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Treatment of GRATS Under The Section 2036 Proposed Regulations - Questions Remain

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TREATMENT OF GRATS UNDER THE SECTION 2036 PROPOSED REGULATIONS—QUESTIONS REMAIN

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The lack of specificity in the Code regarding the estate tax treatment of a retained right to an annuity has resulted in uncertainty. New Proposed Regulations regarding the amount to be included in the gross estate would provide some clarification in the area they cover, but leave some issues in doubt.

[redacted] Proposed Regulations (REG-119097-05, 6/7/07) affect the portion of a trust included in the grantor's gross estate for federal estate tax purposes when the grantor dies during the term for which the grantor retained an interest. Of particular interest are the Proposed Regulations' inclusion rules where the interest retained is an annuity.

RETAINED INTEREST RULES

Section 2036(a)(1) provides that, where the 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 where the decedent retains the right to receive the income for life or for one of two other periods:

- For a period that does not in fact end before the decedent's death.
- 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, the section applies. If the decedent had 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 on the ground that the right was retained for a period that did not in fact end before death. Reg. 20.2036-1(b)(1)(ii) illustrates the not-ascertainable-without-reference-to-death rule. Assume that a father had created a trust under which his daughter was to receive the income for her life and the decedent was to receive the income following the daughter's death. The father is deemed to have retained an income interest not ascertainable without reference to his death. If the father predeceases his daughter, his estate must include the value of the trust's assets but is permitted to reduce the amount includable by the present value (at the date of the father's death) of the daughter's remaining income interest. If the father survives the daughter, Section 2036 applies and the reduction is not permitted.

SECTION 2036 AND ANNUITIES

Neither the Code nor any current Regulation addresses how Section 2036 should be applied where the decedent retains the right to receive an annuity, i.e., a fixed amount, rather than an income interest. The Supreme Court, however, has provided some guidance on this issue. In *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274, 1 AFTR2d 2151 (1958), the Court suggested in dicta that the retention of the right to receive an annuity would not cause Section 2036 to apply if three conditions were present:

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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.

This dicta implies 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 these three conditions are satisfied. The IRS embraced this dicta in Rev. Rul. 77-193, 1977-1 CB 273, where the decedent had sold an asset for an installment note. It concluded that because the purchaser had a personal obligation to make payments on the note, the payments were not dependent on the income the property generated in the hands of the purchaser. The payments therefore were not chargeable solely to the transferred property, and the decedent did not retain the right to receive the property's income. Thus, even though the decedent was still entitled to receive payments under the note at the time of death, Section 2036 did not require that the transferred property be included in the decedent's gross estate.

Supreme Court dicta implies that a decedent who makes a transfer and retains the right to receive an annuity may be subject to Section 2036 unless three conditions are met.

By contrast, in *Estate of Becklenberg*, 31 TC 402 (1958), *rev'd* 273 F.2d 297, 5 AFTR2d 1821 (CA-7, 1959), the Service maintained that the contribution of property by the decedent to a trust in exchange for a $10,000 annuity did not satisfy the criteria in the dicta because no one undertook a personal obligation to make the payments to the decedent. The Tax Court agreed with the IRS and held that the portion of the trust's corpus necessary to produce the $10,000 annuity was included in the decedent's estate.

The Seventh Circuit reversed and refused to include any of the trust's assets in the decedent's gross estate. It concluded that the estate did satisfy the criteria in the dicta in *Fidelity-Philadelphia Trust.* According to the Seventh Circuit, the obligation to make the annuity payments to the decedent was not chargeable solely to the property transferred by the decedent or to the income it would produce. To the contrary, the decedent was one of three grantors and had contributed only approximately 26% of the total amount contributed to the trust. Thus, by reason of the contribution of the others to the trust, under the dicta, the decedent could not be viewed as having retained a right to receive income from the property she had transferred to the trust.[1]

