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ESTATE PLANNING UPDATE

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GARY V. POST

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BIOGRAPHICAL INFORMATION

Gary V. Post, J.D., a Partner in The Blum Firm, P.C., received his J.D. in 1983 from Southern Methodist University School of Law and his B.B.A. magna cum laude/Beta Alpha Psi in 1980 from Texas A & M University. Mr. Post has been practicing law for 24 years and is a frequent speaker and author on various estate planning topics. He is board certified in Estate Planning and Probate Law, serves on the Board of Directors for the Tarrant County Probate Bar Association, serves on the Estate Planning and Probate Law Exam Commission for the Texas Board of Legal Specialization, and is recognized as a Texas Super Lawyer by *Texas Monthly*. Mr. Post is active in the community and served as Chairman of the Board of the American Cancer Society, receiving the *2004 Volunteer of the Year Award*.

ESTATE PLANNING UPDATE

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In most cases, an estate planning update will address changes in the Code, regulations, Treasury/IRS announcements, and new case law, and how each has had an impact on the estate planning practice. The fact is that over the past few years there have only been a few significant developments in the estate planning practice through changes in the law, regulations, cases, etc. However, that does not mean that estate planning professionals need no, or only a cursory, update to keep their practices current.

To the contrary, there have been several developments that have come together at this point in time to create an estate planning environment that is very interesting and challenging, and definitely one in which the estate planning professional cannot afford to nap. Specifically, the following primarily "environmental" developments are impacting estate planning professionals in a very material way today:

1. Low interest rates;
2. The Barnett Shale;
3. Aging Family Limited Partnerships;
4. Allocating the GST exemption and rules with respect to late allocations to correct prior years' errors;
5. Increasing needs for transferring wealth and the frozen $1,000,000.00 Gift Tax Exemption; and
6. The state of the evolving estate tax system and what will it look like (exemption level, tax rate, etc.) next year and beyond.

A. ESTATE PLANNING IN A LOW INTEREST RATE ENVIRONMENT

The degree of benefits to be gained from various estate planning strategies can be significantly affected by the rise and fall of interest rates. In some cases, the value of the gift resulting from the implementation of the strategy is determined by IRS tables that are based on interest rates that change monthly. In other cases, the amount to be transferred back to the donor by the donee is set by the interest rate that changes on a monthly basis. Generally, estate planning strategies that are positively impacted by a low interest rate environment include the use of a Grantor Retained Annuity Trust ("GRAT"), transactions involving trusts that are Grantor Trusts for federal income tax purposes, and the use of Charitable Lead Annuity Trusts. Alternatively, a lower interest rate environment will generally result in less favorable outcomes for a Qualified Personal Residence Trust and a Charitable Remainder Annuity Trust.

The benefits of a sale of an asset to a Grantor Trust (discussed below) grow significantly as interest rates decline. Generally, the client will sell an asset to the Trust in return for a promissory note that will pay interest at the Applicable Federal Rate ("AFR") in effect for the month of the sale. The AFR is usually lower than the rate of return that the trust can earn on the asset in the market place and that spread between the market rate of return and the AFR grows as interest rates decline. Thus, this technique allows the parent the opportunity to make a transfer tax-free shift of wealth to

the children by selling an asset to the children's trust that will appreciate in value at a rate that exceeds the AFR payable by the trust to the parents.

The GRAT involves the client's transfer of an asset to the trust in return for an annuity payment for a fixed number of years. As the client has retained an interest in the property, the value of the gift made to the trust beneficiaries is equal to the value of the trust's remainder interest (i.e., the value of the gifted asset less the value of the annuity interest retained by the donor). The value of the remainder interest (i.e., the gift) is determined with reference to the IRS tables and the § 7520 rate. The higher the § 7520 rate, the higher the value of the remainder interest/gift. Thus, as the § 7520 rate declines, the gift tax value of the remainder interest goes down and the gift tax consequences of the transfer to the GRAT are improved. Another way of looking at the benefits of the GRAT in a low interest rate environment: the degree of value provided by the GRAT can be judged by the extent to which the assets transferred to the trust appreciate so that, at the end of the annuity term, there are assets remaining in the trust that pass to the trust beneficiaries free of any transfer taxes; thus, as the§ 7520 rate declines, the ability of the trust to yield a rate of return on its assets in order to yield a positive gift tax outcome increases.

These types of techniques that allow the client to transfer future appreciation in the value of assets to the next generation free of any estate, gift, or generation-skipping transfer taxes are known as "Estate Freeze" techniques. The estate "freeze" can be illustrated as follows: client transfers an asset worth $1,000,000.00 to a grantor trust in return for a promissory note that is structured with principal of $1,000,000.00 and interest at the AFR in effect in the month of the sale. If that AFR is 4%, then the client has "frozen" the value of that $1,000,000.00 asset in his or her estate at $1,000,000.00, with a 4% growth rate. The technique will work to the extent that the asset grows at a rate greater than 4% in the hands of the trust. Thus, the if the trust earns 10% on the asset, the additional 6% per year rate of return will pass free of any transfer taxes to the trust beneficiaries.

In addition to the fact that these techniques are beneficial today because they work well in a low interest rate environment, they are beneficial in today's estate planning toolbox for another reason. Under the current estate and gift tax system, although the estate tax exemption and generation-skipping transfer tax exemption are to increase from $2,000,000.00 this year to $3,500,000.00 on January 1, 2009, the gift tax exemption is frozen at $1,000,000.00. For many clients, there are many tax and non-tax reasons for them to want to make gifts in excess of that $1,000,000.00 gift tax exemption but they do not want to incur any gift taxes (see the Case Study in C. below). For those clients, it is necessary for the estate planner to be able to develop transfer opportunities that do not constitute gifts for gift tax purposes. The use of the GRAT and gifts of interest to the defective grantor trust are these type of creative planning opportunities that allow the client to make transfers to the next generation and either (1) leverage the gift tax exemption into more than $1,000,000.00 (i.e., by transferring future appreciation, thus greater wealth, to the next generation than the value of the remainder interest/gift determined using the 7520 rates), or (2) make a transfer of future appreciation to the next generation (i.e., that being the appreciation in the value of asset sold to a grantor trust in excess of the AFR rate of interest paid to the donor on the sale) that constitutes no gift for federal gift tax purposes.

