

Structuring Installment Sales to Intentionally Defective Trusts: Using Private Annuities and Promissory Notes

Transferring Appreciated Property Through Asset Sales and Installment Payments

WEDNESDAY, JULY 26, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Structuring Installment Sales to Intentionally-Defective Trusts

Sponsored by:

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Wednesday, July 26, 2017

Presenters:

Julius H. Giarmarco

and

Michael D. Mulligan



Introduction to Intentionally- Defective Grantor Trusts ("IDGTs")

Introduction to IDGTs

➤ What is an IDGT?

- An IDGT seeks to take advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042 and the grantor trust income tax rules of IRC Sections 671-678.
- An IDGT is an irrevocable trust that effectively removes assets from the grantor's gross estate.
- For income tax purposes, however, the trust is "defective", and the grantor is taxed on the trust's income.
- The IDGT's income and appreciation accumulates inside the trust gift and GST tax free.

Introduction to IDGTs

- Common grantor trust triggers:
 - The trust includes a power exercisable by the grantor (in a non fiduciary capacity) to reacquire trust assets by substituting assets of equivalent value. IRC Section 675(4)(C).
 - The trust includes a power held by a non-adverse party to add to the class of beneficiaries (other than the grantor's after-born or after-adopted children). IRC Section 674(a).
 - The trust includes a power to enable the trustee to loan money or assets to the grantor from the trust without adequate security. IRC Section 675(2).

Introduction to IDGTs

- Turning Off Grantor Trust Status.
 - Grantor can release the grantor trust triggers.
 - A trust protector can re-grant them.
 - Toggling?

Introduction to IDGTs

- Reimbursing Grantor for Income Taxes Paid.
 - A discretionary tax reimbursement clause is permissible. See Revenue Ruling 2004-64.
 - However, there must be no express or implied understanding between the grantor and the trustee that the trustee will exercise its discretion in favor of the grantor.
 - And state law must not subject the trust property to the claims of the grantor's creditors. Otherwise, inclusion will result under IRC Sec. 2036.

Introduction to IDGTs

➤ *Crummey* powers.

- If the IDGT is structured as a “Crummey trust”, gifts to the trust will qualify for the Section 2503(b) gift tax annual exclusion.
- However, IRC Section 678(a) provides that a beneficiary and not the grantor will be treated as the owner of the trust (for income tax purposes) if the beneficiary has a power “exercisable solely by himself to vest corpus or the income therefrom in himself”.

Introduction to IDGTs

➤ *Crummey* powers (cont.).

- IRC Section 678(b) provides that the grantor, rather than the beneficiary, will be treated as the owner of the trust with respect to the power over income if the grantor is otherwise treated as the owner.
- However, that Section 678(b) read literally only applies as to a “power over income”. A *Crummey* withdrawal power is generally a power to withdraw corpus.

Introduction to IDGTs

➤ *Crummey* powers.

- Nonetheless, the IRS has privately ruled that a trust remains a grantor trust with respect to the original grantor despite the existence of *Crummey* withdrawal powers. See PLR 200606006; PLR 200603040; PLR 200729005.

Introduction to IDGTs

- GST considerations.
 - As long as the grantor allocates his or her generation-skipping tax (“GST”) exemption to gifts to the IDGT, the trust assets will be exempt from the GST tax.
 - GST exemption need not be applied to the sale transaction.

Introduction to IDGTs

- What assets should be gifted?
 - The grantor may choose to gift cash or marketable securities to the IDGT as the initial seed fund.
 - This type of gift would avoid raising a valuation question and having to check the box on the gift tax return for a valuation discount.
 - But, should the grantor disclose the sale transaction on a gift tax return?



Sale to IDGT Strategy

Sale to IDGT Strategy

- Why an installment sale to an IDGT works:
 - No capital gains tax on sale. Rev. Rul. 85-13.
 - Arbitrage. Freezes value of appreciation on assets sold at the AFR.
 - Interest payments not taxable to grantor.
 - Tax burn. Payment of IDGT's income taxes by grantor leaves more assets in the IDGT – gift tax free. Rev. Rul. 2004-64.
 - Back end-loading (i.e., interest only with a balloon payment).

