Presentation to
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Creative GRAT Structures

and

RPM Trusts

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DECREASING SHORT-TERM GRATS, DISCLAIMER GRATS AND 99-YEAR GRATS

A. GRAT Basics

A "grantor retained annuity trust" (GRAT) is a trust in which the grantor retains the right to receive fixed annuity payments, payable at least annually, for a term of years (an annuity interest). At the end of the term, the remaining trust principal is distributed to the remainder beneficiaries (such as the grantor's descendants) or held in further trust for their benefit. If the grantor survives the term, the remaining trust property is excluded from his or her estate for federal estate tax purposes. If the grantor fails to survive the term, the trust property may be included in his or her gross estate under IRC Section 2036.

B. Gift and Estate Tax Consequences

In general, the gift made to the remaindermen upon creation of a GRAT is equal to the value of the property transferred to the GRAT less the value of the interest retained by the grantor.

1. Application of IRC Section 2702

If a transfer of an interest in trust is made to a member of one's family, then the value of any interest in the trust retained by the transferor (or an applicable family member) is determined under IRC Section 2702. Under that section, the subtraction method is used to determine the value of the transferred interest; that is, the value of the retained interest is subtracted from the value of the property transferred to determine the value of the transferred interest. Any interest retained by the grantor that is a "qualified interest" is valued under the tables in IRC Section 7520 (Publication 1457, Actuarial Tables, Book Aleph), and any interest retained by the grantor that is not a qualified interest is valued at zero. A right to receive fixed amounts payable not less frequently than annually is a qualified interest.[1] Thus, the annuity retained by the grantor in a GRAT is a qualified interest and will be valued using the factors contained in the tables in IRC Section 7520. Those tables determine the present value of the annuity using the Section 7520 rate as the discount rate. The factors are based on the "Section 7520 rate," which is equal to 120 percent of the mid-term AFR, compounded annually, rounded up to the nearest 2/10ths of one percent.

In contrast, if the grantor instead retained the right to all the income earned by the trust, the income interest would not be a qualified interest and it would be valued at zero for purposes of determining the gift made. Because the grantor's interest is valued at zero, there is nothing to subtract from the value of the property transferred to the trust in

[1] IRC §2702(b)(1).

determining the taxable gift to the remaindermen; in other words, the gift to the remaindermen would equal the full value of the property transferred to the trust.

Note that if the annuity is paid other than annually, such as semiannually, quarterly, monthly, or weekly, then the annuity factor must be adjusted (using Table K in Publication 1457) in order to compute the annuity interest involved. For example, if the annuity is payable in monthly installments, then the annuity factor must be multiplied by the appropriate adjustment factor in Table K to compute the adjusted annuity factor, which is used to value the annuity interest.

2. **Remainder and Reversionary Interests**

The grantor could retain a reversionary interest in a GRAT. That is, the GRAT provides that if the grantor fails to survive the GRAT term, the GRAT will terminate and the grantor's estate will receive the GRAT property, causing the property to pass under his or her will or revocable trust. As stated above, if the grantor fails to survive the GRAT term, the entire trust property may be included in his or her gross estate. Thus, by retaining a reversionary interest and causing the GRAT property to pass under the grantor's will or revocable trust, it may be possible to defer or eliminate estate tax through the use of the marital and charitable deductions.

If the grantor retains a reversionary interest in a GRAT, the interests in the GRAT will consist of three components: the annuity interest for the shorter of a term of years or the grantor's life, the remainder (paid to the remaindermen if the grantor survives the term), and the reversion (paid to the grantor's estate if the grantor fails to survive the term). Only the annuity interest is subtracted from the value of the property transferred to the GRAT in determining the taxable gift. The value of the reversion retained by the grantor does not reduce the value of the gift because a reversion is not a qualified interest under IRC Section 2702; the reversion is valued at zero for purposes of determining the value of the interest retained by the grantor. Thus, the taxable gift includes the value of the remainder and the value of the reversion. Put differently, the value of the annuity is reduced due to the possibility that the grantor will not survive for the entire term, in which case he or she may not receive the full amount of all of the annuity payments, thus decreasing the present value of the annuity interest. The decrease in the annuity value is equal to the reversion value.

EXAMPLE:

A 60-year-old person transfers $1 million to a 10-year GRAT that pays him $132,032 per year. If he fails to survive the 10-year term, the property reverts to his estate. The Section 7520 rate is 5.4 percent. Based on the Actuarial Tables, Book Aleph, Publication 1457, the interests created under such GRAT would have the following values:

Value of annuity interest = $932,518 ($132,032 x 7.0628) (Table H)

Value of remainder interest = $0

Value of reversionary interest = $67,482 ($1 million - $932,518 annuity interest - $0 remainder)

If the grantor retains the right to an annuity for a fixed term regardless of whether he or she is living (i.e., no reversion is created), the interests in the GRAT will consist of two components: (1) the annuity interest for a fixed term of years payable to the grantor or, if the grantor does not survive the term, to the grantor's estate and (2) the remainder interest (paid at the end of the term). Under *Walton v. Commissioner*,[2] the value of the annuity interest is based on the stated term of the GRAT and is not decreased by the possibility that the grantor will not survive for the entire term. The annuity interest is subtracted from the value of the property transferred to the GRAT in determining the taxable gift. Because there is no reversion, the taxable gift includes only the value of the remainder. Such a GRAT is often referred to as a "Walton GRAT," or "gift-free GRAT."

3. Estate Inclusion

IRC Sections 2036 and 2033 apply to a GRAT where the grantor does not survive the GRAT term. IRC Section 2033 would include the present value of the remaining annuity payments (or all the trust property if the grantor retains a reversion). However, Section 2036 would not merely include the present value of the remaining annuity payments but would include the amount of property necessary to produce a sufficient amount of income (using the prevailing Section 7520 rate) to fund the remaining annuity payments from such income.[3] Thus, the amount included under IRC Section 2036 is equal to the annuity divided by the Section 7520 rate at the grantor's death.

C. Maximizing Benefits of a GRAT

1. Source of Benefits

The Section 7520 rate is the rate of return the Service assumes the GRAT will realize (i.e., the discount rate) for purposes of determining the value of the annuity interest. A GRAT will serve to transfer property free of gift tax to the remaindermen if and only if the property in the GRAT produces income and appreciation at a rate greater than the Section 7520 rate.

2. Economically Zeroed-Out Walton GRATs

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[2] 115 T.C. No. 41 (2000).

[3] See Rev. Ruls. 82-105, 1982-1 C.B. 133, 76-273, 1976-2 C.B. 268, TAM 200210009 (Nov. 19, 2001).

An economically zeroed-out GRAT (or "zeroed-out" GRAT) is a fixed-term (not the shorter of a term or the grantor's life) GRAT in which the annuity is set so that the present value of the annuity payments, using the Section 7520 rate as the discount rate, is exactly equal to the value of the assets transferred to the GRAT, and thus the remainder (and gift) is zero. This annuity amount can be determined by dividing the amount transferred to the GRAT by the term factor in Table B of the Actuarial Tables, Book Aleph, Publication 1457.

If the GRAT's rate of return equals the Section 7520 rate, then, by definition, the last annuity payment to the grantor will consume the last assets remaining in the GRAT, leaving nothing for the remaindermen. If the property in the GRAT appreciates at a rate greater than the Section 7520 rate, some property will be left to pass to the remaindermen at the end of the GRAT term.

EXAMPLE:

Gary transfers $10 million to a GRAT that pays an annuity of $1,320,324 per year for 10 years. Based on a Section 7520 rate of 5.4 percent, the value of the annuity is $10 million and the value of the remainder is zero.

If the GRAT's rate of return on its assets is 5.4 percent (the rate assumed for purposes of determining the remainder), nothing will be left for the remaindermen.

Year	Start of Year	Growth	Annuity	End of Year
1	$ 10,000,000	$ 540,000	$(1,320,324)	$ 9,219,676
2	$ 9,219,676	$ 497,863	$(1,320,324)	$ 8,397,215
3	$ 8,397,215	$ 453,450	$(1,320,324)	$ 7,530,341
4	$ 7,530,341	$ 406,638	$(1,320,324)	$ 6,616,656
5	$ 6,616,656	$ 357,299	$(1,320,324)	$ 5,653,631
6	$ 5,653,631	$ 305,296	$(1,320,324)	$ 4,638,604
7	$ 4,638,604	$ 250,485	$(1,320,324)	$ 3,568,764
8	$ 3,568,764	$ 192,713	$(1,320,324)	$ 2,441,154
9	$ 2,441,154	$ 131,822	$(1,320,324)	$ 1,252,653
10	$ 1,252,653	$ 67,643	$(1,320,324)	$ (28)

However, if the GRAT's rate of return on its assets is 10 percent, the remaindermen will receive $4,894,864 at the end of the GRAT term. Although the Service expected the remaindermen to receive nothing from the GRAT (because the actuarial value of the remainder was zero at the outset of the GRAT), the remaindermen receive nearly $5 million for no gift tax cost.

