

By **Clay R. Stevens**

The Reverse Defective Grantor Trust

Achieve estate tax exclusion without losing financial security

The gift tax exemption is currently \$5.12 million and, without further Congressional action, will drop back to \$1 million in 2013.¹ While some believe Congress won't allow such a dramatic decrease, many estate planners are recommending their clients take action and irrevocably gift assets to their heirs before the end of the year. However, other than ultra-wealthy clients who have more assets than they'll ever consume, many are being advised by their financial advisors that a married couple can't afford to irrevocably gift up to \$10.24 million of their net worth and sustain their current lifestyle.² Additionally, to get any benefit from the increased exemption amount, a couple may need to gift over \$7 million in 2012 if Congress eventually sets the exemption amount at \$3.5 million per person.³ Therefore, unless a couple can afford to give away nearly \$10.24 million in assets, gifting in 2012 simply to use the increased exemption amount may not be advisable.⁴ In fact, if Congress does act and permanently fixes the exemption amount at the current \$5.12 million,⁵ gifting in 2012 may have other negative consequences without any estate tax benefit. Specifically, if a couple passes away with less than twice the exemption amount in net assets, gifting in 2012 may achieve no estate tax benefit, but would cost the couple a step-up in income tax basis on their entire estate at death.

What if a relatively simple structure allowed a taxpayer to take full advantage of the \$5.12 million exemption amount in 2012 to reduce further estate tax, didn't impact use of his assets to support his lifestyle and allowed a full step-up in income tax basis on all his assets

at death? That structure exists today—a reverse defective grantor trust (reverse DGT).

How it Works

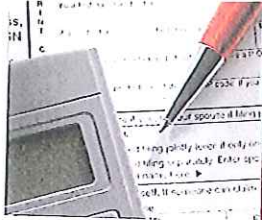
A reverse DGT is a new twist on a relatively common estate-planning transaction—a sale to a defective grantor trust.⁶ It involves three steps:

Step 1: Create an irrevocable grantor trust. A grantor trust in its most simple form is a trust containing certain prohibited provisions causing all of its income to be taxed to the taxpayer who transferred property to the trust.⁷ In addition, the grantor and trust are treated as one entity for all income tax purposes, so that transfers between the grantor and the trust have no income tax consequences.⁸ As a result, not only do transfers between the grantor and trust prevent income tax recognition during the grantor's lifetime, but also payments of interest on promissory notes between the grantor and trust aren't taxable during the grantor's lifetime. In fact, a separate income tax return isn't even necessary for the grantor trust during the grantor's lifetime, minimizing administration and complexity.⁹ The beneficiaries of the irrevocable trust can be the grantor's children or grandchildren, to the extent the grantor wishes to do dynastic planning.¹⁰

Step 2: Irrevocably gift assets to the trust. Unlike a traditional sale to a DGT, wherein the gift is typically 10 percent of the overall value of the assets being transferred, the gift to the reverse DGT can be as high as the grantor's entire remaining exemption amount. The gift can include any type of asset. To ease valuation questions and expense, it's preferable to gift liquid assets, since this structure doesn't rely at all on fractional interest valuation discounts. As discussed below, however, it's best to gift assets with as little current appreciation as possible.¹¹ Whether the grantor will need access to the gifted assets for future lifestyle spending isn't an impediment to using the assets for the gift.



Clay R. Stevens is director of strategic planning at Aspiriant in Los Angeles



Step 3: The grantor may purchase some or all of the assets in the grantor trust (reverse assets) in exchange for a promissory note. The purchase would be an arm's-length transaction for full fair market value (FMV), as with any traditional sale to a DGT, but, unlike the traditional DGT sale, the buyer and seller would be reversed. The promissory note might provide interest-only payments annually and a balloon payment of principal in 20 or 30 years. The note could be secured with any of grantor's property, including the reverse assets. The grantor could defer the purchase until he felt it necessary to acquire the reverse assets, which could be soon after the sale, the following taxable year or even farther into the future. Alternatively, the grantor may never

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purchase the reverse assets and instead feel more secure simply knowing that he could acquire the assets at some point in the future, if necessary.

Unlike a traditional DGT sale, which benefits from the lowest possible interest rate,¹² a higher interest rate is most beneficial from an estate tax perspective, since the interest payments paid to the trust would escape estate tax at the grantor's death. While the applicable federal rate (AFR) rules serve as a minimum rate on an intra-family loan to prevent imposition of gift tax,¹³ it doesn't serve as a maximum. Instead, the appropriate rate depends on several factors, such as credit worthiness of the grantor, any collateral provided and the grantor's debt-value ratios. It's conceivable an FMV interest rate on the loan may be closer to 6 percent to 8 percent.

With a traditional DGT, most estate planners choose a shorter term and recommend the grantor trust pay off the entire promissory note prior to the grantor's death.