Sale to IDGT Strategy

- Why an installment sale to an IDGT works (cont.):
 - Valuation discounts increase effectiveness of technique.
 - Possible discount for value of note in seller's estate.
 - IDGT is an eligible Subchapter S shareholder.
 - Lower interest rate than used in GRATs.
 - An IDGT can purchase an existing life insurance policy on the life of the grantor without subjecting the policy to taxation under the transfer-for-value rule. Rev. Rul. 2007-13.

Sale to IDGT Strategy

- Disadvantages to an IDGT sale:
 - Requires 10% seed funding.
 - Note is taxable in grantor's estate (unless SCIN is used).
 - Potential cash flow problems for grantor by paying IDGT's income taxes.
 - Likely no step-up in basis at grantor's death.
 - Possible gift and estate tax exposure (under IRC Section 2036) if IDGT has insufficient equity.

Sale to IDGT Strategy

- Disadvantages to an IDGT sale (cont.):
 - *Madorin* case.
 - Some conclude loss of grantor trust status either during life or at death causes recognition of gain; note and assets inside IDGT appear simultaneously.
 - Others conclude gain not recognized at death under *Crane*.

Sale to IDGT Strategy

- Funding the IDGT prior to sale.
 - Amount of seed funds.
 - The “seed fund” reduces the risk that the sale will be treated as a transfer with a retained interest by the grantor under IRC Section 2036.
 - In PLR 9535026, the IRS ruled that IRC Sections 2701, 2702 and 2036(a) did not apply if the note retained by the grantor was bona fide debt.

Sale to IDGT Strategy

- Funding the IDGT prior to sale (cont.).
 - In *Sharon Karmazin*, Tax Court Docket No. 2127-03, the IRS challenged an IDGT sale on the basis that IRC Code Sections 2701 and 2702 applied, but later dropped both arguments.
 - In *Karmazin*, the trust had 10% seed money. The case was settled out of court with the only adjustment being a reduction of the valuation discount from 42% to 37%.

Sale to IDGT Strategy

- Funding the IDGT prior to sale (cont.).
 - A personal guarantee by the IDGT beneficiaries assists in substantiating that the sale to the IDGT is at arm's length.
 - However, a beneficiary giving a guarantee may be treated as making a contribution to the IDGT, which could cause the IDGT not to be considered a grantor trust with respect to the original grantor.
 - Consider a third-party guarantee and pay a reasonable guarantee fee.

Sale to IDGT – Three Alternatives

- Promissory Note
- Annuity Based Upon Life
- Self-Canceling Installment Note [SCIN]

