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Sale to an IDIT for a Life Annuity: Confronting the Exhaustion Test and Other Challenges

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I. INTRODUCTION

The sale to a so-called Intentionally Defective Irrevocable Trust (IDIT) in exchange for a promissory note has become a widely used estate planning strategy.[1] An IDIT is a trust that is recognized to exist apart from its grantor for federal estate and gift tax purposes, but not income tax purposes. The IDIT is created by intentionally violating provisions of the grantor trust rules contained in §671 et seq. in ways that do not cause inclusion in the grantor's federal gross estate under §2036–§2038.[2] The technique takes advantage of the fact that the grantor trust income tax rules are more sensitive than the rules governing inclusion in the grantor's estate.

The Internal Revenue Service (IRS) takes the position that an IDIT does not exist for federal income tax purposes.[3] A 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.[4]

A sale can be effected without gift tax consequence if the value of the assets sold to the IDIT does not exceed the value of the IDIT's promissory note received by the seller. The technique works both for estate and generation-skipping tax purposes if the return (net income plus net appreciation) generated by assets in the IDIT over time exceeds the interest rate on the IDIT's promissory note.[5] This result is easier to produce with an IDIT than with a trust that is a separate taxpayer. The IDIT's return on its assets is not reduced by income tax liability. In Rev. Rul. 2004-64,[6] the IRS ruled that the grantor's payment of taxes on an IDIT's income does not constitute a transfer subject to gift tax.

A person whose life expectancy is shortened by illness may anticipate not having an extended period of time for the standard sale to an IDIT to produce a significant estate tax savings. For such an individual, a modification to the standard sale might be considered. The modified technique is a sale to an IDIT in exchange for an annuity that terminates at the seller's death. The modified technique is a variation of a long established estate planning strategy, a sale in exchange for a private annuity.[7] The annuity payments terminate at death, leaving nothing additional to be taxed in the annuitant's estate.

This article discusses both the sale to an IDIT in exchange for a standard promissory note and also the sale in exchange for an annuity for life, in both cases focusing on steps to be taken to avoid possible application of §2036(a)(1) and §2702. A sale to an IDIT for an annuity for life presents issues which do not exist

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

[2] Unless otherwise stated, all Section (§) references are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

[3] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[4] Reg. §1.671-4(b)(2)(i)(A) and §301.6109-1(a)(2)(i)(B).

[5] Michael D. 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. ¶1501 (1998).

[6] 2004-27 I.R.B. 7.

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

with a sale in exchange for a standard promissory note. This article discusses those issues and potential solutions in dealing with them. It also identifies situations in which use of a sale to an IDIT in exchange for an annuity for life might be utilized. Finally, the article compares the annuity for life with a self-cancelling installment note, or SCIN.

II. AVOIDING §2036(a)(1) AND §2702

There are two statutes of primary concern in structuring a sale to an IDIT in exchange for either a promissory note or an annuity. Those statutes are §2036(a)(1) and §2702.

A. The Statutes

Section 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. Section 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 §2702, the value of any interest in the trust retained by the transferor is zero, unless the retained interest is a qualified annuity or 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 §2702.

If a sale to an IDIT in exchange for a promissory note were to produce estate tax inclusion under §2036(a)(1), it is also likely to be considered a gift governed by §2702. If §2702 applies and the right to receive payments from the IDIT does not constitute a qualified interest, such right is valued at zero.[8] If the right to payments is valued at zero, the result is a gift equal to the full value of the property transferred to the IDIT in the sale transaction. The consideration received for such transfer has no effect in reducing the amount of the gift.

It is easy to understand how a sale to an IDIT in exchange for a promissory note or an annuity might be characterized as an §2036(a)(1) or §2702 transfer. Payments by the IDIT are likely to be derived from income generated by the property sold to the IDIT or by the property itself. It is understandable that the IRS might view the right to receive such payments as a retained interest in the property (specifically, the enjoyment of, or right to income from, the property) rather than a sale.

B. The *Fidelity-Philadelphia Trust Co.* Case

In *Fidelity-Philadelphia Trust Co. v. Smith*,[9] the U.S. Supreme Court enunciated the circumstances under which a sale in exchange for payments over time is not to be treated as a transfer includible under §2036(a)(1). Under the tests enunciated by the Court, the size of payments must not be related to the income generated by the transferred property. Further, the debt arising out of the sale must be a personal obligation of the transferee and must not be chargeable solely to the transferred property.[10]

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 §7872(e) and §7872(f)(2), i.e., the applicable federal rate in effect under §1274(d) for the month in which 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 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 chargeable solely to the property sold to the IDIT, practitioners generally take steps to ensure that, in addition to the property sold to the IDIT, other assets are available for use in satisfying the IDIT's promissory note. A common practice is to use other assets to create 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.[11] The 10% figure is based upon conversations Byrle Abbin had

[8] For example, the annuity is not a qualified annuity under §2702 if the IDIT provides for distributions to beneficiaries other than the seller during the time that the annuity payments are being made. Under Reg. §25.2702-3(d)(4), the annuity is not a qualified annuity unless the governing instrument prohibits commutation (prepayment).

[9] 356 U.S. 274 (1958).

[10] 356 U.S. at 280, n. 8; *see also* Rev. Rul. 77-193, 1977-1 C.B. 273.

[11] Byrle 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).

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with IRS personnel in the process of obtaining PLR 9535026.[12]

C. Other Authorities

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 involved 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 §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 §677(a). The cases indicate that the analysis under both §2036(a)(1) and §677(a) is the same.[13]

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.[14] Other cases have recognized the sale. In these cases, the court found that the annuity payments were not tied to trust income, and concluded that in structure and substance, the transactions constituted sales for an annuity rather than a retention of the right to income.[15]

PLR 9436006 and PLR 9535026 are two private letter rulings dealing with sales to IDITs. Both ruled favorably on several issues. TAM 9251004 is an earlier technical advice memorandum that came to an unfavorable conclusion.

In PLR 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 §1274 at the time of 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 IRS ruled that the promissory note would constitute debt, and not a retained interest subject to the provisions of §2702.

The taxpayers in PLR 9535026 proposed to sell stock in a closely held corporation to separate trusts held for their benefit in exchange for promissory notes that 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 §7872.

Citing *Frazee*, the IRS ruled in PLR 9535026 that because the notes would bear interest at the rate prescribed by §7872, they would have a gift tax value equal to their face amount. The ruling also concluded 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 that 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. PLR 9535026 also noted that §2702 would not apply to the sale.

TAM 9251004 is an earlier memorandum in which the IRS National Office advised 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 §2036(a)(1). TAM 9251004 makes no reference to the Supreme Court's decision in *Fidelity-Philadelphia Trust Co. v. Smith*.

D. Settlements in *Karmazin* and *Woelbing*

Karmazin v. Commissioner[16] was a case filed in the Tax Court after a gift tax examiner asserted that §2702 applied to a sale to an IDIT in exchange for the IDIT's promissory note. 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 to produce a 10% cushion. The sales documents provided for the sale of limited partnership interests having a value equal to a fixed dollar amount, which amount equaled the face amount of the promissory note given by the IDITs in the sale transactions. A discount of 42% was claimed on the gift tax return reporting the sale transactions. The gift tax examiner determined that §2702 applied, and assigned a zero value to the IDITs' promissory notes.

[12] Michael D. 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).

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

[14] *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1965); *Lazarus v. Commissioner*, 513 F.2d 824 (9th Cir. 1975); *Bixby v. Commissioner*, 58 T.C. 757 (1972).

