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Private Annuities and Installment Sales: *Trombetta* and Section 2036

BY MITCHELL M. GANS AND JONATHAN G. BLATTMACHR

The Tax Court's reasoning in a recent case calls for a new look at the Supreme Court's 1958 holding in *Fidelity-Philadelphia* interpreting Section 2036. The authors suggest that *Fidelity-Philadelphia* also must be taken into account in determining the applicability of Section 2702 in the context of installment sales and annuity transactions.

In *Estate of Trombetta*, TCM 2013-234, the Tax Court held that Section 2036 applied to a private annuity transaction between the decedent and her grantor trust. As a result, the trust's assets were includable in the decedent's gross estate. While the ultimate outcome may be defensible, the court's reasoning is in some respects problematic. The court's treatment of *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274, 1 AFTR2d 2151 (1958), a landmark Section 2036 case, raises larger questions about the estate tax treatment of private annuity transactions, as well as installment sales to grantor trusts, at least where a guarantee is used as an alternative to seed money.

TROMBETTA—BASIC FACTS

The decedent, as part of larger estate plan,[1] entered into a private annuity transaction with her grantor trust.[2] In exchange for rental real estate properties she contributed to the trust, she received the right to receive periodic payments from the trust over a period of 180 months. The present value of the right to receive the periodic payments was less than the FMV of the property transferred to the trust. The decedent reported the excess as a taxable gift on her gift tax return for the year in which the transaction was consummated (i.e., she reported as a gift the excess of the value of the transferred property over the present value of the right to receive the periodic annuity payments).

The form of the transaction, according to the Tax Court, was a transfer with a retained interest, not a sale. In its findings of fact, the court states the trust agreement "provided that decedent intended her retained inter-

est in the properties to qualify as a qualified interest under section 2702 (b)(1)."[3] This provision was obviously included in the instrument out of concern that failure to satisfy the qualified-interest exception in Section 2702 would trigger the gift tax zero-value rule.[4]

Presumably driven by the same concern, another provision prohibited the trustee from accepting additional contributions of property.[5] Both of these provisions are consistent with a "transfer with retained interest" form. In addition, in the course of discussing the form of the transaction, the court emphasized that the transaction was done with the decedent's grantor trust and that the decedent had reported a taxable gift in connection with the funding of the trust.

The decedent, along with three of her children, were designated as the trustees of the trust. The three children personally guaranteed the trust's annuity obligation, agreeing that "they would be jointly and severally liable for any periodic payment in the event that the annuity trust lacked sufficient funds...."

During the trust's operation, payments of the annuity were not always made in accordance with the agreement. On some occasions, the decedent received less than the annuity amount, and on other occasions she received more to compensate for a prior deficiency.

When the payment was less than the annuity amount, the children did not contribute money to the trust or otherwise furnish any funds. Indeed, during the entire period of the trust's existence, the three children did not make any payments under their guarantee. The trust, however, always had sufficient funds on hand to make the required payments.[6]

The trust instrument provided that, if the trust's income was greater than the annuity amount, the excess could be accumulated or distributed in the discretion of the trustees (the decedent and her three children) to the decedent. Under a state (California) statute, the trustee's discretion was limited by the decedent's needs for her health, education, maintenance, and support,[7] though the decedent's co-trustees could, acting without the decedent's participation, make a discretionary determination to distribute the excess income to her free of the statutory constraint.

The final fact relevant to the court's analysis of Section 2036 relates to mortgages encumbering the property that the decedent had conveyed to the trust. At the time of the consummation of the annuity transaction, the decedent was personally liable on these mortgages. The trustees took "subject to" these mortgage and then made interest and principal payments on the mortgages.

The ultimate outcome may be defensible but the court's reasoning is in some respects problematic, and its treatment of a landmark Supreme Court decision on Section 2036 raises larger questions.

THE TAX COURT'S REASONING

In concluding that Section 2036 applied, the court considered three subsidiary issues:

- Whether the decedent had retained an interest within the meaning of Section 2036(a)(1).
- Whether the Supreme Court decision in *Fidelity-Philadelphia* and its progeny in the controlling circuit required the conclusion that no such interest was retained.
- Whether the bona fide exception to the section applied.[8]

Ruling for the IRS on all three issues, the court held that the trusts were includable under Section 2036(a)(1).

The court's conclusion that the decedent had retained the requisite interest was based on its underlying finding that there was an implied agreement between the decedent and her co-trustees that she would continue to enjoy the transferred property after she conveyed it to the trust. The court based this finding, in turn, on three independent grounds.

First, the court pointed out that the decedent played an important role in management decisions regarding the property after it was transferred to the trust, finding that "the cotrustees generally acted on decedent's recommendation." Based on this, the court concluded that the decedent "retained de facto control over the properties."

Second, the court made reference to the provision in the trust instrument authorizing the trustees to make discretionary distributions of the trust's excess income to the decedent. Under this provision, the decedent as trustee had a 50% vote, with her co-trustees sharing the remaining vote. Thus, while the decedent could not unilaterally take a distribution, she could decide to do so in conjunction with one or more of her co-trustees. In a cryptic passage, the court appears to conclude that the state statute cited by the estate—under which the decedent's authority to participate in deciding about distributions to herself was limited to her needs for her health, education, maintenance, and support—was not relevant in the context of Section 2036(a)(1).

Third, the court determined that, because the property was conveyed to the trustees "subject to" mortgages on which the decedent was person-

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ally liable and because the trustees made payments on the mortgages, the trust's resulting discharge of the decedent's obligation was equivalent to the decedent's having retained an interest in the trust.

Having decided that the decedent had retained an interest under an implied-agreement theory, the court turned to the estate's argument based on *Fidelity-Philadelphia* (and the cases applying it in the Ninth Circuit, the circuit to which an appeal would lie). The Tax Court rejected this argument, finding the children's guarantee irrelevant because they were never called on to make payments and because the decedent had intended that the trust's income would constitute the sole source for the annuity payments.

Finally, the court had no difficulty in resolving the bona fide consideration issue. Relying on the fact that the value of the property conveyed to the trust exceeded the present value of the right to receive the annuity payments—evidence of which was found in the decedent's gift tax return, which reported the excess as a gift—the court concluded that the estate could not invoke the bona fide exception in that the decedent failed to receive adequate consideration. The court found, moreover, that the transaction was not done on an arm's-length basis given that it was consummated without meaningful negotiation and was a component in the decedent's estate planning.

ANALYSIS

For practitioners who advise about private annuity transactions and installment sales to grantor trusts, the most important aspect of the Tax Court's decision in *Trombetta* is its treatment of *Fidelity-Philadelphia*. This is particularly true for those who use a guarantee, rather than seed money, in order to navigate around the Section 2036 risk. *Fidelity-Philadelphia* is also important in ascertaining the scope of Section 2702 as applied to installment sales and annuity transactions. Although there was no issue concerning Section 2702 before the court, the issue is one of concern to practitioners who do these kinds of transactions. In our opinion, Section 2702 should be understood to embody the same contours that the Supreme Court embedded in Section 2036 in *Fidelity-Philadelphia*.

