

Business Owner Estate Planning
Case Studies
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1. Scenario 1 - Haught Wheels, Inc.

- a. Haught Wheels, Inc. is a company that builds and sells custom cars and motorcycles. The company was started by Mr. Jack Haught, Sr. many years ago as a mechanic shop and auto parts store. Over the years the company has evolved into a custom builder and restorer of cars and motorcycles, and, up until the recession, was growing at incredible rate, particularly due to the popularity of reality TV shows featuring shops in the same industry. Even now, the company is somewhat profitable due to a following among the wealthy and the celebrity of some of the owners of the Haughts' best works.
- b. Mr. and Mrs. Haught are both age 68, and they have three children, Jack, Jr., age 46, Bill, age 42 and Sara, age 38. All members of the family actively work in the company. The parents have a moderate lifestyle and have accumulated a \$7 million estate, apart from the value of their stock in the company. All of the children are happy, well-adjusted and have accumulated taxable estates of their own (through investments and a couple of examples of "marrying well"). Each child has two children.
- c. Haught Wheels, Inc. is an S corporation. The Haughts each own 50% of the stock in the company. Their CPA has been recommending they consider giving a couple of shares of stock to their kids each year, but for one reason or another the Haughts haven't acted on this. The Haughts actually had an offer in 2005 from one of their wealthy customers to buy the company for \$10 million, but the Haughts turned it down, wanting to keep the company in the family. Now in 2009 the company is estimated to be worth \$6 million. The family and their advisors believe that the company value is going to rebound over the next few years, and that now is the time to engage in a significant transaction to transition the stock down to the next generation.
- d. One of the advisors has suggested a sale to an intentionally defective grantor trust (IDGT). What do you think and how should it be structured? Why a sale to and IDGT rather than a straight gift or a GRAT?
- e. What would the transaction look like?
 - i. IDGT Document.

- A. Irrevocable trust
 - B. Grantor powers
 - C. Choice of trustee
 - D. Administration during grantor's lifetime
 - E. Administration upon grantor's death
 - F. Generation skipping issues.
 - ii. Sales Agreement and Promissory Note
 - A. How many shares? 100%; 49%
 - B. What term? 9 year note to be able to use mid-term AFR?
 - C. Payment terms? Amortized? Interest only with balloon?
 - D. Pledge agreement
 - iii. "Seed" gift. Cash? Securities? S stock? Personal guaranties?
2. **Scenario 2 - SCIN.** Assume instead that Mr. Haught was already deceased, and that Mrs. Haught has been diagnosed with a rare cancer. The doctors have indicated that although nothing is imminent, they are not confident she will live more than 5 to 7 years. One of their advisors has suggested that the note include a self-cancellation feature so that the obligation to make payments will end at the earlier of the stated term or Mrs. Haught's death. What do you think?
- a. SCIN premium?
 - b. Seller's health?
 - c. Length of term?
3. **Scenario 3 - Subchapter S Issues.** Same facts as in Scenario 1. Three years have gone by since the sale to the IDGT. The company has been making Sub S distributions to the IDGT, and the trust has been properly and timely paying the installment payments to the Haughts. The company has been very profitable lately, and the Haughts are reporting and paying the tax on the company income (since the IDGT is a grantor trust), even though they haven't received any of the Sub S distributions. The Haughts have decided that enough is enough and that they don't want to bear the tax anymore. Accordingly, documents are prepared to switch the trust from grantor trust status to nongrantor trust status (sometimes called "togglng off"). Up until now, the IDGT has been an eligible Sub S shareholder as a grantor trust. Now that the trust has ceased being a grantor trust, how do we make sure that we don't blow the S election?
- a. Pot trust -- ESBT?
 - b. Separate shares -- QSST?
4. **Scenario 4 - GRAT.** Same facts as in Scenario 1 except that the Haughts don't take their advisors' advice and have now sold Haught Wheels, Inc. for \$8 million such that they have a \$15 million estate, all in cash and marketable securities. IRS rates are still very low, and some speculate that certain sectors of the stock market will do well over the next

couple of years. The Haughts have not adjusted their standard of living and do not need much of their net worth. The kids will continue to work for the new owner. They continue to be responsible and have stable marriages, and the Haughts' would be happy to let the children have part of their inheritance now while they have children who would benefit greatly from traveling and educational opportunities. The Haughts' advisors suggest a rolling GRAT strategy, essentially creating a series of GRATs. What do you think?

- a. GRAT v. GRUT?
- b. Term of GRAT?
- c. Rolling strategy?
- d. 20% increase each year?
- e. Structure of remainder interest?

5. **Sale to Intentionally Defective Grantor Trusts.** The grantor trust rules, under which the grantor of a trust is treated as the owner of the trust assets for income tax purposes, are often considered traps that must be avoided in order for a trust to be a separate taxpayer. Many estate planners believe, however, that a carefully planned and utilized grantor trust can be a superior means of transferring family wealth, because there are no income tax consequences to transfers between the grantor and the trust, and because the grantor's payment of the income taxes on trust distributions may not constitute additional taxable gifts. The key planning technique often used with such intentionally defective grantor trusts (IDGTs) is an installment sale to an IDGT.

- a. **Structure.** An installment sale to an IDGT has two components.
 - i. First, the grantor creates an irrevocable trust that is a grantor trust for income tax purposes, the assets of which will be excluded from the grantor's taxable estate for estate tax purposes.
 - ii. Second, the grantor sells assets to the trustee of the IDGT. The sale may be structured as an ordinary installment sale or a sale for a self-canceling installment note (SCIN). Either of these types of sales may provide for equal payments of principal and interest over the life of the loan, payments of interest only for the life of the loan with a balloon payment of principal at the end of the note term, payments of equal amounts of principal over the term of the loan with decreasing amounts of interest added to each payment, or any other reasonable format. This flexibility enables the grantor to tailor the note terms to his or her own needs, as well as to the ability of the trust to meet the installment payments.
- b. **Advantages and Disadvantages.**
 - i. **Advantages.** An installment sale to an IDGT has several important tax and nontax advantages.

- A. **No Sale For Income Tax Purposes.** First, no gain or loss should be recognized by the grantor on the sale of appreciated or depreciated assets to an IDGT. In Revenue Ruling 85-13, the IRS explained that no gain is recognized on a sale to an IDGT, because the selling grantor is deemed still to own the assets of the trust. In that ruling, the grantor sold appreciated property to a grantor trust in exchange for an installment obligation. The IRS stated that the grantor trust rules treat the grantor as the owner of the trust assets, ignoring entirely the existence of the trust. A grantor who is deemed to own all of the trust assets must, therefore, own the note held by the trustee. The debt, therefore, runs both to and from the grantor, and cannot represent a true indebtedness for federal income tax purposes. This results in the disallowance of any deduction for interest paid on the indebtedness, any basis increase to the purchasing trust, and any recognition of gain on the sale.
- B. **Freezes Value.** Second, the asset sold to an IDGT, together with all future appreciation in its value and income produced by the asset in excess of that used to make the payments required by the note, should be removed from the grantor's taxable estate. The grantor trust rules are sufficiently dissimilar from the rules by which it is determined whether an asset is included in the grantor's taxable estate for estate tax purposes, that one can create a trust that is owned by the grantor for income tax purposes, but not for estate tax purposes. Of course, any unpaid balance on a conventional promissory note remaining at the grantor's death will be part of the grantor's taxable estate. The unpaid principal balance on a SCIN should be excluded from the grantor's taxable estate.
- C. **Lower Interest Rate.** Third, a promissory note should be deemed to bear adequate interest and, therefore, to have a value equal to its face amount, if the interest is equal to the applicable federal rate (AFR) under Section 1272. This rate will be lower than the rate used to compute the value of the interests in a GRAT or private annuity, which produce the tax and nontax results closest to those of an installment sale to an IDGT. The lower interest rate is advantageous, because it reduces the amount of the payments that the grantor receives from the buyer, thereby reducing the seller's taxable estate.
- D. **Payment of Income Tax.** Fourth, an installment sale to an IDGT permits the grantor to pay the income taxes on trust income that is not otherwise returned to the grantor through payments on the note. Many grantors, trusts, and beneficiaries are in combined state and federal marginal income tax brackets of 40 percent or more. The grantor's payment of the beneficiary's income taxes effectively

increases the size of the gifts of future trust income and gains by up to 40 percent.