BONA FIDE SALE EXCEPTION

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." In *Wheeler*, 116 F.3d 749, 80 AFTR2d 97-5075 (CA-5, 1997), for example,[2] the decedent transferred a remainder interest for a consideration equal to the value of the transferred interest while retaining the income interest. The court held that, because the consideration received by the decedent was equal to the value of the transferred remainder interest, it was a bona fide sale, and therefore Section 2036 did not apply even though the decedent had retained a right to the income.[3]

Thus, where a transfer is made in exchange for an annuity, the estate may be able to defeat the application of Section 2036 in one of two ways:

- By showing that the conditions contained in the dicta in *Fidelity-Philadelphia Trust* are satisfied and that the decedent should therefore not be viewed as having retained an income interest; or

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[1] Given the outcome in Estate of Becklenberg, 31 TC 402 (1958), *rev'd* 273 F.2d 297, 5 AFTR2d 1821 (CA-7, 1959), and its reading of the dicta in Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274, 1 AFTR2d 2151 (1958), an exchange of property for a private annuity with a trust should not trigger Section 2036 if the trust contains a minimum amount of assets other than the property transferred to the trust in exchange for the annuity. Similarly, even if the trust's only assets are those it receives from the decedent in the sale, the dicta should preclude application of the section if the trust's obligation to make payment to the decedent is guaranteed by a third party having sufficient wealth to make good on the guarantee. For example, in Security Tr. & Sav. Bank, 11 BTA 833 (1928), a case cited by the Supreme Court to illustrate how the dicta should be applied, the Board of Tax Appeals refused to include an asset in the decedent's estate that he had sold to a corporation in exchange for the corporation's promise to pay and a guarantee by a third party. No developed law definitively states that the trust must have assets other than those received in exchange for the annuity. Indeed, the dicta would appear to be irrelevant when the annuity is set at an amount that is not anticipated to equal the income from the transferred property. See Ray, 762 F.2d 1361, 56 AFTR2d 85-6496 (CA-9, 1985). This is largely academic, however, as Reg. 25.7520-3 requires that, in order to avoid making a gift where an asset is transferred to a trust for a private annuity, the trust must have sufficient assets to pay the annuity in full until the measuring life reaches the age of 110 years. For a suggestion that a guarantee might be disregarded where the guarantor has insufficient wealth, see Estate of Fabric, 83 TC 932 (1984), fn. 6.

[2] See also Estate of D'Ambrosio, 101 F.3d 309, 78 AFTR2d 96-7347 (CA-3, 1996), and Estate of Magnin, 184 F.3d 1074, 84 AFTR2d 99-5227 (CA-9, 1999); but see Gradow, 897 F.2d 516, 65 AFTR2d 90-1229 (CA-F.C., 1990).

[3] In Wheeler, 116 F.3d 749, 80 AFTR2d 97-5075 (CA-5, 1997), the court applied the bona fide sale exception without making any inquiry as to the decedent's purpose in entering into the transaction. In Strangi, 417 F.3d 468, 96 AFTR2d 2005-5230 (CA-5, 2005), however, the court held that, at least in the context of a family limited partnership (FLP), the exception does not apply in the absence of a "substantial business or other non-tax purpose" for forming the entity. In thus limiting its decision in Wheeler, the Fifth Circuit in Strangi raises a question about the circumstances in which such a non-tax purpose must be established in order to invoke the exception. For more on the issues in the FLP context, see generally Mezzullo, "IRS Finally Wins a FLP Case on Appeal Where the Taxpayer Failed to Establish Business Purpose," 101 JTAX 217 (October 2004), and Korpics, "Qualifying New FLPs for the Bona Fide Sale Exception: Managing *Thompson, Kimbell, Harper,* and *Stone,*" 102 JTAX 111 (February 2005).

- By showing that the transaction falls within the bona fide sale exception.