But before turning to *Fidelity-Philadelphia* and the Section 2702 implications, we first consider the other issues specific to the *Trombetta* transaction that the court found significant.

Bona fide exception. First, the court correctly determined that the decedent's failure to receive adequate consideration precluded the estate from invoking the bona fide exception.[9] This, of course, confirms the importance, from a planning perspective, of making sure that full consideration is received if it is anticipated that the estate will need to invoke the bona fide exception in order to negate Section 2036 inclusion.

This is not to say, however, that failure to receive adequate consideration is necessarily fatal. To the contrary, as long as the decedent did not retain an interest in the transferred property and as long as the annuity is not deemed to constitute such an interest, Section 2036 should not apply regardless of the adequacy of the consideration the decedent received. Thus, where the decedent received inadequate consideration, the estate will need to persuade the court that, under the contours of *Fidelity-Philadelphia*, no interest was retained—which the Trombetta estate failed to do.

Non-tax purposes. Second, in rejecting the estate's argument that the transaction qualified for the bona fide exception, the court refused to embrace the notion developed in family limited partnership cases that the exception applies if the estate can demonstrate an appropriate non-tax reason for forming the partnership. After refusing to extend the partnership line of cases, the court went on to indicate that, in any event, the estate could not establish a sufficient non-tax reason given the tax-driven nature of the transaction.

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1 Among other things, the decedent created a qualified personal residence trust described in Reg. 25.2702-5.

2 Use of a grantor trust is important from an income tax perspective. Under Prop. Regs. 1.1001-1(j) and 1.72-6(e), any gain inherent in property transferred in exchange for the annuity must be recognized at the time the transaction is consummated. If, however, the annuity transaction is done (as in Trombetta) with a grantor trust, no gain should be recognized. See Rev. Rul. 85-13, 1985-1 CB 184 (a transaction between the grantor and her grantor trust is ignored for income tax purposes). Therefore, Mrs. Trombetta's use of a grantor trust made good planning sense. Nevertheless, from an estate tax perspective the use of a trust creates the risk of Section 2036 inclusion in the decedent's gross estate, a fate suffered by the Trombetta estate. Had Mrs. Trombetta done the annuity transaction with her children instead, the Section 2036 argument would not have been a plausible one under Fidelity-Philadelphia, at least not if the children had sufficient resources to carry out the annuity obligation.

3 The IRS sought a finding that the decedent did not execute a contract of sale with the trust. The estate, in turn, argued that the contract was simply not produced in response to an IRS subpoena. The court does not address the question whether a contract of sale had been executed. See IRS Proposed Finding of Fact No. 57 in its opening brief ("Decedent did not execute a sale document for the transfer of the Annuity Trust Properties to the Annuity Trust. Trans. 170:4-7."). In its reply brief, the estate objected to this proposed finding: "The cited transcript reference simply states that the contract for sale of Tierra Plaza or Black Walnut Square was not included among the documents produced in response to a subpoena issued by Respondent."

4 Under Section 2702(a), the value of a gift of a successor interest (e.g., a remainder) in a trust or similar arrangement is determined by subtracting the value of the interest the transferor has retained from the total value of the property transferred. As a general rule, where the section applies, the value of the interest retained is deemed to be zero, causing the gift to be the entire value of the property transferred. Under Section 2702(b), however, value is given for the retention of a "qualified interest" such as an annuity described in Reg. 25.2703-3(b).

5 See Reg. 25.2702-3.

6 In the Proposed Findings of Fact in its opening brief, the IRS indicated that the estate had admitted that this was the case.

7 See Cal. Prob. Code section 16081(c).

8 Section 2036 does not apply to a transfer "in the case of a bona fide sale for an adequate and full consideration in money or money's worth."

9 An interesting question about the scope of the bona fide exception in Section 2036 could arise if the decedent had received inadequate consideration in an arm's-length transaction that proved to be a bad bargain. Compare Estate of Magnin, 184 F.3d 1074, 84 AFTR2d 99-5227 (CA-9, 1999) (refusing to apply the gift tax "ordinary course of business" exception for purposes of the bona fide exception in Section 2036) with Wheeler, 116 F.3d 749, 80 AFTR2d 97-5075 (CA-5, 1997) (indicating that, given that the gift tax and estate tax are to be construed *in pari materia*, the bona fide exception should be available if the requirements of the gift tax "ordinary course of business" exception are satisfied).

To the extent that the court's analysis implies that a transaction could qualify for the exception based on a showing of a non-tax reason even if the decedent did not receive adequate consideration, it would appear to be wrong. Indeed, even in the partnership cases, the presence of a non-tax reason is insufficient if the decedent did not receive adequate consideration.[10]

The court's analysis of the bona fide issue is problematic on another ground. The opinion can be read as suggesting that a lack of meaningful negotiation or a finding that the transaction was tax-driven renders the exception unavailable. But if in fact the decedent did receive full consideration—even if there was no negotiation—it would make no sense as a policy matter to require inclusion under Section 2036. To do so would result in a double inclusion: the value of the consideration received by the decedent would be included in the estate along with the value of the asset transferred by the decedent.

Section 2036(a)(1) vs. 2036(a)(2). Third, in analyzing the Section 2036 implications of the trustees' discretion to distribute excess income to the decedent, the court conflated Section 2036(a)(1) with Section 2036(a)(2). The Tax Court based its holding entirely on Section 2036(a)(1), yet used Section 2036(a)(2) principles in the course of its analysis. While Section 2036(a)(1) can be invoked on the basis of an implied understanding that is not legally enforceable,[11] Section 2036(a)(2) can be invoked only where the decedent had retained a legally enforceable right.[12] Finding only an implied understanding, not a legally enforceable right, the court's options were limited: Section 2036(a)(1) was the only available provision. The court nonetheless used Section 2036 (a)(2) principles.

In doing so, the Tax Court not only erred in applying these principles in the context of its Section 2036(a)(1) analysis but also failed to acknowledge an important case-law exception under Section 2036(a)(2). In holding that Section 2036(a)(1) applied by reason of the trustees' discretion with respect to excess income, the court emphasized that the decedent was a co-trustee and could control distributions to herself in conjunction with the other trustees. While Section 2036(a)(2) does indeed contain an "in conjunction with" principle—triggering application of the section where the decedent retained the right to exercise control in conjunction with others—there is no such principle in Section 2036(a)(1).

Moreover, under the court-created ascertainable standard exception, Section 2036(a)(2) does not apply if the instrument subjects the trustee's discretion to a standard enforceable under state law—an exception that is irrelevant in the context of Section 2036(a)(1).[13] Even assuming Section 2036(a)(2) principles were relevant, the state statute that circumscribed the trustees' discretion by an ascertainable standard would have rendered that provision inapplicable.[14]

Implied understanding. This is not to say, however, that the trustees' discretion with respect to excess income is entirely irrelevant for Section 2036 (a)(1) purposes. Properly analyzed, the trustees' discretion certainly could serve as a basis for finding an implied understanding that distributions would be made to the decedent. The ascertainable standard imposed by the statute does not preclude such a finding—as indicated, there is no ascertainable-standard exception under Section 2036(a)(1).

