

## VALUE SHIFTING TECHNIQUES

### I. FLP UPDATE

As most of you are probably aware, the Fifth Circuit ruled in favor of the taxpayer in, *Kimbell v. United States*, 93 AFTR 2d 2004-2400 (CA-5, 2004), *vac'g and rem'g* 244 F.Supp. 2d 700, 91 AFTR 2d 2003-585 (DC Tex., 2003). The Fifth Circuit adopted that two-part test used by the District Court in determining whether the bona fide sale exception to Section 2036(a) applied:

- 1) was the transaction a bona fide sale?
- 3) was there adequate and full consideration?

In addressing these questions, the Fifth Circuit turned to its prior decision in *Wheeler v. United States*, 116 F.3d 749 (5<sup>th</sup> Cir. 1997) for guidance. In addressing the question of “full and adequate consideration” the Court in *Wheeler* held that full and adequate consideration is received if the sale does not deplete the gross estate of the transferor. *Wheeler* also makes it clear that the inquiry into what is full and adequate consideration should be an objective inquiry and that a transaction between family members is to be analyzed in a similar manner as that between unrelated third parties.

In *Kimbell*, the Fifth Circuit set forth a three part test for defining full and adequate consideration in the transfer of assets in exchange for a partnership interest:

- (1) whether the interests credited to each of the partners was proportionate to the fair market value of the assets each partner contributed to the partnership;
- (2) whether the assets contributed by each partner to the partnership were properly credited to the respective capital accounts of the partners; and
- (3) whether on termination or dissolution of the partnership, the partners were entitled to distributions from the partnership in amounts equal to their respective capital accounts.

If a taxpayer has received full and adequate consideration for a transfer of property, then the inquiry turns to whether or not the transaction was bona fide. In *Wheeler*, the Fifth Circuit agreed with the assertion by the IRS that an intra-family transaction should take on heightened scrutiny and that the substance of a transaction between family members should be analyzed as well as its form; however, the Fifth Circuit was not willing to require that a transaction between family members satisfy some additional criteria not contained in Section 2036(a) in order to be bona fide.

In *Kimbell*, the Fifth Circuit then reviewed a number of factors which were unchallenged by the IRS which indicate that the transaction was bona fide:

- The Decedent retained sufficient assets outside of the partnership to meet living expenses;
- There was no commingling of the decedent's assets with those of the partnership;

- The partnership formalities were followed;
- The assets were actually assigned to the partnership;
- The assets contributed to the partnership included working interests in oil and gas properties which required active management;
- The Decedent's estate advanced several credible non-tax business reasons as to why the partnership was formed which could not be accomplished with the decedent's trust, which included asset protection, preservation of capital, reduction of administrative costs, preservation of character of property as separate property for descendants, succession for management of assets in event of death of son, mandatory arbitration of disputes.

## II. GRANTOR RETAINED ANNUITY TRUST

**A. Requirements.** A Grantor Retained Annuity Trust (“GRAT”) is a trust designed to comply with the requirements of Code § 2702.<sup>1</sup> § 2702 provides that for purposes of determining whether or not a transfer in trust for the benefit of one or more members of the grantor's family is a gift, the value of the interest retained by the grantor will be valued at zero unless the interest is a qualified interest.

1. Payments to the grantor must be made at least annually. § 2702(b)(1).
2. The payments must be either a fixed amount (annuity) or a fixed percentage of the fair market value of the assets transferred to the GRAT at the date of transfer (unitrust). Treas. Reg. § 25.2702-3(b)(1)(ii).
3. Payments from one year to the next may not increase by more than 20%. Treas. Reg. § 25.2702-3(e), Example 2.
4. The trust agreement must prohibit additional contributions from being made to the trust. Treas. Reg. § 25.2702-3(b)(4).
5. The trust agreement must prohibit commutation of the interest of the grantor.

**B. Gift Tax Implications.** Assuming that the § 2702 requirements are satisfied, then the annuity or unitrust interest retained by the grantor will be a qualified income interest. The value of the remainder interest will be treated as a taxable gift from the grantor to the remainder beneficiaries of the GRAT. The amount of the taxable gift is affected by the following factors:

1. Term of the GRAT. The longer the term of the GRAT, the lower the value of the remainder interest.

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<sup>1</sup>All references to Code refer to the Internal Revenue Code of 1986, as amended, unless otherwise indicated in the text.

2. § 7520 Rate. The higher the § 7520 rate, the higher the value of the remainder interest. (The § 7520 rate for October 2004 is 4.4%).

3. Annuity or Unitrust Amount. The higher the annuity or unitrust amount paid to the grantor each year, the lower the value of the remainder interest.