Year	Start of Year	Growth	Annuity	End of Year
1	$ 10,000,000	$ 1,000,000	$(1,320,324)	$ 9,679,676
2	$ 9,679,676	$ 967,968	$(1,320,324)	$ 9,327,320
3	$ 9,327,320	$ 932,732	$(1,320,324)	$ 8,939,728
4	$ 8,939,728	$ 893,973	$(1,320,324)	$ 8,513,378
5	$ 8,513,378	$ 851,338	$(1,320,324)	$ 8,044,392
6	$ 8,044,392	$ 804,439	$(1,320,324)	$ 7,528,507
7	$ 7,528,507	$ 752,851	$(1,320,324)	$ 6,961,034
8	$ 6,961,034	$ 696,103	$(1,320,324)	$ 6,336,814
9	$ 6,336,814	$ 633,681	$(1,320,324)	$ 5,650,171
10	$ 5,650,171	$ 565,017	$(1,320,324)	$ 4,894,864

3. **Re-GRATs (or Rolling GRATs)**

The Re-GRAT technique is simply a series of short-term (2-year) GRATs. Each successive GRAT is funded with the annuity payments received from the existing GRATs. The annuity payments are continuously redirected to new GRATs, and potentially out of the grantor's taxable estate, significantly increasing the benefit of the GRAT technique.

(i) **Reduced Mortality Risk.** Because these GRATs have very short terms, the probability of the grantor's death during a particular GRAT term is greatly reduced, and the mortality risk associated with GRATs is consequently reduced.

(ii) **Less Investment Risk.** The Re-GRAT technique is also superior to a single GRAT in the event of a year of poor investment returns. With a single GRAT, even a single year of poor investment returns will greatly increase the future returns required in order for the GRAT to benefit the remaindermen. Once the GRAT's returns are "in the hole," it is very difficult for it to recover enough to beat the Section 7520 hurdle rate. Using the Re-GRAT technique, a year of poor investment returns will only affect the GRATs in existence at that time; successive GRATs are unaffected and get a fresh start with a new, lower baseline.

For example, assume the annual rates of return realized by Gary's 10-year GRAT (described above) are 3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%, which yield an average return of 6.2%. However, because in some years the rate of return was less than the 5.4% hurdle rate (including losses in 2 years), the GRAT would leave nothing for the remaindermen at the end of the term-- in fact it would run out of money after 9 years.

Year	Start of Year	Growth	Annuity	End of Year
1	$ 10,000,000	$ 300,000	$(1,320,324)	$ 8,979,676
2	$ 8,979,676	$ (628,577)	$(1,320,324)	$ 7,030,775
3	$ 7,030,775	$ 562,462	$(1,320,324)	$ 6,272,913
4	$ 6,272,913	$ 376,375	$(1,320,324)	$ 5,328,965
5	$ 5,328,965	$ 532,896	$(1,320,324)	$ 4,541,537
6	$ 4,541,537	$ (90,831)	$(1,320,324)	$ 3,130,383
7	$ 3,130,383	$ 469,557	$(1,320,324)	$ 2,279,616
8	$ 2,279,616	$ 273,554	$(1,320,324)	$ 1,232,847
9	$ 1,232,847	$ 110,956	$(1,320,324)	$ 23,479
10	$ 23,479	$ 1,878	$(1,320,324)	$ (1,294,966)

Instead now assume the $10 million was contributed to a 2-year GRAT (GRAT 1), at the end of year 1 the $5,408,621 annuity was contributed to a second 2-year GRAT (GRAT 2), at the end of year 2 the second annuity of GRAT 1 and the first annuity of GRAT 2 were contributed to a third GRAT, and so on for 10 years. Using the same annual rates of return as above (3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%), the remaindermen would receive a total of $2,803,800 from the GRATs. (The bottom line in the charts below show the amounts remaining at the end of each GRAT.)

	1st GRAT	2nd GRAT	3rd GRAT
Funding	$ 10,000,000	$ 5,408,621	$ 7,474,301
Growth - 1st year	$ 300,000	$ (378,603)	$ 597,944
1st Annuity	$ 5,408,621	$ 2,925,318	$ 4,042,566
Amount after 1 year	$ 4,891,379	$ 2,104,699	$ 4,029,678
Growth - 2nd year	$ (342,397)	$ 168,376	$ 241,781
2nd Annuity	$ 4,548,982	$ 2,273,075	$ 4,042,566
Amount after 2 years/benefit of GRATs	$ -	$ -	**$ 228,893**

4th GRAT	5th GRAT	6th GRAT
$ 6,315,642	$ 7,458,458	$ 7,449,889
$ 378,938	$ 745,846	$ (148,998)
$ 3,415,891	$ 4,033,997	$ 4,029,363
$ 3,278,689	$ 4,170,306	$ 3,271,528
$ 327,869	$ (83,406)	$ 490,729
$ 3,415,891	$ 4,033,997	$ 3,762,257
$ 190,666	$ 52,903	$ -

7th GRAT	8th GRAT	9th GRAT
$ 8,063,360	$ 8,123,423	$ 8,754,818
$ 1,209,504	$ 974,811	$ 787,934
$ 4,361,166	$ 4,393,652	$ 4,735,150
$ 4,911,698	$ 4,704,582	$ 4,807,602
$ 589,404	$ 423,412	$ 384,608
$ 4,361,166	$ 4,393,652	$ 4,735,150
$ 1,139,936	$ 734,342	$ 457,061
	Total	**$2,803,800**

Assuming the trust receiving the GRAT remainders achieves the same returns on its investments, the remainder would have a total of $3,329,733 at the end of 10 years, including the growth.

Year	SOY	Growth	Remainder received	EOY
1	$ -	$ -	$ -	$ -
2	$ -	$ -	$ -	$ -
3	$ -	$ -	$ -	$ -
4	$ -	$ -	$ 228,893	$ 228,893
5	$ 228,893	$ 22,889	$ 190,666	$ 442,448
6	$ 442,448	$ (8,849)	$ 52,903	$ 486,502
7	$ 486,502	$ 72,975	$ -	$ 559,477
8	$ 559,477	$ 67,137	$ 1,139,936	$ 1,766,550
9	$ 1,766,550	$ 158,990	$ 734,342	$ 2,659,882
10	$ 2,659,882	$ 212,791	$ 457,061	$ 3,329,733

By using Re-GRATs instead of a single 10-year GRAT, the amount transferred to the remaindermen is increased from $0 to $3.3 million!

(iii) **Interest Rate Risk.** The Section 7520 rate is likely to change over time. Any increase in this interest rate will increase the "hurdle" rate of return the GRATs must achieve to be successful.

However, this risk is offset by the investment benefits of re-GRATs described above. In the example above, even if we assume the 7520 rate increases by .2% every year, the total of the rolling GRAT remainders would be $2,122,905, and the remaindermen would have $2,524,668 at the end of 10 years, including growth (compared to zero from a fixed term GRAT). With .4% annual increases in the 7520 rate, these figures are $1,455,002 and $1,756,911, respectively.

4. **Increasing Rolling GRATs**

Regulation Section 25.2702-3(b)(1)(ii) permits the GRAT annuity to increase annually by up to 20% over the preceding year's annuity (an "increasing GRAT"). Using an increasing GRAT will increase the amount of the remainder when the assets are consistently appreciating, because more of the assets remain in the GRAT for a longer period of time to beat the 7520 rate.

For example, assume a $10 million 2-year GRAT has a fixed annuity of $5,408,621 per year (5.4% 7520 rate). If the GRAT achieves a rate of return of 10% each year, $741,895 will pass to the remaindermen after two years. Alternatively, the GRAT could have an annuity that starts out lower and increases by 20% in the second year. In this case, the annuity would be $4,928,536 in the first year and $5,924,143 in the second year. If the GRAT achieves a rate of return of 10% each year, $764,367 will pass to the remaindermen after two years-- $22,472 more than the level-payment GRAT. (The results are more pronounced over several years.)

However, an increasing GRAT does not always pay off. If the GRAT has poor investment performance, it would be better to receive a larger annuity sooner so that the assets can be recontributed to a new GRAT with a fresh new baseline. For example, if the GRAT's investments achieve a rate of return of .2% in the first year, that GRAT is unlikely to make up the difference in the second year in order to leave a benefit to the remaindermen. Thus, a higher annuity in the first year would be preferable to a lower one that will increase in the second year because the grantor would have more assets to recontribute to a new GRAT that is not "in the hole."

Using our roller-coaster returns from above (3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%), a series of 10 2-year rolling GRATs with increasing annuity payments would leave a total of $2,772,129 for the remaindermen, while using level-payment GRATs would leave them $2,803,800.

Because one cannot reliably predict rates of return, using an increasing annuity cannot be relied upon to increase the benefits of GRATs.

5. **Decreasing Rolling GRATs**

As explained above, one of the advantages of a two-year GRAT is that if a GRAT has a year of poor investment returns, the net benefit will be greatly reduced, if not eliminated. One would prefer to get the assets back out of the GRAT so that they can be put into a new GRAT as soon as possible with a new baseline. For example, if a GRAT is funded with $1 million and the next day the assets decline in value to $700,000, and eventually recover to $1 million again, the GRAT would not be successful because there was zero net growth-- nothing would pass to the remaindermen. Instead, we would prefer to get the assets out of the GRAT and put them into a new GRAT with the new starting value of $700,000. That way, if the assets recover to $1 million in value, the GRAT would have $300,000, or 42% growth, resulting in a tidy amount passing to the remaindermen.

In the case of declining returns, a two-year GRAT will cause more than half of the original value to be distributed to the grantor after one year, and the rest after two years. Each annuity payment could be "re-GRAT-ed" into another GRAT as it is received. However, we would prefer to get as much out of the GRAT as early as possible so that if values are down the assets can get into a GRAT with a new baseline quickly. It is unclear whether a one-year GRAT would be permissible.