But, in inferring the existence of an implied agreement, the Tax Court failed to point to the kind of evidence typically cited by courts in support of such an inference. The court's inference, therefore, is of questionable validity. And it is particularly problematic given the court's conclusion that the IRS had proven the inference by a preponderance of the evidence.

As indicated by the opinion in *Estate of Paxton*, 86 TC 785 (1986), a trust where the grantor is a permissible (discretionary) beneficiary is subject to inclusion under Section 2036(a)(1) under one of two theories:

1. The decedent had an implied understanding that she would receive distributions, or
2. Under state law, the decedent could relegate her creditors to the trust.[15]

Hence, if as a matter of state law the grantor's creditors cannot reach

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10 See, e.g., Estate of Bongard, 124 TC 95 (2005) (explaining the need for a non-tax reason and the requirement that the transferor receive "partnership interests proportionate to the value of the property transferred" in order to satisfy the adequate-consideration prong of the analysis).

11 *Id.* See also Reg. 20.2036-1(c)(i).

12 See Byrum, 408 U.S. 125, 30 AFTR2d 72-5811 (1972).

13 See, e.g., Jennings v. Smith, 161 F.2d 74, 35 AFTR 1203 (CA-2, 1947); Rev. Rul. 73-143, 1973-1 CB 407.

14 Where a trust authorizes discretionary distributions to the grantor and the grantor is one of the co-trustees, it would seem that Section 2036(a)(2) could apply on the theory that the grantor had the right, in conjunction with the co-trustees, to determine the identity of the person who enjoys the trust's income. But, as indicated in text, inclusion would be inappropriate if the trustees' discretion were circumscribed by an ascertainable standard.

15 See also Rev. Rul. 2004-64, 2004-2 CB 7; *cf.* Rev. Rul. 76-103, 1976-1 CB 293.

16 See Ltr. Rul. 200944002 ("the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036. We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036").

17 The courts have used a similar analysis in applying Section 2036 in the family limited partnership cases. See, e.g., Estate of Thompson, 382 F.3d 367, 94 AFTR2d 2004-5764 (CA-3, 2004) (emphasizing, in finding an implied understanding, that the decedent had not retained sufficient assets to cover the cost of living and the fact that distributions had been made to the decedent when needed).

18 In Estate of Fabric, 83 TC 932 (1984), there was a similar failure to consistently make the required annuity payments. Nonetheless, applying Ninth Circuit precedent, the Tax Court rejected the Service's Section 2036 argument. The court concluded that the decedent had received full and adequate consideration, obviating the need for it to reach the question whether the decedent had retained a "string." In Trombetta, in contrast, the decedent reported the transaction as part sale/part gift, enabling the court to conclude that the decedent had not received full consideration and to then reach the string question.

19 See Bigelow, TCM 2005-65, *aff'd* 503 F.3d 955, 100 AFTR2d 2007-6016 (CA-9, 2007).

20 See Rev. Rul. 54-516, 1954-2 CB 54.

21 For the treatment of a wraparound mortgage in the income tax context, see Hunt, 80 TC 1126 (1983).

22 The Regulations that seek to implement Crane do not address the question whether a transferor who is personally liable on a mortgage must include the amount of the underlying debt in amount realized where the transferee takes subject to the mortgage. See Reg. 1.1001-2.

the trust's assets, inclusion under Section 2036(a)(1) would be inappropriate in the absence of an implied understanding.[16]

In *Trombetta*, the court did not consider the question whether, under state law, the decedent's creditors could have reached the trust's assets. As a result, the only basis for inclusion on account of the trustee's discretion to make excess distributions to the decedent would be an implied understanding that such distributions would be made.

In *Paxton*, in addition to concluding that the grantor/decedent could have relegated creditors to the trust, the court found that there was an implied understanding based on two factors. First, actual distributions had been made to the decedent, and second, the decedent had not retained sufficient assets outside of the trust to cover the cost of living. And in *Skinner's Estate*, 316 F.2d 517, 11 AFTR2d 1855 (CA-3, 1963), another self-settled trust case, the court concluded that there was an implied understanding based on the fact that trust income was regularly distributed to the decedent.[17]

It would seem that the only underlying facts in *Trombetta* that could support a finding of an implied understanding—occasional distributions in excess of the annuity amount[18]—are not nearly as compelling as those found sufficient for inferring an implied understanding in *Paxton* or *Skinner*. Moreover, unlike *Trombetta*, neither *Paxton* nor *Skinner* was based on an assumed premise that the IRS bore the burden of establishing the implied understanding by a preponderance of the evidence.

Whether *Trombetta* should be read as reflecting the court's greater willingness to find an implied understanding or whether, instead, the court's finding was influenced by its reaction to the annuity transaction will, perhaps, become clear in future cases.

Impact of the encumbrance. Fourth, the court's conclusion that Section 2036(a)(1) applied by reason of the mortgage encumbering the property conveyed to the trust, while consistent with other authorities and perhaps correct, raises interesting questions.

As indicated, the decedent was personally liable on the mortgage. The trust took the property subject to the mortgage and then made interest and principal payments. In a prior decision, the Tax Court had held, in an opinion affirmed by the Ninth Circuit, that the discharge of a decedent's obligation on a mortgage justified a finding of a Section 2036(a)(1) retained interest.[19]

The court's conclusion was based on its underlying finding that there was an implied agreement between the decedent and her co-trustees that she would continue to enjoy the transferred property after she conveyed it to the trust.

Indeed, Reg. 20.2036-1(b)(2) provides that a decedent is deemed to have retained such a string where income or enjoyment of the transferred property "is to be applied toward the discharge" of the decedent's obligations. Analogously, there is authority to the effect that, under Section 677, the trust's discharge of the grantor's obligation on such a mortgage triggers grantor-trust status.[20]

But the question remains whether this approach elevates the form of the transaction over its substance. Consider, for example, a parent who makes an outright gift to a child of real estate having a value of $1 million subject to a $100,000 mortgage. Has the parent retained a Section 2036(a)(1) string on account of the mortgage? If the parent first paid off the mortgage and sold the property to the child for $100,000 in cash, which the child borrowed by placing his own mortgage on the property, would the result be different? It is difficult to imagine how Section 2036(a)(1) could apply in the latter case. And, yet, the only difference between the child's discharging the parent's mortgage and the child's securing his own mortgage is a mere matter of form and therefore not a compelling basis for distinguishing the two transactions.

Similarly, consider the consequences if the child were to give the parent a wraparound mortgage, rather than taking subject to the parent's mortgage, i.e., if the child gave the parent a note in the amount of $100,000 along with a mortgage securing the note, which "wrapped around" the mortgage on which the parent remained liable. In that event, it would seem difficult for a court to conclude that the parent had retained the right to have her debt discharged by the trust.[21] Yet the difference between the child's taking subject to the parent's mortgage or, instead, supplying his own wraparound mortgage is again a mere matter of form that, ideally, should not affect the outcome.