[15] *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 297 (7th Cir. 1959); *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984).

[16] No. 2127-03 (T.C. filed Feb. 10, 2003).

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The case was settled on terms very favorable to the taxpayer. In the settlement, it was agreed that §2702 did not apply. The sale was recognized, and it was agreed that the promissory notes were debt and 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. The taxpayer agreed that the formula would not be given effect to avoid a gift. 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 I.R.C. Secs. 2701 and 2702 contentions."[17] Many practitioners interpreted the IRS's settlement in *Karmazin* as an indication that the IRS accepted the sale to an IDIT in exchange for a promissory note technique as valid and effective.

Estate of Marian Woelbing v. Commissioner[18] and *Estate of Donald Woelbing*[19] were two companion Tax Court cases that called this interpretation into question. In the *Woelbing* cases, the IRS again asserted the applicability of §2702 to a sale of nonvoting 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 §2513 to treat any gift in the sale as having been made one-half by each of them. Mr. Woelbing died in 2009 and Mrs. Woelbing died in 2013. In addition, the IRS asserted that the assets Mr. Woelbing sold to the IDIT should be included in his federal gross estate under §2036 and §2038.

The *Woelbing* cases were settled. From the stipulated decisions entered in March 2016, it is clear that the IRS abandoned its §2036, §2038 and §2702 arguments in both cases.[20] Practitioners who did not cease recommending the sale to IDIT technique to their clients while the *Woelbing* cases were pending should feel some vindication.

III. SELLER FILES GIFT TAX RETURN

A gift tax return might be filed reporting a sale to IDIT transaction, and taking the position that the sale is not a gift because the value of the IDIT's promissory note is not less than the value of the assets sold to the IDIT.[21] If the gift tax return adequately discloses the sale transaction, the IRS cannot assert otherwise for any purpose after the three-year statute of limitations has elapsed.[22] A timely filed gift tax return can also be used to conclusively establish the value of property for purposes of allocating GST exemption.[23]

IV. GUARANTOR FILES GIFT TAX RETURN

There is authority for the proposition that there is no gift in making a guarantee, only if a payment is made on the guarantee.[24] If guarantees are used to create a cushion or equity in the IDIT for the sale, a guarantor should consider filing a gift tax return. That return would 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. If the guarantor is a beneficiary of the IDIT, it should also preclude the IRS from arguing that the guarantee causes a portion of the IDIT to be included in the guarantor's estate under §2036 or §2038, or that the guarantor's contribution to the IDIT taints it for generation-skipping tax purposes. If the gift is valued at zero, there should be no transfer for estate or generation-skipping tax purposes. If precluded by Reg. §20.2001-1(b) and Reg. §25.2504-2(b) from asserting that the guarantee is an addition to the IDIT for estate and gift tax purposes, it is hoped that the IRS would not argue that the guarantee constitutes an addition to the IDIT for income tax purposes, causing it to cease being a wholly grantor trust.

V. THE 50% PROBABILITY OF SURVIVORSHIP TEST

Reg. §25.7520-3(b)(3) establishes a taxpayer friendly rule in planning for an individual who, because of illness, has an actual life expectancy that is shorter than predicted by the IRS's actuarial tables. Under Reg. §25.7520-3(b)(3), the mortality component prescribed under §7520 may not be used to determine the present value of an annuity, income interest, remainder interest or reversionary interest if an individual who is a measuring life dies or is terminally

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[17] Richard B. Covey and Dan T. Hastings, *Recent (2003) Developments in Transfer and Income Taxation of Trusts and Estates*, 38th Ann. Heckerling Inst. on Est. Plan. ¶129 (2004).

[18] No. 30260-13 (T.C. filed Dec. 26, 2013).

[19] No. 30261-13 (T.C. filed Dec. 26, 2013).

[20] Ronald D. Aucutt, *Parties Settle Closely Watched Tax Court Cases Involving Defined Value Clauses*, L1S1 Estate Planning Newsletter #2419 (May 24, 2016).

[21] Reg. §301.6501(c)-1(f)(4).

[22] §2001(f), §2504(c) and §6501(c)(9).

[23] §2642(b)(1).

[24] Richard B. 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); Jerald D. August, *Planning Around Contingent Liabilities*, 26th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1802 (1992).

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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. Reg. §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 §7520 because an individual is considered to be terminally ill, Reg. §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.[25]

The 50% probability of survivorship test established by Reg. §25.7520-3(b)(3) is frequently not difficult to satisfy. Even a person who is terminally ill will, according to his or her treating physicians, often have greater than a 50% probability of living one year. Reg. §25.7520-3(b)(3) affords planning opportunities for an individual afflicted with an illness that shortens life expectancy, but the probability is less than 50% that the individual's death will occur within one year. If the 50% test of Reg. §25.7520-3(b)(3) is met, the IRS mortality tables under §7520 are binding, even if it is conceded that the individual's actual life expectancy is substantially shorter than predicted by those tables.[26] Even in cases in which an early death is virtually certain, it is frequently possible to satisfy the 50% test of Reg. §25.7520-3(b)(3). An example illustrates planning possibilities.

> *Example:* Assume that an individual is 75 years of age at his or her nearest birthday. Assume that because of illness, the individual has a life expectancy shorter than predicted by the IRS mortality tables, but satisfies the 50% test of Reg. §25.7520-3(b)(3). Assume that the individual sells assets having a value of $10 million to an IDIT in exchange for an annuity payable on each anniversary of the date of sale over the individual's lifetime. If the §7520 rate for the month of sale is 2%, the factor under §7520 for determining the present value of the annuity is 9.5385.[27] Utilizing this factor, an annuity of $1,048,382.87 per year has a present value of $10 million ($10 million ÷ 9.5385). If the individual sells the $10 million in assets to an IDIT in exchange for an annuity of $1,048,382.87 per year for life, the sale transaction will not have any gift tax consequence (assuming the exhaustion test, discussed in VII., below, does not apply).

If the individual dies on the fourth anniversary of the sale, the individual will have received a total of $4,193,531.48 ($1,048,382.87 × 4) in annuity payments.[28] The result is that the individual's estate is reduced by $5,806,468.52 ($10 million − $4,193,531.48), without even considering any income from or appreciation in the value of the $10 million that would have been included in the individual's estate but for the sale.

The sale transaction in the Example produces a better result with a lower §7520 rate than is produced with a higher rate. This is because the value of the right to receive a fixed annuity decreases as the assumed interest rate increases.

The 2% §7520 rate assumed in the Example is close to the historically low rates over the last few years. A 6% rate is more representative of the §7520 rate in effect during normal economic times. Assuming a §7520 rate of 6% in the Example, the factor for calculating the present value of the annuity payable to the individual for life is 7.3052, resulting in an annuity amount of $1,368,887.92 ($10 million ÷ 7.3052). If the individual survives to receive four payments, the individual will receive a total of $5,475,551.68 ($1,368,887.92 × 4), and the reduction in the estate is $4,524,448.32 ($10 million − $5,475,551.68) as opposed to the $5,806,468.52 reduction in the value of the estate achieved with a §7520 rate of 2%. The results of assumed 2% and 6% §7520 rates are summarized in Table I.

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

[26] For a recent case illustrating planning possibilities using the actuarial tables under §7520, see *Estate of Kite v. Commissioner*, T.C. Memo 2013-43.