1. GIFT AND/OR SALE TO GRANTOR TRUST

Selling assets to a grantor trust before the assets appreciate significantly and/or prior to a sale to a third party can help shift appreciation to the next generation free of estate and gift tax. This type of planning tool is known as an "Estate Freeze." This technique works with many different types of assets, including an ownership interest in a business. In fact, in this election year there has been an increase in business owners wanting to sell to avoid a potential increase in the capital gains tax rate after the election. Even if the business is about to be sold to a third party, the business being sold to the grantor trust may well be appraised at a value lower than the third party sales price. This is because it is possible that the sale may not close or that the ultimate sales price will be lower than the original offered price. This technique is especially useful when the business owner is selling the business to a strategic buyer. In such a case, the third party sales price may be significantly higher than the appraised value.

The disparity between the appraised value and the third party sales price may be even greater if the sale to the grantor trust happens before a letter of intent or other written agreement is signed. However, the technique can still be effective even up to the eve of the sale to the third party. The risk is always present that the sale may not occur, resulting in the value of the business interest for transfer tax purposes being lower than the third party sales price. Therefore, it is never too late to explore a sale to a grantor trust.

The steps involved in completing a sale to a grantor trust are as follows:

Step #1: Create the grantor trust.
Step #2: Obtain an appraisal of the business.
Step #3: Fund the grantor trust with a "seed gift," typically in an amount equal to 10% or more of the entire transaction.
Step #4: Transfer the assets (ownership units in business entity, etc.) to the grantor trust.
Step #5: Trust signs a promissory note payable to client in an amount equal to the value of the assets sold and interest at the applicable federal rate (AFR).
Step #6: As the trust has liquidity, it makes payments on the promissory note. Appreciation that occurs in excess of the note payments remains in the trust.
Step #7: Client files a gift tax return reporting the seed gift and disclosing the sale transaction in order to start the running of a 3 year statute of limitations.

The following discussion details the steps and implications involved in selling assets to a grantor trust.

a. General

The sale of assets to an intentionally defective grantor trust ("IDGT") is a useful value shifting technique. 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 utilizes 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 one or more of Sections 671 – 678 of the Code. 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:

i. 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. Sections 677(a)(1) and (2).

ii. 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. Section 675(2).

iii. 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, the loan does not provide for adequate interest, the IDGT will be treated as a grantor trust. Section 675(3).

iv. 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 the grantor's spouse, then the IDGT should be treated as a grantor trust. 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.

v. 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. Section 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. However, the IRS recently ruled in Rev. Rul. 2008-22 that a grantor's power to substitute assets in a non-fiduciary capacity would not cause inclusion the grantor's estate under Section 2036. In the Revenue Ruling, the grantor was prohibited from being trustee, and had to certify in writing that the assets substituted were of equivalent value. It is unclear whether these facts were determinative in the Ruling.

vi. 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 unlimited by a HEMS standard, then the IDGT will be treated as a grantor trust. Section 674(c).

vii. Power to Add Beneficiaries. If a non-adverse party has the power to add beneficiaries to the IDGT, the IDGT will be treated as grantor trust. Section 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 recommends that the grantor make a gift of cash equal to at least 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 and GST exemption is not as effective with a higher cash gift. It may also help in establishing the sale as commercially reasonable if the beneficiaries of the trust personally guarantee the promissory note (discussed below).

d. Sale of Assets

The grantor will then sell assets to the trustee of the IDGT in exchange for a promissory note.

e. Promissory Note

The promissory note should be for a term of years and should bear interest at a rate at least equal to the 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

i. 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.

ii. Death of Grantor During Term of Note

Unlike the Grantor Retained Annuity Trust (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 Section 2036. Rather the value of the note will be includable in the grantor's taxable estate under Section 2033. However, the IRS will likely assert that the death of the grantor turns off 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. This remains an unaswered question in the law.

iii. 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 that complies with the holding in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).

In *McCord*, the taxpayers, a husband and wife, sold all of their limited partnership interests in a certain limited partnership to a GST exempt trust, their sons, and two charitable organizations. The taxpayers directed that a portion of the limited partnership interests equal in value to their remaining GST exemption amounts pass to the GST exempt trust. Second, a portion of the limited partnership interests worth approximately $6.9 million, reduced by the amount passing to the GST exempt trust, would pass to their sons. Third, a portion of the limited partnership interests worth $134,000 would pass to a charitable organization. Fourth, the limited partnership interests remaining after funding the first three gifts would pass to a second charitable organization.

Subsequent to the transfer, an independent appraisal of the limited partnership interests was obtained. Based on this appraisal, the GST exempt trust, the taxpayers' sons, and the charitable organizations entered into a confirmation agreement, in which they agreed on the exact percentage of limited partnership interests allocated to each of them. Under the transfer document, the limited partnership retained a "call" right with respect to the limited partnership interests transferred to the charitable organizations. Approximately three months after the confirmation agreement was signed, the limited partnership exercised its call right and redeemed the charitable organizations' interests in exchange for cash.

The taxpayers filed a gift tax return reporting this transaction. When the gift tax return was later audited, the IRS argued that the value of the limited partnership interests that actually passed to the GST exempt trust and the taxpayers' sons (collectively, the "noncharitable assignees") was greater than that which was reported on the gift tax return. The IRS's argument was successful in the Tax Court, which found in the IRS's favor. The case was appealed to the 5th Circuit.

The 5th Circuit ultimately held that the fair market value of the limited partnership interests must be determined as of the date of the gift and is not affected by subsequent events. Therefore, the confirmation agreement must be ignored and the IRS could not consider the exact percentage of partnership interests transferred to the noncharitable assignees. Rather, the IRS was bound by the formula clause, which directed that a portion of the limited partnership interests equal in value to approximately $6.9 million pass to the noncharitable assignees. As a result, the taxable portion of the gift would not be greater than $6.9 million.

We recently utilized the *McCord* technique for married clients who were planning to sell a business in which they owned a large amount of stock. They wanted to transfer a portion of this stock in a way that would benefit subsequent generations and one or more charitable organizations. They formed a grantor trust, naming their descendants as beneficiaries and gifted a nominal amount of cash to the trust. The clients then sold a portion of their stock to the trust and a donor-advised fund. The transfer document directed that an amount of the stock with a value equal to a certain dollar amount (assume $1 million for illustration purposes) would pass to the trust. The remaining shares of stock would pass to the donor-advised fund. The trust executed a promissory note promising to pay $1 million to the clients in exchange for the stock. The portion passing to the donor-advised fund was treated as a charitable gift. We filed a gift tax return allocating GST exemption to the cash gift and reporting the above sale to the grantor trust.

