# GRANTOR RETAINED ANNUITY TRUSTS VS. SALE TO DEFECTIVE GRANTOR TRUSTS

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Grantor Retained Annuity Trusts and Sales to Defective Grantor Trusts are two tools (in addition to QPRT's) that the practitioner may consider in helping clients discount and freeze estates for estate tax purposes.

## I. Grantor Retained Annuity Trusts (GRATs):

### A. Generally.

While GRATs can be structured in a variety of ways, typically the grantor gifts property to an irrevocable trust. The trust provides that the grantor will receive a fixed amount annually. This is known as the annuity portion of the trust, because the grantor is retaining an annuity in the transferred asset. The annuity is set for a fixed period of time such as the lesser of the grantor's life expectancy or a number of years. When the number of years on which the annuity is to be payed out ends, the grantee (who is the ultimate remainderman trust beneficiary and who will, therefore, be referred to as the beneficiary in the following discussion) receives whatever funds are left in the trust income tax free to the beneficiary. The grantor's interest in the property transferred to the trust is frozen at the value of that asset as of the creation of the GRAT, plus fixed annual payments. The taxable gift to the trust and the grantee as ultimate beneficiary is equal to the present value of the trust remainder valued under IRC § 7520. Any appreciation in the transferred property above the section 7520 discount rate passes to the beneficiary gift tax free. Therefore, the goal of the trust is to outperform the interest rate assumed by section 7520 in calculating the value of the taxable gift.

### B. Example.

On December 1, 2001, a grantor, age 75, gifts closely held stock or commercial real estate worth $500,000.00 to a GRAT. Under the terms of the trust, the grantor receives an annuity payment of $74,500.00 for 10 years. Assuming the section 7520 rate then in effect is 8%, the value of the grantor's retained annuity is $431,379.50. Therefore, the value of the taxable gift is $68,620.50. Assuming the property actually produces annual returns of 8%, nothing will be transferred to the beneficiary at the end of 10 years. However, if the property produces average annual returns in excess of 8%, that excess value will be transferred to the beneficiary free of gift

tax. For example, if the average rate of return were 10%, the beneficiary would receive $109,500.00 free of gift tax. If the average return were 18%, the beneficiary would receive $864,000.00 free of gift tax. Therefore, property which has high appreciation potential is the best suited candidate for use in a GRAT. This may include commercial real estate, closely held stock, pre-IPO stock, and high growth or high yield securities.

**C. Documents.**

There are numerous requirements that must be met in drafting the Grantor Retained Annuity Trust. These requirements are set forth in the Treasury Regulations at § 25.2702-3(b)(1)-(4) and § 25.2702-3(d)(2)-(4). For example, the trust term must equal either the life of the grantor, a period of years, or the lesser of the two. The document must provide for the payment of an annuity amount. This must consist of a right to receive a fixed amount each year and that right must be irrevocable. The annuity payment must actually be made (although it can be made after the end of the taxable year as long as it is made by the due date of the trust's income tax return, without regard to any extensions). The annuity amount can either be a dollar amount or a fraction or percentage of the fair market value of the asset as of the date it is transferred to the trust and as that value is finally determined for federal tax purposes. While payments can be of unequal amount in a given year and can be increased in later years, no yearly payment can be greater than 120% of the payment made in the prior year.

The trust must contain a clause for prorating the annuity in short taxable years. The trust must also prohibit additional asset contributions to the trust, distributions to anyone other than the grantor and prepayment of the grantor's annuity. The annuity being paid to the grantor cannot be paid in kind or by promissory note. The trust or the beneficiary, however, can borrow money to make the annuity payment to the grantor.

**D. Other Tips in the Use of GRATs.**

While the Treasury Regulations set forth the minimum requirements of a GRAT, other factors must be considered in drafting and using GRATs.

In establishing the GRAT, it is important to assess the age, health and mortality risk of the grantor. If the grantor dies during the term of the trust, the IRS takes the position that all of the property in the trust will be included in the grantor's estate under section 2039 of the Code. PLRs 9451056; 9448018; 9345035. One planning strategy would be to use term or other life insurance to insure the life of the grantor for the term of the trust to allow the grantor's heirs to receive a death benefit equal to the tax which would result if the GRAT were included in the grantor's estate.

Another strategy is to include the use of a revocable spousal annuity. In valuing the grantor's retained annuity, the IRS factors in the possibility that the grantor may die during the trust term. This decreases the value of the annuity. If the probability of death is lower the annuity is valued higher. To decrease the probability of death during the term of the trust, some GRATs are structured to pay an annuity for the lesser of the trust term or the joint lives of the grantor and the grantor's spouse. Treasury Reg. § 25.2702-2(a)(5) provides that if the grantor's spouse is given an annuity interest which the grantor can revoke, the grantor is deemed to have retained the spousal interest. While this position has been upheld in Tax Court, in PLR 9707001, 9717008 and 9741061, the IRS ruled that the mortality risk associated with the life of the grantor's spouse would not be factored into valuing the retained annuity.

Care must also be given to selecting the remainder beneficiaries of the GRAT. For example, if the remainder beneficiaries are listed as "the grantor's issue, *per stirpes*", and one of the grantor's children dies during the term of the GRAT, the ultimate transfer to the grandchildren could trigger the GST Tax. This needs to be factored into the grantor's overall estate plan and generation skipping plan, if any. An allocation of the GST exemption to the value of the remainder gift at the creation of the GRAT will not prevent the GRAT from being subject to the GST Tax. To avoid this risk, some practitioners will draft the GRAT to make distributions to the grantor's living children at the time of the termination of the trust, with nothing passing to the issue of any deceased children. Obviously, this requires care so that the grantor's other estate planning documents (such as revocable trusts) equalize distributions to issue of deceased children in the event of a child's death.

Care must also be given to making sure that one uses correct numbers in valuing the asset transferred to the GRAT and have a savings clause. If you use a low valuation is used which the IRS later determines should have been valued higher, the GRAT will not have paid out all

income at the applicable section 7520 rate. This is a difficult situation because Treasury Reg. §25.2702-3(b)(1) requires the annuity amount to be stated as a fixed percentage of the initial fair market value of the trust as finally determined for federal tax purposes. Therefore, the document should state that the annuity payment amount will be based upon that percentage as it relates to the initial fair market value of the trust as finally determined for federal tax purposes so that the payment can be automatically increased if it is determined that the value was higher than estimated at the time of the making of the trust.

A planning device which has been gaining favor is the use of End-Loaded GRATs. These are used to maximize the remainder value and minimize the gift value. An End-Loaded GRAT provides that the annuity payments will increase during the term of the trust and that more assets will be left in the trust in the early years. If the asset in the GRAT sustains level appreciation over its term, there will be a greater return for the remainder beneficiaries. Increasing annuity payments are permitted under Treas. Reg. §25.2702-3(b)(1)(ii). As stated above, however, no yearly annuity payment may be in excess of 120% of the prior year's payment.

Another planning device is the use of separate GRATs to lessen the risk of market volatility when multiple assets with varying potential rates of return are going to be gifted to a GRAT. For example, if one asset worth $200,000.00 produces a rate of return of 8% and another asset worth $200,000.00 produces a rate of return of 12%, the combined average between the two assets is 10%. If one 10 year GRAT is used (and assuming the applicable section 7520 rate is 8%), the amount passing tax free to the beneficiary would be $87,600.00 at the end of the 10 year term. If each asset was placed in a separate GRAT, and while the beneficiary would receive nothing tax free on the asset producing an 8% rate of return, the beneficiary would receive $98,000.00 tax free on the asset producing a 12% rate of return.

In some instances the grantor does not need the annuity payment being generated from the GRAT. Therefore, consider drafting a series of short term GRATs rather than one longer term GRAT. In that case, the amount of property retained in the grantor's estate is minimized, and the risk that the Grantor will die during the term of the GRAT is also minimized.

## II. SALES TO INTENTIONALLY DEFECTIVE IRREVOCABLE TRUSTS (IDITs)

### A. Generally.

For transfer tax purposes, if a person owns or controls the property held in a trust there is no completed gift and the property will be included in the grantor's estate. This is most typically seen in a revocable trust. Prior to 1985, attorneys often established irrevocable trusts in an effort to deny the grantor ownership or control of the trust assets. This allowed the assets in the trust, and the growth on those assets, from being included in the grantor's estate. This also allowed the income derived from trust assets to be taxed to either the trust or the beneficiaries. These trusts were all irrevocable non-grantor complex trusts or simple irrevocable trusts. In a complex irrevocable trust, the income is distributable at the discretion of the Trustee and is not automatically taxed to a particular beneficiary (the trust is taxed). In a simple irrevocable trust, income must be distributed to a particular beneficiary or class of beneficiaries. Therefore, the income is taxed to such beneficiaries.

With the advent of **Rev. Rule. 85-13**, the notion of an intentionally defective irrevocable trust evolved as a new estate planning technique. An IDIT separates the income tax treatment of the trust from its transfer tax characteristics. The income is taxable to the grantor while the principal is not included in the grantor's estate for transfer tax purposes and the transfer of assets to the trust is not deemed to trigger a gift. This dichotomy results from the interplay between Chapters 11-14 of the Code which establish the transfer tax consequences of the transaction and Sections 671-679 of the Code which establish the grantor trust rules.

If the grantor of an IDIT pays the income tax on the IDIT's income, the grantor is not deemed to have made a gift for the benefit of the IDIT beneficiaries. This is because the income tax on the trust income is deemed to be the grantor's obligation. This gives the beneficiaries of the IDIT all of the use of the IDIT assets without any transfer tax costs to the grantor or a concern over exceeding annual exclusion gifting or lifetime gifting limits. Additionally, since the trust is not paying taxes, the trust has more assets available to make investments that can grow tax free for the benefit of the beneficiaries. This also gives the trust more liquidity so that the trust can pay premiums on life insurance owned by the trust. This also means that there is no capital gains tax on the sale of the assets to the trust.