Where the decedent had made a transfer and retained the right to receive an annuity that triggered Section 2036, it was necessary to determine the amount includable. The Regulations are clear that, if the decedent retains the right to all of the income from the transferred property, the entire value of the transferred property is included in the gross estate under Section 2036.[4] The Regulations are similarly clear that, if the decedent retains the right to receive only a portion of the income from the transferred property, only the corresponding portion of the transferred property is includable.[5]

> **In the context of an annuity, the Tax Court created an income-equivalence test based on the income factor contained in the tables in the Regs.**

Applying this valuation approach in the context of an annuity, the Tax Court created an income-equivalence test based on the income factor contained in the tables in the Regulations. In *Estate of Pardee,* 49 TC 140 (1967), *acq.,* the decedent was entitled, as trustee, to use income from a trust that he had funded to discharge his child-support obligation under a divorce decree in the amount of $6,000 per year.[6] The court held that the portion of corpus necessary to produce annual income of this amount was includable. Using the 3.5% assumed rate of return under the tables then in effect,[7] the court concluded that the amount includable under Section 2036 was $174,000 (dividing the annual annuity of $6,000 by the 3.5% table rate).[8]

The Tax Court considered but rejected the possibility of limiting the inclusion amount to the present value of the decedent's remaining support obligation at the time of his death (i.e., to the amount necessary to fund the child-support obligation until the children reached the age of 18). The court's conclusion appears to be correct. To illustrate, assume that a grantor of a trust retains the right to receive the income for two years and then dies within the two-year period. The amount includable under Section 2036(a)(1) is the entire corpus.[9] By a parity of logic, the same result should be reached where the grantor retains the right to receive an annuity for a limited period and then dies within the period.

Nonetheless, it is certainly arguable that, where the transferor retains the right to receive a fixed amount for a fixed period, the transfer is not testamentary in substance and therefore should not be subject to Section 2036. For example, if the grantor retains the right to receive one annuity payment one year after the creation of the trust, treating the arrangement as testamentary in substance seems difficult to justify. On the other hand, in the case of a GRAT, where (as will be discussed) taxpayers have the opportunity to transfer wealth tax free, it may well be appropriate to offset this advantage by making Section 2036 applicable if the grantor should die during the term of the annuity. Such an offset may be proper as a matter of policy even though, as in the case of most GRATs, the grantor retains the right to receive a fixed sum for a short period and the transaction therefore does not have the kind of strong testamentary flavor that Section 2036 normally targets.[10]

> **IRS acknowledges that the amount of the inclusion can never exceed the value of the entire corpus on the valuation date, which of course makes sense.**

In Rev. Rul. 82-105, 1982-1 CB 133, relying largely on *Pardee*[11] and an earlier Revenue Ruling involving the retention of a unitrust interest,[12] the Service applied the same analysis to a charitable remainder annuity trust. In the Ruling, the decedent had funded the trust with $200*x*, re-

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4 See Reg. 20.2036-1(a).

5 *Id.* Nevertheless, the IRS has deviated from these Regulations. In Rev. Rul. 2004-64, 2004-2 CB 7, the Service ruled that the entire trust corpus is includable under Section 2036(a)(1) where the grantor retains the right to receive from the trust the amount of income tax the grantor incurs on the trust's income by reason of its grantor-trust status. Since the income tax on the trust's income must be less than the income itself, a faithful application of the Regulation should result in an inclusion that is less than the entire corpus. For a further discussion of this Ruling, see Gans, Heilborn, and Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," 14 Estate Planning 467 (October 2004).

6 See Reg. 20.2036-1(b)(2) (indicating that the retention of the right to use trust income to discharge the grantor's support obligation is sufficient to make Section 2036(a)(1) applicable).

7 In applying the table rate under the Regulations, the court emphasized that the estate failed to show that the use of the table rate was so unrealistic or unreasonable to warrant a different valuation methodology. For a discussion of an alternative methodology for applying Section 2036 in the context of a retained annuity, see Gans, "GRITs, GRATs and GRUTs: Planning and Policy," 11 Va. Tax Rev. 769 (1992).