Regulation Section 25.2702-3(d)(4) provides, "The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods." The reference to a term of "years" suggests that a GRAT must have a term longer than one year. In Kerr v. Commissioner,[4] the taxpayer created a GRAT with a term of 1 year and 2 days. The

[4] 113 T.C. 450 (1999), aff'd 292 F3d 490 (5th Cir. 2002).

validity of the GRAT was not at issue in the case, suggesting that there was no issue. However, most practitioners create GRATs with a minimum term of two years.

Instead, by using a decreasing GRAT, we can come close to replicating a one-year GRAT, if such a GRAT is not otherwise permitted. Specifically, the GRAT could provide for a payment equal to 90% of the initial trust value at the end of the first year, and a second payment calculated so that the present value of the two payments equals the value of the property contributed. For example, if the 7520 rate is 5.4 percent and $10 million is contributed to the GRAT, the first annuity payment is $9 million (90% of initial value) and the second annuity payment would be $1,623,160. The present value of the two payments, using the 7520 rate as the discount rate, is $10 million. If the assets decline in value to $9 million during the first year, all the assets will be paid out on the first anniversary and can be put into a new GRAT with a $9 million baseline. If this were a normal two year GRAT, only $5,408,621 would be paid out on the first anniversary, leaving the rest sitting in the GRAT until the second anniversary when it can be put into another GRAT.

For example, assume the annual rates of return realized by Gary's 10-year GRAT (described above) are 3%, -7%, 8%, 6%, 10%, -2%, 15%, 12%, 9% and 8%, which yield an average return of 6.2%. As shown above, with regular two-year re-GRATs, the remaindermen would receive a total of $2,803,800 from the GRATs, and assuming the trust receiving the GRAT remainders achieves the same returns on its investments, the remainder would have a total of $3,329,733 at the end of 10 years, including the growth.

However, if those GRATs were decreasing GRATs, the remaindermen would receive a total of $3,167,094 from the GRATs.

	1st GRAT	2nd GRAT	3rd GRAT
Funding	$ 10,000,000	$ 9,000,000	$ 9,309,000
Growth - 1st year	$ 300,000	$ (630,000)	$ 744,720
1st Annuity	$ 9,000,000	$ 8,100,000	$ 8,378,100
Amount after 1 year	$ 1,300,000	$ 270,000	$ 1,675,620
Growth - 2nd year	$ (91,000)	$ 21,600	$ 100,537
2nd Annuity	$ 1,209,000	$ 291,600	$ 1,511,000
Amount after 2 years/benefit of GRATs	$ -	$ -	$ 265,158

4th GRAT	5th GRAT	6th GRAT	7th GRAT	8th GRAT	9th GRAT
$ 8,669,700	$ 9,313,730	$ 9,789,588	$ 10,322,396	$ 10,190,799	$ 10,847,209
$ 520,182	$ 931,373	$ (195,792)	$ 1,548,359	$ 1,222,896	$ 976,249
$ 7,802,730	$ 8,382,357	$ 8,810,629	$ 9,290,157	$ 9,171,719	$ 9,762,488
$ 1,387,152	$ 1,862,746	$ 783,167	$ 2,580,599	$ 2,241,976	$ 2,060,970
$ 138,715	$ (37,255)	$ 117,475	$ 309,672	$ 201,778	$ 164,878
$ 1,407,231	$ 1,511,767	$ 900,642	$ 1,675,490	$ 1,654,130	$ 1,760,676
$ 118,636	$ 313,724	$ -	$ 1,214,781	$ 789,624	$ 465,172

Assuming the trust receiving the GRAT remainders achieves the same returns on its investments, the remainder would have a total of $3,833,366 at the end of 10 years, including the growth-- about $500,000 (or 15%) more than regular re-GRATs.

Year	SOY	Growth	Remainder received	EOY
1	$ -	$ -	$ -	$ -
2	$ -	$ -	$ -	$ -
3	$ -	$ -	$ -	$ -
4	$ -	$ -	$ 265,158	$ 265,158
5	$ 265,158	$ 26,516	$ 118,636	$ 410,309
6	$ 410,309	$ (8,206)	$ 313,724	$ 715,827
7	$ 715,827	$ 107,374	$ -	$ 823,201
8	$ 823,201	$ 98,784	$ 1,214,781	$ 2,136,766
9	$ 2,136,766	$ 192,309	$ 789,624	$ 3,118,699
10	$ 3,118,699	$ 249,496	$ 465,172	**$ 3,833,366**

The benefits are more pronounced when returns are more volatile. If the rate of return the first year is 7% and the following year is 0%, with the rest of the years repeating that pattern (7%, 0%), a single 10-year GRAT or a series of regular re-GRATs would produce ZERO benefit after 10 years. Each GRAT would start out strong but the second year's returns would not be sufficient to leave a remainder. If decreasing re-GRATs are used, the remaindermen would have $462,846 after 10 years. The decreasing re-GRAT "captures" most of the gain achieved in the first year by distributing most of the appreciated assets to the grantor.

Are decreasing annuity payments permitted?

Regulation Section 25.2702-3(b)(1)(ii) says that the annuity payments must be a stated dollar amount payable at least annually, "but only to the extent the amount does not exceed 120 percent of the stated dollar amount payable in the preceding year." Alternatively, the annuity payments can be expressed as a fixed fraction or percentage of the initial fair market value of the trust, "but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year."

Clearly, the annuity amount can change from year to year, or there would be no need for the regulations to impose a 20% annual cap on increases. Moreover, the regulations do not prohibit or limit the amount by which annuity payments may *decrease*. The regulations do not specifically permit decreasing payments either, but they certainly could have if that was intended.

6. Cap or Floor

A GRAT can be structured so that the entire remainder does *not* pass to the remaindermen. Instead, the GRAT could have a "hurdle," so that the first $X is paid to the grantor. The grantor knows the total of the annuity payments he will receive upon creation of the GRAT, and it may not be enough for his own financial goals. Rather than contributing less of the stock or other asset to the GRAT, building in a hurdle can customize the wealth retained and wealth transferred.

Alternatively (or in addition), the GRAT could impose a cap on the amount passing to the remaindermen, with the excess paid to the grantor. A cap can limit the wealth transfer to fit within the grantor's objectives.

A hurdle will not reduce the taxable gift upon creation of a GRAT. The definition of a "qualified interest" under Section 2702(b)(3) includes a "noncontingent remainder interest" but only if all the other interests in the trust consist of the annuity interest. A right to a fixed payment (hurdle) is not a remainder interest.[5] In theory, a cap could reduce the value of the gift since the balance passing to the grantor is a qualified remainder interest; however, if the GRAT is already "zeroed out," then there is no gift to reduce. Further, if the cap is at a level that is not expected to be reached (assuming growth at the 7520 rate), then it will have no value.

D. Disclaimer GRATs

By using a qualified disclaimer under Code Section 2518,[6] one can decide whether to fund a GRAT in hindsight. Section 2518 generally provides that if a person makes a

[5] Reg. 25.2702-3(f)(2).

[6] **Sec. 2518.** (a) GENERAL RULE.—For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

(b) QUALIFIED DISCLAIMER DEFINED.—For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if—

(1) such refusal is in writing,

(2) such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—

(A) the date on which the transfer creating the interest in such person is made, or

(B) the day on which such person attains age 21,

(3) such person has not accepted the interest or any of its benefits, and

(4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—

(A) to the spouse of the decedent, or

(B) to a person other than the person making the disclaimer.

(c) OTHER RULES.—For purposes of subsection (a)—

(1) DISCLAIMER OF UNDIVIDED PORTION OF INTEREST.—A disclaimer with respect to an undivided portion of an interest which meets the requirements of the preceding sentence shall be treated as a qualified disclaimer of such portion of the interest.

(Continued…)

qualified disclaimer, the property is treated as never having been transferred to such person for gift/estate tax purposes. Instead, the property passes pursuant to the instrument of transfer. For example, if A leaves property to B in A's will, but if B is not living it passes to B's children, if B makes a qualified disclaimer, the property will pass to B's children, and B will be treated as never having received the property (*i.e.*, no gift by B).

In the context of a GRAT, one could transfer one or more assets to a lifetime "GPA" marital trust for his or her spouse. The trust would provide that if the spouse makes a qualified disclaimer of any of the property, that property will pass to a GRAT (that has been drafted and executed but not funded). Assume the donor contributes three stocks to the marital trust and 8 months later two have appreciated and one has declined in value. The spouse could make a qualified disclaimer of the appreciated stock, causing them to be transferred to the GRAT. For gift tax purposes, the marital trust is treated as never having received the stocks, and the GRAT is treated as having received them on day one. This can provide quite an advantage with a GRAT.

E. 99-Year GRATs

As stated above, if the grantor of a GRAT does not survive the GRAT term, Section 2036 would include in the grantor's estate the amount of property necessary to produce a sufficient amount of income (using the *prevailing* Section 7520 rate) to fund the remaining annuity payments from such income.[7] Thus, the amount included under IRC Section 2036 is equal to the annuity divided by the Section 7520 rate at the grantor's death.

Thus, the smaller the annuity payments, the less included in the grantor's estate. Annuity payments can be made smaller by making the GRAT term longer, but that increases the odds of the grantor predeceasing the term. However, one can minimize the *amount* included in the estate by having a very long GRAT term.

A $10,000,000, 10-year, zeroed-out GRAT created when the 7520 rate is 2% would have an annuity of $1,113,263 per year. If the grantor dies in year 9 and the 7520 rate is 5%, the amount included in the estate is $1,113,263/.05, or $22,265,268. So, unless the

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(2) POWERS.—A power with respect to property shall be treated as an interest in such property.