The sale to an IDIT is actually a two part process which involves a gift of cash or assets to the trust followed by a sale of the same asset for an installment note. The gift is necessary to avoid an IRS argument that a sale for a note in the entire amount of the asset sold is not commercially reasonable since a bank would not lend money to a trust without an equity cushion. By gifting part of the assets, the IDIT has some equity in the asset to pledge for the note portion of the transaction. It is generally not a good idea to have the interest of the note tied to the earning performance of the assets. The IRS could take the position that the grantor has made a gift with a retained income interest under Section 2036. Generally, the amount gifted to the trust should equal at least ten percent (10%) of the assets being sold. This pre-empts an IRS argument that there are no assets in the trust with equity in the event of a default on the note. **PLR 9535026**.

The note which the grantor receives for the remaining assets sold to the trust must bear interest at the applicable federal rate at **Section 1274** (AFR). Loans with a term of less than three years must use the short term AFR. Loans with a term of between three and nine years must use the midterm AFR. Loans with a term in excess of nine years must use the long term AFR. When rates are low, obviously it makes sense to lock in the interest rate for as long as possible.

If the grantor does not have the financial ability to gift such equity to the trust, the trust might be structured in such a way as to allow the beneficiaries to give a guaranty of the note. However, the IRS is free to argue that consideration must be provided to those who give guarantees. Without a guaranty fee or other consideration to the guarantors, the IRS could take the position that such guarantors are deemed to be contributors to the trust. If this occurs, the original grantor will no longer be considered the sole grantor of the trust. This results in income tax implications to the guarantors and deprives the original grantor of reaping 100% of the benefits of the IDIT as set forth above. There is also a risk that if the rate of return on the trust property is less than the interest rate on the note, then the trust may be required to call on the guarantors to pay off the loan.

By establishing the sale of assets to the IDIT, the grantor is able to freeze the value of the asset at its current fair market value; the sale price of the asset. Except for the portion of the transfer which constituted a gift to the trust, the grantor does not need to use his/her lifetime gift exclusion or GST exemption in funding the trust or in paying income taxes on income which the

trust earns on a yearly basis. If the trust has crummey powers, then the grantor gets to use the grantor's annual exclusion against the gifted portion. If the grantor sells appreciated assets to the trust, no capital gains tax is triggered.

The goal and intention of the IDIT is for the asset in the IDIT to appreciate in value. If the asset does so appreciate, then leverage can be obtained by structuring the note to require interest only during the term of the note, with a balloon of principal at the end of the term. This allows the trust to generate growth outside of the grantor's estate, while only the original asset at its fair market value at the time of sale and interest paid on the note stays within the grantor's estate.

**B. Structure.**

While a sale to an intentionally defective irrevocable trust can be structured between any related or unrelated parties, for purposes of this outline, assume that the transactions taking place will be between a parent and the parent's child or children. A sale to an IDIT is a sales transaction by which a trust established for the benefit of a child uses money loaned to it by the parent to invest. If the investments outperform the amount needed to pay the interest and principal payments due to the parent on the loan, then the child receives a tax benefit.

While such a transaction can be structured in a variety of ways, in general, a parent (also known as the "grantor") sells an asset or group of assets to an irrevocable grantor trust which is designed to be defective for income tax purposes but not defective for estate tax purposes. In exchange for the asset, the trust executes a promissory note in favor of the parent. The note requires the trust to make interest payments to the parent for a number of months or years, with a balloon payment of principal at a specified date. The interest rate is set at the minimum rate required under Section 7872(f)(2)(A). Because the trust is not deemed to be a separate entity for income tax purposes from the parent making the transfer, the sale to the trust is designed not to trigger any capital gains. Any interests payments from the trust to the parents are not considered taxable income to the parent. Analogous to a GRAT, if the annual interest rate earned on the assets transferred to the trust exceeds the annual interest rate set by the IRS under Section 7872(f)(2)(A), the additional return will have been transferred to the child free of gift tax.

In addition to saving capital gains taxes as set forth above, this planning device can be used to fund an irrevocable trust during the life of the parent, without the parent incurring gift taxes. The problem in gifting assets to an irrevocable trust is that the value of the transferred

assets may exceed the parent's unified credit and, therefore, result in the parent having to pay a gift tax on the transfer to the trust or reduce his unified credit accordingly. In addition, if the parent sells appreciated assets to fund the trust, the parent will incur capital gains taxes on the transfer. As a result, the use of an IDIT, while subject to significant IRS scrutiny, can be used. The parent sets up an irrevocable trust which is intentionally "defective." The defect comes from the fact that the maker or grantor of the trust continues to reserve in the trust document sufficient control so that the IRS ignores the trust as a separate entity and treats the trust as a "grantor trust" for tax purposes.

First, the grantor takes appreciated assets (such as stocks) and gifts to the trust at least ten percent (10%) of the total amount with which the grantor wishes to fund the trust. The grantor then sells the remaining stock to the trust. The sale of the stock to the irrevocable trust is ignored for income tax purposes. Rev. Rul. 85-13. As a result, there would be no capital gain on the sale of the stock.

Next, the trust gives a promissory note back to the grantor for the value of the assets sold. If the taxpayer wants to be extremely aggressive (and assuming the appropriate warning letters have been given from counsel), the value of the assets sold and, therefore, the amount which the trust has to repay under the promissory note can be discounted using a limited partnership to first hold the stock. In that scenario, the limited partnership sells limited partnership interests in an entity owning the stock to the irrevocable trust. Payments on the promissory note can be delayed or end-loaded to enhance the earnings potential for the trust and trust asset appreciation. For example, the grantor could allow the trust to build up assets through the dividends paid on the stock and then give the stock back to the grantor as a note payment while the trust retains the income produced from the dividends. By giving the stock back to the grantor in repayment of the note, the stock does not have to be sold to pay the note. Therefore, no capital gains need be recognized. This would not be possible with a GRAT since GRAT payments cannot exceed 120% of the prior year's payment.

The trust would pay annual interest on the promissory note at the Section 1274 rate as set forth above, with a balloon payment at maturity (again, in an attempt to end-load payments). This is better than the Section 7520 rate that applies to a GRAT and, therefore, enhances the likelihood that the earnings of the trust will exceed the interest paid on the note. So long as the value of the property transferred equals the face amount of the note, the exchange is not

considered a gift. As a result, and in addition to deferring capital gains tax on the transfer of the stock, the grantor has also deferred gift/estate taxes until the death of the grantor. The interest paid by the trust on the promissory note is not considered taxable income to the grantor, nor is it deductible to the trust.

All income received by the trust is taxable to the grantor and is not considered a taxable gift to the trust. PLR. 9444033 and PLR. 9543049. As a result, the grantor is actually paying the taxes on the earnings of the trust without having made an additional gift to the trust to allow the trust to pay those taxes. This allows the trust to grow quicker without the need for additional gifts.

The grantor could receive some capital gains if the stock held by the trust is used to pay the note to the grantor. As a result, often the transfer of stock back to the grantor is a preferable way to repay the note. This is a reason for using a limited partnership to discount the value of the required note. Another solution would be the use of life insurance to pay an end-loaded note upon the death of the grantor.

Any stock used to repay the note obligation to the grantor receives a free step-up in basis upon the death of the grantor under Section 1041. This allows the trust to generate income from the assets (such as stock) placed in the trust, later pay the underlying asset back to the grantor (thereby avoiding capital gains taxes in the grantor), and creates a free step-up in basis in the ultimate beneficiary upon the death of the grantor under Section 1041.

If the grantor dies before the note is repaid, the value of the note is includable in the grantor's estate. The grantor, however, still deferred the tax until death (of course, since the grantor did not file gift tax returns during the initial transfer, it is at this point that the IRS can scrutinize and challenge the overall plan). The trust assets, including all post-sale appreciation, are not includable in the grantor's estate. This is preferable to a GRAT because GRAT assets are includable in the grantor's estate if the grantor dies before the end of the trust. Also, unlike a GRAT, the GST exemption can be immediately allocated to the property gifted to the trust.

**C. Example.**

A parent gifts $200,000.00 to an irrevocable grantor trust. The parent later sells $2,000,000.00 in assets to the trust. The trust signs a nine year promissory note of $1,800,000.00, using the $200,000.00 initial gift contribution as a down payment for the purchase of the $2,000,000.00 in assets. The note requires annual interest at the then prevailing rate of 6.71% for

nine years with a balloon payment of $1,800,000.00 in the ninth year. If the transferred property produces a return of 6.71%, nothing will be transferred to the child gift tax free at the end of 10 years. If, however, the property produces an average annual return of 10%, the child will receive $1,064,594.00 gift tax free in year 10. If the property produces an average annual return of 14%, that amount increases to $2,658,220.00. In addition, the parent did not pay capital gains taxes on the sale of the assets to the trust and the parent did not pay gift taxes on the transfer to the trust.

**D. Obtaining Grantor Trust Status.**

A grantor is considered the owner of a trust for income tax purposes if, under Sections 671-679, the grantor retains certain powers over the trust. For example, if the grantor retains a greater than 5% reversionary interest in the trust, the grantor will be deemed the owner of the trust.

Under Section 674(a), the grantor will also be the owner of the trust, or any portion thereof, if the grantor has a power of disposition exercisable by the grantor or a non-adverse party without the consent of the adverse party. Section 674(a) lists multiple exceptions to this rule which should be reviewed prior to drafting.

Section 675 confers grantor trust status if the grantor holds powers of administration over the trust, such as: the power to deal with the trust for less than full consideration, the power to borrow without adequate interest or security, a power to vote stock held by the trust, a power to control trust investments or a power to reacquire the trust property by substituting other property of equal value.

