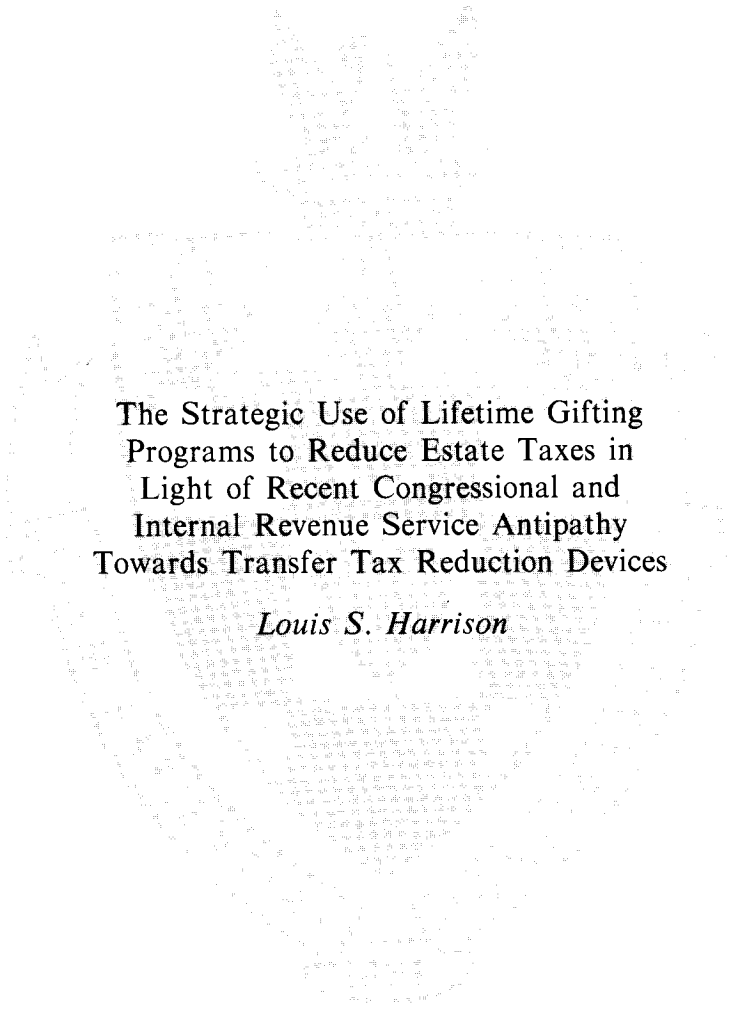


# DEPAUL LAW REVIEW



The Strategic Use of Lifetime Gifting  
Programs to Reduce Estate Taxes in  
Light of Recent Congressional and  
Internal Revenue Service Antipathy  
Towards Transfer Tax Reduction Devices

*Louis S. Harrison*

**THE STRATEGIC USE OF LIFETIME GIFTING  
PROGRAMS TO REDUCE ESTATE TAXES IN LIGHT OF  
RECENT CONGRESSIONAL AND INTERNAL REVENUE  
SERVICE ANTIPATHY TOWARDS TRANSFER TAX  
REDUCTION DEVICES**

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INTRODUCTION

Since 1983, estate planning advisors have been confronted with substantial congressional activity limiting many traditional and worthwhile estate planning strategies. For example, the congressional enactment of section 7872 of the Internal Revenue Code ("Code")<sup>1</sup> eliminated the viability of below-market loans as a means of income shifting. The Tax Reform Act of 1986<sup>2</sup> eliminated "Clifford trusts" and spousal remainder trusts as effective income shifting strategies.<sup>3</sup> The enactment of the Revenue Act of 1987<sup>4</sup> brought with it sec-

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\* Adjunct Professor of Law, DePaul University College of Law; B.A., Colgate University; J.D., Duke University Law School. The author is with the firm Lord, Bissell & Brook. The author wishes to thank Anna Szczepanowski for her assistance in preparing this article.

1. Congress enacted § 7872 of the Internal Revenue Code as part of the Tax Reform Act of 1984, Pub. L. No. 98-369, div. A, title I, § 172(a), 98 Stat. 699 (codified as amended at I.R.C. § 7872 (1988)). Section 7872 embodied certain principles enunciated in *Dickman v. Commissioner*, 465 U.S. 330, 338 (1984) (holding interest-free loans are transfers of property by gift).

2. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

3. Under the rules in effect before the Tax Reform Act of 1986, trusts could be used for the reallocation of income even though the principal would return to the grantor after the first to occur of 10 years or the death of the beneficiary. I.R.C. §§ 671-679 (1982). These were known as "Clifford trusts." See, e.g., Boyle, *Evaluating Split-Interest Valuation*, 24 GA. L. REV. 1, 9 (1989). If the principal were to return to the grantor's spouse, rather than to the grantor, arguably no minimum 10-year term would be required. *Id.* at 9 n.29. This was known as a "spousal remainder trust." *Id.* Short-term trusts as income shifting devices allowed a grantor to retain wealth while relieving the grantor, for a period of time, of the taxes incurred on the income the trust produced. An aggressive use of a spousal remainder trust would allow husband and wife to provide for their children's college expenses out of income, taxed at their children's presumably lower rates, without being required to give up the right to the principal for more than the college term.

The Tax Reform Act of 1986 now taxes trust grantors on the income of any portion of a trust if the grantor or his or her spouse has a reversionary interest worth more than five percent of the value of that portion, I.R.C. § 673(a) (1988), except for certain reversionary interests which take effect on the death of a beneficiary who is a minor descendant of the grantor. *Id.* § 673(b). This change effectively eliminates use of the Clifford and spousal remainder trusts as income shifting devices. In order for the grantor's interest to be below the five percent threshold so as not to be treated as a grantor of a short-term trust for income tax purposes, under interest and mortality tables in effect prior to the enactment of § 7520 by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, title V, § 5031(a), 102 Stat. 3668, the trust would have to provide

tion 2036(c), the anti-estate freeze provision of the Code.<sup>6</sup> Most recently, the Revenue Reconciliation Act of 1990 ("1990 Act")<sup>6</sup> repealed section 2036(c),<sup>7</sup> and, as a substitute, introduced a new chapter into the Code, chapter 14, which sets forth strict gift tax valuation rules.<sup>8</sup>

In the frenzy of recent congressional activity, one estate planning strategy has become predominant as a means to reduce the gross estate. This Article focuses on that strategy, known as "lifetime gifting."<sup>9</sup> Lifetime gifting is an

for payments of income to a beneficiary for at least 32 years, or for the life of a beneficiary who is not more than 31 years old at the time the trust is created. *But see* I.R.S. Notice 89-60, 1989-22 I.R.B. 16, 19 (interest tables in effect in compliance with § 7520).

Even assuming that the grantor trust rules are avoided so that accumulated trust income is taxed at the trust rates, the tax savings under the current reduced marginal income tax rates are not excessive. Further, if the trust in effect distributes net income to a minor beneficiary under the age of 14, the so-called "kiddie tax" may apply, thereby taxing the income at the minor beneficiary's parents' highest marginal income tax rate. *See* I.R.C. § 1(i) (1988) (providing that a child under the age of 14 has his unearned income taxed at his parents' rate). In advising a client on the efficacy and propriety of establishing a trust which will accumulate income for a minor child, the advisor must now weigh the administrative inconvenience of establishing a trust and completing annual returns with the insubstantial tax benefits that could result from the trust. The advisor should also consider, however, that the trust would provide a means in which to invest in high growth, low-yield assets which can be distributed from the trust to a child when the child attains the age of 14 without concern for the so-called "kiddie tax." When the child sells the appreciated assets, the gain will be taxed at the child's presumably lower rates.

4. Pub. L. No. 100-203, 101 Stat. 1330 (codified as amended in scattered sections of 26 U.S.C.).

5. I.R.C. § 2036(c) (1988). The operation of § 2036(c) can be illustrated by the following simplified example:

Father *X* owns two interests, asset *A* and asset *B*, in enterprise *E*. *A* and *B* constitute more than 10% of the total outstanding interests in *E*. On January 23, 1989, *X* transfers asset *B* to his son, *S*, for no consideration. The transfer results in a taxable gift equal to the then fair market value of asset *B*. *X* retains asset *A*. At the time of the transfer, the appreciation potential of asset *B* is greater than the appreciation potential of asset *A*. At *X*'s death 35 years later, asset *A* is still owned by *X*. Asset *B* has appreciated 10 times its value as of the date of transfer. At *X*'s death, the then value of asset *B*, even though it was transferred 35 years previous and even though treated as a taxable gift at the time of the transfer, will be included in *X*'s gross estate for estate tax purposes.

Section 2036(c) was repealed retroactively by § 11601 of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, and replaced with new chapter 14 of the Code, directed more at proper gift tax valuation than punitive estate tax inclusion. *Id.* In the above example illustrating the operation of now-repealed § 2036(c), new chapter 14 would not act to include asset *B* in *X*'s gross estate. Rather, chapter 14 could result in asset *B* being ascribed a higher value for gift tax purposes than was done under prior law. *See infra* notes 19-47 and accompanying text (analyzing new chapter 14).

6. Pub. L. No. 101-508, 104 Stat. 1388 (1990).

7. *Id.* § 11601.

8. *Id.* § 11602 (creating ch. 14, §§ 2701-2704 of the Code).

9. It is important to note that the Tax Reform Act of 1976, Pub. L. No. 94-455, title XX, 90 Stat. 1846, unified the estate and gift tax rate structure. That is, gifts during life are subject to the same tax rate structure as gifts at death. *See* I.R.C. § 2001(b) (1988). Further, an individual is entitled to only one trip through the gift and estate tax brackets. *Id.* § 2035(d)(1) (1988). Congress intended to eliminate differences between gift tax and estate tax by "elimina[ting] ways

expansive topic which encompasses various sophisticated as well as straightforward strategies. Section I of this Article examines four lifetime gifting strategies: (1) grantor retained interest trusts, (2) annual exclusion gifts, (3) leveraging of the unified credit, and (4) gifts of interests in closely held businesses. Section II discusses the potential benefits to the payment of gift tax in conjunction with lifetime gifting strategies. Section III discusses the manner in which gifts should be made. This section also analyzes the recent Internal Revenue Service ("Service") position on gifts made from revocable trusts within three years of the trust grantor's death, and appropriate strategies to minimize gift and estate tax liability in light of the Service's position.

## I. LIFETIME GIFTING STRATEGIES

### A. Grantor Retained Interest Trusts

One type of lifetime gifting strategy which has received substantial attention recently is the grantor retained interest trust ("GRINT"). Prior to the 1990 Act,<sup>10</sup> the GRINT was an effective type of lifetime gifting strategy to achieve substantial transfer tax savings.<sup>11</sup> The 1990 Act substantially impacted on the gift tax consequences of GRINTs and therefore on their viability as a mechanism to achieve meaningful transfer tax savings.

A GRINT is an irrevocable trust established by a grantor<sup>12</sup> in which the grantor retains one or more property rights from the trust for a term of years (or for a period ending on the first to occur of the grantor's death or the expiration of the term of years). The typical property right is either (1) a retention of an income or use interest (such a trust is referred to as a "GRIT," a grantor retained income trust), (2) a retention of an annual fixed dollar amount, known as an annuity interest (such a trust is referred to as a "GRAT," a grantor retained annuity trust), or (3) a retention of a percentage of the periodic fair market value of the trust, known as a unitrust interest (such a trust is referred to as a "GRUT," a grantor retained unitrust). At the expiration of the term of the retained property right, the funds are then distributed outright or continue to be held in trust for the named beneficiaries.<sup>13</sup> If the grantor dies prior to the expiration of the grantor's retained interest

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by which estate planners can reduce the estate and gift tax burden through special patterns of transferring their property . . . ." H.R. REP. NO. 1380, 94th Cong., 2nd Sess. 5, *reprinted in* 1976-3 (Vol. 3) C.B. 735, 741. However, there remain inconsistencies between the estate and gift tax system, other than tax rates, which do provide potential planning opportunities. The lifetime gifting strategies examined in this Article are examples of these opportunities.

10. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

11. *See, e.g.,* Harrison, *The Effective Use of GRITs to Reduce the Gross Estate*, 68 TAXES 524 (1990) (discussing the transfer tax savings associated with the use of certain GRINTs). When this Article refers to "transfer tax savings," reference is to amounts shielded from estate and gift taxes (not necessarily savings from the generation skipping transfer tax).

12. The grantor is the "contributor" of funds to the trust.

13. The grantor designates the named beneficiaries when he or she establishes the trust.

term,<sup>14</sup> the funds may, pursuant to an additional property interest retained by the grantor, revert to the grantor's estate or be subject to a general power of appointment held by the grantor.

Because the trust is irrevocable and the grantor retains no right to alter the terms of the trust, the transfer of funds to the trust is a completed gift.<sup>15</sup> The value of this gift, for gift tax purposes, is the value of the property transferred minus the value of the grantor's retained interests:<sup>16</sup> the right to receive the income (or the annuity-type payment) for the retained interest term, or for a period ending on the first to occur of the grantor's death or the expiration of retained interest term, and (if retained) a reversion of or general power of appointment over the property if the grantor dies prior to the expiration of that certain number of years. The greater the value for gift tax purposes of the grantor's retained interests, the lesser is the value of the taxable gift, that is, the remainder component of the GRINT.

Prior to the 1990 Act, the retained interests were valued pursuant to Treasury Regulation section 25.2512-5<sup>17</sup> and section 7520 of the Code.<sup>18</sup> The 1990 Act now provides that these interests are valued (or, in the case of retained reversionary and income interests, unvalued) pursuant to new section 2702 of the Code, in conjunction with section 7520.<sup>19</sup> Regardless of which sections of the Code apply to the valuation of the retained interests, this valuation is subject to the following general rule: The greater the number of years of the retained interest, the greater the value of the grantor's retained interests and the lesser the value of the taxable gift.<sup>20</sup>

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14. The phrase "retained interest term" is used herein to refer to the period that the grantor retains an annuity, income or use interest in the trust, such as the five-year term, 10-year term, or so on.

15. Treas. Reg. § 25.2511-2 (as amended in 1983).

16. *Id.* (for gift tax purposes, a gift is technically incomplete as to the value of that portion of the interest transferred which is retained by the grantor); see also Treas. Reg. § 25.2511-1(e) (as amended in 1986) ("If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred."); Treas. Reg. § 25.2511-1(h)(7) (as amended in 1986) (giving an example with respect to how to value a gift with a retained interest).

It should be noted that the grantor cannot make a taxable gift to himself because the value of the property transferred would be equal to the value of the property retained.

17. Treas. Reg. § 25.2512-5 (1984).

18. I.R.C. § 7520 (1988).

19. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388. (creating § 2702 of the Code).

20. To illustrate this concept under pre-1990 Act law, assume that *A*, age 60, transfers \$1,000,000 to an irrevocable trust in which he retains an income interest for 5 years. *A*'s brother, *B*, is the trustee. During the month of transfer, the federal midterm rate is 6.8%. The gift consequences to *A* are calculated assuming an interest rate equal to 120% of the federal midterm rate in effect during the month of the transfer. I.R.C. § 7520 (1988). Using the formula,  $1 - 1/(1 + i)^t$ , where *i* equals the interest rate and *t* equals the term of years, the value under pre-1990 Act law of an income interest for 5 years under an assumed interest rate of 8.2% (6.8% x 120%) equals .325684 of the property transferred, or \$325,684.

If *A* retained an income interest for 10 years, then the value of that interest under the same assumptions equals \$545,297.

If the grantor survives the term of years during which he or she has the retained interests, the remaining property in the trust passes to the beneficiaries, free of additional gift or estate tax cost.<sup>21</sup> The only estate or gift tax cost in that event is the gift tax at the time the trust was established.<sup>22</sup> If the grantor dies prior to the expiration of his or her retained property interest, then the tax liability depends upon the type of interest retained. If the retained property interest was an income interest, then the full value of the trust at the time of the grantor's death is included in the grantor's gross estate pursuant to section 2036(a).<sup>23</sup> If the retained property interest was an annuity interest, then a fraction of the value of the trust is included in the grantor's gross estate pursuant to section 2036(a).<sup>24</sup> In either case, the transfer was initially a transfer with a retained income (reversionary) interest and that retained interest is held by the transferor at death.

The 1990 Act creates section 2702 of the Code, which relates to the valuation of retained interests in trusts, and supersedes, in certain situations, those rules set forth in Treasury Regulation section 25.2512-5 for valuing retained interests in trusts.<sup>25</sup> Section 2702 will apply in determining the gift tax value

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Hence, the value of the gift in the first situation equals \$1,000,000 minus \$325,684 (the retained interest), or \$674,316; the value of the gift in the second situation equals \$1,000,000 minus \$545,297 (the retained interest), or \$454,703.

21. *But see* I.R.C. § 2036(c) (1988) (the anti-estate freeze provision of the Code prior to its repeal); Harrison, *supra* note 11, at 529-34 (1990) (discussing the application of § 2036(c) to GRITs).

22. Technically, the gift is of the remainder interest, which is a future interest. Therefore, the gift does not qualify for the gift tax annual exclusion. I.R.C. § 2503(b) (1988). For a discussion on annual exclusion gifts, see *infra* notes 48-53 and accompanying text.

23. I.R.C. § 2036(a). Generally, § 2036(a)(1) includes in the value of a decedent's gross estate for estate tax purposes the value of all property which the decedent has transferred for less than adequate and full consideration, under which he or she has retained the right to the enjoyment of income from, or control over, the property for his or her life. *Id.* § 2036(a)(1). This is often referred to as a "transfer with a retained interest." Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241, 261 (1988).

The full value of the trust may also be included in the grantor's gross estate pursuant to § 2037(a). *See* I.R.C. § 2037(a) (1988). Generally, § 2037(a)(2) includes in the value of a decedent's gross estate for estate tax purposes the value of all property which the decedent has transferred for less than full and adequate consideration, under which he or she retained a reversionary interest in the property which exceeded five percent of the value of the property immediately before the decedent's death. *Id.* § 2037(a)(2).

24. *Id.* § 2036(a). There is no three-year rule pursuant to § 2035 of the Code when the grantor's income interest expires. *Id.* § 2035. This is because there is no "transfer" at that time; it is merely treated as a "lapse." *See* Rev. Rul. 76-273, 1976-2 C.B. 268 (presenting a possible approach to determine the amount of property included in the grantor's gross estate if death occurs during the time the grantor has a retained annuity or unitrust interest, as opposed to a retained income interest).

25. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388. (creating § 2702 of the Code). Dan Rostenkowski, Chairman of the House Ways and Means Committee, initially released, in March of 1990, a discussion draft that would repeal § 2036(c) and substitute in its place a set of rules intended to modify the gift tax valuation rules. *House Ways and Means Committee Chairman Dan Rostenkowski's Discussion Draft of Bill to Modify Section 2306(c) of Internal Revenue Code Relating to Estate Valuation Freezes, Announcement of*

of a transfer of an interest in trust to, or for the benefit of, a member of the transferor's family when the transferor retains an interest in the trust.<sup>26</sup> "Members of the family" include the transferor's spouse, lineal descendants and ancestors, brothers and sisters, lineal descendants and ancestors of the transferor's spouse, and spouses of any of the foregoing.<sup>27</sup> The section, therefore, has application to most, if not all, GRIT situations.

Pursuant to section 2702(a), a retention of a right determined by reference to the income, or a contingent reversionary right to trust corpus, is disregarded for gift tax valuation purposes; that is, the right is treated as being of zero value.<sup>28</sup> Only "qualified interests" are valued. Such interests include: (1) a fixed amount payable at least annually, (2) an amount payable at least annually which is a fixed percentage of the fair market value of the trust's assets (a "unitrust" interest), or (3) a noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2).<sup>29</sup>

If a grantor establishes the historical GRIT by retaining an income and reversionary interest for a term of years, the value of the gift would, under the new section 2702(a) valuation rules, be the full value of the property transferred.<sup>30</sup> Instead of the traditional GRIT, a grantor must now generally establish either a GRAT or a GRUT. But without the ability to reduce the gift tax value of the remainder by a contingent right to the property, for example, by retaining a reversion or power of appointment,<sup>31</sup> and by requiring that pay-

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*April 24 Hearing on Draft and Summary of Draft*, Released March 22, 1990, 1990-57 Daily Tax Rep. (BNA) L-1 (Mar. 23, 1990). The rules set forth in the proposal operated "by adopting valuation assumptions that take into account the likelihood that related parties will not exercise rights in an arm's-length manner." *Federal Tax Consequences of Estate Freezes*, [New Materials] Fed. Est. & Gift Tax Rep. (CCH) ¶ 11,860 (Mar. 24, 1990). He introduced later in that year H.R. 5425, a bill which substantially followed the text of the discussion draft, and which formed the foundation of the 1990 Act's provisions affecting GRITs. H.R. 5425, 101st Cong., 2d Sess., reprinted in [New Materials] Fed. Est. & Gift Tax Rep. (CCH) ¶ 11,868 (1990). The new § 2702 substantially follows the analogous provisions proposed in Rostenkowski's Bill, H.R. 5425.

26. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388 (creating § 2702(a)(1) of the Code).

27. *Id.* (creating §§ 2702(e), 2704(c)(2) of the Code).

28. *Id.* (creating § 2702(a)(2)(A) of the Code). *But see infra* notes 46-47 and accompanying text.

29. *Id.* (creating § 2702(b)(1)-(3) of the Code). The retention of a right to a fixed amount payable annually creates a GRAT and the retention of a right to a fixed percentage of the annual fair market value payable annually creates a GRUT.

30. The retained interests in a GRIT do not fall within the definition of "qualified interests." *See id.* Therefore, the retained interests would be valued at zero, and the value of the gift for gift tax purposes would equal the full value of the property transferred.

31. When a GRIT was established, if the grantor retained both an interest for a term of years and a reversion in or a general power of appointment over the property during that term, the Code allowed the gift tax value of the GRIT to be reduced to account for the risk that the property would not vest with the remainderman. I.R.C. § 7520 (1988); Treas. Reg. § 25.2512-5 (1984). Thus, if the grantor survived past the term of years of the GRIT, and the property vested with the remainderman, the property transferred was only partially subject to a transfer tax because of the discount allowed. *See generally* Harrison, *supra* note 11, at 526 (explaining the sources of transfer tax savings with GRITs prior to the 1990 Act).

ments be either in an annuity or unitrust form,<sup>32</sup> the proposal substantially impairs the viability of GRINTS for transfer tax savings purposes.

The GRUT can result in no transfer tax gain because the valuation of the remainder interest in a GRUT is merely a percentage of the contributed property—based on the grantor's retained interest—and is not generally dependent on interest rates.<sup>33</sup> For example, the remainder interest in a one-year 9% GRUT is 91% of the property transferred (100% minus the 9% retained interest), in a two-year 9% GRUT, it is 82.81% (91% less 9% of that amount), and so on. If a grantor retains a unitrust interest, even though the percentage is fixed, the amount that the grantor is to receive each year will change based on a change in the fair market value of the GRUT.

If a unitrust interest is retained, then regardless of the rate of after-tax

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32. The primary advantage of the GRIT, in addition to the reduction of the gift tax value by retention of a reversion, *see supra* note 31, was the ability of the trustee, after the gift tax valuation, to reduce the grantor's retained income interest to the benefit of the remainderman. The trustee of a GRIT could decide to invest in high growth, low yield assets, thereby transferring, in effect, more property to the remainderman than was assumed for gift tax valuation purposes, while depriving the grantor of his or her assumed retained income. For example, if the gift tax valuation discount rate was assumed to be 10.80%, then the grantor was assumed to be receiving a 10.80% rate of return each year via his or her income interest. If the trustee invested the GRIT in assets which yielded 6.80% in income and 4% in growth each year, then 6.80% in income was returned to the grantor while the 4% in growth was transferred, free of gift tax, to the remainderman. This arguably was abusive since the initial gift tax valuation assumed that the grantor would be receiving income equal to 10.80% of the GRIT each year.