(3) CERTAIN TRANSFERS TREATED AS DISCLAIMERS.—A written transfer of the transferor's entire interest in the property—

(A) which meets the requirements similar to the requirements of paragraphs (2) and (3) of subsection (b), and

(B) which is to a person or persons who would have received the property had the transferor made a qualified disclaimer (within the meaning of subsection (b)), shall be treated as a qualified disclaimer.

[7] See Rev. Ruls. 82-105, 1982-1 C.B. 133, 76-273, 1976-2 C.B. 268, TAM 200210009 (Nov. 19, 2001).

GRAT has appreciated to more than $22 million after paying annuity payments totaling $8.9 million over 8 years, it will all be included in the estate.

If the same GRAT had a 99 year term, the annuity would be only $232,773 per year, and if the grantor died in year 9 when then 7520 rate was 5%, the amount included in the estate is $232,773/.05, or $4,655,460. Thus, anything over roughly $4.6 million of value in the GRAT will not be subject to estate tax. Moreover, because the annuity payments are much smaller, only $1.8 million of annuity payments will have been paid, increasing the odds of a substantial amount remaining in the GRAT. If the GRAT achieved a 5% rate of return over the 8 years, it will have $12.55 million, so about $8 million escapes estate tax ($12.55 million - $4.6 million). If the grantor dies in year 20, the GRAT will have more than $18 million, so more than $13.4 million escapes estate taxation.

More assets will escape estate taxation:

1. The more the 7520 interest rate has increased since inception, and

2. The more the GRAT assets have appreciated (which often is tied to how long the grantor lives).

For example, if the grantor lives 20 years, the 7520 rate is 7% at his death, and the GRAT assets appreciated 6% per year, the GRAT will have about $22 million, $3.3 million of which is included in the estate and $18.7 million escapes taxation.

The low annuity payment also has a practical and tax benefit of requiring less cash flow, and leaving more assets in the GRAT to appreciate.

But, the GRAT lasts for 99 years! The annuity payments will continue to be slowly paid to the estate, and the bulk of the assets (remainder) will not be paid until after the 99 year term. So, the GRAT will benefit grandchildren-- or perhaps great-grandchildren. And since a GRAT cannot be GST exempt, GST tax will be triggered when the last child who is a potential remainder beneficiary dies.

If we instead use a 50 year term, the GRAT could benefit grandchildren. The annuity would be $318,232 per year, and if the grantor died in year 9 when then 7520 rate was 5%, the amount included in the estate $6,364,643.

F. Conclusions

Both the *amount* and *probability* of passing wealth to the next generation can be increased by using rolling GRATs, and these are increased even more when decreasing rolling GRATs are utilized. Disclaimer GRATs increase the odds even more.

99-year GRATs are an interesting alternative, but it is a long time to wait for the payoff, and GST tax will be triggered when it passes to grandchildren.

RPM TRUSTS

A "remainder purchase marital trust," or "RPM Trust," involves a transfer to a trust for the grantor's spouse's benefit that is designed to qualify for the gift tax marital deduction and that will not be subject to estate tax at the spouse's death. As a result, the trust property passes to the grantor's children completely free of gift and estate taxes.[8]

A. Terminable Interest Rule

Section 2523(a) generally provides that a transfer by gift of an interest in property to the donor's spouse qualifies for the gift tax marital deduction. However, Section 2523(b) provides that no marital deduction is allowed if, upon the occurrence of an event or on the lapse of time, the spouse's interest in the transferred property will end and, as a result, the property passes to another person "*for less than an adequate and full consideration in money or money's worth"* (emphasis added). This rule is often referred to as the "terminable interest rule."

There are two exceptions to the terminable interest rule, pursuant to which terminable interests will qualify for the gift tax marital deduction. These exceptions are contained in Sections 2523(e) (a life estate with a general power of appointment trust, or "GPA marital trust") and 2523(f) (a qualified terminable interest property, or QTIP, trust). If either of these exceptions is used, the trust property will qualify for the gift tax marital deduction, but will be subject to estate tax at the death of the spouse, under either Section 2041 (by reason of the general power of appointment, or "GPA") or Section 2044 (by reason of the QTIP election).

B. RPM Trusts: Why They Work

The basic construct of an RPM Trust is as follows: One spouse (H) transfers assets to a trust in which the other spouse (W) has an interest (*e.g.*, an annuity or income interest) for a specified term or life, after which the trust assets pass to a trust for the children. At the time the RPM Trust is funded, the children's trust pays for its remainder interest. The spouse's interest qualifies for the gift tax marital deduction (as explained below) and the interest of the children's trust is not a gift because it is paid for.

In the RPM Trust, the spouse will not have a GPA and no QTIP election will be made, so the trust property should not be included in the spouse's estate at her death. Nonetheless, the interest in the trust transferred to the grantor's spouse should qualify for the gift tax marital deduction even though a person (*e.g.*, the grantor's children) will receive the trust

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8 For other articles on RPM Trusts, see David A. Handler & Deborah V. Dunn, "RPM Trusts: Turning the Tables on Chapter 14," Trusts & Est., July 2000, at 31; David A. Handler & Deborah V. Dunn, "RPM Annuity Trusts: A 'Great' Alternative," Special Supplement to Lawyers Weekly USA, Jan. 24, 2004, at 1; David A. Handler & Deborah V. Dunn, "GRATs and RPM Annuity Trusts: A Comparison," Tax Management Estate, Gifts and Trust Journal Vol. 29, No. 4, July 8, 2004.

property (*i.e.*, the remainder interest) after the termination of the spouse's interest. The basis for this result is as follows:

- The denial of a marital deduction for a transfer to a spouse of interests in property that lapses, causing the property to pass to another party on the termination of the spouse's interest, only applies if the other party receives his interest for less than "*an adequate and full consideration in money or money's worth."* Section 2523(b) (emphasis added).

- With an RPM Trust, the remaindermen ***pay*** the grantor adequate and full consideration for their interest; thus, by its terms, Section 2523(b) does not apply, and the gift of the income interest to the spouse should qualify for the gift tax marital deduction.[9]

The remaindermen will have transferred to the grantor property having a value equal to the present value of what they will eventually receive from the RPM Trust. This property, as reinvested, will be subject to estate tax at his death. Thus, in theory, no circumvention of the estate tax will have occurred.

In order to eliminate valuation issues in determining the value of the remainder interest (and thus the purchase price to be paid by the remaindermen), we recommend that the grantor's spouse receive either an income interest or an annuity interest in the trust; that is, an interest that requires that the spouse receive a fixed annuity or that all income be distributed to her. This structure makes the valuation of the spouse's interest a simple annuity or life estate calculation. The value of the remainder interest will equal the value of the property the grantor transfers less the value of the spouse's annuity interest or income interest, determined in accordance with Section 7520 and the tables and interest rates promulgated thereunder.

By contrast, if ascertainable standards or discretionary standards are used, then even the best appraiser cannot guarantee that the purchase price will withstand challenge. The valuation of support rights is at best uncertain, while the valuation of a purely discretionary interest is less certain still.

C. RPM Income Trust

In an RPM Income Trust, the spouse receives all of the income for a fixed term of years, for the spouse's (or the grantor's) life, or for the shorter of a term and life. The remainder is purchased by a trust for the children. ***All*** of the capital appreciation on the trust property will be transferred to the children free of gift and estate tax. State law may require that the trust pay at least some income to the spouse, and may give the spouse the right to recoup the minimum amount of income out of capital gains if the trust does not in

[9] As explained below regarding Code Section 2702, the grantor's spouse should not be a beneficiary of the trust that purchases the remainder.

fact earn that income. Even if the trust generates income at the rate of 1% or 2% per annum (and such amount is paid to the spouse as the income beneficiary), all growth in excess of that amount will pass to the remaindermen.

> **Example.** Howard makes a $2 million gift of cash and marketable securities to a Dynasty Trust, using his and his wife Hanna's combined $2 million gift tax exemptions. Howard then transfers $4,493,069 to an RPM Income Trust for Hanna's benefit, from which she will receive all of the income for 18 years, or until Hanna's death if sooner, and sells the remainder interest in the RPM Income Trust (the right to receive the remaining trust property after the 18-year term) to the Dynasty Trust for $2 million.

1. Assuming Section 7520 rate of 5.8% and Hanna is 60, the value of the remainder under the Section 7520 valuation tables is the $2 million the Dynasty Trust paid. This is the equivalent of a 55.5% "discount" ($2 million is 55.5% of $4.49 million).

2. Because the Dynasty Trust purchases the remainder interest in the RPM Income Trust, Hanna's income interest qualifies for the gift tax marital deduction. Thus, no gift tax is due as a result of the $4.49 million transfer to the RPM Income Trust.

3. If during the 18 year term of the RPM Income Trust, the trust property generates income of 2% per year and capital appreciation of 8% per year (10% total), at the end of 18 years the trust assets would have a value of $17.95 million, all of which would pass free of gift and estate taxes to the Dynasty Trust.

