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Subject: Joy Matak, Sandra D. Glazier & Martin M. Shenkman - Estate Planning Six-Part Series for Late 2020, Part 4: Enhanced Techniques for Note Sales

"2020 is grinding to a close with uncertain federal elections pending the Georgia Senate runoff races, and experts warning that a new COVID wave could cause more economic disruption for the United States in the coming months until a vaccine is widely disseminated. Regardless of the outcome of the runoff elections, rising deficits may force federal and state governments to consider additional tax legislation and ultra-high-net worth ('UHNW') clients may be well advised to continue to pursue active estate tax minimization planning in the current environment.

While significant attention has been given to guiding clients to use the large temporary exemptions before they may be reduced or otherwise expire, this represents only part of the tax risks present in the current environment. Democratic proposals have included a host of possible restrictions that could adversely affect planning for those UHNW clients for whom using exemption is not sufficient:

- *Discounts may be reduced or eliminated.*
- *Assets in grantor trusts could be held to be includable in the grantor's estate.*
- *A tax may be assessed periodically against dynastic trusts.*
- *GRATs may be so restricted as to become of limited, if any, use.*
- *And more.*

Consequently, late 2020 planning may require much more than planning for exemption amounts. If discounts are eliminated, multi-generational planning adversely affected, the effectiveness of rolling GRAT planning impaired or other changes implemented (e.g. elimination of basis step-up), UHNW clients may be well served by completing wealth transfers in the waning days of 2020.

Even in the midst of all of this turmoil, consider the contrast: late 2020 may be the 'best it will ever be' for planning clients, particularly those who want to freeze assets using a sale to an intentionally defective grantor trust; lifetime exemptions are high, discounts are permissible, grantor trusts are viable, and perhaps dynastic trusts may be grandfathered and escape a periodic assessment of GST tax. This could all be especially true if legislative changes reduce the efficacy of future planning by dropping the exemption or curtailing valuation discounts.

If one or more manner or type of note sale transactions appear warranted, practitioners may not wish to limit the discussion of available planning options so that the client can make an informed decision that appears to best suit their desires and needs. Additional installments of this series will follow and explore other opportunities for planning before year-end."

Joy Matak, JD, LLM, Sandra D. Glazier, Esq. and **Martin M. Shenkman, Esq.** provide members with important and timely commentary in the form of a six-part series, Part 4 of which is a discussion of enhanced techniques for note sales.[i]

Joy Matak, JD, LLM is a Partner at **Sax** and Head of the firm's **Trust and Estate Practice**. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the Tax Management Estates, Gifts and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law entitled Estate Planning: Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017.

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Here is their commentary:

COMMENT:

Note Sale Modifications Because Limited Time Exists Before Year End

Given how late it is in the year, practitioners may have to select options and steps that will facilitate completing the note sale in 2020. These might include:

1. Obtaining a figure from an appraiser for the value while waiting until 2021 for the actual report.
2. It may not even be possible to obtain a figure from an appraiser in time to complete a transaction if an appraiser was not hired some time ago. Does that mean that planning may be prevented if a valuation cannot be obtained? Perhaps, but it may be worth exploring

with the client the possibility of using a two-tiered valuation adjustment mechanism. **Example**: The client had an appraisal done about 18 months ago. That value is clearly stale and there is not sufficient time before year end to have the appraiser provide an updated value. What if the equity interests were sold to a grantor trust for a King-type price adjustment note with two tiers of adjustments? The second and common adjustment in a King-type note would be to adjust the face value of the note to equal the gift tax value as finally determined. But what if a first tier of adjustment were added as well. The first tier recites that the current valuation was estimated based on an adjustment to the stale appraisal and that an independent appraiser has been hired and when that report is received the face value of the note will be adjusted retroactively to the 2020 sale date to reflect that data. Might this be a means to complete a transaction before year end?

3. The mechanism used for a valuation adjustment might have to be dictated by the limited time period remaining in 2020, with the client being informed of the potential risks. **Example:** The practitioner's preferred valuation adjustment mechanism is to use a spill over to a nearly zeroed out GRAT. However, the practitioner may believe that there is insufficient time to complete and fund a GRAT and craft the spill over with a GRAT before year end. So instead a Wandry adjustment mechanism is used as it does not require the creation of a new GRAT and can be effectuated with the provisions in the assignment reflecting a fixed value of interests and not a stated number of shares, etc.
4. Entity documentation and various administrative steps may be deferred until 2021 to facilitate expediting the transaction. **Example**: Interests in a family FLP are to be assigned. A gift (or sale) assignment is completed. While the practitioner would normally also prepare an amended and restated limited partnership agreement, might documenting the amendment be deferred until 2021?

Can A Note Sale Transaction Be Enhanced?

Practitioners might explore opportunities to refine and improve note sales transactions, with some of the considerations outlined in this fourth installment of this 2020 planning series:

1. Using Sales to Extend GST Exemption to Assets not Already Exempt.

2. Consider “Stepped” or Deferred Interest to Facilitate a Larger Sale than Current Cash Flow May Permit.
3. Differentiate Collateral on Note Sale to Possibly Defeat IRS Challenges of a Retained Interest on a Note Sale.
4. Defined Value Mechanisms Might be Enhanced and Modified for New Planning.
5. Divide a QTIP to Possibly Contain the Risk of a 2519 Challenge before a Distribution or Sale Transaction.