As a result of this perceived abuse, the Service imposed a "reasonable rate of return" requirement on GRITs. If the remainder interest was initially valued assuming an income interest at *X%*, and the grantor did not receive a "reasonable rate of income" (which was not defined but was probably something approximating *X%*) then in each year in which the grantor did not receive a reasonable rate of return, the Service deemed the grantor to have made a taxable gift. Priv. Ltr. Rul. 88-06-082 (Nov. 18, 1987); *see also* Priv. Ltr. Rul. 89-05-045 (Nov. 8, 1988) (stating that failure of the grantor each year to exercise power to make the trust "normally productive under the standards usually applicable to simple trusts" will result in an additional gift); Priv. Ltr. Rul. 88-01-008 (Oct. 7, 1987) (in a trust funded with subchapter S stock whose dividend rate was substantially lower than the average rate for publicly traded corporations, the grantor made a gift each year equal to the lost income which would have been recognized had the trust property been more productive); Priv. Ltr. Rul. 86-42-028 (July 16, 1986) (stating that the valuation tables may not be used where property which produced a low rate of return, averaging less than one percent for the immediately preceding five years, was transferred to the GRIT *and* the grantor had no right to compel the trustee to make the property more productive). The new valuation rules established by the 1990 Act dictate that, except for retained interests in either a personal residence or tangible property, discussed *infra* notes 46-47 and accompanying text, the grantor's retained interest be in an annuity or unitrust form in order to decrease the value of the remainder interest for gift tax purposes. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388 (creating § 2702(b) of the Code); *see supra* note 29 and accompanying text. This requirement eliminates the potential abuse associated with GRITs that did not earn a "reasonable rate of return."

33. If the annuity payment is made at the end of the year (rather than at the beginning of the year) based on fair market value as of the beginning of the year, the value of the remainder interest, and therefore the taxable gift, increases. *See* Table F, I.R.S. Publication 1458 (Aug. 1989). The theory behind that increase is that the remainder interest has the use of each annuity interest for one year and therefore receives a one-year rate of return on each annuity payment.



income and appreciation ("rate of return") on investments experienced during the existence of the retained interest term, the discounted present value of the property at the end of the retained interest term would generally equal the gift tax value of the property transferred. In other words, the grantor would be in an equivalent position from a transfer tax savings perspective by gifting the remainder component of the GRUT directly to a beneficiary versus establishing the GRUT.<sup>34</sup>

*Example 1:* To illustrate this concept, assume that a grantor establishes a GRUT and retains the right to receive 9% of the GRUT annually, payable at the date of funding and thereafter at the anniversary date, for a five-year term. Pursuant to the Service's valuation tables,<sup>35</sup> the present worth of the remainder interest in a five-year 9% GRUT (with the annuity payment made at the beginning of the year) equals .624032 of the interest transferred. If the GRUT is funded with \$1,000,000, then the grantor will have made a gift equal to \$624,032. If the GRUT experiences a 13% rate of return, this \$624,032 may be compared with the discounted present value of the property which ultimately passes to the remainderman at the end of the five-year term:

Beginning of Year	Amount of Property	9% of Property Returned to Grantor	Appreciation By 13%	Property Remaining at End of Year
1	\$1,000,000	\$90,000	\$118,300	\$1,028,300
2	1,028,300	92,547	121,648	1,057,401
3	1,057,401	95,166	125,091	1,087,325
4	1,087,325	97,859	128,631	1,118,097
5	1,118,097	100,6239	132,271	1,149,739

It is only consistent to use 13% as the discount factor to determine the present value of \$1,149,739, the property passing to the remainderman at the end of the term. That is, had the gift of \$624,032 been given outright rather than transferred via the GRUT, it is a logical assumption that the \$624,032 could have experienced the same growth rate as the property in the GRUT. The discounted present value of \$1,149,739 received five years in the future, under an assumed discount rate of 13%, is \$624,032,<sup>36</sup> which is the same as the initial gift tax value incurred in setting up the GRUT.

Whereas a retained unitrust interest eliminates the potential for transfer tax savings, a retained annuity interest leaves open the possibility for transfer tax savings. But even with the use of a GRAT, section 2702 eliminates two major transfer tax saving components previously associated with a GRIT. First, there is no reduction in the gift tax value of the remainder by retention of a rever-

34. See *infra* notes 54-60 and accompanying text (discussing the unified credit and leveraging the unified credit, topics which affect on this GRIT analysis).

35. Table D, I.R.S. Publication 1458 (Aug. 1989).

36. The discounted present value formula is:  $1/(1 + i)^t \times A$ , where  $i$  equals the interest rate,  $t$  equals the term of years and  $A$  equals the future lump-sum payment. Here, the calculation is:  $1/(1 + .13)^5 \times \$1,149,739$ .

sion. Second, the trustee can no longer deprive the grantor of the grantor's retained interest—income—by investing in high growth assets (which had the effect of transferring a part of the grantor's income interest tax free to the remainderpeople).<sup>37</sup>

The only time that the establishment of a GRAT will result in a transfer tax advantage is if the GRAT experiences an average rate of return greater than the discount rate used for gift tax purposes to value the GRAT when it is established. A transfer tax gain results in that situation because the discounted present value of the annuity will be greater than its true value under the rate of return experienced by the GRAT. The actual transfer tax savings is the difference between the discounted present value of the annuity under the assumed rate and the discounted present value under the actual GRAT rate of return, multiplied by the initial funding amount, and increased each year by the GRAT rate of return. The formula for determining the amount which, because of the GRAT, passes free of any transfer tax is:

$$\left[ \frac{1 - \frac{1}{(1+i)^t}}{i} - \frac{1 - \frac{1}{(1+i_2)^t}}{i_2} \right] \times A \times F \times (1+i_2)^t$$

In this formula,  $i$  is the assumed gift tax valuation rate,  $i_2$  is the actual investment return rate,  $t$  is the number of years of the GRAT,  $A$  is the percentage of the initial value of the GRAT paid as an annuity, and  $F$  is the initial funding amount of the GRAT. By removing the factor  $(1+i_2)^t$ , the equation produces the result in discounted present value dollars.

*Example 2:* Assume a five-year GRAT is created. In order to reduce the value of the remainder pursuant to the new section 2702 valuation rules, the grantor,  $G$ , retains a five-year, \$50,000 per year annuity interest in the \$1,000,000 transferred to the GRAT. Assume 120% of the federal midterm rate in effect for the month of the transfer is 10.60%. The value of this annuity interest is .18667 of the value of the interest transferred.<sup>38</sup>  $G$  could retain a reversionary interest in the property if she dies prior to the expiration of her income interest, but the value of this reversion for gift tax purposes would be zero under section 2702. Hence, the value of the remainder

37. See *supra* notes 31-32. Implicit throughout this section is the conclusion that the congressional draftsman of new § 2702 was either extremely analytical and perceptive, or fortuitous, in enacting a scheme which is reasonable on its face and in effect eliminates most uses of GRINTs as transfer tax reduction devices.

38. See Appendix A.

interest is .81333 of the value of the interest transferred (that is, 1 minus .18667, the value of the grantor's retained interest). Because \$1,000,000 was transferred to the trust, the gift is equal to \$813,330. If the after-tax income and appreciation experienced by the property in the trust is, on average, 9% annually, then at the end of five years, the following property remains in the trust:

<u>End of Year</u>	<u>Amount in Trust</u>	<u>Payout to Grantor</u>	<u>Property Remaining in the Trust</u>
1	\$1,090,000	\$50,000	\$1,040,000
2	1,133,600	50,000	1,083,600
3	1,181,124	50,000	1,131,124
4	1,232,925	50,000	1,182,925
5	1,289,388	50,000	<u>1,239,388</u>
	Amount Remaining:		<u>\$1,239,388</u>

The discounted present value of the right to receive \$1,239,388 five years in the future, under an assumed discount rate of 9%, equals \$805,517,<sup>39</sup> which is .805517 of the interest transferred. Therefore, the grantor—by being treated as having made a taxable gift of \$813,330 in year one—has paid more gift tax, or has used more of her unified credit,<sup>40</sup> than necessary in order to ensure that the donees have \$1,239,388 five years in the future.

If the income and appreciation attributable to this trust property during this period averaged a rate equal to 10.60%, the rate initially assumed in valuing the gift for gift tax purposes, then the discounted present value of the property at the end of five years would equal the gift tax value.<sup>41</sup>

If the income and appreciation attributable to this property during this period averaged a rate in excess of 10.60%, then a more positive result would occur: the grantor would have transferred more property to the remainderman than the amount deemed transferred for gift tax purposes.<sup>42</sup> However, absent a substantial difference between the gift tax valuation rate and the actual rate of return experienced by the GRAT, the transfer tax savings will not be that substantial.<sup>43</sup> And from a pragmatic perspective, the transfer tax savings may

39. The calculation is:  $1/(1 + .09)^5 \times \$1,239,388$ .

40. See *infra* notes 54-60 and accompanying text (discussing the unified credit).

41. See Appendix B.

42. See Appendix C.

43. For example, Appendix C illustrates that if the GRAT rate of return is 12% whereas the initial valuation rate was 10.60%, then a 5% (\$50,000 per year), five-year GRAT funded with \$1,000,000 will yield a transfer tax gain of \$819,761 minus \$813,330 or \$6,431 (in discounted present value dollars). The rate of return in that case was about 13% greater than the assumed gift tax valuation rate. Consider a GRAT funded with \$1,000,000 at an assumed discount rate for gift tax purposes of 6%. If the actual rate of return is 10%, then a five-year, 5% GRAT will result in transfer tax savings equal to \$21,079 (in discounted present value dollars). However, larger numbers and larger differentials between the assumed gift tax valuation rate and actual GRAT rate of return increase the potential for transfer tax savings.

not be worth the trouble of explaining: (1) the GRAT technique to a potential grantor; (2) the risk that, if the retained annuity amount was not sufficiently large to have reduced the gift tax value of the remainder to zero, the assumed gift tax discount rate turns out to be greater than the average actual rates of return; and (3) the other downside generally associated with a grantor retained interest trust.<sup>44</sup>

The effective date of new section 2702 was October 8, 1990.<sup>45</sup> Because of section 2702, the GRIT concept, even in GRAT form (and especially in GRIT or GRUT form), has been effectively removed from the tax planner's arsenal except in the most unusual of economic environments (for example, when the federal midterm rate used to value the GRAT is exceptionally low compared to the expected rate of return which will be experienced by the GRAT). Use of the grantor retained interest concept will now involve an added degree of risk by the grantor, the hope being that the rate of return experienced by the GRAT substantially exceeds the assumed rate for gift tax valuation purposes.

The new valuation rules set forth in section 2702(a) do not apply to certain transfers of interests in a personal residence or tangible property.<sup>46</sup> Hence, a GRIT could be created under current law and funded solely with a personal residence or tangible property.<sup>47</sup>

#### B. Annual Exclusion Gifts

Annual exclusion gifts remain an effective means to reduce eventual estate taxes. Section 2503(b) of the Code provides that a gift of a present interest in property will not result in a taxable gift, to the extent the total amount given to the donee by the donor in any one year is less than or equal to \$10,000.<sup>48</sup> Section 2513 increases this amount to \$20,000 per donee if the donor's spouse

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44. For example, if the grantor passes away during the term of his or her retained annuity interest, a portion of the then value of the GRAT is back in the grantor's gross estate for estate tax purposes. See I.R.C. § 2036(a) (1988); see also Rev. Rul. 76-273, 1976-2 C.B. 268; *supra* notes 23-24 and accompanying text. A second downside is that the trust must be irrevocable and therefore, once established, the trust terms cannot change (absent the exercise of a properly designed power of appointment). Because the property will ultimately pass to beneficiaries at the termination of the grantor's annuity interest, the grantor must be certain that he or she will not need the funds to live on after the expiration of the grantor's annuity interest. A third downside relates to the administrative inconvenience of having a trust. One other than the grantor should be the trustee. The trust terms must be carefully considered and properly drafted. Moreover, the trust must file income tax returns and I.R.S. form 1041s each year and make the appropriate annuity distributions.

45. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602, 104 Stat. 1388 (creating § 2704(e)(1)(A) of the Code).

46. *Id.* (creating §§ 2702(a)(3)(A)(ii), 2702(c)(4) of the Code).

47. The value of the retained interest of a GRIT funded with personal property is "the amount for which such interest could be sold to an unrelated third party." *Id.* (creating § 2702(c)(4)(B) of the Code). As a practical matter, those instances in which a GRIT would be established and funded with a personal residence or tangible personal property may be quite rare.

48. I.R.C. § 2503(b) (1988).

consents to having the gift treated as if he or she had made one-half of the gift.<sup>49</sup> This \$10,000, or \$20,000 if the spouse consents, per donee per year is often referred to as the "gift tax annual exclusion." There is no limit on the number of potential donees in any year.<sup>50</sup>

Under recent Joint Committee on Taxation proposals, the gift tax annual exclusion would be limited in total to \$30,000 per donor per year.<sup>51</sup> Under these proposals, the current limitation of \$10,000 per donee would continue to apply.<sup>52</sup>

If a husband and wife have a modest-size family, which includes grandchildren, an annual gifting program can make substantial inroads to reducing the couple's gross estate.

*Example 3:* Grandmother and Grandfather have three children, two of whom are married, and four minor grandchildren. The current gross estate for estate tax purposes of Grandmother and Grandfather approximates \$5,000,000. If Grandmother and Grandfather engage in an annual gifting program to each of the potential nine donees (three children, two spouses of those children, and four grandchildren), Grandmother and Grandfather could give away \$180,000 per year without any gift tax. At the end of ten years, \$1.8 million, plus the income from and appreciation of that property, would have been gifted free of gift tax and would not be subject to estate tax at the grandparents' deaths. Further, if properly structured, the transfers could also avoid generation-skipping transfer tax.<sup>53</sup>

### C. Taxable Gifts and the Unified Credit: Leveraging the Credit by Gifts During Life

Another viable strategy for lifetime gifting is the use of the unified credit during life. The Code provides a credit on the first \$192,800 in gift or estate taxes incurred by an individual.<sup>54</sup> This amount, referred to as the "unified credit against gift and estate taxes," will shield the first \$600,000 in taxable transfers from any actual payment of tax.<sup>55</sup>

Currently, the unified credit remains stable at \$192,800. Unlike the tax

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49. *Id.* § 2513.

50. *Id.* § 2503.

51. Joint Committee on Taxation Staff Explanation (JCS-4-90) of Miscellaneous Tax Proposals Scheduled for Hearing Feb. 21-22, 1990, before House Ways and Means Committee's Subcommittee on Select Revenue Measures, Released Feb. 14, 1990, 1990-32 Daily Tax Rep. (BNA) L-3 (Feb. 15, 1990) [hereinafter Tax Proposals]. These proposals have not yet been included in any congressional bill.

52. *Id.*

53. A generation-skipping transfer tax is imposed on certain transfers to a person two or more generations below the transferor. I.R.C. §§ 2601-2613 (1988). The generation-skipping transfer tax uses a flat rate equal to the then highest estate and gift tax rate. Each transferor is allowed a \$1 million exemption allocable to and among transferred property. *Id.* § 2631(a).

54. *Id.* §§ 2010(a), 2505(a).

55. To the extent the unified credit is used during life, it will not be available at death to decrease the actual estate tax payment. *See id.* § 2001.

rates schedules, the unified credit is not indexed for inflation.<sup>56</sup> This means that in an era when investors receive positive returns on their investment, the value of the \$600,000 that the unified credit can shield against the payment of either estate or gift tax becomes worth less each year.

*Example 4:* The present worth of one dollar to be received  $t$  years in the future during a period when the average rate of return is  $x\%$  annually can be calculated by the following algebraic formula:  $1/(1 + x\%)^t$ . If the average rate of return during the next five years is 10.20%, then the value of \$600,000 in five years equals only .615307 of the \$600,000, or \$369,184.<sup>57</sup> In other words, the value of \$600,000 to be received five years in the future, in today's dollars, is only \$369,184.

Therefore, in order for an individual to maximize the economic benefit of the unified credit, the individual should use the unified credit during life as opposed to having the estate use the credit at death.

*Example 5:* Suppose client  $A$  gratuitously transfers assets currently worth \$600,000, thereby fully utilizing  $A$ 's unified credit.<sup>58</sup> If these assets appreciate to \$3,000,000 twenty years from now, then that \$3,000,000 will be out of  $A$ 's gross estate for estate tax purposes. On the other hand, if this transfer is not made now, then those assets, worth \$3,000,000 at  $A$ 's passing, will be in  $A$ 's estate and only \$600,000 of that amount will be shielded from the estate tax by  $A$ 's unified credit available at death.

Of course, additional considerations become relevant when deciding whether to use the unified credit during life. One consideration is the interplay between taxable gifts and annual exclusion gifts. For example, if an individual has three potential donees, the grantor can transfer \$60,000 per year to those donees and, in ten years, give away \$600,000.<sup>59</sup> If the same donor had used the unified credit in year one to gift \$600,000, but had not combined that gift with additional gifts of \$20,000 per beneficiary per year, then the donor would have in effect partially wasted the unified credit.<sup>60</sup>

One should also consider the fact that gifts are irrevocable. Therefore, from a practical perspective, a donor must be certain that he or she will not need in the future the funds that have been gifted. In this regard, each potential donor

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56. See, e.g., I.R.C. § 1(f) (1988) (tax tables are to be adjusted for inflation each calendar year). As expected, Congress has ignored the inequities of the current transfer tax system in its efforts to eliminate areas of abuse.

57.  $1/(1 + .1020)^5$ .

58. Assuming the annual exclusion does not apply.

59. Assuming the grantor's spouse consents to having the gift treated as if he or she had made half of it. For an explanation of annual exclusion gifts and the current amounts allowed see *supra* notes 48-50 and accompanying text.

60. Arguably the \$600,000 transferred in year one will increase in value faster than \$60,000 per year transferred over a 10-year period (any increase in value is not subject to gift or estate taxes). However, depending on the actual rate of return, this potential difference should not outweigh the "waste" of using the unified credit when the same gratuitous transfers could have been accomplished by annual exclusion gifts, thereby preserving the unified credit for future use.

should be treated differently, and part of the gifting discussion with any potential donor should focus on the aspect of future income needs.

*D. Gifting Interests in Closely Held Stock in Order to Obtain Valuation Discounts*

If an individual decides to engage in an inter vivos gifting strategy, and that individual holds stock in a closely held business, the securities in that business may be an attractive asset to gift.<sup>61</sup> First, closely held stock may appreciate more than other assets held by the individual, such as stock of publicly traded corporations. Moreover, if an individual has a controlling interest in a closely held corporation, the transfer by that individual of a portion of his or her interest in the corporation prior to death may lead to three beneficial valuation results. First, the gift itself may be entitled to a valuation reduction because it is a gift of a noncontrolling interest in the corporation. This valuation reduction is referred to as a "minority discount."<sup>62</sup> Second, at the individual's passing, the closely held corporate stock in his or her gross estate may no longer be subject to a control premium tacked onto its valuation.<sup>63</sup> Finally, the individual may be allowed a minority discount for the shares included in the individual's gross estate.<sup>64</sup>

*Example 6:* Father owns fifty-five percent of the voting common stock of closely held corporation C. During his lifetime and a substantial time prior to his death (at least three years), Father transfers a sufficient amount of

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61. The following analysis is subject to the caveat that in any inter vivos gifting program, it is generally desirable to transfer assets with as high a basis as possible in order to avoid income tax exposure in the future, for example, when the donee sells the gifted property. Gifted assets retain the same basis in the hands of the donee as they had in the hands of the donor. I.R.C. § 1015(a) (1988). For example, an inter vivos gift of \$10,000 in cash is worth more to the donee than an inter vivos gift of \$10,000 in securities if the donor's basis in the securities was less than \$10,000. If the donee were to immediately sell the securities, the donee would have to pay an income tax on the sale proceeds.

Assets with a low basis should generally be retained by the donor in order to achieve a basis step-up at death. See I.R.C. § 1014 (1988) (basis of property acquired from a decedent is its fair market value at the date of the decedent's death).

However, an annual exclusion gift, discussed *supra* notes 48-53 and accompanying text, which removes assets that would otherwise have resulted in additional estate tax being incurred, will be tax beneficial regardless of the donor's basis. Income taxes are generally at a highest marginal rate of 33% before January 1, 1991 (or roughly 31% thereafter) which is less than the lowest effective marginal estate tax rate, 37%. I.R.C. § 2001(b) (1988). Assuming minority discounts will emanate from a taxable gift of a small amount of closely held stock with a low basis, see *infra* notes 68-96 and accompanying text, that type of gift should produce potential estate tax savings which substantially outweigh the income tax loss by not achieving a basis step-up at death as to the gifted shares. However, a taxable gift of a substantial amount of closely held stock with a low basis needs to be analyzed to determine if the potential estate tax savings by achieving minority discounts outweighs the income tax disadvantage associated with the loss of the basis step-up as to the gifted stock.

62. See *infra* notes 68-80 and accompanying text.

63. See *infra* notes 97-102 and accompanying text.

64. See *infra* notes 81-96 and accompanying text.

the stock to other family members so he owns only forty-five percent of the voting stock of the corporation. Along with the transfer, Father *de facto* relinquishes control of the corporation, and his current minority stock interest demonstrably affects his beneficial interests in the corporation (*inter alia*, he loses his position as Chairman of the Board of the corporation). Further, the actions of Father and his family in voting the stock do not evidence unitary control. In valuing the forty-five percent interest at Father's death, the estate may be able to argue effectively that there should be no "control premium" tacked onto the valuation of the stock because Father did not own a controlling block of the stock at his death.<sup>65</sup> Further, in valuing the shares that were transferred to other family members during Father's lifetime, it is arguable that a minority discount should apply.<sup>66</sup> Moreover, Father's estate may now be entitled to a minority discount in valuing the closely held shares held by Father at his death.<sup>67</sup>

The gifting of interests in closely held stock should be carefully analyzed in light of existing and developing case law and the Service's position on the availability of minority discounts and the imposition of control premiums.

### 1. *Minority Discounts*

In valuing any interest in the gross estate, the starting point is fair market value. Fair market value is determined according to the familiar "willing buyer/willing seller" test. Under this test, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."<sup>68</sup> The willing buyer/willing seller test recognizes that a block of shares of a closely held corporation may be less valuable if the block constitutes a minority interest. Consequently, in certain situations, a "minority discount" will apply.<sup>69</sup> In effect, the minority

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65. See *infra* notes 97-102 and accompanying text.

66. See *infra* notes 72-80 and accompanying text.

67. In this situation, the Service may take the opinion that a type of family attribution rule should apply. See, e.g., Rev. Rul. 81-253, 1981-2 C.B. 187, 188 ("[W]here a controlling interest in stock is owned by a family, the value per share of stock owned by one family member is the same as stock owned by any other family member and is the same value that would exist if all of the stock were held by one person."); see also *infra* notes 81-96 and accompanying text. Moreover, if a reviewing court adheres to the reasoning set forth in the recent Tax Court case, *Estate of Murphy v. Commissioner*, [1990] Tax Ct. Mem. Dec. (P-H) ¶ 90472 (Aug. 30, 1990), then the Father's estate will need to demonstrate, if possible, one or more of the following: that Father, in fact, relinquished majority control of the corporation, that there was not an informal agreement among the family members to retain control and to vote the stock in essence as one block, and that the transfer was motivated by more than just the anticipated transfer tax benefit associated with obtaining a minority discount. *Id.*; see *infra* notes 84-96 and accompanying text (discussing the *Murphy* decision).