Year	Start of Year	Growth	Income Paid	End of Year
1	$ 4,493,069	$ 449,307	$ (89,861)	$ 4,852,515
2	$ 4,852,515	$ 485,251	$ (97,050)	$ 5,240,716
3	$ 5,240,716	$ 524,072	$ (104,814)	$ 5,659,973
4	$ 5,659,973	$ 565,997	$ (113,199)	$ 6,112,771
5	$ 6,112,771	$ 611,277	$ (122,255)	$ 6,601,792
6	$ 6,601,792	$ 660,179	$ (132,036)	$ 7,129,936
7	$ 7,129,936	$ 712,994	$ (142,599)	$ 7,700,331
8	$ 7,700,331	$ 770,033	$ (154,007)	$ 8,316,357
9	$ 8,316,357	$ 831,636	$ (166,327)	$ 8,981,666
10	$ 8,981,666	$ 898,167	$ (179,633)	$ 9,700,199
11	$ 9,700,199	$ 970,020	$ (194,004)	$10,476,215
12	$10,476,215	$1,047,621	$ (209,524)	$11,314,312
13	$11,314,312	$1,131,431	$ (226,286)	$12,219,457
14	$12,219,457	$1,221,946	$ (244,389)	$13,197,014
15	$13,197,014	$1,319,701	$ (263,940)	$14,252,775
16	$14,252,775	$1,425,277	$ (285,055)	$15,392,997
17	$15,392,997	$1,539,300	$ (307,860)	$16,624,436
18	$16,624,436	$1,662,444	$ (332,489)	$17,954,391

If Hanna died during the 18 year term, the income interest would terminate and the remaining assets would pass to the Dynasty Trust even sooner, increasing the benefits. For example, if Hanna died after 10 years, the $9.7 million in the RPM Trust would pass to the Dynasty Trust at that time. Assuming 10% growth thereafter (with no income paid to Hanna), the trust would grow to **$20.8 million** by the end of the 18th year.

In the alternative, Howard could have sold "discounted" assets to the Dynasty Trust for $2 million. Assume he sells interests in a limited partnership to the trust subject to a 33% discount: the trust purchases LP units with a $3 million liquidation value for $2 million. If those interests grow in value by 10% per year for 18 years, they would be worth $16.67 million-- **$1.28 million less** than the RPM Income Trust. Moreover, Howard had to obtain an appraisal of his LP units.

When a *fixed term* is used, the difference is more pronounced: The RPM Trust could be funded with $5,517,881 (a 63.75% discount), and would transfer **$22 million** to the Dynasty Trust after 18 years-- $5.3 million more than the LP sale.

Advantages Over Other Techniques

The RPM Income Trust transfers wealth more efficiently than a grantor retained annuity trust ("GRAT") and sale to a grantor trust, which transfer to the remaindermen only the growth in excess of the Section 7520 rate (on the GRAT) or the interest rate (on the note). Those rates could be several times higher than the 1% or 2% minimum income rate that may apply to an RPM Income Trust. Moreover, for those techniques to result in *any* property passing to descendants, the transferred property must appreciate or grow faster than the applicable rate, whereas the RPM Income Trust does not require that the transferred property achieve any particular rate of return (provided that the trust comply with any applicable state law requirements regarding the satisfaction of a mandatory income interest).

The RPM Income Trust can also achieve greater "discounts" than an FLP. In the example above, the Dynasty Trust paid $2 million for the right to receive the $4.49 million transferred to the trust, plus appreciation, less the income. Ignoring the income, the Dynasty Trust essentially purchased the $4.49 million for a **55% discount**. This is a greater discount than could be obtained with an FLP, and without an appraisal.

Use of Section 7520 Tables to Value the Income Interest

Code Section 7520 contains tables that are to be used to value income interests unless the value ascribed to the interest by the tables is "unrealistic and unreasonable" and there is a more reasonable and realistic means by which to determine its fair market value, and the

burden of showing that the result is unreasonable rests with the party seeking to deviate from the tables.[10]

Sections 20.7520-3(b)(2)(ii) and 25.7520-3(b)(2)(ii) of the Treasury Regulations (Treas. Reg.) provide that the income factors promulgated pursuant to Section 7520:

> may not be used to determine the present value of an income or similar interest in trust for a term of years, or for the life of one or more individuals, unless the effect of the trust . . . is to provide the income beneficiary with the that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation.

Certainly a trust with a mandatory income interest in favor of the grantor's spouse should satisfy the foregoing requirements. Examples 1 and 2 in Treas. Reg. Sections 20.7520-3(b)(2)(ii) and 25.7520-3(b)(2)(ii) make clear that the spouse should be given the power to direct the trustee to "make the trust corpus productive consistent with income yield standards for trusts under applicable state law," and specifically contemplate that the minimum rate of income that a productive trust may produce "may be substantially below the Section 7520 interest rate on the valuation date." Moreover, Example 2 of these regulations shows that, so long as the beneficiary has the power to make the trust property productive of income, the fact that it actually does not produce income will not preclude use of the Section 7520 income factors. (In this example, the trust owned non-dividend paying stock, and the beneficiary had the power to require the trustee to make the trust property productive of income).

However, in *O'Reilly v. Comm'r.*,[11] the Eighth Circuit held that the Section 7520 tables could not be used to value an income interest in a trust that owns stock that pays dividends at a significantly lower rate than the tables assume. The tables assumed the income was paid at a 4% or 5% rate, while the stock paid a very small dividend (about a

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[10] See Vernon v. Commissioner, 66 T.C. 484, 489 (1976), Weller v. Commissioner, 38 T.C. 790, 803 (1962); Estate of Gribauskas v. Commissioner, 116 T.C. 142 (2001); Bank of Cal. v. United States, 672 F.2d 758, 759 (9th Cir. 1982); Estate of Shackleford v. United States, 262 F.3d 1028 (9th Cir. 2001); Estate of Gladys J. Cook v. Commissioner, 349 F3d 850 (5th Cir., 2003).

[11] 973 F.2d 1403 (8th Circuit 1992).

1% yield). Under this case, it would be impossible to create an RPM Income Trust with anything except bonds, because any portfolio with stocks in it will not generate income equal to the Section 7520 rate.

However, although the *O'Reilly* case was decided in 1992, the trusts at issue (known as "grantor retained income trusts") were created in 1985 and 1986, which was *before* Section 7520 was enacted and the applicable federal rate (AFR) began to "float." In contrast, the valuation tables issued under Section 7520 are based on the AFR (which changes monthly) and are used to value transfers made on or after May 1, 1989. The regulations under Section 7520 provide that taxpayers and the Service *must* use these tables to value partial interest in property except in limited circumstances, one of which is where the income interest does not provide beneficial enjoyment consistent with the nature of the interest under state law.

Moreover, the trust instruments in *O'Reilly* relieved the trustee of its fiduciary duty to diversify trust assets into property that produces a reasonable rate of return, and the trustee was expressly authorized to retain the minimally productive, closely-held stock. That would not be the case in the RPM Income Trust.

Thus, as long as the RPM Income Trust permits the spouse-beneficiary to exercise his rights to enforce the trustee's fiduciary obligations and to direct the trustee to convert unproductive property into income-producing property, use of the Section 7520 valuation tables should be allowed. Accordingly, so long as purchase price paid by the remaindermen for the corresponding remainder interest is based on such tables, the remaindermen should be treated as having paid full and adequate consideration for the remainder interest.

D. RPM Annuity Trust

In an RPM Annuity Trust, the spouse receives an annuity for a fixed term of years, for the spouse's (or the grantor's) life, or for the shorter of a term and life, and the remainder is purchased by a trust for the children. The annuity could be structured so that the remainder value is minimized, thereby significantly reducing the purchase price to be paid by the remaindermen. In this case, the growth of the trust property in excess of the Section 7520 rate will pass to the remaindermen.

> **Example.** Howard transfers $10 million of cash and marketable securities to an RPM Annuity Trust for Hanna's benefit, from which she (or her estate) will receive an annuity of $1,015,213 for a term of 15 years. Howard simultaneously sells the remainder interest in the RPM Annuity Trust (the right to receive the remaining trust property after the 15-year term) to a Dynasty Trust.

1. Assuming a Section 7520 rate of 5.8%, the value of the annuity interest is $9,990,000 and the value of the remainder interest is $10,000 under the Section 7520 valuation tables. Thus, the Dynasty Trust pays Howard $10,000 for the remainder.

2. Because the Dynasty Trust *purchases* the remainder interest in the RPM Annuity Trust, Hanna's annuity interest qualifies for the gift tax marital deduction. Thus, no gift tax is due as a result of the $10 million transfer to the RPM Annuity Trust.

3. If during the 15-year term of the RPM Annuity Trust the trust property realizes an annualized rate of return of 10%, at the end of 15 years the trust assets would have a value of $9.5 million, all of which would pass free of gift and estate taxes to the Dynasty Trust.

Year	Start of Year	Growth	Annuity	End of Year
1	$ 10,000,000	$ 1,000,000	$ (1,015,203)	$ 9,984,797
2	$ 9,984,797	$ 998,480	$ (1,015,203)	$ 9,968,074
3	$ 9,968,074	$ 996,807	$ (1,015,203)	$ 9,949,679
4	$ 9,949,679	$ 994,968	$ (1,015,203)	$ 9,929,445
5	$ 9,929,445	$ 992,944	$ (1,015,203)	$ 9,907,186
6	$ 9,907,186	$ 990,719	$ (1,015,203)	$ 9,882,702
7	$ 9,882,702	$ 988,270	$ (1,015,203)	$ 9,855,770
8	$ 9,855,770	$ 985,577	$ (1,015,203)	$ 9,826,144
9	$ 9,826,144	$ 982,614	$ (1,015,203)	$ 9,793,556
10	$ 9,793,556	$ 979,356	$ (1,015,203)	$ 9,757,709
11	$ 9,757,709	$ 975,771	$ (1,015,203)	$ 9,718,277
12	$ 9,718,277	$ 971,828	$ (1,015,203)	$ 9,674,903
13	$ 9,674,903	$ 967,490	$ (1,015,203)	$ 9,627,190
14	$ 9,627,190	$ 962,719	$ (1,015,203)	$ 9,574,707
15	$ 9,574,707	$ 957,471	$ (1,015,203)	$ 9,516,975

If the RPM Annuity Trust were structured to pay the annuity for the *shorter of* 15 years or Hanna's life and Hanna is 60, the remainder interest would cost $1.05 million, rather than $10,000. However, if Hanna dies in the 10th year, the RPM Annuity Trust provides the Dynasty Trust with a "windfall" in that the property then held by the Trust will pass to the Dynasty Trust several years earlier than anticipated without making any more annuity payments. The RPM Annuity Trust would have $9.97 million after 10 years, which would grow to **$15.65 million** after 5 additional years (for a total time frame of 15 years).