Using Sales to Extend GST Exemption to Assets not Already Exempt

Practitioners might consider opportunities to extend Generation Skipping Transfer Tax exemption (“GST exemption”) to trusts that are not now exempt (a “non-GST Exempt trust”). From the outset, we note that, as the lifetime exemptions from gift and estate tax rose so did the GST exemption. A taxpayer may make a late allocation up to her remaining GST exemption after all other transfers are taken into account.

However, if the taxpayer’s remaining GST exemption is insufficient to cover the value of the assets in a non-GST Exempt trust, a practitioner may consider another alternative: selling those assets to an existing “old and cold” GST Exempt trust. What if such a trust does not exist? Also, what if the assets are held in the non-GST Exempt trust (e.g. a QTIP formed on the death of the first spouse who had used all GST exemption during his or her lifetime). Is there still a possible planning approach to help shift growth out of that non-GST Exempt trust into a GST Exempt trust?

A family member of the client may create a new irrevocable trust that is a so-called Section 678 grantor trust as to the existing non-GST Exempt trust, funding that new trust using a portion of her current gift and GST exemptions. If the old and the new trusts are both grantor trusts, then the old non-GST Exempt trust might sell assets to the 678 trust in a note sale transaction, thereby freezing the value in the non-GST Exempt trust.

Consider “Stepped” or Deferred Interest to Facilitate a Larger Sale than Current Cash Flow May Permit

> **Example**: If Covid has temporarily depressed cash flow from a business interest being sold, perhaps this technique can facilitate completing a sale now.

Assume a client is going to engage in a note sale (that is, an installment sale) to a grantor dynasty trust (which some call an Intentionally Defective Irrevocable Grantor Trust or "IDIGT," although the result will be the same even if the trust is not intentionally made to be a grantor trust).[ii] But what if the entity whose interests are being sold has current cash flow needs for business research and development? In such a situation, distributions might be difficult and/or limited for several years. Might the purchasing trust backload (defer) the interest that accrues under the term of the note? If this were done during the first X years of the note, the purchaser might pay interest every year at a rate of say 1%. The remaining and unpaid 2% interest (assuming a 3% applicable federal rate ("AFR")) will accrue and compound at the same 3% AFR rate until it is paid. Thus, the note will have negative amortization during the first X years of its term. After the first X years, the purchasing trust would then pay the full interest that accrues every year on a current basis (or if advisable from a cash flow perspective another "step" in rate could be used). During the remaining term of the note, the purchaser will also pay the compounded shortfalls in interest payments that arose during the first X years of the note.

If the purchasing trust will not have sufficient cash flow to currently pay all the interest that would have normally accrued during the first X years of the note, it might be argued that the purchasing trust could be characterized as "thinly capitalized." Therefore, it's advisable for practitioners considering such a note structure to confirm and corroborate that thin capitalization does not undermine the validity of the debt itself and hence the transaction. It may be important to avoid transactions that might create an issue as to whether the note will be respected as debt or whether it could instead be characterized as equity. The issue of the trust not being "thinly capitalized" will generally depend on the balance sheet of the trust at the time of the transaction reflecting the then current appraised value of assets owned by the purchasing trust.

The delayed payment during the first X years of the note of the interest that accrues generally should not by itself cause the note that the purchaser gives to the seller to be re-characterized (e.g. as an invalid indebtedness, a gift, as equity instead of debt, etc.).

It does not appear that using variable interest by itself will undermine the validity of a note. If a loan requires payments of interest calculated at a rate of interest based in whole or in part on an objective index or combination of indices of market interest rates (e.g., a prime rate, the applicable federal rate, the average yield on government securities as reflected in the weekly Treasury bill rate, the Treasury constant maturity series, or LIBOR (London interbank offered rate)), the loan will be treated as having sufficiently stated interest if the rate fixed by the index is no lower than the applicable federal rate (1) on the date the loan is made, in the case of a term loan, and (2) for each semiannual period that the loan is outstanding, in the case of a demand loan.

For term loans determining the AFR is simply arrived at by applying the interest rate that is equal to the AFR with the same compounding period for the month in which the loan is made. For sale transactions the appropriate AFR is based not on the term of the note, but on its weighted average maturity.

Section 7872, which created new rules for the tax treatment of loans with below-market interest rates, went into effect on June 6, 1984. The scope of this code section and its application for gift tax purposes were addressed in *Frazee*.[iii] The Tax Court determined that the Section 7872 AFR, and not the Section 483(e) 6% interest rate, was controlling for gift tax valuation purposes. Accordingly, because the intra-family sale of real property in *Frazee* was not a bona fide arm's-length transaction free of donative intent, the court held that the excess of the face amount of a note bearing 7% interest over its recomputed present value, using the AFR for long-term loans, constituted a gift of interest.

