even if the retained use is for a term of years (as opposed to a use for life), if the decedent dies during the term.

Example 1 of Reg. 20.2036-1(c)(2)(iii) involves the death of a grantor who transferred $100,000 to a charitable remainder annuity trust that was to pay the grantor and then the grantor's child $7,500 annually. The trust was worth $300,000 when the grantor died and the Section 7520 rate was then 6%. (The example recites that the executor did not elect alternate valuation.) The example concludes that $7,500 divided by .06, or $125,000 of the trust corpus, is included in the grantor's estate under Section 2036(a)(1).

The Preamble to TD 9414 explicitly rules out the availability of the bona fide sale exception in the context of a zeroed-out GRAT.

The example adds that the result would have been the same if the grantor had retained the annuity payments for a term of years that did not end before the grantor died. It also refers to Section 2038 (which applies to certain pre-death transfers over which a power to revoke is held at or within three years of death) if the grantor had retained the right to revoke the child's secondary annuity interest or to change the charitable remainder beneficiary of the trust. Unfortunately, the example does not explain what portion of the trust would be included in the grantor's estate under Section 2038 in those cases.

Example 2 of Reg. 20.2036-1(c)(2)(iii) involves the death of a

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27 As explained in Blattmachr, Hatcher, Weinreb, Weiss, and Zeydel, "Selected Comparisons of Selected Estate Tax Reduction Strategies," Fall 2007 ACTEC Annual Meeting Proceedings.

28 For background, see Walton, 115 TC 589 (2000). See also Notice 2003-72, 2003-2 CB 964.

29 This is explained in detail in Blattmachr Zeydel, *supra* note 12.

30 Computed as .53/.11 = 4.818. If the Section 7520 rate is lower, the value would have to grow even more substantially (e.g., .53/.06 = 8.833). If the annuity represents a small percentage of the amount contributed to the trust, the growth needed to result in some portion of the trust being excluded would be small (e.g., .15/.11 = 1.364).

Practice Notes

- Reg. 25.2702-3 spells out detailed requirements (such as prohibiting commutation or prepayment of the retained interest) in order for the exceptions to the special valuation rules to apply to a retained annuity interest. Such provisions are not typically incorporated in private annuity arrangements. In light of the statement in the Preamble distinguishing annuity-type transfers from bona fide sales, it may be prudent to incorporate these requirements in a private annuity arrangement, although arguably Section 2702 should not apply where the obligor under the arrangement has independent property that is liable to pay the annuity.
- In light of Rev. Rul. 82-128, it may be appropriate to have any person who would succeed to an interest in a pooled income fund or a farm or residence, the remainder of which has been contributed to charity, to agree to be responsible for any estate tax due on the interest at the grantor's death.

grantor who transferred $100,000 to a GRAT to pay the grantor $12,000 a year for ten years, the annuity to be made in monthly installments. Because the payments are to be made monthly (as opposed to, for example, at the anniversary of the creation of the trust), the annual payment is adjusted to $12,326.40. Thus, the amount included is $12,326.40/.06, or $205,440.

The example states that even if the annuity payments continued after the grantor's death to his or her estate, the portion of trust corpus includable in the grantor's gross estate still would be as calculated in the example. Although it is inviting to conclude that nothing additional is included in the grantor's gross estate on account of the estate's entitlement to continued annuity payments, it is possible that the conclusion is limited to the application of Section 2036(a)(1) as opposed to, for example, Section 2033 (relating to property owned by a decedent at death).[31]

Example 3 of Reg. 20.2036-1(c)(2)(iii) involves the death of a grantor who transferred $100,000 to a charitable remainder unitrust to pay to the grantor and, following the grantor's death, to the grantor's child, 6% annually, but in quarterly installments, of the value of the trust on December 15 of the year prior to payment. The example computes the amount of corpus necessary to yield the unitrust payments.

