A “REALITY OF SALE” ANALYSIS

OF

INSTALLMENT SALES TO GRANTOR TRUSTS:

PROPERLY STRUCTURED, THE BEST TRANSFER TAX STRATEGY

By

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I. Introduction.

The sale to an Intentionally Defective Irrevocable Trust ("IDIT") in exchange for the IDIT's promissory note has become an established estate planning technique.[1] If the seller's life expectancy is shortened by illness, an annuity based upon the seller's life or a Self-Cancelling Installment Note ("SCIN") may be substituted for the promissory note. Unlike a standard promissory note, payments under the annuity or SCIN terminate at the seller's death, leaving only payments which the seller received during his or her lifetime to be included in the seller's estate.

This paper discusses the standard sale transaction, as well as the two variations. The paper then examines authorities (including what Jerry Hesch, the Director of this Institute, refers to as "reality of sale" cases) which indicate that a properly structured sale to an IDIT should be a successful transfer tax planning strategy.

Four recent cases have generated a great deal of interest among estate planning commentators. One case is a final decision by the Tax Court, *Estate of Trombetta v. Commissioner*.[2] The others are the companion cases of *Estate of Marian Woelbing v. Commissioner* and *Estate of Donald Woelbing v. Commissioner*,[3] and the case of *Estate of Davidson v. Commissioner*.[4] Chief Counsel Advise (CCA) 201330033 was issued in connection with the *Davidson* case. This paper discusses these cases and their impact on the sale to an IDIT strategy.

II. Structure of Standard Sale to IDIT Transaction.

The term Intentionally Defective Irrevocable Trust or IDIT describes a particular type of trust. The existence of an IDIT apart from its grantor is recognized for estate, gift and generation-skipping tax purposes, but not for income tax purposes. Any uncompensated transfer to an IDIT constitutes a gift. The assets of an IDIT are not included in the estate of its grantor at death. An IDIT is created by inserting provisions in the governing instrument which violate the

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[1] Mulligan, *Fifteen Years of Sales to IDITs – Where Are We Now?*, 235 ACTEC J. 227 (2009).

[2] 106 T.C.M. 416 (2013).

[3] Docket Nos. 30260-13 and 30261-13, respectively.

[4] Docket No. 13748-13.

grantor trust income tax rules under IRC Secs. 671-677, but do not cause estate tax inclusion. It is fairly easy to achieve this result.[5]

The position of the Internal Revenue Service ("IRS") is that an IDIT does not exist for Federal income tax purposes.[6] All income of an IDIT, including capital gain, is taxed directly to its grantor. The grantor's sale of appreciated property to an IDIT causes no recognition of gain. Interest on a promissory note paid by an IDIT to its grantor is not taxed to the grantor or deductible by the IDIT. For income tax purposes, such interest is ignored. An IDIT has the option to use the social security number of its grantor as its tax identification number.[7]

The standard sale to an IDIT technique involves a grantor establishing an IDIT and selling assets to the IDIT in exchange for the IDIT's promissory note. The IRS has asserted in litigation that IRC Sec. 7872 applies to a promissory note given in a sale transaction, and that if, pursuant to IRC Sec. 7872(f), a promissory note bears interest at the applicable Federal rate under IRC Sec. 1274, it has a gift tax value equal to its face amount. This position has been accepted by the Tax Court.[8] The sale to an IDIT is a mechanism by which equity can be converted into debt without income tax consequences.[9]

Under IRC Sec. 7872(f)(2)(A), the applicable Federal rate for a term loan is the rate in effect under IRC Sec. 1274(d) as of the date upon which the loan is made. IRC Sec. 1274(d)(2) establishes a special rule for determining the applicable Federal rate for a sale or exchange. Under IRC Sec. 1274(d)(2), the applicable Federal rate is the lowest of the interest rates for the month in which there is a binding contract for the sale or exchange, and the two immediately preceding months. Because a lower interest rate on an IDIT's promissory note reduces the value of the seller's estate, it is tempting to make use of the IRC Sec. 1274(d)(2) exception when the applicable Federal rate for one of the two months preceding the month of sale is lower than the rate for the month of sale.

IRC Sec. 1274(d) is an income tax statute. As noted in the discussion with note 6, *supra*, the IRS takes the position that transactions between a grantor trust and its grantor are not recognized for income tax purposes. It is conceivable that the IRS might apply this position to

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[5] Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note – An End Run Around Chapter 14?*, 32nd Ann.U.Miami Philip E. Heckerling Inst. On Est. Plan. ¶1504 (1998).

[6] Rev.Rul. 85-13, 1985-1 C.B.184.

[7] Treas.Reg.Secs. 671-4(b)(2)(i)(A) and 301.6109-1(a)(2)(i)(B).

[8] *Frazee v. Commissioner*, 98 T.C. 554 (1992); *Estate of True v. Commissioner*, 82 T.C.M 27 (2001), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004). *See also* Ltr. Ruls. 9408018 and 9535026.

[9] For an article advocating abolition of the grantor trust rules to foreclose this kind of planning see Rics, *I Dig It, But Congress Shouldn't Let Me: Closing the IDGT Loophole*, 36 ACTEC L.J. 641 (2010).

assert that a sale to an IDIT is not a sale or exchange for purposes of IRC Sec. 1274(d)(2). In most cases, the variation in the interest rates over the three month period described in IRC Sec. 1274(d)(2) is unlikely to be substantial. It would seem advisable not to risk challenge by the IRS and use the applicable Federal rate for the month of sale and not either of the two preceding months.[10]

In the sale of difficult to value assets to an IDIT, the sales documents might describe the quantity of an asset being sold through the use of a formula expressing that quantity as a dollar amount rather than as a number or percentage of units, *e.g.*, as $X worth of ABC, Inc. stock rather than XX number of shares of ABC, Inc. stock. Recent cases indicate that the courts might recognize the effectiveness of such a formula to eliminate any gift if the IRS successfully argues that the assets being sold to the trust have a greater per unit value than contemplated in the sale transaction.[11] In such event, the formula operates to reduce the number or percentage of units transferred so that the dollar amount transferred remains constant. If the formula is effective, the reduction in units transferred avoids a gift.

Similar to a grantor retained annuity trust, or GRAT, the sale to an IDIT technique produces an estate tax savings if the assets sold to the IDIT generate a total return (net income plus appreciation) which exceeds the interest on the IDIT's promissory note. In such case, the excess return is trapped inside the IDIT and excluded from the seller's estate. Except for interest on the note, the sale is a "freeze" technique. Net return in excess of interest on the note is easier to produce with an IDIT than with a trust which is a separate taxpayer. With an IDIT, the grantor pays all taxes due on income and capital gain generated by the assets of the IDIT. The IDIT's return on assets is not reduced by income tax liability.

The sale technique is particularly powerful when interests in a partnership, limited liability company or S corporation are sold to the IDIT. There is no income tax imposed upon such an entity. Rather, tax is imposed upon its owners. The seller of an interest in such an entity to an IDIT continues to be taxed on the portion of the entity's income attributable to that interest. If the entity makes a distribution to its owners for the payment of income taxes, that distribution is received by the IDIT, even though tax is due from the seller. The IDIT can move funds to the seller by making payments on the promissory note, which has the effect of reducing, not just freezing, the seller's estate.

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[10] For a different point of view, see Hesch, Gassman and Denicolo, *Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, 36 T.M.Est., Gifts and Tr. J. No. 2, 128 (2011).

[11] *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008); *aff'd* 586 F.3d 1061 (8th Cir. 2009); *Petter v. Commissioner*, 98 T.C.M. 534 (2009), *aff'd* 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C.Memo. 2011-133 (2011); *Wandry v. Commissioner*, 103 T.C.M. 1472 (2012).

Although the grantor's payment of taxes on an IDIT's income could be viewed as an indirect gift increasing the value of an IDIT, the IRS ruled in Rev.Rul. 2004-64[12] that such payment does not constitute a transfer subject to gift tax. Rev. Rul. 2004-64 permits a grantor to pay taxes on income which is not in the grantor's estate without having such payment being treated as a gift.

The sale to an IDIT technique also produces favorable generation-skipping tax results. If the IDIT to which a sale is made has an inclusion ratio of zero for generation-skipping tax purposes and if the value of assets sold to the IDIT does not exceed the face amount of the promissory note which the seller receives in the sale, then the sale does not change the IDIT's inclusion ratio. Any assets which are excluded from the seller's estate for Federal estate tax purposes are also insulated from generation-skipping tax. The significant point is that this insulation occurs without any allocation of additional GST exemption.

III. IRC Secs. 2036(a)(i) and 2702 and *Fidelity-Philadelphia Trust Co.*

If the sale is to be successful, the seller cannot retain any interest in the assets sold which is subject to tax under IRC Sec. 2036(a)(1) or 2702. IRC Sec. 2036(a)(1) includes in a transferor's gross estate any transfer (other than a bona fide sale for an adequate and full consideration in money or money's worth) under which the transferor has retained, for life or for any period not ascertainable without reference to the transferor's death or for any period which does not in fact end before the transferor's death, the possession or enjoyment of, or right to income from, the transferred property. IRC Sec. 2702 governs the value for Federal gift tax purposes of a transfer to a trust to (or for the benefit of) a member of the transferor's family. Under IRC Sec. 2702, the value of any interest in the trust retained by the transferor is zero, unless the retained interest is a qualified annuity, unitrust interest or a noncontingent remainder interest in which all other interests are qualified annuity or unitrust interests. So-called grantor retained annuity trusts (GRATs) or qualified personal residence trusts (QPRTs) are planning techniques designed to qualify under IRC Sec. 2702. If a sale to an IDIT in exchange for a promissory note produces estate tax inclusion under IRC Sec. 2036(a)(1), it also likely produces gift tax consequences under IRC Sec. 2702. Those consequences are likely to be severe, since the applicability of IRC Sec. 2702 is likely to cause the promissory note to be assigned a value of zero, resulting in the value of assets transferred to the IDIT in the sale being exposed to gift tax, with no reduction due to the promissory note.

It is easy to comprehend how a sale to an IDIT in exchange for payments from the IDIT over time might be treated as an IRC Sec. 2036(a)(1) transfer. Payments by the IDIT, including, specifically, any interest on deferred payments, are payable from income generated by the property sold to the IDIT. In *Fidelity-Philadelphia Trust Co. v. Smith*,[13] the United States Supreme Court enunciated the circumstances under which a sale in exchange for deferred payments is not to be treated as a transfer includable under IRC Sec. 2036(a)(1). Under the tests enunciated by the Supreme Court, the size of payments on the promissory note must not be

[12] 2004-2 C.B. 7.