- E. **GRAT Regulations Inapplicable.** Fifth, Section 2702, which imposes substantial technical rules to GRATs, GRUTs, and certain similar transactions, should not apply to an installment sale to an IDGT, because the promissory note is not an interest in the trust.
 - F. **Still "Works" with Early Death.** Sixth, the grantor need not outlive the term of the installment obligation to obtain estate planning benefits for an installment sale to an IDGT. The trust property, apart from the installment note, should be excluded from the grantor's gross estate; the promissory note will, however, be part of the grantor's gross estate. Assets of a GRAT or GRUT are included in the grantor's gross estate, unless the grantor outlives the reserved annuity or unitrust term.
 - G. **GST Advantages.** Seventh, it should be simpler to structure an installment sale to an IDGT in a manner that avoids potential GST tax problems, than to do so with a GRAT or GRUT. An installment sale to an IDGT involves a transfer for full and adequate consideration, and thus should not subject the buying trust to the GST tax, even if the trust ultimately passes to grandchildren or other skip persons. On the other hand, a gift of a remainder interest in a GRAT is subject to the GST tax, to the extent that the trust fund ultimately passes to a grandchild or other skip person.
- ii. **Disadvantages.** There are several possible disadvantages to the use of an installment sale to an IDGT.
- A. **Potential Future Change of "No Sale" Rule.** First, the IRS position in Revenue Ruling 85-13 -- that no gain is recognized on an installment sale to a grantor trust -- is not without its critics, and it could be changed at some future date.
 - B. **Little Precedent.** Second, there are no court cases and little IRS precedent supporting the estate planning advantages of an installment sale to an IDGT. On the other hand, the regulations detail clearly the rules for GRATs and GRUTs, and rulings and case law detail clearly the rules for private annuities.
 - C. **Uncertainty Over Income Tax Consequences if Death During Term.** Third, there is some debate over whether gain is recognized if the grantor dies while the trust is a grantor trust, causing the trust to become a separate taxpayer for income tax purposes.

c. **Planning and Drafting.**

- i. **Drafting the IDGT.** There are several methods traditionally employed to create an IDGT, the transfers to which are complete for gift and estate tax purposes. Generally speaking, an irrevocable trust is established, and such trust will contain one or more provisions that will cause the trust to be treated as a grantor trust for income tax purposes.
- ii. **“Seed” money.** There is really no substantial authority regarding how much principal a trust must have before one can validly sell its assets in exchange for an installment note. In Private Letter Ruling 9535026, the IRS approved an installment sale to a grantor trust that had principal equal to 10 percent of the value of the assets sold to the trust. In general, the trust should have sufficient assets, either by principal or guaranties from trust beneficiaries, to justify the making of the loan. Consider obtaining confirmation from at least one commercial lender that the same loan would have been made on similar terms, given the principal of the trust, the guaranties provided, the interest rate and the nature of the asset sold. The principal required of the trust should logically be less if the assets being sold are more easily converted into cash.
- iii. **Drafting the Installment Note.** An installment note received from an IDGT may assume many forms, such as a note with level payments of principal and interest over a stated term, a note with interest only paid for a term and a balloon payment of principal at the end of the note term, or a self-canceling installment note. In all events, however, the transaction will succeed for estate tax purposes only if the note is deemed to represent a bona fide indebtedness.

6. **Self-Canceling Installment Notes.** The fair market value on the date of death of an unpaid installment obligation is includable in the estate of a seller who dies before the debt is entirely satisfied. The Tax Court, however, has held that nothing is includable in the decedent's gross estate if the note contained a bona fide provision under which all obligation to pay automatically ceased on the obligee's premature death. Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), acq. in result 1981-1 CB 2. Such notes are called self-canceling installment notes (SCINs), and they can be a very useful way to remove significant assets from the seller's estate.

- a. **Structure.** A SCIN is structured exactly like any other intrafamily installment obligation, except that it contains an additional provision that discharges the buyer from the obligation to make any payments after the seller's death. The self-canceling feature relieves the buyer of any further obligation to make payments to the seller's estate or successors, if the seller dies before all of the installments have come due, but the self-canceling feature is ignored if the seller outlives the installment payment period.

b. **Advantages and Disadvantages.**

- i. **Advantages.** A SCIN has all of the advantages associated with an intrafamily installment sale, including an immediate freeze on the transfer tax value of the asset sold and a limitation on the income generated by that asset. The seller can, furthermore, forgive some of the installments to convert the transaction into an installment gift, as with other intrafamily installment sales. The primary advantage of a SCIN over other intrafamily installment sales is that there is no residual value included in the seller's gross estate, if the seller dies during the term of the installment obligation. This may be a significant advantage if the seller dies during the early years of a long-term SCIN.
- ii. **Disadvantages.** A SCIN has all of the usual disadvantages associated with an intrafamily installment sale to a non-grantor trust, including the recognition of gain and interest income by the seller. The SCIN has two additional significant disadvantages.
 - A. First, a SCIN is more complicated than an ordinary installment sale. Drafting a SCIN is slightly more complicated than drafting an ordinary installment obligation, because the SCIN must contain an appropriate provision relieving the seller of the obligation to continue payments after death. In addition, additional considerations of the seller's health and an appropriate risk premium (discussed below) are required.
 - B. Second, in an extreme situation, a SCIN can be very easy to recast as a large gift. In Estate of Musgrove v. United States, 33 Fed. Cl. 657 (Fed. Cl. 1995). the decedent sold certain assets to his son for an interest-free demand note. The note provided that the obligation to pay would be canceled upon the decedent's death before demand. The note was unsecured and the son admitted that he did not know when or if he would be able to repay the loan. The decedent died one month later from health problems that existed on the date of the sale. The federal Claims Court held that the difference between a loan and a gift between family members is the existence of a "real expectation of repayment and intent to enforce the collection of the indebtedness." The Musgrove court found no such intent, based on the son's lack of funds, the father's poor health, and the self-canceling feature of the note. The court did not, however, deny the general validity of SCINs, or the ability of such sales to remove assets from the seller's gross estate, but it did hold that the individual facts of each case must be examined to determine whether the transaction does constitute a bona fide debt arrangement.