In this case, that amount is determined by dividing the trust's equivalent income interest rate by the Section 7520 rate (which was 6% at the time of the grantor's death; the example states that the executor did not elect alternate valuation). The example first adjusts the unitrust payout percentage to its equivalent income interest rate (which is the adjusted payout rate divided by [1 - the adjusted payout rate]). The adjusted payout rate reflects the quarterly payment of the unitrust amount in accordance with Reg. 1.664-4(e)(3), as mentioned above. That causes the equivalent income interest rate to be 6.141%. That payout is divided by the 6% Section 7520 rate in effect at the grantor's death, which means 102.35% of the trust would be included in the grantor's gross estate under Section 2036(a)(1).

The example concludes that, because the computation yields a result exceeding 100% of the trust, 100% is included. The example also concludes that, if the grantor had retained the right to a 3% unitrust payment, "then the amount included in D's estate would be the amount needed to produce a 3 percent unitrust interest." It would seem, though not entirely clear, that the amount would be determined by recomputing the trust's equivalent income interest rate using 3%, and thus would cause more than one-half the trust to be included. The example says the result would be the same if the trust were a GRUT rather than a CRUT.[32]

Example 4 of Reg. 20.2036-1(c)(2)(iii) involves the death of a grantor who transferred property to a GRIT to pay the income to the grantor for 15 years, at which time it would terminate in favor of persons who were not members of the grantor's family within the meaning of Section 2704(c)(2).[33] Because the grantor had retained the right to all income, the example concludes the entire trust is included in the grantor's estate under Section 2036(a)(1). The example adds that if the grantor had retained the right to 60% of the income, then 60% of the trust would be so included. The example states that the executor did not elect alternate valuation—it is uncertain why that statement is added.

Example 5 of Reg. 20.2036-1(c)(2)(iii) involves a transfer to a pooled income fund and is discussed above.

Example 6 of Reg. 20.2036-1(c)(2)(iii) involves a grantor who dies during the retained-use term of a QPRT described in Reg. 25.2702-5(c). The example concludes the entire value of the home is included in the grantor's estate. Again, for rea-

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31 See the prior discussion concluding that inclusion under Section 2033 would constitute "double counting."

32 Although the Preamble rejected a suggestion that the amount of the charitable deduction be "corrected" from what was in a similar example in the Proposed Regulations, and stated that it was not appropriate to determine the charitable deduction for purposes of the Section 2036 Regulations, the example nonetheless lists the child's age at the grantor's death as 55 years as well as the month and year of death, which seems irrelevant to the example's conclusions. It may mean, however, that the Service believes that the trust's qualification for a charitable deduction must be retested at the death of the grantor.

33 Apparently the reason the example states that the remainder beneficiaries are not members of the grantor's family, as so defined, is that under Section 2702 the entire value of the property transferred to the GRIT would be a taxable gift (and not just the actuarially determined value of the remainder) if the successors had been family members.

sons that are not clear at all, the example also states that the executor does not elect alternate valuation.

THE RMA RULING

In Rev. Rul. 2008-35, the IRS invoked Section 2036, as well as other theories, in concluding that valuation discounts would be inappropriate for a restricted management account (RMA). The Service was apparently anxious to close down this type of planning strategy. The Ruling raises provocative questions, however, and does not explain how Section 2036 and the final Regulations should apply.

In the Ruling, A executes an agreement with a bank, making a deposit of marketable securities and cash. The bank has the discretion to select an investment advisor to manage the assets. The agreement is to remain in effect for five years. During this period, no distributions are to be made from the account. When the period terminates, all assets under management are to be returned to A or A's estate. A is advised that the account's investment potential will be enhanced by giving the bank the exclusive right to manage the account for a fixed term.

The Service concludes that the restrictions under the agreement cannot be taken into account for estate or gift tax purposes. In other words, if A were to die or instead make an inter vivos gift of the account, the value would be determined without regard to the restrictions imposed by the agreement. The IRS reaches this conclusion on the basis of several, independent grounds.

First, the Service emphasizes that A retains sole ownership of the assets in the account. As a consequence, for both estate and gift tax purposes, the IRS reasons that the assets themselves should be valued without regard to the agreement or any restrictions it imposes. The Service goes on to say that, in substance, the arrangement is a management contract. It is analogous, the IRS says, to a pension or IRA account holding securities, in which case the full value of the securities are subject to transfer tax without any discount. Similarly, the Service maintains, it is analogous to the case where a person owning real estate grants management rights to a property manager, which—according to the IRS—should not produce a transfer-tax discount.