8 See also United States Nat'l Bank of Portland, 188 F. Supp. 332, 6 AFTR2d 6179 (DC Ore., 1960), which was cited by the Tax Court (applying the same valuation methodology).

9 See, e.g., Nicol's Estate, 56 TC 179 (1971) (applying Section 2036(a)(1) where the grantor had retained the right for a five-year period and then died within that period—indicating that the provision in the Regulations under the 1939 Code to the effect that no such inclusion would be appropriate unless the grantor contemplated death within the period is not included in the existing Regulations).

10 For a further discussion of this issue, see Whitty, "Heresy or Prophesy: The Case for Limiting Estate Tax Inclusion of GRATs to the Annuity Payment Right," 41 Real Prop. Prob. & Tr. J. 381 (2006) (responding to a critique by Lawrence P. Katzenstein of an earlier article by the author and maintaining, contrary to Mr. Katzenstein's position, that only the present value of the outstanding annuity payments should be included in the grantor's estate).

11 The Service also analogized to cases involving the computation of the marital deduction where the spouse was given an annuity interest instead of an income interest. See Northeastern Pennsylvania Nat'l Bank & Tr. Co., 387 U.S. 213, 19 AFTR2d 1874 (1967); Citizens Nat'l Bank of Evansville, 359 F.2d 817, 17 AFTR2d 1416 (CA-7, 1966), *cert. den.*

12 See Rev. Rul. 76-273, 1976-2 CB 268.

taining the right to receive an annuity of \$12*x* for life. At the date of death, the value of the trust's corpus was \$300*x*. Using the same income-equivalence analysis the court applied in *Pardee*, the IRS concluded that \$200*x* was includable in the decedent's estate under Section 2036(a)(1), being the corpus necessary to produce an annuity of \$12*x* using the 6% rate of return that the tables then assumed (\$12*x* divided by 6% = \$200*x*).[13]

The GRAT is not free from risk—should the grantor die before the termination of the annuity interest, the assets in the GRAT are subject to inclusion.

Two observations should be made about Rev. Rul. 82-105. First, the Service acknowledges that the amount of the inclusion can never exceed the value of the entire corpus on the valuation date. This, of course, makes sense in that Section 2036 is designed to bring a transferred asset back into the transferor's estate, not to create an inclusion beyond the transferred amount. Second, the IRS intimates that inclusion also might be appropriate under some other Code provision—presumably Section 2039[14]—and that the amount of the inclusion might, as a result, be different from the inclusion amount under Section 2036.

GRATs AND ESTATE TAX INCLUSION

With the 1990 enactment of Section 2702, taxpayers began creating arrangements described in Section 2702(b), commonly called grantor retained annuity trusts or GRATs.

In a GRAT, the grantor retains the right to receive an annuity for a fixed period. Properly structured, the value of the taxable gift made in a GRAT is equal to the value of the property transferred to the trust reduced by the actuarial value of the annuity interest retained by the grantor. At the expiration of this period, the remainder passes to the grantor's descendants or other beneficiaries (or to a trust or trusts for their benefit). If the assets in the GRAT produce a sufficient return, wealth passes to the remainder beneficiaries on the termination of the grantor's annuity interest—with the grantor having made a small or no taxable gift.[15] Thus, the GRAT permits the possible transfer of wealth on a tax-free (or nearly tax-free) basis.

Nevertheless, the GRAT is not free from risk. First, if, as suggested, the assets in the GRAT produce an insufficient return, no wealth will be transferred to the remainder beneficiaries. Second—and most critical in terms of this article—should the grantor die before the termination of the annuity interest, the assets in the GRAT are subject to inclusion in the grantor's gross estate.