c. **Planning and Drafting.**

i. **The SCIN Premium.**

- A. **Generally.** All of the cases upholding SCINs stress that the self-canceling feature was a bargained-for consideration between the parties and that the buyers paid a distinct premium for that feature. This is a critical feature for transfer tax purposes. The failure to pay a premium for a self-canceling feature in a SCIN strongly suggests that the transaction is, at least in part, a gift with a retained life estate includable in the decedent's gross estate under Section 2036(a). A buyer and seller who are not close family members will normally negotiate a purchase price that reflects the premium, but most SCINs are executed between close family members. Close family members rarely meet across a bargaining table, each with separate legal counsel, to discuss purchases and sales. Thus, it is important to use sound actuarial principles in establishing the premium for any self-canceling feature in a note between family members.
- B. **The Seller's Health.** The best seller for whom a SCIN should be used, from a purely tax standpoint, is one whose actuarial life expectancy greatly exceeds his or her real life expectancy. The risk premium in this situation, is based on the actuarial life expectancy, but relatively few payments are made during the seller's lifetime. This analysis requires that the computation of the premium on a SCIN be based on the Treasury actuarial tables. Those tables do not apply to a seller who suffers from a deteriorating physical condition of advanced stages such that death is imminent. The regulations state that the actuarial tables apply unless "there is at least a 50 percent probability that the individual will not survive for more than 1 year from the valuation date." An individual who survives for at least eighteen months is presumed not to have been terminally ill, "unless the contrary is established by clear and convincing evidence." Regs. 1.7520-3(b)(3); 20.7520-3(b)(3); 25.7520-3(b)(3).
- C. **Interest premium versus principal premium.** The note's total value must reflect the risk premium. The note's total value reflects both interest and principal features, as well as the length of the obligation and the adequacy of any security, so the premium could be reflected either in a greater purchase price (a principal premium) or in an above-market interest rate (an interest premium). Generally, the parties' respective income tax considerations should determine which form of premium is better,

with an interest premium providing the seller with more potentially deductible interest payments (assuming a nongrantor trust situation).

- ii. **Length of Term.** The SCIN's term should not exceed the seller's actuarial life expectancy. A high premium can be imposed to balance the probability that the seller will never receive any payments after his or her actuarial life expectancy.
- iii. **Retained Controls.** The seller should neither retain the gratuitous use of the property sold for a SCIN, nor limit the buyer's right to dispose of the property after the sale. The property sold for a SCIN may be the collateral for the note, however. Nonetheless, it is prudent, where possible, for the buyer to pledge other assets as security, so that the seller has no right to reacquire the sold assets under any circumstances.
- iv. **The Interest Rate.** A seller who receives as payment a SCIN that does not include an adequate premium for the self-canceling feature, will be deemed to have made a part-sale part-gift. A gift tax should be imposed on the difference between the fair market value of the property sold and the actual value of the note received, in such cases. This problem can be avoided by structuring the note as much like a market note as possible, except for the premium principal price or interest rate. There should be adequate collateral and a reasonable term, and if the premium is reflected by a higher principal price, there should still be a market rate of interest.
- v. **Gift Tax (Section 2702).** The special valuation rules of Section 2702 should not apply to a sale of assets to a trust in exchange for a SCIN. In Private Letter Ruling 9436006, the taxpayer sold a partnership interest to a trust for a negotiable, twenty-five-year interest-bearing term note. The IRS stated that Section 2702 did not apply, because the promissory note was not an interest in the trust. A self-cancellation feature should not change this result, and a sale of assets to a trust in exchange for a SCIN should not be taxed under the special valuation rules of Section 2702.
- vi. **Income Tax Reporting.** The gain on the sale of property in exchange for a SCIN (other than to an IDGT) is reported much like any other sale for an installment obligation, under Section 453. A SCIN establishes a fixed interest and principal payment schedule and term, but some of the payments are conditioned on the seller's survivorship. In effect, a SCIN provides for payments equal to the lesser of the amounts that would be paid over the stipulated term or the seller's life. Temporary regulations state that: "[u]nless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3), contingent payment sales are to be reported on the installment method. As used in this section, the term "contingent payment sale" means a sale or other disposition of property in which the

aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs." A SCIN should, therefore, be treated as having a stated maximum selling price, and the ordinary installment sales rules should apply to the arrangement during the seller's life as if the contingency did not exist.

- vii. **Gain and Basis on the Seller's Death.** The seller's death before a SCIN has been entirely satisfied extinguishes the unpaid balance of the debt. The income tax consequences of this event are not entirely clear. Section 453B(f) states that an installment obligation that becomes unenforceable for any reason is treated as having been disposed of. Section 453B, however, does not apply to "the transmission of an installment obligation at death." Installment obligations transmitted at death are treated as income in respect of a decedent (IRD), and any subsequent cancellation or unenforceability is treated as a transfer of the item of IRD, accelerating its recognition. Thus, the unrecognized gain portion of a SCIN is an item of income IRD, taxable to the seller's estate under Sections 453B(f)(1) and 691(a)(2). See Estate of Frane v. Commissioner, 98 T.C. 341 (1992), aff'd in part, rev'd in part 998 F.2d 567 (8th Cir. 1993). Need cite

7. **Family S Corporations.**

- a. **Generally.** Subchapter C of the Code states that regular corporations (known also as C corporations) are separate taxable entities for federal income tax purposes. Net earnings of a C corporation are thus taxed twice: once as corporate income and again as dividend income paid to the stockholders. Net losses generated by a C corporation are not available to the stockholders and must be carried forward or backward for use against the corporation's own earnings. The stockholders of a family corporation may avoid this double taxation of corporate earnings, by making an election (the S election) to have the corporation taxed under Subchapter S of the Code, rather than under subchapter C of the Code. The net earnings and losses of an S corporation are taxed directly to the stockholders in the proportions of their stock ownership on each day of the taxable year. Net earnings are taxed only once and net losses can be used by the stockholders to offset other taxable income.
 - i. The Code imposes significant limitations on the number and types of stockholders of an S corporation and on the types of trusts that an S corporation may use for transfers of stock. The shareholder limit is rarely a problem in family business situations. However, the limitation on the use of trusts to hold S corporation stock can create a serious complication for family wealth transfers. The rule that the stockholders must be U.S. persons, estates, or specific types of domestic trusts makes S corporations virtually useless for foreign donors.

- ii. The valuation of the stock of a closely held corporation is always difficult, because each closely held corporation is unique and there are rarely comparable sales from which to determine fair market value. Thus, the appraiser must compare closely held corporations with the most similar publicly traded corporations and make appropriate adjustments for the differences in size and marketability of interests.
 - iii. This problem is magnified when the earnings of a closely held corporation are taxed directly to the shareholders under a subchapter S election. The absence of a corporate income tax makes it difficult to compare the values of publicly traded corporations with those of subchapter S corporations.
- b. **Trusts as S Corporation Stockholders: Generally.** Grantors often want to transfer stock to a trust for a minor or other person who may lack sufficient experience to manage a large block of stock, or because the grantor fears that the shares will fall into the hands of the transferee's spouse or creditors. Five types of trusts are eligible S corporation stockholders:
- 1. Voting trusts
 - 2. Qualified Subchapter S trusts (QSSTs)
 - 3. Domestic grantor trusts
 - 4. Domestic beneficiary-controlled trusts
 - 5. Electing small business trusts (EBSTs)

Voting trusts are eligible to hold S corporation stock, but they are not well suited for use as family wealth transfer vehicles, because they are established by the beneficiaries to delegate voting rights to a third party, and they require that all distributions, including terminating distributions, be made to the beneficiaries in proportion to their contributions. Thus, QSSTs, domestic grantor trusts, beneficiary-controlled trusts, and EBSTs are the only practical alternatives for transferors who wish to restrict a transferee's immediate control over S corporation shares.