[13] 356 U.S. 274 (1958).

related to the income generated by the transferred property. Further, the debt created by the promissory note must be a personal obligation of the transferee and must not be chargeable solely to the transferred property.[14]

In a standard sale to an IDIT transaction in exchange for the IDIT's promissory note, the interest rate on the promissory note is determined in accordance with IRC Secs. 7872(e) and (f)(2), i.e., the applicable Federal rate in effect under IRC Sec. 1274(d) on the date the sale is effected. Use of the applicable Federal rate satisfies the first test under the *Fidelity-Philadelphia Trust Co.* case, i.e., that payments under the promissory note must not be related to the income generated by the property sold to the IDIT. In seeking to meet the second and third tests established by *Fidelity-Philadelphia Trust Co.* that the obligation on the promissory note must be a personal obligation of the transferee and not be chargeable solely to the property sold to the IDIT, practitioners generally use a cushion of at least 10% of the value of the property sold to the IDIT. This cushion comes from sources other than the sale, *e.g.*, by the seller's gift to the IDIT or beneficiary guarantees of the IDIT's promissory note.[15] The 10% figure is based upon conversations Byrle Abbin had with IRS personnel in the process of obtaining Ltr.Rul. 9535026.[16]

IV. Sale for a Private Annuity.

The use of the standard sale to IDIT for a promissory note technique is not generally recommended in the case of an individual whose life expectancy is shortened by virtue of illness. For such an individual, a variation of the standard sale to IDIT in exchange for a promissory note might be considered. That variation is a sale to an IDIT in exchange for an annuity which terminates at the seller's death. The sale transaction is a variation of a long-established estate planning technique, a sale in exchange for a private annuity.[17]

A. 50% Probability of Survivorship. Treas.Reg.Sec. 25.7520-3(b)(3) establishes a planning friendly rule in determining the life expectancy of an individual who is suffering from an illness which can be anticipated to shorten life expectancy. Under Treas.Reg.Sec. 25.7520-3(b)(3), the mortality component prescribed under IRC Sec. 7520 may not be used to determine the present value of an annuity, income interest, remainder interest or reversionary

[14] 356 U.S. at p. 280; see also Rev.Rul. 77-193, 1977-1 C.B. 273.

[15] Abbin, *[S]He Loves Me, [S]He Loves Me Not - Responding to Succession Planning Needs Through a Three Dimensional Analysis of Considerations to be Applied in Selecting From the Cafeteria of Techniques*, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1300.1 (1997).

[16] Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note – An End Run Around Chapter 14?*, 32nd Ann.U.Miami Philip E. Heckerling Inst. On Est. Plan. ¶1505.2 (1998).

[17] A private annuity has been described as the most talked about but least frequently used strategy in estate planning. Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 Columbia L. Rev. 2 (March 1977).

interest if an individual who is a measuring life dies or is terminally ill at the time the gift is completed. For purposes of this rule, an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year. Treas.Reg.Sec. 25.7520-3(b)(3) further provides that if the individual survives for 18 months or longer after the date the gift is completed, the individual is presumed to have not been terminally ill at the date the gift was completed unless the contrary is established by clear and convincing evidence. If the IRS mortality tables are not to be used in valuing an interest under IRC Sec. 7520 because an individual is considered to be terminally ill, Treas.Reg.Sec. 25.7520-3(b)(4) provides that the value of the interest is to be determined taking into account the individual's actual life expectancy.[18]

The test established by Treas.Reg.Sec. 25.7520-3(b)(3) affords significant planning opportunities when an individual is afflicted with an illness which shortens life expectancy, but there is less than a 50% probability that the individual's death will occur within one year. If the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3) is met, the IRS mortality tables under IRC Sec. 7520 are binding even if it is conceded that the individual's actual life expectancy is substantially shorter than predicted by those tables. It is conclusively presumed that an individual will survive for his or her life expectancy under the tables even though that may actually be highly unlikely. Even in cases in which an early death is virtually certain, it is frequently possible to satisfy the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3).

The factors in the IRS tables for computing the amount of an annuity which is conditioned upon an individual's life are larger than those which are for a fixed term whether or not the individual is living. The premium compensates for the fact that an individual who is the measuring life may die and shorten the term of the annuity payments. The premium has the effect of shoring up the present value of the annuity. Because of the premium, a sale in exchange for an annuity for life should not be used unless it appears that the seller's life expectancy is shorter than predicted by the IRS actuarial tables. If an individual survives for the period predicted by the IRS actuarial tables, use of an annuity for the individual's life causes the value of the individual's estate to be increased over the value resulting from an ordinary promissory note.

B. The Exhaustion Test. The premium which shores up the value of annuity payments conditioned upon survivorship has a significant impact on the sale for an annuity for life transaction. The premium causes the exhaustion test established under Treas.Reg.Sec. 25.7520-3(b)(2)(i) to be a factor which must be taken into account in structuring a sale to an IDIT in exchange for an annuity for life.

Treas.Reg.Sec. 25.7520-3(b)(2)(i) provides that a standard IRC Sec. 7520 factor may not be used to determine the present value of an annuity for a specified term of years or the life of one or more individuals unless the effect of the trust, will or other governing instrument is to ensure that the annuity will be paid for the entire defined period. This, in essence, is the

[18] *See also* Treas.Reg.Secs. 1.7520-3(b)(3), 20.7520-3(b)(3) and the Examples at Treas.Reg.Secs. 1.7520-3(b)(4), 20.7520-3(b)(4) and 25.7520-3(b)(4).

exhaustion test. The annuity is not considered payable for the entire defined period if, considering the applicable IRC Sec. 7520 interest rate on the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. When an individual's life is used to measure the term of the annuity payments, the determination of whether or not the annuity is expected to exhaust the fund is to be made under the assumption that it is possible for the individual to survive until the age of 110 years. If the provisions for the annuity do not satisfy the exhaustion test, Treas.Reg.Sec. 25.7520-3(b)(2)(i) requires a special factor to be calculated for use in valuing the annuity.

Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) illustrates how the special factor is to be calculated in a postulated factual situation. In Example 5, a donor who is 60 years of age and in normal health transfers property worth $1 million to a trust which is to make an annual payment of $100,000 to a charitable organization for the life of the donor. At the donor's death, the remainder is to be distributed to the donor's child. The IRC Sec. 7520 rate is stated to be 6.8%. Example 5 calculates that if the trust earns the assumed 6.8% IRC Sec. 7520 rate, it will only be able to make 17 annual payments in full and will be exhausted after making a partial 18th payment of $32,714.74. As a result, for purposes of determining the value of the distribution to charity, the Regulation requires the provisions governing the annuity payments to be recharacterized as a distribution to charity of $67,287.26 ($100,000 - $32,714.74) per year for the donor's life or, if shorter, for a period of 17 years, plus a distribution of $32,714.74 per year for the donor's life or, if shorter, for a period of 18 years. The present value of an annuity of $67,287.28 per year payable for 17 years or until the prior death of a person age 60 is calculated to be $597,013.12. The present value of an annuity of $32,712.72 per year payable for 18 years or until the prior death of a person age 60 is calculated to be $296,887.56. Thus, the present value of the annuity payable to charity in Example 5 is $893,900.68 ($597,013.12 + $296,887.56). The conclusion in Example 5 is that of the $1 million originally placed in the trust, only $880,213.38 qualifies for the charitable deduction, resulting in a taxable gift equal to $119,786.62 ($1 million - $880,213.38).

Intuitively, it might be difficult to see how there could be such a large taxable gift upon the creation of the trust described in Example 5. Some commentators have asserted that Treas.Reg.Sec. 25.7520-3(b)(2)(i) is invalid, because of the assumption in the Regulation that the individual whose life is used to establish the term of the annuity will live until the age of 110 years.[19] According to these commentators, this is an unreasonable assumption. Under Table 2000CM, which is the table the IRS currently uses to compute actuarial factors involving survivorship, only 1,477 out of an initial population of 100,000 survive to the age of 100 years.

The calculations prescribed by Example 5 of IRC Sec. 7520-3(b)(2)(v) are based upon assumptions that are standard in the use of IRS tables under IRC Sec. 7520. It is assumed that the assets in the trust produce a net return equal to the applicable IRC Sec. 7520 interest rate, and that the assets of the trust do not appreciate or depreciate in value. Based upon those

[19] Katzenstein, *Turning the Tables: When Do the IRS Actuarial Tables Not Apply?*, 37th Ann.U.Miami Philip E. Heckerling Inst. On Est. Plan. Ch. 3 (2003); Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies?*, 49th Ann.U.Miami Philip E. Heckerling Inst. On Est. Plan ¶606 (2015).

assumptions, a projection is made as to when the trust will run out of funds. Under the exhaustion test, the time for making annuity payments cannot be assumed to extend beyond the time that the computations project the trust to be exhausted.

From this viewpoint, the exhaustion test as promulgated by Treas.Reg.Sec. 25.7520-3(b)(2)(i) and Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) appears quite reasonable. IRC Sec. 7520(a) provides that the value of any annuity shall be determined under tables prescribed by the Secretary. IRC Sec. 7520(b) provides that IRC Sec. 7520 shall apply for purposes of any provisions specified in the Regulations. Because Congress has delegated authority to fill in gaps in IRC Sec. 7520, the Regulations under that statute are legislative regulations which are given controlling weight unless arbitrary, capricious or manifestly contrary to the statute.[20] It seems unlikely that the courts will find Treas.Reg.Sec. 25.7520-3(b)(2)(i) and Example 5 of Treas.Reg.Sec. 25.7520-3(b)(2)(v) to be invalid.[21] It is possible to reduce the shortfall under the exhaustion test by increasing the amount of the annuity payments or by setting the term of the annuity as the shorter of the seller's life or a term of years which approximates the seller's life expectancy under the IRS tables.[22]

C. <u>Another Individual as Measuring Life</u>. There is a disadvantage with a sale to an IDIT for an annuity based upon the seller's life. If the seller dies within a short time of the sale, the IDIT loses grantor trust status for income tax purposes. The ability to shift value to the IDIT and its beneficiaries by the grantor paying income taxes is lost.

A married couple can avoid this result. If one spouse is ill, the healthy spouse might effect the sale to an IDIT established by the healthy spouse in exchange for an annuity which is based upon the life of the spouse who is ill. There is nothing in IRC Sec. 7520 or the Regulations thereunder or in any other authority which indicates that it is impermissible for one spouse to effect a sale to an IDIT in exchange for an annuity which uses the other spouse as the measuring life rather than the life of the spouse effecting the sale. Specifically, the annuity might be payable for a period of years or the earlier death of the spouse who is ill. If the annuity payments cease upon the death of such spouse, the IDIT continues to be a grantor trust for income tax purposes.

Treasury Regulations governing charitable lead trusts identify persons whose lives may be used to define the term of a charitable lead trust. Under these Regulations, permissible lives are limited to the donor, the donor's spouse and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in IRC Sec. 170, 2055 or 2522), is

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[20] *Chevron v. National Resources Defense Council*, 467 U.S. 837 (1984).

[21] For an excellent discussion of this issue and the exhaustion test generally, see McGrath, *Private Annuity Sales and the Exhaustion Test*, 31 T.M.Est., Gifts and Tr. J. 167 (July/Aug. 2006).

[22] Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies?*, 49th Ann.U.Miami Philip E. Heckerling Inst. On Est. Plan ¶606.9 (2015).

either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.[23] Even if these Regulations applied to a sale to an IDIT for an annuity, the seller's spouse is a permitted measuring life. However, these Regulations are limited in their application to charitable lead trusts, and do not apply to a sale to an IDIT for an annuity. No regulation or other authority by its terms limits the identity of the persons whose lives might be used in a sale to an IDIT for an annuity. Indeed, there does not appear to be any regulation or other promulgated IRS authority which would preclude the use of a complete stranger as the measuring life in a sale to an IDIT for an annuity based upon an individual's life.