Despite the wide popularity that GRATs have enjoyed, Treasury and the IRS did not—until now—issue any published guidance on the estate tax treatment of these trusts. Instead, the Service argued in nonpublished guidance that, where the grantor dies during the annuity term, Sections 2036 and 2039 apply.[16] In applying Section 2036, the IRS relied on the methodology it applied in Rev. Rul. 82-105, determining the amount of corpus necessary to produce the annuity. Unlike the Revenue Ruling, however, the Service used the Section 7520 rate in its calculation (Section 7520 had not been enacted at the time Rev. Rul. 82-105 was issued). Acknowledging that the Section 2036 calculation might lead to inclusion of less than the entire corpus, the IRS went on to apply Section 2039. In doing so, the Service concluded that, under Section 2039 the value of the entire corpus must be included.

In the Prop. Regs., Treasury and the IRS have expanded the Section 2036 methodology contained in Rev. Rul. 82-105, making it applicable to GRATs.

At first blush, the Service's Section 2039 theory appears to be rather problematic from the taxpayer's perspective in that, unlike Section 2036, it always requires full inclusion of the GRAT's corpus. As a practical matter, however, there often is not much difference in the application of these two sections in the context of a GRAT. That is because, in most GRATs, the annuity term is rather short (perhaps two years) and, in order to minimize the value of the remainder (i.e., the taxable gift), the annuity amount is rather high in relation to the value of the contributed assets. As a result, if the grantor's death occurs during the annuity term, the entire value of the GRAT's corpus is included under Section 2036, thus rendering the Service's Section 2039 contention superfluous.

THE PROPOSED REGULATIONS

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13 Because, in the Ruling, the charity received the remainder on the death of the grantor, the estate was concomitantly entitled to a charitable deduction under Section 2055 for the entire \$200*x*. Had the trust provided for a noncharitable annuity after the decedent's death, the charitable deduction would not, of course, have fully offset the inclusion.

14 Section 2039 provides that a decedent's gross estate includes the value of an annuity or other payment under any form of contract or agreement (other than a policy of insurance on the decedent's life) receivable by any beneficiary by reason of surviving the decedent if, under the contract or agreement, an annuity or other payment was payable to the decedent or if the decedent possessed the right to receive the annuity for life, for a period not ascertainable without reference to the decedent's death or for a period that does not, in fact, end before the decedent's death.

15 But see TAM 200245053 (indicating that the Preamble to the Section 2702 Regulations contemplates that a GRAT cannot be zeroed out, i.e., that the value of the remainder, determined at inception, must be greater than zero or the grantor's retained annuity is not a qualified interest and therefore the grantor is treated as making a taxable gift at inception equal to the value of the assets contributed to the GRAT).

16 See, e.g., TAM 200210009.

applicable to GRATs.[17] Thus, under the Proposed Regulations, where the grantor of a GRAT dies during the annuity term, the amount includable is to be calculated under an income-equivalence test: the amount includable will equal the amount of corpus necessary to produce the annuity based on the Section 7520 rate in effect on the valuation date. And, as Rev. Rul. 82-105 indicates, the inclusion amount cannot exceed the value of the corpus.

On the other hand, the Proposed Regulations disavow the Section 2039 argument that the Service had previously advanced in nonpublished guidance.[18] Given the fact that the Proposed Regulations do little more than confirm the Service's previous Section 2036 position and disavow the Section 2039 argument with which it had previously flirted, one might wonder why the government felt the need to incorporate its position in Regulations rather than a Revenue Ruling. Presumably, with Regulations receiving greater deference than Revenue Rulings in the courts,[19] the government concluded that the Regulations would accomplish a definitive resolution of the issue.

One might wonder why the government felt the need to incorporate its position in Regulations rather than a Revenue Ruling.