- c. **Qualified Subchapter S Trusts.** Qualified subchapter S trusts (QSSTs) are one of the most useful types of trusts for holding S corporation stock.
- i. A trust is a QSST if:
 - A. The trust holds stock in one or more S corporations;
 - B. All the net income of the trust is distributed or is required to be distributed currently to one U.S. citizen or resident (although there may be successive income beneficiaries after the initial income beneficiary dies);
 - C. The trust must, by its terms, distribute principal to no one other than the income beneficiary during the income beneficiary's life;

- D. The income beneficiary's interest must, by the trust's terms, terminate at the beneficiary's death or when the trust terminates, if earlier; and
- E. The income beneficiary, or the income beneficiary's legal representative, must elect to be treated as the deemed owner, under Section 678, of that portion of the trust consisting of the S corporation stock. I.R.C. 1361(d); Reg 1.1361-1(j).

Many common trusts can qualify as QSSTs, including minors' trusts that qualify for the gift tax annual exclusion under Section 2503(c), trusts that pay all current income to the beneficiary and then pay the principal to the beneficiary when the beneficiary reaches a certain age, marital deduction qualifying terminable interest property (QTIP) trusts, and marital deduction power-of-appointment trusts.

The income beneficiary of a QSST must elect to be taxed under Section 678 as the owner of the trust's S corporation shares. The income beneficiary is, therefore, taxed on the S corporation's net income and losses as if he or she personally owned the trust's shares of the stock. The character of items of income and deduction passed through from the corporate level to the individual level applies to the beneficiary of a QSST. The deemed owner of a QSST is treated as the real S corporation stockholder for purposes of the subchapter S requirements, such as the number of S corporation shares.

- ii. **Capital Gains.** A QSST must currently distribute, or be required to distribute, all its income. "Income" of a QSST means trust accounting income, as determined under the governing instrument and applicable state law. Capital gains from the sale of the trust's S corporation shares are treated as income of the trust, rather than income of the beneficiary. Therefore, the trust can report its gain on the installment method, under Section 453, if the sale otherwise qualifies as an installment sale.
- iii. **The QSST Election.** A trust is a QSST only if the income beneficiary affirmatively elects to be taxed as the deemed owner of the portion of the trust consisting of the S corporation stock. The beneficiary's legal representative, or the natural or adoptive parent of a minor beneficiary, makes the election with respect to each S corporation whose stock the trust owns. The election is made in a signed statement filed with the IRS center with which the S corporation files its income tax return. This statement must:
 - A. Include the name, address, and taxpayer identification number of the start current income beneficiary, the trust, and the corporation;

- B. Identify the election as an election made under Section 1361(d)(2);
- C. Specify the date on which the election is to become effective (not earlier than fifteen days and two months before the date on which the election is filed);
- D. Specify the date (or dates) on which the stock of the corporation was transferred to the trust; and
- E. Provide all information and representations necessary to show that, under the terms of the trust and applicable local law --
 - (a) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);
 - (b) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;
 - (c) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or the termination of the trust; and
 - (d) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.
 - (e) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.
 - (f) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary. Once made, the election is revocable only with the consent of the Commissioner of Internal Revenue.

iv. **Death of the Income Beneficiary.** Two different results can occur when the income beneficiary of a QSST dies. First, the beneficiary's estate may become the new S corporation stockholder, in which case, the executor and trustee have two years from the date of death within which to transfer the stock to a qualifying stockholder or to bring the trust into compliance with the Subchapter S rules. Second, the trust, as constituted after the death of the income beneficiary, may continue to qualify as a QSST. This

occurs if there is a successor income beneficiary to whom income must be paid currently. In such situations, the successor beneficiary automatically is deemed to have elected to be the owner of the trust under Section 678, unless he or she files an affirmative rejection of the election.

- d. **S Corporation Grantor Trusts.** A grantor trust may hold stock of an S corporation if the grantor is treated as the owner of the entire trust for income tax purposes. Ownership of the entire trust causes the grantor to be taxed on the trust's profits and losses until the trust terminates and the stock is distributed to the beneficiaries. A donor who wants to shift S corporation income to a donee will want to avoid using a grantor trust to hold the shares. A grantor may, however, wish to use a grantor trust to hold shares of the stock of an S corporation that generates net losses, so that the grantor can take advantage of the losses on his or her personal income tax return. The grantor trust may also be a very useful form of S corporation trust if transferring family wealth rather than income shifting is the donor's primary objective.

- i. **Generally.** The rule allowing grantor trusts to hold S corporation stock seems to have been intended to apply primarily to revocable trusts. A gift to a revocable trust, of course, shifts neither income nor wealth to the donee. Section 1361, however, is not actually so limited, and allows a trust to hold S corporation stock if it is “[a] trust all of which is treated (under subpart E of part I of Subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.” Subpart E of part I of Subchapter J includes Sections 671 through 678. Any domestic trust that is treated as owned entirely by the grantor for income tax purposes, whether or not its contents are includable in the grantor's gross estate for estate tax purposes, can therefore qualify as an S corporation grantor trust.

One of the most common examples of an S corporation grantor trust is a grantor retained annuity trust (GRAT). This is an irrevocable trust as to which the grantor retains, for a specified number of years, a right to a fixed annuity, payable from trust income and principal. The trust funds are distributed to the grantor's donees at the end of the trust term, in such shares as the trust instrument requires. A GRAT is a grantor trust because the grantor may receive all of the trust's income and principal in annuity payments; therefore, a GRAT is an eligible S corporation stockholder.

- ii. **Gift Tax.**

A. **Annual exclusion.** Gifts to an S corporation grantor trust cannot usually qualify for the gift tax annual exclusion because the grantor must retain sufficient rights or interests, or give them to someone else, to cause the trust to be owned by the grantor for income tax purposes. Retained powers and interests are inconsistent with the

concept of a gift of a present interest and, therefore, disqualify the trust for the gift tax annual exclusion.

B. **Payment of income taxes as a gift.** The grantor's payment of income tax associated with the income of the trust is essentially an additional non taxable gift.

iii. **Death of the Grantor.** An S corporation grantor trust loses its special tax status when the grantor dies. The grantor's estate, rather than the trust, becomes the S corporation stockholder, and the executor has a limited period within which to have the trust continue to be a qualifying stockholder, or allow the S corporation's special tax status to be involuntarily revoked. A grantor's executor has two years within which to make one of these arrangements:

- (a) Hold the S corporation shares in a trust that continues to meet the requirements for an eligible S corporation stockholder;
- (b) Distributing the stock to a beneficiary who could be a qualifying stockholder;
- (c) Selling the stock to the beneficiary or another qualifying stockholder; or
- (d) Seeking judicial reformation of the instrument itself to allow it to qualify as another form of S corporation stockholder.

iv. **Planning.** The flexibility of grantor trusts makes them useful for making gifts of S corporation stock. The trust's duration and the trustee's discretion in making payments of income and principal can be crafted to suit the grantor's wishes, as long as the grantor's or trustee's powers create a trust owned wholly by the grantor for income tax purposes. The use of grantor trusts to make gifts of S corporation stock is complicated, however, because the grantor is taxed on income retained by the trust or distributed to the stockholders. A grantor trust can be disadvantageous, therefore, for making gifts of the stock of an S corporation that generates net profits, if the beneficiaries are in lower income tax brackets than the grantor. The same trust can be advantageous if the beneficiaries are in higher tax brackets than the grantor, or if the corporation's investments generate tax losses that may be used by the grantor.