Section 7872 applies to any transaction that (1) is a bona fide loan, (2) is below market, (3) falls within one of four categories of below-market loans, and (4) does not qualify for one of several exceptions. The four categories are loans (1) from a donor to a donee, (2) from an employer to an employee, (3) from a corporation to a shareholder, and (4) with interest arrangements made for tax avoidance purposes.[iv] The below-market-rate demand loan is a two-step transaction:

- The lender is treated as having transferred on the last day of the calendar year an amount equal to the forgone interest (the prevailing federal rate of interest less the loan's actual interest rate) to the borrower; and

- The borrower/trust is then treated as transferring that amount back to the lender as imputed interest.

What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under Section 7872. But if the note provides for the interest to accrue and is not paid, the original issue discount ("OID") rules will apply. The OID rules do not apply merely because interest that is to be paid currently is not paid. They only apply where there is accrual/deferral by the terms of the note. The OID rules would have the taxpayer report a pro rata amount of the overall amount of the OID over the life of the loan using a constant yield method under the Regulations for Section 1272. On a sale to a grantor trust the OID complications appear to be obviated at least until grantor trust status terminates. So, while these rules should apply, they should have no income tax significance while grantor trust status is retained.

Different variations may be crafted based upon the needs of the parties. Perhaps:

- Interest may be accrued rather than paid during the term of note.

- Pay interest that cannot be paid in cash by issuing a note from the borrower/trust for any unpaid interest. There does not seem to be any consistency in views as to whether this will make the note more problematic to support on audit. One view is that there is nothing prohibiting paying a note interest payment in-kind, e.g. with another note. The opposing view is that this might make the transaction appear uneconomic in contrast to "baking in" the cash flow considerations from inception, e.g. with a stepped note.

Be Mindful of Hart Scott Rodino Act Requirements

It's important to be mindful that large estate planning transactions may trigger reporting requirements under the Hart-Scott-Rodino Antitrust Improvements Act ("HSR").[v] HSR imposes an obligation to file a premerger notification report form with the Premerger Notification Office of the Federal Trade Commission ("FTC"). This may all be counter-intuitive since a sale of interests in a closely-held or family business to a trust created by the family can hardly be viewed as negatively impacting competition, but, meeting the filing requirements, or finding an exemption, may be necessary to avoid potentially onerous penalty provisions.

Acquisitions resulting from a gift, intestate succession, testamentary disposition or transfer by a grantor to an irrevocable trust may be exempt from the filing or other requirements of HSR.[vi] However, the conclusion may not be simple or assured and practitioners should consider consulting with an expert in these matters. There could be an impact on the HSR determination based on trustee and trust protector provisions included in the trust instrument, and, specifically, who has the ability to remove and replace trustees.

Differentiate Collateral on Note Sale to Possibly Defeat IRS Challenges of a Retained Interest on a Note Sale

When selling assets to an existing irrevocable trust that was created to meet prior planning goals, consider using assets other than the assets being sold in the current transaction as collateral.

> **<u>Example</u>**: ABC, LLC interests were sold to a trust years ago and that transaction has been completed and any note repaid. Now, the taxpayer is contemplating selling XYZ, LLC interests to the same trust. Instead of using XYZ, LLC interests as collateral on the note the trust now gives the selling taxpayer, what if instead ABC, LLC interests are used as collateral for the note? Might that reduce the potential strings attached to the asset sold that the IRS might otherwise use to argue for estate tax inclusion?

What if a guarantee is used and the terms require that the seller/lender/donor must first proceed against the guarantor before proceeding against the collateral? While unconventional, might that create more distance from the asset sold if there is no collateral in the trust other than the original asset? How would the guarantee fee have to be adjusted to reflect this increased risk? Since the guarantor would be first “in line” before the collateral, the fee to be charged would have to be greater than in a traditional guarantee arrangement. In such instances, it might be prudent to have an independent appraiser evaluate what a fair guarantee fee might be for the transaction.

Defined Value Mechanisms Might be Enhanced and Modified for New Planning

Can the potential gift tax risk of a large transaction be minimized? While large transactions often include mechanisms to minimize current gift tax risk, there seems to be some disagreement (or perhaps just many different opinions) in the planning community about how to structure such arrangements than might be expected. For UHNW clients pursing current large dollar planning, using some variation of these mechanism may warrant consideration. Some transactions are structured using some application of one of the key defined value cases.[vii] These types of mechanisms are based on the entirety of an intended defined value being transferred away from the transferor. However, if there is an excess value over what the buyer in the transaction is paying as a result of an IRS audit adjustment, that excess value could be poured into a non-taxable receptacle. This non-taxable receptacle could be a charity (but, be cautious if a private foundation is used since this may not be a feasible mechanism), a grantor retained annuity trust ("GRAT"), marital trust (other than a "QTIP" which requires the election to be made on the gift tax return by the due date for the year the gift was deemed to have been made), or an incomplete gift trust. However, as with many aspects of planning, there is little agreement amongst practitioners as to which spillover or structure is best. Therefore it is important to analyze and weigh the options when evaluating UHNW transfer planning. While the law is not new in this area, there are new perspectives, and planning structures, some of which the following discussions endeavor to present. A complete discussion of already established law will not be provided.