Even allowing the Trustee the right to use trust assets to purchase life insurance on the life of the grantor can result in grantor trust status; something the trustees may do anyway to leverage the assets in the trust upon the death of the grantor.

**E. Other Tips in the Use of Intentionally Defective Irrevocable Trusts.**

Section 2702 provides that if the note given by the trust to the grantor is characterized as equity and not debt, the transaction can be recast as a transfer in trust with a retained interest in the grantor, subject to a zero valuation rule. Therefore, to avoid this trap, the trust should be capitalized with some equity. Generally, a 10% equity cushion has been considered a safe harbor. PLR 9436006. Also, under Section 2701(a)(4), there is a mandated 10% minimum value for common units in partnership capitalization freezes. Personal guaranties and security should also be used.

In drafting the trust, avoid the use of safe harbor provisions for increasing the face amount of the note if the IRS finds that the value of the property placed in the trust is greater than estimated for establishing the note payment. While permitted in GRATs, the same is not permitted in an IDIT. See ***Comm'r v. Proctor, 142 F.2d 824 (4th Cir. 1944)***.

Because the transaction does not constitute a taxable gift, a gift tax return does not need to be filed. As a result, the statute of limitations does not begin to run. Therefore, even though not required, it may still be advisable to report the transfer on a gift tax return which follows the gift tax adequate disclosure rules as set forth in Treas. Reg. Section 301.6501(c)-1.

If the note is not repaid prior to death, the unpaid principal balance will be included in the grantor's taxable estate. Some estates of taxpayers have argued that the trust is thinly capitalized and that a discount on the note balance is appropriate. However, this argument runs the risk that the IRS will contend that there was insufficient equity at the time of the initial transaction.

**F. Important Historic and More Recent Legal Authority in Sales to an Intentionally Defective Irrevocable Trust.**

**Section 2701:** This Section was designed to prevent the transferring of wealth through the non-exercise of discretionary rights. Such discretionary rights are valued at zero. The goal in establishing an IDIT is to produce an estate freeze while avoiding Section 2701.

**Section 2702:** This Section was designed to eliminate the undervaluation of gifts of interests in trust and term interests. Undervaluation was caused when taxpayers controlled the return on retained interests, usually producing a lower return than assumed by IRS actuarial tables. Such retained interests are valued at zero, unless they take an easily valued form such as an annuity or uni-trust interest. While this Section is a concern when using a GRAT, the sale to an IDIT is generally not subject to this Section.

**Rev. Rul. 85-13, 1985-1 C.B. 184:** The IRS disregards a grantor trust as a separate taxpayer for income tax purposes and the transactions between the grantor and the IDIT have no income tax consequences. Therefore, no gain or loss is recognized on the sale to the IDIT. The grantor is not taxed separately on interest payments on the note. The grantor continues to be taxed individually on all income generated by assets held by the IDIT, as thought the IDIT did not exist and ignoring interest on the note.

**Sections 671, *et seq.*:** Ownership of an IDIT for income tax purposes results from intentionally violating one or more of the grantor trust rules under these Sections. This makes both the income and the principal portions of the trust tax directly to the grantor. As a result, it is easier to produce a total net return in excess of interest on the note to the grantor, since the grantor is liable for taxes on the trust's income and the trust is not being reduced by the payment of taxes.

**Section 1274:** This sets the applicable interest rate required for an IDIT note. This rate is less than the annuity rate on a GRAT under **Section 7520**. The 7520 rate is 120% of the 1274 rate under **Section 7520(a)(2)**.

***Frazee v. Commissioner, 98 T.C. 554 (1992)*:** The Tax Court adopted the IRS position that the value of a promissory note given in exchange for the sale of property was to be determined under **Section 7872**. That Section incorporates the Section 1274 rate under **Section 7872(f)**. This case also established the notion that there is no gift tax if the note principal equals the fair market value of the asset transferred to the trust.

***Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958)*:** To satisfy the test of a sale, the rate of interest should be as provided in Section 7872(f), the obligation under the note not be tied solely to the assets sold to the trust, and the note should be a personal obligation of the purchaser. This means that the trustee or other beneficiaries with sufficient assets should generally be willing to personally guarantee the note. There should also be an equity cushion like those insisted upon by banks. A 10% gift of equity to the trust has been held to satisfy IRS requirements. **See also:** ***PLR 9515039 and Rev. Rul. 77-193***.

Since the IRS is looking for a transaction that is based upon an arms length type of loan transaction, thought should be given to pledging security for lthe loan portion of the transfer. This may include a security agreement with UCC-1's for non-real property, mortgages for real property or stock pledges for capital stock.

**G. Conclusion.** The IRS can still argue that the transfer to an IDIT is not a sale but a transfer with a retained life estate and that **Section 2036** keeps the assets in the grantor's estate and, therefore, Section 2702 also applies. This would mean that GRAT rules apply so that the grantor cannot claim that the transfer is not a qualified interest. Therefore, the grantor would have made a gift equal to the value of the property as if the trust does not exist.

While Rev. Rul. 85-13 and ***Frazee***, aids the taxpayer, Section 2702 is still at issue unless the note is a true debt instrument which must be paid even if the property value goes down, and which contains the ability to go after all assets of the trust and which contains a 10% equity cushion of gifted assets (although there is no definitive authority for the amount of equity cushion required). The note should also require beneficiaries with independent assets to act as guarantors.

If the grantor dies while the note is outstanding, the trust loses its grantor trust status. There is an open issue as to whether that creates an income tax problem since the IRS could argue that the face amount of the note above the trust's transferred basis in the assets equals taxable gain. If the IRS takes this position the trust would get a basis adjustment and the estate would get a **Section 691(c)** deduction on the estate tax return and/or the note could receive a **Section 1014** free step-up in basis. As a result, the IRS may not take the position that there is such a taxable gain. Therefore, the note would be in the seller's estate and the trust would continue a carryover basis. Since there is no certainty as to which position the IRS will take, it is advisable to structure the note to pay back the grantor during his lifetime. The note term should not be structured to exceed the actuarial life expectancy of the grantor. The note should provide that there is no pre-payment penalty. The trust might also consider using appreciated assets to pay off the note. There would be no capital gains on the payoff using these assets since this is a grantor trust under Rev. Rul. 85-13. In addition, the grantor's heirs would still receive a Section 1014 free step-up in basis in those assets at the death of the grantor.

All of the benefits derived from the gift and sale of an IDIT are enhanced and leveraged when the grantor is able to take a discount on the value of the assets gifted and sold, such as through the use of a family limited partnership. Since the use of an IDIT allows the grantor to freeze the value of the assets being gifted and sold to the IDIT at the time of the transfer, by discounting the value of those assets at the time of the transfer, the grantor freezes a lower value in his estate and allows the real value of the IDIT to grows significantly higher in relation to the discounted value left in the grantor's estate.

## III. Using Family Limited Partnerships/Family Limited Liability Companies to Generate a Discount on the Gift and/or Sale to the IDIT

**A. Generally.** The transfer tax savings using an IDIT is leveraged even further when the gift and/or sale of the assets to the IDIT are discounted by first placing those assets into a limited partnership or limited liability company. Such a strategy attempts to utilize both marketability and minority discount theories. While much has been written about utilizing such entities to achieve transfer tax savings, those entities may also have non-transfer tax savings uses.

For example, a client may want to share ownership with another person but maintain a controlling interest. This often occurs when a client takes in investors who will be granted equity rights but will not be involved in day to day decision making. These investors may be non-managing members of a limited liability company. The client seeking to maintain control may be the managing member. Unlike a corporation, the client can give more than 50% of the equity to the investor without risking a loss of control. The investing owner may also want limited liability company interests so that he or she can receive liability protection while maintaining flow through partnership tax treatment.

Limited liability companies are also used to achieve controlled gifting strategies. A client may wish to transfer some ownership to a child for estate planning reasons, or to start having that child become involved in business affairs. Often, however, the child is either not old enough or yet responsible enough to be involved in decision making.

Limited liability companies are also used to provide owners with liability protection from third parties. Generally, members in a limited liability company are given liability shields analogous to those given to shareholders in a corporation. Unlike a corporation, however, the members can still receive the tax advantages of partnership/flow through tax treatment. Limited liability companies give owners liability protection which is unique to entities which are taxed as partnerships. A creditor of a member may force the member to transfer his or her membership interest to the creditor. The creditor, however, becomes an "assignee," and not a member. Therefore, that creditor is not eligible to participate in management of the entity. The creditor may obtain a "charging order." This entitles the creditor to the debtor's share of any company distributions that are actually made. Therefore, the creditor is treated as a partner for income tax purposes and is taxed on the debtor's proportionate share of company income, even if the company does not make any distributions. Therefore, the creditor is taxed on income which the creditor has not received. See RSA 304-B:41; ***Baybank v. Catamount Construction 141 NH***

***780 (1997).*** This can create a disincentive for creditors to go after limited liability company interests. Given out of state decisions [starting in the bankruptcy context in ***In Re: Ashley Albright, No. 01-11367 (Bkrptc.D.Col. 04/04/2003)*** in which the United States bankruptcy court for the District of Colorado held that since there was no other member to protect, there was no reason to limit the ability of a creditor to reach the assets of the LLC] which have refused to relegate creditors to a charging order in a single member LLC entity, many practitioners are counseling the use of multi-member LLCs. This may involve the use of the member's spouse as a member holding some small percentage of ownership.

The Colorado limited liability statute at issue in ***Ashley Albright*** was similar to the New Hampshire statute since it treated the limited liability company interest as personal property. The court made note of the fact that the statute requiring the consent of all other members in order to allow a substitute member was irrelevant where there were no other members. The court also cited the portion of the Colorado statute that allowed members to change managers.