For income tax purposes, it makes no difference whether the transferee discharges the transferor's mortgage or instead pays the transferor with borrowed funds obtained by mortgaging the property. Reflecting substance rather than form, the Regulations, following the Supreme Court decision in *Crane*, 331 U.S. 1, 35 AFTR 776 (1947), make clear that the transferor is deemed to have the same amount realized and therefore the same amount of gain in both situations. In other words, whether the transferee discharges the transferor's $100,000 mortgage or instead pays cash by securing his own mortgage, the transaction would be treated as a part sale/part gift and the transferor would be required to include the $100,000 in amount realized.[22]

If substance were similarly emphasized in the analysis of Section 2036, what would be the result? While a sale for less than full consideration could

not qualify for the bona fide exception, Section 2036 could possibly be negated nonetheless on the ground that, under *Fidelity-Philadelphia,* the transferor should not be treated as having retained an interest in the transferred property. As will be discussed, however, it is not entirely clear whether *Fidelity-Philadelphia* has any application in the case of a part sale/part gift. We now turn our focus to *Fidelity-Philadelphia* and how, in our view, the *Trombetta* court failed to apply it properly.

Applying Section 2036 to an Annuity or Sale

In an annuity transaction, Section 2036, on its face, does not make clear whether it has any application. At first blush, it would seem that the retention of the right to receive a fixed sum over time should not be treated as the retention of the right to the income of the transferred property or its possession or enjoyment within the meaning of Section 2036(a)(1). After all, while the income generated by the transferred property will necessarily fluctuate from year to year, a fixed annuity payment does not depend on the income generated or the performance of the transferred asset and does not fluctuate over time.

On the other hand, one might contend that, as a matter of substance over form, a person who makes a transfer of $20 while retaining the right to receive $1 per year for a designated period of years where it is anticipated that the asset will generate a return of 5% ($1 per year) should be treated as having retained something that is roughly equivalent to the income to be generated by the $20 during the designated period. The difficulty, however, with the substance over form approach is that, if not limited, it could make any sale in exchange for a series of future payments potentially subject to Section 2036(a)(1).

For example, if an individual sold an asset to his daughter, or to a trust for her benefit, in exchange for an installment note and then died before the note was fully discharged, such a broad application of Section 2036(a)(1) could result in disregarding the sale and the asset's inclusion in the decedent's gross estate (assuming the requirements of the bona fide exception were not satisfied), even if the daughter or the trust had substantial independent resources with which to make payment on the note.

The *Fidelity-Philadelphia* principle. In *Fidelity-Philadelphia,* the Supreme Court sought to create a principle that could be used in distinguishing between a sale (or exchange), on the one hand, and a transfer where the transferor retains the right to receive fixed payments that in substance is equivalent to the retention of the right to receive income, on the other. The Court indicated that, if three conditions are satisfied, the transaction should be viewed as a sale and the decedent should not be treated as having retained a Section 2036(a)(1) string:

1. The obligation to make payments to the decedent is not chargeable to the transferred property.
2. The obligation is the transferee's personal obligation.
3. The amount of the payments to be made to the decedent is not dependent on the actual amount of income generated by the transferred property.[23]

If any of these conditions is not satisfied, however, the implication is that the decedent should be treated as having retained a Section 2036(a)(1) interest, leading to inclusion of the transferred asset in the gross estate unless the bona fide exception is available. It is worth noting that while the Supreme Court formulated this principle in the context of discussing an annuity transaction, the IRS has indicated that it applies to installment sales as well.[24] Consequently, in an installment sale, as long as the *Fidelity-Philadelphia* criteria are satisfied, Section 2036 should not apply, even if the decedent died before the note was fully discharged and even if the bona fide exception could not be satisfied (because for example, the estate could not demonstrate that the decedent had received full and adequate consideration).

Seed money under *Fidelity-Philadelphia.* Although practitioners may not fully appreciate it, the notion that seed money is necessary in the event of an installment sale[25] to a trust in order to avoid inclusion under Section 2036 stems from the *Fidelity-Philadelphia* principle. In other words, if the trust has sufficient seed money, the principle's three conditions are satisfied:

1. The installment obligation is not chargeable solely to the transferred property but to the seed money as well;
2. The obligation can be viewed as the personal obligation of the trust

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23 The Court stated in fn. 8: "Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. [Citing Estate of Bergan, 1 TC 543 (1943), *acq.*; Security Trust & Savings Bank, Trustee, 11 BTA 833 (1928); Johnson, 10 BTA 411 (1928); Hirsh, 35 F.2d 982, 8 AFTR 9812 (Ct. Cl., 1929); *cf.* Welch v. Hall, 134 F.2d 366, 30 AFTR 1134 (CA-1, 1943).] In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made."

24 Rev. Rul. 77-193, 1977-1 CB 273.

25 See Hatcher and Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 JTAX 152 (March 2000).

26 The applicability of the Fidelity-Philadelphia principle in the context of a sale to a trust, as opposed to an individual, has not been questioned. The Trombetta court unhesitatingly assumed its pertinence. See also Ray, 762 F.2d 1361, 56 AFTR2d 85-6496 (CA-9, 1985); Estate of Becklenberg, 273 F.2d 297, 5 AFTR2d 1821 (CA-7, 1959).

27 As noted in the text, above, the court concluded the bona fide exception to Section 2036 did not apply because the decedent transferred greater value to the trust than the value of the annuity. If, however, the transfer to the trust actually was two transfers (one for annuity streams and equal to the value of that stream, and a second, separate transfer as a gift to provide the seed capital), then perhaps the bona fide exception should apply.

28 See TD 9414, 7/14/08 (indicating that, in order to constitute a sale as opposed to a transfer with a retained interest, there must be a transaction "between two parties, each of whom is the owner of a property interest before the sale"). See generally Blattmachr, Gans, and Zeydel, "Final Regulations on Estate Tax Inclusion for GRATs and Similar Arrangements Leave Open Issues," 109 JTAX 217 (October 2008).

29 See Hatcher and Manigault, *supra* note 25.

30 See Estate of Fabric, *supra* note 18.

31 The court apparently found troubling the trust's failure to make the annuity payments to the decedent as required under the agreement. Although the court made no reference to it, in the context of a charitable remainder trust, a similar failure enabled the IRS to successfully challenge the original treatment of the transaction (i.e., a charitable deduction for the value of the remainder was denied). See Estate of Atkinson, 115 TC 26 (2000), *aff'd* 309 F.3d 1290, 90 AFTR2d 2002-6845 (CA-11, 2002).

in the sense that it can be paid from the trust's other assets; and

3. Because the amount of the installment obligation is fixed and the seed money can be used in discharging the obligation, it is not dependent, or at least not entirely dependent, on the amount of income actually generated by the asset sold to the trust.