e. **Electing Small Business Trusts.** Section 1361(e) allows most trusts to hold stock in an S corporation, regardless of the number of beneficiaries or the nature of their distributive interests, if the trust qualifies as an electing small business trust (ESBT). These rules exclude, however, tax-exempt trusts and trusts that are

QSSTs with respect to the corporation for whose shares the QSST election has been made.

i. **Definitions.**

- A. **ESBT.** Section 1361(e) defines “ESBT” as a trust in which all the beneficiaries are U.S. individuals or estates eligible to be S corporation stockholders, except that charitable organizations may hold contingent remainder interests. No beneficiary of an ESBT may acquire an interest in the trust by purchase or taxable exchange. A QSST, charitable remainder trust, or other tax-exempt trust cannot be an ESBT. A grantor trust may, however, elect to be an ESBT, if the person deemed to own the trust under the grantor trust rules and the trustee both consent to the S election.
- B. **Beneficiary.** The regulations state that an ESBT “beneficiary” includes any person who has a present or future interest in the trust, other than a remote contingent interest. A person is a beneficiary of an ESBT, for this purpose, if he or she has a present, remainder or reversionary interest in the trust. For example, a potential appointee under a currently exercisable power of appointment is not a beneficiary for purposes of determining whether the trust may be an ESBT. Thus, an individual with a remainder or reversionary interest in a trust would be a beneficiary for purposes of the ESBT rules. A person is not a beneficiary of an ESBT solely on account of a future interest that has less than a 5 percent probability of receiving a distribution from the trust, or the possibility that a power of appointment may be exercised in favor of that person (until that power is actually exercised). A person is not an eligible beneficiary of an ESBT if he or she acquires an interest in the trust by purchase. The regulations make it clear, however, that this restriction does not prevent the ESBT from buying stock of the S corporation, or from the deemed purchase of such stock that might arise when encumbered shares are given to the trust or when stock is given to the trust by a net gift.
- C. **Potential Current Beneficiary.** Once a trust has elected to become an ESBT, each “potential current beneficiary” is treated as a shareholder of the S corporation, for purposes of applying both the quantitative (100 shareholders) and qualitative (who may be an eligible shareholder) limitations on S corporation shareholders. A potential current beneficiary is any person who is entitled to receive or who may receive, in someone's discretion, a current distribution of income or principal from the trust.

- ii. **ESBT Election.** A trustee must elect for a trust to be taxed as an ESBT. The election must generally be filed within the 16 day and 2 month period beginning on the day that the stock is transferred to the trust. The ESBT election applies to the taxable year for which it is made and all later years. The election is irrevocable, except with the consent of the Secretary of the Treasury.

The regulations state that the trustee makes the ESBT election by filing a timely statement with the service center in which the S corporation files its income tax return, even if the trust files its returns with a different service center. One cannot make a protective ESBT election that would apply only if the trust failed otherwise to qualify as an eligible S corporation shareholder.

An ESBT election is revocable only with the consent of the IRS; such consent can be obtained by requesting a private letter ruling to that effect. Consent to revoke an ESBT election is automatic if the trust converts to a QSST and the trustee follows the procedures set forth in the regulations for converting to a QSST.

- iii. **Taxation of an ESBT.** The portion of an ESBT that consists of stock of an S corporation to which the ESBT election applies is treated as a separate trust for income tax purposes. This separate trust, referred to here as the ESBT portion, is taxable on its S corporation income as a separate taxpayer, notwithstanding the usual rules of fiduciary income taxation. The ESBT portion is taxed at the highest individual rate on this portion of its income. The taxable income attributable to the ESBT portion includes all items of income, loss, or deduction allocated to it as an S corporation stockholder under the rules of subchapter S, the gain or loss from the sale of the S corporation stock, and any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock (to the extent provided in the regulations). Otherwise, allowable capital losses are allowed only to the extent of capital gains.

The ordinary fiduciary income tax rules do not apply to the ESBT portion, so the income tax on the ESBT portion's S corporation income is computed without any deduction for distributions to beneficiaries, and without any other deduction or credit except for administrative expenses and state and local income taxes that are allowed under regulations to be issued by the Treasury. The income of the ESBT portion is not included in either the trust's distributable net income or the gross income of any trust beneficiary. No item relating to the ESBT portion's S corporation stock may be apportioned to any beneficiary.

The items taken into account by the ESBT portion of the trust are disregarded in determining the tax liability with regard to the rest of the

ESBT (the non-ESBT portion). Distributions from the non-ESBT portion are deductible in computing its taxable income under the usual fiduciary income tax rules, but its distributable net income does not include any income attributable to the S corporation stock.

iv. **Conversion From an ESBT to a QSST (and Vice Versa).** The ESBT rules have encouraged many practitioners to convert other forms of subchapter S trusts to ESBTs in order to gain complete flexibility with respect to the timing and amount of trust distributions.

A. A trust can convert from a QSST to an ESBT if:

- (a) The trust meets all of the requirements to be an ESBT (except for the requirement that the trust not have a QSST election in effect);
- (b) The trustee and the current income beneficiary of the trust sign the ESBT election;
- (c) The ESBT election is filed with the service center where the S corporation files its income tax return;
- (d) The ESBT election states at the top of the document “ATTENTION ENTITY CONTROL -- CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361-1(j)”;
- (e) The ESBT election includes all information otherwise required for an ESBT election; and
- (f) The trust has not converted from an ESBT to a QSST within the thirty-six-month period preceding the effective date of the new ESBT election.

The date on which the ESBT election is to be effective is not more than fifteen days and two months prior to the date on which the election is filed and cannot be more than twelve months after the date on which the election is filed.

B. A trust can convert from an ESBT to a QSST if:

- (a) The trust meets all of the requirements to be a QSST;
- (b) The trustee and the current income beneficiary of the trust sign the QSST election;

- (c) The QSST election is filed with the service center where the S corporation files its income tax return;
- (d) The QSST election states at the top of the document “ATTENTION ENTITY CONTROL -- CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m) ”;
- (e) The QSST election includes all information otherwise required for a QSST election; and
- (f) The trust has not converted from a QSST to an ESBT within the thirty-six-month period preceding the effective date of the new QSST election.

The date on which the QSST election is to be effective is not more than fifteen days and two months prior to the date on which the election is filed and cannot be more than twelve months after the date on which the election is filed.

7. **Grantor Retained Annuity Trusts.** The grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT) permits an individual to give away an asset with little or no gift tax, regardless of how valuable the asset may be, while retaining all or part of the income from the property for a specified term of years. GRATs and GRUTs are also specifically approved by the Code. IRC Sec. 2702. A GRAT or GRUT is a gift of a remainder interest in a trust, which, because the donor retains an annuity or unitrust interest for a term of years, has a reduced value for gift tax purposes. Thus, the donor can give away the remainder interest with a significantly reduced gift tax.

- a. **Structure.** A donor creates a GRAT or GRUT by transferring assets to an irrevocable trust, and retaining an annuity or unitrust interest for a specified number of years. The annuity interest is a fixed dollar amount or fixed percentage of the trust's initial value, and the unitrust interest is a fixed percentage of the annual value of the trust. The value of the annuity or unitrust is determined according to the actuarial tables issued pursuant to Section 7520. The donor's retained interest terminates after a stated number of years, and the trust assets are distributed outright to designated beneficiaries, or held in a continuing trust for their benefit.

The transfer of assets to a GRAT or a GRUT is a taxable gift of the value of the entire property, less the value of the reserved annuity or unitrust interest. The amount of the donor's taxable gift may be reduced to zero or close to zero, if the annuity or unitrust rate is high enough and the grantor is young enough.