[27] All of the factors utilized in this article were derived through the use of NumberCruncher, a product of Leimberg & LeClair, Inc., and rounded to the nearest hundredth at each step. Computations for the figures appearing in Tables I, II and III were performed manually. The figures appearing in the columns Amount of Gift and Additional Amount Needed to Avoid Gift of Tables IV, V and VI were calculated in the manner directed by Reg. §25.7520-3(b)(2)(i) and Reg. §25.7520-3(b)(2)(v) *Ex.* 5. The figures shown as Amount of Gift in Tables VII and VIII were derived through the use of NumberCruncher. The figures shown as Additional Amount Needed to Avoid Gift in Tables VII and VIII were determined through a computer created spreadsheet.

[28] In valuing annuity, unitrust and income interest payable for an individual's life, the §7520 tables assume that payments will be made for a partial year of survivorship. To comply with this, the sale agreement should provide for a pro rata payment for a partial year and not terminate the seller's right to payment on the anniversary of the sale immediately preceding the seller's death.

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TABLE I
REDUCTION IN VALUE OF ESTATE ASSUMING INDIVIDUAL IN EXAMPLE DIES AFTER 4 PAYMENTS

Assumed §7520 Rate	2%	6%
Annual Amount Having Present Value of $10 Million	$1,048,382.87	$1,368,887.92
Total Received After Four Years	$4,193,531.48	$5,475,551.68
Reduction in Value of Estate	$5,806,468.52	$4,524,448.32

If the continuation of the right to receive annuity payments is based upon the life of an individual, the amount payable to the individual includes a premium to compensate for the possibility that the individual may die prematurely. The amount of the premium is calculated actuarially based upon the data contained in Table 2000CM. Table 2000CM is a mortality table commencing with a population of 100,000 in year one. It traces the number of the survivors of that initial population in each of the subsequent years through year 110. In year 109, 11 of the original 100,000 individuals remain alive. In year 110, all are deceased.

VI. SHORTENED LIFE EXPECTANCY

Because of the premium, an annuity based upon life should not be used if the annuitant is likely to survive to or beyond his or her life expectancy. Tables II and III illustrate this point. Table II shows the amounts that would be received by the individual in the Example posed above if the sale were effected in exchange for an annuity for life as compared to the amounts received under a standard promissory note. The Tables show the results if the seller dies on the 4th, 8th, 12th and 16th anniversary of the sale. It is assumed that interest on the promissory note is payable annually on the anniversary date of the note and that the annuity is payable annually. In Table II, the interest rate assumed for both the promissory note and the annuity is 2%, even though the §1274(d) rate is likely to be lower than the §7520 rate.[29] Assuming the same interest rate means that the difference in results in Table II is attributable solely to the annuity premium compensating for the possibility of premature death. Table III contains the same analysis as Table II, except that the interest rate on the promissory note and the annuity is assumed to be 6%.

[29] Under §7520(a)(2), the §7520 rate is 120% of the federal mid-term rate under §1274(d)(1). The federal mid-term rate is for periods over three years but not over nine years. It is conceivable that the long-term rate under §1274(d)(1) could exceed the §7520 rate. The long-term rate under §1274(d)(1) is for periods in excess of nine years.

TABLE II
COMPARISON OF LIFE ANNUITY
AND INTEREST ONLY PROMISSORY NOTE – INTEREST = 2%

Annual Annuity Payment = $1,048,382.87

Annual Interest Payment on Promissory Note = $200,000

(1) Number of Years	(2) Total Annuity Payments Received	(3) Total Interest Payments Received Plus Face Amount of Promissory Note	(4) Excess of (3) over (2)
4	$4,193,531.48	$10,800,000.00	$6,606,468.52
8	$8,387,062.96	$11,600,000.00	$3,212,937.04
12	$12,580,594.44	$12,400,000.00	($180,594.44)
16	$16,774,125.92	$13,200,000.00	($3,574,125.92)

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TABLE III
COMPARISON OF LIFE ANNUITY
AND INTEREST ONLY PROMISSORY NOTE – INTEREST = 6%

Annual Annuity Payment = $1,368,887.92
Annual Interest Payment on Promissory Note = $600,000

(1) Number of Years	(2) Total Annuity Payments Received	(3) Total Interest Payments Received Plus Face Amount of Promissory Note	(4) Excess of (3) over (2)
4	$5,475,551.68	$12,400,000.00	$6,924,448.32
8	$10,951,103.36	$14,800,000.00	$3,848,896.64
12	$16,426,655.04	$17,200,000.00	$773,344.96
16	$21,902,206.72	$19,600,000.00	($2,302,206.72)

Tables II and III show similar results. Initially, there is a substantial reduction in the value of the estate produced by the sale in exchange for a life annuity as compared to that produced by a sale in exchange for a standard interest only promissory note. This result changes with the passage of time. Under Table 2000CM, an individual 75 years of age has a life expectancy of just over 11 years. Both Table II and Table III illustrate that as the seller survives beyond his or her life expectancy, the sale for a life annuity causes an increase in the value of the seller's estate over that resulting from a sale for an interest only promissory note.

VII. THE EXHAUSTION TEST

The premium that 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 Reg. §25.7520-3(b)(2)(i) to be a factor that must be taken into account in structuring a sale to an IDIT in exchange for an annuity for life.

A. Passing or Failing the Exhaustion Test

Reg. §25.7520-3(b)(2)(i) provides that a standard §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.

Under Reg. §25.7520-3(b)(2)(i), if the amount of the fixed annuity payment does not exceed the effective §7520 rate at the date of the transfer, the corpus is assumed to be sufficient to make all annuity payments. In such case, the standard applicable §7520 factor may be used to calculate the present value of the annuity. This is true whether the annuity payments are to be made for a term of years or the life of one or more individuals.

If the fixed annual payment exceeds the applicable §7520 rate, Reg. §25.7520-3(b)(2)(i) directs how it is to be determined whether or not the exhaustion test is satisfied. If the fixed annuity is payable for a definite period of years, the annual amount is to be multiplied by the Table B term certain annuity factor under Reg. §25.7520-1(c)(1) for the number of years of the definite term. Table B contains actuarial factors used in determining the present value of an interest for a term of years. If the fixed annuity is payable for the life of one or more individuals, the annuity amount is to be multiplied by the Table B annuity factor for the excess (in years) of 110 over the age of the youngest individual.

If the computation in either of the two preceding paragraphs produces a figure that exceeds the value of the limited fund, the annuity arrangement fails the exhaustion test. The consequence is that a standard §7520 annuity factor may not be used to determine the present value of the annuity. Rather, it is necessary to compute a special §7520 annuity factor that takes into account the exhaustion of the fund.[30]

B. Calculating the Special Factor

Reg. §25.7520-3(b)(2)(v) *Ex.* 5 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 that 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 §7520 rate is stated to be 6.8%. After calculating that the proposed annuity payments do not satisfy the exhaustion test, Example 5 states that if a trust earns the assumed 6.8% §7520 rate, it will only be able to make 17 an-

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[30] Reg. §25.7520-3(b)(2)(i) is a gift tax regulation. *See also* Reg. §1.7520-3(b)(2)(i) and §20.7520-3(b)(2)(i), which are identical to Reg. §25.7520-3(b)(2)(i) and apply respectively for income and estate tax purposes.