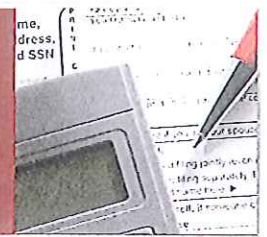
With a reverse DGT, it's more likely that, due to the length of the note, the note will remain outstanding at the grantor's death. However, the note will serve as a valid deduction against the grantor's other assets at death, including the assets purchased from the grantor trust. Typically, a decedent may not claim an estate tax deduction for the value of a note to the extent the note wasn't received as part of a transaction in which the grantor received full and adequate consideration.¹⁴ But, since the grantor issued the note to the trust in an arm's-length sale for consideration, the note shouldn't be disregarded.¹⁵ Additionally, since the reverse assets are included in the grantor's estate, the basis of those assets is increased to FMV.¹⁶ This is different from a traditional DGT, in which the assets of the trust aren't included in the grantor's estate and, thus, don't receive any increase in basis at death.¹⁷

For example, assume a single grantor has \$9 million of liquid assets, but may need some of these assets to support his lifestyle. He would create a reverse DGT, use up his remaining exemption amount in 2012 by gifting \$5.12 million of liquid assets to the grantor trust and later purchase those assets from the trust for a \$5.12 million promissory note. If the grantor passes away holding \$6 million of the original \$9 million in assets, the note would completely offset most of the value of the remaining assets, and only a small amount of estate tax would be due regardless of the size of the exemption amount at his death. Additionally, any appreciation in those assets would be erased since the assets would receive a step-up in basis to FMV. But, most importantly, the grantor would have retained the use of the liquid assets during life to support his lifestyle.

As an alternative to holding the note until death, the grantor, instead, may decide to repay the note with cash or assets in the future, when he's more comfortable with his own spending needs. For a grantor who's reluctant to gift in 2012 out of an abundance of caution, despite having more assets than he will likely consume, this option might be very attractive. This plan is especially useful to the extent the note can be repaid with non-appreciated property so the assets won't miss out on a basis increase at death as of a result of being outside the taxable estate.

Retained Use of Trust Assets

Under basic estate tax law, to the extent a grantor transfers assets to an irrevocable trust and retains the use of the trust assets, the trust assets are included in the



grantor's estate.¹⁸ In the case of the reverse DGT, the grantor receives back the assets gifted to the trust and has full use of them. However, the grantor exchanges the gifted assets with a promissory note of equal FMV. An exception exists to the retained use rules for transfers resulting from bona fide sales for full and adequate consideration.¹⁹ Therefore, as long as the value of the promissory note equals the value of the assets purchased from the trust, the retained use rules shouldn't create any estate tax inclusion.

Even if the grantor doesn't retain any direct ownership in the trust assets, the grantor's use of trust assets may be implied from the facts surrounding the actions of the trust. This argument has been successful in challenging the use of family limited partnerships (FLPs), in which the actions of the partnership suggest that the transferor continued to retain the same rights and use of the transferred assets.²⁰ It's also been applied to trusts when the existence of an implied agreement between the grantor and trustee was found—especially when the grantor transferred substantially all of his property to the trust.²¹

In a reverse DGT, it might appear that some implied agreement existed to allow the grantor to use the trust assets. But, the grantor purchased the trust assets for full FMV and replaced them with a promissory note. The reverse assets are being included in the grantor's estate, and including both the assets and the note in the grantor's estate would amount to double counting. To include the trust assets in the estate, the Internal Revenue Service would have to find an implied agreement that the grantor would be given access to the assets held by the trust. At the date of the grantor's death, when the retained use argument would be tested, the only assets in the trust would be the outstanding balance of the note and any accumulated note payments. To the extent payments are made as scheduled under the terms of the note and the note payments aren't made available to the grantor, it would be difficult to find that any implied agreement existed.

Alternatively, the IRS might argue that the purchase of assets wasn't for full FMV by attempting to disregard the note owed by the grantor as a valid debt. In determining whether a bona fide creditor-debtor relationship exists, transactions among family members are presumed to be a gift.²² However, family members can rebut the presumption by establishing a real expectation that the debt will be repaid and the terms of the

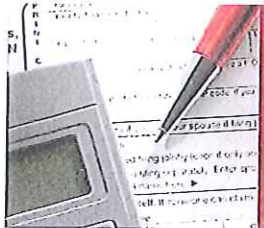
loan enforced.²³ While little authority exists for recharacterizing debt owed by the grantor to a prior donee as a taxable gift, some cases have disregarded debt as a valid obligation in the situation in which the grantor received a note from someone in exchange for property.²⁴

Courts consider several factors in determining whether a real expectation of payment exists, including: (1) a written promissory note, (2) imposition of interest, (3) existence of security for the note, (4) fixed maturity date, (5) whether the creditor demanded payment when due, (6) whether the debtor repaid the debt when required, (7) the creditor's ability to repay the note, (8) extraneous documents reflecting the transaction as a debt, and (9) whether the note was reported con-