D. Convert a Note Into an Annuity. A seller may have previously effected a sale to an IDIT in exchange for a promissory note. If the seller's health deteriorates after the original sale while a balance remains due on the promissory note, it should be possible for the seller to exchange the promissory note for an annuity based upon the seller's life. Exchanging a promissory note for an annuity would be similar in concept to renegotiating a promissory note given by an IDIT in a sale transaction when the applicable Federal rate decreases after the sale. A lower interest rate on the promissory note results in less interest being paid to the seller and a reduction in the seller's estate. Most commentators believe that an IDIT's promissory note can be refinanced at the applicable Federal rate in force in the month of refinancing without unfavorable transfer tax consequences, so long as the promissory note authorizes prepayment without penalty.[24]

It would seem that a promissory note could be exchanged for an annuity without unfavorable transfer tax consequences even if the promissory note does not contain a prepayment clause. The exchange would not constitute a gift by the seller so long as the annuity received for the promissory note had a value under IRC Sec. 7520 equal to the balance of interest and principal due on the promissory note as of the date of the exchange. The seller would need to satisfy the 50% survivorship test of Treas.Reg.Sec. 25.7520-3(b)(3) as of the date of the exchange. In computing the annuity payments to be made to the seller, the interest rate used should be IRC Sec. 7520 rate for the month in which the exchange occurs.

Following the rationale of the discussion in Section IV C, *supra*, if a seller who has effected a sale to an IDIT in exchange for the IDIT's promissory note has a spouse whose health deteriorates, it should be possible for the seller to exchange the IDIT's promissory note for an annuity based upon the life of the spouse who is ill.

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[23] See Treas.Reg.Secs. 20.2055-2(e)(2)(vi)(A) and 25.2522(c)-3(c)(2)(vi)(A) for charitable lead annuity trusts, and 20.2055-2(e)(2)(vii)(A) and 25.2522(c)-3(c)(2)(vii)(A) for charitable lead unitrusts.

[24] Blattmachr, Crawford and Madden, *How Low Can you Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J.Tax No. 7, 22 (2008); Harrington, *Question and Answer Session*, 38th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1216 (2004); Zeydel, *Estate Planning in a Low Interest Rate Environment*, 36 Est. Plan. No. 7, 17 (2009).

V. Self-Cancelling Installment Note (SCIN).

The Self-Cancelling Installment Note, or SCIN, is another device which might be used when the seller's life expectancy is shortened by illness. A SCIN generally takes the form of an ordinary installment note which provides for periodic payments at specified intervals, *e.g.*, annually, semi-annually, quarterly or even monthly. Unlike an ordinary installment note which remains due if the seller dies, a SCIN provides that the obligation to make further payments ceases at the seller's death. Any outstanding obligation which is canceled at the seller's death is not included in the seller's gross estate.[25] The balance due on the SCIN at the seller's death escapes Federal estate tax.

Many of the considerations which arise with the use of an annuity for life payable by an IDIT also arise with the use of a SCIN. As discussed in Section X, *infra*, the issuance of CCA 201330033 and the arguments made by the IRS in the case of *Estate of Davidson v. Commissioner* raise the question as to whether the annuity for life should be preferred over the SCIN.

VI. Income Tax Consequences If Seller Holds IDIT's Promissory Note at Death.

There is one issue regarding the standard sale to IDIT technique which has generated more discussion than any other. That issue is whether the seller's death, while holding a promissory note received on the sale of appreciated property to an IDIT, causes gain to be realized on the note.[26]

The possibility exists that the IDIT's loss of grantor trust status as a result of the seller's death causes a sale to be deemed to occur under the rationale of *Madorin v. Commissioner*.[27] In

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[25] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980) *acq. result* 1981-1 C.B.2; *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003).

[26] *See* Nicholson, *Sale to a Grantor Controlled Trust: Better Than a GRAT?* 37 BNA Tax Mgmt. Memo. 99 (1996); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation* - 1996, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶120. 2E (1997); Practical Drafting, pp. 4833-4835 (1997); Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts and Tr. J. No. 1, 3 (1999); Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J.Tax No. 1, 49 (2001); Aucutt, *Installment Sales to Grantor Trusts*, 4 Bus. Entities, No. 2, 28 (2002); Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J.Tax. No. 3, 149 (2002); Hodge, *On the Death of Dr. Jekyll - Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at Grantor's Death*, 29 Tax Mgmt. Est., Gifts and Trust J., No. 6, 275 (2004); Peebles, *Death of an IDIT Noteholder*, 144 Tr. & Est. No. 8, 28 (2005); Cantrell, *Gain is Realized at Death*, 149 Tr. & Est. No. 2, 20 (2010); Gans and Blattmachr, *No Gain at Death*, 149 Tr. & Est. No. 2, 34(2010).

[27] 84 T.C. 667 (1985). *See also* Treas.Reg.Sec. 1.1001(c), Example (5) and Rev.Rul. 77-402, 1977-2 C.B. 222.

Madorin and the other authorities cited in n. 27, *supra*, an individual transfers a tax shelter to a wholly-grantor trust. When the tax shelter is about to produce phantom income, the grantor renounces the powers which cause grantor trust status in an effort to have the phantom income taxed to the trust rather than the grantor. The cited authorities hold that the loss of grantor trust status upon the grantor's renunciation is to be treated as a transfer of the shelter to a newly-formed non-grantor trust, which is a disposition causing the grantor to recognize income.

The commentators cited in n. 26, *supra*, disagree on whether the *Madorin* rationale applies when the IDIT's loss of grantor trust status is the result of the seller's death. The commentators also disagree on the effect, if any, of the seller's death on the income tax basis of the promissory note. Finally, there is disagreement regarding the effect of the seller's death on the basis of the assets sold to the IDIT.

A. Gain Recognized at Death? The commentators who conclude that the seller's death causes gain to be realized come to that conclusion because the transfer of assets to the IDIT and the coming into existence of the promissory note occur simultaneously at the seller's death. Because these events occur simultaneously, these commentators believe they should be treated as a sale of the IDIT's assets under the *Madorin* rationale. Some express the view that the sale can be regarded as occurring immediately before the seller's death.[28]

The recognition issue does not arise with either a sale for an annuity for the seller's life or a SCIN. This is because the obligation to make further payments ceases at the seller's death. There is no obligation of the IDIT which comes into existence at the seller's death which could be treated as issued by the IDIT in exchange for assets of the IDIT.

Assume that an individual has sold appreciated assets to an IDIT in exchange for the IDIT's promissory note. Assume that no payments have been made against principal and that, additionally, there is accrued interest on the note as of the seller's death. Although any payments received on the promissory note by the seller during seller's lifetime have no income tax consequence, the commentators who conclude the *Madorin* rationale applies believe that gain is realized to the extent that amounts remaining due on the note (principal plus accrued income) exceed the seller's basis in the note immediately prior to death. Any gain constitutes income in respect of a decedent (IRD) and, as such, the promissory note does not acquire a new income tax basis under IRC Sec. 1014 by virtue of the seller's death.[29] If the deemed sale at the seller's death qualifies for installment treatment, gain is recognized as payments are received by the seller's successor in interest. If the deemed sale does not qualify for installment treatment,[30] the

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[28] *See, e.g.*, Covey, *Recent Developments Concerning Estate, Gift and Income Taxation* - 1996, 31st Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶120. 2E (1997).

[29] IRC Sec. 691(a)(4).

[30] For example, IRC Sec. 453(k)(2) provides that installment treatment is not available for the sale of marketable securities.

gain is reported on the seller's final income tax return,[31] and the income tax payable on that gain is a debt deductible for Federal estate tax purposes under IRC Sec. 2053.

Suppose that the original amount of the promissory note exceeded the seller's basis in the property, but that the seller receives payments on the note so that the balance due upon the seller's death is less than the seller's basis in the property. If the *Madorin* rationale applies at the seller's death, no gain would be recognized. Any loss would be disallowed under IRC Sec. 267 because the IDIT and the grantor are related parties. The basis of the property held by the IDIT would be reduced to the balance due on the note.

The position that the *Madorin* rationale should not apply to cause gain on the promissory note to be realized at the seller's death rests on the principle that transfers at death generally do not cause realization of income.[32] This is true even if an identical transfer during lifetime would cause income to be realized. The exception created by IRC Sec. 453B(c) for the transfer of an installment obligation at death is an example of the principle that transfers at death generally do not cause a realization of income, and is an exception to the general rule established by IRC Sec. 453B(a) that the disposition of an installment note causes recognition of gain on the note.[33]

The commentators who conclude there is no realization at death believe that the Supreme Court's decision in *Crane v. Commissioner*[34] is direct authority for their position. In *Crane*, a surviving spouse inherited an apartment building at her husband's death. The apartment building was encumbered by nonrecourse indebtedness which was exactly equal to the Federal estate tax value of the building. Rather than treating the transfer of the building as a sale for an amount equal to the liability (which would have caused the spouse's income tax basis in the building to be determined under the predecessor of IRC Sec. 1012), the Supreme Court indicated that the surviving spouse's basis in the building was to be determined under the predecessor of IRC Sec. 1014, unreduced by the indebtedness.

If the spouse in *Crane* had transferred the property subject to the indebtedness during her lifetime, gain would have been recognized to the extent that the indebtedness exceeded her basis.[35] This is true even though the indebtedness was nonrecourse.[36]

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[31] Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J.Tax No. 1, 49 (2001).

[32] This general proposition was recognized in CCA200923024.

[33] For other examples of situations in which there are no income tax consequences to a transfer at death, see Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J.Tax. No. 3, 149 (2002). For a list of situations in which death produces income tax consequences, see Peebles, *Death of an IDIT Noteholder*, 144 Tr. & Est. No. 8, 28 (2005).

[34] 331 U.S. 1 (1947).

[35] Treas.Reg.Sec. 1.1001(e).

The commentators who conclude that death causes gain to be recognized find no justification for concluding that the authorities referred to in note 33, *supra*, apply only to the termination of grantor trust status during the grantor's lifetime.[37] These commentators also believe that *Crane* is not authority for the proposition that there is no recognition of gain on the seller's death. For example, one commentator states that the issue in *Crane* was the amount of income which the surviving spouse should recognize when she sold the building while it remained subject to the nonrecourse mortgage. Noting that the mortgage was equal to the fair market value of the building, this commentator observes that the surviving spouse's basis in *Crane* would have been the same whether she was viewed as having received the building by inheritance or by purchase for the amount of the nonrecourse indebtedness. The commentator further states that the court in *Crane* did not discuss whether the building was acquired by inheritance or by sale.[38]

These comments appear to give insufficient weight to the Supreme Court's reference in *Crane* to the predecessor to IRC Sec. 1014 rather than the predecessor of IRC Sec. 1012 in discussing the surviving spouse's basis in the building. The Court's reference to the predecessor to IRC Sec. 1014 rather than the predecessor IRC Sec. 1012 may not be a "discussion," but it should not simply be ignored. The Court clearly did not view the distribution of the building to the spouse in *Crane* as a sale.

B. <u>Effect of Seller's Death on Basis of IDIT's Promissory Note</u>. One's view on the effect of the seller's death on the income tax basis of the IDIT's promissory note depends upon one's opinion on whether or not the seller's death is a taxable event. If one believes the seller's death is a taxable event, the basis of the promissory note would not be stepped up to its fair market value on date of death or alternate valuation date because it constitutes IRD. Gain would be recognized to the extent that the balance due on the note exceeded seller's basis immediately before death, increased by any adjustment allowable under IRC Sec. 691(c).