- b. **Advantages.** GRATs and GRUTs have several advantages as a technique for making large gifts with low gift tax.

- i. **Removal of Appreciation.** First, they involve an immediate gift of the entire asset, so any future appreciation inures to the remainder beneficiary. The grantor need not make separate gifts of the future appreciation on any retained interest. GRATs and GRUTs are superior to installment gifts, gifts of family corporation stock, and gifts of family partnership interests, in this respect, because the grantor need not make additional gifts to transfer a large asset to the donee. On the other hand, if the asset given away does not generate enough income or gains to pay the designated annuity or unitrust interest, some of the assets will have to be sold to realize enough cash to make up the deficiencies.
 - ii. **Retention of Income.** Second, the grantor retains most or all of the income generated by the property given away. Any income above that required to pay the annuity or unitrust will be accumulated for the remainder beneficiary without added gift taxes. On the other hand, principal will need to be invaded if the trust assets generate less income than the annuity or unitrust interest, and the amount passing ultimately to the remainder beneficiaries may be less than the amount on which gift tax was paid.
 - iii. **Possible Removal of Some Assets Even If Death During Term.** Third, depending on the language of the trust document, it is possible that some of the value of the trust assets may be removed from the grantor's gross estate even if the grantor dies during the annuity or unitrust term, if the value of the trust assets increases significantly. Treas. Regs. § 20.2036-1(c)(2).
 - iv. **Sanctioned Technique.** Fourth, GRATs and GRUTs are specifically approved by Chapter 14 of the Code, providing a measure of comfort in the tax result being anticipated. A GRAT or GRUT must comply with complex regulations, but once this is done, the trust should clearly provide a significant reduction in the gift tax on the transferred assets.
- c. **Disadvantages.** GRATs and GRUTs also pose several disadvantages.
- i. **Grantor Responsible for Income Taxes.** First, the trust must be a grantor trust under Section 677, because all of the income and principal is or may be paid to or accumulated for the benefit of the grantor. The grantor will, therefore, be taxed on all trust income and gains, even if they exceed the amount paid as an annuity or unitrust interest. The ordinary income of a GRAT or GRUT is not often likely to exceed the required annuity or unitrust amount, but recognition of substantial undistributed capital gains is both possible and probable for a GRAT or GRUT, because the grantor will usually fund such trusts with assets that are expected to appreciate in value.

- ii. **Survival Requirement.** Second, the grantor must outlive the annuity or unitrust interest in order to obtain any estate tax savings. The annuity or unitrust interest, as discussed previously, represents a retained interest under Section 2036(a), and the grantor's gross estate includes the value of any gift over which the grantor retains an income interest for life or for a period that in fact ends during the grantor's life. The assets of a GRAT or GRUT are, therefore, usually included in full in the gross estate of a grantor who does not outlive the reserved annuity or unitrust interest.
- iii. **Grantor Must Part with Underlying Asset.** Third, the grantor receives most or all of the trust income as the reserved annuity or unitrust, but the trust assets are no longer the grantor's personal assets. Neither the grantor nor the remainder beneficiary can pledge or sell the trust assets for the personal benefit, and neither can include the assets on a personal financial statement for purposes of securing loans (although the grantor can include the annuity or unitrust interest and the remainder beneficiary the remainder interest).
- iv. **Annuity Rate v. Gift Amount Quandary.** Fourth, the annuity or unitrust interest of a GRAT or GRUT must usually be relatively high in order to obtain significant gift tax savings, because the annuity must be valued based on the interest rate set under Section 7520. Section 7520 assumes a rate of return on the GRAT or GRUT assets equal to 120 percent of the applicable federal rate, and thus may presume an above-market rate of return. The higher imputed interest rate under Section 7520 forces the grantor to retain a higher annuity or unitrust rate (or an annuity or unitrust for a longer term), in order to reduce the value of the remainder to an acceptable level.
- v. **Good Asset Performance Required.** Fifth, the high annuity or unitrust interest required to reduce the remainder interests adequately mean that only high-yield assets are suitable for a GRAT or GRUT. A GRAT or GRUT that invests in assets yielding less than the required annuity or unitrust amount will have fewer assets available at termination than it had when it was created. Thus, in a GRAT or GRUT designed to preserve significant remainder for the donee, the investments should yield as much or nearly as much as the annuity.
- vi. **No Gift Tax Annual Exclusion.** Sixth, the gift portion of a GRAT or GRUT is a remainder interest, no part of which qualifies for the gift tax annual exclusion. The GRAT or GRUT is, therefore, often structured to yield a taxable gift within the grantor's unified credit, thereby avoiding any current gift tax.

- vii. **Formal Arrangement.** Seventh, GRATs and GRUTs are moderately complicated, requiring a formal trust agreement, a trustee, a tax identification number, and annual trust income tax returns. There is no **tax** reason why the grantor cannot serve as a trustee during the term of the annuity. The trust is already a grantor trust and its property is already includable in the grantor's gross estate if the grantor dies during the annuity period. General estate and income tax considerations may prompt the grantor to resign as trustee at the end of the annuity term, however, if the trust continues for the benefit of the remainder beneficiaries. In addition, practical considerations of ensuring that the trust is administered properly suggest that a professional trustee may be warranted.
- viii. **Delayed GST Allocation.** Unlike a transfer to an IDGT, GST exemption cannot be allocated until the end of the term of the GRAT. The hope and expectation is that the GRAT will be worth more at the end of the term, so more exemption has to be allocated to permit the transfer to grandchildren or GST trusts.
- d. **Section 2702 Requirements.** Section 2702 dictates the technical requirements of a GRAT or GRUT. Section 2702 applies to a transfer with a reserved interest if:
 - A. There is a transfer in trust.
 - B. The transfer is to or for the benefit of a member of the transferor's family.
 - C. There is a retention of an interest in the trust by the transferor or by an “applicable family member,” including the transferor's spouse, an ancestor of the transferor or of the transferor's spouse.

Section 2702(a)(2) states that the gift tax value of the transferred interest in a transaction to which the section applies is the total property the value of the transferred property, less the value of any retained qualified interest. Thus, the value of a remainder interest in trust given to a member of the transferor's family, will be the entire value of the transferred property, without regard to the grantor's retained interest, unless that interest is a “qualified interest.”

Section 2702(b) defines a “qualified interest” as a fixed annuity payable at least annually, a fixed percentage of the value of the trust assets payable at least annually (i.e., a unitrust interest), or a remainder following an annuity or unitrust interest. The retained interest in a qualified GRAT or GRUT, therefore, is a qualified interest for purposes of Section 2702.

- e. **Designing the Annuity or Unitrust Interest.** The design of the annuity or unitrust interest in a GRAT or GRUT raises several technical and planning issues.