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nual payments in full and will be exhausted after making a partial 18th payment of $32,712.72. As a result, for purposes of determining the present value of the distribution to charity, the regulation requires the provisions governing the annuity payments be recharacterized as a distribution to charity of $67,287.28 ($100,000.00 − $32,712.72) per year for the donor's life or, if shorter, for a period of 17 years, plus a distribution of $32,712.72 per year for the donor's life or, if shorter, for a period of 18 years. The present value at an §7520 rate of 6.8% of an annuity of $67,287.28 per year payable for 17 years or until the prior death of a person age 60 is $597,013.12 ($67,287.28 × 8.8726). At the same 6.8% interest rate, 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 $296,887.56 ($32,712.72 × 9.0756). 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 means that of the $1 million originally placed in the trust, only $893,900.68 qualifies for the charitable deduction, resulting in a taxable gift equal to $106,099.32 ($1 million − $893,900.68).

C. Validity of Example 5

The conclusion of Example 5 does not appear harsh. The gift is approximately 10.6% of the $1 million placed in the trust. Nevertheless, some commentators have asserted that Reg. §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 might live until the age of 110 years.[31] According to the commentators, this assumption should result in a conclusion that all assets of the trust in Example 5 will be distributed to charity. Under this analysis, the amount of the charitable deduction in Example 5 should be equal to the full $1 million placed in the trust.

The calculations prescribed by Reg. §25.7520-3(b)(2)(v) *Ex.* 5 are based upon assumptions that are standard in the use of IRS tables under §7520. It is assumed that the assets in the trust produce a net return equal to the applicable §7520 interest rate and that the assets of the trust do not appreciate or depreciate in value. Based upon those assumptions, a projection is made as to when the trust will be depleted. The factors for a life annuity under §7520 assume that annuity payments will be made as long as the person who is the measuring life remains alive. Under the exhaustion test, the time during which annuity payments are made is not assumed to extend beyond the time that computations project the trust to run out of assets.

Rather than being invalid, the exhaustion test as promulgated by Reg. §25.7520-3(b)(2)(i) and Reg. §25.7520-3(b)(2)(v) *Ex.* 5 actually appears quite rational. Section 7520(a) provides that the value of any annuity shall be determined under tables prescribed by the Secretary. Section 7520(b) provides that §7520 shall apply for purposes of any provisions specified in the regulations. Because Congress has delegated authority to fill in gaps in §7520, the regulations under that statute are legislative regulations which are given controlling weight unless arbitrary, capricious or manifestly contrary to the statute.[32] It seems unlikely that the courts will find Reg. §25.7520-3(b)(2)(i) and Reg. §25.7520-3(b)(2)(v) *Ex.* 5 to be invalid.[33]

D. Consequences of Failing the Exhaustion Test

The impact of failing the exhaustion test can be illustrated using the facts of the Example, i.e. a 75-year old individual selling assets having a value of $10 million to an IDIT in exchange for an annuity payable over the seller's lifetime. As noted above, the factor at an assumed §7520 rate of 2% for computing an annuity for the life of an individual 75 years of age is 9.5385, producing an annuity of $1,048,382.87 per year. Under the assumptions of Example 5 of Reg. §25.7520-3(b)(2)(v), a fund of $10 million produces an annuity of $1,048,382.87 per year for 10 years and a final payment in the 11th year of $724,648.58. The present right to receive this annuity is determined by adding two sums, i.e., the present value of the right to receive $724,648.58 for a period of 11 years or the seller's prior death and the present value of the right to receive $323,734.29 ($1,048,382.87 − $724,648.58) per year for a period of 10 years or the seller's prior death. At an §7520 rate of 2%, the factor for 11 years or the seller's prior death is 7.4847 which, when multiplied by $724,648.58, produces a present value of $5,423,777.23. The factor for an annuity payable for 10 years or the seller's prior death is 7.0762 which, when multiplied by $323,734.29 produces a present value of $2,290,808.58. This figure, when added to $5,423,777.23, produces a sum of

[31] Lawrence P. 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); Steve R. Akers, *Private Annuities and SCINs: Disappearing Value or Disappearing Strategies?*, 49th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan ¶606 (2015).

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

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

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$7,714,585.81. The seller's gift under the exhaustion test is $2,285,414.19 ($10,000,000.00 – $7,714,585.81).

As noted above, the factor for an annuity for the life of an individual age 75 at an assumed §7520 rate of 6% is 7.3052, resulting in an annuity of $1,368,887.92 per year. Under the assumptions of Example 5 of Reg. §25.7520-3(b)(2)(v), a fund of $10 million at an §7520 rate of 6% produces an annuity of $1,368,887.92 per year for a period of nine years and a final payment in the 10th year of $1,234,282.09. At an §7520 rate of 6%, the factor for an annuity of 10 years or the seller's prior death is 5.9064, which when multiplied by $1,234,282.09 ($1,368,887.92 – $134,605.83) produces a present value of $7,290,163.74. The factor for an annuity payable for 9 years or the seller's prior death is 5.5937, which, when multiplied by $134,605.83, produces a present value of $752,944.63. This figure, when added to $7,290,163.74, produces a sum of $8,043,108.37. The seller's gift under the exhaustion test is $1,956,891.63 ($10,000,000.00 – $8,043,108.37).

Under Reg. §25.7520-3(b)(2)(i), the exhaustion test is passed if the assets in the IDIT have a value equal to the product obtained by multiplying the annuity amount by the Table B term certain annuity factor for a term equal to 110 years minus the annuitant's age. For an individual who is 75 years of age (an assumed term of 35 years), the factor is 24.9986 and an assumed §7520 interest rate of 2% for which the annuity is $1,048,382.87 per year, producing a value of $26,208,104.01 (24.9986 × $1,048,382.87). At an §7520 rate of 6% (for which the annuity is $1,368,887.92), the factor is 14.4982, producing a value of $19,846,410.84 (14.4982 × $1,368,887.92).

At an assumed §7520 rate of 2%, the $26,208,104.01 in value in the IDIT needed to avoid a gift under the exhaustion test is $16,208,104.01, or approximately 162%, in excess of the $10 million involved in the sale. At an assumed §7520 rate of 6%, the total $19,846,410.84 in value needed to avoid a gift under the exhaustion test is $9,846,410.84, or over 98%, in excess of the $10 million involved in the sale. These results are summarized in Table IV.

TABLE IV
ANNUITY FOR LIFE
COMPARISON OF GIFT UNDER EXHAUSTION TEST WITH AMOUNT NEEDED TO AVOID GIFT

Assumed §7520 Rate	Annuity Amount	Amount of Gift	Additional Amount Needed To Avoid Gift
2%	$1,048,382.87	$2,285,414.19	$16,208,104.01
6%	$1,368,887.92	$1,956,891.63	$9,846,410.84

F. Coping with Failing the Exhaustion Test

Table IV illustrates that the gift tax consequences of failing the exhaustion test are modest. On the other hand, the value required to avoid a gift is substantial. There are two factors operating to reduce the amount of the gift on failing the exhaustion test. The first factor is that the gift is based upon present values discounted for the passage of time. Exhaustion does not occur until sometime in the future, and the amount of the gift represents the present value of the future projected shortfall in annual annuity payments. The second factor is that when the shortfall occurs, many in the population in Table 2000CM who were alive at age 75 years have died, and the significance of deaths after that point is reduced. For example, of the 64,561 individuals which Table 2000CM shows alive at age 75, 34,471 are still alive 10 years later at age 85, or 53.4%. The impact of mortality is reduced by the time exhaustion occurs.