The trust and the donor-advised fund subsequently agreed on an allocation of the shares, based on an appraisal that was performed by an independent appraisal firm. A few months after the above transaction took place, the business was sold to a third party. For several reasons, the appraised value was lower than the ultimate sales price. After repaying the promissory note to our clients, the trust was left with an amount of cash equal to the difference between the ultimate sales price for the shares it owned, less the amount repaid under the note. In the instant case, we expect that the trust will ultimately own assets with a value in the tens of millions of dollars from the sale, and the donor-advised fund will have approximately $1 million in assets. By using this technique, our clients were able to make these transfers free of gift tax and using a minimal amount of their GST exemptions.

CASE STUDY: SALE OF FLP UNITS TO A GRANTOR TRUST TO AVOID SECTION 2036 ATTACK

We have a client, Anne, who formed a limited partnership (the "LP") several years ago. When the LP was formed, Anne was the 99% limited partner and a limited liability company (the "LLC") was the 1% general partner. Anne's two children owned the LLC in equal shares. Subsequent to the formation of the LP, Anne gifted a portion of her LP interests to her children.

The LP began making periodic distributions and Anne proceeded to gift her other assets to her children and charity. After some time had passed, Anne had gifted away so many of her assets that she began to rely on the distributions from the LP to cover her personal and living expenses.

If Anne passed away owning these LP interests, her Estate would be vulnerable to an attack by the IRS under Section 2036 of the Code. Section 2036 provides that property with respect to which the decedent has retained a life estate will be included in the decedent's gross estate for

federal estate tax purposes. A retained life estate can be found when the decedent has retained the right to income from the property. The IRS has been successful in arguing that, when a decedent transfers virtually all of her assets into an LP during her life, there was an implied agreement that distributions could be made to her whenever she needed funds, thus resulting in the decedent being treated as if she retained the right to income from the property.

For example, assume at the time of Anne's death she owned a 40% LP interest and the value of the assets owned by the LP was $15,000,000.00. Further, assume that the fair market value of the 40% LP interest for federal estate tax purposes (including a 40% discount) was $3,600,000.00. Assuming a 45% estate tax rate, the estate tax on Anne's LP interest would be $1,620,000.00.

Alternatively, if the IRS successfully argued that Anne had retained a life estate in the LP property, then Section 2036 would apply to cause Anne's estate to include $6,000,000.00 of the LP property (40% of $15,000,000.00) as an asset in her estate. Assuming a 45% estate tax rate, the estate tax related to the LP would increase to $2,700,000.00 (a $1,080,000.00 tax increase).

In order to avoid the IRS making this argument at Anne's death, we proposed that Anne sell all of her LP interests during her life so that when she passes away, she will not own any interest in the LP. As a result, the LP will not be shown on Anne's estate tax return, making it difficult for the IRS to argue that Section 2036 should apply to bring the value of the LP's assets into Anne's gross estate for federal estate tax purposes.

In accordance with our proposal, Anne created two irrevocable trusts – one for each of her children. The trusts were structured as "grantor trusts" for income tax purposes so that all of the trusts' income would be taxed on Anne's personal income tax return. Not only does this allow the trust assets to grow without being depleted by income taxes, but it also allows Anne to sell assets to the trusts without recognizing gain.

After creating the trusts, Anne sold her remaining LP interests to them. In exchange, each trust executed a promissory note in favor of Anne, promising to pay her an amount equal to the fair market value of the LP interests (including applicable discounts) sold to it, with interest equal to the applicable federal rate in effect at the time of the sale. As Anne receives payments on the note, she will not recognize gain or recognize the interest payments as income. The trusts will receive periodic distributions from the LP, which they can use to pay down the note owing to Anne. Although Anne will no longer receive distributions from the LP, she will receive payments on the promissory notes for several years until they are paid in full. She can use these payments to cover her living expenses.

Once the sale was complete, Anne owned no LP interests. When she passes away, all that will be reported on her estate tax return is a promissory note, to the extent that it has not been paid off. If the promissory note is paid in full prior to Anne's death, even the note will not be reported on her estate tax return. In the year that the sale is made, we will file a gift tax return reporting the sale so that the three-year statute of limitations on the IRS's ability to challenge the transaction can begin running.

CASE STUDY: SALE TO A GRANTOR TRUST PRIOR TO LIQUIDATION EVENT

Gift planning can be especially effective when assets with a high appreciation potential, but low current value, are transferred to future generations. One of our clients, Bob, owned just such an asset. Bob owned stock in a privately-held corporation that was under contract to be sold to a publicly-traded corporation. Bob was a minority shareholder in the corporation, so his stock was subject to voting and other restrictions.

Bob wanted his children to share in the benefits that would arise when the stock was sold. Our goal was to transfer the stock to Bob's children with the lowest gift tax impact possible. Because Bob was a minority shareholder in the corporation and the contract to sell the corporation had not yet been finalized, the fair market value of Bob's stock was significantly less than the contract sales price. We were able to take advantage of this spread to transfer wealth to Bob's children with no gift tax cost.

Bob created an irrevocable trust, which was structured as a grantor trust for income tax purposes, for the benefit of his children. Bob sold a portion of his stock to the trust in exchange for a promissory note equal to the fair market value of the stock, which was $1.2 million (after considering a 40% discount off of its contract price of $2 million). After the sale, Bob owned a promissory note with a principal balance of $1.2 million, and the trust owned the stock.

A few months later, the stock was sold to the publicly-traded corporation at its contract price of $2 million. As a result of the sale, the trust received a cash inflow of $2 million. Because it is a grantor trust, it will not bear any of the income taxes generated by the sale, but rather Bob will pay those income taxes out of his personal funds. The trust will use a portion of the sales proceeds to pay off the note owing to Bob. After payment of the principal and interest on the note, the trust was left with a little less than $800,000 cash. This entire amount was transferred to the trust without using up any of Bob's gift tax exemption amount.

The cash can be invested and can continue to grow in an estate tax protected vehicle without being depleted by income taxes as long as the trust is classified as a grantor trust for income tax purposes. In the year of the sale to the trust, a gift tax return should be filed reporting the transaction so that the statute of limitations can begin running.