68. Treas. Reg. § 20.2031-1(b) (as amended in 1965).

69. The discount assumes that an average per share value has been determined for all of the corporation's shares, such as pursuant to a book value or capitalization approach. The rationale behind the minority discount is persuasive. Shares representing a minority interest in a closely



discount devalues the minority block of shares of a closely held corporation from the value that would otherwise be determined by using an average value for all of the corporation's shares. A minority discount will generally apply if an individual holds less than a fifty percent interest in a closely held corporation.<sup>70</sup> The size of the minority discount varies from case to case and often involves an interrelated discount for lack of marketability.<sup>71</sup>

When shares are transferred to other family members, the issue of minority discounts becomes more difficult. The Service's interpretation of the Code and Regulations was articulated in Revenue Ruling 81-253:<sup>72</sup>

It is the position of the Service that ordinarily no minority discounts will be allowed with respect to transfers of shares of stock among family members where, at the time of the transfer, control (either majority voting control or de facto control) of the corporation exists in the family.<sup>73</sup>

The Service's position represents what are known as "family attribution principles." According to these principles, the rationale for the minority discount does not apply if the family as a whole still retains a controlling interest in the closely held corporation after the transfer of a minority block of shares to another family member. In these circumstances, there is no justification to devalue these shares, even though the shares represent a "minority" interest, since the shares are in fact valuable as part of a controlling majority. However, the case law generally does not support the Service's position with respect to family attribution in this setting.<sup>74</sup>

In the courts, two primary categories of issues have arisen with respect to the availability of minority discounts for intrafamily stock transfers: (1) whether a minority discount is allowed for gift tax purposes for shares given away during lifetime to family members;<sup>75</sup> and (2) whether a minority discount is allowed for estate tax purposes when a decedent owns a minority in-

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held corporation are not theoretically that attractive to most buyers since the minority shares (absent a voting or related agreement) have no real power to influence corporate policies such as determining whether to liquidate, to sell or merge the company, to issue dividends, to elect the board of directors, to determine salaries and so on. As a practical matter, the most likely potential buyers of a minority interest in a closely held corporation are the controlling shareholders. *See, e.g., Bartram v. Graham*, 157 F. Supp. 757, 770 (D. Conn. 1957) ("[T]he minority position in a closely held corporation not traded in on any market would undoubtedly cause investors generally to seek a discount from liquidating values . . .").

70. *See, e.g., Estate of Bright v. United States*, 658 F.2d 999, 1002-03 (Former 5th Cir. 1981) ("[T]he Tax Court has uniformly valued a decedent's stock for estate tax purposes as a minority interest when the decedent himself owned less than 50% . . .").

71. *See, e.g., Bartram v. Graham*, 157 F. Supp. 757 (D. Conn. 1957) (minority discount of 20% held appropriate); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954) (minority discount of 66% held appropriate).

72. Rev. Rul. 81-253, 1981-2 C.B. 187.

73. *Id.* at 188 (citation omitted); *see also Priv. Ltr. Rul. 80-10-017* (Dec. 6, 1979) (no minority discount allowed when shares transferred to a family member and shares owned by family unit as a whole constitute control).

74. *See infra* notes 77-96.

75. *See, e.g., Knott v. Commissioner*, 54 T.C.M. (CCH) 1249 (1987). *See infra* note 78.

terest in a corporation at his or her death but the decedent's family, as a whole, holds a controlling interest.<sup>76</sup>

The general position of the courts with respect to the gift tax question, and the one most typically adopted by the Tax Court, is that a minority discount is available when a minority interest is transferred to a family member.<sup>77</sup> The courts generally allow the minority discount even though the donor had a controlling interest prior to the transfer, and even though majority control is still retained by the aggregation of all of the family's shares.<sup>78</sup>

Not all courts, however, have allowed a minority discount in these intrafamily transfer situations, especially in the absence of family discord.<sup>79</sup> Fur-

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76. See, e.g., *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982). Because of family control of various corporations, the Service argued that minority discounts were inappropriate even though the decedent owned only 20% of the stock in each of the corporations. *Id.* at 952. The court rejected this position and held that decedent's interests in the various corporations were to be valued as minority interests. *Id.* at 956.

77. See, e.g., *Knott v. Commissioner*, 54 T.C.M. (CCH) 1249 (1987). See *infra* note 78. But see *Estate of Murphy v. Commissioner*, [1990] Tax Ct. Mem. Dec. (P-H) ¶ 90472 (Aug. 30, 1990); *infra* notes 84-95 and accompanying text (discussing the *Murphy* decision).

78. See *Knott*, 54 T.M.C. (CCH) at 1249. The donor transferred a 65% interest in a partnership to various family members, with each family member receiving a minority interest. *Id.* at 1251. The court rejected the Service's contention that family attribution rules should apply in valuing partnership interests for gift tax purposes: "This Court has held . . . that a minority interest in a corporation should not be assumed to have any controlling value even though the shareholder's family controls the corporation." *Id.* at 1255; see also *Ward v. Commissioner*, 87 T.C. 78, 109 (1986) (a 33½% discount allowed for gifts of noncontrolling shares from the parents, who owned control of the corporation, to their sons); *Carr v. Commissioner*, 49 T.C.M. (CCH) 507, 513-14 (1985) (the Tax Court permitted a 25% minority discount for a gift transfer from the taxpayer's parents to their children of stock in a corporation even though 100% of the shares of the corporation were owned by the taxpayers, their children and grandchildren); *Harwood v. Commissioner*, 82 T.C. 239, 268-69 (1984) (a 50% discount in the value of family partnership interest transferred by gift to the taxpayer's children was allowed based on minority interest, lack of marketability, and restrictive clauses in the partnership agreement).

79. See, e.g., *Blanchard v. United States*, 291 F. Supp. 348, 352 (D. Iowa 1968) (although gifts to various donees each constituted a minority interest, the court valued each gift as part of the controlling interest since arm's length sales of the stock within three weeks of the valuation date evidenced that they were treated as control shares by each of the donees); see also *Murphy*, [1990] Tax Ct. Mem. Dec. (P-H) at ¶ 90472 (disallowing minority discount for donor's two gifts of .88% interests of the stock, reducing her interest from 51.41% to 49.65%, because the transfer "did not appreciably affect the decedent's beneficial interest" as evidenced by the fact that the donor and her family continued to exercise control powers over the corporation even after the transfer); *Driver v. United States*, 76-2 U.S. Tax Cas. (CCH) ¶ 13,155 (W.D. Wis. 1976) (holding that it would place "form over substance" to view the transfer of an 84% control in a company as anything other than a transfer of a controlling interest). The Fifth Circuit in *Estate of Bright v. United States*, 658 F.2d 999 (Former 5th Cir. 1981), analyzed the *Driver* case as follows: "Our research has led us to the conclusion that *Driver* stands alone in judicially engrafting a family attribution doctrine upon the standards governing gift or estate tax valuation, and, for the reasons set out in this opinion, we decline to follow it." *Id.* at 1005.

Further, Congress has not been ignorant of this area. The House Ways and Means Committee version of the legislation that became the Revenue Act of 1987 included a provision that would have imposed a family attribution rule to determine whether a minority discount was appropriate. The provision would have imposed on the taxpayer the burden of proving the appropriateness of a

ther, the Service continues to apply Revenue Ruling 81-253 in the gift tax context to disallow minority discounts when the family owns control, absent evidence of family disharmony.<sup>80</sup>

The courts' position with respect to estate tax valuations is even stronger than in the analogous gift tax context. Apart from the recent case of *Estate of Murphy v. Commissioner*,<sup>81</sup> the well-settled view of the courts, though not of the Service,<sup>82</sup> is that, in estate tax valuations, shares of closely held stock owned by the decedent at the date of his or her death are treated as a unit and are not increased by shares held by other family members.<sup>83</sup>

The recent Tax Court case, *Estate of Murphy v. Commissioner*,<sup>84</sup> departed from the well-settled view of the courts in this area. In *Murphy*, the decedent, eighteen days before her death, transferred .88% interests in a corporation to each of her two children.<sup>85</sup> Before the transfer, the decedent held control over a 51.41% block of voting stock in the corporation.<sup>86</sup> After the transfer, she held a 49.65% interest in the voting rights of the corporation.<sup>87</sup> Applying the established principle that a less than fifty percent interest is a minority interest,<sup>88</sup> the decedent's estate sought to obtain a minority discount for decedent's 49.65% interest in the voting stock of the corporation at her death.<sup>89</sup> The court refused to allow a minority discount in this situation, holding that the transfer of 1.76% of the stock, the purpose of which was to relinquish control, "lacked substance and economic effect."<sup>90</sup> Accordingly, it disregarded "the plan to appear to relinquish control for transfer tax purposes, and treat[ed] the

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minority discount by "clear and convincing evidence." See H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. (1987).

80. See Tech. Adv. Mem. 89-07-002 (Nov. 1, 1988).

81. [1990] Tax Ct. Mem. Dec. (P-H) ¶ 90472 (Aug. 30, 1990); see *infra* notes 84-95 and accompanying text (discussing the *Murphy* decision).

82. See Rev. Rul. 81-253, 1981-2 C.B. 187.

83. See, e.g., *Estate of Andrews v. Commissioner*, 79 T.C. 938, 951-56 (1982) (rejecting the Service's argument that minority discounts were inappropriate even though decedent owned only 20% of the stock in various corporations because of family control and holding that decedent's interests in the various corporations were to be valued as minority interests); see also *Bright v. United States*, 658 F.2d 999, 1005 (Former 5th Cir. 1981) ("We conclude that the case law reflects long established precedent that family attribution should not apply to lump a decedent's stock with that of related parties for estate tax valuation purposes."); *Sundquist v. United States*, 74-2 U.S. Tax Cas. (CCH) ¶ 13,035 (E.D. Wash. 1974) (rejecting family attribution); cf. *Murphy*, [1990] Tax Ct. Mem. Dec. (P-H) at ¶ 90472 (considering whether the family as a unit maintained control of the corporation in determining whether a minority discount was appropriate); Rev. Rul. 81-253, 1981-2 C.B. 187 (family attribution is appropriate). Because of *Murphy*, the case law now has to be closely scrutinized to determine if future cases will adhere to the Tax Court's reasoning in *Murphy* or expand and adopt the Fifth Circuit's reasoning in *Bright*.

84. [1990] Tax Ct. Mem. Dec. (P-H) ¶ 90472 (Aug. 30, 1990).

85. *Id.*

86. *Id.*

87. *Id.*

88. See *supra* notes 68-80 and accompanying text.

89. *Murphy*, [1990] Tax Ct. Mem. Dec. (P-H) at ¶ 90472.

90. *Id.*

gift and transfer as part of one plan transferring control over to decedent's children."<sup>91</sup> The court distinguished *Bright v. United States*<sup>92</sup> by contending that in *Bright* the decedent during life always had a minority interest (exclusive of the application of family attribution rules).<sup>93</sup>

The *Murphy* court was influenced substantially by the fact that the transfer occurred eighteen days before death. According to the court, to allow a minority discount in that situation would result in an adulteration of the gift and estate tax system. Because the transfer occurred so close to death, the court concluded that nothing of substance had been transferred.<sup>94</sup> Nevertheless, if the transfer had occurred four years before death instead of eighteen days, the *Murphy* court's reasoning could still have precluded the availability of a minority discount to the decedent's stockholding. Under one of the primary tests implicitly set forth by the court for the donor to be entitled to a minority discount at death, the inter vivos transfer of control must be accompanied by a change in the donor's substantive rights.<sup>95</sup>

In summary, the courts generally, though not uniformly, agree that minority discounts are available for purposes of gift tax valuation when a noncontrolling block of closely held stock is transferred to a family member. Moreover, the courts were, prior to the Tax Court opinion in *Murphy*, uniform in their agreement that the minority discount is available for purposes of estate tax valuation if the decedent did not at death hold a control block of stock, regardless of the fact that control may have been in decedent's family. In other words, family attribution principles did not generally apply in determining the availability of a minority discount. Regrettably, the Tax Court's opinion in *Murphy* may represent the beginning of a judicial trend accepting the reasoning behind, though not the actual theory of, the Service's application of family attribution principles to this area.<sup>96</sup>

## 2. Control Premiums

The Treasury regulations indicate that, when valuing shares, in certain situations a premium should be added when the shares represent a controlling interest.<sup>97</sup> Also, the Service has specifically set forth "control" as one of the

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91. *Id.*

92. 658 F.2d 999 (Former 5th Cir. 1981) (valuing decedent's stock for estate tax purposes as a minority interest when decedent owns less than 50% interest).