Backloading the Annuity

In contrast to a GRAT in which the annuity cannot increase annually by more than 20% in order to be a "qualified annuity interest" and thus not subject to Section 2702's special valuation rules, no such restriction exists for an RPM Annuity Trust (as will be explained below). There is, thus, greater flexibility in structuring the annuity interest. By structuring the annuity as a series of small fixed payments, with a large "back-loaded"

payment as the final annuity payment (a "back-loaded" RPM Annuity Trust), substantially more wealth can be transferred.[12]

After the series of small payments, the final annuity payment must be large enough to "zero out" (or nearly zero out) the value of the remainder interest. That is, the annuity is structured so that the present value of all annuity payments, using the Section 7520 rate as the discount rate, will equal the value of the property transferred to a RPM Annuity Trust less the desired remainder (e.g., $10,000).

> **Example of Back Loaded RPM Annuity Trust**. Howard transfers $10 million of cash and marketable securities to an RPM Annuity Trust for Hanna's benefit, from which she (or her estate) will receive an annuity of $10,000 per year for 14 years, and a payment of $23.05 million in year 15. Howard simultaneously sells the remainder interest in the RPM Annuity Trust (the right to receive the remaining trust property after the 15-year term) to a Dynasty Trust. Based on a Section 7520 rate of 5.8%, the cumulative value of the fourteen $10,000 annuity payments and the $23 million fifteenth payment is $9,990,000. Thus, the remainder value is $10,000, which the Dynasty Trust pays Howard for the remainder. If the RPM Trust's rate of return on its assets is 10%, **$18.4 million** will pass to the Dynasty Trust at the end of the 15 year term, which is nearly **$9 million more** than with the fixed-payment RPM Annuity Trust above.

Year	Start of Year	Growth	Annuity	End of Year
1	$ 10,000,000	$ 1,000,000	$ (10,000)	$ 10,990,000
2	$ 10,990,000	$ 1,099,000	$ (10,000)	$ 12,079,000
3	$ 12,079,000	$ 1,207,900	$ (10,000)	$ 13,276,900
4	$ 13,276,900	$ 1,327,690	$ (10,000)	$ 14,594,590
5	$ 14,594,590	$ 1,459,459	$ (10,000)	$ 16,044,049
6	$ 16,044,049	$ 1,604,405	$ (10,000)	$ 17,638,454
7	$ 17,638,454	$ 1,763,845	$ (10,000)	$ 19,392,299
8	$ 19,392,299	$ 1,939,230	$ (10,000)	$ 21,321,529
9	$ 21,321,529	$ 2,132,153	$ (10,000)	$ 23,443,682
10	$ 23,443,682	$ 2,344,368	$ (10,000)	$ 25,778,050
11	$ 25,778,050	$ 2,577,805	$ (10,000)	$ 28,345,855
12	$ 28,345,855	$ 2,834,586	$ (10,000)	$ 31,170,441
13	$ 31,170,441	$ 3,117,044	$ (10,000)	$ 34,277,485
14	$ 34,277,485	$ 3,427,749	$ (10,000)	$ 37,695,234
15	$ 37,695,234	$ 3,769,523	$ (23,053,635)	$ 18,411,122

[12] See Deborah V. Dunn and Katherine M. Cunningham, "Advantages to Back-Loading: An Analysis of Back-Loaded Annuity Payments from a CLAT or RPM Annuity Trust." Tax Management Estate, Gifts and Trust Journal, Vol. 29, No. 6, November 11, 2004.

Advantages Over Other Techniques

The RPM Annuity Trust has two advantages over a GRAT. First, there is no mortality risk. That is, if the grantor's spouse dies during the annuity term (and such term does not end on the spouse's death), only the present value of the remaining annuity payments is included in her taxable estate; the amount by which the value of the trust property exceeds the present value of the annuity is not subject to estate tax. Second, there is no taxable gift upon creation of the RPM Annuity Trust, assuming the Children's Trust has sufficient funds with which to purchase the remainder.

The advantage that the RPM Annuity Trust has over a sale to a grantor trust is that if the grantor or his spouse dies during the annuity term, no capital gain will be recognized by the trust. In contrast, if a grantor dies with a note outstanding from a sale, capital gain may be recognized. On the other hand, the sale has a lower "hurdle rate" than in the RPM Annuity Trust. That is, the trust's rate of return on its investments must exceed the Section 7520 rate in order for the RPM Annuity Trust to provide a benefit, which is 20% higher than the applicable federal rate (AFR) which must be beat in the case of the sale.

Use of Section 7520 to Value the Annuity Interest

As with income interests, Code Section 7520 contains tables that are to be used to value annuity interests unless the value ascribed to the interest by the tables is "unrealistic and unreasonable" and there is a more reasonable and realistic means by which to determine its fair market value, and the burden of showing that the result is unreasonable rests with the party seeking to deviate from the tables.[13]

These tables simply determine the present value of receiving the annuity from the trust until the end of the term, or until the spouse-beneficiary's death, if earlier. Because the amount of the annuity is fixed and is not dependent on the income or appreciation of the trust assets, the annuity's value is certain, and use of the Section 7520 tables should not be subject to challenge by the Service.

Even if the annuity payments are not the same each year (*e.g.*, increasing or back-loaded payments), Section 7520 can and should be used to value such a payment stream. Reg. Section 25.7520-1 states that, for gift tax purposes, the fair market value of annuities, interests for life or for a term of years is their present value determined under Section 7520. Reg. Section 25.7520-1(c) states, "The present value on the valuation date of an annuity, life estate, term of years, remainder, or reversion is computed by using the section 7520 interest rate component that is described in paragraph (b)(1) of this section and the mortality component that is described in paragraph (b)(2) of this section." For

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13 See Vernon v. Commissioner, 66 T.C. 484, 489 (1976), Weller v. Commissioner, 38 T.C. 790, 803 (1962); Estate of Gribauskas v. Commissioner, 116 T.C. 142 (2001); Bank of Cal. v. United States, 672 F.2d 758, 759 (9th Cir. 1982); Estate of Shackleford v. United States, 262 F.3d 1028 (9th Cir. 2001); Estate of Gladys J. Cook v. Commissioner, 349 F3d 850 (5th Cir., 2003).

taxpayers' convenience, Section 7520 contains tables of "standard" actuarial factors to compute these present values. For example, a "standard" section 7520 annuity factor is the present value of the right to receive $1.00 per year for a defined period, using the interest rate prescribed under section 7520 for the appropriate month. Thus, the "standard" factors are pre-calculated present value figures that may be used for convenience to calculate the present value of an "ordinary annuity interest." The present value of a non-"ordinary" annuity interest (*i.e.*, one in which the annuity payment is not the same each year) would be determined "by hand" using the section 7520 interest rate and mortality component (if applicable), and without use of the standardized tables.

Thus, so long as the purchase price paid by the remaindermen for the remainder interest is determined by subtracting the value of the annuity interest (as determined under Section 7520) from the value of the assets transferred to the RPM Annuity Trust, the remaindermen should be deemed to have paid full and adequate consideration for the remainder interest.

Finally, under Reg. Section 25.7520-3(b)(2)(i), a standard section 7520 annuity factor may not be used if the annuity is payable from "a trust or other limited fund" and, considering the applicable Section 7520 rate on the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For example, for a fixed annuity payable annually at the end of each year, if the amount of the annuity payment (expressed as a percentage of the initial corpus) is less than or equal to the applicable Section 7520 interest rate at the date of the transfer, the corpus is assumed to be sufficient to make all payments. Moreover, if the annuity is payable for the spouse's life, the trust must have sufficient assets to pay the annuity until the spouse would attain age 110. If the trust does not have sufficient funds under either of these tests, it will be necessary to calculate a special Section 7520 annuity factor that takes into account the exhaustion of the trust or fund.

E. Asset Valuation Issues

The benefits of the RPM Trust depend on the successful resolution of several valuation issues related to the RPM Trust structure discussed below.

1. Effect of Undervaluation on Marital Deduction. It is unclear how a determination by the Service that the property contributed to the RPM trust was undervalued, and therefore that the amount paid for the remainder interest was insufficient, would affect the availability of the gift tax marital deduction. Two different results are possible:

- No portion of the RPM Trust would be deemed to qualify for the marital deduction because the remainder beneficiaries did not pay adequate and full consideration, or

- The allowable marital deduction will be equal to a fraction of the value of the RPM Trust, the numerator of which is equal to the amount the remaindermen pay

for their remainder interest and the denominator of which is equal to the value of the entire RPM Trust.