Hence, it seems that, by reason of *Fidelity-Philadelphia*, if the trust has adequate additional property, no estate tax inclusion should occur on account of an annuity or installment obligation owed to the decedent.[26] But what if the additional property is contributed to the trust in conjunction with the consummation of the annuity or installment sale transaction?

For example, in *Trombetta* the decedent had contributed property to the trust having a value in excess of the present value of the annuity obligation undertaken by the trust in the exchange. In effect, the transaction was a part sale/part gift.[27] The question is whether the gift portion can be treated as seed money in order to establish compliance with the *Fidelity-Philadelphia* criteria.

Or is it, perhaps, more appropriate to require that the seed money be contributed to the trust in an unrelated, earlier transaction? Similarly, in the case of a conveyance to a trust where the trust takes property subject to a mortgage on which the decedent is personally liable and where the value of the property is greater than the mortgage, the resulting part sale/part gift raises the same seed-money question.

Unfortunately, the *Fidelity-Philadelphia* Court did not address this question. It would appear that *Trombetta* has now supplied an answer to this question, effectively concluding that the gift portion of a part sale/part gift transaction cannot be treated as creating the requisite seed money.

The Service had taken the same view on the seed money question in a technical advice memorandum. In TAM 9251004, the donor transferred stock to a trust in exchange for an installment note. The value of the stock being in excess of the amount of the note, the transaction constituted a part sale/part gift. The TAM reasoned that, because the trust had no other assets, it would have to use dividends to be earned on the stock in order to make payments on the note. It concluded that the decedent had retained a Section 2036(a)(1) string, implicitly finding that the portion of the stock constituting a gift to the trust could not serve as seed money.

As a result, the TAM, as well as *Trombetta*, appears to conclude that the gift portion of a part sale/part gift transaction does not establish seed money for purposes of *Fidelity-Philadelphia*—though neither the TAM nor *Trombetta* explicitly analyzes the issue in these terms.

Given the TAM and, now, *Trombetta*, practitioners who rely on seed money in order to negate the Section 2036 risk, when doing an installment sale or annuity transaction, need to make sure that the money is contributed to the trust prior to consummating the transaction. And, of course, in order to avoid an IRS argument based on the step transaction doctrine, the money should not be contributed to the trust on the eve of the transaction.[28]

Personal guarantees under *Fidelity-Philadelphia*. As an alternative to seed money, some practitioners use a personal guarantee of the trust's obligation to make the installment or annuity payments.[29] In fact, as indicated, the annuity transaction in *Trombetta* was structured in that fashion. The personal-guarantee approach also stems from *Fidelity-Philadelphia*. Indeed, in *Security Trust & Savings Bank, Trustee*, 11 BTA 833 (1928), one of the cases cited by the Supreme Court in *Fidelity-Philadelphia* in support of the criteria it articulated, a guarantee was used.

The apparent rationale is that, with a guarantee, the obligation is not chargeable solely to the transferred property but can be enforced against the guarantor; the guarantor has a personal obligation; and the payments are not a function of the actual income generated by the transferred asset in the sense that they will be made, without regard to the actual income, by the guarantor if necessary. In short, the guarantee lends credence to the view that the transaction constitutes a sale as a matter of substance.

As long as the decedent did not retain an interest in the transferred property and as long as the annuity is not deemed to constitute such an interest, Section 2036 should not apply regardless of the adequacy of the consideration the decedent received.

Compliance with the *Fidelity-Philadelphia* criteria should certainly require that the guarantee be bona fide. Therefore, if the guarantor does not have the economic wherewithal with which to satisfy the guarantee, it might be ignored.[30] But if the guarantor has the ability to discharge the obligation and intends to honor the guarantee, it should be sufficient to preclude a finding that the annuity or installment note constitutes a retained string that could trigger estate tax inclusion under Section 2036(a)(1).

In *Trombetta*, the Tax Court appeared to ignore this aspect of *Fidelity-Philadelphia*. It concluded that, because the decedent's children who provided the guarantee did not in fact make payments on the obligation, the guarantee should not be taken into account. This makes no sense under the facts of the case.

To be sure, had the trust failed to make annuity payments because it had insufficient assets and had the guarantors nevertheless failed to make payments on their obligation, disregarding the guarantee on the ground that it lacked substance might well have been the correct outcome. But, as the IRS conceded, the trust always had sufficient resources on hand with which to make payment of the annuity.[31] As a result, there was no practical need for the guarantors to make payment. If the *Trombetta* court's analysis of the guarantee is correct, no guarantee will ever be effective in negating Section 2036 where the trust makes the required payments on a timely basis and the guarantor's obligation is therefore not triggered—a result that cannot be squared with *Fidelity-Philadelphia*.

In short, the *Trombetta* court fails to appreciate that *Fidelity-Philadelphia* focuses on the transaction at inception. It does not require, or permit, a post-death retroactive inquiry into the actual operation of the transaction. For example, if the guarantor had substantial resources at inception but then suffered an unanticipated economic loss and was, therefore, unable to make payments on the guarantee, this should not lead to the conclusion that the decedent had retained an interest. Indeed, if the court's approach were correct, every annuity transaction or installment sale would be vulnerable to an IRS string argument if, as in most instances, the primary obligor makes the payments and there is no need for the guarantor to discharge the obligation.

Finally, *Trombetta* presented an interesting fact pattern in that it involved a part sale/part gift in conjunction with a guarantee. As suggested, it is not clear whether the gift portion in such a transaction can serve as seed money for *Fidelity-Philadelphia* purposes. Assuming it cannot, the question remains whether the presence of a guarantee can nonetheless eliminate the Section 2036(a)(1) string.

To illustrate, assume that the decedent had sold an asset with a value of $100 to the trust in exchange for a note for $60. If it is assumed that the $40 gift portion cannot serve as seed money and that there is no other seed money in the trust, it would seem that the *Fidelity-Philadelphia* criteria could nonetheless be satisfied by a guarantee of the note. Concededly, *Fidelity-Philadelphia* does not explicitly address the effect of a guarantee in the context of a part sale/part gift. But, given the Court's logic, it would seem that the effectiveness of a guarantee should not be undermined merely because the price at which the asset was sold was less than its value.[32]

Properly analyzed, the trustees' discretion certainly could serve as a basis for finding an implied understanding that distributions would be made to the decedent. The ascertainable standard imposed by the statute does not preclude such a finding.

The Ninth Circuit Approach

Perhaps because *Trombetta* is appealable to the Ninth Circuit, the Tax Court focused on precedent in that circuit, in particular on *Ray*, 762 F.2d 1361, 56 AFTR2d 85-6496 (CA-9, 1985).

In *Ray*, the decedent transferred property to a trust and retained the right to receive an annuity. The court held that the decedent had retained an interest sufficient to result in Section 2036 inclusion. In reaching that conclusion, the Ninth Circuit emphasized that the decedent had chosen the form of a transfer with a retained interest, rather than a sale: "Nothing in the record indicates that the parties intended a sale in exchange for an annuity."