**C. Zeroed Out GRAT.** The Tax Court decision in *Walton v. Commissioner*, 115 TC 589 (2000) now effectively allows a taxpayer to “zero-out” a GRAT - meaning that the remainder interest would be valued zero or slightly in excess of zero depending upon the manipulation of the factors discussed in Section B above. Obviously, the grantor cannot adjust the § 7520 rate, so the grantor will have to manipulate the term of the GRAT and the payout amount in order to effectively zero out the GRAT.

**D. GST Implications.** The grantor cannot allocate any of his or her GST exemption to the remainder interest in the GRAT until the GRAT term ends because of the estate tax inclusion period. Prop. Treas. Reg. § 26.2632-1(c)(3)(ii).

**E. Ideal Assets.** The ideal assets to be used for a GRAT are those with significant appreciation potential.

1. Single Stock. Particularly effective is the creation of a GRAT with a single stock, since a diversified portfolio will likely not have the significant appreciation potential of a single stock. Since a GRAT can be designed to zero out the value of the remainder interest, the grantor will not “waste” lifetime gift tax exemption by allocating to a transfer in which the assets decline in value or fail to grow at a rate in excess of the § 7520 rate. Thus, a grantor could create a series of zeroed out GRATs which are each funded with a single stock. The GRATs in which the stock appreciates in excess of the § 7520 rate will have achieved the goal of transferring value from the grantor’s estate with little or no transfer tax cost. From a transfer tax perspective, the grantor will not suffer because of the GRATs which have stocks which decline in value or fail to grow in excess of the § 7520 rate. The grantor’s only loss will be the professional fees associated with the creation of the GRAT.

2. Grant of Option to Acquire Stock. One idea is for the grantor to transfer an option to acquire stock which the grantor owns to a GRAT. The option should be written so that there can be a cash settlement upon exercise of the option. If the underlying stock increases in value, then the trustee of the GRAT will choose to exercise the option.

3. Substitution of Low Basis Assets. If a grantor has established a GRAT with low basis assets, the grantor can retain the right in the GRAT to substitute assets of equal value. Thus, a grantor can transfer cash or other high basis assets to a GRAT before the expiration of the term so that the low basis assets might be included in the grantor’s taxable estate which will provide for a basis step up at the grantor’s death.

## **F. Risks of GRAT**

1. Death of Grantor during term of GRAT. If the Grantor dies during the term of the GRAT, then either the fair market value of the assets in the trust will be included in the Grantor's taxable estate under § 2036, or possibly the value of the assets in the GRAT necessary to produce sufficient income under § 2039.

## **III. SALE OF ASSETS TO INTENTIONALLY DEFECTIVE GRANTOR TRUST**

**A. General.** The sale of assets to an intentionally defective grantor trust ("IDGT") is another value shifting technique. Unlike the GRAT, the transfer tax implications of a sale of assets to an IDGT are not explicitly addressed in the Code. Rather, the sale of assets to an IDGT exploits the difference in the characterization of trusts for income tax purposes and transfer tax purposes. A grantor establishes a trust which is designed to be treated as a grantor trust for income tax purposes because of the application of the one or more of §§ 671 - 678. The trust is also designed so that the grantor is not treated as retaining any interest in the trust which would cause inclusion in the grantor's taxable estate.

**B. Grantor Trust.** The following are some methods to design the IDGT so that the grantor will be treated as the owner for income tax purposes:

1. Spouse as Beneficiary. If the IDGT provides that the spouse is a permissible beneficiary of income and principal, then the IDGT should be treated as a grantor trust in its entirety. § 677(a)(1) and (2).

2. Power of Grantor to Borrow from IDGT. If the IDGT provides that a grantor can borrow from the IDGT without providing adequate security for the loan, the IDGT will be treated as a grantor trust. § 675(2).

3. Actual Loan from IDGT to Grantor. If the IDGT makes a loan to the grantor or the grantor's spouse and the loan is not adequately collateralized, or in the case of a loan to the grantor's spouse, then loan does not require provide for adequate interest, the IDGT will be treated as a grantor trust. § 675(3).

4. Payment of Insurance Premiums. If the principal and income of the IDGT can be used to pay life insurance premiums on the life of the grantor or his spouse, then the IDT should be treated as a grantor trust. Code Section 677(a)(3). The IRS has gone back and forth on the issue of whether just the ability of the trustee to use trust income to make life insurance premium payments on the life of the grantor is sufficient to cause the IDGT to be treated as a grantor trust, or whether actual use of the trust income to make such payments is necessary.

5. Substitution of Trust Assets. The ability of the grantor to substitute assets of the IDGT for assets of equal value will cause the IDGT to be treated as a grantor trust if such power is exercisable in a non-fiduciary capacity without the approval or consent of someone in a fiduciary capacity. § 675(4)(C). The IRS has refused to rule on the question of whether a power can be

exercised in a non-fiduciary capacity on the grounds that it is a question of fact. PLRs 9437022, 9524032, 9642039, and 9713017.