1. Risks of Accepting Results

Because the amount of a gift resulting from failing the exhaustion test is relatively small, the temptation might be simply to accept that result and report the gift under Reg. §25.7520-3(b)(2)(v) *Ex.* 5 on the seller's gift tax return. The gift would frequently be covered by the seller's unused gift and estate tax applicable exclusion amount. Even if the gift generates a gift tax, the amount of gift tax would be small compared to the potential estate tax savings that the transaction might ultimately produce. A problem with this tactic is that it increases risk under §2036(a)(1) and §2702.

Accepting the gift tax result under Example 5 of Reg. §25.7520-3(b)(2)(v) does not only produce a gift, it also eliminates any cushion of other assets designed to satisfy the second and third tests of *Fidelity-Philadelphia Trust Co.* described in II.B., above. Without a cushion that satisfies these tests, the sale is likely to be treated as a transfer with a retained interest under §2036(a)(1), causing the assets sold to the IDIT to be included in the seller's estate. As noted in II.B., above, if §2036(a)(1) applies, the sale is also likely to be treated as a transfer to a trust with a retained interest under §2702. If the annuity is valued at zero, the seller makes a gift of the full value of the as-

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sets transferred to the IDIT in the sale transaction. Simply accepting the consequences of Example 5 of Reg. §25.7520-3(b)(2)(v) does not appear to be an acceptable alternative.

2. Additional Gift by Seller

A gift by the seller of additional amounts to cover both the amounts needed to avoid the exhaustion test and to provide at least a 10% cushion is impractical. Even if the seller has sufficient assets to make such a gift, incurring a gift tax on a gift of the magnitude of the amounts appearing in Column 4 of Table IV and a further 10% cushion is unlikely to be acceptable.

3. Guarantee by Beneficiaries

The discussion in II.B., above points out that in a standard sale in exchange for an IDIT's promissory note, personal guarantees by beneficiaries are frequently used to provide the 10% cushion. As noted in that discussion, there is authority for the proposition that a guarantee in a standard sale does not constitute a gift unless and until a payment is made on the guarantee. It would seem to be difficult to come to the same conclusion if a life annuity rather than a standard promissory note is received in a sale to an IDIT transaction. With a standard sale, there is no equivalent to the exhaustion test. There is not the same potential for a shortfall in a sale for a standard promissory note as there is with a sale in exchange for an annuity for life. With a sale to an IDIT in exchange for a standard promissory note, it is possible to take the position that a guarantee is not a gift. With Reg. §25.7520-3(b)(2)(i) and Example 5 of Reg. §25.7520-3(b)(2)(v), assuming they are valid, there is no question about the gift. It would seem that the effect of a guarantee is not to eliminate the gift, but merely to shift the person treated as making the gift from the seller to the guarantor.

In addition to any guarantee that is used to avoid failing the exhaustion test, it would seem that there should also be at least a 10% cushion (i.e. 10% of the purchase price in the sale transaction) to satisfy the second and third tests under *Fidelity-Philadelphia Trust Co.* If this 10% cushion is afforded through the use of a guarantee, it should be possible for the guarantor to take the position on a gift tax return that the guarantee affording the 10% cushion does not constitute a gift under the authorities discussed in the materials referenced in note 23, above, even if the guarantor reports the guarantee given to avoid failing the exhaustion test as a gift.

As illustrated by Table IV, the amount of a gift resulting from failing the exhaustion test is modest. The gift tax consequences of a guarantee sufficient to avoid a gift by the seller under the exhaustion test might be acceptable to a beneficiary. If the IDIT is to be exempt from generation-skipping tax, steps should be taken to permit the guarantor to allocate sufficient GST exemption to reduce the inclusion ratio of the gift to zero. A point to be considered is that interests and powers conferred upon a guarantor who is a beneficiary of the IDIT might result in the gift being treated as a transfer with retained interests or powers causing inclusion in the beneficiary's estate under either or both of §2036 and §2038. If so, the interests and powers would result in ETIP under §2642(f), precluding allocation of the beneficiary's GST exemption to cover the gift. This result can be avoided with a provision in the instrument governing the IDIT that a beneficiary is not to possess any interest or power with respect to any assets or portion of the IDIT of which the beneficiary is transferor for federal estate and gift tax purposes.

Although a beneficiary's guarantee of the amount needed to avoid failing the exhaustion test likely constitutes a gift for federal gift tax purposes, it should not constitute a gratuitous transfer for purposes of the grantor trust rules under §671, et seq. Reg. §1.671-2(e)(2)(i) provides that a transfer may be considered a gratuitous transfer causing application of the grantor trust income tax rules "without regard to whether the transfer is treated as a gift for gift tax purposes." The purpose of the grantor trust income tax rules is to preclude grantors from utilizing trusts to shift income away from themselves. In the case of a guarantee, there is no transfer that has any possibility of shifting income. A beneficiary's guarantee should have no impact on the IDIT's status as a grantor trust taxable entirely to the seller.

4. Using a Guarantor Other Than a Beneficiary of the IDIT

It would seem possible to structure a guarantee so that it is given without gift tax consequences. An existing trust that is not includible in any individual's federal gross estate, if such a trust exists, might be a candidate as the guarantor. To be valid, any guarantee must be within the powers conferred upon the trustees of the existing trust. If there are beneficiaries of the existing trust who are also beneficiaries of the IDIT, the provisions of the existing trust governing distributions to beneficiaries may be broad enough to authorize the existing trust's guarantee. For example, provisions in the existing trust might authorize distributions directly or indirectly to or for the benefit of trust beneficiaries.

The provisions governing distributions from an existing trust may not be broad enough to permit that trust to effect a guarantee without compensation. Nevertheless, the provisions governing management and investment under most trust instruments should generally be broad enough to permit trustees to effect a guarantee in exchange for a fee.

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If an unrelated individual or a corporation, limited liability company or other entity that is owned by unrelated parties is willing to effect a guarantee in an arm's-length agreement in exchange for a fee, it should be possible to structure that guarantee so as to avoid a gift under the exhaustion test without adverse gift tax consequences to the guarantor or its owners. Reg. §25.2512-8 provides that any transaction that is bona fide, at arm's length and free from any donative intent is considered to be made for an adequate and full consideration in money or money's worth, and thus is not subject to gift tax. If Reg. §25.2512-8 applies, the adequacy of consideration received for the guarantee is not relevant. The guarantee simply does not constitute a gift.

VIII. LIMITING ANNUITY TO SHORTER OF LIFE OR A TERM OF YEARS

Although the gift tax consequences of a beneficiary's guarantee of an amount sufficient to avoid the exhaustion test may be manageable, there is a significant obstacle to the use of guarantees to avoid the exhaustion test. For a guarantee to be effective, the guarantor must have sufficient wherewithal to pay on the guarantee. As illustrated by Column 4 of Table IV, above, the amounts that must be available to avoid the exhaustion test are substantial. It may be a challenge to find a guarantor with sufficient resources to support a guarantee in a sale in exchange for an annuity for life.

A possible solution to this practical problem is to structure the annuity so that less value is needed to avoid a gift under the exhaustion test so that the resources required of the guarantor to support the guarantee are reduced. One method of achieving this reduction is to eliminate from the possible term of the annuity years that have little impact on the amount of the gift under the exhaustion test. As noted in VII.E., above, the inability to pay an annuity for the years in which the individual would be very elderly has little gift tax consequence because few of the original 100,000 persons in Table 2000CM live to advanced ages. The amount required to avoid a gift in a later year under the exhaustion test is much greater than the amount of the gift that results if the exhaustion test is not satisfied for that year. Eliminating these years from consideration has little impact upon the effectiveness of the transaction to reduce estate taxes, but has a substantial effect in reducing the amounts that must be made available to avoid failing the exhaustion test.