If gain is not realized on the seller's death, then the promissory note is not IRD. Because the IDIT is a grantor trust, no payments on the promissory note during the seller's lifetime can constitute taxable income to the seller. The absence of IRD results in the promissory note acquiring a new income tax basis under IRC Sec. 1014 equal to the value at which it is included in the seller's gross estate. Note that reporting the note on the seller's estate tax return at a discounted value risks converting what would have been tax free amounts due under the note into ordinary income under the market discount rules of IRC Secs. 1276-1278.

C. <u>Effect of Seller's Death on Basis of Assets Purchased by IDIT</u>. If one believes that seller's death causes gain to be realized under the *Madorin* rationale, it is because a purchase and sale is deemed to occur at seller's death. Because the IDIT's assets are viewed as having

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[36] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[37] *See, e.g.*, Cantrell, *Gain is Realized at Death*, 149 Tr. & Est. No. 2, 20 (2010).

[38] *Id*.

been acquired by purchase, those assets acquire a new income tax basis at the seller's death under IRC Sec. 1012 equal to what is treated as the purchase price.

One would expect that a person who is of the view that death is not a realization event would also conclude that the seller's death does not cause any change to the IDIT's basis in the assets which it purchased from seller. If the seller's death is not believed to be a realization event, it is consistent to conclude that the seller's death does not bring about any change in the basis of the IDIT's assets. Several commentators who do not believe that the seller's death is a realization event have also expressed the view that the seller's death causes no change in the IDIT's basis.[39] There is a consistency in this view which is conceptually appealing. There are, however, other commentators who, while believing that the seller's death does not cause realization of gain, nevertheless believe that the seller's death causes a change in the income tax basis of the IDIT's assets.

D. Change in Basis Under IRC Sec. 1012. The authors of one article (herein "Messrs. Manning and Hesch") express the view that the seller is to be regarded as transferring assets to the IDIT at death when the IDIT's grantor trust status for income tax purposes terminates. That transfer is in exchange for the promissory note, and, in their view, constitutes a sale requiring basis to be adjusted under IRC Sec. 1012 even though under *Crane* there is no realization of gain.[40]

Messrs. Manning and Hesch recognize that their opinion that the basis of the IDIT's assets should be adjusted under IRC Sec. 1012 seems inconsistent with their view that no gain is realized at the seller's death. Even though under *Crane* there is no realization of gain, they still view the seller's death as causing a simultaneous deemed transfer of assets to the IDIT and the deemed issuance of the promissory note. These two events, which are treated as occurring simultaneously, together with the fact that the IDIT actually gave the promissory note to the seller during the seller's lifetime in exchange for the assets purchased, should in their view cause the note to be treated as given for such assets at seller's death. Such treatment makes IRC Sec. 1012 applicable to determine the IDIT's basis in the assets.

The effort by Messrs. Manning and Hesch to address the inconsistency of their position is thought-provoking. In this author's view, however, the inconsistency should not be accepted as correct unless it is inescapable, i.e., unless there exists no other reasonable analysis or explanation that avoids the inconsistency.

[39] Aucutt, *Installment Sales to Grantor Trusts*, 4 Bus. Entities, No. 2, 28 (2002); Peebles, *Death of an IDIT Noteholder*, 144 Tr. & Est. No. 8, 28 (2005).

[40] Manning and Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts and Tr. J. No. 1, 3 (1999). See also Hodge, *On the Death of Dr. Jekyll - Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at Grantor's Death*, 29 T.M. Est., Gifts and Tr. J., No. 6, 275 (2004).

This author does not believe that the inconsistency is inescapable. In this author's view, *Crane* should be regarded as establishing that there is no sale by the seller or purchase by the IDIT. If there is no realization of gain, that is because there is no purchase. This view also seems more consistent with the rationale of Rev.Rul. 85-13. Under that rationale, a wholly grantor trust does not exist apart from its grantor for income tax purposes. Under Rev.Rul. 85-13, the income tax consequences of a sale between an IDIT and its grantor during the grantor's lifetime are not suspended or delayed. The sale is treated as not occurring. Not applying IRC Sec. 1012 at the seller's death is more consistent with this treatment.

Without *Crane*, perhaps it would be appropriate to treat the simultaneous transfer of assets to the IDIT and the IDIT's issuance of the promissory note at the seller's death as a purchase and sale. However, just because two events occur simultaneously does not mean that they are actually one event. With the treatment of the transaction in *Crane* as a background, a better conceptual result is produced if IRC Sec. 1012 is not viewed as applicable, just as the predecessor to IRC Sec. 1012 was not considered applicable by the Supreme Court in *Crane*.

E. Change in Basis Under IRC Sec. 1014(b)(1). The authors of another article (herein "Messrs. Blattmachr, Gans and Jacobson") believe that the IDIT's assets acquire a new income tax basis under IRC Sec. 1014 upon the seller's death even though the assets of the IDIT are not included in the seller's gross estate for Federal estate tax purposes.[41] Messrs. Blattmachr, Gans and Jacobson express the view that a step up in basis under IRC Sec. 1014(b)(1) does not, by the express terms of the statute, require estate tax inclusion as a prerequisite for a basis step up. The statutory language only requires that an asset be acquired from a decedent by "bequest, devise, or inheritance." Because an IDIT is not recognized to exist for income tax purposes during the grantor's lifetime under the rationale of Rev.Rul. 85-13, assets titled in the name of an IDIT at the time of the grantor's death should be viewed for income tax purposes as passing to the IDIT by "bequest, devise, or inheritance" at the grantor's death when the IDIT loses its grantor trust status and becomes a separate taxpayer.

Messrs. Blattmachr, Gans and Jacobson recognize that their view on the applicability of IRC Sec. 1014(b)(1) to increase the basis of assets held by an IDIT at the death of its grantor is unconventional. The conventional view is for the basis of an asset to be changed under IRC Sec. 1014, it must be included in an individual's gross estate. Messrs. Blattmachr, Gans and Jacobson concede that Treas.Reg.Sec. 1.1014-2(a)(1) and the 1954 legislative history appear to contemplate that IRC Sec. 1014(b)(1) applies only to property passing under a decedent's Will or under the laws of intestacy, i.e., through a probate estate, where the property is included in the Federal gross estate. They note that IRC Secs. 1014(b)(2) and (3) make IRC Sec. 1014 applicable to certain lifetime trusts which constitute grantor trusts for income tax purposes. While conceding that their construction of IRC Sec. 1014(b)(1) makes IRC Secs. 1014(b)(2) and (3) unnecessary, they reject the proposition that IRC Sec. 1014(b)(1) applies only to assets passing through a probate estate. They point out that IRC Secs. 1014(b)(1), (2) and (3) were enacted before Rev.Rul. 85-13 was issued. At the time of enactment of IRC Secs. 1014(b)(1), (2) and (3), it was not at all clear that transactions between a grantor trust and its grantor should

[41] Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J.Tax. No. 3, 149 (2002).

be disregarded for income tax purposes. As a result, according to Messrs. Blattmachr, Gans and Jacobson, Congress would not have known that the rules created by IRC Secs. 1014(b)(2) and (3) were already covered by IRC Sec. 1014(b)(1).

A problem with the construction given IRC Sec. 1014(b)(1) by Messrs. Blattmachr, Gans and Jacobson is that Treas.Reg.Sec. 1.1014-2(a)(1), in describing property which passes by "bequest, devise, or inheritance," mentions only two ways such passing occurs. One is by the decedent's Will, and the other is by the laws of intestacy. Both of these methods occur only with a probate administration. Treas.Reg.Sec. 1.1014-2(a)(1) was itself issued prior to Rev.Rul. 85-13. At the time Treas.Reg.Sec. 1.1014-2(a)(1) was issued, it was not clear that assets held in a grantor trust should be viewed, for income tax purposes, as passing to the trust upon the grantor's death. If the consequences of grantor trust status were not clarified until the issuance of Rev.Rul. 85-13, it seems improper to use the conclusions of Rev.Rul. 85-13 in construing the language of Treas.Reg.Sec. 1.1014-2(a)(1). IRC Sec. 1014(b)(1) and Treas.Reg.Sec. 1.1014-2(a)(1) should be construed as requiring an actual probate administration and not as referring to a deemed transfer at the grantor's death which exists only as a result of Rev.Rul. 85-13. It is this author's view that IRC Sec. 1014(b)(1) does not apply to adjust the basis of assets held by an IDIT at the death of its grantor.[42] Note that in Rev.Proc. 2015-37[43] the IRS has indicated that it will not issue private letter rulings on whether assets in an IDIT receive an IRC Sec. 1014 basis adjustment at the death of the IDIT's grantor when those assets are not included in the grantor's Federal gross estate.

F. Conclusions on Income Tax Consequences of Seller's Death. Summarizing, in this author's opinion, the death of a seller holding an IDIT's promissory note is essentially an income tax nonevent. Specifically, this author believes that, under *Crane*, there is no realization of gain on the seller's death. This author also believes that the IDIT's promissory note held by the seller at death acquires a new income tax basis equal to its Federal estate tax value in the seller's gross estate. Finally, this author believes that the income tax basis of the assets held by the IDIT at the seller's death does not change.

This author recognizes that these opinions are not shared by many respected commentators. He believes, however, that they represent the best analysis of what occurs at the seller's death, applying the principles of *Crane*, Rev.Rul. 85-13 and the other authorities discussed in this Section VI.

VII. Authorities Supporting Effectiveness of Sale to IDIT Strategy.

If a sale to an IDIT is to be effective, it must be recognized as a true sale resulting in the removal of the assets sold from the original owner's estate and the substitution of the IDIT's obligation to pay (whether in the form of a promissory note, annuity based upon life or SCIN) for those assets. The most flexibility would be produced by creating a new IDIT holding no assets other than those sold to it. Those assets might be sold to the IDIT for its promissory note, which

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[42] See CCA 200937028 which reaches this same conclusion.

[43] 2015-26 IRB.

would bear interest at the applicable Federal rate and have a gift tax value equal to its face. Assuming the value of property transferred does not exceed the value of the note, the sale would be the gift tax equivalent of a zeroed-out GRAT.

With a zeroed-out GRAT, the value of property transferred to the GRAT does not exceed the value of the retained annuity.[44] Since there is no gift, there is no possibility of wasting applicable credit amount if the value of property placed in the GRAT decreases rather than increases. In the same way, a sale to an IDIT with no assets in the IDIT other than those being sold would not cause any wastage of applicable exclusion amount in the event the assets sold decrease in value after the sale. If the assets decrease in value after the sale, those assets could simply be returned to the seller in partial payment on the promissory note. The situation would be the same as if the sale had never been effected, and no applicable exclusion amount would be wasted.

A. <u>"Reality of Sale" Cases</u>. A number of what Jerry Hesch has described in several articles as "reality of sale" income tax cases indicate that the courts would recognize the sale described in the immediately preceding paragraph. In those "reality of sale" cases, the courts have rejected IRS arguments that various transactions should not be recognized. In the "reality of sale" cases, the courts have held that the key elements in determining whether there has, in fact, been a sale is the reasonableness of the purchase price and a reasonable expectation that the purchaser will be able to perform. Two leading "reality of sale" cases are *Frank Lyon Co. v. U.S.*[45] and *Commissioner v. Brown*[46].