Surprisingly, the Proposed Regulations do not explicitly address the possible application of the bona fide sale exception in the case of a GRAT. Thus, taxpayers may be able to argue that, despite the Regulations, Section 2036 does not apply where the bona fide exception has been satisfied. To be sure, where the GRAT is not zeroed out—that is, the value of the assets the grantor contributes to the trust exceeds the value of the grantor's retained annuity interest—it cannot be maintained that the grantor had received full and adequate consideration. As a result, the exception presumably would not be available. But where the GRAT is zeroed out—despite the Service's unofficial position that, for gift tax purposes, a GRAT cannot be zeroed out,[20]—the exception might be available. For in a zeroed-out GRAT, the grantor does receive a consideration equal in value to the contributed property.[21] And while the courts have begun to require taxpayers to establish a non-tax purpose in order to defeat Section 2036 in the FLP context,[22] the courts have not thus far imposed such a requirement in applying the bona fide sale exception in Section 2036 in other contexts.[23]

WALTON GRATs

Given the popularity of *Walton* GRATs,[24] it also is surprising that the Proposed Regulations fail to address affirmatively—let alone illustrate—how they should be treated for estate tax purposes. In a *Walton* GRAT, in the event of the grantor's death during the annuity term, the remaining annuity payments are payable to the grantor's estate.[25] The Proposed Regulations fail to address the estate tax treatment of the post-death payments. After indicating that Section 2036 applies, they suggest the possibility that other Code sections also might apply "in appropriate circumstances beyond those described in these proposed regulations."[26] This raises the question whether Section 2033 should apply to the post-death payments.

EXAMPLE: The grantor creates a *Walton* GRAT, retaining the right to receive an annuity of $100 for three years and the right to have her estate receive any remaining annuity payments should death occur during the annuity term. If the grantor dies after having received the first year's annuity payment, the Section 2036 inclusion under the Proposed Regulations is determined by dividing the annuity amount of $100 by the Section 7520 rate in effect on the valuation date. If the Section 7520 rate at the date of death is 5%, the Section 2036 inclusion would be $2,000. If, however, the value of the GRAT's corpus at the time of death is only, say, $400, the amount includable under Section 2036 is $400 (the Section 2036 inclusion is never greater than the value of the corpus on the valuation date).

The question the Proposed Regulations do not address is whether the

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17 The Proposed Regulations similarly make the calculation used in the charitable remainder unitrust in Rev. Rul. 76-273, *supra* note 12, applicable where the grantor retains a unitrust interest in a noncharitable trust.

18 In disavowing Section 2039, the Proposed Regulations make clear that taxpayers will not be permitted to make the Section 2039 argument. See Prop. Reg. 20.2036-1(c)(2)(ii), Examples 1 and 2, and Prop. Reg. 20.2039-1. In taking this position, the Proposed Regulations implicitly recognize that an inclusion under Section 2039 could produce a tax benefit for taxpayers in the form of the marital deduction. See Section 2056(b)(7)(C).

19 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).

20 See TAM 200245053.

21 But see Ray, *supra* note 1 (distinguishing between a retention and a sale for Section 2036 purposes and concluding that the decedent had retained an interest rather than having made a bona fide sale). Also, while in general the tax treatment of a transaction of course is determined by its substance rather than its form, the taxpayer is not permitted to argue that the chosen form should be disregarded on the ground that it is inconsistent with its substance. See National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 33 AFTR2d 74-1347 (1974).

22 See, e.g., Strangi, *supra* note 3.

23 See *id.*, fn. 9 (suggesting that, under the court's earlier decision in Wheeler, *supra* note 3, no showing of non-tax purpose may be necessary where a taxpayer seeks to invoke the bona fide sale exception in Section 2036 outside of the FLP context).

24 See Reg. 25.2702-3(e) (treating as a qualified interest the entire retained annuity even where it is payable to the grantor's estate in the event of the grantor's death during the annuity term).

25 See *id.* (embracing Walton, 115 TC 589 (2000), *acq.* Notice 2003-72, 2003-2 CB 964).

26 See the Preamble to REG-119097-05, 6/7/07.

estate must include under Section 2033, in addition to the $400 inclusion under Section 2036, the value of the right to receive the two additional annuity payments to be paid to the grantor's estate. Although one might be inclined, on a cursory analysis, to conclude that Section 2033 should apply in the suggested manner, this would result in double taxation. The amount of the Section 2036 inclusion represents the value of that portion of the corpus necessary to produce the annuity payments for an indefinite duration (and, of course, the value of the right cannot exceed the value of the corpus). If the post-death payments were included under Section 2033, in addition to the Section 2036 inclusion amount, the same corpus would be taxed twice. Thus, to prevent double taxation the final Regulations should provide that Section 2033 does not apply in this context.