6. **Power to Spray Principal and Income.** If a majority of the trustees of the IDGT are related or subordinate to the trustee and if the trustees have the ability to make discretionary distributions of principal and income, then the IDGT will be treated as a grantor trust. § 674(c).

7. **Power to Add Beneficiaries.** If a nonadverse party has the power to add beneficiaries to the IDGT, the IDGT will be treated as grantor trust. § 674.

**C. Gift of Seed Money.** The grantor will gift cash to the trust which will be used by the trustee to purchase assets from the grantor. There is no magic amount which the grantor must transfer to the trust. Most literature addressing this point recommend that the grantor make a gift of cash equal to 10% of the total purchase price which provides for a 90% to 10% debt to equity ratio. One attack made by the IRS on the sale of assets to an IDGT is that the sale is not commercially reasonable by claiming that the equity is too low. A larger gift from the grantor can lessen the likelihood of challenge by the IRS, although the leveraging of the lifetime gift tax exemption is not as effective with a higher cash gift.

**D. Sale of Assets.** The grantor will then sell assets to the trustee of the IDGT in exchange for the gift of cash as well as a promissory note.

**E. Promissory Note.** The promissory note should be for a term of years and should bear interest at a rate in excess of relevant applicable federal rate. The note can be structured to provide for payments of “interest-only” during the term, with a balloon payment of principal at the end of the term of the note. The benefit of structuring the note with a balloon payment is that it maximizes the asset base in the IDGT which will allow for a greater shift of appreciation out of the grantor’s estate.

**F. Risks.**

1. **Sale will not be respected.** The IRS may attempt to assert that the sale should not be respected because it does not have commercially reasonable terms. The beneficiaries of the IDGT may wish to personally guarantee payments by the IDGT to the grantor in order to increase the likelihood that the sale will be respected.

2. **Undervaluation of Assets.** If hard to value assets are sold to the IDGT and the IRS successfully argues that the assets were worth more than the sales price, then the grantor may owe gift tax if the grantor has fully utilized the lifetime gift exemption. One way to mitigate this risk is to use a valuation adjustment clause in the sale documentation which will comply with the holding in *McCord v. Commissioner*, 120 T.C. No. 13 (2003).

3. **Death of Grantor During Term of Note.** Unlike the GRAT, if the grantor dies while the note is outstanding, the assets sold to the IDGT will not be brought back into the grantor’s

taxable estate under either §§ 2036 or 2039. Rather the value of the note will be includible in the grantor's taxable estate under § 2033. However, the IRS will likely assert that the death of the grantor triggers the grantor trust status of the IDGT at the moment of death and that the grantor must recognize income to the extent that the fair market value of the note exceeds the taxpayer's income tax basis in the assets sold to the IDGT.

#### **IV. LOCKING IN INCREASE IN GST EXEMPTION**

**A. GST Exemption.** The lifetime gift tax exemption amount is currently fixed at \$1,000,000 with no increase currently contemplated under existing law. The generation-skipping tax exemption is currently at \$1,500,000 and is scheduled to increase to \$2,000,000 in 2006 and further increase to \$3,500,000 in 2009. However, the GST exemption is set to return to \$1,000,000 in 2011 (indexed for inflation) without any Congressional intervention.

For wealthy clients, the increase in the GST exemption is a welcome opportunity to shift additional wealth to younger generation family members. However, for clients who have already used their lifetime gift exemption of \$1,000,000 making full use of the current \$1,500,000 GST exemption by making a gift to a GST exempt trust would result in the imposition of \$200,000 of gift tax which is likely not palatable to most clients.

**B. Inter vivos QTIP Trust.** A client could make a lifetime gift of \$1,500,000 (or remaining GST exemption if the client has already made such an allocation) to a trust for the benefit of the client's spouse which is designed to be a qualified terminal interest property ("QTIP") under § 2056. No gift tax will be due on the transfer because of the unlimited marital deduction for gifts between spouses. However, on the United States Gift and Generation Skipping Tax Return (Form 709) an election should be made to treat the trust as a QTIP Trust. In addition, the "reverse QTIP election" should be made for GST purposes so that the donor spouse is treated as the transferor for GST purposes. As the GST exemption increases in 2006 and again in 2009, additional gifts can be made.

**C. Discounted Assets.** An excellent way to further take advantage of the opportunity is to use FLP units to fund the inter vivos QTIP Trust.

**D. Reciprocal Trust Doctrine.** If each spouse wants to create an inter vivos QTIP Trust for the other, care should be taken to avoid the application of the reciprocal trust doctrine.