The taxpayer in *Frank Lyon Co.* entered into agreements by which it purchased a building for $500,000 in cash and a mortgage of $7,140,000 borrowed from a third party, and then leased the building to a bank. Under the lease, the bank was obligated to pay rent equal to the principal and interest payments on the mortgage, and had the option to purchase the building on various dates for an amount equal to the unpaid balance of the mortgage, plus the taxpayer's $500,000 investment with interest at 6% compounded on that investment. The United States Supreme Court rejected the IRS's argument that the taxpayer was not entitled to certain deductions as the owner of the building, and that it was a mere conduit for a loan by the lender to the bank. The Supreme Court noted that the taxpayer would sustain economic consequences if the bank did not perform under the lease or did not exercise its purchase option.

The issue in *Brown* was whether the transfer of stock to a charity constituted a sale entitling the transferor long-term capital gain treatment. Under the sales agreement, the bulk of the purchase price was a promissory note to be paid over ten years solely out of the earnings of the business. The charity had no obligation under its promissory note if the income from the business was insufficient to pay the note. The IRS argued that because the purchasing charity

[44] Melcher, Zuengler and Rosenbloom, *Creating the Optimal Structure for Discounted Zeroed-Out GRATs*, 17 The Practical Tax Lawyer 25 (Spring 2003).

[45] 435 U.S. 561 (1978).

[46] 380 U.S. 563 (1965).

bore no risk of loss, the transaction did not constitute a sale. According to the IRS, the proceeds received by the seller were to be taxed as ordinary income. The Supreme Court held that since the price for the business was reasonable, the transaction constituted a sale entitled to long-term capital gain treatment even though all of the risk of loss remained with the seller.

An important element in both *Frank Lyon Co.* and *Brown* was that the amount of the seller provided financing did not exceed a reasonable estimate of the fair market value of the assets purchased. In addition, the terms of sale were such that there was a reasonable expectation that the indebtedness could be paid in full.[47]

Although the so-called "reality of sale" authorities indicate that the structure of sale described in the first paragraph of this Section VII should be recognized as a sale, that does not answer the question for estate and gift tax purposes. In addition to satisfying the "reality of sale" tests, to avoid IRC Secs. 2036(a)(1) and 2702(a), a sale must also satisfy the requirements established by *Fidelity-Philadelphia Trust Co.*

B. Cases Involving Sales to Trusts. There are a number of cases in which the tax effectiveness of sales to trusts has been analyzed. These cases involve sales to trusts in exchange for annuities. Several of the cases involve the question of whether the sales should be recognized as such or, alternatively, treated as a transfer with a retained interest resulting in estate tax inclusion under IRC Sec. 2036(a)(1). Other decisions involved the issue of whether a sale is to be recognized as such for income tax purposes or whether the income of the trust should be taxed directly to the grantor under IRC Sec. 677(a). The cases indicate that the analysis under both statutes is the same.[48]

Cases have held that a sale to a trust in exchange for an annuity is to be ignored and treated as a retained income interest when the annuity payments specified in the sale approximately equal the income generated by assets conveyed to the trust, when the only source of cash for the annuity payments was the transferred property and when the formalities of sale or trust administration were not observed.[49] Other cases have recognized the sale. In these cases, the annuity payments were found not to be tied to trust income and, additionally, formalities were observed. In these cases, the courts concluded that in structure and substance, the transactions constituted sales for an annuity rather than a retention of income.[50]

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[47] See also *Lebowitz v. Commissioner*, 917 F.2d 1314 (2d Cir 1990); *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq in result only*, Rev.Rul. 69-77, 1969-1 C.B. 59; Rev.Proc. 2001-28, 2001-1 C.B. 1156.

[48] *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1965); *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984).

[49] *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1965); *Lazarus v. Commissioner*, 513 F.2d 824 (9th Cir 1975); *Bixby v. Commissioner*, 58 T.C. 751 (1972); .

[50] *La Fargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982); *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984); *Estate of Becklenberg v. Commissioner*, 273 F.2d 292 (7th Cir. 1959); *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984).

C. <u>Other Authorities</u>. *Estate of Kite v. Commissioner*[51] also involves a sale of assets in exchange for an annuity. The sale transaction did not involve a trust, but is useful in illustrating how a sale will be recognized as effective for estate tax purposes even if aggressive so long as "reality of sale" principles and the tests of *Fidelity-Philadelphia Trust Co.* are satisfied.

In *Kite*, the decedent, through her revocable trust, sold her entire interest in a general partnership to her three children in exchange for three separate private annuities. Under the terms of sale, the payment of the annuity obligations was not to commence for a period of ten years. The decedent died approximately three years after entering into the transaction without having received a single payment.

Prior to entering into the annuity transaction, the decedent's children met with the family's attorney who described the proposed transaction to them. They were advised that if their mother died within the ten year period, their obligation to make any annuity payments would terminate. If their mother survived the ten year deferral period, then they would be liable for the annuity payments. The children were advised that, based upon their own net worth without considering the assets which they purchased from their mother, they could be insolvent after the first three years of annuity payments.

The Internal Revenue Service argued that it was improper to use the IRS actuarial tables in valuing the ten year deferred annuities, because the decedent's deteriorating health at the time the transaction was entered into made her death within ten years foreseeable. At trial, there was testimony that the decedent's health was failing, but no evidence was produced that the decedent was terminally ill. At the time of the transactions, the decedent received a letter from her treating physician that she had at least a fifty percent probability of surviving eighteen months or longer. The Internal Revenue Service did not challenge this opinion at trial.

The court rejected the Internal Revenue Service's argument that the decedent's death was foreseeable from her actual health and the medical costs she was incurring at the time she entered into the annuity transactions. The court held that increased medical costs do not prove a terminable interest under IRC Sec. 7520. The court also rejected the Internal Revenue Service's argument that the annuity transaction was illusory. The court found that the decedent and her children had intended to be bound by their obligations under the annuity agreements. The court noted that the decedent had access to other assets to maintain her lifestyle after the sales, and also pointed out that the decedent could have made a substantial profit on the transaction had she survived to receive annuity payments.

Ltr.Ruls. 9436006 and 9535026 are two private letter rulings dealing with sales to IDITs. Both ruled favorably on a variety of issues.

In Ltr.Rul. 9436006, the taxpayer intended to sell publicly traded stock and closely held partnership interests to an IDIT in exchange for the IDIT's promissory note, with the purchase price bearing interest at the long-term applicable Federal rate under IRC Sec. 1274 at the time of

[51] 105 T.C.M. 1277 (2013).

sale. The note was to have a term of 25 years, providing for quarterly payments of interest, with principal due at the end of the 25 year term. The Ruling held that the promissory note would constitute debt, and not an interest subject to the provisions of IRC Sec. 2702.

The taxpayers in Ltr.Rul. 9535026 proposed to sell stock in a closely held corporation to separate trusts held for their benefit in exchange for promissory notes which would provide for payment of interest for a period of 20 years, with all principal under the note becoming due and payable on the expiration of the 20 year period. Interest on the note was sufficient so that the notes would not be considered below market loans under IRC Sec. 7872.

Citing *Frazee*, Ltr.Rul. 9535026 held that because the notes would bear interest at the rate prescribed by IRC Sec. 7872, they would have a gift tax value equal to their face value. The Ruling also held that if the fair market value of stock sold to a separate trust was equal to the face amount of the note received in exchange for such stock, the sale would not constitute a transfer subject to gift tax. This determination was conditioned upon two assumptions: (i) that no facts are presented which would indicate that the notes would not be paid according to their terms; and (ii) that the separate trusts' ability to pay the notes is not otherwise in doubt. The IRS's conclusions on the gift issue were essentially based upon a "reality of sale" analysis. Ltr.Rul. 9535026 also held that IRC Sec. 2702 would not apply to the sale.

Ltr.Rul 9251004 is an earlier ruling in which the Internal Revenue Service held that a sale of closely held stock to an Irrevocable Trust in exchange for the trust's promissory note constituted a transfer with a retained right to income from the transferred property causing the stock to be included in the decedent's estate under IRC Sec. 2036(a)(1). Ltr.Rul. 9251004 makes no reference to the United States Supreme Court's decision in *Fidelity-Philadelphia Trust Co. v. Smith*.

VIII. The *Trombetta* Case.

As suggested in Section I, *supra*, four recent cases have impacted the sale to an IDIT technique. *Trombetta* is the only one of those four cases in which the Tax Court has, as of July 2015, issued an opinion. That opinion was unfavorable to the petitioner.

A. Facts and Results. In *Trombetta*, the decedent transferred two highly leveraged rental properties to a trust which she had established, the terms of which provided her with an annuity. The annuity was to continue for one hundred eighty months, which the decedent retained the power to reduce. Decedent remained personally liable on the indebtedness after the rental properties were transferred into the trust.

Under the terms of the annuity trust, decedent was to receive $75,000 for the first twelve month period of the annuity term, with a four percent increase at the beginning of each successive twelve month period. If the income of the annuity trust exceeded the amounts due the decedent as annuity payments, the trustees could distribute the excess income to the decedent or accumulate it in the annuity trust. The trust instrument provided that the decedent intended her retained annuity in the trust to be a qualified interest under IRC Sec. 2702(b)(1).

The decedent and three of her children were named as trustees of the annuity trust. The decedent retained fifty percent of the trustees' voting rights, and the co-trustees split the remaining voting rights. The decedent's three children who were acting as co-trustees each personally guaranteed payment of the annuity amounts due the decedent.

The annuity trust was prohibited from making any distributions to the decedent after the term of the annuity payments had expired. The annuity trust itself would terminate upon the later to occur of the decedent's death or the expiration of the annuity term. Upon termination, the annuity trust was to be distributed to the decedent's children or grandchildren.

The decedent reported her transfer of the rental properties on a gift tax return, reducing the value of the gift by the value of her retained annuity interest. In subsequent years, the trust made payments of varying amounts to the decedent. During the term of the annuity payments, decedent reduced that term from one hundred eighty to one hundred fifty-six months. Decedent died several months after the expiration of the shortened annuity term. At the decedent's death, there was a balance due her resulting from the underpayment of annuity amounts. After the decedent's death, the unpaid balance due the decedent was paid to the decedent's estate, together with interest. The decedent's children who were co-trustees never made any payments to the decedent under their guarantees.

The Tax Court held that because of the decedent's retained interests in the rental properties, they were included in her gross estate under IRC Sec. 2036(a)(1). The court held that IRC Sec. 2036(a)(1) applied by virtue of IRC Sec. 2035(a) because the decedent's shortening of the annuity term constituted a transfer occurring within three years of her death.

The court rejected the estate's argument that the decedent received adequate and full consideration for her transfer under the parenthetical exception in IRC Sec. 2036 for bona fide sales. The court noted that the value of the annuity payments which the decedent reserved was less than the value of the rental properties which she transferred to the trust.

The court also observed that no bona fide sale, in terms of an arm's length transaction, had occurred. There was no meaningful negotiation or bargaining with the decedent's co-trustees or beneficiaries of the trust. According to the court, the decedent, as sole beneficiary of the trust and the sole transferor, formed the transaction, funded the annuity trust and essentially stood on both sides of the transaction. The court found that there were no legitimate and significant non-tax reasons for establishing the trust. It noted that the decedent transferred the properties into the annuity trust on the advice of her estate planning counselors, and that her actions with respect to the trust were consistent with an estate plan rather than a legitimate business.