With the note issued by the reverse DGT, it's expected that all the note formalities would be followed, since there's a valid expectation that the note will be repaid in the future.

sistently for tax purposes.²⁵ In a recent 2012 Tax Court case, the court examined these factors and found a valid debtor-creditor relationship between a taxpayer's sons and the taxpayer's FLP, despite the fact that no payments were made on the notes, no collateral was provided, the notes didn't contain a maturity date and it was unclear whether the sons had the ability to repay the notes.²⁶ The Tax Court concluded that a reasonable expectation of repayment existed because actual promissory notes were created and the extraneous evidence confirmed the existence of such notes. In a prior Tax Court case, the court examined the above factors and determined the creditor didn't have a reasonable expectation of payment, because the notes weren't interest-bearing or secured, the terms weren't respected and the extraneous records weren't consistent with the position that the transfers were loans.²⁷

With the note issued by the reverse DGT, it's expected that all the note formalities would be followed, since there's a valid expectation that the note will be repaid



in the future. The grantor would execute a note instrument providing adequate interest. Ideally, the interest rate would be based on commercially reasonable terms and could be as high as 6 percent to 8 percent per year. The grantor would make regular interest payments on the note, and unlike most of the prior examples, the note would definitely be repaid—either during the grantor's lifetime or after the grantor's death. To be safe, the reverse assets and possibly other grantor assets would secure the note, although it's not clear whether any security on the loan is required.²⁸ Additionally, it's expected that the note will be properly recorded as debt for federal tax purposes on the estate tax return, if held until death, and that it will be recorded as a non-taxable

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gift on the gift tax return. As a result, if the promissory note in the reverse DGT was respected as valid debt, then the sale of the asset for the promissory note would qualify as a transfer for fair and adequate consideration, and the assets of the trust shouldn't be included in the estate as a retained interest.

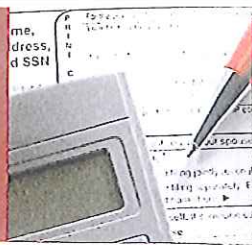
Step-Transaction Doctrine

The step-transaction is a judicial doctrine typically used to prevent income tax avoidance strategies, but courts have applied it in limited circumstances to the transfer tax area.²⁹ Under the step-transaction doctrine, if a taxpayer enters into several transactions that are so interdependent that they can't be viewed separately, a court may collapse the steps into one integrated transaction. A court may invoke this doctrine when: (1) each step is connected by a binding commitment, (2) each step has no independent significance without consideration of the integrated transaction, or (3) a series of separate steps were part of a prearranged plan agreed to by all the parties prior to the transaction.³⁰ If the IRS recharacterizes the transfer to the trust and subsequent repurchase as the issuance of the

promissory note by the grantor to the trust without consideration, then the promissory note wouldn't be deductible as an expense of the estate upon the grantor's death.³¹ Additionally, if the IRS didn't respect the sale of the assets from the trust to the grantor and treated the grantor as retaining an interest in the trust, then it could include the trust assets in the grantor's estate.³²

As some commentators note, applying the step-transaction doctrine to estate-planning techniques under a prearranged plan or "end result test" would cause almost all estate strategies to fail.³³ But, in the limited cases in which the IRS successfully challenged an estate strategy with the step-transaction doctrine, there's been a very short period of time between the steps.³⁴ In the cases in which the passage of time between the steps results in some non-tax consequences, the IRS has been less successful in collapsing the transactions. However, even in the cases in which the IRS has been successful, the step-transaction doctrine hasn't been used to disregard the separate transactions, but instead has been used to treat them as one transaction for discount valuation purposes. In fact, in one recent step-transaction "victory," in which the IRS collapsed the gift and sale into one transaction, the IRS didn't respect the sale by reducing the transfer by the value of the note issued as part of the sale.³⁵ With the reverse DGT, the strategy doesn't rely on valuation discounts and it's done preferably to transfer undiscounted assets to minimize valuation concerns.

Additionally, assuming there's some time between the gift and the sale in the reverse DGT, the grantor and trust risk significant non-tax consequences between the time of the initial gift and the later sale. If the value of the property depreciates between the gift and the sale date, the trust bears the risk of loss. On the contrary, if the value of the property appreciates between the gift and the sale date, the grantor will have to issue a promissory note to the trust in excess of the original gift amount. In either case, the grantor will have added a debt to his balance sheet by entering into the transaction that could affect his later ability to get credit and therefore can't be ignored. The IRS has been unsuccessful in cases in which the two transactions were only days apart, but there was "real risk of economic change" between the two transactions.³⁵ To the extent desired, the gift and the purchase by the grantor could be separated by sufficient time to create real risk of economic change in the value. In fact, only the gift needs to take place in 2012 to take advantage of the increased exemption



amount and any purchase of the reverse assets could take place in 2013 or at some time in the future, when the grantor wants to acquire the assets from the trust. However, since as little as five days has been held to prevent the application of the step-transaction doctrine, to the extent the assets contributed bear the risk of appreciation or depreciation, an extended time period between the gift and sale with the reverse DGT shouldn't be necessary.³⁷