Second, the Service argues that, under Section 2703, the restrictions must be ignored for transfer tax purposes.

Third, on the assumption that A dies during the term of the agreement, the IRS invokes Section 2036. Reasoning from the premise that, under this section, the value of assets in a trust or entity are included in the gross estate without reduction on account of the trust's or the entity's structure, the Service concludes that the restrictions imposed by a management account must be similarly disregarded.

A critical difficulty with this Ruling is its conclusory nature. Unlike a Regulation, a Revenue Ruling receives deference in court only if it is well-reasoned and therefore persuasive.[34] Given its lack of analysis, the Ruling is not likely to be a valuable weapon in the Service's hands should the issue be litigated. Thus, it would not be surprising if the IRS eventually incorporated its conclusions in a Regulation in order to strengthen its position.

The deference issue aside, the Ruling raises interesting substantive questions. In *Estate of Hillgren*, TCM 2004-46, the decedent had granted her brother exclusive management rights with respect to a real estate investment. In valuing the investment for purposes of determining her estate tax, the court permitted a discount on account of the management contract. It did so on the ground that the decedent had a valid business purpose for giving her brother the management rights.

Surprisingly, the Ruling does not cite *Hillgren* or acknowledge its business-purpose test. To the contrary, it in effect claims that a management contract with respect to real estate cannot generate valuation discounts. Inasmuch as the Ruling does posit a non-tax purpose for the RMA (i.e., an enhanced return on the investments in the account), one is left to assume that the IRS disagrees with *Hillgren*—although it is plausible that the Service finds it distinguishable or simply overlooked it.

Given the Ruling's non-tax-purpose assumption, consideration might have been given to the applicability of the safe harbor in Section 2703. Under the safe harbor in subsection (b), the section is rendered inoperative if the agreement satisfies three conditions:

1. It is part of a bona fide business arrangement.
2. The arrangement is not a device to transfer the property to family members for less than full consideration.
3. The arrangement is comparable to arrangements made by parties acting at arm's length.

Since Rev. Rul. 2008-35 assumed the presence of a business purpose, it would have been helpful if the Ruling had gone on to explain why one of the safe harbor's other two conditions had not been satisfied.[35]

The Service's argument that the deposit of assets in the account does not change the nature of the property rights, and that therefore the value of the underlying assets must be used for transfer tax purposes, also raises questions. Consider a case where a deposit is made in a bank account and where the amount of the deposit exceeds the FDIC insurance limit. If, at the time of the depositor's death, the account still has not matured and the bank's creditworthiness has become seriously questionable, it would seem that the

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[34] See, e.g., Blattmachr, Gans, and Rios, *The Circular 230 Deskbook* (PLI, 2006); Gans, "Deference and the End of Tax Practice," 36 Real Prop. Prob. & Tr. J. 731 (2002); Gans and Soled, "A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference," 7 Fla. Tax Rev. 569 (2006). See also generally Schnee and Seago, "Deference Issues in the Tax Law: *Mead* Clarifies the *Chevron* Rule—or Does It?," 96 JTAX 366 (June 2002).

[35] Although Section 2703 uses the term "decedent" and therefore appears to target valuation for estate tax purposes only, the Tax Court recently applied it in the gift tax context. See Holman, 130 TC No. 12.

value of the account for estate tax purposes necessarily would take these factors into account.[36] In other words, the property interest to be valued for purposes of Section 2033 would be the account and not the assets in the account.

In invoking the recent cases involving securities held in an IRA or pension account, in which a lack-of-liquidity discount was denied,[37] the Service failed to consider the structure of Section 2039. Under this section, which controls in the case of pension or IRA assets, the amount includable is the value of the amount payable to the beneficiary. Thus, the section explicitly focuses not on the value of the underlying asset but rather on the value of what the beneficiary will ultimately receive. Denying a discount for lack of liquidity in the IRA or pension context makes some sense, given the statutory language. But since Section 2039 does not apply to an RMA, the Service's analogy to these cases raises additional questions.