#### **V. CHARITABLE LEAD ANNUITY TRUST**

**A. Structure.** A charitable lead annuity trust ("CLAT") potentially provides a way for a client with charitable desires to benefit a charity while at the same time shifting assets to children with little or no transfer tax cost. A CLAT is structured so that the grantor transfers property to a trust which will make an annual payment to one or more charitable organizations for a number of years. At the end of the term of the CLAT, the remaining assets can pass to the grantor's descendants.

**B. Gift Tax Implications.** The trustor is deemed to make a taxable gift equal to the present value of the remainder interest passing to the trustor's descendants. The same factors which influence the value of the taxable gift in the creation of the GRAT determine the value of the taxable gift associated with the CLAT.

1. Term of the CLAT. The longer the term of the CLAT, the lower the value of the remainder interest.

2. § 7520 Rate. The higher the § 7520 rate, the higher the value of the remainder interest. (The § 7520 rate for October 2004 is 4.4%).

3. Annuity or Unitrust Amount. The higher the annuity amount paid to the charities each year, the lower the value of the remainder interest.

**C. Income Tax Implications.** The income tax effects of the CLAT depend upon whether the grantor chooses to treat the CLAT as either a grantor or non-grantor trust for income tax purposes.

1. Grantor Trust. If the CLAT is structured as a grantor trust, the grantor will receive a charitable deduction for income tax purposes when the CLAT is created, but the grantor must recognize taxable income each year to the extent that it is generated by the CLAT.

2. Nongrantor Trust. If the CLAT is structured as a nongrantor trust, the grantor does not receive a charitable deduction when the CLAT is created, but the grantor does not have to recognize taxable income each year as it is generated by the CLAT.

## **VI. QUALIFIED PERSONAL RESIDENCE TRUST**

A properly designed qualified personal residence trust ("QPRT") allows a client to transfer a residence to a trust and retain the right to use the residence for a term set forth in the trust agreement. At the end of the term the residence will pass to the client's descendants. The creation of the QPRT will result in a taxable gift equal to the present value of the remainder interest which will pass to the client's descendants. Factors affecting the value of the taxable gift:

1. Value of Residence. The greater the value of the residence, the greater the value of the remainder interest and the greater the taxable gift.

2. Term of the QPRT. The longer the term of the QPRT, the lower the value of the remainder interest and the taxable gift.

3. § 7520 Rate. The higher the § 7520 rate, the *lower* the value of the remainder interest and the taxable gift. (The § 7520 rate for October 2004 is 4.4%).

## PLANNING WHEN DEATH IS NEAR

### I. SALE OF ASSETS IN EXCHANGE FOR PRIVATE ANNUITY

**A. Description.** In this transaction the seller sells assets to the buyer in exchange for the buyer's promise to provide a stream of payments to the seller which will terminate upon the seller's death. As long as the seller has a more than 50% chance of living more than one year, then the IRS mortality tables and the § 7520 rate in effect at the time of the sale can be used to compute the annual payment required by the annuity. Treas. Reg. § 1.7520-3(b)(3). Death is presumed to not be "clearly imminent" if the seller lives for at least 18 months after the sale, unless there is clear and convincing evidence to the contrary.

**B. Transfer Tax Consequences.** Provided that the seller can satisfy the health requirements of § 7520 and the annuity payments are computed in accordance with the tables provided thereunder, there should be no taxable gift. Furthermore, since the annuity payments terminate upon the death of the seller, the annuity has no value for purposes of computing the seller's gross estate. § 2039.

**C. Income Tax Consequences.** The seller will have to recognize some amount of income each year depending on the seller's income tax basis in the property sold and the sales price computed using the § 7520 tables. The purchaser's income tax basis in the property purchased is equal to the amount paid.

### II. SALE OF ASSETS IN EXCHANGE FOR A SELF-CANCELLING INSTALLMENT NOTE

**A. Description.** Similar to the sale of assets in exchange for a private annuity, a sale of assets in exchange for a self-cancelling installment note ("SCIN") involves the seller receiving a debt obligation which will terminate upon the death of the seller-debt instrument holder, with any remaining balance payable by the purchaser-debtor automatically cancelling. In order to compensate the seller for the risk of cancellation, the SCIN must have a risk premium which can be in the form of a higher interest rate or a higher sale price.

**B. Transfer Tax Consequences.** There should be no gift upon the sale of the assets in exchange for the SCIN provided that the interest rate or principal is adjusted to compensate the seller for the self-cancelling feature. Since the note cancels upon the death of the seller, the note has no value for purposes of computing the seller's gross estate. The use of a SCIN was recognized as a bona fide sale by the Sixth Circuit in *Costanza v. Commissioner*, 320 F.3d 595 (CA-6, 2003), *rev'g* TCM 2001-128. The Sixth Circuit Court of Appeals held that a sale utilizing a SCIN was a bona fide sale of property; however, the Sixth Circuit remanded the case back to the Tax Court to determine if any portion of the SCIN was a "bargain sale" and therefore partially a taxable gift.