Elimination of later years can be achieved by structuring the term of the annuity to continue for the shorter of the seller's lifetime or a fixed term. Table V, below, illustrates the use of a number of different fixed terms under the hypothetical facts posed in the Example, i.e., a sale of assets having a fair market value of $10 million by an individual 75 years of age. The sale in Table V is for an annuity payable over the shorter of the seller's lifetime or a specified term of six years, 12 years, 15 years or 20 years. Table V assumes an §7520 rate of 2%. For comparative purposes, Table V also restates the amounts from Table IV for an annuity payable for life with no term of years limitation. Table VI, below, shows the results with the same hypothetical facts as Table V, but at an assumed §7520 rate of 6%.

TABLE V
ANNUITY FOR SHORTER OF LIFE OR TERM OF YEARS AT 2%
COMPARISON OF GIFT UNDER EXHAUSTION TEST
WITH AMOUNT NEEDED TO AVOID GIFT

Years	Annuity Factor	Annuity Amount	Gift Under Exhaustion Test	Additional Amount Needed To Avoid Gift
6	4.9171	$2,033,719.06	$1,061,912.71	$1,391,673.94
12	7.8444	$1,274,794.76	$1,812,920.86	$3,481,337.03
15	8.6576	$1,155,054.52	$2,036,790.49	$4,841,642.04
20	9.3237	$1,072,535.58	$2,224,702.05	$7,537,458.28
Life Annuity (No Term Limit)	9.5385	$1,048,382.87	$2,285,414.19	$16,208,104.01

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TABLE VI
ANNUITY FOR SHORTER OF LIFE OR TERM OF YEARS AT 6%
COMPARISON OF GIFT UNDER EXHAUSTION TEST
WITH AMOUNT NEEDED TO AVOID GIFT

Years	Annuity Factor	Annuity Amount	Gift Under Exhaustion Test	Additional Amount Needed To Avoid Gift
6	4.3405	$2,303,882.04	$1,013,884.22	$1,328,879.16
12	6.4007	$1,562,329.12	$1,644,165.87	$3,098,254.88
15	6.8774	$1,454,037.86	$1,804,910.69	$4,121,906.50
20	7.2166	$1,385,694.09	$1,926,894.92	$5,893,772.64
Life Annuity (No Term Limit)	7.3052	$1,368,887.92	$1,956,891.63	$9,846,410.84

Column 1 of Tables V and VI lists the number of years of the specified term. Column 2 is the special factor for calculating the value of an annuity payable for the shorter of the life of an individual 75 years of age or the specified number of years. The factor listed in Column 2 is calculated pursuant to the methodology outlined in Example 5 of Reg. §25.7520-3(b)(2)(v). Column 3 is the annuity amount which, based upon the factor in Column 2, produces an annuity having a present value of $10 million. This amount is determined by dividing $10 million by the factor listed in Column 2. Column 4 is the gift under the exhaustion test calculated in the manner prescribed by Example 5 of Reg. §25.7520-3(b)(2)(v). Column 5 represents the total amount needed to avoid a gift under the exhaustion test. In the case of a guarantee, Column 5 is the net worth that the guarantor must have at the time of the guarantee for the guarantee to be effective in order to avoid a gift under the exhaustion test.

Referring to Tables V and VI, the smallest gift is produced with a six-year maximum term. A six-year maximum term also produces the closest correlation between the gift under the exhaustion test and the amount needed to avoid that gift. With a six-year maximum term, however, the annuity amount payable to the seller becomes so large that the sale transaction is likely to produce little reduction in the value of the seller's estate.

Of the terms illustrated in Tables V and VI, the 20-year maximum term produces the smallest annuity amount payable to the seller. A maximum term of 20 years does not produce a significant reduction in the gift made under the exhaustion test as compared to the gift with an annuity for life with no maximum term. Tables V and VI both show, however, that a 20-year maximum term has a significant impact in reducing the amount needed to avoid a gift under the exhaustion test.

Frequently, placing a maximum term close to the seller's life expectancy will be viewed as a means of harmonizing the variables involved in a sale to an IDIT for an annuity. As previously noted, under Table 2000CM, an individual who is 75 years of age has a life expectancy of approximately 11 years. Tables V and VI show the results of a maximum term of 12 years and illustrate how a maximum term which is approximately equal to the seller's life expectancy seems to harmonize different considerations in an acceptable fashion. With an assumed §7520 rate of 2%, the annuity amount is $1,274,794.76, while the amount needed to avoid a gift under the exhaustion test is $3,481,337.03, or approximately 34.8% of the $10 million sold to the IDIT. If the seller dies on the fourth anniversary of the sale, the seller would have received annuity payments totaling $5,099,179.04, producing a reduction in the estate of $4,900,820.96 ($10 million − $5,099,179.04). With an assumed §7520 rate of 6%, the annuity amount is $1,562,329.12, while the amount needed to avoid a gift under the exhaustion test is $3,098,254.88. If the seller dies on the fourth anniversary of the sale, the seller will have received annuity payments totaling $6,249,316.48, producing a reduction in the estate of $3,750,683.52 ($10 million − $6,249,316.48).

As the §7520 rate increases, the size of the annuity payments becomes an increasingly important consideration. At a 6% §7520 rate, the amount of the annuity is much greater than at the 2% rate. Because of these larger payments, the results at a 6% §7520 rate are not as beneficial as with an §7520 rate of 2%. Although the amount of the annuity payments increases as the §7520 rate increases, the amount needed to avoid a gift under the exhaustion test decreases. As a result, in structuring the annuity sale, the practitioner may wish to provide for a longer term when the annuity transaction is effected in periods of higher interest rates (e.g., 6%) as opposed to a sale when the §7520 rate is lower (e.g., 2%). The figures appearing in Table VI for a maximum term of 15 years illustrate this point. These figures might be compared to the figures in Table V for a sale for the maximum term of 12 years.

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If a seller satisfies the 50% survivorship test of Reg. §25.7520-3(b)(3), it is the exhaustion test that produces the greatest problems in successfully effecting a sale to an IDIT in exchange for an annuity. Each situation in which a sale to an IDIT for an annuity might be considered presents its own set of facts. It is not possible to devise a uniform structure which fits all situations. It would seem, however, that placing some upward limit on the term of the annuity payments is almost certainly to be preferred over an annuity for life with no maximum term. In the vast majority of cases with an annuity for life with no maximum term, it would seem that the amounts needed to avoid a gift under the exhaustion test are simply not available. In most cases, the amounts available to avoid a gift under the exhaustion test are limited. Frequently, the amounts available to avoid a gift under the exhaustion test will impact what maximum term is selected.[34]

IX. END-LOADING ANNUITY PAYMENTS

A grantor retained annuity trust (GRAT) is an irrevocable trust from which the grantor reserves the right to receive payments for a specified period of time. At the end of the specified period, assets in the GRAT pass to other beneficiaries. The payments to the grantor are designed to qualify under §2702(b)(1) and reduce the value of the gift made on establishing the GRAT.

Section 2702(b)(1) includes in the definition of ''qualified interest'' any interest that consists of the right to receive fixed amounts payable not less frequently than annually. In construing §2702(b), Reg. §25.2702-3(b)(1)(ii)(A) does not require the same amount to be paid annually, but rather permits payments to increase 120% each year during the term of the GRAT.