The court also indicated that the substance of the transaction in *Ray* was consistent with the chosen form in that the amount of the annuity closely approximated the trust's anticipated income. In the course of distinguishing its decision in *LaFargue*, 689 F.2d 845, 50 AFTR2d 82-5944 (CA-9, 1982), a case involving Section 677 (an income tax provision), the court intimated that the grantor's continuing control over the transferred asset was more consistent with a retained-interest transfer than with a sale.

After concluding that Ninth Circuit precedent suggested that the decedent should be viewed as having retained a Section 2036(a)(1) interest, the *Ray* court turned to the estate's argument that the *Fidelity-Philadelphia* principle should preclude this outcome. The court rejected the estate's argument on the ground that the obligation to make payments to the decedent was chargeable solely to the transferred property. Although the court does not elaborate, it would seem that the Ninth Circuit would have reached a different conclusion had the trust been funded with adequate seed money or had the trust's obligation been guaranteed.[33]

Given the *Ray* estate's inability to bring itself within the *Fidelity-Philadelphia* criteria, the court did not need to further consider the estate's argument. It nonetheless went on to reiterate in this context that the annuity amount was designed to approximate the trust's expected income, a fact that in the court's view cut against the estate's argument.

The *Trombetta* court's analysis is problematic in three respects. First, *Trombetta* fails to clarify sufficiently the relationship between the *Fidelity-Philadelphia* criteria and the various

factors cited by the *Ray* court. For example, *Trombetta* fails to make clear whether compliance with the *Fidelity-Philadelphia* contours can negate Section 2036 inclusion even where the annuity amount is equal to the trust's anticipated income—or, conversely, whether inclusion can be avoided because the annuity amount bears no relationship to anticipated income even if the *Fidelity-Philadelphia* criteria are not satisfied. This failing is not, however, of the *Trombetta* court's own making; *Ray* itself was not entirely clear on this issue. Nevertheless, given the structure of the *Trombetta* opinion, as well as the structure of the *Ray* opinion itself, it would seem that both courts contemplate that an estate can defeat a finding of a retained Section 2036(a)(1) string if *either* it satisfies the *Fidelity-Philadelphia* criteria or there is no relationship between the annuity amount and anticipated income.

Second, in focusing on the relationship between the annuity amount and anticipated income, *Trombetta*, as well as *Ray*, gives relevance—although, as indicated, how much relevance is not clear—to an artificial factor that is at odds with the *Fidelity-Philadelphia* criteria. If, for example, there is no seed money in the trust and no guarantee provided, *Fidelity-Philadelphia* contemplates that, based on its substance, the transaction should be treated as a transfer with a retained interest rather than a sale. But if a taxpayer can defeat Section 2036 inclusion in these circumstances through the simple expedient of fixing the annuity amount so that it bears no relationship to expected income, the criteria established in *Fidelity-Philadelphia* for making the distinction on the basis of substance becomes vulnerable to a manipulation of the transaction's form.[34]

Third, the *Trombetta* court's emphasis on the decedent's continuing role in the management of the property after the consummation of the annuity transaction—a factor also cited by the *Ray* court[35]—is inconsistent with *Byrum*, 408 U.S. 125, 30 AFTR2d 72-5811 (1972). In *Byrum*, the Supreme Court rejected the Service's argument that Section 2036 should apply on the basis of the decedent's ability to control management-type decisions.[36] As a result, to whatever extent a role in management may be relevant for income tax purposes under Section 677, as suggested by *Trombetta* as well as *Ray*, it should play no role in the Section 2036 context.

Section 2036 Regulations and Annuity Transactions

In 2008, the Regulations under Section 2036 were amended to provide guidance on the section's application where the grantor of a grantor retained annuity trust (GRAT) dies during the term of the annuity.[37] The Preamble to TD 9414, 7/14/08, seeks to distinguish between a sale, on the one hand, and a transfer with a retained interest, on the other—or, in the words of the Preamble, between a "bona fide sale" and "the retention of an annuity interest in property transferred." Echoing the *Fidelity-Philadelphia* criteria, but without citing to it, the Preamble suggests that the hallmark of a sale is an agreement between two parties where each brings his or her own property to the negotiating table.

Clearly, in a GRAT, only the grantor supplies property. The trust has no resources other than the property contributed by the grantor. Under the Regulations, therefore, a GRAT is treated as a transfer with a retained interest, not a sale, and Section 2036 applies where the grantor dies during the annuity term. In sharp contrast, in an installment sale or an annuity transaction where the trust has sufficient seed money or someone provides a guarantee of the trust's obligation, the transaction should be viewed as a sale and therefore not subject to Section 2036, whether examined from the vantage point of the Preamble or *Fidelity-Philadelphia*.

The Preamble does not seek to overrule *Fidelity-Philadelphia*. To the

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32 There also is a seed-money issue under Reg. 25.7520-3. The Regulation requires, for an annuity transaction with a trust, that the trust have sufficient assets to pay the annuity until the annuitant reaches the age of 110. If the trust does not have sufficient resources to meet this requirement, the value of the annuity is reduced to reflect the trust's impaired creditworthiness, resulting in a taxable gift. Two alternatives are available in order to prevent a taxable gift from occurring at the time the annuity transaction is consummated: (1) make the sale to a trust that has other resources, perhaps based on a contribution previously made to it; or (2) have the trust's annuity obligation guaranteed by the trusts's beneficiaries or some other third party with sufficient economic wherewithal to make the payments if necessary. Either one of these alternatives should, in addition to preventing a taxable gift, satisfy the Fidelity-Philadelphia criteria. The extent to which using a guarantee in lieu of "seed capital" may increase the risk of adverse estate, gift, or generation-skipping transfer tax consequences seems undeveloped and, therefore, uncertain.

Under a third alternative, a contribution of additional resources could be made to the trust at the time the annuity transaction is consummated. While this alternative will satisfy the sufficient-resources requirement in the Regulation, it may, after Trombetta, be insufficient to satisfy the Fidelity-Philadelphia criteria. And, of course, the contribution of the additional resources would constitute a taxable gift.

33 But see Reg. 25.7520-3(b)(2)(i), discussed in note 32, *supra*.

34 In Fidelity-Philadelphia, the Supreme Court indicated that if the payments to the decedent are determined by the trust's actual income, the decedent should be viewed as having retained a Section 2036(a)(1) string. So, for example, if the annuity payment is to be made only if the asset transferred to the purchaser generates sufficient income, the Fidelity-Philadelphia criteria cannot be satisfied. See Estate of Hurford, TCM 2008-278 (applying Section 2036 to a private annuity where the estate conceded that the purchasers of family limited partnership units did not have the economic ability to make the annuity payments and that it was intended that money would be withdrawn from the partnership to enable them to pay the annuity amount). But if the purchaser has the economic wherewithal to make the payments irrespective of the income generated—as where the trust's obligation is guaranteed or the trust has sufficient seed money—the amount of anticipated income to be earned by the trust and its relationship to the amount of the annuity should be irrelevant.