Nelson[viii] Makes Clear that Words Matter in Defined Value Clauses

While the Tax Court in *Wandry* upheld a defined value mechanism based on the specific wording of the clause in the assignment documents, the IRS appealed the decision and ultimately issued a statement that the commissioner did not acquiesce to the Court's conclusion. The Service has made its intention to contest *Wandry*, especially if taxpayers deviate in any way from the specific language upheld by the Tax Court.

In *Nelson*, the taxpayer used a defined value clause described by the Tax Court as follows:

> … [The gift was] expressed in the memorandum of gift as a 'limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 *** , as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.' Similarly, the sale [was] expressed in the memorandum of sale as a 'limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 *** , as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment.'[ix]

The Tax Court was particularly swayed by the argument that the clauses were dependent upon an appraisal within a fixed period of time rather than "as that determined for Federal estate tax purposes."[x] As a result, the Court concluded that the defined value clause did not operate to allow for an adjustment of the value transferred once the IRS revalued the transferred property. Rather, the percentage limited partner interests became fixed upon receipt of the qualified appraiser's report within the time prescribed by the relevant clause.

Therefore, it's important to take note of this recent clarification in the law of defined value mechanisms when drafting clauses in the future.

Is *Wandry*[xi] King? What Type of Price Adjustment Mechanism Might You Use?

The *King* case might provide a planning option to consider.[xii] *King* upheld the use of a price adjustment clause.

> **<u>Example</u>**: Simplifying this might be as follows: "Taxpayer hereby transfers $100 worth of stock to XYZ trust for a note. If the value of the stock is finally determined for gift tax purposes to be greater than $100 the face amount of the note shall be adjusted accordingly." Some practitioners report what they describe as favorable results on audits using this approach.

Other practitioners are less optimistic and are simply not comfortable with a *King* type approach. Some object to *King* based on the structure of the adjustment. For example, might the adjustment of the note be viewed as an impermissible condition subsequent under a *Procter*[xiii] analysis? On the other hand, some view *King* as an "outlier" not to be relied upon because it is only a 10th Circuit case. The *Ward* case rained a bit on the *King* parade according to some views.[xiv] A variation of a traditional *King* type approach might be for the note's face value to be defined as being the gift tax value as finally determined.[xv] Does this negate a challenge under *Procter*? In any case, the federal district court distinguished *King* from *Procter* because the court found that the sale transaction was made in the ordinary course of business, at arm's length and free from any donative intent, which under Reg. 25.2512-8 meant there was no gift. That may be a difficult business standard to sustain in some family transactions.

Wandry might present another option to consider as part of the efforts to minimize gift tax.[xvi] In the *Wandry* case, the tax court upheld an approach that relied on the transfer of a fixed value of assets to a trust rather than a specified portion of equity.

> **Example**: Simplifying this might be as follows: "Taxpayer hereby transfers $100 worth of stock to XYZ trust." While many practitioners prefer a *Wandry* approach over a *King* approach, the IRS has non-acquiesced to the *Wandry* decision.[xvii] Thus, in a "traditional" *Wandry* clause the taxpayer may transfer a fixed dollar amount of shares only (that is, "I hereby transfer $100 worth of stock in XYZ"). Another variation of a *Wandry* approach is for the beneficiaries to execute a disclaimer of any value in excess of the specified value. The concept behind this approach is that this would make it difficult for the IRS to argue more was transferred if the recipient trust is prohibited by the disclaimer from accepting the incremental value.[xviii] [xix]

Consider a Two-Tiered *Wandry* Approach to Deflect a *Powell* Challenge

If the premise for much of the late-year 2020 planning is that the laws may all change retroactively to January 1, 2021 then consummating all possible transfers in 2020 might be a goal to pursue. If that is the case, then the application of the traditional Wandry price adjustment mechanism may not suffice. That is because a successful Wandry price adjustment mechanism could result in the client having retained (never gifted or sold) the value of the asset above the gift tax value as finally determined. In late 2020 that could be more problematic than in perhaps any other year. After all, if as of January 1, 2021 discounts are eliminated, transfers to grantor trusts are included in the grantor's estate, etc. it could prove very difficult to shift that retained value outside the grantor's estate after 2020. Perhaps a two-tier Wandry approach might provide a solution to this unique 2020 planning dilemma.

There are certain circumstances when a client may need to transfer all of the equity in a closely held business. By way of example, the transferor may have an income tax or contractual reason to transfer all equity. On these occasions, it may not be feasible to use a traditional *Wandry* clause that could result in some part of the equity being returned to the transferor.

One problem with a *Wandry* clause is that it could leave shares in the selling taxpayer or trust's hands, which may not be desirable for business or personal reasons. As explained above, this might be particularly undesirable in 2020. This could create uncertainty with respect to the trust's ESBT status if all S corporation shares are sold but the operation of a *Wandry* clause causes shares to remain in the trust. For example, does the ESBT election end when all shares are sold? If so, what occurs when it is later determined that S corporation shares are retained in the selling trust?