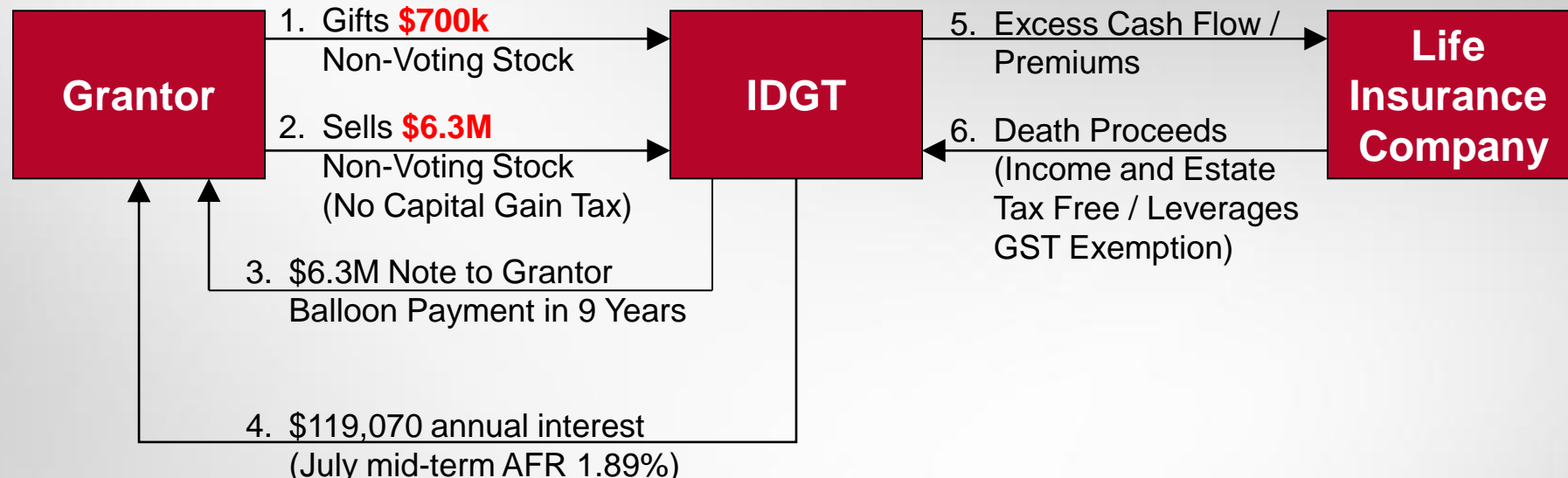
Standard Sale for Promissory Note

- Note bears interest at **AFR** (*Frazee*).
- *Fidelity-Philadelphia Trust Co* Tests:
 - Interest not tied to income.
 - Other assets (10%).
- Sale Agreement / Note.
 - It is common for a nine-year note to be used in IDGT transactions, which would apply the mid-term rate.
 - The note typically permits prepayment in kind.
 - The note can be a self-canceling installment note (SCIN).

Sale to IDGT Strategy

- Sale Agreement / Note.
 - Should have 10% equity or personal guarantee.
 - The note is typically structured to provide annual payments of interest only with a balloon payment at the end of the term.
 - Interest at AFR.
 - An independent written appraisal of the asset being sold to the IDGT should be obtained.

Sale to IDGT Diagram



Advantages:

- After **30% discount** for lack of control and lack of marketability.
- Arbitrage.
- Tax burn: Grantor's estate reduced by the income taxes paid on behalf of the trust.
- The trust property escapes estate taxation for as long as permitted under state law.
- IDGT can purchase a life insurance policy on Grantor's life without triggering the transfer for value rule; and IDGT is an eligible Subchapter S shareholder.



Tax Issues Regarding Sales to IDGTs

Tax Issues Regarding Sales to IDGTs

- IRC Section 2036(a)(1) Attack.
 - If the note is a retained interest, then IRC Section 2036(a)(1) would cause the entire trust property to be included in the grantor's estate at its date-of-death value.
 - If the note is respected as bona fide debt, there is no retained interest.

Tax Issues Regarding Sales to IDGTs

- IRC Section 2701 Attack.
 - Under IRC Section 2701, the amount of the taxable gift is the value of the property transferred minus the value of any “qualified interests” retained by the transferor.
 - If the IDGT note has a fixed due date and payments are made at least annually, the payments should be a qualified retained interest.
 - However, the required return for a preferred partnership interest is generally much higher than the AFR.

Tax Issues Regarding Sales to IDGTs

- IRC Section 2702 Attack.
 - IRC Section 2702 provides that except for GRATs, GRUTs and QPRTs, any other split interest held by the grantor in a trust is valued at zero, resulting in a taxable gift of the FMV of the property sold.
 - If the IDGT is bona fide debt, then IRC Section 2702 does not apply.



Introduction to Private Annuities

Introduction to Private Annuities

➤ Introduction.

- A private annuity is a transaction in which one individual (the “annuitant”) sells property to another individual in exchange for an annuity, usually measured by the seller’s lifetime.
- Upon the death of the annuitant, the annuity payments stop.
- This is a “bet-to-die” strategy.

Introduction to Private Annuities

➤ Introduction (cont.).

- The seller can retain no interest in the transferred property, nor should payment of the annuity be tied to the income from the property. IRC Section 2036.
- Additionally, if the annuity is only payable out of the transferred property, there is a risk that the annuity will be recharacterized as a retained interest in the transferred property. IRC Section 2036.
- To avoid a Section 2036 argument, the purchaser should own other assets so that the annuity payment does not depend entirely upon the property sold. *Philadelphia Trust*, 356 U.S. 274 (1958).