CASE STUDY: PREFUNDING CHILDREN'S INHERITANCES TO AVOID ESTATE TAXES

Most clients have up to three types of heirs – family members, charitable organizations, and the IRS. Many of our clients who are charitably inclined wish to instill this value in their children, as well as provide an adequate inheritance to allow their children to lead comfortable lives. The traditional estate planning approach has been to utilize a bypass trust after the first spouse's death to minimize estate taxes, but leave assets to the children only at the second death. As a result, the IRS typically receives 45% of everything above the clients' combined exemption amounts. The children receive whatever is left after paying the IRS.

By prefunding a child's inheritance during the client's life, estate taxes can be significantly reduced and even eliminated in some cases. For example, a set of married clients, Jack and Jill, want to prefund their children's inheritances and avoid paying estate taxes altogether. They also want to create a private family foundation, which they and their children can manage and use to perpetuate the family's tradition of charitable giving.

Jack and Jill own mineral interests in the Barnett Shale that currently have a low value but are expected to appreciate significantly in the future (as additionall wells are completed and royalty payments received and invested). They create an irrevocable trust for the benefit of each of their children and make significant gifts to each trust, although they keep the total amount of gifts to the trusts under their lifetime gift tax exemption amounts. This will give them a cushion in case they want to make additional gifts in the future.

The trusts are drafted as grantor trusts for income tax purposes. As a result, the income generated by the trusts will be reported on Jack and Jill's income tax return, allowing the trusts to grow without being depleted by income taxes. Over time, Jack and Jill can sell assets to the trusts without recognizing gain. A particularly attractive asset for a sale to the trusts is their Barnett Shale mineral interests. By selling the mineral interests to the trusts at the currently low value, the trusts will receive the future appreciation at no estate or gift tax cost to Jack and Jill.

When the trusts' assets have reached a level where Jack and Jill feel the children are adequately provided for, Jack and Jill's estate plan can be modified to provide that their remaining assets pass to the private family foundation, rather than their children, at their deaths. In the interim, their plans may be drafted to leave a formula amount to their children, which would consider the amount of assets already in the children's trusts and adjust their inheritances accordingly. As the amount of assets in the children's trusts grow, the formula funding will result in the children receiving less at Jack and Jill's deaths. The remainder can be directed to pass to the private family foundation.

If their entire taxable estates pass to the foundation, no estate taxes will be triggered upon Jack and Jill's deaths. The children will receive their inheritance in two forms – one in the form of the trusts which can make distributions to the children or for their benefit for health, education, maintenance, and support needs, and one in the form of the private family foundation, which the children can manage and use to benefit charitable causes in the name of the family. By starting planning early, it is possible for a client to completely disinherit the IRS.

2. TRANSFER TO GRANTOR RETAINED ANNUITY TRUST

A grantor retained annuity trust ("GRAT") is another useful "Estate Freeze" tool for shifting future appreciation to lower generations free of the gift, estate, and generation-skipping transfer taxes. For example, a client with an interest in a business can create a zeroed out GRAT and fund it with ownership interests in the business. The excess appreciation will be shifted to future generations at no transfer tax cost.

The steps involved in creating and funding a GRAT are as follows:

Step #1: Create the GRAT.
Step #2: Obtain an appraisal of the business.
Step #3: Transfer ownership interests in the business entity to the GRAT.
Step #4: In return, the GRAT promises to pay the client an annuity equal to the value of the assets transferred, based on the appraisal.
Step #5: Client files a gift tax return reporting the gift to the GRAT. (Note that GST exemption cannot be allocated until the annuity term ends.)
Step #6: When the annuity term ends, the GRAT continues as a Dynasty Trust for the benefit of the client's descendants. Appreciation that occurs in excess of the annuity payments remains in trust for those descendants.

The following discussion sets forth the requirements and implications of using a GRAT in estate planning.

a. Requirements

A GRAT is a trust designed to comply with the requirements of Section 2702 of the Code. Section 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 Section 2702 requirements are satisfied, then the annuity or unitrust interest retained by the grantor will be a qualified income interest and its fair market value will be deducted from the value of the business interest transferred to determine the value of the remainder interest for gift tax purposes. 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:

- Term of the GRAT. The longer the term of the GRAT, the higher the value of the annuity or unitrust interest retained by the grantor and the lower the value of the remainder interest.

- Section 7520 Rate. The higher the §7520 rate, the higher the value of the remainder interest. Therefore, lower §7520 rates generate lower gift tax costs. (The §7520 rate for August 2008 is 4.2%, up from a five-year low of 3.2% in May).

- 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 at zero or slightly in excess of zero depending upon the manipulation of the factors discussed in Section 2.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.

- 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.

- 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.

- 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. Risk of GRAT: Death of Grantor During Term of GRAT

If the Grantor dies during the term of the GRAT, then the value of the assets in the GRAT necessary to produce sufficient income to pay the annuity will be includable in the Grantor's estate under Section 2036. Recently issued final regulations abandoned the IRS's previous position that the entire amount should be included under Section 2039, but the formula that the IRS uses to determine the amount includable under Section 2036 assures that the entire amount will be included in the Grantor's estate in almost every GRAT where the Grantor dies during the term.

CASE STUDY: LARGE GRAT

We have a client, Steve, who obtained his wealth primarily through GRAT transfers from his parents, who owned an oil and gas business. Over the years, the parents were successful in transferring over 80% of the business to their children in this manner. Steve's share of the business is now valued at over $1 billion dollars. This year, our client came to us to start that process over again so that he could begin to transfer his interest in the business to his own children.

Steve is in his 40's and healthy, so the risk of mortality was low regardless of the length of the term. Steve had several factors to consider when determining the exact terms of the GRAT. Specifically, he had to weigh the cost of appraisals, trends in the 7520 rate, and the short and long term outlooks for the performance of the company.

Steve weighed the relative benefits of short term GRATs and longer term GRATS. While shorter term GRATs are becoming more and more common, and research is showing that short term 'rolling' GRATs are usually the best performing GRATs, the client felt that the company was going to suffer a down year in the next two years before enjoying a sustained growth period. Furthermore, he was considering his options in May of this year when the 7520 rate was at a historic low of 3.2%. Therefore, Steve ultimately decided to go with a five-year GRAT, and will roll his annuity payments

into new GRATs of appropriate lengths depending upon the conditions at the time. In this way, the client locked in the low 3.2% rate for five years. He also chose to take advantage of the ability to start with lesser payments in the early years and increase each year by 20%. This will give the GRAT a better chance to overcome a bad year in the early years of the GRAT (if the near-term downturn that he projects does in fact occur).