ACCELERATING GRATs

Another popular GRAT strategy that the Proposed Regulations fail to address is the accelerating GRAT, i.e., a GRAT where the annuity payments increase each year.[27] In a non-accelerating GRAT, the annuity amount remains constant, resulting in a straightforward Section 2036 calculation. But what if the amount of the annuity increases each year? Which annuity amount should be used in calculating the inclusion?

Example: A taxpayer creates a GRAT, retaining the right to an annuity of $100,000 at the first anniversary, $120,000 on the second anniversary, and $144,000 on the third anniversary, when the trust will end.[28] The grantor dies in the second year, immediately after having received the first annuity payment, when the trust is worth $2 million and the Section 7520 rate is 7.2%. (Alternate valuation is not elected.) Under the Proposed Regulations, there is no indication as to the appropriate treatment of such an accelerating GRAT.

Under the existing Regulations, where a grantor retains an income interest that is contingent on surviving the current income beneficiary, she is treated as having retained an income interest in the entire corpus even if she predeceases the current income beneficiary.[29] Indeed, even if the grantor retains the right to receive income for a single day following the current income beneficiary's death and the grantor dies first, she is treated as having retained the right to the trust's entire income for Section 2036 purposes. In other words, where the portion of the trust's income the grantor is entitled to receive escalates over time, the inclusion amount is determined on the basis of the grantor's greatest entitlement even if the grantor dies earlier. The existing Regulations provide, however, that where such an outstanding interest is "actually being enjoyed" at the time of the grantor's death, the present value of the outstanding interest may be subtracted from the value of the corpus in determining the Section 2036 inclusion amount.[30]

If the treatment of an accelerating GRAT under the Proposed Regulations is to remain consistent with the existing Regulations, it would seem that the Section 2036 calculation in the example above should be based on the final annuity payment of $144,000 (i.e., the grantor's greatest entitlement). Furthermore, as for an outstanding income interest, a subtraction should be permitted in determining the inclusion amount to reflect the fact that neither the grantor nor the grantor's estate will receive $144,000 for the second year (assuming it is a *Walton* GRAT, the grantor's estate will receive $120,000 for the second year and $144,000 for the third year). In other words, if the subtraction methodology contained in the existing Regulations is applied, the inclusion amount must be reduced by the present value of the right to receive $24,000 (i.e., a subtraction should be authorized because someone other than the grantor will in fact receive this $24,000, with the grantor's estate re-

Practice Notes

The Proposed Regulations have proposed effective dates that are more complicated than usual. According to the Preamble, the first, second, and fourth sentences in Prop. Reg. 20.2039-1(a) and the provisions in Prop. Regs. 20.2036-1(a)(1), (a)(2), and (c)(1)(i) are applicable to the estates of decedents dying after 8/16/54. The fifth sentence of Prop. Reg. 20.2039-1(a) is applicable to the estates of decedents dying after 10/26/72, and to the estates of decedents for which the period for filing a claim for credit or refund of an estate tax overpayment ends after 10/26/72. The provisions of Prop. Regs. 20.2036-1(c)(1)(ii) and (2), 20.2039-1(e), and the third, sixth, and seventh sentences of Prop. Reg. 20.2039-1(a) apply to the estates of decedents for which the valuation date of the gross estate is on or after the date of publication of the Treasury Decision adopting these rules as final Regulations in the *Federal Register*.

In terms of the future, the Proposed Regulations eliminate the threat that Section 2039 may be applied to GRATs. As a practical matter, however, in most cases full inclusion will nonetheless occur under Section 2036 should the grantor die during the annuity term.