Income Tax Consequences at Death

An unresolved issue with a traditional sale to a DGT is the income tax effect at death if some of the original promissory note remains outstanding. It's relatively clear that the trust must recognize gain if grantor trust status terminates during the grantor's life, to the extent the outstanding liabilities owed by the trust exceed the trust's basis in the assets.³⁸ The gain arises because the grantor is treated as having transferred the trust assets to the trust on termination of the grantor trust status in exchange for being discharged of any trust liabilities.³⁹ On the grantor's death, however, no statutory authority, ruling or case law exists definitively providing whether gain is recognized if the trust holds promissory notes owed by the trust to the grantor.⁴⁰ In fact, many commentators conclude that death shouldn't be an income realization event and that no gain is recognized due to the existence of the promissory notes.⁴¹

If the grantor must recognize any income upon termination of the grantor trust status, either during life or at death, the gain only arises to the extent the liabilities of the trust exceed the basis of the trust assets.⁴² In the case of the reverse DGT, the trust doesn't owe any liabilities that are potentially being discharged at death, and instead, any debt associated with the prior transfer between the grantor and the trust remains with the grantor upon termination of the grantor trust nature. Therefore, termination of grantor trust status on the death of the grantor shouldn't be an income realization event.

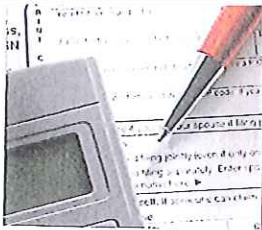
Even if the IRS were to argue that the grantor's death was an income realization event based on the notes owed by the grantor to the trust, the trust's basis in the assets sold to the grantor should have basis equal to the face value of the notes. Upon the gift of assets to any irrevocable trust, the trust takes the donor's basis in those assets.⁴³ To the extent the assets gifted to the trust

aren't appreciated, the principal balance on the note should equal the basis of the trust assets at the time of sale.⁴⁴ Therefore, the possible discharge of liabilities wouldn't exceed the basis of the assets sold, and no gain would result.⁴⁵

Whether any gain must be recognized on the estate's repayment of the interest and principal of the note following the death of the grantor is a separate issue. If the property gifted to the trust wasn't appreciated, then no gain would have been recognized at the time of sale regardless of whether the trust was a grantor trust. As a result, later repayment of the principal balance on the debt after death likewise shouldn't bring rise to any gain. For that reason, it's better to gift non-appreciated property to the reverse DGT. If appreciated property were gifted to the reverse DGT, gain presumably would need to be recognized on repayment of such notes following death. However, the reverse assets would be included in the grantor's estate and receive a step-up in basis at death to help mitigate this negative result.⁴⁶ Additionally, not only appreciated reverse assets get stepped-up to FMV at death, but also any appreciation in those assets after they were sold to the grantor would get a step-up in basis. The gain on the repayment of the note, on the contrary, is limited to any pre-gift appreciation.

Another potential source of income tax issues following death is accrued, but unpaid, interest on the promissory notes issued to the trust. Nothing prevents the grantor from accruing some or all of the interest on the note to the trust.⁴⁷ But, satisfaction of such interest post-death will be an income tax realization event to the trust.⁴⁸ For that reason, it's best not to accrue interest on the reverse DGT, but instead, pay interest regularly on the note. If the grantor doesn't have the liquid assets to service the interest regularly, then the interest rate could be reduced as long as it at least equals the AFR for the month of sale.⁴⁹ To the extent such interest is current at the time of death, only future interest payments made on the note would give rise to income tax.

If the grantor has sufficient liquid assets, the best way to minimize all the negative income tax consequences on the transfer would be for the grantor to gift cash into the trust. The grantor could then borrow the cash from the trust as needed in the future in exchange for an interest bearing promissory note. The trust's basis in the cash and thus the trust's basis in the note would be equal to the principal balance of the note. As long as the grantor services the interest on



the note regularly, no income tax should result from the entire reverse DGT transaction upon repayment following the grantor's death. However, to the extent the grantor doesn't have sufficient cash to fund the gift and must use property, any negative income tax consequences can be minimized if the property used isn't highly appreciated.

Fiduciary Responsibilities of Trustee

Like any estate-planning transaction involving irrevocable trusts, a reverse DGT also must deal with the issue of who should serve as trustee. And, as with all irrevocable trusts, it's often recommended that the grantor not serve as sole trustee.⁵⁰ At minimum, a reverse DGT

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should have an independent loan director approve the sale to the grantor to help insulate the grantor from retained interest arguments and to provide additional legitimacy to any loan. Regardless of who's serving as trustee, however, the trustee is subject to fiduciary responsibilities to the beneficiaries under local trust law, including the duty to make suitable investments as a prudent investor.⁵¹ To the extent the grantor purchases assets from the estate using a promissory note and consumes so much of his estate that he's unable to satisfy his full legal obligation at death, the trustee may then be subject to claims from beneficiaries of mismanagement.