Steve elected to put all of his interest in the company in the GRAT, as there is no real downside risk. If the GRAT 'fails,' he will merely get all of his interest back. He was able to get a favorable deal for the cost of appraisals over the next five years because he purchased the appraisals as a package. If the company performs conservatively well in comparison with past performance, Steve will transfer approximately $110 million to trusts for his children at the end of the GRAT term with no transfer tax.

B. ALLOCATION OF GST EXEMPTION

As of January 1, 2004, the GST exemption is the same as the Estate Tax exemption (thus, $2,000,000 for 2006-2008, $3,500,000 for 2009). The individual may allocate his or her exemption to the transfer of any property (lifetime or at death) with respect to which he is the "transferor." An individual's GST exemption may be allocated at any time on or before the due date (including extensions actually granted) for filing the estate tax return for his or her estate. An allocation, once made, is irrevocable.

Once the GST exemption has been allocated to transferred property, the property (and all income and appreciation with respect to the property after the effective date of the allocation) is exempted from the GSTT. For example, if a parent forms a trust and transfers property to that trust with a Gift Tax value of $30,000 and effectively allocates $30,000 of his GST exemption to that transfer, then the trust (and all of the income and appreciation of the trust assets that accrues thereafter) will be exempt from the GSTT. Thus, when the child dies and his interest passes to his children (a Taxable Termination), the fact that the trust is exempted from the GSTT will cause there to be no tax due at the time of that otherwise taxable generation-skipping transfer.

1. ALLOCATION ON 709

A donor may allocate GST exemption to a lifetime transfer of property by accomplishing that allocation on a timely filed Form 709 reporting that transfer. A 709 will be filed on a timely basis if it is filed on or before its due date (including extensions actually granted). If the allocation is on a timely filed return, then the allocation is effective as of the date of the transfer of the property. Thus, an allocation of GST exemption equal to the dollar value of the property as reported on the timely filed 709 (*i.e.*, the value on the date it was transferred) will cause the transfer to be fully exempted from the GSTT.

Subject to the deemed allocation rules (discussed below), the rules change if the allocation of GST exemption with respect to a specific transfer is a late allocation (*i.e.*, an allocation made after the due date, including granted extensions, for filing the Gift Tax return with respect to the transfer). See Sections 2642(b)(3), 26.2632-1(b)(2)(ii) and (iii), and 26.2642-2(a)(2) for rules with respect to late allocations. In this case, the late allocation can still be accomplished by filing

a Form 709, but the effective date for a late allocation is the date that a 709 is filed and, most importantly, the dollar amount of the GST exemption that must be allocated to the property in order to fully exempt it from the GSTT is the fair market value of the property on that date. To address the difficulty in determining the fair market value of an asset on the date a 709 is filed, Regulation Section 26.2642-2(a)(2) provides that for determining the fair market value of the property, the taxpayer may elect to treat the allocation as having been made on the first day of the month in which the 709 is filed.

Practitioner Suggestion. The rules for a timely allocation of GST exemption on a Form 709 are obviously ones that the return preparer must be aware of, though there are ample incentives for the Gift Tax return to be filed on a timely basis. Still, the consequences of a late filing can be quite substantial when the cost is lost GST exemption. For example, assume property is transferred to a trust on February 15, 2000, with a gift tax value of $25,000. Further, assume that a timely filed Gift Tax return reporting that gift and allocating $25,000 of GST exemption to fully exempt it from the tax is not filed. Then, assume that mistake is found and the late allocation of GST exemption is made on a Gift Tax return filed on April 15, 2008. Further, assume that the value of that $25,000 asset at that date is $60,000. In this case, $60,000 of GST exemption will be used to fully exempt the asset from the GSTT, when the same result could have been achieved on a timely filed gift tax return through the use of only $25,000 of GST exemption.

The late allocation can actually be a tool to reverse that outcome and cause the transfer to be fully exempted from the tax through the use of a lesser amount of GST exemption than the value of the gift at the date it was made. For example, assume that stock was transferred to a trust on January 15, 2007, and at that time the stock had a value of $200,000. The Gift Tax return reporting that stock gift is extended until October 15, 2008. At that time, the stock in the company has dropped substantially so that the gifted stock is now worth $60,000. At this time, assuming that by election out or otherwise the deemed allocation rules do not apply, the taxpayer can choose to not make an allocation of the GST exemption to the trust on the timely filed Gift Tax return (on which it would take a $200,000 allocation of GST exemption to fully exempt the gift from the tax) and, instead, make a late allocation of the GST exemption upon a gift tax return filed October 16, 2008. On that return, an allocation of GST exemption equal in amount to the then current fair market value of the stock ($60,000) would be sufficient to fully exempt that stock (and all appreciation and income from the stock) from the GSTT.

2. DEEMED ALLOCATION – DIRECT SKIP

Section 2632(b) has long provided for an automatic allocation of GST exemption to a Direct Skip transfer made by an individual during lifetime. The way this works is that if an individual makes a Direct Skip transfer during a year and fails to allocate any (or an insufficient amount) of GST exemption to that gift on a timely filed Gift Tax return for that year, then there will be an automatic allocation of a sufficient amount of the individual's unused GST exemption to the extent necessary to fully exempt the property from the GSTT. Just like an actual allocation of GST exemption on the Gift Tax return, the automatic allocation is effective as of the date of the transfer and thus allocates an amount of exemption up to the fair market value as of the date of the transfer and no more. The automatic allocation occurs, and becomes irrevocable, once the due date (including extensions actually granted) for the Gift Tax return passes.

The individual may elect to not have the automatic allocation of GST exemption apply to a Direct Skip transfer. This election is made on a timely filed gift tax return by describing the transfer and stating the extent to which the automatic allocation is not to apply. The election out of Section 2632(b) is irrevocable after the due date (including extensions granted) of the Gift Tax return.

Example: Grandparent gifts $12,000 to a trust for grandchild on July 15, 2007. This was the only gift by grandparent to grandchild for that year. A Gift Tax return reporting other gifts is filed for grandparent on the due date of April 15, 2008, but that return does not report the gift to the grandchild and no GST exemption is allocated to the gift. [Note: This gift qualified for the Annual Gift Tax Exclusion, so it did not have to be reported for gift tax purposes. However, it was not eligible for the automatic allocation of GST exemption so a GST tax was due on April 15, 2008.] Grandparent has her full GST exemption remaining. Pursuant to the deemed allocation rules of Section 2632(b), $12,000 of grandparent's GST exemption is automatically allocated to the July 15, 2007, Direct Skip gift to grandchild (wholly exempting that gift and the recipient trust from the GSTT). As of April 16, 2008, the automatic allocation of GST exemption is irrevocable.