The court did, however, ultimately reinforce the notion of the charging order remedy by stating that the result would have been different had there been other non-debtor members of the LLC at issue. In fact the court stated that a trustee in bankruptcy would have no voting rights in the LLC as against a debtor holding the control and domination of the membership and management of the LLC.

Practitioners, in response to ***Ashley Albright***, are advising the use of multi-member LLCs if charging order protection is sought. Many are recommending at least a 10% interest in the second member, even though the court in ***Ashley Albright*** suggested that a "minimal interest" held by a second member would be enough. Some practitioners are also putting provisions in their operating agreements limiting the ability of a member or assignee of a member to replace a manager. This may involve a management appointment for life. Other practitioners are putting reserve clauses in their operating agreements which allow managers to set profits aside for future business purposes. This allows the managers to withhold distributions to members (and, therefore, creditors of members) by asserting future business needs such as future purchases or capital needs.

Limited liability companies have also been used to establish a hierarchy for decision making among potential competing and conflicting owners. For example, multiple owners may be involved in a family held business or family owned real estate. Parents in estate planning may want to ensure that all owners have equity rights but that certain persons make decisions. The decision makers would be the managing members.

When selecting a limited liability company or limited partnership for the primary purpose of estate planning the client will generally be focusing on three distinct issues. For purposes of the examples used in these materials, I will assume that a parent is selecting a business entity as part of an overall estate plan for the children; although the use of children is merely being used to provide a consistent example. First, the parent will not want to create any adverse income tax consequences to himself or herself and, to a varying extent, the children. Second, the parent will not want to give up control of the business while the parent is living (or at least for some period of time). Third, the family will want to take advantage of any estate freezes and/or valuation discounts for estate and gift tax purposes.

In an example of a typical structure, a limited liability company is established to hold the parents' interest in a business, investments or investment real estate. Since the parents are receiving the entire membership interest in exchange for their contribution, there is no income tax effect to the transfer of assets to the limited liability company.

The LLC is made up of two types of membership interests. The first type is a managing membership interest. This interest is the interest which has all of the rights to make management and major decisions affecting the company. The second type is a limited non-managing membership interest. This interest carries no right to make management or other major decisions, and is in fact legally prevented from making any such decisions in the operating agreement.

In the extreme, the membership could be made up of 99% non-managing membership interests and 1% managing membership interests. The parents gift their non-managing membership interests to their children (or other heirs). Therefore, the parents have effectively gifted away 99% of their membership interests. However, by retaining a 1% managing membership interest, they maintain control over the LLC and its holdings. The advantage of using a limited liability company over a family limited partnership is that many ongoing businesses are already limited liability companies and, therefore, can be structured to support the

gifts without forming a new entity. Also, there is no issue of a general partner having liability exposure to third parties. Unlike a partnership, and depending upon the operating agreement of the company, an owner cannot withdraw and cause the termination of the entity and/or force that owner's share of company assets to be distributed. The authority cited in these materials will be a mix of decisions and rulings dealing with both LLCs and LPs.

In 1959, the IRS published **Rev. Rul. 59-60, 1959-1 C.B. 237** which outlines eight relevant factors in determining the value of closely held businesses. The factors include:

A. The nature of the business and its history;

B. the economic outlook in general and of the specific industry;

C. the book value and financial condition of the business;

D. the earning capacity of the business;

E. the dividend paying capacity of the business;

F. whether goodwill or other intangible value is present;

G. sales of the stock and the size of the block that is being valued; and

H. market price of traded stocks in the same or similar line of business.

**Rev. Rul. 59-60, 1959-1 C.B. 237** was made applicable to partnerships and proprietorships by **Rev. Rul. 68-609, 1968-2 C.B. 327.**

**B. Minority Discount.** The IRS generally permits discounts based on two factors when valuing an interest in a limited partnership. The first factor is the "minority discount," defined as a minority interest in the value of the entity that reflects an absence of power or control. By definition, a non-managing member has no ability to participate in the decision-making and management of a LLCs business. This lack-of-control makes the non-managing member's interest unattractive to an outside investor and, therefore, less valuable.

A partner in a partnership can generally withdraw from the partnership at any time. If a partner does withdraw, he or she will generally be entitled to receive the value of his or her interest in the partnership. A withdrawing partner can even cause the dissolution of the business. If there is dissolution, each partner receives his interest in the assets of the partnership. For this reason the partnership interest may receive a smaller lack of control discount than a limited liability company interest.

**C. Marketability Discount.** In addition to minority discounts granted for lack-of-control or voting power, the IRS has permitted marketability discounts. A marketability discount is an amount or percentage reduction from an ownership interest to reflect a lack of liquidity.

The value of a donor's interest in a limited liability company for estate and gift tax purposes is the fair market value of the interest itself, rather than that of the underlying assets. Generally, an interest in an LLC is not easily transferable and the assignee to which it is transferred has no assurance that he or she will be allowed to become a member. For these reasons, the courts have frequently valued interests in limited liability companies at a significant discount against the net value of the underlying assets. Although the discounts granted have varied depending on economic conditions and the facts of each case, combined discounts for lack-of-control and lack-of-marketability have generally been in the range of 30% to 40% of the net asset value of the LLC interest.

The lack-of-marketability and lack-of-control valuation discounts that apply to the ownership interest in LLCs can significantly reduce the donor's transfer tax base. Planners should note that the discount applies to the value of the transferred interests as well as the value of the retained interests and can reduce the value of a donor's estate by an amount greater than the actual value of the assets transferred.

**D. Historic Legal Authority in Discount Valuations.** Section 704(e): defines when a partnership made up of family members will be valid for income tax purposes. This Section requires that the partnership's capital be a "**material income producing factor**" and that the donees be the "**real owners**" of the partnership interests which they hold by virtue of dominion and control over those interests.

**TAM 9719006:** If the donee does not have sufficient control over the partnership interest for income tax purposes, such ownership should be disregarded for transfer tax purposes.

- beware of partnerships made up solely of residential real estate and marketable securities.

- beware of partnerships formed by durable powers of attorney at a time of donor incompetence.

- beware of partnerships in which assets are transferred without much time elapsing before gifting of interests and/or death of the donor.

Sections 2512 and 2031: Fair market value is defined as "the price at which property would change hands between a willing buyer and a willing seller, with neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts."

**Rev. Rul. 93-12, 1993-1 CB 202:** The IRS reversed its previously held position and agreed that family control will not be taken into consideration in determining fair market value for transfer tax purposes.

- Value property at the time of contribution to the entity <u>and</u> at the time those interests are transferred to the partners and could result in double discounts, for example, minority interests in stock of a family held business.
- The IRS has agreed to two discount factors: lack of liquidity/marketability discount and lack of control/minority discount.
- A restriction on the right of a donee to liquidate the entity can result in a larger discount for lack of control since assets such as commercial real estate and passive investments (including marketable securities) will often have their greatest value upon liquidation than as part of the entity as a going concern.

**E. Current IRS Attacks on Discounting.**

The recent IRS attacks on LLCs have focused on several areas. First, that the arrangements had no business purpose and lacked economic substance; the whole transaction was just designed to reduce the donor's transfer tax liability and should be disregarded as a sham. This is sometimes known as "Economic Substance Doctrine". ***Griffin v. United States 42 F. Supp. 2d 700 (W.D. Tex. 1998); Estate of Murphy v. Commissioner T.C. Memo. 1990-472 (August 30, 1990);*** and ***IRS Field Service Advise 200049003 (December 8, 2000). TAMs 9736004; 9735003; 973004; 9725002; 9723009; 9719006 and 9842003.*** The above TAMs result from cases involving elderly donors and/or deathbed donors with transfers under durable powers of attorney. They also resulted from cases involving highly liquid property such as marketable securities and family residences.

Second, under Section 2703(a)(2) the LLC entity itself should be disregarded as a "restriction" that lacks a bona fide business purpose. Section 2703(a)(2) states that for purposes of transfer tax "the value of any property shall be determined without regard to...any restriction on the right to sell or use such property". This Section was originally intended to apply to buy-sell agreements that had no purpose beyond reducing transfer tax valuations. The IRS argues

that, under this Section, the entity itself is a restriction of the use of the assets and should be disregarded. This seems to disregard state law provisions which make LPs and LLCs valid entities which have their own definitions of property rights. ***Commissioner v. Bosch Estate, 387 U.S. 456 (1967)***- federal law will look to the states to determine the property rights of taxpayers.

Third, that any restriction on liquidation contained in the LLC should be disregarded under Section 2704(b). Section 2704(b)(1) provides that for purposes of transfer tax if there is a transfer of an interest in an entity to a member of the donor's family and the donor and members of the donor's family control the entity immediately before the transfer, any "applicable restriction" shall be disregarded in determining the value of the transferred interest. Under Section 2704(b)(2), the words "applicable restriction" mean any restriction that effectively limits the ability of the entity to liquidate if the restriction lapses after the transfer of the interest or the donor or member of donor's family alone or collectively has the right to remove the restriction after the transfer (example, family members control a partnership and can amend the partnership agreement after the transfer to remove the restriction). However, under Section 2704(b)(3)(B) the term "applicable restriction" does not include a restriction imposed under federal or state law. Therefore, a restriction on the ability to liquidate the entity can only be disregarded if it is <u>more</u> restrictive than the limitations that would apply under state law. This Section requires that restrictions on liquidation that are more restrictive than those imposed by state law are to be **disregarded**, if such restrictions will lapse after the transfer or can be removed by the transferor or by members of his family. Such restrictions usually mean the right to withdraw and be paid for the owner's interest or the right to cause a liquidation of the entity. The IRS will, therefore, read out any more restrictive provisions. This will obviously increase the value to the donee, thereby reducing or eliminating the discount.