One option to minimize this risk is to have the terms of the trust document lessen the fiduciary standards applicable to the trustee with respect to these types of transactions.⁵² Eliminating such responsibilities altogether may increase the possibility of retained interest claims by the IRS, especially if the grantor is serving as trustee. However, in many grantor trusts, the grantor retains the right to bor-

row trust assets without any security, and it's likely the existence of such right wouldn't cause estate tax inclusion.⁵³ To the extent borrowing without any security doesn't cause a problem, then borrowing with some security, presumably, shouldn't create an issue. But, it's good practice to provide full and adequate security for any loan owed by the grantor to the reverse DGT, and such collateral may include the grantor's other non-liquid assets. Another way to protect the trustee is to fully indemnify him from claims by a beneficiary for such actions if taken in good faith, and the indemnification likely is warranted even if the loan is properly collateralized.

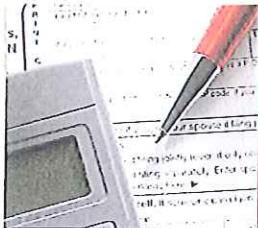
Disregarded Basis Step-up

To prevent taxpayers from gifting appreciated property to a person whose death is imminent for the purpose of obtaining a step-up in basis when the property is bequeathed back to the donor, the Internal Revenue Code prohibits a decedent's assets from receiving a step-up in basis at death when the decedent dies within one year of the gift.⁵⁴ In the case of the reverse DGT, even if the grantor passes away within a year of acquiring the assets from the trust, the assets should be entitled to a step-up for several reasons. First, this provision applies to gifts and, although the trust will have received the property by gift, the grantor re-acquires the reverse assets through a sale in exchange for a promissory note. Second, even if the IRS characterized the DGT sale as a gift transaction, the trust isn't the beneficiary of the grantor's estate. The beneficiaries of the trust and the recipients of the grantor's estate may be the same individuals, but it's contemplated the trust provisions would differ from the terms of the estate bequest. In either case, if the property gifted to the trust initially isn't appreciated or the grantor survives more than one year after the DGT sale, the prohibition wouldn't have any consequence, even if applicable.

Reasons Not Applicable

No estate-planning transaction is applicable for every situation. The reverse DGT is no exception. Planners should account for three non-tax considerations in evaluating the merits of the reverse DGT for a particular taxpayer.

1. Size of estate. If the grantor's estate isn't likely to exceed her remaining exemption amount, using the reverse DGT will provide no estate tax benefit.



Instead, the grantor will have incurred costs to create and administer the structure and will have to deal with the added complexity, without any corresponding estate tax savings. The problem in 2012 will be in determining whether a grantor will eventually be subject to estate tax. If a single grantor's estate is less than \$1 million and not expected to increase in value, then it's clear no estate tax will be due, regardless of whether any future legislation is passed. Otherwise, the grantor and her advisors are left to guess on the eventual size of the exemption amount. Many estate-planning professionals assume Congress will eventually pass some legislation setting the exemption amount at a number in excess of \$1 million, but whether that number will be \$2 million, \$3.5 million or \$5 million is far from certain.


Depending on the expected estate tax due at the grantor's death, the administration of making regular interest payments on the note may be too burdensome for some grantors.

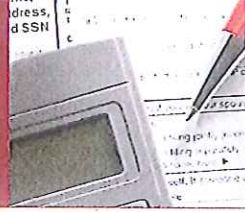
Plus, many individuals will see their assets increase over time so that a grantor with an estate of \$1.5 million today may have an estate of \$3 million in 10 years, and that size estate may exceed the exemption amount at that time.

On the flip side, if the grantor's estate is so large that it will likely be subject to estate tax regardless of the exemption amount, returning the assets to the grantor may not be prudent. If the property gifted to the trust is likely to appreciate at a higher rate than the prescribed interest rate, returning the assets to the grantor only increases the estate tax due at death. Locking in the future appreciation on the assets at the low AFR may provide a better estate tax result. However, the prescribed rate for the reverse DGT may be much higher than the AFR, and the grantor may be willing to lock in an automatic 6 percent to 8 percent return on

notes depending on the type of assets being contributed. For example, if a grantor gifts cash to a DGT in the current low interest rate environment, the return may be as small as 1 percent versus the guaranteed 6 percent to 8 percent return on the notes to the extent such higher interest rate is justifiable.