**C. Income Tax Consequences.** The seller will recognize income each year depending upon how much of each payment is attributable to interest as well as the seller's income tax basis



in the property sold. The buyer will take an income tax basis in the property equal to the sales price and will receive an income tax deduction equal to the interest paid year, which may or may not be deductible depending on whether or not the buyer has investment income.

**D. Planning Opportunities - SCINS and Private Annuities**

Both SCINS and private annuities present excellent estate tax reduction strategies in this low interest rate environment.

From the perspective of the senior generation family member, a private annuity may be preferable if he or she needs the income stream from the sale to provide retirement income. The private annuity will continue for the life of the senior generation family member even though he or she outlives their actuarially determined life expectancy.

A SCIN may be more attractive to the junior family member if the junior family member has investment income which he or she can offset with the investment interest expense deduction generated by the SCIN payments, as opposed to the private annuity interest payments which must be capitalized. Also, the SCIN provides more flexibility in structuring payment terms. A SCIN can be structured to provide for unequal payments which may be beneficial to the junior family member who is managing cash flow. Also, if the junior family member plans to use the asset acquired in a trade or business or dispose of the asset in a taxable transaction in the near future, the SCIN could be structured so that the risk premium to the senior generation family member is reflected in a purchase price above fair market value with a lower interest rate. By structuring the SCIN in this manner, the junior family member would receive a higher income tax basis for depreciation and sale purposes.

**III. INCOME TAX BASIS PLANNING.**

**A. General.** One area that is often overlooked when dealing with a client for whom death in near is reviewing the separate versus community property nature of the client's property. The surviving spouse's income tax basis of all community property as well as the decedent spouse's separate property will be its value as of the date of death. The surviving spouse's income tax basis in his or her separate property will remain unchanged. These rules provide some planning opportunities. As the estate tax exemption amount increases over the next several years, the estate tax will not be a concern for as many people but income tax planning will still be important.

**B. Spouse with Built-In Gain Separate Property.** If one spouse has separate property which has appreciated in value and the other spouse is in failing health, the healthy spouse can convert his or her separate property to community property. Upon the death of the other spouse, the income tax basis in the property will then receive a full step in basis to its fair market value as of the death of the first spouse. The surviving spouse can then dispose of the property without recognizing gain.

**C. Community Property with Built-In Loss.** If a married couple owns community property which has declined in value so that their income tax basis exceeds its value, the property can be converted to the separate property of the healthier spouse to avoid a step down in basis to the fair market value of the property at the death of the first spouse if the property were to remain as community property.

#### **IV. FLP PACKING**

For a client who has established an FLP which is “old and cold”, the client could transfer additional assets into the FLP prior to death. The IRS does not like death bed FLPs, but if the client had previously created an FLP which satisfies the *Kimbell* test of bona fide sale for full and adequate consideration, the IRS would have difficulty using § 2036 to bring all of the assets back into the client’s taxable estate at their undiscounted value because the original transfer of assets to the FLP should be viewed as a separate and distinct transfer for § 2036 purposes. Another point to bear in mind is that if a client has a shorter life expectancy, he or she will not need to retain as many assets outside of the FLP in order to meet living expenses.

#### **V. IRA ACCELERATION**

For certain clients who have IRAs and are near death, it may be advisable for the client to withdraw all of the assets in the IRA prior to death in certain circumstances. The withdrawal will trigger income tax, but if the income tax is payable in the year of the client’s death, then the income tax liability becomes an estate administration expense deductible under § 2053. Since the maximum estate tax rate is 48% and the maximum income tax rate is 35%, the withdrawal may produce an overall tax savings. One other factor to consider is whether or not the client’s designated beneficiaries are likely to withdraw most or all of the IRA balance soon after the death of the client. If this is the case, the value of the ability of the beneficiaries to prolong the income tax deferral on the growth of the assets will be lost.

For example, assume an unmarried client has a \$5 million taxable estate, with a \$1 million IRA balance. Upon the client’s death, the IRA will generate \$480,000 of estate tax. If the IRA beneficiary then decides to withdraw all of the funds in the IRA, then \$350,000 of income tax will be due as well (ignoring the effect of the IRD income tax deduction), making the total tax liability \$830,000. In contrast, if the client withdrew the funds from the IRA prior to death, the same \$350,000 income tax liability would be due. However, only the net IRA proceeds of \$650,000 would be includable in the taxable estate, which would generate an estate tax liability of \$312,000. As a result the total tax liability would be \$662,000 as opposed to \$830,000, for a savings of \$168,000.