TAM 7605283200D,[14] the *only* ruling on this issue, supports the latter position. In that ruling, the IRS held that where the decedent's spouse received a terminable interest in an annuity from the decedent and a portion of the interest passing to persons other than the decedent's spouse was paid for with full and adequate consideration (and a portion was not so paid for by such persons), then that fraction that was so paid for will qualify for the marital deduction and the balance will not. In this TAM, the decedent owned 30% of the company that gave him an annuity payable to him for life and then to his spouse until her death or remarriage. The IRS said that at his death the annuity was includible in his gross estate and the spouse received a terminable interest in that if she remarries or dies, the shareholders of the company will be "enriched" by not having to pay the annuity anymore. Thus, an interest in the annuity passed to persons other than the spouse. The IRS held that the other shareholders paid adequate consideration for their interest via the company's promise to pay the annuity in accordance with its terms. However, the interest in this annuity passing to the decedent's heirs by virtue of receiving his stock in the company at his death was not paid for by such persons for full and adequate consideration (the decedent furnished such consideration as a shareholder, but he is not a person to whom an interest in the annuity passed at his death).

General Counsel Memorandum 38505[15] is somewhat in conflict with TAM 7605283200D. In that memo, the taxpayer made a transfer to charity in a manner similar to the RPM Annuity Trust only in that a third party paid for (and would receive) a future benefit. At issue was whether the gift to charity qualified for the gift tax charitable deduction under Code Section 2522. Like the marital deduction, Section 2522 permits a gift tax charitable deduction only for certain types of trusts that benefit both charity and individuals. However, if the individual paid full and adequate consideration for his or her interest, the trust has no formal requirements and the charity's interest will qualify for the gift tax charitable deduction. This exception parallels, in concept and in language, the marital deduction exception upon which the RPM Trust is based. In GCM 38505, the Service determined that if the amount paid by the third party (remainderman) was less than the value of his interest, the gift by the donor to charity failed to qualify for the gift tax charitable deduction in its entirety. Thus, no charitable deduction would be allowed--not even an amount proportionate to the payment made by the remainderman.

Based on TAM 7605283200D and GCM 38505, it is unclear whether the Service would disallow the entire marital deduction, or only a fraction of the deduction, if the remaindermen do not pay adequate consideration for the remainder. These two rulings have opposite results, neither is directly on point, and neither has precedential value. We believe the TAM is more indicative of the Service's anticipated position on the RPM

[14] May 28, 1976.

[15] September 19, 1980.

Trust because the facts of TAM 7605283200D are more similar to an RPM Trust than are the facts of GCM 38505, and the provision of Code Section 2523 that was at issue in TAM 7605283200 is the same provision on which the RPM Trust technique is based. However, the IRS could take the view that the marital deduction fails for the entire trust. After all, Section 2523(b)(1) does *not* say "to the extent" adequate and full consideration in money or money's worth is received.

2. Eliminating Valuation Risks To eliminate the valuation risks associated with an RPM Trust, one could either fund the trust with cash and publicly-traded securities, or have the remainder interest paid for with the same asset used to fund the RPM Trust. For example, if an RPM Trust is funded with LP units and the trust purchasing the remainder uses LP units in the same partnership to pay for the remainder, then there will be no valuation risk. Any discrepancy in the value of the LP units transferred to the RPM Trust will apply equally to the LP units used to purchase the remainder, eliminating the possibility for any underpayment.

F. Section 2702

Section 2702(a) does not apply generally to an RPM Trust. Section 2702(a)(1) provides that solely for purposes of determining whether the transfer of an interest in trust for the benefit of a member of the transferor's family is a gift and the value of the transfer, the value of any interest of the trust *retained* by the transferor or any applicable family member is determined as provided in Section 2702(a)(2). However, in an RPM Trust, the grantor does not "retain" any interest in the trust; rather, he simultaneously transfers an income or annuity interest to his spouse and sells the remainder to his children. Reg. Section 25.2702-2(3) provides that, "Retained means held by the same individual both before and after the transfer in trust," and Reg. Section 25.2702-2(d), Example 3, illustrates that if a grantor transfers property in trust that pays all of the income to his spouse for life with remainder to his children, Section 2702 does not apply because neither the grantor nor the spouse held an interest both before and after the transfer.

Nevertheless, Section 2702(c)(2) contains a "joint purchase rule," which appears to apply to an RPM Trust. That rule states that if two or more members of a family acquire interests in the same property in the same transaction (*e.g.*, the grantor's spouse and the Dynasty Trust acquire interests in the RPM Trust), the family member acquiring the term interest (spouse) is treated as having acquired the entire property and transferred the remainder interest to the other family member (*e.g.*, the Dynasty Trust) in exchange for any consideration the other family member paid for such interest.

Despite use of the word "purchase" in the heading of Section 2702(c)(2), the rule's application is not limited to situations in which both parties purchase their interests. The operative language of Section 2702(c)(2) (as opposed to the heading) states that it applies to situations in which two or more members of a family "acquire" interests in the same property in the same transaction, and no common definition of the word "acquire"

implies that consideration is paid.[16] One can "acquire" property via gift, bequest or purchase, and this fact is recognized in the Code: for example, Section 2039 contains the phrase, "[W]here any property has been acquired by gift, bequest, devise . . . ." If the word "acquire" required consideration, one could not acquire property by gift, bequest or devise.

The word "acquire" is used throughout the Code to refer to situations that include acquisitions by gift or bequest, and not merely purchases. Section 2703(a) provides, "For purposes of this subtitle, the value of any property shall be determined without regard to (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property . . ." The phrase "or other right to acquire" is intended to be a catch-all for any other scenario, with or without consideration, that allows one to obtain ownership of property for less than adequate consideration. Other Code sections refer to situations in which property is "acquired by purchase," which would be a redundant phrase if all "acquisitions" were purchases.[17] Whenever the Code or regulations intend to refer to a "purchase" in the gift, estate and GST regime, they do so by referring to a "bona fide sale for an adequate and full consideration in money or money's worth."[18]

This, in turn, brings Section 2702(a) into play, which determines the value of the property received by each party in the transaction. The value of the spouse's interest is determined, and then subtracted from the value of the property transferred to the RPM Trust to determine the value of the Dynasty Trust's remainder interest. If the spouse's interest is a "qualified interest," it is valued under the Section 7520 tables; otherwise, it is given a value of zero.[19] If the spouse's interest is not a qualified interest (*i.e.*, it is valued at zero), she will be treated as having transferred all the property in the RPM Trust to the Dynasty Trust in exchange for the relatively small amount it paid for its interest.

However, even if the spouse's interest is not a qualified interest (as in the case of an RPM Income Trust or an RPM Annuity Trust that fails to satisfy all of the requirements in Reg. Section 25.2702-3(b) and (d)), the spouse will *not* be treated as having made a gift to the Dynasty Trust. The last sentence of Regulation Section 25.2702-4(c) states that, for purposes of Section 2702, the amount of the gift caused by the joint purchase rule "*will not exceed the amount of consideration furnished by [the term holder] for all interests in the property*." [emphasis added] Because the spouse (the term holder) receives her

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[16] The American Heritage Dictionary of the English Language, Fourth Edition, defines "acquire" as "to gain possession of." Merriam-Webster's Dictionary of Law 1996 defines "acquire" as "To come into possession, ownership, or control of obtain as one's own."

[17] See, e.g., Reg. Sections 1.355-6(a)(3), 1.179-4(a), 1.897-1(o)(4)(i), 1.954-2, 1.108-2, 53.4943-6.

[18] See Sections 2036, 2037, 2038, 2039, 2040, 2522, 2523 and 2512.

[19] Reg. 25.2702-2(b)(2).

interest as a gift and has furnished no consideration for that interest, the deemed gift by the spouse under Section 2702 will always be zero.

The last sentence of Regulation Section 25.2702-4(c) was the subject of particular focus by the Service between issuance of the regulation in proposed and final forms, and it was specifically intended to prevent a gift of an interest that qualifies for the marital deduction from being treated as a gift by the spouse-donee. In its proposed form, the last sentence of Reg. Section 25.2702-4(c) read:

> For purposes of this paragraph (c), the amount considered transferred by the individual acquiring the term interest shall not exceed the amount of consideration furnished by the individual for all interests acquired by the individual in the property.[20]

In the introduction to the final regulations, the Service stated, "In response to another comment, the limit on the amount the term holder is considered to transfer in a joint purchase is clarified." The regulation was revised to read (its current form):

> For purposes of this paragraph (c), the amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property.[21]

Further, the introduction to the proposed regulations to Section 2702 contains the following:

> Definition of Retained
>
> The proposed regulations treat an interest as "retained" by the transferor or an applicable family member only if it is held by the same individual both before and after the transfer. Thus, an individual will not pay gift tax on more than the full value of the property, even if one of the interests is transferred to an applicable family member. *The result is the same under the proposed regulations even if the transfer of the income interest qualifies for a marital deduction, because the property will later be included in the transferee spouse's estate.* [emphasis added]

The Service apparently was mindful of the marital deduction when drafting the regulations to Section 2702. The last sentence of Reg. Section 25.2702-4(c) is required to avoid gift tax on a gift that qualifies for the marital deduction. Without it, the creation

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20 PS-92-90 (Apr. 9, 1991), 1991-1 C.B. 998.

21 T.D. 8395, 1992-1 C.B. 316 (Jan. 28, 1992).

of an ordinary QTIP marital trust (income interest to spouse with remainder to children) would cause spouse-beneficiary to be treated as the transferor of the property to the trust while retaining a non-qualified income interest, resulting in a taxable gift by the spouse of the entire corpus to the remaindermen. Under the regulation, the amount of the taxable gift is limited to the consideration furnished by the spouse, which would be zero. Similarly, the last sentence of Reg. Section 25.2702-4(c) should prevent a taxable gift by the spouse where the spouse's interest qualifies for the marital deduction by reason of the remaindermen's payment of full and adequate consideration for their interest.