Fourth, under Section 2036(a)(1) there was an implied agreement that the transfer was not complete and the transaction should be treated as if the donor still owned the asset. These have been part of the line of cases which have looked to a totality of the circumstances (with no one controlling factor) to hold that in reality nothing had changed between the donor and the donee. ***Estate of Strangi v. Commissioner, 85 T.C.M. (CCH) 1331 (2003); Estate of Harper v. Commissioner, 83 T.C.M. (CCH) 1641 (2002); Kimbell v. United States, 244 F. Supp. 2d 700 (N.D. Tex 2003); Estate of Thompson, T.C. Memo. 2002-246 (Sept. 26, 2002).***

Fifth, there was a gift on formation of the entity because the donor did not control the entity at the time of funding. This argument was outlined in **TAM 9842003 (October 16, 1998)**. The IRS argues that the donor made a taxable gift when the assets were transferred to the LLC upon formation and not when interests in the LLC were transferred at a claimed discount. While **Church** and **Jones** (discussed below) hold that there is no gift if a contributing partner's Capital Account is properly allocated, it is still better to avoid this issue by having the donor control the LLC at the time of funding.

**F. Recent Legal Authority in Discount Valuations.**

***Murphy v. Commissioner, 60 T.C.M. 654 (1990).*** Cited by the IRS in TAM 9719006 to support its argument that there was no business purpose to the Family Limited Partnership ("FLP") at issue, using a "stepped transaction" position and also arguing that the family retained control of the entity. The IRS focused on the fact that the transaction was done solely to reduce estate taxes.

In ***Kerr v. Commissioner, 113 TC No. 30 (1999)***, the Tax Court rejected IRS arguments that Section 2704(b) should reduce the discounts claimed for gifts of family limited partnership interest, because the partnership restrictions that produced these discounts were "applicable restrictions" under Section 2704(b). Acting on the advice of counsel, the taxpayers and their children formed two family limited partnerships, KFLP and KILP. The taxpayers contributed all of the capital and were the sole general partners. The capital of KILP consisted of stocks, bonds, and real estate. The capital of KFLP was life insurance policies on the taxpayers' lives as well as interest in KILP. The taxpayers promptly assigned part of their general partnership interests to each of their children.

In 1994, the taxpayers transferred limited partnership interests in both partnerships to the University of Texas and then contributed limited partnership interests to grantor retained annuity trusts (GRATs) they created, with remainder interests vested in trusts for their descendant's. The taxpayers also made additional gifts of limited partnership interests to each of their children. The taxpayers filed gift tax returns valuing the partnership interests with a 52.5% discount for lack of liquidity and control (plus an additional 25% on the KFLP interest held by KILP). The IRS rejected the discounts, asserting that the liquidation and dissolution restrictions must be disregarded as applicable restrictions under Section 2704(b).

Tax Court granted summary judgment to the taxpayers, allowing discounts for lack of marketability and control. The Tax Court rejected the IRS' argument that they had actually transferred to the GRATs only interests as assignees, rather than interests, as limited partners, stating that the taxpayers had previously ignored the formalities required by the partnership agreement for the admission of new partners and that the documentation on the assignments to the trusts reflected an intention that the trustees acquires partnership interests, rather than an assignee interests. The Tax Court further stated that there was only a very small distinction between the rights of limited partners under the agreements and the rights of assignees.

***Kerr*** is significant for the following reasons: First, it is the first judicial rejection of the IRS's attempt to construe Section 2704(b) broadly enough to reduce or eliminate marketability and control discounts for most family limited partnerships. Second, the Tax Court held that a family limited partnership restriction on a limited partner's ability to withdraw from the partnership was not an applicable restriction. Third, the ***Kerr*** decision is a reminder of the critical importance of following the terms of the family limited partnership. ***Estate of Schauerhamer v. Commissioner, 73 T.C.M. 1997-242.*** The Tax Court found that there was implied agreement that the donor would retain the economic benefit of the partnership assets until her death. The Tax Court focused on the fact that the donor/general partner ignored the terms of the partnership. Therefore, the assets of the partnership were included in the donor's estate under Section 2036(a)(i). However, in the pre-2003 decision of ***Estate of Strangi v. Commissioner, 115 T.C. No. 35; No. 4102-99 (Nov. 30, 2000)*** and in ***Knight v. Commissioner, 115 T.C. No. 36, No. 11955-98 (Nov. 30, 2000)***, the Tax Court ignored the fact that the partnership made certain personal expense payments on behalf of the donor, thereby ignoring the fact that the partners did not respect the formalities of the entity. The Tax Court refused to disregard the entities as lacking a business purpose citing the fact that they had been validly created under state law, they had changed relationships with creditors and they had changed the donor's relationship with heirs. The Tax Court did not focus on the donor's intent. The Tax Court did, however, reduce the discounts taken to 15%. In ***Strangi***, the Court also suggested that a 99% limited partnership interest suggested a strong possibility of inclusion in the donor's estate under Section 2036 (not raised by the IRS in a timely manner).

**TAM 199938005:** If donor general partner has the right to vote the stock of a controlled corporation (20% or more of voting power of all classes of stock for at least 3 years prior to donor's death), the entire value of the stock will be in the donor's estate.

***Estate of Reichardt*, *114 T.C. 144 (March 1, 2000)***: Cited in ***Strangi*,** and holding that the donor, who had terminal cancer and died 14 months after the partnership was formed, had an implied agreement with his children that he would retain the present economic benefits in the transferred property until his death. Even though not legally enforceable, the Tax Court looked at the intent of the parties.

In ***W.W. Jones II v. Commissioner, 116 T.C. No. 11 (March 6, 2001)***, the decedent established two family limited partnerships. One family limited partnership was created with his son, A.C. Jones, to which he transferred surface rights in a ranch, and his son transferred a one-fifth interest in a ranch owned by the son with his four sisters. Another limited partnership was formed with Jones' four daughters. The decedent transferred surface rights to another ranch and his four daughters each transferred a one-fifth interest in the ranch that they owned together with their brother. The son acquired a 1% general partnership interest and a 3.4611% limited partnership interest in exchange for his contribution to the partnership between himself and his father. The father received a 95.5389% limited partnership interest in exchange for his contribution to the partnership. Consequently the son was the only general partner.

On the same day that the partnership was formed, father gave his son an 83.08% interest in the partnership, and retained a 12.4589% limited partnership interest. In the partnership between father and the daughters, two of the daughters received a 1% general partnership interest and a 1.9555% limited partnership interest in exchange for their contribution to the partnership and the other two daughters each received a 2.9555% limited partnership interest for their contributions to the partnerships. The father received an 88.178% limited partnership interest in exchange for his contribution to the partnership.

Also, on the same day that the partnership was formed, the father transferred to each of his daughters a 16.912% limited partnership interest and retained a 20.518% limited partnership interest. The partnership with the daughters provided for the removal of the general partner and the dissolution of the partnership by the act of partners owning an aggregated 75% interest in the partnership. The partnership with the son provided partners owning an aggregated 51% interest in the partnership could remove the general partner. The valuation of the transferred interests in

the partnership between the father and son was based on a 66% discount from net asset value and the partnership with the daughters on a 58% discount from net asset value. The discounts included secondary market, lack-of-marketability, and built-in-gains discounts.

The Court rejected the estate's argument that the interest to be valued should be an assignee interest and not a limited partnership interest. Although consents of the partners to the transferors were not obtained, as required under the partnership agreements, the facts indicated that father transferred limited partnership interests to the children and not assignee interests. The Court also found that the restriction on limited partner's right to withdraw from the partnership or demand any return of any part of the partner's capital account was not an applicable restriction under Section 2704(b). The Court, agreeing with the holdings in ***Kerr v. Commissioner; Harper v. Commissioner, TC Memo 2000-202;*** **and** ***Knight v. Commissioner, 115 T.C. 506 (2000)***, held that an applicable restriction was a restriction on the right of a partner to cause a liquidation on the partnership itself and not a redemption of a partner's own interest in the partnership.

The ***Jones*** case is another rejection of the IRS' gift-on-formation theory and its definition of an applicable restriction under Section 2704(b). It is also the first case dealing specifically with the effect of a potential capital gains tax on unrealized appreciation when valuing a transferred interest in an entity classified as a partnership.

Practitioners should note that the terms of the partnership agreement concerning control are important in determining whether a lack-of-control discount is available and the appropriate sum of a discount. In the partnership agreement between the father and the son, the 83.08% limited partnership interest transferred to the son was not entitled to a lack-of-control discount because the recipient of the interest could remove the general partner and cause dissolution of the partnership. The facts in the case do not indicate why the partnership agreement provided that partners holding an aggregate 51% of the partnership interests could remove the general partner. Because the son was the only general partner of the partnership, and the father presumably intended to transfer a substantial percentage of the limited partnership interest to the son when he established the limited partnership, there was apparently no practical reason for such a provision.

***Church v. United States, 2000-1 U.S. Tax Cas. (CCH) 60,369 (W.D. Tex. 2000), aff'd, 2001-2 U.S. Tax Cas. (CCH) 60,415 (5<sup>th</sup> Cir. 2001)*****:** The partnership at issue was formed just two days prior to the donor's death and was funded with approximately 2/3 marketable securities. It was also funded under a durable power of attorney. The Court's rendition of the

facts focused on the 1/3 of assets consisting of a family ranch and the fact that the donor died unexpectedly (although she was in his second cancer remission). The Court found that the cause and timing of the donor's death was irrelevant. The Court found that the family may have formed the partnership to keep out discord, especially given a history with a rogue relative who was part owner of the ranch. The court rejected the government's Section 2703 argument, holding that Section 2703 was only intended to apply in a buy-sell context.