#### **VI. PREVIOUSLY TAXED PROPERTY CREDIT**

If a partial (or no) QTIP election causes a taxable estate at the first death, and if those assets pass to a bypass trust with mandatory income to the survivor, or stays in the presumptive QTIP Trust which still requires mandatory income to the survivor, the survivor's estate will qualify for a §2013 PTP credit, if the survivor dies within ten years of the first death. The credit is based on the estate tax paid on those assets in the estate of the first spouse to die which were left to the surviving

spouse. In this case, the asset is the present value of the stream of mandatory income payments, calculated using the life expectancy of the surviving spouse. As long as the survivor has more than a 50% chance of living more than one year (determined on the date of the first spouse's death), then the IRS mortality tables can be used. See TAM 8512004 (residuary estate passed to bypass trust providing income to spouse for life; QTIP election was not made, generating estate tax at first death).

The PTP credit applies if the survivor dies within ten years of the first spouse. The theory behind the credit is that it would be a harsh result to subject the same property to estate taxation more than once in a short time period. The following table illustrates the credit's sliding scale.

Number of Years Between Death of First and Second Spouse	PTP Credit
1	100%
2	100%
3	80%
4	80%
5	60%
6	60%
7	40%
8	40%
9	20%
10	20%

The PTP credit is calculated by multiplying the Federal Estate Tax of the first spouse to die by a fraction designed to allocate to the credit the portion of that tax attributable to the property received by the surviving spouse. The numerator of the fraction is the Net Property Transferred to the Survivor and the denominator is the Adjusted Taxable Estate of the first spouse. The following definitions apply:

Federal Estate Tax - the federal estate tax paid by the estate of the first spouse to die (excluding inheritance taxes paid to a state), plus any PTP credit allowed the estate or any credit allowed for gift taxes paid on prior transfers.

Net Property Transferred to the Survivor - the value of the property transferred to the surviving spouse (as such property is valued in determining the federal estate liability of the first spouse), less any debts, expenses and taxes chargeable to such property.

§ 2013(c) imposes a limitation on the amount of the PTP credit. The credit is limited to the amount by which the estate tax imposed on the survivor's estate (computed without considering any PTP credit to which the estate is entitled), exceeds the amount that estate tax would be if it was determined by excluding from the gross estate the Net Property Transferred to the Survivor.

Note that the PTP credit applies as long as assets which were taxed in the first estate pass to the survivor. There is no requirement that the transferred assets be included in the survivor's estate. In this case, although the stream of mandatory income payments vanishes at the survivor's death, the credit is still based on their value as of the date of the first spouse's death.

## POST-MORTEM OPPORTUNITIES

### I. DEDUCTIBILITY OF INTEREST

**A. Administration Expenses.** § 2053(a) provides a deduction in computing the value of a taxable estate for all expenses of administration that are allowable under the state law governing the administration of the estate and which are actually and necessarily incurred in the administration of an estate. Such expenses must also be reasonably incurred in the administration of the estate. Treas. Reg. § 20.2053-1(b)(3) provides that a deduction is allowable even if the exact amount of the expenses is not known as long as the amount can be reasonably ascertained and it will be paid with reasonable certainty. An example of the application can be found on Schedule J of the Form 706 where a box must be checked which indicates that attorney and accountant fees deducted by the estate are either actual or estimated.

**B. Illiquid Assets.** In some estates, the bulk of the assets consist of stock or partnership interests held in a family business or investment entity by the decedent. Depending on the terms of a buy-sell agreement, or even the existence of such an agreement, the executor of the estate may not be able to dispose of the interest held by the decedent which would leave the executor in the position of having to try to borrow the funds necessary to pay the estate tax liability which is due within nine months of the death of the decedent. In the event that the executor borrows the funds to satisfy the estate tax liability, all of the interest incurred over the term of the borrowing may be deductible by the estate in computing the value of the taxable estate as long as the interest incurred can be computed with reasonable certainty and will actually be paid.

**C. Internal Revenue Service Position.** In Rev. Rul. 84-75, 1984-1 C.B. 193, the executor of an estate borrowed funds to satisfy the estate tax liability in order to avoid a fire sale of the assets owned by the estate. The IRS found that the interest was deductible as a necessary expense incurred in the administration of the estate under § 2053(a)(2). Under the terms of the debt instrument evidencing the loan obtained by the estate, the estate had the right to prepay the loan at any time and the holder could accelerate the principal on the default by the estate. Because of the presence of these factors, the IRS ruled that the amount of the interest which the estate might pay was uncertain within the meaning of Treas. Reg. § 20.2053-1(b)(3). As a result, interest was only deductible to the extent which it accrued and was paid by the estate.