The solution, in some circumstances, may be a "two-tiered *Wandry*" arrangement which consists of a traditional *Wandry* transfer followed by the simultaneous sale of any shares (or other assets) left by the *Wandry* adjustment clause if the clause is triggered. In other words, the transferor makes a gift of a specified value of the shares of the entity, believing that all of the transferor's interest in the entity is equal to the value being transferred. In the event that the shares are re-valued on audit (such that the value that the transferor sought to transfer does not cover all of the shares), the transferor will have sold shares that exceed the intended gift value. The second tier of the *Wandry* arrangement could consist of a second sale of any shares that remain by operation of the *Wandry* arrangement in the selling taxpayer or trust's hands, effective as of the same date as the primary *Wandry* sale. The price for this second sale, if any, would be equal to the gift tax value as finally determined. The sale could be supported by a note upon which interest accrues from closing and is required to be made current within a specified time period, e.g., 90-days of the final determination.

If feasible, it might be better for a transferor to use grantor trusts for these types of transactions. Otherwise, if the *Wandry* clause is triggered, the transferor could incur an income tax – and possibly interest and penalties – for a sale transaction deemed to have occurred on the date when the original gift was made. However, in some instances, if shares are held by a non-grantor trust there may be no viable option for avoiding income tax on the transaction (e.g. a non-grantor trust that is not GST exempt is the transferor).

Further, to the extent that the asset being sold consists of S corporation shares, a non-grantor trust may not be a valid shareholder (absent an ESBT or QSST election[xx]), which could potentially challenge the entity's status as an S corporation.

> **<u>Example</u>**: On August 1, 2020, Jack transfers shares in his S corporation with an aggregate fair market value of $1 million to the Jack Family Trust, which is a valid S corporation shareholder (it is either an ESBT, QSST, or grantor trust). Jack believes that he has transferred all of his S corporation shares but, if it turns out that the aggregate value of all of Jack's shares were worth more than $1 million, Jack will be deemed to have sold the excess shares to the Jack and Jill Trust, which is a non-grantor trust, provided he doesn't limit the number of share to those having a value of $1 million. The Jack and Jill Trust does not own any S corporation shares. In 2022, the IRS selects Jack's gift tax return for audit and determines that the value of the shares transferred to the Jack Family Trust was $1.2 million (because he didn't limit the number of shares to those having a value of $1 million). As a result, Jack is deemed to have sold $200,000 worth of shares of S corporation stock to the Jack and Jill Trust on August 1, 2020. However, the time for the Jack and Jill Trust to have made an ESBT election or otherwise qualify as a valid S corporation shareholder has long since passed. As a result, the entity itself could be deemed to have lost its S corporation status.

Incorporate an Economic Adjustments Mechanism in Your Defined Value Technique

Defined value mechanisms operate to fix the dollar amount of interests in a closely held business that are sold, while leaving open the possibility that there may be an adjustment as to the number of shares or percentage interests in the business actually sold. Thus, inherent in these defined value mechanisms is the possibility that the owner of a particular asset (e.g., stock in a closely held business or an LLC interest) may change from the inception of the transaction.

While defined value mechanisms routinely address the allocation of these equity interests, how are the economic implications of the adjustment provided for? If five years pass from the date of a transaction until the interests sold are determined definitively, how will the economic consequences of that five-year period be addressed? The consequences might include dividends or distributions that need to be repaid from the recipient to the correct party, e.g., the seller. Also, what mechanism will be used to assure that the equity interests are properly adjusted? Will merely providing for an adjustment clause alone suffice? Consider the following possible approach illustrating provisions when the valuation adjustment mechanism uses a spill-over of excess value to a GRAT.[xxi]

There is limited guidance on this planning strategy and some commentators argue that operation of a defined value clause to fund a GRAT back to the date of the original transaction constitutes an additional contribution in violation of the regulations governing GRATs. The concern centers around the fact that the exact dollar amount that will fund the GRAT cannot be known at the time of the transaction because a well-drafted defined value clause pours over assets equal in value to the amount which exceeds a specific dollar amount. Further, those commentators posit this adjustment causes an impermissible redetermination of the annuity.

Defined value clauses are intended to relate back to the date of the original transaction as though no time has passed between the date when all of the transfer instruments were originally executed and the date on which the value of the assets is finally determined for federal gift tax purposes.

It is worth noting that the Service has not acquiesced to the use of formula clauses and has signaled interest in challenging defined value clauses.[xxii] It is prudent to warn clients of the risks attendant to the use of defined value clauses and to carefully draft such clauses in order to minimize such risks to the extent possible

When this aggressive strategy is used, consider drafting an agreement between the individual transferor and the GRAT that contains the terms of the defined value mechanism. The assignment to the GRAT might also make specific reference to the mechanism and specify that what is being assigned is that percentage of interests (or shares of stock) in the closely held business as may be adjusted upon a final determination for federal gift tax purposes of the fair market value of the interests (or shares of stock).