- i. **Technical requirements.**
 - A. The regulations contain five rules that apply to both GRATs and GRUTs:
 - (a) The trust must function exclusively as a GRAT or a GRUT from the first day of the trust's existence. The two formats cannot be combined in a single interest.
 - (b) The trust must prohibit distributions to any persons other than the annuitant (the transferor or an applicable family member retaining the qualified interest), during the reserved annuity or unitrust interest. The trust cannot permit distributions of income or principal to persons other than the annuitant, regardless of need or hardship.
 - (c) The governing instrument must fix the term of the retained annuity or unitrust interest. This annuity or unitrust interest may continue for the life of the annuitant (the transferor or an applicable family member), for a specified term of years, or for the shorter of these two periods. Successive term interests for one annuitant are treated, for this purpose, as a single interest.
 - (d) The trust instrument must prohibit any commutation or prepayment of the interest of the annuitant. Commutation will otherwise occur when, either under applicable state law or pursuant to the governing instrument, the parties decided to terminate the trust early and to distribute a fractional share of the trust fund to the term owner and a fractional share to the remainder owner, based on the actuarial value of their respective interests. Commutation is otherwise very useful when the term owner realizes that he or she is not likely to outlive the retained term interest, and wishes to exclude a portion of the trust assets from his or her gross estate.
 - (e) The trust instrument must preclude the use of notes and other similar debt instruments to satisfy the annuity requirements.
 - B. The regulations also state that a GRAT must meet four additional rules. Specifically, a GRAT must provide as follows:
 - (a) The annuity interest must be an irrevocable right to receive a fixed amount payable annually or more often. The

amount may be expressed as either a fixed dollar amount or a fixed percentage of the trust's initial value.

- (b) A GRAT that describes the annuity amount as a percentage of the initial value of the trust assets must include a provision requiring that, if the trustee incorrectly values the trust assets, a compensating payment must be made either to or by the annuitant on account of the misvaluation.
- (c) A GRAT must include a provision requiring that the annuity amount be adjusted in short taxable years and in the trust's last taxable year.
- (d) A GRAT must absolutely prohibit the trustee from accepting any additional contributions to the trust.

C. The regulations also impose the following separate requirements for a GRUT:

- (a) The unitrust interest in a GRUT must be an irrevocable right to receive a fixed percentage of the annual value of the trust fund, payable annually or more often. The trust may select any date for valuation of the trust assets, but using the first day of the taxable year as the valuation date provides for the easiest administration, since the trustee knows during the entire year how much can be paid to the annuitant.
- (b) The trust instrument must provide that, if the trustee of a GRUT incorrectly values the trust assets in any year, a compensating payment must be required to be made either to or by the annuitant on account of the misvaluation.
- (c) A GRUT must include a provision requiring that the unitrust amount be adjusted in short taxable years and in the trust's last taxable year.
- (d) Regulations Section 25.2702-3(b)(4) states that a GRAT or GRUT annuity amount payable on the anniversary date of the creation of the trust may be paid up to 105 days after the anniversary date, but not later than the date by which the trustee is required to file the federal income tax return of the trust for the taxable year (without regard to extensions).

- D. **Size of the annuity or unitrust interest.** The longer the trust term and the larger the annuity or unitrust interest, the smaller the taxable gift that the grantor is deemed to make. Nonetheless, the size and length of the reserved annuity or unitrust interest will depend upon several factors.
- (a) First, the annuity or unitrust interest should not continue longer than the grantor's life expectancy, determined taking into account all relevant health factors. The principal of a GRAT or GRUT is included in the grantor's gross estate if the grantor dies during the trust term.
 - (b) Second, the annuity or unitrust interest should not be so large as to produce a serious liquidity problem. A GRAT or GRUT that holds largely illiquid assets, such as real estate or interests in a family holding company, may need to limit the annuity or unitrust interest to the income generated by those assets.
 - (c) Third, the trust should, if possible, pay a sufficient annuity or unitrust interest to reduce the taxable gift to an amount that is sheltered by the grantor's unified credit.
- E. **Increasing payments.** The annuity or unitrust amount can vary each year, to the extent that it does not increase in any year by more than 20 percent of the preceding year's annuity or unitrust amount. The regulations also permit the reduction in the annuity or unitrust amount from year to year, and they make it clear that no portion of payments made after the death of the annuitant will be deemed part of the qualified interest.
- F. **GRAT versus GRUT.** Generally, a grantor who seeks the maximum value for the retained annuity or unitrust interest (and the minimum value for the remainder interest given away) will want to select a GRAT if the annuity percentage is greater than the Section 7520 rate, and will prefer a GRUT if the unitrust percentage is less than the Section 7520 rate.

A GRAT produces a smaller taxable gift than does a GRUT, if the annuity rate is greater than the Section 7520 interest rate. A GRAT, the annuity rate of which exceeds the trust income, will be required to distribute some trust principal each year, and each annuity payment will consist of an ever-increasing share of principal. A GRUT, the unitrust rate of which exceeds the trust income, will be required to distribute some trust principal each year, but the principal will remain more intact than with a GRAT,

because the unitrust amount drops as the principal drops. The size of the unitrust payment is reduced because it is determined by a percentage of the value of the trust fund on the first day of each taxable year. Thus, the value of a retained interest in a GRUT with a unitrust rate higher than the Section 7520 rate will be lower than the value of a comparable annuity interest in a GRAT.

A GRUT produces a smaller taxable gift than a GRAT if the annuity rate is lower than the assumed rate of return under Section 7520. This is logical because, if the annuity payment under a GRAT is expected to be less than the trust's income, there will be ever-increasing additions to the trust principal, coupled with a fixed annuity payment. On the other hand, as the principal of a GRUT increases, the unitrust payment increases.

- f. **Structure of the Remainder Interest.** The remainder beneficiary's interest may be distributed outright at the termination of the annuity or held in continued trust, depending on the grantor's nontax desires.
- g. **Generation-Skipping GRATs and GRUTs.** A GRAT or GRUT permits the donor to make a relatively large gift at a reduced gift tax cost, but the leverage of the annuity or unitrust interest does not reduce the amount of the transfer subject to GST tax. The generation-skipping transfer that occurs when the remainder interest in a GRAT or GRUT passes to grandchildren or other skip persons, occurs for GST tax purposes only when the retained annuity or unitrust interest terminates. The grantor cannot allocate any GST tax exemption to transfers to a GRAT or GRUT before the annuity or unitrust interest terminates. The grantor's allocation of GST tax exemption to the GRAT or GRUT when the annuity interest terminates, is based on the value of the assets in the trust at that time.
- h. **Back-Loading.** The annuity or unitrust interest in a GRAT can either be a fixed amount or percentage of the annual value of the trust fund, or it can vary from year to year. An annuity or unitrust interest is a qualified interest only to the extent that a year's payments are not more than 120 percent of the preceding year's payments.
- i. **The Illiquid GRAT.** A GRAT or GRUT that holds few liquid assets may have difficulty paying the annuity or unitrust interest. Some practitioners attempted to resolve this dilemma by having the trust distribute a promissory note to the grantor. The regulations preclude the trustee of a GRAT or GRUT from satisfying the annuity or unitrust amount by distributing a note or similar financial instrument to the grantor. The regulations state that the annuity or unitrust payment must be made in cash or with trust assets, and that distributing the trust's note, other debt instrument, option to buy trust assets at some future time, or some other similar financial arrangement does not constitute a distribution for purposes of the requirements for a qualified GRAT or GRUT. In addition, the regulations

require that the governing instrument of a GRAT or GRUT expressly prohibit the use of notes, debt instruments, options, or other similar financial arrangements that effectively delay receipt by the grantor of the annual payment necessary to satisfy the annuity or unitrust interest amount. The grantor's annuity or unitrust interest in a trust that fails to include this language will not be a qualified interest under Section 2702, and the grantor's gift will be valued without regard to the reserved interest; that is, as a gift of the entire trust fund.