In PLR 199903038, an executor borrowed funds from a third party lender in order to avoid selling closely-held stock owned by the decedent. Under the terms of the note memorializing the debt, the executor did not have the right to prepay the loan and upon default, all interest would be due along with all principal. The IRS found that the interest would be deductible as an administration expense since the amount of interest to be paid could be estimated with reasonable certainty and assuming that it was necessary for the estate to incur the loan in the administration of the estate. The IRS would not rule on whether or not the loan was necessary.

TAM 145318-03 the IRS addressed the issue of the deductibility of interest on indebtedness incurred by an estate to satisfy the estate tax liabilities of the decedent. The decedent owned 99% of the limited partnership interests at his death and the partnership interests comprised the bulk of the assets in the estate. The estate granted a security interest in its 99% partnership interest to the partnership in order to secure the loan. The assets of the partnership consisted of over 50% cash and marketable securities.

The IRS disallowed the deduction because it determined that the borrowing was not necessary. The IRS pointed to the fact that the co-executor of the estate was also the sole remaining general partner in the partnership and that there would be no fiduciary restraint on the general partner from redeeming the estate's partnership interest. Also, the IRS pointed to the fact that the partnership had over 50% liquid assets, with the remainder consisting of real estate and promissory notes, and that there was no active business conducted by the partnership. The IRS pointed to the fact that the same individuals stood on both sides of the transaction. The IRS also stated that it was questionable as to whether or not the payments would actually be made and that even if the payments are made that they will have no economic impact on the parties. The IRS then pointed to several income tax cases in which deductions for interest were denied.

**Case Law.** In *Graegin v. Commissioner*, T.C. Memo 1988-477, the executors of an estate borrowed funds from the decedent's closely-held corporation to satisfy the estate tax liability of the decedent. The note evidencing the indebtedness provided for a fifteen (15) year term bearing interest at fifteen percent (15%) per year, with all interest and principal due at the end of the term of the loan. The note prohibited the prepayment of interest and principal. Testimony indicated that a fifteen (15) year term was chosen because it coincided with the surviving spouse's life expectancy at which time funds from the surviving spouse's trust along with dividends paid over the term of the note would be used to pay the interest and principal. The Tax Court found that the interest was reasonably incurred in the administration of the estate and that the amount of interest could be reasonably ascertained under the terms of the note. As a result, the Tax Court allowed a deduction for all of the interest to be paid over the life of the note. *See also Estate of Todd*, 57 TC 288 (1971) (estate did not hold liquid assets and non-liquid assets would have to be sold at reduced prices); *Estate of McKee*, TCM 1996-362 (executors determined it was in the best interests of the estate not to sell closely-held stock to pay estate taxes).

**D. Structure of Note.** In order for an estate to be in the best position to deduct all of the interest projected to be paid on the indebtedness incurred to pay the estate tax liability, the note should preclude prepayment of the note by the estate and should require that in the event that the principal is accelerated for any reason that all of the interest which would have been paid over the life of the note becomes due as well.

**E. Identity of Borrower.** In the event that a third party lender is willing to lend the funds to the estate, the estate would likely have an easier time defending the deductibility if the estate chose to borrow from the third party lender. At a minimum, the terms offered by the third party lender would serve as a benchmark for the terms of an arms' length transaction. If no third party lender is willing to make a loan to the estate, then the estate can seek to borrow from a related entity such as a trust or even the entity whose interests have made the estate illiquid. If the estate can borrow from a related entity whose ownership does not track the interest of the beneficiaries in the estate, then the estate will be in a better position to defend the necessity of the debt. From the perspective of the entity making the loan, the possibility of earning an above-market return on the funds advanced to the estate may buttress the validity of the borrowing.

## **II. PLANNING WITH QTIP ASSETS.**

**A. General.** Upon the death of the first spouse in larger estates, oftentimes the recipient of the largest portion of the decedent's assets is a qualified terminal interest trust ("QTIP Trust"). Use of a QTIP Trust defers the payment of estate taxes at the first death, but limits or prohibits the surviving spouse from directing the disposition of the assets in the QTIP Trust. Upon the death of the surviving spouse, the assets in the QTIP Trust are includable in the taxable estate of the surviving spouse. § 2044 allows the estate of the surviving spouse to be reimbursed from the QTIP Trust for the estate tax attributable to the inclusion of the QTIP Trust assets in the surviving spouse's taxable estate.

**B. Contribution of Assets to FLP.** One way to minimize the impact of the estate tax liability at the death of the surviving spouse is to have the trustee of the QTIP Trust contribute some or all of the assets of the QTIP Trust to an existing FLP or take part in the formation of a new FLP. Other partners in the FLP could include the surviving spouse and the Bypass Trust.