Specifically, Elsie Church and her children executed a partnership agreement to centralize management and consolidate their interests in a 23,000-acre ranch. The three individuals were named limited partners and although it had not yet been formed, a corporation that would be formed by the children was named general partner. Each limited partner contributed his or her undivided interest in the ranch and Elsie contributed an additional $1,000,000 in securities. The partnership owned 57% of the ranch and other family members owned the rest. Elsie owned 62% of the partnership's interest. A special allocation gave Elsie 99% of the taxable income from the securities she contributed, after expenses, and 62% of the income attributable to ranch operations. The corporate general partner had not been formed when Elsie died and the partnership had not yet filed its certificate with the state. Elsie's death was unexpected although she had been fighting breast cancer and was in remission. The partnership assets were worth approximately $1,500,000 at Elsie's death.

The IRS argued that Elsie had not effectively conveyed the securities to the partnership before she died, or that creating the partnership was a taxable gift equal to the difference between the value of the assets she contributed and the value of the partnership interest she received. The District Court granted summary judgment for the estate, holding that:

a) The estate held only an assignee interest worth far less than the decedent's partnership interests;
b) Despite the failure to file all the proper documents until after the decedent's death, the partnership was not a sham and its existence could not be ignored (the court held that the partners had substantially complied with the state law requirements);
c) Creating the partnership was not a taxable gift;
d) Section 2703 did not treat the partnership agreement as a restriction on the transfer of the underlying assets; and

e) Section 2703 did not apply, because the partnership was a bona fid business arrangement. The partnership was not a device to transfer property to members of Elsie's family for less than full and adequate consideration in money or money's worth and the terms and restrictions of the partnership agreement were comparable to similar arrangements entered into by persons in arm's-length transactions.

This is a very good case for taxpayers. However, the decision was rendered by a District Court in Texas not known for its expertise in tax law. The case was affirmed by the 5th Circuit. However, the 5th Circuit's decision was a *per curiam* decision which did not address the merits. There is also a suggestion that the Court was upset with the government in the case over unproven allegations.

***Shepard v. Commissioner, 115 T.C. No. 30; No. 2574-97 (Oct. 26, 2000)*:** This decision focuses on the estate depletion theory which reasons that for valuation purposes one looks to the value of what the donor gives and not to the value of what the donee receives.

***Estate of Strangi v. Commissioner, 115 T.C. No. 35; No. 4102-99 (November 30,2000)***: This decision focuses on both a willing seller and a willing buyer and reasons that both sides of the transaction must be examined. Some observers believe that the Tax Court was telling the government that it gives away too much in Rev. Rul. 93-12.

***Knight v. Commissioner, 115 T.C. No. 36, No. 11955-98 (Nov. 30, 2000)*:** The Tax Court held that Section 2704 was inapplicable because the partnership agreement was no more restrictive than state law. The Tax Court reduced the taxpayer-claimed portfolio discount of 44% to 15%.

***Estate of Dailey, T.C.M. 2001-263 (Oct. 3, 2001)*:** In finding a 40% limited partnership discount, the Tax Court noted that the IRS had stipulated that, pursuant to Section 7491 (a), when the petitioner introduces credible discount evidence, the burden of proof shifts to the IRS relative to valuation. The Tax Court, citing ***Strangi*** and ***Knight*** also found that the family limited partnership was validly formed under state law and therefore refused to disregard it for tax purposes.

***Estate of Harper v. Commissioner*, *83 T.C.M. (CCH) 1641(2002)***: The taxpayer commingled assets with the entity, made disproportionate distributions that did not respect the partnership agreement and delayed in properly funding the entity. Therefore, the court concluded that the partnership was merely a "testamentary vehicle" for the decedent's estate plan. This shows that the IRS can be successful in Section 2036 arguments given the right facts.

**Field Service Advice 200049003 (Sept. 1, 2000):** The IRS has determined that, based on decisions to date, Sections 2703, 2704(b) and 2036 can all be used as a basis for giving notice of gift and estate tax deficiencies. This is the IRS outline on how to attack family limited liability companies.

***Estate of Leichter v Commissioner 85 T.C.M. (CCH) 1991 (2003)*:** The value reported by the taxpayer on an estate tax return is an admission of value and the taxpayer cannot later claim a larger discount.

***Estate of McCord 120 T.C. No. 13 (2003)***: Shows that courts do not take a macro approach to valuation discounts but instead look to each asset within the limited partnership to determine the discount appropriate for each such asset. Recently, the IRS circulated an appeals settlement matrix which outlined the range of discounts being routinely given by asset class:

| Type of Partnership | Range of Discounts |
|---|---|
| Good Section 2036 Case (Pship w/in 6 mos. of death) | 0 - 15% |
| Passive Assets | 25 - 30% |
| Active Management Assets | 35 - 40% |

**The IRS Business Plan** for 2003 included a priority item to examine the Section 2704 restrictions on liquidation within the context of family limited partnerships.

***Lappo v. Commissioner T.C. Memo. 2003-258(September 3, 2003)*:** The tax court applied a 15% minority interest discount and a 24% marketability discount on limited partnership interests where the limited partnership was comprised of approximately 40% marketable securities and approximately 60% real estate.

Under the partnership agreement the general partners had exclusive authority to manage the operations and affairs of the business, including the distribution of cash. No partners had the right to withdrawal capital or receive distributions unless provided in the partnership agreement. No partner could demand or receive assets other than cash in return for that partner's capital interest. No partner could be paid interest on capital contributed to or accumulated in the

partnership. The withdrawal of a general partner would cause dissolution of the partnership unless another general partner remains or all other remaining partners agreed to continue the partnership and appoint another general partner.

The limited partners had no rights to participate in management. A limited partner could assign his or her interest but that assignment would not dissolve the partnership or entitle the assignee to become a partner or exercise rights of a partner without the consent of the general partner. The partnership had the right to purchase all of a limited partner's interest upon that partner's death or upon a transfer of the limited partner's interest by operation of law. The purchase price would be fair market value or, if that amount was not agreed upon, determined by an appraisal. The partnership had a right of first refusal over an attempt of a limited partner to sell his or her interest. The partnership had the right to pay 15% less than a third party offer. The partnership was to continue until December 31, 2045, unless dissolved sooner by the consent of all of the partners or by the withdrawal of all general partners or by judicial dissolution.

**G. Combining Discounts with Annual Exclusion Gifting.**

Section 2503(b): The annual gift exclusion is available when the donee has the unrestricted right to immediate use or enjoyment of the property. Gifts of future interest do not apply for the exclusion under **Reg. 25.2503-3(a).**

Therefore, can the annual exclusion be taken with an LLC transfer? In **TAM 9751003**, the IRS ruled that a limited partner's interests were too restricted to enjoy immediate economic benefits and denied the exclusion. This matter involved a very restrictive partnership agreement.

In ***Hackl v. Commissioner***, ***118 T.C. 279 (2002), aff'd 2003 U.S. App. Lexis 13936 (7th Cir. 2003)***, The Tax Court held that transferred interests in a limited liability company did not give a substantial current economic benefit since the operating agreement prevented the donee from accessing any present substantial economic or financial benefit and, further, barred alienation as a way of reaching such present economic value. Therefore, the Tax Court disallowed split gift annual exclusions for the transfer of the discounted LLC interests to the donor's eight children, children's spouses and twenty-five grandchildren. The Tax Court may have erred by concluding that the gifted units could not be transferred. Instead, the agreement had a customarily used provision which made a transferee an assignee.

**H. Reason to Adequately Form LLC Before Transferring Assets.**

***Shepard v. Commissioner, 115 T.C. No. 30; No. 2574-97 (Oct. 26, 2000)*:** This case involved a donor who transferred land to a partnership in which the donor was the only partner. The next day the donor transferred partnership interests to the donees. The Tax Court found that since a partnership cannot have only one partner, the transfer to the donees was not a gift of partnership interests but was an indirect gift of undivided interests in property. Therefore, instead of a 33.5% discount which could have been taken had the gifts been of partnership interests, the discount was limited to 15% (made up of a 3% lack of control discount, a 10% discount for possible disagreement of the partners over property disposition and a 2% discount for potential partitioning).

**I. Risks Beyond Disallowance of Discount.**

Section 6662(g): Imposes a 20% undervaluation penalty if the value of the property subject to transfer tax is undervalued by 50% or more.

Section 6701: Allows a penalty to be assessed against the advisor who "aides and abets" the understatement of tax liability.

**J. The *Strangi* Cases.**

Perhaps no cases have generated as much discussion and debate among practitioners who use LLCs and LLPs in estate planning as the various ***Strangi*** decisions, staring with ***Strangi v. Commissioner, 115 T.C. 478(2000)*** and culminating in ***Strangi v. Commissioner, 85 T.C.M. (CCH) 1131 (2003), aff'd 417 F.3d 468 (5th, Cir. 2005)***.

The Strangi Family Limited Partnership (SFLP) was created in 1994 along with its corporate general partner, Stranco, Inc. Albert Strangi, the decedent, transferred $49,350 to Stranco, Inc. in exchange for a 47% interest in the corporation. Mr. Strangi's four children contributed a total of $55,650 of their own money to Stranco for a 53% interest in the corporation. This left each child with a 13.25% interest in the company.

After Stranco, Inc. was created and funded, Stranco, Inc. transferred all of its holdings to SFLP in exchange for a 1% general partnership interest. Mr. Strangi also contributed $9,676,929 to the SFLP in exchange for a 99% limited partnership interest. This contribution included Mr. Strangi's personal residence and most of his cash and securities. Stranco, Inc. hired Mr. Strangi's son-in-law (Michael Gulig) to manege the day-to-day operations of both Stranco, Inc.

and the SFLP. Mr. Strangi's son-in-law, who was a licensed attorney, was acting on behalf of Mr. Strangi under a 1988 Power of Attorney which Mr. Strangi executed in order to facilitate the sale of Mr. Strangi's house back in 1988.