> **<u>Sample Economic Adjustment Clause Between Buying Trust and GRAT</u>:** A re-allocation of funds may be required as a result of any re-allocation of the Shares from the Buyer to the GRAT under the economic adjustment provisions of the Transfer Agreement following an initial adjustment (e.g., an income tax audit). A second re-allocation of funds may be required as a result of a second adjustment to the allocation of the Shares from the Buyer to the GRAT following a second and final adjustment (e.g., a gift tax audit following an initial income tax audit). It is understood that the Escrow Agent shall not release any of the Shares to the Buyer or the GRAT until the Buyer and the GRAT: (i) acknowledge in a written document acceptable to the Escrow Agent (the "Escrow Release") that pursuant to the terms of the Transfer Agreement, the Buyer and the GRAT have determined the number of Shares to be sold to the Buyer (i.e., the "Actual Sale Shares") and the number of Shares to be gifted to the GRAT (i.e., the Actual Gift Shares") and (ii) set forth in such Escrow Release instructions directing the Escrow Agent as to the number of Shares that are to be released to each Party. It is understood that the CPA Report will corroborate the amount of dividends, other distributions, or other economic benefits that accrued to the Buyer prior to the Distribution Date (as defined in the Transfer Agreement), and that are properly allocable to the GRAT, if any. The Escrow Agent shall not submit the Existing Stock Certificate, the Sale Stock Power or the Gift Stock Power to the Corporation (or its transfer agent) pursuant to Section X until after the Escrow Agent receives written notice signed by the Buyer and the GRAT, in form and substance satisfactory to the Escrow Agent, that the Buyer has reimbursed the GRAT, or made adequate arrangements to reimburse the GRAT as permitted under the Transfer Agreement, for any amounts payable to the GRAT pursuant to the CPA Report."

Consider Using a Two Tier Defined Value Adjustment on Sales to Non-Grantor Trusts

The use of non-grantor trusts may have application to garner income tax benefits. A sale to a grantor trust would be essential if there is significant gain in the assets being sold in order to avoid recognition of gain on the occasion of the sale.[xxiii] Also, use of a grantor trust provides continued tax burn (that is, the grantor pays the income tax on income received by the trust), and the ability to exercise a swap or substitution power could be indispensable to basis step-up planning (by trading high basis assets the grantor owns for low basis assets in the trust, before the grantor dies).[xxiv]

However, in some instances, use of a non-grantor trust might be advantageous to the buyer in a note sale or other transaction, particularly where the assets to be sold to the non-grantor trust were recently inherited by a surviving spouse. The basis step-up on the death of the first spouse should mitigate or possibly avoid capital gain on the sale of the assets by the survivor to the non-grantor trust. Perhaps the purchaser could be an old grantor trust that turned into a non-grantor trust by operation of its terms upon the death of the first spouse. In such a case, it is conceivable that the trust may already have substantial assets necessary to secure the transaction without any need for seed gifts or guarantees, thereby lowering any perceived risk inherent in such a sales transaction.

How might a defined value mechanism be structured for such a transaction? It would appear that a two-tier defined value mechanism would be necessary to address both income tax audit results as well as gift tax audit results, since a sale to a non-grantor trust could trigger both income and gift tax audit adjustments. The income tax audit adjustment might be based on an IRS argument that the value of the asset (e.g., stock in a closely-held corporation) was understated so that the transaction is in reality a part gift/part sale with fewer shares having been sold. This adjustment could be independent from a later gift tax audit that argues the valuation was low, and hence a gift was made. Thus, in contrast to the economic adjustment clause illustrated above for a sale to a grantor trust, a two-tier adjustment might be necessary to conform the economics to the ultimate result of the transaction.

> **<u>Sample Clause</u>**: “The Parties acknowledge that since the transaction is subject to income taxes and gift taxes, there is a chance that the transaction could be examined twice by the IRS. That is, the IRS could audit the transaction for both gift tax and income tax purposes, resulting in two possible economic adjustments. To the extent that two economic adjustments are required (e.g., a gift tax audit following an earlier income tax audit at which time an adjustment was made),

the Parties further agree to take any and all reasonable additional actions, and to execute any additional documents, in order to effectuate such adjustment payments, as the Accountant determines appropriate, if any."

An escrow agreement governing the holding of transfer documents might then address both the income and gift tax audit which would impact the release of equity as well as the holding of equity as security for the note.

Sample Clause: "Allocation of the Shares. The Shares shall be held by the Escrow Agent pending the events necessary for the Shares to be valued, which may occur in two tranches, resulting from an income tax audit and a gift tax audit. As a result of that valuation process, the Parties shall determine, pursuant to the Transfer Agreement, the number of Shares that shall be deemed sold to the Buyer effective as of the date hereof (the "Actual Sale Shares") and the number of Shares that shall be deemed gifted to the GRAT (the "Actual Gift Shares"). All of the aforementioned steps are independent of the events associated with the repayment of the Secured Promissory Note (as defined herein)."

Since the buyer is a non-grantor trust, it may have incurred income tax as a result of distributions, dividends or other economic consequences while holding business interests it purchased pending a final determination of the gift tax value and the adjustment to reflect that result. Does this tax cost get factored into the economic adjustment clause concept discussed above?