Reg. §25.2702-2(b)(2) provides that the value of a qualified retained interest under §2702 is to be determined under §7520. A GRAT ''works'' if the assets transferred to the GRAT produce a net return (net income plus appreciation) in excess of the interest rate under §7520 used to value the grantor's retained interest. The excess net return is retained in the GRAT and eliminated from the grantor's estate. The 120% rule of Reg. §25.2702-3(b)(1)(ii) permits payments to the grantor to be slowed, or end-loaded. If the assets of the GRAT are producing a net return in excess of the applicable §7520 interest rate, end-loading results in the retention of assets in the GRAT for a longer period of time and the elimination of greater value from the grantor's estate.

Because Reg. §25.2702-2(b)(2) provides that the value of a qualified retained interest under §2702 is to be determined under §7520, the 120% end-loading payment schedule authorized under Reg. §25.2702-3(b)(1)(ii) constitutes an interest to which the valuation rules of §7520 apply. The 50% probability of survivorship test is one of the valuation rules of §7520. If a 120% end-loading payment schedule is conditioned upon an individual's continued survivorship, the 50% probability of survivorship test should apply to the valuation of payments under that schedule. The IRS should not be able to assert that the 120% end-loading payment schedule is not an annuity to which §7520 applies. See the discussion in XII., below.

In addition to the benefits of end-loading with GRATs directly above, there is an additional potential benefit of end-loading annuity payments received in a sale to an IDIT. If the seller dies early in the time specified for the payments, the end-loaded payments are never made, resulting in additional value being excluded from the seller's estate. Table VII illustrates this point under the hypothetical facts posed in the Example, i.e. a sale to an IDIT of assets having a fair market value of $10 million by an individual 75 years of age. The purchase price in Table VII is the right to receive annual payments payable over the shorter of seller's lifetime or a term of 12 years. Payments qualify under the 120% rule of Reg. §25.2702-3(b)(1)(ii). The schedule of payments under Table VII has a present value of $10 million at an §7520 interest rate of 2%. Table VIII shows the results with the same hypothetical facts as Table VII, but at an assumed §7520 interest rate of 6%.

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[34] See XII.C., below, for a discussion of the possible use by the IRS of Reg. §1.1275-(f) to assert that an annuity for the shorter of life or term of years is not an annuity to which the 50% probability of survivorship test of Reg. §25.7520-3(b)(3) applies.

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TABLE VII
120% ANNUITY PAYMENTS FOR SHORTER OF LIFE OR TERM OF YEARS AT 2%

Year	Required Payment		
1	$465,075.00	Gift Under Exhaustion Test =	$2,721,726.65
2	$558,090.00		
3	$669,708.00	Gift Under Table V (12 years) =	$1,812,920.86
4	$803,649.00		
5	$964,378.00	Additional Amount Needed to	
6	$1,157,253.00	Avoid Gift =	$6,995,000.00
7	$1,388,703.00		(approximate)
8	$1,666,443.00		
9	$1,999,731.00	Additional Amount Under	
10	$2,399,677.00	Table V (12 years) Needed	
11	$2,879,612.00	To Avoid Gift	$3,481,337.03
12	$3,455,534.00		
Total	$18,407,853.00		

TABLE VIII
120% ANNUITY PAYMENTS FOR SHORTER OF LIFE OR TERM OF YEARS AT 6%

Year	Required Payment		
1	$617,049.00	Gift Under Exhaustion Test =	$2,527,180.63
2	$740,458.00		
3	$888,549.00	Gift Under Table VI (12 years) =	$1,644,165.87
4	$1,066,258.00		
5	$1,279,509.00	Additional Amount Needed to	
6	$1,535,410.00	Avoid Gift =	$9,900,000.00
7	$1,842,492.00		(approximate)
8	$2,210,990.00		
9	$2,653,188.00	Additional Amount Under	
10	$3,183,825.00	Table VI (12 years) Needed	
11	$3,820,590.00	To Avoid Gift	$3,098,254.88
12	$4,584,708.00		
Total	$24,423,026.00.00		

In addition to itemizing the payments to be made under the 120% rule, Tables VII and VIII show the gift resulting from the gift under the exhaustion test and the additional amount needed to avoid a gift under the exhaustion test at §7520 rates of 2% and 6%, respectively. For comparative purposes, Tables VII and VIII also repeat these amounts for a period of 12 years from Tables V and VI.

The Gift Under Exhaustion Test is significantly greater in Tables VII and VIII than in Tables V and VI. The Additional Amount Needed to Avoid Gift is also significantly greater in Tables VII and VIII as compared to Tables V and VI. On the other hand, the amounts initially received as an annuity payment under Tables VII and VIII are significantly less than the initial annuity payments under Tables V and VI. It is not until the 7th year that the amount distributed for a year under Table VII ($1,388,703.00) exceeds the annual annuity under Table V ($1,274,794.76), and that the amount distributed for a year in Table VIII ($1,842,492.00) exceeds the annual annuity for 12 years under Table VI ($1,562,329.12).

If the seller receiving annuity payments pursuant to the schedule set forth in Table VII (at an assumed §7520 rate of 2%) dies on the fourth anniversary of the sale, such seller will have received a total of $2,496,522 in payments. This total is $2,602,657.04 less than the $5,099,174.09 received by the seller in Table V receiving annual payments for the shorter of the seller's lifetime or 12 years who dies on the fourth

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anniversary of the sale. Thus, payment under the schedule set forth in Table VII produces an additional $2,602,657.04 reduction in the value of the seller's estate. If the seller receiving annuity payments pursuant to the schedule set forth in Table VIII (at an assumed §7520 rate of 6%) dies on the fourth anniversary of the sale, such seller will have received a total of $3,312,314 in payments. This total is $2,937,002.48 less than the $6,249,316.48 received by the seller in Table VI receiving annual payments for the shorter of seller's lifetime or 12 years who dies on the fourth anniversary of the sale. Payment under the schedule set forth in Table VIII produces an additional $2,937,002.48 reduction in the value of the seller's estate. The results described in this paragraph are summarized in Table IX.

TABLE IX
ANNUITY FOR SHORTER OF LIFE OR 12 YEARS;
DEATH ON THE 4TH ANNIVERSARY OF SALE

§7520 Rate	Annuity Payment	Total Received; Table VII or VIII	Reduction in Total Payments Received
2%	$5,099,179.04 (4 × $1,274,794.76)	$2,496,522.00	$2,602,657.04
6%	$6,249,316.48 (4 × $1,562,329.12)	$3,312,314.00	$2,937,002.48

If the seller lives for the full 12 year period, total payments received under Table V would be $15,297,537.12 ($1,274,794.76 × 12), or $3,110,315.88 less than the total payments shown under Table VII ($18,407,853.00). With an §7520 rate of 6% under Table VI, the total payments received over the 12 year period would be $18,747,949.44 ($1,562,329.12 × 12), or $5,675,076.56 less than the total payments shown under Table VIII ($24,423,026.00). Under the assumed facts of Tables VII and VIII, a 120% end-loading schedule should likely not be used unless death within 8 or 9 years, at most, is a virtual certainty. As the seller's age increases, the room for error in estimating longevity decreases.

X. ANOTHER INDIVIDUAL AS MEASURING LIFE

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 that is based upon the life of the spouse who is ill. There is nothing in §7520 or the regulations thereunder or in any other authority that indicates that it is impermissible for one spouse to effect a sale to an IDIT in exchange for an annuity that 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 §170, §2055 or §2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.[35] 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 a life 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 a life annuity. Indeed, there does not appear to be any regulation or other promulgated IRS authority that 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.