Introduction to Private Annuities

- Overview of Transfer Tax Consequences.
 - If the value of purchaser's promise (according to the annuity tables issued under Section 7520) equals the value of the property sold, the seller does not make a gift.
 - When the seller dies, nothing is included in his/her estate.
 - The actuarial tables are key in deciding whether to use a private annuity. The tables are found in Publications 1457 (Alpha Volume) and 1458 (Beta Volume).

Introduction to Private Annuities

- Overview of Transfer Tax Consequences (cont.)
 - According to the regulations, the actuarial tables cannot be used if there is at least a 50% chance that the seller will die within a year, because of his or her affliction with a terminal illness or condition. Treas. Reg. Sections 20.7520(b)(i), 25.7520-3(b)(3).
 - An individual who survives for at least 18 months is presumed not to have been terminally ill. Treas. Regs. 1.7520-20(b)(3), 20.7520(b)(3) and 25.7520(b)(3).

Introduction to Private Annuities

- When are private annuities likely to be a good idea?
 - If the transferred asset is expected to outperform the IRC Section 7520 rate.
 - Where the seller is not expected to live for his/her full life expectancy but whose life expectancy may still be valued under the actuarial tables.
 - A private annuity is a bet-to-die strategy, but not a deathbed technique.
 - For personal financial reasons, the seller cannot surrender the property sold without receiving a lifetime income.

Introduction to Private Annuities

- Gift Tax Consequences.
 - If the annuity has a value equal to the property interests given for it, there will be no gift tax consequences associated with the transfer.
 - The method for valuing the annuity is set forth in Rev. Rul. 84-162, 1984-2 C.B. 200.

Introduction to Private Annuities

- Estate Tax Consequences for Annuitant-Seller.
 - If no gift is made at the outset, and the annuity terminates on the annuitant's death, the property sold in exchange for the annuity will not be includable in the annuitant's estate at his/her death, because his/her interest expires at that time.
 - However, any annuity payments (and income or appreciation) which the annuitant has received, but not consumed, will be includable in his/her estate.

Introduction to Private Annuities

- Income Tax Consequences for Annuitant-Seller.
 - With the release of Prop. Treas. Reg. Sections 1.72-6(e) and 1.1001-1(j) in October 2006, the Treasury and IRS have signaled their intent to recognize gain or loss at the time of the exchange of property (other than money) for an annuity contract.
 - The proposed Regulations are effective for exchanges after Oct. 18, 2006.

Introduction to Private Annuities

- Income Tax Consequences for Annuitant-Seller (cont.).
 - Previously, annuitants recognized such gain over their remaining life expectancy.
 - The new rules would, if adopted in final form as proposed, require annuitants to calculate the fair market value (FMV) of property exchanged for an annuity and for any gain or loss to be realized immediately.

Introduction to Private Annuities

- Income Tax Consequences for Annuitant-Seller (cont.).
 - Thereafter, annuity payments would be partly excluded from income as a return of the annuitant's investment and partly taxed as ordinary income (i.e., interest).
 - The proposed Regulations may make alternatives to private annuity contracts more attractive, such as installment sales to IDGTs in exchange for private annuity or SCIN.

Introduction to Private Annuities

- Income Tax Consequences to the Buyer.
 - Buyer's basis in purchased interest is equal to the amount of payments actually made.
 - The buyer's initial basis is the value of the annuity.
 - If the business owner lives less than expected, the buyer's basis will be adjusted downward to the total payments made.
 - If the business owner lives longer than expected, the buyer's basis will be adjusted upward to the total payments made.

Introduction to Private Annuities

- Income Tax Consequences to the Buyer (cont.).
 - Even though a portion of each annuity payment will be considered ordinary income to the seller, no portion of the buyer's payments are deductible (as interest) since they are considered capital expenditures by the buyer.

Introduction to Private Annuities

➤ Exhaustion Test.