What if there is insufficient seed money and no guarantee, making it impossible for the estate to satisfy the Fidelity-Philadelphia criteria? Is it possible for the estate to nonetheless argue against a Section 2036(a)(1) string by showing that there was no mathematical relationship between the anticipated income and the amount of the annuity? As suggested in the text, the Ray court appeared willing to accept such an argument. But it is valuable to distinguish this argument from the Fidelity-Philadelphia Court's point about the relationship between income and annuity. Whereas Fidelity-Philadelphia focused on the relationship between the annuity and *actual* income, the Ray court's focus is on the relationship between the annuity and *anticipated* income.

35 See also Estate of Hurford, *supra* note 34 (citing the decedent's continuing role in management in concluding that Section 2036 applied in the context of a private annuity).

36 See Byrum, *supra* note 12 ("At the outset we observe that this Court has never held that trust property must be included in a settlor's gross estate solely because the settlor retained the power to manage trust assets"); see also Rev. Rul. 81-15, 1981-1 CB 457.

37 See note 28, *supra*.

contrary, as suggested, it adopts, in essence, the same framework. Thus, having found that the estate failed to satisfy the *Fidelity-Philadelphia* criteria, the *Trombetta* court's conclusion would not have been altered had it considered the Preamble.

Section 2702 and Section 2036

Section 2702 provides that, in the case of certain transfers to a family member, any retained interest is deemed as a general rule to have a value of zero. The section was designed, in large part, to prevent a transferor from claiming that the retention of an income interest resulted in the reduction in the amount of the taxable gift—a reduction that was at the core of the pre-Section 2702 grantor retained income trust (GRIT) strategy.[38]

Under an important exception for what is referred to as a "qualified interest," a transferor who retains the right to receive an annuity can reduce the amount of the taxable gift by the present value of the annuity provided certain special rules contained in the Regulations are satisfied. The Code section, as well as the Regulations, contemplate that it will apply where an interest is retained in connection with a transfer, as with a GRIT.

But what if the transaction is structured as a sale in exchange for a private annuity? Does Section 2702 apply? Put differently, must the special rules in the Regulations be satisfied in the case of such a sale in order to reduce the amount of the taxable gift by the present value of the annuity?

While neither the text of Section 2702 nor the Regulations address this question, it would seem that Congress intended the section to have a limited scope: targeting transfers with a retained interest like a GRIT but not sales in exchange for a private annuity. Prior to the enactment of Section 2702, as discussed, the Supreme Court in *Fidelity-Philadelphia* had considered the same question—whether such a sale should be treated in the same fashion as a transfer with a retained interest—for purposes of Section 2036. As indicated, the Court concluded that, if certain criteria are satisfied, the transaction should be treated as a sale, not as a transfer with a retained interest, and therefore not subject to Section 2036.

In enacting Section 2702, Congress used the same concepts of "transfer" and "retention" that are employed in Section 2036. Given that Congress enacted Section 2702 against the backdrop of *Fidelity-Philadelphia* and used the same key concepts, the section should be read in a similar fashion: no application if the criteria established by the *Fidelity-Philadelphia* Court for treating a transaction as a sale in exchange for an annuity are satisfied. For where Congress uses language or concepts in an amendment that have a well-ingrained meaning, Congress is to be understood as intending the amendment to incorporate that meaning.[39]

Moreover, if the distinction made by the Court in *Fidelity-Philadelphia* were ignored in the context of Section 2702, the section would have an expansive and therefore problematic scope. It potentially could apply to any installment sale—just as Section 2036 would be applicable to installment sales in the absence of the *Fidelity-Philadelphia* distinction.[40] The section, therefore, should be read as incorporating the distinction.

Nonetheless, as a matter of cautious drafting, it would seem prudent to assume that a sale in exchange for a private annuity may be within the scope of Section 2702. After all, if the IRS were to argue successfully that the *Fidelity-Philadelphia* distinction did not apply in this context, a failure to include in the trust instrument provisions making it compliant with the Regulations under Section 2702 could result in severe gift tax consequences: the annuity would be deemed to have a value of zero. Consequently, as will be discussed, it would make sense to include, as the drafter did in *Trombetta*, prohibitions designed to make the trust compliant with the Section 2702 Regulations. But, in using the retained annuity form, the question becomes whether the drafter in *Trombetta* may have erred in terms of increasing the risk of Section 2036 inclusion, a subject to which we now turn.

Whether *Trombetta* should be read as reflecting the court's greater willingness to find an implied understanding or whether, instead, the court's finding was influenced by its reaction to the annuity transaction will, perhaps, become clear in future cases.

Reconsidering Section 2036 and *Fidelity-Philadelphia*: Does Form Matter?

In *Trombetta*, as suggested, the decedent designed the transaction as a transfer with a retained annuity rather than as a sale in exchange for the annuity. The trust instrument affirmatively provided that the decedent retained the annuity within the meaning of Section 2702. The drafter apparently chose this

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38 See Gans, "GRITs, GRATs and GRUTs: Planning and Policy," 11 Va. Tax Rev. 761 (1992).

39 See Merrill Lynch, Pierce, Fenner & Smith Inc. v Dabit, 547 U.S. 71 (2006) ("And when judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its ... judicial interpretations as well" (internal quotation marks omitted)).

40 See Rev. Rul. 77-193, *supra* note 24 (applying Fidelity-Philadelphia in concluding that Section 2036 does not apply to an installment sale).

41 See note 23, *supra* (Fidelity-Philadelphia, fn. 8, citing with approval Security Trust & Savings Bank, Trustee, in which the transaction was found to be a sale, not a retained annuity, based on a guarantee).

42 See Regs. 25.2702-3(b)(5) and -3(d)(5).

form based on a concern about triggering the Section 2702 zero-value rule—structured as a retained interest, the annuity was within the scope of the section, but the zero-value rule was negated by including necessary provisions in the trust instrument that, in accordance with the underlying Regulations, produce this effect.

While the drafter's decision to use the retained annuity form in *Trombetta* is understandable given the concern about Section 2702, it may not have been necessary. Even more problematic, the use of this form may have the effect of increasing the risk of Section 2036 inclusion of the trust's assets in the decedent's gross estate.

In terms of increasing Section 2036 risk where the retained annuity form is used, consider again *Ray*. In *Ray*, the decedent transferred assets to a trust while retaining the right to receive an annuity. In holding that Section 2036 applied, the court pointed to the fact that the decedent had chosen this form, as opposed to selling the assets to the trust in exchange for the annuity. Although the court did not indicate that the taxpayer's chosen form was dispositive, the court's willingness to give some weight to this factor is not surprising.

After all, as a general matter, a taxpayer who chooses a form that leads to an adverse tax result is not permitted to argue that the form should be disregarded in favor of the substance of the transaction. Under the Supreme Court's decision in *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 33 AFTR2d 74-1347 (1974), only the IRS is permitted to make a substance over form argument. Although the *Ray* court did not cite it, the court's unwillingness to allow the estate to disavow the form chosen by the decedent is certainly consistent with *National Alfalfa*.