XI. 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

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

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health deteriorates after the original sale and 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.[36]

It would seem that a promissory note could be exchanged for an annuity without unfavorable transfer tax consequences. The exchange would not constitute a gift by the seller so long as the annuity received for the promissory note had a value under §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 Reg. §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 §7520 rate for the month in which the exchange occurs.

Following the rationale of the discussion in IX., above, 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.

XII. USE OF A SELF-CANCELING INSTALLMENT NOTE (SCIN) — THE *DAVIDSON* CASE

The Self-Cancelling Installment Note, or SCIN, is another device that might be used when the seller's life expectancy is shortened by illness. A SCIN generally takes the form of an ordinary installment note that provides for periodic payments at specified intervals, e.g., annually, semi-annually, quarterly or even monthly. Unlike an ordinary installment note that 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 that is canceled at the seller's death is not included in the seller's gross estate.[37] 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. The issuance of CCA 201330033 and the arguments made by the IRS in the case of *Estate of Davidson v. Commissioner* [38] raise the question as to whether the annuity for life should be preferred over the SCIN. Specifically, the question is whether the 50% test of Reg. §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.

A. Use of Tables Under §7520 for a Sale Governed by §7872

Section 7520(b) provides that §7520 is not to apply for purposes of part I of subchapter D of chapter 1 or any other provision specified in regulations. Reg. §25.7520-3(a)(7) provides that §7520 does not apply for purposes of §7872.[39]

The extent to which Reg. §25.7520-3(a)(7) precludes application of §7520 to §7872 is not clear. It may be that the intent of Reg. §25.7520-3(a)(7) is only to emphasize that the interest rate under §7520 is not to apply to §7872 transactions, and that Reg. §25.7520-3(a)(7) does not preclude use of the actuarial tables under §7520 to sales in which the interest rate is determined under §7872. However, the language of Reg. §25.7520-3(a)(7) is not so limited. Reg. §25.7520-3(a)(7) can be construed as making the actuarial tables under §7520 and the 50% test of Reg. §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 §7872. An advantage to the 50% test under Reg. §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 §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 Reg. §25.7520-3(a)(7), it would seem that the interest rate prescribed by §7520 should be used with a SCIN in a case in which the 50% test of Reg. §25.7520-3(b)(2)(i) is important. The SCINs in *Davidson*, discussed below, bore interest at the §7520 rate.

The IRS's official position appears to be that even if an interest rate under §7520 is used, §7520 does not

[36] Jonathan G. Blattmachr, Bridget J. Crawford and Elisabeth O. 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); Carol A. Harrington, *Question and Answer Session*, 38th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1216 (2004); Diana S.C. Zeydel, *Estate Planning in a Low Interest Rate Environment*, 36 Est. Plan. No. 7, 17 (2009).

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

[38] Docket No. 13748-13 (T.C. filed June 14, 2013).

[39] *See also* Reg. §1.7520-3(a)(7) and §20.7520-3(a)(7).

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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.[40]

B. *Davidson* and CCA 201330033

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 §7520, the decedent's life expectancy was 5.8 years at the time of the transaction. The decedent's physician wrote a letter on Oct. 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 of $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 §7520 can be applied to an SCIN. This uncertainty is frequently of critical importance. If the tables apply, an estate need only demonstrate that an individual has 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 Reg. §25.7520-3(b)(3). If the tables do not apply, this conclusive presumption is not available, and the individual's actual life expectancy is used. If an individual is ill at the time of the sale, use of the individual's actual life expectancy could significantly reduce the value of the SCIN and result in a substantial gift.

Since the payments for a life 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 Reg. §25.7520-3(b)(3), it would seem that practitioners contemplating sale transactions terminating at death should choose a life annuity over a SCIN, at least until the law on this issue is clarified.

C. Reg. §1.1275-1(j) and Use of Actuarial Tables Under §7520 in Valuing Annuity for Shorter of Life or a Term of Years

In a recent article, fellow practitioners state that Reg. §1.1275-1(j) supports the IRS's position in *Davidson* and CCA 201330033 that the actuarial tables under §7520 do not apply to a SCIN.[41] The purpose of Reg. §1.1275-1(j) is to define an "annuity" that is not considered to be a debt instrument subject to the OID rules.[42] While not specifically addressing the issue, the discussion in the article evidences its authors' belief that the IRS could also use Reg. §1.1275-1(j) to

[40] See CCA 201330033, which was issued in connection with the *Davidson* case.

[41] Kenneth J. Crotty, Jerome M. Hesch, Edward P. Wojnaroski, Jr., and Alan S. Gassman, *IRS Position Puts More Skin in the Game of Using SCINs*, 41 Est. Plan. No. 1, 3 (Jan. 2014).

[42] Reg. §1.1275-1(j) provides as follows:

> **(j) Life annuity exception under section 1275(a)(1)(B)(i).**
>
> (1) *Purpose*. Section 1275(a)(1)(B)(i) excepts an annuity contract from the definition of debt instrument if section 72 applies to the contract and the contract depends (in whole or in substantial part) on the life expectancy of one or more individuals. This paragraph (j) provides rules to ensure that an annuity contract qualifies for the exception in section 1275(a)(1)(B)(i) only

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assert that §7520 does not apply to an annuity payable for the shorter of life or a term of years. The argument would be that the term of years prevents distributions from increasing commensurately with the longevity of the annuitant. For at least two reasons, the IRS should not be able to use Reg. §1.1275-1(j) in this fashion.

First, as noted above, Reg. §1.1275-1(j) expressly states its purpose. That purpose does not include what qualifies or does not qualify under §7520. Secondly, IRS Publication 1457, *Actuarial Values, Version 3A* (5-2009), which contains examples illustrating the use of the actuarial tables under §7520, includes as examples the use of the tables to determine factors for life and a term of years. It is difficult to see how the IRS could successfully argue that §7520 does not apply to value an annuity payable for the shorter or life or a term of years when its own publication illustrates the use of the tables under §7520 for such an annuity.

XIII. CONCLUSION

Even if an individual is ill, the 50% probability of survivorship test is frequently not an impediment to a sale to an IDIT in exchange for annuity payments conditioned upon the individual's survivorship. If an individual satisfies the 50% probability of survivorship test, the IRS is bound to accept use of Table 2000CM in determining the individual's actual life expectancy even if the individual's actual life expectancy is significantly shorter than predicted by that table.

Unlike the 50% probability of survivorship test, the exhaustion test represents a true obstacle to such a sale. This article has examined the exhaustion test and the problems it creates, and has suggested an annuity term of the shorter of the seller's life or a stated number of years as a means of addressing those problems. The article has suggested situations in which the sale technique might be considered. It has also suggested the use of an annuity rather than a SCIN so long as the IRS continues to maintain its position that the 50% probability of survivorship test does not apply to SCINs.

Paraphrasing the Cooper article cited in note 6, above, the sale to an IDIT in exchange for an annuity conditioned upon an individual's survivorship is currently not the most talked about topic in estate planning. It should also not be the least frequently used estate planning strategy.

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in cases where the life contingency under the contract is real and significant.

(2) *General rule*.

(i) Rule. For purposes of section 1275(a)(1)(B)(i), an annuity contract depends (in whole or in substantial part) on the life expectancy of one or more individuals only if—

(A) The contract provides for periodic distributions made no less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and

(B) The contract does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

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