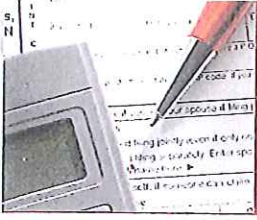
2. Administration of interest payments. Depending on the expected estate tax due at the grantor's death, the administration of making regular interest payments on the note may be too burdensome for some grantors. As discussed above, to avoid income taxation of the accrued interest upon payment following the death of the grantor, the grantor should make regular interest payments on the notes annually. These payments serve to further reduce the grantor's estate for estate tax purposes, but may create cash flow issues for illiquid grantors. One option is to reduce the interest rate on the notes to the minimum AFR upon the date of transfer. While this isn't ideal from a wealth transfer perspective, to the extent the grantor's estate won't be subject to estate tax because of the existence of the note to the trust, using the lower interest rate will be preferable. Alternatively, to the extent interest payments accumulate in the trust, the grantor could also enter into another exchange or loan with the trust in the future to recover some or all of the accumulation. For example, if the grantor has other illiquid assets, she may sell those assets to the trust in exchange for the accumulated interest payments using a traditional sale to a DGT transaction. In either case, making regular interest payments will create some administrative responsibilities, and for some grantors who aren't likely to have a large estate tax bill, subjecting oneself to those responsibilities may not be worth the hassle.

3. Inability to change terms of trust. For the promissory note held by the trust to be excluded from the grantor's estate, the trust must be irrevocable, and the grantor can't retain rights to alter the beneficiaries. This is the same for any irrevocable trust, but may become more important with the reverse DGT to the extent the majority of a grantor's assets are passing through the trust at the death of the grantor following repayment of the debt. If the grantor wouldn't otherwise be subject to substantial estate tax, because her taxable estate without the reverse DGT is unlikely to greatly exceed the exemption amount at death, minimizing the control a grantor would have to change her estate plan at death may not be worth the estate tax savings. But, the estate tax savings for a grantor who does have a large taxable estate may justify the limitations. 



Endnotes

1. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provides that several estate and gift tax changes scheduled to sunset on Jan. 1, 2011 will now sunset on Jan. 1, 2013, including the change in the unified credit equivalent from \$5.12 million to \$1 million. 2010 Tax Relief Act, PL 111-312. All references to unified credit equivalent will be referred to as "exemption amount" throughout this article.
2. To increase a married couple's access to gifted assets, some estate planners are considering the use of two nearly identical trusts whereby each spouse is a potential beneficiary of the other spouse's gift trust. Paul Sullivan, "To Give or Not to Give, Up to \$5.12 Million," *N.Y. Times* (June 22, 2012). Aside from the need to avoid the reciprocal trust doctrine, the surviving spouse still loses access to half the gifted assets upon the first death, and none of the gifted assets receive a step-up in basis at death. See *infra* note 16 and accompanying text.
3. If Congress sets the exemption amount at \$3.5 million per person (the amount provided in President Obama's 2012 budget proposal), and a couple together can only afford to gift \$7 million in 2012, then the couple will simply have used up their entire \$7 million credit by gifting in 2012 and will be in no different position with respect to the credit if they hadn't gifted anything in 2012. Therefore, unless the couple can afford to give away a full \$10.24 million in assets, gifting less may not use any of the 2012 increased exemption amount.
4. One option to reduce the need to gift a full \$10.24 million is to have only one spouse make gifts of up to \$5.12 million with separate property during 2012 so that he fully uses his available exemption amount. The non-gifting spouse will then have preserved her remaining exemption amount in full for use on future gifts. However, the non-gifting spouse will still lose the ability to fully use her exemption amount to the extent the exemption amount at her death is less than \$5.12 million.