Finally, the Service's Section 2036 analysis merits consideration. In the bank account example just posited, it does not seem that Section 2036 should apply. In other words, as suggested, it would seem that the valuation question would be how much a hypothetical seller and purchaser would agree upon as the appropriate price for the depositor's contract right. The conventional understanding of Section 2036 does not encompass this kind of contract. There are perhaps two reasons for rejecting the section in this context. First, it is questionable whether a transfer has occurred if the transferor receives back an asset having equal value. Second, given that it is an equal-value exchange, the section's bona fide sale exception would appear to be potentially relevant.

In the Section 2036 FLP cases,[38] both of these issues were initially critical. Under a consensus forged by the courts, the transfer of assets to a partnership or other entity is treated as a transfer for Section 2036 purposes even though the transferor receives in the exchange an interest in the entity that is commensurate with the value of the assets contributed.[39] The courts also largely agree, however, that if such an equal-value exchange of assets for an interest in the entity is motivated by a sufficient non-tax purpose, the bona fide sale exception makes Section 2036 inapplicable.[40]

If this same reasoning were applied to an RMA, it would seem at first blush that the non-tax purpose for entering into the arrangement might well suffice to trigger the exception. On the other hand, the Preamble to TD 9414 does suggest a possible rationale that the IRS could employ in response to a bona fide sale exception argument: that the exception does not apply where the transferor retains the transferred interest, as distinguished from the case where another person purchases the interest by supplying his or her own assets as the consideration. Under this rationale, it might be possible to distinguish the bank-deposit example from the RMA. In the latter situation, the person making the deposit retains the right to receive all of the return generated by the transferred assets. As a result, it might be appropriate to conclude that, despite the existence of a non-tax purpose, the exception is unavailable. In the former situation, in contrast, the depositor does not retain any rights with respect to the deposited funds. The bank's undertaking to repay with interest out of its own funds should not, on this analysis, be viewed as something retained by the depositor.

CONCLUSION

The final Regulations provide guidance and make important clarifications as to the amount of certain retained interest trusts and similar transfers included under Section 2036(a)(1) in the transferor's gross estate when he or she dies during the retained interest term, whether the retained interest is an income interest, the right to use property, or entitlement to an annuity or unitrust payment. In general, the amount included is determined by dividing the payout rate at death by the Section 7520 rate then in effect.

Unfortunately, the Regulations are incomplete in several respects, including covering increasing payments from GRATs and providing explicit rules with respect to continuing payments to the grantor's estate from a GRAT, GRUT, or other arrangement as to whether they are separately included in the grantor's gross estate—especially when alternate valuation is elected. Indeed, no guidance is provided at all where alternate valuation is elected. Also lacking is an explanation of how a charitable deduction may be affected by reason of the possible inclusion of the transferred property in the grantor's gross estate.

The Preamble may suggest that it will be appropriate to consider incorporating all of the requirements for GRATs into a private annuity arrangement. Although, under the Regulations, given the structure of most GRATs, it seems likely that the entire amount in a GRAT will be included in the grantor's gross estate if death occurs during the annuity term, it seems that shorter-term/high payout GRATs continue to be appropriate for consideration.

Additional questions about the application of the final Regulations to other arrangements such as restricted management accounts are also raised by Rev. Rul. 2008-35. The Service appears inclined to call all arrangements settled exclusively with the transferor's assets potential transfers with a retained interest falling outside the bona fide sale exception, and thus potentially subject to estate tax inclusion under Section 2036. ■

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36 See Reg. 20.2031-4 (indicating that the value of a loan must be determined by taking the creditworthiness of the borrower into account). See also GCM 36959, 12/20/76 (anticipating Rev. Rul. 79-340, 1979-2 CB 320, and indicating that a certificate of deposit should be analyzed as a note under Reg. 20.2031-4).

37 The Ruling cites Estate of Kahn, 125 TC 227 (2005), and Smith ex. rel. Estate of Smith, 391 F.3d 621, 94 AFTR2d 2004-6891 (CA-5, 2004).

38 See note 8, *supra*.

39 *Id.*

40 *Id.*