The estate argued that the decedent wished to reduce her responsibilities in the management of the rental properties. The court noted, however, that the trust agreement did not preclude the decedent from participating as a trustee in managing the properties and that the decedent had, in fact, continued in managing the properties after the trust was established. The court concluded that the decedent retained de facto control over the transferred properties and that, consequently, the decedent retained an IRC Sec. 2036(a)(1) interest in the properties.

The court also noted that the trust instrument provided that income in excess of the annuity payments could be distributed to the decedent at the discretion of the trustees, that the decedent held fifty percent of the trustees' vote. In addition, because the properties were conveyed to the annuity trust subject to the mortgages upon which the decedent remained liable, the court found that the decedent received an economic benefit when the trust made payments on the mortgages. According to the court, the decedent impliedly maintained the same enjoyment of the rental properties and their income stream as she had before she had transferred them into the trust.

The court rejected the estate's argument that under the Supreme Court's decision in *Fidelity-Philadelphia*, the decedent retained an interest in the annuity and not in the rental properties. While noting that the decedent formally structured the transaction as an annuity obligation and did not calculate the amount of the annuity payments on the basis of the trust's income, her conduct showed that her transfer was more akin to a transfer with a retained interest than a sale for an annuity. Payments were made to her solely out of trust income. The court noted that the co-trustees were never called upon to pay under their guarantees when income was insufficient to fund the annuity payments in full. The court held that the tests established by the *Fidelity-Philadelphia* case were not satisfied. According to the court, the amounts distributed to the decedent were based upon the trust's income and were derived solely from the property which the decedent transferred to the trust.

B. Commentators' Response to *Trombetta*. The court's technical analysis in *Trombetta* can be criticized.[52] For example, it used implied powers which it found were retained by the decedent as a basis for its conclusions. Implied retained interests are a sufficient basis for inclusion under IRC Sec. 2036(a)(1), but only ascertainable and enforceable powers cause inclusion under IRC Sec. 2036(a)(2).[53]

The principal source of difficulty for the estate in *Trombetta* was the provision in the trust instrument authorizing the trustees to distribute excess income to the decedent. An implied understanding between the decedent and her children acting as trustees was sufficient to cause inclusion under IRC Sec. 2036(a)(1). At a minimum, the court's litany of other justifications in its decision is unnecessary.

There has been a good deal of commentary on the *Trombetta* decision.[54] Commentators have recommended a number of steps which should be considered in structuring sale to IDIT

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[52] Gans & Blattmachr, *Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. Tax 226 (May 2014).

[53] *U.S. v. Byrum*, 408 U.S. 125 (1972). IRC Sec. 2036(a)(2) includes transfers with respect to which the transferor has retained the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the transferred property or the income therefrom. Although *Byrum* was legislatively overruled by the enactment of IRC Sec. 2036(b), the decision remains "good law" to the extent not expressly modified by that statute. Rev.Rul. 81-15, 1981-1 C.B. 457; *Daniels v. Commissioner*, 68 T.C.M. 1310 (1994).

[54] See Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies*, 49 U.Miami Philip E. Heckerling Inst. on Est. Plan., ¶605.3 (2015); Gans & Blattmachr, *Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. Tax

transactions. In addition to taking steps designed to satisfy "reality of sale" and *Fidelity-Philadelphia Trust Co*. tests, the suggestions include the following:

1. The IDIT should have an independent trustee, not the seller or the seller's spouse. The seller should also not possess any direct or indirect decision making authority with respect to the IDIT.

2. To the extent possible, have the purchasing IDIT funded with assets the transfer of which is "old and cold." If there is no "old and cold" trust, gifts of "seed capital" should be effected earlier in time than the sale, perhaps in a different tax year, to avoid aggregation with the sale.

3. If an interest in a closely held business is being sold to the IDIT, the seller should dispose of any voting interest in the business, and should resign as an officer, director or manager of the business.

4. There should be arm's-length negotiations to arrive at the purchase price and other terms of sale, with the trustee of the IDIT and its beneficiaries being represented by separate counsel.

C. Comments on Recommendations. Many of the recommendations are a response to the observations made in the *Trombetta* opinion. One objective of the commentators' recommendations is to eliminate, except for the IDIT's promissory note, any interaction between the seller and the assets which the seller has conveyed to the IDIT. The concern is that any interaction might cause the IRS to ignore the sale and assert that the assets conveyed to the IDIT are to be included in the seller's gross estate. Uncertainty exists on the extent to which interaction must cease because, unlike the GRAT, there are no regulations or other rules issued by the IRS governing how a sale to an IDIT transaction is to be structured.

Many clients will find at least some of the recommendations unpalatable. For example, most business owners will balk at the suggestion that they should surrender control of a business when they are selling interests in the business to an IDIT. Many clients will be discouraged by the prospect of having independent counsel represent the IDIT and its beneficiaries, and that the sales price for the assets sold to the IDIT is to be arrived at through arm's-length negotiations. Many sellers also prefer to be trustee of the IDIT. A question arises as to whether the failure to follow some or all of the recommendations will cause a sale to an IDIT transaction to fail.

1. Seller as Trustee. So long as a trust does not contain stock described in IRC Sec. 2036(b)(2) or insurance on the grantor's life which could be included in the grantor's estate under IRC Sec. 2042, a grantor of a trust can serve as trustee of that trust without causing

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226 (May 2014); Johnson, Hesch and Wojnaroski, *Recent Tax Court Cases Offer Guidance for Planners When Structuring Private Annuities and Self-Cancelling Installment Notes (SCINs)*, 39 T.M. Est., Gifts and Tr. J. 210 (2014); Esterces, *Tips for Structuring Private Annuities After Trombetta*, 41 Est. Plan. No. 7, 11 (2014).

the assets of the trust to be included in the grantor's estate.[55] Administrative powers, such as the power to invest and the power to allocate receipts and disbursements between income and principal, do not cause estate tax inclusion under IRC Sec. 2036(a)(2) or Sec. 2038(a)(1), so long as the powers are not overbroad and are subject to judicially enforceable limitations.[56] A power retained by the grantor of a trust to distribute income or principal to trust beneficiaries does not cause inclusion, if the power is limited by a definite external standard. Cases have held IRC Secs. 2036(a)(2) and 2038(a)(1) inapplicable when grantors have retained the right to distribute assets to provide for "illness," "infirmity," "disability," "sickness," "accident" or other "emergency" affecting a trust beneficiary, and also to provide for a beneficiary's "health," "support," "maintenance", "welfare," "happiness" and "comfort."[57] Although the IRS contends otherwise, it appears that the definite external standard which will accomplish exclusion under IRC Secs. 2036(a)(2) and 2038(a)(1) is less restrictive than the ascertainable standard described in IRC Sec. 2041(b)(1)(A). The safest rule to follow, however, is to only utilize the ascertainable standard set forth in IRC Sec. 2041(b)(1)(A) to avoid an argument with the IRS.

Even if a grantor has retained no beneficial interest in the IDIT, the ability given creditors under state law to reach the trust to satisfy the grantor's legal obligation to support a beneficiary of the trust may cause the trust to be included in the grantor's estate. If the grantor as trustee has discretion to satisfy legal support obligations out of the trust, the trust is included in the grantor's estate.[58] If the grantor is to act as a trustee, the governing instrument should expressly preclude the grantor from making use of trust assets to satisfy the grantor's legal support obligations.

In spite of the authorities cited in notes 56 and 57, many practitioners hesitate to name the grantor as a trustee of an irrevocable trust which is designed to be excluded from the grantor's gross estate. For example, in the Bisignano article cited in footnote 55 above, the author, who is a well-known and highly regarded estate planning attorney, asserted that the more he researched the law on the point, the more convinced he became that there was little to fear in utilizing self-

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[55] Bisignano, *When the Only One You Trust is Yourself – Drafting and Planning With Self Trusteed Irrevocable Nongrantor Trusts*, State Bar of Texas – Advanced Drafting: Estate Planning and Probate Course (October, 2006).

[56] *Old Colony Trust Co. v. United States*, 423 F.2d 601 (1st Cir. 1970); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), *acq*. 1973-2 C.B. 3; *Estate of Ford v. Commissioner*, 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971), *non acq*., 1978-2 C.B. 3; *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968); *Estate of Peters v. Commissioner*, 23 T.C.M. 994 (1964); *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of King*, 37 T.C. 973 (1962), *non acq*. 1963-1 C.B. 5; *Miller v. United States*, 325 F.Supp. 1287 (E.D.Pa. 1971).

[57] *Estate of Budd*, 49 T.C. 468 (1968); *Estate of Pardee*, 49 T.C. 140 (1967), acq. 1973 2 C.B. 3; *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of Weir*, 17 T.C. 409 (1951); *Estate of Kasch*, 30 T.C. 102 (1958), acq. 1958 2 C.B. 6; *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); Rev.Rul. 73-143, 1973 1 C.B. 407.

[58] *Estate of McTighe*, 36 T.C.M. 1655 (1977); *Estate of Pardee*, 49 T.C. 140 (1967), *acq*. 1973 2 C.B. 3; Rev.Rul. 59-357, 1959 2 C.B. 212; Rev.Rul. 70-348, 1970 2 C.B. 193.

trusteed trusts, and that "self-trusteed trusts can indeed be successfully drafted so long as the draftsman is careful." In spite of this conclusion, the author goes on to state that "third-party trustees should be the norm and self-trusteed trust the exception." It is not clear why this should be the case. Mr. Bisignano gives no reasons in his article for this statement.

Given the general reluctance to name the grantor as trustee as evidenced by the Bisignano article, it is not surprising that commentators have suggested that the seller should not act as trustee of the IDIT in a sale transaction. The *Trombetta* court's statement that the decedent was on both sides of the transaction in that case increases their reluctance. While *Trombetta* and a number of the other cases cited in note 49, *supra*, refer to the grantor of a trust being on both sides of the transaction, that fact was just one of a number of justifications that the courts used in reaching a result adverse to the taxpayer. A trustee has fiduciary duties which, if observed, should preclude an adverse result in a sale transaction in which the seller is the trustee of the IDIT.

A good illustration of this point is the case of *Goodman v. Commissioner*.[59] The decision in *Goodman* followed the Fifth Circuit's affirmance of the Tax Court's decision in *Rushing v. Commissioner*.[60] In *Rushing*, the seller sold corporate stock to a trust for the benefit of his children after the corporation had adopted a plan of liquidation. The stock was sold in exchange for the trust's installment obligation. The IRS challenged the transaction, asserting that the taxpayer was not entitled to installment treatment and should be taxed immediately on the sale. The Fifth Circuit rejected the IRS argument and held that the taxpayer was entitled to installment treatment, emphasizing that the trust had a corporate trustee independent of the taxpayer.