5. A timing problem also exists for most estate planners in that Congress is unlikely to act prior to the election in November—as Congress did in 2010 when the exemption amount was set to automatically revert back to \$1 million at year-end, and legislation was signed on Dec. 17, 2010. To the extent estate planners want more certainty before acting, it may then be impossible to get such transactions implemented before year-end. One option may be to implement a traditional sale to a defective grantor trust (DGT) in exchange for a promissory note and then forgive such note at year-end to the extent Congress doesn't act and the credit is likely to revert back to \$1 million. But, the assets in the DGT won't receive a step-up in basis. See *infra* note 16 and accompanying text.
6. Sales to DGTs have grown in popularity and usage since first introduced in a 1996 article. See Michael D. Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 *Estate Planning* 3 (January 1996). See also Ronald D. Aucutt, "Installment Sales to Grantor Trusts," 4 No. 2 *Bus. Entities* 28 (March/April 2002).
7. See Internal Revenue Code Section 671. The taxpayer must create the irrevocable trust and include certain provisions, like the power of the grantor to exchange trust property for other property of equal fair market value or the power of an independent person to add charitable beneficiaries, which causes the trust to be treated as a grantor trust. See IRC Section 675(4); IRC Section 674(a).
8. Revenue Ruling 85-13, 1985-1 C.B. 184.
9. Treasury Regulations Section 1.671-4(b)(1).
10. Assuming the grantor wants the trust be held for multiple generations, the grantor would want to allocate his generation-skipping transfer (GST) tax exemption to any gift to insulate future distributions from GST tax. If a sufficient portion of the grantor's GST tax exemption is allocated to the original gift to the trust so that the trust has a zero inclusion ratio, then the assets of the trust—including any future growth—can eventually pass to the grantor's grandchildren in trust without estate or GST tax.
11. See *infra* notes 41-52 and accompanying text.
12. For most traditional sale to DGT transactions, the promissory note is often structured as a 9-year note so that the interest rate can be set at the minimum applicable federal rate (AFR) for a mid-term loan.
13. See IRC Section 7872(e) (providing that a gift loan is only a below market loan if the interest rate on the note is less than the AFR under IRC Section 1274(d)).
14. See IRC Section 2053(c)(1)(A); Treas. Regs. Section 20.2053-4(d)(5); see also Rev. Rul. 84-25, 1984-1 C.B. 191.
15. See *infra* notes 20-30 and accompanying text.
16. See IRC Section 1014(b)(1); Treas. Regs. Section 1.1014-2(a)(1). This is different from a traditional sale to a DGT, when the trust assets aren't included in the grantor's estate. In that case, there's some uncertainty as to the basis of such assets, but it's likely that the assets of the trust won't receive a step-up in income tax basis. See *infra* note 17 and accompanying text.
17. See Roy M. Adams, "2001: An Estate Planning Odyssey," *Ninth Annual Estate & Charitable Gift Planning Institute*, 106-115 (2001); see also Elliott Manning and Jerome M. Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt., Estate, Gifts & Trusts J.* 3 (1993); but see Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *J. of Tax'n* 149 (1992).
18. IRC Section 2036.
19. *Ibid.*
20. *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-145 (T.C. 2003).
21. *Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986) (finding an implied understanding that the grantor would receive distributions when requested).
22. See *Harwood*, 82 T.C. 239, 258 (1984).
23. See *Estate of Van Anda*, 12 T.C. 1158, 1162 (1949), *aff'd per curiam*, 192 F.2d 391 (2d Cir. 1951).
24. See, e.g., *Estate of Maxwell*, 98 T.C. 594, 603-604 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993); *Estate of Kelly*, 63 T.C. 321, 324-325 (1974).
25. *Estate of Lockett*, T.C. Memo. 2012-123; see *Zimmerman v. United States*, 318 F.2d 611, 613 (9th Cir. 1963); *Estate of Maxwell*, *ibid.*; *Estate of Kelly*, *ibid.* at pp. 323-324; *Estate of Van Anda*, *supra* note 23 at pp. 1162-1163.
26. *Estate of Lockett*, *ibid.*
27. *Belli, Melia*, T.C. Memo. 1989-403 (1989).
28. See Michael D. Mulligan, "Power to Substitute in Grantor Does Not Cause Inclusion, With a Significant Caveat," 109 *J. Tax'n* 32 (July 2008) ("The absence of security should not affect the validity of the debt and should not raise