Doc # 598674

EXHIBIT A

Transfer Date:	12/2009
\$7520 Rate:	3.20%
Applicable Federal Rate:	2.64%(Use Mid-Term AFR)
Gift in Trust:	\$666,666
Sale to Trust:	\$6,000,000
Payment Periods:	Annual
Payment Timing:	End
Term of Payment:	9
Income Earned by Trust:	9.00%
Grantor's Age(s):	60
Future Value of Remainder:	\$4,612,974
Payment on Note:	\$757,721
Gift Tax Value of GRAT:	\$821,606
Gift Tax Value of IDIT:	\$666,666

<u>Year</u>	<u>Beginning Principal</u>	<u>Income of Trust</u>	<u>Payment on Note</u>	<u>Ending Principal</u>
1	\$6,666,666	\$600,000	\$757,721	\$6,508,945
2	\$6,508,945	\$585,805	\$757,721	\$6,337,029
3	\$6,337,029	\$570,333	\$757,721	\$6,149,640
4	\$6,149,640	\$553,468	\$757,721	\$5,945,387
5	\$5,945,387	\$535,085	\$757,721	\$5,722,751
6	\$5,722,751	\$515,048	\$757,721	\$5,480,078
7	\$5,480,078	\$493,207	\$757,721	\$5,215,563
8	\$5,215,563	\$469,401	\$757,721	\$4,927,243
9	\$4,927,243	\$443,452	\$757,721	\$4,612,974

EXHIBIT B

Self-Canceling Installment Note

12/1/2009

Transfer Date:	12/2009
Discount Rate:	3.20%
FMV of Property:	\$6,000,000
Cost Basis:	\$1,000,000
Recapture (Sec. 1245 or 1250):	\$0
Initial Down Payment:	\$0
Age(s):	68
Term of Note:	15
Type of Note:	Interest Only
Annuity Valuation:	Complete
No-Risk-Premium Market Interest Rate:	4.17%
Payment Period:	Annual

	Risk Premium	
	<u>Principal</u>	<u>Interest</u>
Mortality Risk Premium (Principal):	\$2,242,288.90	N/A
Total Sale Price:	\$8,242,288.90	\$6,000,000.00
Principal Amount of Note:	\$8,242,288.90	\$6,000,000.00
Mortality Risk Premium (Interest):	N/A	2.8440%
Total Interest Rate:	4.1700%	7.0140%
Annual Principal Payments:	\$0.00	\$0.00
Annual Interest Payments:	\$343,703.45	\$420,781.91
Total Annual Payments:	\$343,703.45	\$420,781.91
Balloon Payment at the End of Note:	\$8,242,288.90	\$6,000,000.00
Total Interest to be Paid:	\$5,155,551.75	\$6,311,728.65
Total Capital Gain:	\$7,242,288.90	\$5,000,000.00
Profit Percentage (Capital Gain / Sale Price):	87.87%	83.33%
Capital Gain Recognized in Year of Sale:	\$0.00	\$0.00
Basis Recovery in Year of Sale:	\$0.00	\$0.00

EXHIBIT C

Grantor Retained Annuity Trust

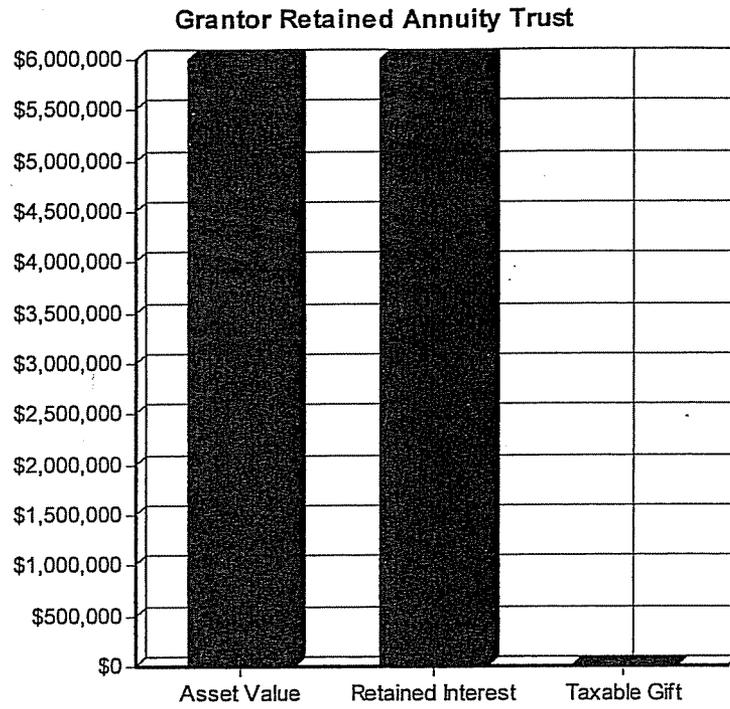
12/1/2009

Type of Calculation:	Term
Transfer Date:	12/2009
§7520 Rate:	3.20%
Grantor's Age:	68
Income Earned by Trust:	2.00%
Term:	2
Total Number of Payments:	2
Annual Growth of Principal:	8.00%
Pre-discounted FMV:	\$6,000,000
Discounted FMV:	\$6,000,000
Percentage Payout:	53.50168%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Distribute Principal in Kind:	Yes
Vary Annuity Payments?	Yes
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

*** §2702 IS Applicable ***

Base Term Certain Annuity Factor:	1.9267
Frequency Adjustment Factor:	1.0000
Initial Annual Annuity Payout:	\$3,210,100.80
Initial Amount of Payment Per Period:	\$3,210,100.80
Annual Annuity Payment Growth:	2.00%
Value of Term Certain Annuity Interest:	\$6,000,000.00
Value of Grantor's Retained Interest:	\$6,000,000.00
(1) Taxable Gift (Based on Term Interest):	\$0.00

Year	Economic Schedule				
	Beginning Principal	8.00% Growth	2.00% Annual Income	Annual Payment	Remainder
1	\$6,000,000.00	\$480,000.00	\$124,800.00	\$3,210,100.80	\$3,394,699.20
2	\$3,394,699.20	\$271,575.94	\$70,609.74	\$3,274,302.82	\$462,582.06
Summary	\$6,000,000.00	\$751,575.94	\$195,409.74	\$6,484,403.62	\$462,582.06



**AFR Tables
Result**

EXHIBIT D

REV. RUL. 2009-38 TABLE 1

Applicable Federal Rates (AFR) for December 2009

	<u>Period for Compounding</u>			
	Annual	Semiannual	Quarterly	Monthly
Short-Term				
AFR	.69%	.69%	.69%	.69%
110% AFR	.76%	.76%	.76%	.76%
120% AFR	.83%	.83%	.83%	.83%
130% AFR	.90%	.90%	.90%	.90%
Mid-Term				
AFR	2.64%	2.62%	2.61%	2.61%
110% AFR	2.90%	2.88%	2.87%	2.86%
120% AFR	3.16%	3.14%	3.13%	3.12%
130% AFR	3.44%	3.41%	3.40%	3.39%
150% AFR	3.97%	3.93%	3.91%	3.90%
175% AFR	4.64%	4.59%	4.56%	4.55%
Long-Term				
AFR	4.17%	4.13%	4.11%	4.09%
110% AFR	4.59%	4.54%	4.51%	4.50%
120% AFR	5.02%	4.96%	4.93%	4.91%
130% AFR	5.44%	5.37%	5.33%	5.31%

EXHIBIT E

**AFR Tables
Result**

REV. RUL. 2009-38 TABLE 5

Rate Under IRC Section 7520 for December 2009

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	3.2%
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