In *Goodman*, the taxpayers sold apartments to trusts of which they were trustees for installment notes the day before the trusts sold the apartments to an unrelated party. The Tax Court rejected the IRS's arguments that installment sale treatment should be denied. While distinguishing other cases involving taxpayers participating in transactions with themselves as trustees, the court stated that the fact that taxpayers were trustees was not the basis for the holdings in those cases. The court's opinion contains the following:

> Considering our holdings in a number of other cases, we conclude that the fact that a seller of property is the trustee of the trusts to which the property is sold, standing alone, does not cause the same to lack substance or bona fides, or the seller to constructively receive the income from the sale received by the trusts. The crucial factor is whether the trustee was acting solely as trustee and in the best interests of the trusts in making the purchase and sale of the property.
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> In our view, under the facts here present, [the taxpayers] did not have control over the proceeds of the sale or control over making the sale to Cathedral

[59] 74 T.C. 684 (1980)

[60] 441 F.2d 593 (5th Cir. 1971), *aff'g* 52 T.C. 888 (1969).

except in their capacity as trustees, which was a capacity distinct and apart from their capacity as individual sellers of the property.[61]

2. Seed Capital. The suggestions regarding the transfer of seed capital to the IDIT arise from concern that seed capital which is transferred to an IDIT as a part of a sale transaction may not constitute other assets under the test of *Fidelity-Philadelphia Trust Co.* Commentators having this concern point out that the transfer in *Trombetta* was a part gift/part sale occurring simultaneously, and the court held *Fidelity-Philadelphia Trust Co.* inapplicable. Ltr.Rul. 9251004, discussed in Section VII C, *supra*, is also cited for the proposition that assets transferred to an IDIT as the gift portion of a part gift/part sale do not constitute other assets under *Fidelity-Philadelphia Trust Co.*

A problem with this analysis is that the *Trombetta* opinion discusses *Fidelity-Philadelphia Trust Co.* in connection with the children's guarantees, not their mother's gift to the annuity trust. The court basically found the children's guarantees to be illusory, because they were never called upon by their mother. The *Trombetta* opinion does not discuss *Fidelity-Philadelphia Trust Co.* in connection with the decedent's gift to the annuity trust. Similarly, it is difficult to see how Ltr.Rul. 9251004 can be viewed as authority for the proposition that assets gifted to an IDIT in a part gift/part sale transaction cannot serve as other assets under *Fidelity-Philadelphia Trust Co.* when the Ruling itself makes no reference to that case.

Neither *Trombetta* nor Ltr.Rul. 9251004 should be viewed as authority for the proposition that assets gifted to an IDIT as a part of a sale cannot serve as other assets under *Fidelity-Philadelphia Trust Co.* This is especially true if the assets being sold and those being gifted are delineated in the transaction documents.

Commentators who express concern about a gift occurring simultaneously with a sale qualifying as other assets prefer the use of an "old and cold" trust, i.e. a trust with assets which were clearly transferred into the trust independent of the sale. If there is no such trust, the commentators suggest delaying the sale for some time after the gift is made to the trust. If possible, it is suggested that the sale occur in a year different than the gift. As a practical matter, it is difficult to see how the passage of one year cures any problem if it is clear by the relatively small amount gifted to the new trust as compared to the sale that the gift and sale actually are a part of the same plan. If the gift and sale are truly related, it is not apparent why the passage of time has the effect of separating them from one another.

A guarantee by trust beneficiaries of at least 10% of the note is a method of avoiding the other assets issue. It has been suggested that a guarantee by trust beneficiaries might constitute a gift to the IDIT. The law is presently unclear as to when a gift upon a guarantee occurs. There is authority that a gift occurs when (and if) a payment is made on a guarantee, rather than when the

[61] 74 T.C. at pp. 708, 709. Note that the decision in *Rushing* and its progeny led to the enactment of IRC Sec. 452(e) that disallows installment treatment in sales to a related party if the buyer disposes of the purchased property within two years.

guarantee is made.[62] On the other hand, there is authority for the proposition that a gift occurs when the guarantee becomes binding and enforceable rather than when (and if) payment is made.[63]

If the guarantor is treated as making an addition to the IDIT in giving the guarantee and if the IDIT confers beneficial interests upon the guarantor, the portion of the IDIT attributable to such addition could be included in the guarantor's estate under IRC Sec. 2036(a)(1). In addition, the guarantor would be a transferor to the IDIT for purposes of Chapter 13. If a portion of the IDIT is includable in the guarantor's estate under IRC Sec. 2036(a)(1), then while he or she remains a beneficiary, the ETIP rules of IRC Sec. 2642(f) would preclude allocation of the guarantor's GST exemption to protect the IDIT from generation-skipping tax. If the guarantor is the seller's spouse, the seller would not be able to allocate GST exemption to the IDIT because inclusion of a part of the IDIT in the spouse's estate constitutes ETIP for the seller.[64]

Potential problems with respect to possible inclusion in the guarantor's estate and ETIP can be solved by drafting. The trust instrument could provide that in no event is any distribution to be made to an individual out of any asset or portion of the IDIT treated for estate, gift or generation-skipping tax purposes as having been added to the IDIT by the individual. With such a provision, any transfer to the IDIT resulting from the guarantee would be a completed gift, but would not remain in the guarantor's estate and would permit allocation of the guarantor's GST exemption to the transfer (and the seller's GST exemption if the guarantor is the seller's spouse).

If the guarantor is considered to have made a gift to the IDIT by making the guarantee, it is also possible that the guarantor could be treated as a grantor for purposes of the grantor trust income tax rules under IRC Secs. 671, *et seq.* If the guarantor is treated as the grantor of part of the IDIT for income tax purposes, the IDIT would not be a wholly grantor trust and the sale of appreciated property by the grantor to the IDIT would have income tax consequences.

Although the possibility exists that a guarantor can be treated as having made an addition to the IDIT for purposes of the grantor trust rules, this should not be the case. The purpose of the grantor trust rules is to avoid the shifting of income from assets. In the case of the guarantee, there is no transfer of assets from the guarantor into the IDIT on which the guarantor was taxed prior to the transfer. The guarantee has no potential to shift income away from the guarantor. The guarantor should not be treated as the owner of any portion of the IDIT for income tax

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[62] August, *Planning Around Contingent Liabilities*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1802 (1992); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶119.4 [A][2] (1992).

[63] Covey, *Recent Developments Concerning Estate, Gift and Income Taxation-1991*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶119.4 [A][2] (1992).

[64] IRC Sec. 2642(f)(4).

purposes. This should be an instance in which the treatment of a transfer is different for gift tax purposes than for income tax purposes.

Risk of the guarantor being treated as making an addition to the IDIT can be reduced by paying the guarantor a fee for the guarantee. The amount of guarantee fee needed to eliminated a gift is uncertain. Some practitioners use an annual guarantee fee of .5% or 1% of the amount guaranteed, payable annually, so long as the guarantee continues in effect. It should be possible to eliminate the guarantee, and the necessity of paying a fee, without unfavorable gift tax consequences if the value of the assets of the IDIT increases sufficiently to create the equivalent of a 10% cushion for the IDIT's promissory note.

Another strategy to deal with a potential gift by a guarantor is for the guarantor to file a gift tax return. That return would disclose the guarantee and take the position that the guarantee does not constitute a gift for Federal gift tax purposes. If the statute of limitations runs on that return, it should preclude the IRS from asserting otherwise.[65] A timely filed gift tax return can also be used to establish conclusively the value of property for purposes of allocating GST exemption.[66]

3. Surrender All Interests in Business. The suggestion that a seller of an interest in a closely-held business should give up other interests in the business would seem unnecessary under the United States Supreme Court's decision in *U.S. v. Byrum.*[67] In *Byrum*, the decedent transferred stock in closely-held corporations to an irrevocable trust for the benefit of his children, retaining the right to vote the transferred stock. The right to vote the transferred stock, together with other stock owned by the decedent, gave the decedent a majority vote in each corporation. The Supreme Court held that the decedent's retention of the right to vote did not constitute a retention of the enjoyment of the transferred stock within the meaning of IRC Sec. 2036(a)(1). The court also held that the decedent's retention of the right to vote the stock was not an ascertainable and legally enforceable power to control the corporations necessary to bring about inclusion under IRC Sec. 2036(a)(2).[68] The court held that the decedent's ability to continue to control the payment of dividends from the corporations, by virtue of his power to vote, was not sufficient control to cause the transferred stock to be included in the decedent's estate under IRC Sec. 2036(a)(2). It would seem that *Byrum* settled the indirect control concerns expressed by the commentators who suggest that a seller of interests in a business to an IDIT should break off all contact with the business. Under *Byrum*, the powers to run a business are not those which generate inclusion under IRC Sec. 2036(a)(2).

4. Arm's Length Transaction. Commentators' suggestions about arm's length negotiations and separate counsel are intended to structure a sale to an IDIT transaction as an arm's length transaction. Courts review intrafamily transactions with special scrutiny. This

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[65] IRC Secs. 2001(f), 2504(c) and 6501(c)(9).

[66] IRC Sec. 2642(b)(1).

[67] 408 U.S. 125 (1972).

[68] See the discussion on the continuing validity of *Byrum* in note 53, *supra*.

does not mean, however, that a sale to an IDIT will be recognized only if it is an arm's length transaction.

In *Estate of Thompson v. Commissioner*[69], the Third Circuit held that the assets which a decedent had transferred into a limited partnership were includable in the decedent's estate under IRC Sec. 2036(a)(1). In addressing the parenthetical exception to the application of that statute for a "bona fide sale for an adequate and full consideration," the court's opinion contains an extensive discussion of intrafamily and arm's length transactions:

> The Commissioner argues that there was no "bona fide sale" in this case because decedent "stood on both sides of the transaction" as transferor and a limited partnership of the family partnerships. The Commissioner's position is supported by several cases which have concluded that a "bona fide sale" requires an arm's length bargain. *See, e.g., Bank of New York v. United States*, 526 F.2d 1012, 1016 (3d Cir. 1975) ("[T]he value of the claim settled by the estate may not be deducted if the agreement on which the claim was based was not bargained at arm's length.); *Harper*, 83 T.C.M. at 1653 (denying the §2036 exception, in part, where there was no "arm's length bargaining because decedent "stood on both sides of the transaction"); *Strangi*, 85 T.C.M. at 1343 (finding no bona fide sale where "decedent essentially stood on both sides of the transaction"). As a practical matter, an "arm's length" transaction provides good evidence of a "bona fide sale," especially with intrafamily transactions. . . .
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> That said, however, neither the Internal Revenue Code nor the governing Treasury Regulations define "bona fide sale" to include an "arm's length transaction." Treasury Regulation 20.2036-1(a) defines "bona fide sale for adequate and full consideration" as a transfer made "in good faith" and for a price that is "adequate and full equivalent reducible to a money value." 26 C.F.R. §20.2036-1(a) (referring to 26 C.F.R. §20.2043-1(a)). Based in part on an interpretation of this regulation, the Court of Appeals for the Fifth Circuit concluded a "bona fide sale" only requires "a sale in which the decedent/transferor actually parted with her interest in the assets transferred and the partnership/transferee actually parted with the partnership interest issued in exchange." See *Kimbell*, 371 F.3d at 265. The court reasoned:
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> [J]ust because a transaction takes place between family members does not impose an additional requirement not set forth in the statute to establish that it is bona fide. A transaction that is a bona fide sale between strangers must also be bona fide between members of the same family. In addition, the absence of negotiations between family members over price or terms in not a compelling factor in the determination . . . particularly when the exchange value is set by objective factors.
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> *Id*. at 263 (discussing *Wheeler*, 116 F.3d 749 (internal citations omitted).