After dispensing with the estate's argument that the chosen form should be disregarded, the Ninth Circuit went on to address the estate's argument based on *Fidelity-Philadelphia*. It also found this argument wanting, concluding that the annuity obligation was in fact chargeable solely to the assets the decedent had transferred to the trust. The trust contained only the assets that the decedent had contributed to it at the time the annuity transaction was consummated, and no one had guaranteed the payment of the annuity to the decedent.

> **PRACTICE NOTES**
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> **As a matter of cautious drafting, it would seem prudent to assume that a sale in exchange for a private annuity may be within the scope of Section 2702. After all, if the IRS were to argue successfully that the *Fidelity-Philadelphia* distinction did not apply in this context, a failure to include in the trust instrument provisions making it compliant with the Regulations under Section 2702 could result in severe gift tax consequences: the annuity would be deemed to have a value of zero. Consequently, it would make sense to include, as the drafter did in *Trombetta*, prohibitions designed to make the trust compliant with the Section 2702 Regulations. In using the retained-annuity form, however, the question becomes whether the drafter in *Trombetta* may have erred in terms of increasing the risk of Section 2036 inclusion.**

Having rejected the *Fidelity-Philadelphia* argument, the Ninth Circuit in *Ray* had no need to examine more carefully the relationship between the use of the retained annuity form and *Fidelity-Philadelphia*. That is, the court did not need to consider whether Section 2036 inclusion could be negated by satisfying the criteria in *Fidelity-Philadelphia* in circumstances in which the decedent had used the retained annuity form.

Consider whether the court in *Ray* might have come to a different conclusion if, as in *Trombetta*, the trust's annuity obligation had been guaranteed by a third party. It would seem that, notwithstanding the use of the retained annuity form, Section 2036 should not apply in such a case. For, in accordance with *Fidelity-Philadelphia*, the use of a guarantee establishes that, in substance, the transaction is in the nature of a sale.[41]

This conclusion should not be altered merely because the decedent had used the retained annuity structure rather than a sale format if, as a matter of substance, under the *Fidelity-Philadelphia* criteria the transaction is a sale. Indeed, in establishing the criteria for distinguishing a sale from a retained annuity, the *Fidelity-Philadelphia* Court sought to clarify the substantive differences between the two and could not have contemplated that the use of the retained annuity structure would be determinative even if the substantive criteria articulated by the Court for treating the arrangement as a sale were otherwise satisfied. Nonetheless, given the lack of clarity about how to resolve the possible tension between *Fidelity-Philadelphia* and *National Alfalfa*, using the sale form would appear to be the safer approach.

If the sale approach is used, however, what about the risk of triggering the Section 2702 zero-value rule, a risk that obviously drove the drafter in *Trombetta* to use the retained annuity form? It would seem that, if the trust instrument contains the necessary provisions to make it compliant with the Regulations under Section 2702, the zero-value rule should be inapplicable even if the sale form is used. So, for example, the instrument should prohibit additional contributions and commutation.[42] With the necessary prohibitions included in the instrument, there should be no risk of triggering the zero-value rule simply because the sale format is used.

Simply put, there is no requirement in the Section 2702 Regulations that the retained annuity form be used in order to negate the zero-value rule. Therefore, the use of the retained annuity form in *Trombetta* would appear to have been an error, having increased the risk of Section 2036 inclusion out of a concern about a nonexistent Section 2702 risk.

CONCLUSION

Whether or not the *Trombetta* court's reasoning or ultimate conclusion is correct, the decision offers some cau-

tionary lessons for practitioners who do private annuity or installment sales transactions.

First, as the estate planning community is well aware, where a trust is used as the purchasing vehicle, the risk of Section 2036 inclusion of the assets held by the trust must be considered. A common approach used in order to defeat a retained-string argument is to fund the trust with seed money. *Trombetta* can be read to suggest that where seed money is used, it should not be contributed to the trust in connection with the sale, but rather in an earlier, unrelated transaction.

Another approach involves the use of a guarantee. While this is an attractive alternative—enabling planners to sidestep the question of how much seed money is necessary and whether it was timely contributed—the *Trombetta* court's hostility is of concern. After all, in most cases the guarantor is never called on to make payment. If, as *Trombetta* suggests, this serves as a basis for finding the retention of a Section 2036(a)(1) string, few transactions using a guarantee will be upheld. The court's reasoning in terms of this issue is difficult to reconcile with *Fidelity-Philadelphia*, but its hostility may deter some practitioners from using the guarantee approach.

Second, whether the transaction is cast as a sale or as a transfer with a retained interest should not be determinative as long as it complies with the *Fidelity-Philadelphia* criteria. For example, even if the transfer with a retained interest form is used, the presence of a guarantee should preclude a finding of a retained string. But given the *Trombetta* court's inclination to focus on the form of the transaction, it would be prudent to use the sale format instead. And, given the *Trombetta* court's concern about the lack of meaningful negotiation, it perhaps would be helpful for each party to the transaction to have separate counsel, although that would appear unnecessary when the value is dictated by statute (as it is under Section 7520 for an annuity).

Parenthetically, married couples may be able to avoid a retained-string argument without having to use either seed money or a guarantee. Consider, for example, an installment sale in which both spouses play a role: The wife lends cash to a trust at the applicable federal rate (AFR) and the trust, in turn, uses the cash to buy assets from the husband. The IRS would not be able to argue that the husband had retained a string given the absence of his entitlement to payments once the sale is consummated. Nor would the IRS be able to assert a retained-string argument in the wife's estate inasmuch as she did nothing more than make an AFR loan to the trust.

Variations on this approach might include the use of a marital trust. For example, the husband could fund a general power trust for the benefit of the wife, and this trust could then loan cash to a descendants' trust in order to enable it to make a cash purchase from the husband. Again, the Service would not appear to be able to make a retained-string argument in either estate. For those using such an approach, *Trombetta's* constricted interpretation of *Fidelity-Philadelphia* would not be a threat.

Third, the risk that the Section 2702 zero-value rule will apply cannot be overlooked. The decedent in *Trombetta* carefully included in the trust instrument prohibitions designed to comply with the Section 2702 Regulations. But there was no need to provide that the decedent had retained the annuity. The zero-value rule can be avoided without such a provision, and, as indicated, it appears to create more Section 2036 risk than the sale format.

Finally, given *Trombetta*, it makes no sense to authorize the trustees to make distributions to the grantor/decedent in excess of the annuity amount. While the existence of such authority does not in and of itself create a predicate for finding a Section 2036 implied understanding—and, indeed, such authority is explicitly allowed under the Section 2702 Regulations—it must be conceded that the *Trombetta* court pointed to this authority in finding a retained interest. Also, given the court's emphasis on the decedent's continuing role in management and the trust's discharge of the decedent's mortgage liability, prudent planners will take appropriate measures to avoid IRS arguments of this ilk. ●