- A sale to a trust for a private annuity must also meet the exhaustion test. Treas. Reg. Sections 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 25.7520-3(b)(2)(i).
- The Regulations assume that, for purposes of valuing an annuity, the transferor / annuitant will live to age 110. The Regs. contain a safe harbor and a detailed mechanical procedure to determine whether trusts lack sufficient funds to sustain the annuity payments until the transferor / annuitant attains age 110.

Introduction to Private Annuities

- Exhaustion Test (cont.).
 - Because failing the exhaustion test can result in potential gift tax exposure, the trust should have other funds or personal guarantees so that the private annuity sale is not disregarded.
 - While an IDGT sale for a private annuity will avoid the up front capital gains tax, this additional funding requirement is far more substantial than the 10% seed gift suggested for installment sales and the interest premium for a SCIN.

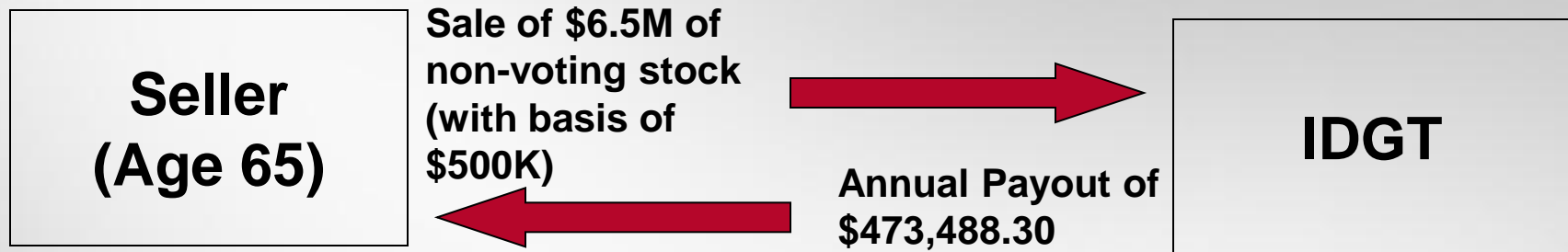
Introduction to Private Annuities

- Deferred Private Annuity – *Estate of Kite*, T.C. Memo 2013-43.
 - Decedent sold LLC interests to children in exchange for a deferred private annuity (no payments for 10 years).
 - Decedent died three years into the agreement.
 - Tax Court rejected the IRS's argument that the transaction was a disguised gift.


Introduction to Private Annuities

- Deferred Private Annuity – *Estate of Kite* (cont.).
 - The Tax Court ruled that the taxpayer did not suffer from a terminal illness; had a 50% actuarially-determined odds of living more than one year (based on a doctor's letter); and with presumption in taxpayer's favor since she survived more than 18 months (relying on IRC Section 7520 Regs).
 - Enforceability of agreement was determinative (children had ability to make the annuity payments).

Private Annuities Diagram



- Fair market value of stock is \$10M, less 35% valuation discount.
- No capital gain realized on sale.
- Calculation assumes a 19.5 year life expectancy.
- Standard valuation tables may be used if annuitant has at least a 50% probability of living one year. If the annuitant survives for at least 18 months, the 50% test is presumed to have been met.
- IRC Section 7520 Rate = 2.4%.



Introduction to Self-Canceling Installment Notes (“SCINs”)

Introduction to SCINs

➤ Background.

- A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion (in the seller's estate) of the unpaid obligation on the date of the seller's death.
- One way to avoid this problem is to use a self-canceling installment note (SCIN): a debt obligation containing a provision canceling any future payments upon the death of the initial payee.

Introduction to SCINs

➤ Mortality Premium.

- To avoid gift taxes, the value of the SCIN must equal the FMV of the property sold.
- For the value of the SCIN to equal the value of the property sold, the seller must be compensated for the risk that he/she may die during the term of the note and, thus, not receive the full purchase price.

Introduction to SCINs

- Mortality Premium (cont.).
 - The risk premium can be structured using a higher than “normal” interest rate, a higher principal face amount of the note, or a combination of the two.
 - There is not universal agreement as to how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments.

Introduction to SCINs

➤ Case Law.

- In *Estate of Moss v Commissioner*, 74 T.C. 1239 (1980), the Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under IRC Section 2033, because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock".

Introduction to SCINs

➤ Case Law (cont.).