3. DEEMED ALLOCATION – OTHER TRANSFERS

By their nature, Direct Skip transfers trigger an immediate GSTT due on or before the due date for filing a Gift Tax return for the year in which the transfer is made. It is for this reason that the Congress felt comfortable at the early stages of the GSTT in providing a "safety net" for those individuals who fail to properly allocate GST exemption on a timely filed return and thus do not fully exempt the transfer from the tax. This safety net operates by allocating GST exemption for those individuals through the deemed allocation rules of Section 2632(b). If, for some reason, the individual did not want that allocation (*i.e.*, wanted to pay the GSTT), then he or she could elect out of the allocation on a timely filed Gift Tax return. The Congress did not initially see a need to provide such a safety net with respect to other transfers (*i.e.*, those that did not trigger an immediate GSTT, but could trigger such tax in the future). However, by the year 2001, the perception (and reality) was that there existed a substantial number of cases in which transfers that should have received an allocation of GST exemption had received either an insufficient allocation or none at all. Thus, the 2001 Tax Act introduced Section 2632(c) to provide for a deemed allocation of GST exemption to certain lifetime transfer to trusts.

Section 2632(c) provides that there will be an automatic allocation of an individual's GST exemption to the following transfers made by the individual during his or her lifetime: a transfer of property (other than a Direct Skip), subject to the Gift Tax, to a trust that could have a generation-skipping transfer with respect to the transferor, unless the trust qualifies under one of the six exceptions provided in Section 2632(c)(3)(B). The purpose of the six exceptions is to prohibit the automatic allocation of GST exemption to trust arrangements that, though they could trigger a GSTT, are structured so that they are not expected to incur such a tax. For example, exceptions are provided for:

- a trust that requires that more than 25% of the trust principal will be distributed to a non-skip person before that person reaches the age of 46 – Section 2632(c)(3)(B)(i);

- a trust that requires that more than 25% of the principal be distributed to a non-skip person if that person is living on the date of death of another individual who is more than 10 years older than such person (*e.g.*, trust property is to pass outright to a child of the donor if such child is living upon the death of the donor/parent) – Section 2632(c)(3)(B)(ii);

- a trust that is structured so that any portion of the principal would be included in the gross estate of a non-skip person (other than the transferor) if that person died immediately after the transfer (*e.g.*, a non-exempt trust that is structured to last for the lifetime of a child of the donor/parent, with that child granted a general power of appointment exercisable under his Will that causes the trust estate to be taxable in his or her estate) – Section 2632(c)(3)(B)(iv).

Section 2632(c)(5) provides for three <u>elections</u>.

1. An election to have Section 2632(c) not apply to an otherwise subject transfer. To be effective, this election must be made on a timely filed Gift Tax return for the calendar year in which the transfer was made.

2. An election to have Section 2632(c) not apply to any or all transfers made to a specific trust. This election will be timely if made on a timely filed Gift Tax return for the calendar year for which the election is to become effective.

3. An election to subject any or all transfers made to a specific trust to the automatic allocation rule of 2632(c). This election is made on a timely filed Gift Tax return for the calendar year for which the election is to become effective.

Section 26.2632-1(b)(iii) allows the transferor, in addition to being able to elect out of a prior transfer subject to Section 2642(f), and current and future year transfers to a specified trust or trusts, the option to elect out of the automatic allocation on all future transfers made by the transferor to all trusts, whether or not such trusts are in existence at the time of the election, or any combination of elections. This election is made on a timely filed Gift Tax return for the calendar year in which the first transfer to be covered by the elect out is made.

<u>Note</u>: The deemed allocation rules under Section 2632(c) apply to transfers subject to the Gift or Estate Tax made <u>after December 31, 2000</u>, and to estate tax inclusion periods ending after December 31, 2000. Thus, the Section 2632(c) "safety net" does not apply to gift transfers made prior to January 1, 2001.

<u>Example</u>: Parent gifts $12,000 to a trust for child in August, 2008, with the trust to last for the child's lifetime and then pass to her children. The gift qualifies for the Annual Gift Tax Exclusion and does not have to be reported for Gift Tax purposes. However, the preparer's duties do not stop there. There is an intentional Taxable Termination that will trigger a GSTT at the death of the child, so it is intended that the gift be allocated GST exemption to fully exempt it from that

tax. Prior to the deemed allocation rules of Section 2632(c), a common mistake was to neither report the gift on the 709 nor allocate to the trust $12,000 of GST exemption (most likely because reporting was not required for Gift Tax purposes or a mistaken belief that Annual Exclusion gifts were also exempted from the GSTT). As a result, the trust would be subject to the imposition of the GSTT upon the death of the child. Under the rules of Section 2632(c), if no 709 is filed, there will be an automatic allocation of $12,000 to the trust, thus protecting it from the GSTT exposure.

Example: Same facts as the preceding example, except that the gift is $15,000. In this case, the Annual Exclusion shelters only $12,000 from the Gift Tax and there is a $3,000 taxable gift. Another mistake is a tendency at this point to allocate only $3,000 of GST exemption to the gift. This fails to recognize that the $12,000 Annual Exclusion is a Gift Tax function and does not apply in the GSTT context. An allocation of only $3,000 of GST exemption in this case causes approximately one-fifth of the trust to be exempt, with the remaining four-fifths subject to the tax (an undesirable outcome). The proper action is to allocate enough GST exemption to cover the total value of the gift to the trust ($15,000 in this case). Again, the deemed allocation rules would correct this error and avoid the GSTT exposure for the trust by providing an automatic allocation of the remaining $12,000 of GST exemption needed to fully exempt the trust.

4. RETROACTIVE ALLOCATIONS

The 2001 Tax Act also added Section 2632(d) to allow a late allocation of GST exemption for a specific type trust arrangement that, though it is not intended to result in a generation-skipping transfer, can operate to skip a generation in the event there is an unnatural order of deaths (*i.e.*, a child predeceases a parent).