Divide a QTIP to Possibly Contain the Risk of a 2519 Challenge

The transfer of the qualifying income interest of the spouse in a QTIP trust is a transfer by the spouse subject to gift tax under Section 2511.[xxv] More importantly, the transfer of any part (or all) of that income interest can result in a transfer of the entire amount in the QTIP trust. Therefore, if the IRS were to successfully assert a Section 2519 transfer (because the spouse lost part of the income interest in the trust), the entirety of a QTIP trust could be deemed transferred with potentially significant gift tax consequences for UHNW clients (for lesser wealth clients the current high exemptions might eliminate any tax cost to a Section 2519 deemed gift and hence make this otherwise worrisome tax challenge an affirmative planning tool).[xxvi]

A successful Section 2519 challenge could impose draconian consequences to a client’s transaction. Any steps that could be taken or, even alternate planning structures that insulate or mitigate such risk might be advantageous, even if it proves difficult to evaluate the scope of the risk or to weigh the effectiveness of steps that might be taken. If a sale is to be made by a trust that is a separate trust or share of a QTIP trust, perhaps steps might be taken to insulate the remainder, or main QTIP trust. A 2014 PLR provides a suggestion as to how, in part, this Section 2519 insurance might be obtained.[xxvii] The concepts in the PLR might also be extended to provide insulation to different types of estate planning transactions.

The PLR provided as follows:

> Decedent's executor elected to treat Marital Trust as qualified terminable interest property (QTIP) under §2056(b)(7) of the Internal Revenue Code…The trustees of Marital Trust propose to divide Marital Trust into three separate trusts, Trust 1, Trust 2, and Trust 3. The terms of Trust 1 will be identical to the terms of Marital Trust. Following the division, the trustees intend to convert Trust 2 to a total return unitrust with an annual unitrust payment equal to not less than three percent or more than five percent of the fair market value of the assets of Trust 2 determined as of the first day of each taxable year. The trustees, with the consent and joinder of the trustees of Family Trust and Decedent's children, will petition Court for a court order to terminate Trust 3 and distribute the assets of Trust 3 equally to Decedent's children…the division of Marital Trust into three separate trusts each separate trust will be a QTIP trust under §2056(b)(7) and the division will not be a deemed gift or other disposition under §2519.

But the division of a marital trust might be used more proactively to insulate against a Section 2519 attack if the QTIP trust is selling an asset. Assume, for example, that an irrevocable trust that qualified as a QTIP trust (e.g., a failed GRAT structured to qualify for a marital deduction) is, pursuant to the terms of the governing instrument, to be combined or poured into the primary QTIP trust. If that first trust is to engage in a sale or transaction that might pose any Section 2519 arguments, perhaps the two QTIPs can be bifurcated to prevent a 2519 attack from reaching the second QTIP. In other words, one might wish to take steps to prevent the otherwise intended combination of the two QTIP trusts (e.g., the failed GRAT/QTIP merging into the primary QTIP at the end of the term of that failed GRAT). The same governing instrument might include powers to divide trusts and even not to merge trusts. Consider the following language:

> **Sample Clause**: “Whenever two trusts created under this instrument are directed to be combined into a single trust (for example, because property of one trust is to be added to the other trust), the Trustee is authorized, in the exercise of its sole and absolute discretion, instead of combining said trusts, to administer them as two separate trusts with identical terms in accordance with the provisions that would have governed the combined trusts.”

It may be feasible for the trustees of each of the QTIP trusts to exercise these powers in advance to prevent merger and to otherwise administer the trusts as independent and separate QTIP trusts. If an institutional trustee is named in any of the QTIP trusts it may be feasible for the institution to confirm the action to prevent a merger of the separate QTIP trusts in order to provide greater independence to the transaction then if merely family members approved the transaction. This affirmative action, prior to consummating a transaction, could make it difficult for the IRS to assert a Section 2519 challenge against the separate QTIP trust that did not engage in the subject transaction.

Use of an Independent Escrow Agent

If a sale occurs which is subject to a defined value mechanism and/or a deferred payout supporting the note, who holds the collateral for the note? Who holds what documentation pending the resolution of the defined value mechanism? In many cases these documents are held by the estate planner crafting the transaction. Might there be a better option? The *Ward* court noted:

> Furthermore, since there is no assurance that the petitioners will either recover the excess shares or, at the time of their deaths, possess the power to recover such shares, and since the shares are not worthless, the petitioners' estates may be reduced by the transfer of the shares.[xxviii]

Might having title documents held in the hands of an independent escrow agent who assures that necessary adjustments are made, deflect this concern? Using an independent law firm, not a firm otherwise involved in the transaction, with a detailed escrow agreement specifying which documents should be held, and how they should be handled, might add additional credibility to the arrangement and negate the issue raised by the *Ward* court. Endeavoring to adhere to all relevant formalities could be important.

In the *Wandry* case, the taxpayers listed percentage interests on the schedules attached to the gift tax return, not dollar figures as would have been consistent with the transfer of a fixed dollar amount. While the court did not change its conclusion because of this issue, it is certainly better to avoid such inconsistencies. Adhering to the formalities of a detailed escrow agreement, one reviewed along with all documentation by an independent agent, might also help safeguard transactions from these issues. It will be important for the tax-preparer of the closely-held business income tax returns to prepare the entity tax returns in a manner consistent with the defined value clause and it might be helpful for the preparer to include footnotes that describe that operation of the defined value clause may change the income tax return filed. As with all planning, collaboration can be key to ensuring that the plan is upheld.