Mr. Stangi died two months after the creation of the SFLP. The executor of Mr. Strangi's estate reported his general and limited partnership shares in his estate giving the value of the shares a 33% discount from the total value of the FLP, citing a lack of control and a lack of marketability discount. The IRS issued a deficiency notice claiming that the full value of the property contributed to the SFLP by Mr. Strangi should be included in his estate. The IRS disregarded the FLP and any discounts.

In the original 2000 Strangi decision [***Strangi v. Commissioner, 115 T.C. 478(2000)***], sometimes referred to as Strangi I, the Tax Court recognized the validity of the FLP and held that the estate was entitled to include less than the full market value of the property transferred to the FLP. However, the court found that the discount percentage taken was excessive. On appeal [***Gulig v. Commissioner, 293 F.3d 279,282 (5th Cir. 2002)***], sometimes referred to as Strangi II, the U.S. 5th Circuit Court of Appeals upheld the lower court's decision, however it denied the Commissioner's leave to amend the pleadings and allow a trial on the Section 2036(a) issue.

In Strangi III [***Strangi v. Commissioner, 85 T.C.M. (CCH) 1131 (2003)***], the commissioner attacked the FLP on two fronts under Section 2036(a), arguing retained interests. First, the IRS argued that there was an implied agreement between Mr. Strangi and his children by which Mr. Strangi could retain enjoyment of an income from the property he transferred into the FLP. The IRS argued that this violated Section 2036(a)(1). The court found that although the FLP was formed correctly, the IRS was not barred from finding that the transfer was subject to an implied agreement that Mr. Strangi would retain the "economic benefit" of the property.

The court focused on the fact that the assets retained by Mr. Strangi were mostly illiquid and that, therefore, the SFLP and Stranco would be a primary source of Mr. Strangi's liquidity. The court also focused on the fact that Mr. Strangi retained possession of his home after it had been contributed to the SFLP. No rent had been paid to the SFLP for three years following Mr. Strangi's death. The court was not persuaded by the fact that the SFLP accrued rentals on its books when no actual money changed hands.

The court also focused on the fact that the SFLP paid many of Mr. Strangi's personal expenses. These payments included payment for Mr. Strangi's maid's back surgery, $40,000.00 for Mr. Strangi's funeral, payment of Mr. Strangi's estate taxes, payment of a specific bequest from Mr. Strangi's will and other personal expenses. Again, the court was not persuaded by the fact that the estate noted these payments as advances on the books of the SFLP.

The court also focused on certain testamentary characteristics of the SFLP agreement. The court cited Mr. Strangi's advanced age, declining health (Mr. Strangi had been diagnosed with terminal cancer and was not expected to live more than 2 years after the creation of the SFLP) and the fact that the contributions to the SFLP constituted a majority of Mr. Strangi's assets. This showed that there was an implied agreement that the SFLP was intended to serve only an estate planning function. Such an implied agreement alone would not be fatal; however, the court held that the arrangement was such that "virtually nothing beyond formal title changed in [Mr. Strangi's] relationship to his assets.

The second argument made by the IRS was made under Section 2036(a)(2). The Service argued that the transferred property should be included in Mr. Strangi's estate on the grounds that Mr. Strangi could determine which beneficiary would receive property upon winding up of the SFLP. While the court did not need to reach this argument, having already found inclusion under 2036(a)(1), the court nevertheless addressed this argument.

Mr. Strangi's estate argued that the power retained by Mr. Strangi was no greater than the power retained in ***U.S. v Byrum*, *408 U.S. 125 (1972)***, in which the court held that any power that Mr. Byrum retained in the entity was limited by fiduciary duties owed to other owners and did not, therefore, warrant inclusion on a theory of retained interest. Mr. Strangi's estate argued that Mr. Strangi was only a limited partner with no right to control the SFLP. Moreover, the SFLP was a minority stockholder in Stranco. The estate also argued that Mr. Strangi had state law fiduciary duties as in ***Byrum***. The IRS countered that Mr. Strangi's power exceeded that of ***Byrum***.

The court again sided with the Service. Not only did Mr. Strangi retain a "legally enforceable right" to control who benefits from the transferred property, but those rights were not constrained as they were in ***Byrum***. Stranco was the managing general partner of the SFLP with the sole discretion to determine distributions. The authority to manage Stranco was given to Mr. Strangi's power of attorney (Mr. Gulig) through a management agreement which allowed Mr. Gulig the right to make distribution decisions unilaterally.

Unlike ***Byrum***, Mr. Strangi retained the power to determine the present enjoyment of the property in the SFLP by retaining a power to terminate the SFLP in conjunction with the other partners. The court also cited the fact that Mr. Strangi could, in conjunction with only one other board member or Stranco, declare a dividend from Stranco. Therefore, Mr. Strangi retained sufficient control over Stranco to force a dividend in violation of Section 2036(a)(2). In ***Byrum***, only an independent Trustee had the ability to determine distributions from the trust at issue.

The court refused to apply a fiduciary duty limitation argument as in ***Byrum*** by pointing out that in ***Strangi*** there was no independent Trustee who could withhold or distribute money. The court also focused on the fact that in ***Byrum*** fiduciary duties ran to a large number or unrelated parties while the fiduciary duties in ***Strangi*** ran to only one limited partner, Mr. Strangi. The court reasoned that while fiduciary duties may limit a general partner, it is unlikely that a related party would actually enforce the fiduciary duty. Also worth noting was the fact that Mr. Gulig, the person in charge of both Stranco and the SFLP, himself had preexisting fiduciary duties to Mr. Strangi. The court believed that Mr. Gulig would honor his obligations to Mr. Strangi over his fiduciary duties to the SFLP in Stranco. The court concluded that "[i]ntrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the [Byrum] scenario." The court also disregarded that fact that there was a non-family member beneficiary (a college foundation) since that foundation would only be receiving a 1% interest in Stranco. The court called this 1% interest "window dressing".

Some practitioners believe that ***Strangi*** has ended the use of family limited partnerships and family limited liability companies as a discounted estate planning tool. Other practitioners merely believe that ***Strangi*** has narrowed or even laid out the guidelines for a valid discounted FLP and FLLC. Some practitioners believe that ***Strangi*** was a warning and an exception based upon bad facts.

It is interesting to note that the same Fifth Circuit court which decided ***Strangi*** also later decided ***Kimbell v. U.S.*** on May 20, 2004, which allowed for a discount in a family limited partnership. In ***Kimbell***, the court cited the fact that Mrs. Kimbell "retained sufficient assets outside the Partnership for her own support and there was no commingling of Partnership and her personal assets." The court cited ***Strangi*** in this section of its decision. The court also pointed out that in ***Kimbell***, "Partnership formalities were satisfied and the assets contributed to the Partnership were actually assigned to the Partnership". Moreover, the assets in the FLP did not require active management. Finally, the taxpayer was able to establish a non-tax business reason for the formation of the FLP which could not have been accomplished through Mrs. Kimbell's trust.

To avoid the Section 2036(a)(1) problems in ***Strangi*** head on, practitioners should be mindful of the following. First, it is critical to follow the form of the partnership agreement. Don't overlook simple tasks such as making out rental checks if personal real estate is held in the FLP or FLLC. Second, distributions should be made in pro-rata amounts and actually paid to the investors. Third, the grantor should retain enough money so that he or she is not insolvent. The grantor should leave enough liquid assets out to pay personal expenses. Fourth, the grantor should not transfer too much of his or her estate to the FLP or FLLC. ***Strangi*** looked at both the amount of money retained and the total percentage of assets transferred. The greater the percentage transferred, the harder it is to defeat the argument that the arrangement is an estate planning device and not a legitimate business plan. Related to this is an examination of the grantor's health and life expectancy at the time of the transfer. It is also helpful to avoid using a power of attorney to make the transfer to the FLP or FLLC.

To avoid the Section 2036(a)(2) problems in ***Strangi*** head on, practitioners should be mindful of the following. First, do not let the grantor or the grantor's power of attorney be the sole manager of the FLP or FLLC. The less control in the hands of the grantor and/or in the hands of the grantor's power of attorney the better. Of course, that power cannot be transferred to the donees of the grantor or the Service could argue that lack of control discounts are not appropriate. A good solution would be to have an unrelated party as a partner to whom fiduciary duties would run. Second, the partnership documents should never expressly take away the fiduciary duties of the general partner. This would take away any chance to argue ***Byrum***.

Third, consider creating a trust, like in ***Byrum***, to be the general partner. That way, if a court determines that the grantor has the ability to force distributions to the trust, an independent trustee would still have to make the ultimate distribution decisions.

**K. Conclusions and Suggestions.**

Since the IRS has not been greatly successful in challenging the very notion of discounting, the issue in litigation will often turn on the discount amount taken and the valuation methodology used by the taxpayer (2003 ***Strangi*** not withstanding). Courts are still split on the methodology to use to value fractional interests. Some Courts focus solely on the value to the donee, some focus solely on the value to the donor and some focus on the value to both the donor and the donee. Nationally, the Tax Court is generally rejecting one sided willing-buyer appraisals which fail to consider the willing-seller side of the transaction (pre-2003 ***Strangi, Knight*, and *Jones***,). The Tax Court will generally require tax payers to produce good comparable appraisals [pre-2003 ***Strangi, Knight, Jones***, and ***Shepherd v. Commissioner***, ***115 T.C. 478 (2000, rem'd 239 F.3d 279 (5th CIR. 2002))***]. Once the petitioner introduces credible discount evidence, the burden of proof shifts to the IRS relative to valuation. ***Estate of Dailey, T.C.M. 2001-263 (Oct. 3, 2001)***.