93. *Murphy*, [1990] Tax Ct. Mem. Dec. (P-H) at ¶ 90472.

94. *Id.*

95. *Id.* The *Murphy* court's reasoning, though expressly denying the use of a family attribution principles, picks up various aspects of that theme. *Id.* For example, one of the primary justifications for denying a minority discount in the case was that the donor, in conjunction with her two children, still maintained control of the corporation after the transfer. *Id.*

96. For a recent case that did not follow the *Murphy* reasoning, see Estate of Lenheim, [1990] Tax Ct. Mem. Dec. (P-H) ¶ 90403 (Sept. 1, 1990).

97. Treas. Reg. § 20.2031-2(f) (as amended in 1976) ("the degree of control of the business represented by the block of stock to be valued" is a factor to be considered when valuing an interest in a closely-held business held by the estate); Treas. Reg. § 25.2512-2(f) (as amended in

factors used in valuing closely held shares.<sup>98</sup> The Tax Court has accepted the control premium theory in various cases.<sup>99</sup>

With regard to whether family attribution principles apply to the imposition of control premiums upon intrafamily transfer of closely held stock, the courts and the Service generally follow their same reasoning as in the minority discount area.<sup>100</sup> Thus, absent evidence of family disharmony, the Service would possibly apply family attribution rules to tack on a control premium in valuing shares transferred from the controlling shareholder to other family members, even though none of these donees obtained a controlling interest.<sup>101</sup> Conversely, the courts tend to ignore family attribution and do not tack on a control premium in valuing family-controlled stock in a closely held corporation.<sup>102</sup>

## II. THE BENEFITS OF THE PAYMENT OF GIFT TAX

An additional transfer tax savings occurs if the grantor pays a gift tax. In that event, there will be an additional estate tax savings that could be quite substantial. Estate taxes will be saved based on an important distinction between the gift tax system and the estate tax system. The gift tax system is tax exclusive; that is, there is no additional gift tax on the amount used to pay the gift tax. In contrast, the estate tax system is tax inclusive; in essence, there is an additional estate tax on the amount used to pay the estate tax. The following example illustrates this concept:

*Example 7:* If a testator dies with a gross estate in excess of \$8,000,000, the testator pays an estate tax of \$1,100,000 on the last \$2,000,000 transferred.<sup>103</sup> As a result, only \$900,000, of the top \$2,000,000 in the testator's gross estate, passes to the beneficiaries. If the testator isolated this same \$2,000,000 and transferred it to the same beneficiaries three years before his

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1976) ("the degree of control of the business represented by the block of stock to be valued" is a factor to be considered when valuing an interest in a closely held business transferred by inter vivos gift).

98. Rev. Rul. 59-60, 1959-1 C.B. 237, 243 ("[I]t is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.").

99. *E.g.*, Estate of Salisbury v. Commissioner, 34 T.C.M. (CCH) 1441 (1975).

100. *See supra* notes 68-96 and accompanying text.

101. *See, e.g.*, Priv. Ltr. Rul. 89-07-002 (Nov 1, 1988) (stating that where a controlling shareholder of a closely held corporation forgoes a portion of the consideration otherwise receivable on redemption of his controlling shares, and after the redemption the remaining shareholders possess only minority interests, the foregone portion of the consideration otherwise receivable is a gift which is valued based on the difference between the consideration received and the value of the controlling interest without regard to the minority character of the interests of the remaining shareholders).

102. *See, e.g.*, Estate of Bright v. United States, 658 F.2d 999 (Former 5th Cir. 1981) (the court rejected the government's attempt to use family-owned control as a basis of a control premium in valuing decedent's shares, which by themselves represented only a 27.5% interest in the corporation).

103.  $\$2,000,000 \times .55 = \$1,100,000$ .

death, how much could be transferred and what would the lost opportunity costs be? For consistency, assume a gift tax rate of fifty-five percent and prior use of the full unified credit.

The testator could transfer approximately \$1,290,322 during life.<sup>104</sup> The gift tax at the fifty-five percent rate would be \$709,678. The transfer tax savings based on the gift tax exclusively is \$390,322.<sup>105</sup> The real tax savings must take into account, however, that interest and appreciation as to the \$709,678—the gift tax paid—will be lost. Assume that the \$709,678 would grow at a seven percent after-tax rate.

The amount “lost” to the beneficiaries at the end of year three is  $\$159,708 \times .55$ , which equals \$87,839.<sup>106</sup> This is merely twenty-two percent of the tax savings attributable to making the gift transfer inter vivos versus testamentary. Further, this tax cost ignores the additional tax savings attributable to the fact that appreciation experienced by the transferred property will not be subject to estate tax. Moreover, it is unlikely that the gift tax rate will equal the assumed marginal rate in this example of fifty-five percent; therefore, the actual opportunity cost to the beneficiaries of paying the gift tax should be less than the amount illustrated in this example.

In order for the gift tax paid to be excluded from the gross estate, and hence, to obtain the benefit of gift tax exclusivity, the grantor must survive for at least three years after the transfer of property.<sup>107</sup>

### III. THE MANNER IN WHICH GIFTS MAY BE MADE

#### A. Gifts Made Directly by the Donor

To the extent that a grantor makes an annual exclusion-type gift outright to a beneficiary or, if the beneficiary is a minor, to that beneficiary's custodian pursuant to the state's Uniform Gifts or Transfers to Minors Act, the transfer will qualify for the annual exclusion from gift tax.<sup>108</sup> If the transfer is to a donee or donees by means of an irrevocable trust, then the potential donees must have a legitimate withdrawal power over the transferred property in or-

104. To derive that amount, the following formula may be used:

$X + X(.55) = \$2,000,000$ , where  $X$  equals the maximum amount of the gift that may be made at an assumed gift tax rate of 55%.

105.  $\$1,100,000 - 709,678 = \$390,322$  (the difference between the amount of estate taxes paid on \$2,000,000 transferred at death and the amount of gift taxes paid on \$2,000,000 transferred three years before death assuming a constant 55% rate).

106. The \$159,708 figure represents the amount of interest and appreciation as to the \$790,678:  $\$709,678 \times (1.07)^3 - 709,678 = \$159,708$ . This figure is then multiplied by the eventual estate tax that must be paid on this amount to arrive at the amount lost to the beneficiaries:  $\$159,708 \times .55 = \$87,839$ .

107. See I.R.C. § 2035(c) (1988).

108. *Id.* § 2503(b) (providing that a gift of a “future interest” will not qualify for the \$10,000 per donee annual exclusion from gift tax); Rev. Rul. 59-357, 1959-2 C.B. 212 (finding that for transfers to a custodian account, if the donor is not the custodian, then the property will not be included in the donor's gross estate, nor will it be an adjustable taxable gift for purposes of “grossing up” the donor's gross estate).

der to qualify for the annual exclusion from gift tax.<sup>109</sup>

The three-year survival rule that generally applies to gift taxes paid does not apply to annual exclusion gifts. These gifts can be made at any time prior to death.<sup>110</sup> Annual exclusion gifts will not be subject to gift tax, nor will they be included in the estate tax calculation as part of the gross estate or as an "adjusted taxable gift."<sup>111</sup> For example, suppose one day before the donor dies, she makes ten annual exclusion gifts. She has transferred \$100,000 out of her gross estate without the payment of any gift or estate tax.

If property in excess of the annual exclusion amount is transferred to a donee in any calendar year, then that transfer will result in a taxable gift.<sup>112</sup> To the extent the donor's aggregate taxable gifts<sup>113</sup> do not exceed \$600,000, the donor will not have to pay gift tax. The tax on aggregate taxable gifts of \$600,000 will equal \$192,800, the amount of the credit against the gift tax allowed to each individual.<sup>114</sup>

Upon the donor's death, the amount of all taxable gifts will be added to the donor's taxable estate for purposes of "grossing up" the taxable estate, that is, pushing the estate into a higher estate tax bracket.<sup>115</sup> However, the donor will be entitled to a credit for the amount of gift tax payable on these "adjusted taxable gifts" included in the tax base when the donor's estate tax is calculated.<sup>116</sup>

109. Hence the development of the so-called "Crummey withdrawal power," in which the beneficiaries of a trust or their guardians are given a withdrawal power for a certain number of days, such as thirty. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). Failure to exercise the power to withdraw the property during this period results in the property remaining in the trust. For a further discussion of this point, see Harrison, *Lapse of Crummey Power Need Not Result in Taxable Gift if Hanging Power is Used*, 17 ESTATE PLANNING 140 (1990). Recently, there was a proposal made by the Joint Committee on Taxation which would eliminate the ability of donors to create present interests in trusts by using lapsing withdrawal powers. Tax Proposals, *supra* note 51. This proposal has not yet been included as part of any congressional bill.

110. I.R.C. § 2035(d)(1) (1988).

111. *Id.* § 2503(a)-(b).

112. *Id.*

113. The aggregate taxable gifts are the total of all taxable gifts made or deemed made by the donor.

114. I.R.C. § 2010 (1988); see *supra* notes 54-55 and accompanying text.

115. I.R.C. § 2001(b)(1)(A)-(B) (1988).

116. *Id.* § 2001(b)(2). For example, when an individual that gratuitously transferred \$1,000,000 during life dies with \$1,000,000 more in her gross estate, how is that additional \$1,000,000 taxed? This is accomplished as follows: The Code provides that the amount upon which the tentative tax is to be computed equals the taxable estate (i.e., the property included in an individual's estate for estate tax purposes, the "gross estate" minus allowable deductions) plus the amount of "adjusted taxable gifts." *Id.* at § 2001(b)(1)(A)-(B). "Adjusted taxable gifts" are taxable gifts made after 1976, other than gifts which are includible in the gross estate of the decedent. *Id.* Thus, although the decedent in this example dies with a taxable estate of only \$1,000,000, all taxable gifts which the decedent made during her lifetime, other than gifts which are included in the gross estate, are added to the taxable estate for purposes of determining how much estate tax will be paid.

Therefore, the person who transfers \$1,000,000 during her life, and thereafter dies with a taxable estate of \$1,000,000, will compute her estate tax based on the \$2,000,000 amount—the tax-

If the adjusted taxable gifts have appreciated between the time the gift was made and the donor's death, this appreciation is not included in the decedent's gross estate.<sup>117</sup> Therefore, any appreciation on adjusted taxable gifts escapes transfer taxation. This is one reason why it is important to ensure that taxable gifts made during life only come back into the estate tax calculation as "adjusted taxable gifts," which is at their gift tax value, and not as part of the gross estate. Otherwise, taxable gifts would be valued as of the date of death, or on the alternate valuation date, and, in effect, a transfer tax would be assessed on the appreciation.<sup>118</sup>

#### B. Gifts Made from Revocable Trusts

Revocable lifetime trusts are established by individuals for a variety of reasons, including to avoid probate, to ensure privacy of testamentary gifts and financial affairs, to provide for the management of assets in the event of disability, and to avoid ancillary probate in other states.<sup>119</sup> The revocable lifetime trust is not a means to avoid estate or gift tax. Since the trust is revocable and subject to change at any time by the grantor, the transfer of assets to the revocable trust is not considered a completed gift for gift tax purposes.<sup>120</sup> Thus, the benefits derived from lifetime gifting do not apply. However, if the trust document provides for distribution to someone other than the grantor and the trustee makes such distributions, or if the trustee distributes property to a third party pursuant to the specific directions of the grantor, the grantor will have then made a gift of the amount distributed at the time of the actual distribution.<sup>121</sup> From a practical standpoint, there should be no difference for transfer tax purposes between distributions made from a revocable trust to a third party versus gifts made by the grantor himself to a third party.