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[69] 382 F.3d 367 (3d Cir. 2004)

> We similarly believe a "bona fide sale" does not necessarily require an "arm's length transaction" between the transferor and an unrelated third-party. Of course, evidence of an "arm's length transaction" or "bargained-for exchange" is highly probative to the §2036 inquiry. But we see no statutory basis for adopting an interpretation of "bona fide sale" that would automatically defeat the §2036 exception for all intra-family transfers. *Wheeler*, 116 F.3d at 655 ("Unless and until the Congress declares that intrafamily transfers are to be treated differently . . . we must rely on the objective criteria set forth in the statute and Treasury Regulations to determine whether a sale comes within the ambit of the exception to section 2036(a).").
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> We are mindful of the mischief that may arise in the family estate planning context. As the Supreme Court observed, "the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used." *Comm'r v. Culbertson*, 337 U.S. 733, 649, 69 S.Ct. 1210, 93 L.Ed. 1659 (1949). But such mischief can be adequately monitored by heightened scrutiny of intra-family transfers, and does not require a uniform prohibition on transfers to family limited partnerships. *See id*. ("[T]he existence of the family relationship does not create a status which itself determines tax questions, but is simply a warning that things may not be what they seem."); *Kimbell*, 371 F.3d at 265 ("[W]hen the transaction is between family members, it is subject to heightened scrutiny.")[70]

IX. The *Woelbing* Cases.

In the *Woelbing* cases, currently pending in the Tax Court, the IRS is asserting the applicability of IRC Sec. 2702 to a sale of non-voting stock of a closely held corporation by Mr. Woelbing to an IDIT in exchange for the IDIT's promissory note. The Woelbings were husband and wife. They both consented under IRC Sec. 2513 to treat any gift on the sale as having been made one-half by each of them. The IRS also asserts that the assets sold to the IDIT by Mr. Woelbing should be included in his Federal gross estate under IRC Secs. 2036 and 2038. In the *Woelbing* cases, the IRS is claiming that the stock sold to the IDIT had a value of $116.8 million on the date of sale, rather than the $59 million established as the purchase price in the sale transaction documents.

The *Woelbing* cases involve facts which are similar to those in *Karmazin v. Commissioner*[71]. *Karmazin* was a case filed in the Tax Court involving an asserted gift tax deficiency arising out of sales to IDITs. In *Karmazin,* the taxpayer sold limited partnership interests to two IDITs in exchange for the IDITs' promissory notes. The notes bore interest at the applicable Federal rate. The taxpayer made gifts of limited partnership interests affording a 10% cushion. The sales documents provided for the sale of limited partnership interests having a

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[70] 382 F.3d at pp. 381-2.

[71] Tax Ct. Dock. No. 2127-03.

value equal to a fixed dollar amount, which amount equaled the face amount of the promissory notes given by the IDITs in the sale transactions. A discount of 42% was claimed on the gift tax return reporting the sale.

The case was settled on terms very favorable to the taxpayer. In the settlement, it was agreed that IRC Sec. 2702 did not apply. The sales were recognized, and it was agreed that the promissory notes had gift tax values equal to their face amounts. The discount produced by the limited partnership was agreed to be 37%, rather than the 42% claimed. Thus, the deficiency originally asserted by the gift tax examiner was reduced by 95%. These settlement terms were so favorable to the taxpayer that one commentary concluded that the IRS "was not serious" about its IRC Sec. 2702 contentions.[72]

Given the settlement in *Karmazin*, it may be that the *Woelbing* cases will ultimately turn out to be valuation cases, rather than a challenge to the sale to IDIT technique. Practitioners who did not cease recommending the sale to an IDIT technique to clients while *Karmazin* was pending will likely not be deterred from recommending the sale technique to their clients during the pendency of the *Woelbing* cases.

X. Use of a Self-Canceling Installment Note (SCIN) – The *Davidson* Case.

A SCIN is structurally similar to an annuity based upon an individual's life. A question arises as to whether the 50% test of Treas.Reg.Sec. 25.7520-3(b)(3) applies to a SCIN as it does to an annuity based upon life. The answer to this question is uncertain.

IRC Sec. 7520(b) provides that IRC Sec. 7520 is not to apply for purposes of part I of subchapter D of chapter 1 or any other provision specified in regulations. Treas.Reg.Sec. 25.7520-3(a)(7) provides that IRC Sec. 7520 does not apply for purposes of IRC Sec. 7872.[73]

The extent to which Treas.Reg.Sec. 25.7520-3(a)(7) precludes application of IRC Sec. 7520 to IRC Sec. 7872 is not clear. It may be that the intent of Treas.Reg.Sec. 25.7520-3(a)(7) is only to emphasize that the interest rate under IRC 7520 is not to apply to IRC Sec. 7872 transactions, and that Treas.Reg.Sec. 25.7520-3(a)(7) does not preclude use of the actuarial tables under IRC Sec. 7520 to sales in which the interest rate is determined under IRC Sec. 7872. However, the language of Treas.Reg.Sec. 25.7520-3(a)(7) is not so limited. Treas.Reg.Sec. 25.7520-3(a)(7) can be construed as making the actuarial tables under IRC Sec. 7520 and the 50% test of Treas.Reg.Sec. 25.7520-3(b)(2)(i) inapplicable to a sale to an IDIT transaction in which the interest on the promissory note bears interest at the rate specified under IRC Sec. 7872. An advantage to the 50% test under IRC Sec. 25.7520-3(b)(2)(i) is that if the seller satisfies the 50% test, the IRS is bound to use the actuarial tables under IRC Sec. 7520 in determining the seller's life expectancy, even if it is conceded that the seller's actual life expectancy is substantially shorter than predicted by the tables. To avoid possible application of

[72] Covey and Hastings, *Recent (2003) Developments in Transfer and Income Taxation of Trusts and Estates*, 38th Ann. Philip E. Heckerling Inst. on Est. Plan. ¶ 129 (2004).

[73] *See also* Treas.Reg.Secs. 1.7520-3(a)(7) and 20.7520-3(a)(7).

Treas.Reg.Sec. 25.7520-3(a)(7), it would seem that the interest rate prescribed by IRC Sec. 7520 should be used with a SCIN in a case in which the 50% test of Treas.Reg.Sec. 25.7520-3(b)(2)(i) is important. The SCINs in *Davidson*, discussed *infra*, bore interest at the IRC Sec. 7520 rate.

The IRS's official position appears to be that even if an interest rate under IRC Sec. 7520 is used, IRC Sec. 7520 does not apply to a SCIN, for the reason that a SCIN is a promissory note and not an annuity, interest for life or a term of years, or a remainder or a reversion. See CCA 201330033. That CCA was issued in connection with the *Davidson* case.

The Tax Court pleadings in the *Davidson* case reveal that William Davidson was the President, Chairman and Chief Executive Officer of Guardian Industries Corp. and a former owner of the Detroit Pistons. In December of 2008 and January of 2009, at the age of 86, he entered into a number of gift and sale transactions, including two large sales for SCINs. Shortly after the transactions, he was diagnosed with a terminal illness and died on March 13, 2009, before receiving any payment on the SCINs. In the notice of deficiency, the IRS asserted gift, estate and generation-skipping tax deficiencies in excess of $2.8 billion. An important issue in the case is whether the SCINs constituted valid consideration for the sales. According to the IRS mortality tables under IRC Sec. 7520, the decedent's life expectancy was 5.8 years at the time of the transaction. The decedent's physician wrote a letter on October 20, 2008 indicating that the decedent maintained an active exercise schedule and was working. The physician expressed the view that the decedent was in good health commensurate with his age group, and participated in a healthy life style, exercise regimens and activities which required keen mental rigor. The physician wrote a similar letter on December 16, 2008. Four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS, expressed the view that in January 2009 the decedent had greater than a 50% probability of living at least one year.

The IRS's position in the *Davidson* case is expressed in CCA 201330033, as follows:

> We do not believe that the §7520 tables apply to value the notes in this situation. By its terms, §7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in §25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986)

The case has been settled. On July 6, 2015, the Tax Court entered a stipulated decision with the IRS agreeing to a total $152 million increase in the estate's combined gift, estate and generation-skipping tax liability. Given the settlement of *Davidson*, it remains uncertain whether the rules of IRC Sec. 7520 can be applied to a SCIN. This uncertainty is frequently of critical importance. If the tables apply, an estate need only demonstrate that a decedent had greater than a 50% probability of living more than one year in order to be able to take advantage of the conclusive presumption of life expectancy established by Treas.Reg.Sec. 25.7520-3(b)(3). If the tables do not apply, this conclusive presumption is not available, and the decedent's actual life expectancy is used. If a decedent is ill at the time of the sale, use of the decedent's actual life expectancy could significantly reduce the value of the SCIN and result in a substantial gift.

Since the payments for an annuity can be structured in a way that is very similar to a promissory note or SCIN, there would seem to be no reason from a non-tax viewpoint to favor one over the other. Given the IRS's position that a SCIN does not qualify for the 50% test under Treas.Reg.Sec. 25.7520-3(b)(3), it would seem that practitioners contemplating sale transactions terminating at death should choose an annuity over a SCIN, at least until the law on this issue is clarified.

XI. Conclusion.

This paper has yet to address the claim made in its title, i.e. that the sale to an IDIT is the best transfer tax strategy. Through a sale to an IDIT, future appreciation in assets can be eliminated from the seller's estate without income tax consequences on the sale. Except for interest on the promissory note, the seller's estate can be frozen at current value. Because the seller remains liable for the payment of taxes on income generated by the IDIT's assets, a sale can actually produce a reduction in the value of the seller's estate. The sale for an annuity based upon life can produce results which are dramatic.

As noted in Section I, *supra*, the standard sale to an IDIT for the IDIT's promissory note is similar to a GRAT. The technique "works" if the assets sold produce a total net return (net income plus appreciation) in excess of the interest on the promissory note. While recognizing that the sale to IDIT is superior to a GRAT in reducing a generation-skipping tax, a respected commentary recently expressed a preference for the GRAT over the standard sale to an IDIT.[74] Two reasons are given for this preference.

One reason for the expressed preference is that the Regulations authorize the use of a formula to describe the annuity from a GRAT.[75] Expressing the annuity as a formulaic percentage of the value of property transferred into the GRAT can eliminate any gift in the event the property is revalued upwards by the IRS. In such event, the effect of the formula is to increase the amount of the annuity payments so that the value of the gift remains unchanged. The IRS's position is that except when expressly approved by IRS rule or regulation, formula transfers are invalid on public policy grounds. However, as noted at note II, *supra*, the courts to date have rejected the IRS's position.

The other reason expressed in the commentary for the preference of the GRAT over the sale strategy is that the GRAT can produce a zeroed-out result, while a sale cannot. As discussed in Section VIII C 2, *supra*, above, it appears that guarantees by IDIT beneficiaries who file gift

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[74] See Practical Drafting, p. 11,996 (U.S. Trust April 2015). For a comparison of the two techniques, see Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note – An End Run Around Chapter 14?*, 32^{nd} Ann.U.Miami Philip E. Heckerling Inst. On Est. Plan. ¶1502 (1998).

[75] Treas.Reg.Sec. 25.2702-3(b)(1)(i)(B).

tax returns reporting their guarantees as not being gifts or who are paid a fee for their guarantees can produce a zero gift result.

This paper has sought to demonstrate that the sale to an IDIT is a valid strategy which will be recognized as a sale, as opposed to a transfer with an IRC Secs. 2036(a)(1) or 2702(a) retained interest, if "reality of sale" principles and the rules established by *Fidelity-Philadelphia Trust Co.* are observed. It has also sought to demonstrate that the sale can be successful without being burdened by the restrictions referred to in Section VIII B, *supra*. The sale to an IDIT strategy is a user friendly, effective planning strategy that can be remarkably successful.