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27 Reg. 25.2702-3 provides that an annuity will constitute a qualified interest for purposes of Section 2702 if it remains constant or increases by no more than 20% each year.

28 If the annuity amount increases by more than 20%, it will not be a qualified interest for purposes of Section 2702. See *id.*

29 See generally Reg. 20.2036-1 and in particular Reg. 20.2036-1(b)(1)(ii).

30 See Reg. 20.2036-1; see also Reg. 20.2036-1(b)(1)(ii) (indicating that the subtraction is permitted where another person "was in fact enjoying the income at the time of the decedent's death").

ceiving only $120,000 for the second year).

It must be conceded, however, that the suggested subtraction for the accelerated GRAT is not entirely consistent with the existing Regulations. For, unlike the outstanding income interest under the existing Regulations, the $24,000 that will inure to the benefit of a beneficiary other than the grantor is not "actually being enjoyed" by that beneficiary at the time of the grantor's death (it will instead be held in the trust and pass along with the remainder when the GRAT term ends).

Nonetheless, it would seem that as a matter of policy less than the entire corpus of the GRAT should be included in the grantor's gross estate when inclusion is based on the amount of increased annuity payments due in the future that will in fact inure to the benefit of a beneficiary other than the grantor. It is possible for the final Regulations to authorize a subtraction without altering the "actually being enjoyed" requirement. The final Regulations could instead provide that, for an accelerating GRAT, an adjustment must be made to reflect the fact that, in the example above, $24,000 does not pass back to the grantor.

To illustrate, when the grantor in the example died, the trust was worth $2 million and the Section 7520 rate was 7.2%. Thus, the trust would be deemed to be earning $144,000 in income in the year the grantor died. The grantor, however, was entitled to receive only $120,000 in that year. Hence, $24,000 of income would be added to the "corpus" and make the trust worth $2,024,000 at the end of the following year. Because the $144,000 annuity would represent only 98.81% of the $145,728 in income that would be projected to be earned on a trust of $2,024,000 (assuming a 7.2% earning rate), arguably that same percentage should be applied to determine the portion of the date-of-death value to be included. Therefore, only 98.81% of the $2 million trust, or $1,976,285 of the GRAT, should be included in the grantor's gross estate.

PRIVATE ANNUITIES

The Proposed Regulations do not provide any substantive guidance concerning the estate tax treatment of private annuity transactions. They do, however, intimate that Section 2036 may apply in this context if the decedent had retained an interest in the property given in exchange for the annuity.[31] Although the text of the Proposed Regulations provides no further clarification on this issue, it would seem that Treasury and the IRS intend to continue applying the Supreme Court's dicta in *Fidelity-Philadelphia Trust* in determining whether the property transferred in a private annuity should be included in the gross estate under Section 2036.[32]

CONCLUSION

The Proposed Regulations largely embrace existing law on the application of Section 2036 to GRATs where the grantor dies during the annuity term. At the same time, however, they disavow the Section 2039 argument that the Service had made in non-published guidance. Nonetheless, given the practical reality that most GRATs are short-term in duration and therefore tend to set a high annuity relative to the value of the contributed assets, full inclusion of the corpus typically will result under the Section 2036 methodology. It would be helpful if, in the final Regulations, clarification is provided with respect to the treatment of *Walton* GRATs and accelerating GRATs. It also would be helpful if the final Regulations definitively clarified whether or not the bona fide sale exception applies in the case of a GRAT. ■

NOTES

31 The Preamble contains the following parenthetical: "For example, although section 2039 generally will apply to govern the includability of annuities purchased by or on behalf of the decedent and annuities provided by the decedent's employer in the decedent's gross estate, section 2036 may instead be applied if the facts and circumstances indicate that the annuity constituted a retained interest in the property exchanged for that annuity."

32 But see GCM 39503, 5/19/86 ("A private annuity also should not be included in the transferor's gross estate for Federal estate tax purposes").