Specifically, Section 2632(d) provides that (1) if, a non-skip person has an interest in a trust, is a lineal descendant of a grandparent of the transferor (or of a grandparent of the transferor's spouse or former spouse), is a member of a generation below the transferor and predeceases the transferor, (2) then, the transferor may allocate his or her unused GST exemption to previous transfers he or she has made to the trust.

If the allocation is made on a Gift Tax return filed on or before the due date for gifts made within the calendar year in which the non-skip person dies, then:

1. the amount of the exemption that will need to be allocated to fully exempt each gift to the trust from the GSTT will be the value of the gift as of the date it was transferred to the trust (*i.e.*, the allocation is treated as if made on a timely filed 709 with respect to the gift);

2. the allocation is effective immediately before the death of the non-skip person, so that the trust is fully exempted from the GSTT at the time of the death; and

3. the unused portion of the transferor's GST exemption is determined at the point immediately before such death.

Example: Parent transfers $100,000 cash in trust for child in 2005 when the child is age 32. Child is to receive distributions of income and principal, subject to the Trustee's discretion, until the child reaches the age of 60, at which time the trust is to terminate and the property is to be distributed outright to the child. In the event the child should die prior to reaching age 60, then the trust property is to be retained in trust for the benefit of his children. The trust arrangement is not designed to, or expected to, cause the trust property to pass to the transferor's grandchildren; however, due to the death of the child prior to age 60, at the time of his death a Taxable Termination occurs as the trust property passes to his children. The parent allocated no GST exemption to the trust, but, assuming the parent survives the child and has sufficient unused GST exemption, the parent can avoid having the trust suffer a GSTT by making a Section 2632(d) retroactive allocation of GST exemption to the trust. If the allocation is made on a Gift Tax return filed on or before the due date for gifts made in the year in which the child dies, the amount of GST exemption necessary to fully exempt the trust from the tax will be an amount equal to $100,000, the value of the gift to the trust as of the date such gift was made (avoiding the normal "late allocation" rules that would require an amount of GST exemption equal to the value of the property on the date that the return is filed).

5. RELIEF FROM LATE ELECTIONS / SUBSTANTIAL COMPLIANCE

The 2001 Tax Act also included relief provisions for taxpayers with respect to late allocations of GST exemption and substantial compliance scenarios. Section 2642(g).

a. Late Elections

Section 2642(g)(1) directs the Secretary to identify circumstances and procedures through which extensions of time will be granted to allow a taxpayer to make a late allocation of GST exemption, elect out of an automatic allocation of GST exemption to a Direct Skip transfer, and elect in or out of the Section 2632(c) automatic allocations with respect to transfers to trusts (that are not Direct Skips). This discretion is to be exercised after considering all relevant circumstances, including evidence of intent contained in the trust agreement.

This Section is applicable to relief requests pending on, or filed after, December 31, 2000, and is explicitly made applicable to transfers made before that date (transfers that are not eligible for relief under the Section 2632(c) automatic allocation or Section 2632(d) retroactive allocation rules).

In the event that an extension of time to allocate GST exemption is granted, then the amount of GST exemption needed to fully exempt the transfer from the tax will be the value as of the date of the transfer (as if the allocation was accomplished on a timely filed 709).

See c., d., and e. below for the IRS response to this Section's directive.

b. Substantial Compliance

Section 2642(g)(2) addresses the case in which there was an allocation of GST exemption that was ineffective to fully exempt the transfer from the GSTT. Under that Section,

if there was substantial compliance with the rules for allocating GST exemption, then there is a deemed allocation of the transferor's unused GST exemption to the extent necessary to fully exempt (or exempt to the greatest extent possible) such transfer from the tax. Again, all relevant circumstances are to be considered in determining whether "substantial compliance" is present, including evidence of intent contained in the trust agreement.

The relief available under Section 2642(g)(2) applies to transfers subject to the estate or gift tax made after December 31, 2000. For pre-December 31, 2000, transfers where the IRS has granted relief from ineffective allocations of GST exemption on "substantial compliance" grounds, see PLR 200017013 and PLR 199919027.

c. Notice 2001-50

The IRS issued Notice 2001-50, 2001-2 CB 189, 8/02/2001 in response to its direction in Section 2642(g)(1) to provide guidance with respect to relief from late allocations of GST exemption. That Notice establishes that:

i. A taxpayer is to follow the provisions of Section 301.9100-3 of the Procedure and Administration Regulations in seeking an extension of time to make an allocation of GST exemption (a late allocation), an election under Section 2632(b)(3) [automatic allocation to Direct Skip], or an election under Section 2632(c) [automatic allocation to other transfers to trust].

ii. Generally, relief will be granted under that Section 301.9100-3 if the taxpayer can show that he or she acted reasonably and in good faith and that such relief would not prejudice the interests of the government.

iii. The taxpayer's request should follow the procedures for requesting a private letter ruling under Section 301.9100 (contained in Section 5.02 of Rev. Proc. 2001-1, or its successor), 2001-1 I.R.B. 1, 28.

iv. The Notice is effective as to requests pending on, or filed after, December 31, 2000.

d. Revenue Procedure 2004-46 – Simplified Procedure for Certain Late Allocations

Effective August 2, 2004, the IRS introduced a simplified procedure taxpayers can use to make a late allocation of GST exemption under certain situations. In these cases, the late allocation is accomplished by simply filing a 709 for the year of the transfer (regardless of whether one has previously been filed). This allows the taxpayer to avoid the letter ruling process and related user fees that accompany the procedures for a late allocation provided in Notice 2001-50.