- *Estate of Costanza v Commissioner*, 320 F. 3d 595 (6th Cir. 2003) ruled that a SCIN should not be ignored for gift tax purposes.
- In *Estate of Frane v Commissioner*. 98 T.C. 341 (1992), the Tax Court held that gain should be recognized upon the seller's death on the seller's final income tax return (not by the seller's estate).
- The Eighth Circuit changed the result, adopting the IRS's alternate position that the decedent's estate recognizes the deferred gain on its income tax return as an item of IRD. *Estate of Frane*, 998 F.2d 567 (8th Cir. 1993).

Introduction to SCINs

- Chief Counsel Advice 201330033.
 - The IRS Chief Counsel Office weighed in on the treatment of SCINs in announcing that IRC Section 7520 should not apply in valuing SCINs, and the valuation should be based on a method that takes into account the willing-buyer willing-seller standard in Treas. Reg. Sec. 25.2512-8.
 - Thus, according to the IRS, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account.

Introduction to SCINs

➤ *Estate of William M. Davidson.*

- In December 2008 and January 2009, William M. Davidson, the owner of the Detroit Pistons and Guardian Industries Corp., made gifts, substitutions, a five-year GRAT, and sales that eventually paid him no consideration at all.
- He was 86, and his actuarial life expectancy was about five years. He lived for 50 days after making the last transfer and died on March 13, 2009.

Introduction to SCINs

- *Estate of William M. Davidson (cont.).*
 - The consideration for some of Mr. Davidson's sales included five-year balloon SCINs at the Section 7520 rate with an 88% principal premium; and five-year balloon SCINs at the Section 7520 rate with a 13.43% interest rate premium.

Introduction to SCINs

- *Estate of William M. Davidson* (cont.).
 - The Davidson Estate filed its Tax Court petition on June 14, 2013 (Docket No. 13748-13), and the IRS filed its answer on August 9, 2013.
 - Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 and in its answer in the Tax Court, the IRS believed the notes should be valued, not under Section 7520, but under a willing-buyer willing-seller standard that took account of Mr. Davidson's health.

Introduction to SCINs

- *Estate of William M. Davidson (cont.).*
 - Combined gift and estate tax deficiencies, with some acknowledged double counting, were about \$2.8 billion.
 - In July 2015, the estate stipulated to estate and GST taxes of \$321 million.
 - Even if IRS position is questionable, why risk availability of 50% test?



Cases Impacting Sale to IDGT Strategy

Cases Impacting Sale to IDGT Strategy

- *Trombetta*
- *Woelbing* (two companion cases)
- *Davidson and CCA201330033*

Cases Impacting Sale to IDGT Strategy

➤ *Trombetta.*

- Decedent transferred mortgaged rental properties to annuity trust; value of transferred property exceeded value of reserved annuity payments; decedent's children guaranteed annuity; decedent as Trustee with ½ of vote; Trustees authorized to distribute excess income to decedent.
- Implied understandings; no negotiation; decedent on both sides of transaction; decedent benefited from trust payments on mortgage; no legitimate business reasons for transaction.

Cases Impacting Sale to IDGT Strategy

- Response to *Trombetta*.
 - Independent Trustee.
 - 10% cushion funded with “old and cold” assets.
 - Don’t peg payments to IDGT’s income.
 - Observe all formalities.
 - Seller should dispose of all other interest in a closely-held business and give up all contacts as an officer, director or manager.
 - Arm’s-length negotiation with Trustees and beneficiaries represented by separate counsel.

Cases Impacting Sale to IDGT Strategy

➤ *Woebeling Cases*

- IRS asserted inclusion under Section 2036 and gift under Section 2702.
- Facts similar to *Karmazin* case which was settled recognizing validity of sale on terms favorable to estate.
- Cases have been settled; IRS gave up on Section 2036 and Section 2702.

Cases Impacting Sale to IDGT Strategy

➤ *Davidson.*

- Sales to IDGTs for SCINs.
- IRS asserts 50% probability of survivorship test not apply to a SCIN.
- Even if IRS position is questionable, why risk availability of 50% test?

THANK YOU

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