Conclusion

The late 2020 planning environment and potential for massive tax changes is unpredictable, making it all the more possible that legislative changes imposed after the new year might reduce the efficacy of planning using so-called “freeze” techniques like note sales transactions. Nonetheless, note sales remain a very powerful wealth transfer strategy, particularly with low interest rates and economic disturbances causing lower-than-normal valuations. It’s important to remain alert to possible broad changes to the wealth transfer laws and attempt to factor the possibility of such changes into planning considerations.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Joy Matak
Sandra Glazier
Martin Shenkman

CITE AS:

CITATIONS:

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[i] This newsletter is an adaption of a portion of a paper submitted to the Notre Dame Tax and Estate Planning Institute, which was an adaption of Martin M. Shenkman, Jonathan G. Blattmachr, Joy Matak, & Sandra D. Glazier, Steve Leimberg's Estate Planning Email Newsletter #2745, 03-Sep-19, "Estate and Tax Planning Roadmap for 2019-2020."

[ii] Portions based on: Shenkman and Blattmachr: "Estate Planning Updates and Planning Nuggets January - April 2019," Estate Planning Newsletter 2728 (June 4, 2019).

[iii] *Frazee v. Commissioner*, 98 Tax Ct. 554 (1992).

[iv] Section 7872(c); Section 7872(a)(1).

[v] See Jay D. Waxenberg and Jason A. Lederman, "The intersection of trusts and anti-trust: Why you, an estate planner, should care about Hart-Scott-Rodino," 51 Real Property, Trust and Estate Law Journal, at 431.

[vi] 16 CFR Part 802.71.

[vii] *McCord*, CA-5, 2006-2 USTC ¶60,530; *Petter Est.*, 98 TCM 534, TC Memo. 2009-280; *Christiansen Est*., 130 TC 1, CCH Dec. 57,301, aff'd CA-8, 2009-2 USTC ¶60,585

[viii] Nelson v. Commission, T.C. Memo 2020-81.

[ix] Nelson at *19-20.

[x] Id.

[xi] *Wandry, et al. v. Comm'r*, TC Memo 2012-88.

[xii] *J. King*, CA-10, 76-2 USTC ¶13,165.

[xiii] *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944).

[xiv] *C. Ward*, 87 TC 78, CCH Dec. 43,178.

[xv] This idea is attributed to Steven Gorin, Esq., Gorin, part III.B.3.a.iv. Defined Consideration Clause, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 7/14/2019), available by emailing the author at sgorin@thompsoncoburn.com.

[xvi] *Wandry et al*., 103 TCM 1472, CCH Dec. 59,000(M), TC Memo. 2012-88.

[xvii] IRB 2012-46.

[xviii] This idea is attributed to Stacy Eastland.

[xix] However, if a trust is the recipient, the trustee will need to analyze whether and to what extent, if any, the exercise of such a disclaimer might constitute a breach of fiduciary duties owed to the beneficiaries.

[xx] A sub-chapter S corporation is limited in the types of trusts that can be valid shareholders specifically: grantor trusts, ESBTs and QSSTs. IRC Sect. 1361(c)(2)(A)(v) describes the rules for a trust to qualify as an Electing Small Business Trust (ESBTs), generally limiting beneficiaries to individuals, estates, or charitable organizations. IRC Sect. 1361(d)(3)(B) defines a qualified subchapter S trust (QSST) which must distribute all of the income from the S corporation to one individual who is a citizen or resident of the U.S.

[xxi] Reg. 25.2702-3.

[xxii] Wandry v. Commissioner, T.C. Memo 2012-88, in which the Tax Court upheld a formula clause, but see Nelson v. Commissioner, T.C. Memo 2020-81, discussed later in this newsletter.

[xxiii] See Rev. Rul. 85-13.

[xxiv] Issues associated with exercise of the power of substitution, the possibility that an exercise might undermine ultimate goals of disposition, the timing and determination of equivalent value, as well as fiduciary duties triggered by such exercise, are beyond the scope of this newsletter, but merit consideration.

[xxv] Reg. 25.2519-1(a).

[xxvi] *Estate of Kite v. Commr.*, T.C. Memo. 2013-43. Note, however, that the retention of the balance of the income interest by the spouse might trigger estate tax inclusion in the estate of that spouse not under Section 2044 (which causes a QTIP trust be included in the estate of the beneficiary spouse) but under Section 2036 because the spouse retained an income interest in the QTIP trust that the spouse was deemed to have given away under Section 2519.

[xxvii] See PLR 201426016 (not precedent).

[xxviii] The Ward Court referenced Harwood v. Commissioner, 82 T.C. at 275 n. 28. Ward v. Comm'r., 87 T.C. 78 (1986); Rev. Rul. 86-41, 1986-1 C.B. 300. Cf. King v. U.S., 545 F.2d 700 (10th Cir. 1976).