The IRS seems to be weakest in those cases in which it argues Section 2703, 2704 (liquidation restrictions), gift on formation and absence of business purpose issues.

The IRS seems to be stronger in those cases when it shows deficiencies in the creation or funding of the entity, Section 2036 (implied agreement to retain control), and the amount of valuation discounts. Challenges based on the nature or maintenance of the entity did fail in ***Church*, *Shepherd***, pre-2003 ***Strangi*, and *Knight***,. However, when the facts establish a greater disregard for the entity, the IRS is likely to be more successful. ***(Estate of Harper v. Commissioner***, ***83 T.C.M. (CCH) 1641(2002))***.

The taxpayer will want to be mindful of bad facts: having a history of disregarding the formalities of the entity, including commingling and making distributions not provided for in the operating agreement; placing overly burdensome restrictions in the operating agreement; and avoiding funding near death and/or using durable powers of attorney. Since the IRS has, as of late, been having more success in challenging LLC structures and discounts in general related to

LLCs, some practitioners are using restricted management agreements for gift and estate discount purposes. Such agreements are generally less expensive than maintaining LLCs and are less prone to IRS challenges.

Attorneys drafting limited operating agreements should also be mindful of stating purposes for the entity beyond mere transfer tax avoidance. For example, it would be wise to include non-transfer tax reasons in the formation documents, such as:

> The nature of the primary business or purposes are: to protect assets from future creditors; to avoid fractional interests in property; to avoid transfers to non-family members; to provide proper centralized management of family assets; to increase investment flexibility not provided for in a trust; to preserve family harmony by avoiding disputes between family members; to generate economies of scale and reduced costs; to promote family knowledge and communication about assets and investment strategies; to own interests in, operate, manage, develop, improve, lease, buy and sell investments, real estate, and any other purpose not prohibited by law.

The donor should form and fund the partnership first, and then make gifts of partnership interests to the intended donees. The IRS could more easily argue that Section 2703 applies when a donor creates a partnership with nominal or no assets, gives the donees a significant partnership interest, and then transfers a large amount of property to the partnership, thus, making automatic gifts to the donees. The IRS could take the position that the entire partnership agreement was a restriction on the transfer of the underlying assets. This argument would be far more difficult to make if the donor creates the partnership, funds it with significant assets and then after an appropriate period, gifts the donees partnership interests.

The parties should follow all the procedures required by state law and the partnership agreement in all actions they take with respect to the partnership;

(a) The general partner should retain only those rights and powers normally associated with a general partnership interest under state law and no extraordinary powers;

(b) The partnership should hold only business or investment assets (or both), and that it not hold assets for the personal use of the general partner; and

(c) The general partner should report all partnership actions to the limited partners and the limited partners should act to ensure that the general partners do not exercise broader authorities over the partnership affairs than those granted under state law and the partnership agreement.

2003 ***Strangi*** notwithstanding, the retention of only a limited partnership interest will help create discounts for estate and gift tax purposes if a donor is willing to relinquish control over the partnership assets to one or more donees and if the donor does not have a right to dissolve the partnership or the right to receive more for his or her interest than its fair value, based on partnership distributions. If there is retained control but that control is subject to a fiduciary duty such as a reasonably definite external standard, then under ***United States v. Byrum, 408 U.S. 125 (1972)*** there would be no inclusion under Section 2036.

Some commentators have argued that since Section 2036(a)(2) will not apply when there is a transfer for full and adequate consideration and there has been no diminution in the donor's net worth, the Section 2036(a)(2) problem can be avoided by simply having the donor swap property or take back a note or private annuity. The question remains how the tax payer can take a discount on a gift tax return if there was no gift. The partnership agreement could include a restriction on liquidation and provide that an entity unrelated to the family (for example, a charity or non-profit organization that would not object to receiving a partnership interest as a gift) must agree to its removal. Inclusion of this restriction could prevent the application of Section 2704 for gift and estate tax purposes. Section 2704(b)(2)(B)(II).

If the donor is trying to specifically respond to the 2003 ***Strangi*** problems, the donor should consider the strategies discussed as well as the following. First, the partnership agreement should limit distributions to an ascertainable standard with some preclusion against the donor having the ability to vote with others to amend the partnership agreement (however, because state law may not recognize such a preclusion and since the IRS values without regard to provisions in the partnership agreement which are more restrictive than state law, this strategy is questionable). Second, the donor should not directly or indirectly (or through another entity) own any of the general partnership interests (however, this may not be practical for clients seeking to maintain control). Third, consider transferring limited partnership interests to a trust

with an independent trustee, but avoid completed gift treatment by the retention of a testamentary limited power of appointment. This would make the trust a grantor trust qualifying for Section 2034 inclusion.

The donor could consider forming a corporation or limited liability company in which he or she is the sole or majority owner and the corporation or limited liability company is the general partner of a family limited partnership. As owner of all or a majority of the corporation or limited liability company, the donor can indirectly exercise the corporation's right to liquidate the partnership. The right would not lapse at the death of the donor. Furthermore, a change in the ownership of the stock of the corporate partner would not cause the corporation to lose its status as a general partner nor be deemed a transfer of the partnership interest. Therefore, the death of the sole or majority stockholder of a corporate general partner should not cause a taxable event under Section 2704(a).

The lapse of a general partner's right to compel the liquidation of the general partnership may similarly be avoided by having the general partnership interest held in a revocable trust. The change in the trustee of a revocable trust upon the death of a Grantor does not terminate its status as a general partner nor cause a deemed transfer. Therefore, the death of the Grantor of a revocable trust should not cause a taxable event under Section 2704(a).

Of course, with respect to those restrictions that apply to family owned partnerships, the donors could always include **non-family members** in the entity.

The taxpayer should remember to appraise and claim discounts by asset class in accordance with ***McCord*** and not take a general discount. The appraisal must tie empirical data to the partnership in question.

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See Smith and Olsen, "The Use of Family Limited Partnerships and Limited Liability Companies (LLC's) in Estate Planning," ALI-ABA Course of Study, Qualified Plans, PC's and Welfare Benefits (February 10,1994).

See Reg. Section 301.7701-4

**L. Post-*Strangi* decisions.**

The courts have continued to strike down the discount when clients have failed to respect pot-formation formalities, even if the documents were formed correctly. These cases have included ***Estate(s) of Korby v. Commissioner, 89 T.C.M. 1143 and 1150 (2005); Estate of Bigelow v. Commissioner, 89 T.C.M. (CCH) 954 (2005).*** To gain a sense of where discount litigation may be heading, review ***Estate of Bongard v. Commissioner, 124 T.C. (No. 8) (2005)***.

**M. Comparison of GRATs to IDITs.**

Generally, a Intentionally Defective Irrevocable Trust will produce better investment and potential transfer tax savings results for the beneficiaries/remaindermen. One reason is that the Section 1274 interest rate which must be paid on the note from the Intentionally Defective Irrevocable Trust to the grantor is lower than the applicable Section 7520 rate used for a GRAT. For example, the Section 7520 rate is 120% of the Section 1274(d) rate used for notes of nine years or less. Therefore, the grantor is taking back a smaller amount into his/her estate. It should be noted, however, that the increased gain attributable to the different rates may be mitigated if Re-GRATs are used.

Another reason is that the note back to the grantor (which is the portion which the grantor takes back into his/her estate) can be end-loaded. This allows the assets in the IDIT to grow larger than if the trust had to make large loan repayments each year. In a GRAT, no year's payment back to the grantor can exceed 120% of the prior year's payment. This also allows the trust to be able to repay the grantor with assets that have appreciated over the term of the note, perhaps even the very business interests or stocks transferred to the trust in the first place. Since those assets are now back in the grantor's estate, the grantor can now pass those assets to the same beneficiaries at death with a free step up in basis.

A third reason is that in an IDIT the grantor is taxed on the earnings of the trust. This means that the grantor actually can make the IDIT's income tax payments, thereby allowing the assets in the IDIT to grow free of diminution for taxes. This also allows the grantor to, in essence, make further non-taxable gifts to the beneficiaries of the trust/remaindermen by paying their trust's income taxes on a yearly basis.

Fourth, if the grantor dies during the term of the GRAT, the entire property in the trust will be included in the grantor's estate. If the grantor dies during the term of the note established under the IDIT, only the value of the note will be included in the grantor's estate.

Fifth, while a GRAT can pose difficult and risky GST tax issues, an IDIT can be structured as an effective GST tax avoidance device.

While potential performance and tax savings appear greater in using an IDIT over a GRAT, there are other important considerations in comparing the two devices. First, a GRAT is a creation of statute and has had a longer history of acceptance than an IDIT. An IDIT is a creation of lawyers. That having been said, however, as more time has passed and as more estates have been audited, the IDIT has become a recognized and accepted estate planning option.

Second, with a GRAT, the entire transaction is reported to the IRS at the time and statutes of limitation begin to run during the life of the grantor. With an IDIT, only the portion of the assets gifted to the IDIT may be reported and no certainty over the entire transaction can result until the death of the grantor and the subsequent passing of the statute of limitations. A GRAT is also less likely to be audited because an audit revealing an undervaluation can be corrected in the document if proper drafting techniques are used. An audit which reveals an under-reported gift in an IDIT can result in the grantor either paying unintended or larger than estimated gift tax on the portion of the asset gifted to the IDIT.

Third, a GRAT can contain automatic annuity adjustment clauses which the IRS has honored. With an IDIT, price adjustment clauses have been held void as against public policy.

Based on these comparisons, an IDIT may yield greater returns, but a GRAT is preferable for the risk adverse client. The difference in returns between the two devices may be mitigated with Re-GRATs.