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ble estate plus adjusted taxable gifts. Moreover, the estate is not taxed at the lower 18% through 39% brackets applicable to the first \$1,000,000 in taxable transfers. Rather, it is taxed at the 41% through 45% rates. *Id.* § 2001(c).

After the estate tax has been calculated, that individual is allowed a credit for the amount of gift tax which "would have been payable" with respect to gifts made by the decedent after December 31, 1976. *Id.* § 2001(b)(2). Therefore, the total transfer taxes paid (gift tax plus estate tax) by the individual who transfers \$1,000,000 one day before she dies, and dies with an additional \$1,000,000 in her gross estate, will be the same as the total transfer taxes (estate taxes only) paid by the individual who dies with \$2,000,000 in her gross estate.

117. In calculating the tentative estate tax, adjusted taxable gifts are added to the grantor's taxable estate in the amounts the gifts were valued at the date of the granting of the gifts. See I.R.C. §§ 2001, 2503 (1988).

118. *Id.* § 2032. If property which has been previously gifted and which has appreciated in value since that time returns to the donor as part of the donor's gross estate and not as an adjusted taxable gift, then a step-up in income tax basis would result. This is a positive result but does not outweigh the detriment to increased estate taxes resulting from this return. See *supra* note 61.

119. See generally Kohn, *Revocable Trusts—An Overview*, 49 ALA. LAW. 332 (1988) (discussing the benefits to establishing revocable trusts).

120. Treas. Reg. § 25.2511-2(b) (as amended in 1983).

121. Treas. Reg. § 25.2511-2(f) (as amended in 1983).



1. *The Service's Limitations on Gifts Made from Revocable Trusts*

Practitioners beware: recent private letter rulings indicate that the Service may not in fact treat distributions from revocable trusts in the same manner as gifts directly from a donor. In Technical Advice Memorandum 86-09-005,<sup>122</sup> *D* established a revocable trust primarily for his own benefit. Pursuant to the terms of the trust, the trustees had discretion to make gifts to *A*, *B*, *C*, and *E* in amounts up to \$10,000 per year. Within three years prior to *D*'s death, the trustees made distributions from the trust to *A* of \$15,005, to *B* of \$13,420, to *C* of \$10,028, and to *E* of \$10,025. Had *D* made these gifts directly, and not pursuant to his revocable trust, no amount of those gifts would have been included in the gross estate and only those amounts of the gifts exceeding the annual exclusion amount would have been treated as adjusted taxable gifts. But in Technical Advice Memorandum 86-09-005,<sup>123</sup> the Service resorted to section 2038,<sup>124</sup> both alone and in conjunction with section 2035(d)(2),<sup>125</sup> to rule that the full amounts of these gifts were in *D*'s gross estate for estate tax purposes.<sup>126</sup> Thus, the date of death value of the gifts were subject to estate tax and the decedent was not able to utilize the annual exclusion amount available for gifts made during lifetime.

Section 2038 provides that the value of the gross estate shall include the value of all property "to the extent of any interest therein of which the decedent has at any time made a transfer . . . if the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, or revoke."<sup>127</sup> The establishment of the revocable trust is subject to a power to revoke; therefore, the principal remaining in the trust at the date of the decedent's death will be included in the gross estate pursuant to section 2038.<sup>128</sup>

With respect to the gifts made from the trust in Technical Advice Memorandum 86-09-005, the Service first noted that *D* had the unrestricted right to

122. Tech. Adv. Mem. 86-09-005 (Nov. 26, 1985).

123. *Id.*

124. Section 2038(a) of the Code provides:

The value of a gross estate shall include the value of all property-

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To the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or moneys worth), by trust or otherwise, where the enjoyment thereof was subject at the date of death to any change through the exercise of a power . . . by the decedent . . . to alter, amend, revoke or terminate, or where any such power is *relinquished* during the three-year period ending on the date of the decedent's death.

I.R.C. § 2038(a) (1988) (emphasis added).

125. Section 2035 of the Code provides in essence that the gross estate includes the value of any property interest transferred by a decedent within three years before death if that interest would have been included in a decedent's gross estate under §§ 2036, 2037, 2038, or 2042 if such interest had not been transferred. *Id.* § 2035.

126. Tech. Adv. Mem. 86-09-005 (Nov. 26, 1985).

127. I.R.C. § 2038(a) (1988).

128. Tech. Adv. Mem. 86-09-005 (Nov. 26, 1985).

remove the trustee and appoint himself as trustee.<sup>129</sup> As a result, *D* constructively had all of the powers of the trustee.<sup>130</sup> The distribution of trust assets to *A*, *B*, *C*, and *E* acted as a "relinquishment" of the trustee's dominion and control over such assets.<sup>131</sup> Since *D* had the power of trustee, the Service concluded there was a "relinquishment" of *D*'s power over such assets within a three-year period ending on the date of *D*'s death.<sup>132</sup> The assets were therefore included in *D*'s gross estate under section 2038(a) of the Code.<sup>133</sup>

This reasoning is fairly tenuous. It seems that regardless of whether property is distributed from the trust to the grantor or to a third party, the grantor in each case technically loses the power to revoke the trust with respect to the distributed assets. Therefore, the more logical result is that distributions from the trust should be treated as "terminations" rather than "relinquishments," and should not result in the distributed assets being included in the grantor's gross estate under section 2038(a).

In Technical Advice Memorandum 86-09-005, the Service cited another justification for inclusion of the property in *D*'s gross estate:<sup>134</sup> section 2035(d)(2).<sup>135</sup> This section provides that the value of the gross estate shall include the value of all property that the decedent has transferred during the three-year period ending on the date of the decedent's death if the property would have been included in the value of the gross estate under section 2038 had no transfer been made.<sup>136</sup> Property transferred from a revocable trust would have been includible in the grantor's gross estate pursuant to section 2038 if the transfer had not been made.<sup>137</sup> Thus, the three-year rule under section 2035(d)(2) applied to the transfers from the trust in Technical Advice Memorandum 86-09-995.<sup>138</sup>

From a technical perspective, this argument is correct. However, the legislative history of the current version of section 2035 indicates that Congress most likely was concerned about the establishment of an irrevocable trust in which the decedent retained an interest or had the ability to control the management of the trust, but the decedent relinquished the retained interest or management immediately before death in order to avoid inclusion of the property in

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129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.*

135. I.R.C. § 2035(d)(2) (1988).

136. *Id.*

137. *See id.* § 2038.

138. In the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, title IV, §§ 403(b)(3)(b), 424(a), 95 Stat. 301, 317, Congress amended the previous general rule, set forth in section 2035(a) of the Code, that gift transfers within three years of death are includible in the gross estate. Congress retained the three-year rule only for transfers of property that would otherwise have been includible in the gross estate under §§ 2036-2038 and 2042 had the transfers not been made. *See* I.R.C. § 2035(d)(1) (1988).

the gross estate.<sup>139</sup> There is no indication in the congressional history to the current version of section 2035 that Congress intended gifts made from revocable trusts within three years prior to death to be included in the gross estate pursuant to that section.

Approximately three and one-half years after Technical Advice Memorandum 86-09-005, the Service again considered the issue of whether distributions from revocable trusts must be included in the grantor's gross estate if made within three years of death. In Technical Advice Memorandum 89-40-003,<sup>140</sup> the decedent had executed an instrument entitled "Trust Arrangement Y" with a bank under which the decedent was the sole beneficiary.<sup>141</sup> Any assets remaining in the trust at decedent's death were to pour over into his estate. The trustee, at the decedent's direction, transferred common stock held in the trust arrangement to the decedent's grandchildren and great-grandchildren. Each gift qualified for the annual exclusion. The decedent died within three years of the making of these gifts.<sup>142</sup> The Service concluded that because section 2033<sup>143</sup> applied to include the assets in the trust arrangement in the decedent's gross estate, section 2038 did not apply.<sup>144</sup> Because section 2038 did not apply,<sup>145</sup> the three-year rule of that section and section 2035 was inapplicable.<sup>146</sup> The implication, however, was that had section 2038 applied to include the assets in the trust arrangement in decedent's gross estate, the three-year rule under that section and section 2035 would also have applied. For example, had the assets been distributed to named beneficiaries and not to the decedent's estate at the decedent's death, as with a typical pour-over will/living trust plan, the gifts made within three years of death would have been brought back into the decedent's gross estate.<sup>147</sup>

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139. See General Explanation of the Economic Recovery Tax Act of 1981, H.R. 4242, 97th Cong., Pub. L. No. 97-34, prepared by the Staff of the Joint Committee on Taxation; see also H.R. REP. NO. 201, 97th Cong., 1st Sess. (1981). The Ways and Means Committee commenting on the Economic Recovery Tax Act stated:

Under the unified transfer tax system adopted in the Tax Reform Act of 1976, the inclusion in the gross estate of gifts made within three years of death generally has the effect of including only the property's post-gift appreciation in the gross estate . . . . The committee believes that inclusion of such appreciation generally is unnecessary except for gifts of life insurance and certain property included in the gross estate pursuant to certain of the so-called transfer sections (§§ 2036, 2037, 2038, 2041, and 2042).

*Id.* at 186-87.

140. Tech. Adv. Mem. 89-40-003 (June 30, 1989).

141. *Id.*

142. *Id.*

143. I.R.C. § 2033 (1988).

144. Tech. Adv. Mem. 89-40-003 (June 30, 1989).

145. Sections 2036, 2037, and 2042 also did not apply. *Id.*

146. Tech. Adv. Mem. 89-40-003 (June 30, 1989).

147. Under these circumstances, the assets in the trust arrangement would have been included in the decedent's gross estate pursuant to § 2038 (not § 2033) and, as a result, following the reasoning of Technical Advice Memorandum 86-09-005, the gifts made within three years of death from the trust arrangement would be included in the decedent's gross estate.

It was not long after the ruling in Technical Advice Memorandum 89-40-003 that the Service affirmed the implication, though in a bizarre manner. In Technical Advice Memorandum 90-10-004,<sup>148</sup> the terms of the revocable trust allowed for distributions from the trust to the grantor during her competency.<sup>149</sup> The trustee had no power to transfer trust property directly from the trust to other beneficiaries during the grantor's competency. Nonetheless, stock held in the trust was transferred from the trustee to third-party beneficiaries in annual exclusion amounts within three years of the decedent's death.<sup>150</sup> The Service held that the three-year rules under sections 2035 and 2038 did not apply in this situation since "the stock at issue could only have been transferred out of the trust pursuant to the exercise of [the grantor's] power to withdraw trust corpus for [her] benefit."<sup>151</sup> According to the Service:

[T]he transfer of the shares of stock to the nine donees must be viewed as a withdrawal of trust corpus by [the grantor] for her benefit, followed by a transfer of the shares by [the grantor] (in [her] capacity as an individual not as trustee) to the nine donees . . . . Therefore, the transaction does not constitute a relinquishment of the power to revoke the trust with respect to the distributed assets subject to section 2038(a)(1), or a transfer of an interest in property that would have been includible under [section] 2038(a)(1) if the property had been retained by the decedent, subject to inclusion under [section] 2035(a) and (d)(2) of the Code.<sup>152</sup>

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148. Tech. Adv. Mem. 90-10-004 (Nov. 17, 1989).

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.* The Service's reasoning regarding the "relinquishment" issue is not completely clear. If the distribution to third parties by a trustee acts as a "relinquishment" of the donor's power to "alter, amend, revoke or terminate" the trust with respect to the distributed property (which was the conclusion reached by the Service in Tech. Adv. Mem. 86-09-005 and subsequent rulings), then the same can be said of a distribution to the donor. The Service apparently is focusing on the grantor's power to control the property. If the grantor withdraws the property from the trust, arguably there is no relinquishment since the grantor controls the property. Moreover, at the time of withdrawal the property no longer becomes subject to inclusion in the gross estate under § 2038, but rather is then subject to inclusion under § 2033. Hence, the subsequent transfer by the grantor to the third parties, though technically a "relinquishment" at that point under the Service's reasoning, does not invoke the § 2038 three-year rule. If this is indeed the Service's position, it may not be a correct interpretation of § 2038. As discussed previously in the text, the more logical reading of § 2038 is that a distribution of property from the trust, regardless of whether the distribution is to the grantor or to a third party, is a "termination" and not a "relinquishment" of the grantor's right to amend the trust as to that property. *See supra* text accompanying notes 123-26.