**C. No Aggregation of Interests for Discount Purposes.** Under Rev. Rul. 93-12, the IRS ruled that it will not aggregate the ownership interests of family members for purposes of valuing such ownership interests. Therefore, FLP interests owned by a QTIP Trust should not be aggregated with those owned outright by a surviving spouse or through another trust.

**D. Section 2519 Concerns.** Under § 2519, a surviving spouse is treated as making a taxable gift to the extent that there is a disposition of all, or a part of, the qualifying income interest in a QTIP Trust. One concern with the participation of a QTIP Trust in an FLP is the potential application of § 2519 to the contribution of assets by a QTIP Trust to an FLP. This issue was addressed by the IRS in FSA 199920016 in which the IRS held in that there would be no disposition of the qualifying income interest because the surviving spouse disposed of the corpus and not the income interest. The IRS cautioned that a contribution to an FLP could result in such a disposition in the right circumstances, but acknowledged that a contribution to a partnership could be a very lucrative investment in the right circumstances. In this case the surviving spouse continued to receive income distributions in roughly the same amount before the transfer to the partnership.

## **MISCELLANEOUS**

## **I. FRANCHISE TAX PLANNING**

Although several bills were introduced in the last Texas legislative session which would have expanded the scope of the franchise tax to include partnerships, no change was made to existing law which exempts both general and limited partnerships from being subject to the franchise tax. The franchise tax is imposed at the rate of 4.5% of net income and applies to all corporations and limited liability companies with gross receipts in excess of \$150,000 per year. It is important to note that the sale of business or investment assets will also trigger franchise tax for a corporation or limited liability company and may cause an entity which was not normally subject to the franchise tax to become subject to such tax.

It is possible to convert an existing corporation or limited liability company into a partnership in order to avoid the imposition of the franchise tax. The conversion can be accomplished without incurring any federal income tax and even may be accomplished immediately prior to the sale of assets and still avoid the franchise tax on such sale.

## **II. PAYROLL TAX PLANNING**

It is common for a corporation to avoid franchise tax by paying a bonus to its shareholder-employees which brings the corporation's taxable income to zero. However, though the corporation avoids the 4.5% franchise tax, the corporation and shareholders are still paying 2.9% payroll taxes on the bonus. The payroll tax can be avoided by converting to an entity not subject to franchise tax and taking the bonus as a dividend or distribution instead. This savings is especially easy for doctors, dentists, and other professionals who can operate as a Professional Association, but is available for other businesses and professionals as well.

Another technique to reduce payroll taxes is discussed immediately below under the topic of Personal Goodwill.

## **III. PERSONAL GOODWILL**

**A. Case Law.** Two Tax Court cases have recognized the concept of "personal goodwill." In *Norwalk v. Commissioner*, TC Memo 1998-279, an accounting firm organized as a corporation liquidated and two of the shareholder-employees joined another accounting firm. The IRS argued that the shareholder-employees recognized income from a distribution of goodwill to the shareholder-employees upon the liquidation of the corporation. The Tax Court disagreed, finding that since there was no covenant not to compete between the corporation and the shareholder-employees, that any clients would likely follow the individual accountants. Therefore, the goodwill associated with these relationships was the property of the shareholder-employees and not the corporation.

In *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998), the taxpayer was a corporation engaged in the distribution of ice cream products, including Haagen-Dazs products. The corporation engaged in an internal reorganization which culminated in a newly formed subsidiary and the sole shareholder of the newly formed subsidiary selling the Haagen-Dazs distribution rights. The IRS argued that the sole shareholder recognized income upon the deemed liquidation of the

corporation equal to the amount that the purchaser of the Haagen-Dazs distribution rights paid to the sole shareholder for the covenant not to compete. The Tax Court found that the personal relationships and distribution network developed by the sole shareholder were his separate property and not corporate assets.

**B. Planning Opportunities.**

1. Sale of Business. When a business is being sold, it may be possible to allocate a portion of the purchase price to the personal goodwill of one or more shareholders in appropriate circumstances. In the case of the sale of assets of a C corporation, this technique is particularly effective, since the portion of the purchase price allocated to the personal goodwill will be payable directly to the shareholder(s) and, thus, avoid corporate level taxation.

2. Payroll Tax Savings. Both *Norwalk* and *Martin Ice Cream* acknowledge the concept of personal goodwill upon the sale of the business. However, those cases can also be used as support for the deduction of ongoing payments from a corporation to shareholders for the annual use of the personal goodwill by the corporation. Payments received by the shareholder employee would not be considered compensation and, therefore, would not be subject to the 2.9% Medicare tax. The corporation would issue a Form 1099 to the shareholder for the royalty payment made to him for the right to use the shareholder's personally-owned goodwill. This payment should be documented in the corporate minutes and the shareholder's employment agreement.



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*by Marvin E. Blum*

*Presentation to*

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