- Section 2036 or 2038 problems, so long as the trust is required to charge adequate interest.”)
29. See Jay A. Soled, “Use of Judicial Doctrines in Resolving Transfer Tax Controversies,” 42 *B.C. L. Rev.* 587, 588-596 (May 2001).
 30. *Ibid.* at p. 596; see also *Long Term Capital Holdings v. U.S.*, 330 F. Supp.2d 122, 191 (D. Conn. 2004) (discussing the end result test).
 31. See *infra* note 54 and accompanying text.
 32. See *supra* notes 19-31 and accompanying text.
 33. See Soled, *supra* note 29 at p. 607 (arguing that all marital trusts could be subject to question by a broad application of the step-transaction doctrine).
 34. See *Pierre v. Comm’r*, T.C. Memo. 2010-106 (T.C. 2010) (combine same day gift and sale of interests); *Driver v. U.S.*, 76-2 U.S. Tax Cas. (CCH) par. 13, 155, at 85,695 (W.D. Wis. 1976) (collapse two transactions two days apart); *Blanchard v. U.S.*, 291 F. Supp. 348, 348-50 (S.D. Iowa 1968) (gift and sale collapsed when separated by three weeks); *Estate of Cidulka v. Comm’r*, T.C. Memo. 1996-149 (same day sale and stock redemption collapsed); *Shepherd v. Comm’r*, 115 T.C. 376, 389 (2000), *aff’d*, 283 F.3d 1258 (11th Cir. 2002) (same day transfers of interests collapsed); *Senda v. Comm’r*, T.C. Memo. 2004-160, *aff’d*, 433 F.3d 1044 (8th Cir. 2006) (same day funding of partnership and gifts of interests collapsed).
 35. *Pierre v. Comm’r*, *ibid.* (explicitly providing that the step-transaction doctrine only applied to treat two same transactions as one and not to disregard the creation or funding of the entity or the note issued in exchange for the assets sold).
 36. *Holman v. Comm’r*, 601 F.3d 763, 770, 772 (8th Cir. 2010) (noting that the value could have changed in the six days between the two transactions); see *Gross v. Comm’r*, T.C. Memo. 2008-221 (T.C. 2008) (finding that 11 days were sufficient to prevent the transaction from being collapsed).
 37. For additional ways to avoid the application of the step-transaction doctrine, see Steve R. Akers, Samuel A. Donaldson, Charles D. Fox IV, Jeffrey N. Pennell and Howard M. Zaritsky, “Recent Developments—2010,” 45 *Inst. on Est. Plan.* 1, par. 102 (2011).
 38. See Treas. Regs. Section 1.1001-2, ex. 5 (treating grantor trust termination as a transfer and requiring recognition of gain to the extent liabilities exceed basis); *Madorin v. Comm’r*, 84 TC 667 (1984) (same for income tax shelter); Rev. Rul. 77-402 (same). The ruling was also applied in non-tax shelter cases, including estate-planning transfers, when grantor trust status was terminated during the grantor’s lifetime. See Technical Advice Memorandum 200010010; T.A.M. 200010011; T.A.M. 200011005.
 39. See Treas. Regs. Section 1.1001-2(a); Treas. Regs. Section 1001-1(c) ex. 5.
 40. See Mark L. Ascher, “The Grantor Trust Rules Should Be Repealed,” 96 *Iowa L. Rev.* 885, 922-924 (2011).
 41. *Ibid.* See also Blattmachr, Gans and Jacobson, *supra* note 17, at pp. 149-54; Milford B. Hatcher, Jr. and Edward M. Manigault, “Using Beneficiary Guarantees in Defective Grantor Trusts,” 92 *J. Tax’n* 152, 163 (2000); Fred Nicholson, “Sale to a Grantor Controlled Trust: Better than a GRAT?,” 37 *Tax Mgmt Memorandum* (BNA) No. 8, at 102-103 (Apr. 15, 1996); Michael D. Mulligan, “Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?,” 32 *Inst. on Est. Plan.*, 15 par. 1509.2 (1998);
 42. See Mark L. Ascher, “When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction,” 41 *Tax L. Rev.* 253, 273 (1986).
 43. IRC Section 1015.
 44. See Blattmachr, Gans and Jacobson, *supra* note 17 (discussing the three competing theories of taxation post-death with a grantor trust—all of which would provide a basis in the transferred asset of at least the seller’s original basis in the property).
 45. If the measuring date for the asset transfers was the date of death, one might consider whether the basis of the assets retained by the grantor at that time determines the amount of gain. But, what if the grantor no longer holds those assets or has consumed them, how might the basis be determined? It’s difficult to see how the IRS could then argue the transfer of the remaining assets took place upon death and measure the debt against the basis of the remaining assets.
 46. See *supra* note 18 and accompanying text.
 47. See Milford Hatcher, Jr., “Planning for Existing FLPs,” 35 *Inst. on Est. Plan.* 3, par. 302.4(A)(2) (2001) (discussing how backloading interest payments is permissible but may cause the IRS to recharacterize the debt as equity if not paid somewhat regularly).
 48. But see Elliott Manning and Jerome M. Hesch, “Beyond the Basic Freeze: Further Uses of Defined Payment Sales,” 32 *Inst. on Est. Plan.* 16, par. 1601.2(a)(5)(E) (2000).
 49. See *supra* note 13 and accompanying text. Other more complicated options exist to lessen the burden of servicing the interest. Specifically, if the grantor made several interest payments to the trust, and the trust later decides to make an additional loan to the grantor of some of those funds, the trust should have a basis in the new notes equal to the face value of the new notes, and repayment of those additional loans post-death shouldn’t bring rise to gain.
 50. To the extent the trust terms provide the trustee with unfettered control or enjoyment of the trust assets, either direct or indirect, the grantor, if serving as trustee, could have the trust assets included in the grantor’s estate under IRC Sections 2036 or 2038. See Darin N. Digby, “What Powers Can a Donor Retain Over Transferred Property?,” 24 *Estate Planning* 318 (Aug./Sept. 1997). But, if the grantor’s retained powers are limited by an ascertainable standard and subject to fiduciary responsibilities, then serving as trustee shouldn’t cause estate tax inclusion. See *U.S. v. Byrum*, 408 U.S. 125 (1972).
 51. Under the Uniform Prudent Investor Act (UPIA), which most states have adopted in some form, a trustee must manage the trust solely for the benefit of the beneficiaries and not his own and must exercise proper skill, care and caution. See UPIA Sections 2, 5 (1994).
 52. *Ibid.* Section 1(b).
 53. See Jay A. Soled, “Reforming the Grantor Trust Rules,” 76 *Notre Dame L. Rev.* 375, 412 (2001) (noting that while not certain, the inclusion of such power shouldn’t cause estate tax inclusion since there’s no corresponding estate tax code section to that grantor trust power).
 54. IRC Section 1014(e).