The Service's reasoning with regard to the § 2035(d)(2) "transfer" issue is more logical. Once the shares are withdrawn from the trust for the benefit of the grantor, those shares will potentially be includible in the grantor's gross estate pursuant to § 2033. Thereafter, the transfers from the decedent to the third parties would not have been included in the decedent's gross estate under § 2038 if the transfers had not been made; rather, the transfers would have been includible in the decedent's gross estate pursuant to § 2033. Hence, the three-year rule under § 2035 is inapplicable.

The Service made analogous rulings in Priv. Ltr. Rul. 90-10-005 (Nov. 17, 1989), Tech. Adv.

In contrast to the terms of the trust in Technical Advice Memorandum 90-10-004, the revocable trust established by the decedent in Technical Advice Memorandum 90-15-001 did allow the trustees to distribute income or corpus to children of the grantor and spouses of children.<sup>153</sup> During the three-year period ending on the date of the decedent's death, the trustees, acting on the decedent's instructions, distributed property directly from the trust to several of these individuals. The taxpayer sought to characterize the transactions as transfers out of the trust, pursuant to the exercise of the decedent's power to withdraw corpus for his own benefit.<sup>154</sup> The Service concluded that the transfers to the several donees should be viewed as distributions of trust corpus to third parties and not as withdrawals of trust corpus by the decedent for his own benefit followed by a gift of the property to several donees. Therefore, the distributions of property from the trust were includible in the decedent's gross estate because the grantor died within three years of these distributions.<sup>155</sup>

Although the letter rulings since 1986 typically involved annual exclusion gifts,<sup>156</sup> theoretically the same reasoning applies to taxable gifts made from a revocable trust. This is important because if the property gifted appreciates after the gifts are made, the gifts become involved in the estate tax calculation as part of the gross estate at the property's value at the date of death and not as adjusted taxable gifts at their gift tax value.<sup>157</sup> Therefore, the appreciation is included in the gross estate for estate tax purposes.<sup>158</sup>

## 2. *Strategies to Overcome the Service's Position*

Until Congress steps in to correct the Service's illogical behavior,<sup>159</sup> or until the Service itself reconsiders its position, the practitioner must take steps to avoid the reasoning and holdings in the Service's recent letter rulings. When the grantor is competent, lifetime gifts from a revocable trust will not be in-

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Mem. 90-18-004 (Jan. 24, 1990), and Priv. Ltr. Rul. 90-17-002 (Jan. 5, 1990).

153. Tech. Adv. Mem. 90-15-001 (Dec. 29, 1989).

154. *Id.*

155. *Id.* Accord Priv. Ltr. Rul. 90-16-002 (Dec. 29, 1989) (holding that facts indicated that the transfers to the several donees had to be viewed as gifts of trust corpus to third parties and not as withdrawals of trust corpus by the grantor for her own benefit followed by a gift to the property to the several donees). A United States district court has finally considered this issue. In *Estate of Perkins v. United States*, No. 1:89CV1937 (N.D. Ohio Sept. 20, 1990) (LEXIS, Genfed library, Currnt file), the court agreed with the reasoning set forth by the Service in Technical Advice Memorandum 86-09-005 and its progeny and held that gifts made from a revocable trust within three years of death are (absent the availability of any of the exceptions discussed in the Internal Revenue Service letter rulings) includible in the decedent's gross estate. *Id.*

156. *See, e.g.*, Priv. Ltr. Rul. 90-16-002 (Dec. 29, 1989); Tech. Adv. Mem. 90-15-001 (Dec. 29, 1989).

157. *See supra* notes 108-18 and accompanying text (discussing the use of adjusted taxable gifts as a lifetime gifting strategy).

158. *See supra* notes 108-18 and accompanying text.

159. The proposals on tax simplification submitted by the Committee on Ways and Means, COMM. ON WAYS AND MEANS, H.R. DOC. 27 101st Cong., 1st Sess. (1990), would amend § 2035 to eliminate the problem (that is, overrule the Service's position).

cluded in the gross estate for estate tax purposes if the trustee distributes property directly to the grantor, and the grantor makes the gifts directly. When the grantor is incompetent, then an additional step should be included. First, the trustee should distribute the property back to the grantor. Second, transfer of the property should be made pursuant to a durable power of attorney, assuming the state in which the grantor is domiciled allows an agent to make these types of gifts pursuant to an express gifting power in a durable power of attorney. The durable power of attorney should be set up at the same time the revocable trust is established, but in any event prior to disability.

By adhering to these additional procedural steps in making lifetime gifts from a revocable trust, the donor can avoid the illogical and punitive effect of the recent letter rulings which hold that gifts made from certain revocable trusts within three years of death must be included in a decedent's gross estate when calculating the estate tax.

#### IV. CONCLUSION

Despite the unified gift and estate tax rate structure, lifetime gifting, if properly done, can be used to reduce the overall gift and estate tax burden. First, in an era of low interest rates when investment returns greatly in excess of these rates can be expected, the use of grantor retained annuity trusts may be an effective way to gift property at a reduced gift tax value. In principle, this is done by having the donor retain a right to receive annually, for a term of years, a fixed amount from the property gifted, thereby reducing the value of this property for gift tax purposes. Second, annual exclusion gifts of up to \$10,000 per donee per year, with no current limit on the number of donees, can be made by a donor. Annual exclusion gifts are not treated as "taxable gifts"; that is, such gifts do not invoke the gift (or estate) tax. Third, the donor during lifetime can use his or her unified credit, which shields the first \$600,000 of "taxable gifts" (gifts of more than \$10,000 per donee per year). In so doing, the donor will eliminate the necessity of paying any gift tax on such amount. To the extent that the gifted property appreciates in value in the hands of the donee, the appreciation will not be subject to estate tax in the donor's gross estate because the underlying property will not be in the donor's gross estate. In this way, the unified credit, if used during life, can be leveraged for inflation. Fourth, if shares in closely held stock controlled by a family are gifted, then (though subject to challenge by the Internal Revenue Service and evolving judicial standards) valuation discounts are available which can reduce the overall gift and estate tax exposure. Fifth, the actual payment of gift taxes can ultimately reduce the overall gift and estate tax burden on the donor's estate. This is because the gift tax system, unlike the estate tax system, is tax exclusive; there is no additional tax on the amount used to pay the gift tax, whereas there is, in essence, an additional tax on the amount used to pay the estate tax.

When engaging in lifetime gifting, an individual and his or her advisor should be cognizant of congressional and Internal Revenue Service antipathy

towards strategies that reduce overall estate and gift taxes. For example, Congress has recently amended the Internal Revenue Code in such a way that effective use of most types of grantor retained income trusts, previously a tremendous avenue for reducing transfer taxes, has been eliminated. One of its replacements, the grantor retained annuity trust, though potentially beneficial from a transfer tax savings perspective, does not realistically offer the same level of flexibility and potential tax advantage as the grantor retained income trust. A further proposal, not yet a part of any congressional bill, would limit the amount of annual exclusion gifts to \$30,000 per donor per year. Moreover, the Service has taken a bizarre position with regard to gifts made from revocable trusts, a position that is statutorily supported but not logical. As a result, in considering any gifting strategy, a donor must now be advised of the technical distinction between outright gifts and those made from revocable trusts.

A goal of estate planning is to reduce gift and estate tax obligations. This purpose can properly be achieved only if the practitioner keeps current with the activities of Congress and the Internal Revenue Service and understands the potential impact of these activities on planning strategies such as those described in this Article.

## APPENDIX A

CALCULATION OF THE VALUE OF AN ANNUITY INTEREST IN  
A GRANTOR RETAINED ANNUITY TRUST

Assuming an interest rate of 10.60%, the value of an annuity interest at 5% of an initial fair market value payout rate in a five-year GRAT is calculated as follows:

1. Using Department of I.R.S. Publication 1457 (Aug. 1989), the value of an annuity interest in \$1 for five years at an assumed interest rate of 10.60% equals 3.7334.

2. Since the annuity is at 5% of \$1, the value of a an annuity on 5% of \$1 equals  $3.7334 \times .05$ , or .18667.

## APPENDIX B

CALCULATION OF THE VALUE OF THE PROPERTY PAID OUT  
BY A GRANTOR RETAINED ANNUITY TRUST WITH INCOME  
AND APPRECIATION EXPERIENCED BY THE PROPERTY AT AN  
AVERAGE ANNUAL RATE OF 10.60%

If 120% of the federal midterm rate in effect for the month of a transfer is 10.60%, the value of an annuity interest for five years, at a 5% (of the transferred property) rate, is .18667 of the value of the interest transferred. See Appendix A.

Hence, the value of the remainder interest is .81333 of the value of the interest transferred (1 minus .18667, the value of the grantor's retained interest). If \$1,000,000 were transferred, there would be a gift equal to \$813,330. If the after-tax income and appreciation experienced by the property is on average 10.60%, then at the end of five years, the value of the property transferred is:

End of Year	Amount Transferred (Increased Annually by 10.60%)	Payout to Annuity Holder	Value of Property After Payout of Annuity Amount
0	\$1,000,000	-0-	\$1,000,000
1	1,106,000	\$50,000	1,056,000
2	1,167,936	50,000	1,117,936
3	1,236,437	50,000	1,186,437
4	1,312,199	50,000	1,262,199
5	1,395,992	50,000	<u>1,345,992</u>
	Amount Remaining:		<u>\$1,345,992</u>

The discounted present value of the right to receive \$1,345,992 five years in the future, under an assumed interest/discount rate of 10.60%, equals \$813,330, which is .81333 of the interest transferred. (The formula is  $1/(1+x)^t$ , where  $x$  equals the interest rate and  $t$  equals the term for years.) This amount is the same amount as the taxable gift made in year one.



## APPENDIX C

CALCULATION OF THE VALUE OF PROPERTY PAID OUT BY A  
GRANTOR RETAINED ANNUITY TRUST WITH INCOME AND  
APPRECIATION EXPERIENCED BY THE PROPERTY AT AN  
AVERAGE ANNUAL RATE OF 12%

If 120% of the federal midterm rate in effect for the month of a transfer is 10.60%, the value of an annuity interest for five years, at a 5% (of the transferred property) rate, is .18667 of the value of the interest transferred. See Appendix A.

Hence, the value of the remainder interest is .813336 of the value of the interest transferred (i.e., 1 minus .18667, the value of the grantor's retained interest). If \$1,000,000 were transferred, there would be a gift equal to \$813,330. If the after-tax income and appreciation experienced by the property is on average 12%, then at the end of five years, the value of the property transferred is:

End of Year	Amount Transferred (Increased Annually by 12%)	Payout to Annuity Holder	Value of Property After Payout of Annuity Amount
0	\$1,000,000	-0-	\$1,000,000
1	1,120,000	\$50,000	1,070,000
2	1,198,400	50,000	1,148,400
3	1,286,208	50,000	1,236,208
4	1,384,552	50,000	1,334,552
5	1,494,699	50,000	1,444,699
		Amount Remaining:	<u>\$1,444,699</u>

The discounted present value of the right to receive \$1,444,699 five years in the future, under an assumed interest/discount rate of 12%, equals \$819,761, which is .819761 of the interest transferred. (The formula is  $1/(1+x)^t$ , where  $x$  equals the interest rate and  $t$  equals the term for years.) This amount is greater than the amount of the taxable gift deemed made in year one. In other words, the transferee is, under the assumed economic conditions, receiving more property than is treated, for gift tax purposes, as having been transferred to the transferee.