A taxpayer may use this procedure to make a late allocation of GST exemption to a transfer to a trust only if the following requirements are satisfied:

i. the transfer was a gift to a trust from which a generation-skipping transfer may be made;

ii. the transfer was made on or before December 31, 2000;

iii. no Taxable Distributions have been made from the trust and no Taxable Terminations have occurred;

iv. the transfer qualified for the Annual Gift Tax Exclusion and the total gifts made by the taxpayer to that donee for that year (including the transfer to the trust in question) was less than or equal to the applicable Annual Exclusion for that year;

v. no GST exemption was allocated to the transfer; and

vi. at the time the late allocation is made, the taxpayer has unused GST exemption available to allocate to the transfer.

e. Proposed Regulations Under IRC Section 2642(g)(1)

These proposed Regulations seek to more clearly and permanently set out the factors for determining whether to grant relief to a taxpayer under the provisions of IRC Section 2642(g)(1). Instead of simply directing the taxpayer to the more general provisions of Section 301.9100-3, the procedures, factors, and information required under the proposed Regulations are specific to GST allocation and are intended to replace Section 301.9100-3 in that regard. However, the two central requirements remain; the taxpayer had to have acted reasonably and in good faith, and the government must not be prejudiced by the granting of relief.

i. The proposed Regulations list factors to determine whether the taxpayer acted in good faith, including evidence in the trust document or related documents regarding the intention with respect to GST allocation, intervening events beyond the taxpayers control, lack of awareness of the need to allocate GST despite reasonable diligence, consistency with prior allocations, and reasonable reliance on qualified professionals.

ii. The factors for determining whether the government will be prejudiced by the granting of relief include whether the taxpayer is attempting to use hindsight as an advantage, the timing of the request for relief as it relates to whether there is sufficient time for the government to challenge the identity of the transferor, the value of the property transferred, or any other relevant aspect of the transaction, and whether there has been an intervening taxable termination or taxable distribution.

The taxpayer will also be required to provide more information to the government under the proposed Regulations, including affidavits from anyone who had information or knowledge about the events leading up to the failure to allocate GST or the discovery of the failure.

C. PLANNING FOR THE BARNETT SHALE

Mineral interests owned in the Barnett Shale can yield estate tax concerns to the property owners through the appreciation in the value of the property (including the mineral interests) and through the receipt of hundreds of thousands (or more) of royalty dollars per year. For some clients who already owned large estates and were engaged in estate planning (like the family outlined in the prior Case Study on prefunding children's inheritances), this is just an adjustment in their planning, but for many other families this creation of wealth is a new phenomenon and estate planning has not been a priority among the family objectives. However, the reality of the situation for these families is that estate planning, both from the tax and non-tax perspective, has become critical. Allowing all of this wealth to be concentrated in the older generation (who, in many cases, are in their 70's and 80's) can result in a significant diminution in the value of that family wealth through the payment of federal estate taxes upon the death of the older generation members. In addition, the arrival of this wealth creates many non-tax concerns and potential problems, including the potential for the waste of wealth through spendthrift tendencies of children and grandchildren, the loss of wealth through the end of a marriage by death or divorce, the loss of wealth through newly arising paramours, suitors, and "friends," and creditor concerns.

CASE STUDY: BARNETT SHALE PLANNING FOR NEW WEALTH

The following case study addresses a fairly typical family situation in these Barnett Shale days and how their needs resulting from their new wealth were addressed. The client (husband and wife) own 350 acres (including minerals) in the Barnett Shale. They are receiving approximately $800,000.00 per year in royalty payments from several completed wells and look to be the recipients of additional future royalties from wells yet to be completed. Prior to the Barnett Shale drilling, their total estate was worth approximately $1,200,000.00 (including the farm land) and their annual cash flow and living expenses were modest. The clients are both in their early 70's, one is suffering from declining health, and they have four children and nine grandchildren.

The clients want to retain some of the annual income received from the royalty payments, but want to shift the bulk of the royalty payments and mineral interests to their children and grandchildren. In addition, their objectives include minimizing the federal estate tax and protecting their heirs' inheritance.

The clients had previously transferred interests in the farm land and minerals to their children through annual exclusion gifts and also transferred some acreage to one of their sons who built a house thereon. The parents and the children all transferred their mineral interests to a Texas limited partnership in return for limited partnership interests. In addition, the parents formed a Texas limited liability company and that LLC transferred cash to the partnership in return for a 1% general partnership interest.

The clients planned to transfer limited partnership interests to a separate trust for each of their children. In determining the percentage interests to be transferred to each trust, they considered: the amount of partnership interests that they needed to retain to supplement their other income to meet their continuing living expenses, including expenses that might be needed for the parent in declining health; and, the value of the limited partnership interests to be gifted (including

applicable discounts) in light of the fact that they would have to pay a gift tax to the extent that the value of the gifts exceeded their remaining $1,000,000.00 gift tax exemption per spouse and any available annual exclusion amounts for the year of the gift. Another consideration that was taken into account was the fact that the value of the mineral interests (and thus the gift value of the limited partnership interests) were expected to, perhaps substantially, increase in the future as new wells were completed.

The clients created four irrevocable trusts for their children and made significant gifts of limited partnership interests to the trusts, although the total amount of the gifts was kept under the gift tax exemption level to allow a cushion for any valuation challenges raised by the IRS. The gifts to the trusts were valued at a discounted rate to reflect the fact that they were limited partnership interests and thus subject to restrictions.

In addition, each trust was structured as a Dynasty Trust so that it would last for the lifetime of the child and the child's descendants until required to terminate under the Texas Rule Against Perpetuities. This allowed the clients to accomplish their objectives of: (1) sheltering the full value of the gift and all future appreciation and income from the estate and generation-skipping transfer tax systems for the lives of children, grandchildren, etc.; (2) protect all trust assets from the reach of the creditors of their heirs while the property was held in trust; and (3) protect against the loss of family assets held under the trust upon the end of an heir's marriage by death or divorce.

Each trust was drafted as a grantor trust for income tax purposes, so all income generated by each trust would be reported on the parents' income tax return. This would allow the trust to grow, free of any transfer taxes, by the amount of income tax paid by the parents each year.

Once the gift transfer was complete, the parents, having been limited by the gift tax exemption level, still desired to transfer more of the partnership interests to their children. Other factors also made current transfers attractive. First, the fact that the partnership interests were expected to increase in value as additional wells were completed meant that current transfers could be accomplished at lower values and thus allow a greater amount of future appreciation to transfer free of any transfer taxes to the heirs. Second, the low interest rate environment made transfers through the use of a GRAT or sale to a IDGT attractive.

The clients chose to move forward before the end of the year with a sale of limited partnership interests to the grantor trusts created for the children in return for promissory notes. The fact that the mineral interests owned by the partnership were expected to increase at a greater rate than the low AFR required on the promissory notes allowed the client to transfer that additional appreciation to the heirs free of any transfer taxes. In addition, by using the sale to the IDGT instead of the GRAT, some immediate generation-skipping transfer tax benefits were attained. As mentioned previously, assets held in the GRAT cannot be allocated GST exemption until the estate tax inclusion period ends. However, assets purchased by a trust that is already wholly exempt from the generation-skipping transfer tax are also free from that tax without the allocation of any GST exemption.