Finally, if the grantor's spouse is a beneficiary of the trust that purchases the remainder, she would have two interests in the RPM Trust: as the income beneficiary or annuitant, and as a beneficiary of the remainder. Under the joint purchase rule, the spouse is treated as acquiring the entire property and transferring to other members of her family the interests they acquired in exchange for any consideration paid by those family members, but her gift is limited to the amount of consideration she furnished for all interests in the property. If the spouse is a beneficiary of the trust purchasing the remainder, the IRS could argue that the spouse furnished some of the consideration for the remainder, and that portion of the consideration would constitute a taxable gift by the spouse. Therefore, the grantor's spouse should not be a beneficiary of the remainder trust.

G. Gift Splitting

Section 2513 allows spouses to elect to be treated, solely for gift tax purposes, as making one-half of the gifts both spouses make from his or her separate funds. Thus, the gift tax liability can be split between two spouses, even though only one spouse actually transfers assets.

The election to split gifts applies to all gifts made to third parties by both spouses during the calendar year for which the election is made, except with respect to any gifts that are not permitted to be split. Thus, spouses may not elect to split gifts to some donees but not split the gifts made to others during the same calendar year. Similarly, they cannot elect to split gifts made by one spouse without electing to split gifts made by the other.[22]

Moreover, gifts by one spouse to the other cannot be split, and if one spouse transferred property in part to his spouse and in part to third parties, the consent is effective with respect to the interest transferred to third parties only to the extent the third parties' interest is ascertainable at the time of the gift and hence severable from the interest transferred to his spouse.[23]

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22 See Reg. Section 25.2513-1(b)(5).

23 See Reg. Section 25.2513-1(b)(4).

Finally, it is important to note that Section 2513 says that the "gift" is treated as having been made one-half by each spouse, and does not treat each spouse as having transferred one-half of all the assets transferred.

If one spouse (H) makes a gift to an RPM Trust during a year in which they elect to split gifts, the non-transferring spouse (W) will be treated as making one-half of the gift. However, the interest transferred to W cannot be split, and the remainder interest was not transferred as a gift, but is sold to the remaindermen. Therefore, Section 2513 should not apply to the transfer made to the RPM Trust.

H. The Gradow Case

It is critical to the economic viability of the RPM Trust that the Dynasty Trust's payment of adequate and full consideration for the remainder interest equal the actuarial value of such interest, and not the value of the entire trust. In *Gradow v. U.S.*,[24] the Tax Court held and the Federal Circuit affirmed the Service's assertion that although the Section 7520 tables may be used to value annuity and remainder interests for gift tax purposes, that valuation will not be respected for estate tax purposes. Specifically, in *Gradow*, the court held that under Section 2036(a), a transfer of a remainder interest in property will only be deemed to be for full and adequate consideration if the transfer is for the full value of the property (not just the value of the remainder interest).25

There are several responses to this. First, *Gradow* has no application to the RPM Trust because the grantor does not retain any interest in the property: he transfers an income or annuity interest and sells the remainder interest. Thus, none of the property in the RPM Trust is even arguably includible in the grantor's estate and thus Section 2036 and *Gradow* have no application.

Second, the validity of the Service's position is dubious, at best. The Service takes the position that for purposes of the gift tax, consideration equal to the actuarial value of the remainder interest constitutes adequate consideration when the grantor retains a "qualified interest" under Section 2702. Under *Gradow*, for estate tax purposes, the Service takes a different position. Applying different meanings to the phrase "adequate consideration" for purposes of the gift tax and estate tax is inconsistent with such tax systems being in pari materia. The Supreme Court set forth the general principle that, because the gift and estate taxes complement each other, the phrase "adequate and full

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24 897 F.2d 516 (Fed. Cir. 1990).

25 See also, United States v. Past, 347 F.2d 7 (9th Cir. 1965), Pittman v. United States, 878 F.Supp. 833 (E.D.N.C. 1994), TAM 9133001 (January 31, 1990), Estate of Rachel N. Parker v. United States, 95-1 USTC ¶60,199 (U.S. District Court for the Northern District of Georgia, 1995) and Estate of Magnin, TC Memo 1996-25, 71 TCM 1856 (January 24, 1996), *rev'd* 184 F.3d 1074 (9th Cir. 1999).

consideration" must mean the same thing in both statutes.[26] The Tax Court also has reached this conclusion.[27]

Moreover, three circuit courts have subsequently held that consideration equal to the fair market value of the remainder interest is adequate for purposes of Section 2036.[28] These cases have the weight of logic and the explicit provisions of Section 2036 behind them. The court in Wheeler recognized that the sale of a remainder interest for its actuarial value does not result in the circumvention of the estate tax, because the consideration received for the remainder interest, reinvested at the assumed IRS interest rates for the applicable life expectancy or term, will equal the value of the property in which the remainder interest is sold. The court stated:

> If a sale of a remainder interest for its actuarial value--an amount, it is worth noting, that is nothing more than the product of the undisputed "fair market value" of the underlying estate multiplied by an actuarial factor designed to adjust for the investment return over the actuarial period--constitutes adequate and full consideration under section 2036(a), then the estate holder successfully "freezes" the value of the transferred remainder at its date-of-transfer value. Accordingly, any post-transfer appreciation of the remainder interest over and above the appreciation percentage anticipated by the actuarial tables passes to the remainderman free of the estate tax. But, of course, this is a problem only if the proceeds of the sale are not invested in assets which appreciate as much (or depreciate as little) as the remainder. Moreover, those who recall the Great Depression, as well as more recent times, know that assets frequently do not appreciate.

Note that all of these cases involved challenges by the Service to transactions that occurred before the Section 7520 tables were created as part of Chapter 14 of the Code.

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[26] See Merrill v. Fahs, 65 S.Ct 655, 656 (1945) ("The gift tax was supplementary to the estate tax. The two are *in pari materia* and must be construed together.") (quoting Estate of Sanford v. Commissioner, 60 S.Ct. 51, 56 (1939)); Commissioner v. Wemyss, 65 S.Ct. 652 (1945); see also, Estate of Friedman v. Commissioner, 40 T.C. 714, 718-19 (1963) ("The phrase 'an adequate and full consideration in money or money's worth,' common to both the estate and gift tax statutes here pertinent, is to be given an 'identical construction' in regard to each of them.") (citing Fahs, 65 S.Ct. at 656).

[27] In Estate of McClendon, TC Memo 1993-459, 66 TCM 946 (Sept. 30, 1993), the Tax Court cited the foregoing cases to also hold the gift tax and estate tax *in pari materia* and must be construed together. Commentators have also urged the same construction should apply. See, *e.g.*, Martha W. Jordan, *Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702*, 14 Va. Tax Rev. 671; Steven A. Horowitz, *Economic Reality In Estate Planning: The Case for Remainder Interest Sales*, 73 Taxes 386 (1995); Jeffrey N. Pennell, *Cases Addressing Sale of Remainder Wrongly Decided*, 22 Est. Plan. 305 (1995).

[28] See Wheeler v. U.S., 97-2 USTC ¶60,278 (5th Cir. 1997); D'Ambrosio v. Commissioner, 101 F.3d 309 (3d Cir. 1996); Magnin v. Comm'r., 184 F.3d 1074 (9th Cir. 1999).

We have not seen a case or ruling in which the Service challenged a *post*-Chapter 14 transaction on the grounds that the method of valuing a remainder interest for gift tax purposes under Chapter 14 is not appropriate for estate tax purposes.[29] Thus, it is not necessarily the Service's view that post-Chapter 14 sales of remainder interests qualifying for valuation under the Section 7520 tables pursuant to Section 2702 will not be respected for federal estate tax purposes.

I. Timing of Transaction

The gift of the income or annuity interest to the grantor's spouse and the sale of the remainder interest to the remaindermen *must* be treated as occurring simultaneously. If the sale is deemed to occur after the gift, the gift will not qualify for the marital deduction because, at the time of the gift, the remaindermen will not have paid adequate and full consideration for their interest. If the sale is deemed to occur before the gift, the grantor would have retained an interest in the property (the life estate) and Section 2702 would apply, causing the value of the remainder interest to be equal to the full value of the property for gift tax purposes in the case of the RPM Income Trust (in which the spouse's interest is not a "qualified interest"), as well as in the case of an RPM Annuity Trust if it does not satisfy the requirements of a qualified annuity interest..

However, it should be simple to structure the gift and the sale of the RPM Trust interests as simultaneous transactions. The remaindermen should be a party to the RPM Trust and sign the trust as purchaser of the remainder interest, so that the same agreement that creates the income or annuity interest also provides for the sale of the remainder interest. Such a structure should not be subject to attack by the Service, as the Service routinely attempts to characterize several transactions as part of a single transaction under the step-transaction doctrine. For example, if a parent transfers property to a child and the child then hands the parent a check for the fair market value of the property, the parent and child would not be deemed to have made successive gifts to one another. Rather, their actions would be viewed as a single transaction in which the parent sold property to the child. Concurrent transfers of a life estate and a remainder are even contemplated by the Code. See *Example 3*, Treas. Reg. Section 25.2702-2(d).

J. Divorce

The RPM Trust should not have a "divorce clause." That is, the spouse's income or annuity interest should be irrevocable and not terminate by reason of divorce during the term of the trust. Otherwise, the value of the income, annuity and remainder interests could not be determined by reference to the Section 7520 tables.

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[29] In PLR 9412036 (December 23, 1993), the Service ruled that Section 2036 was applicable to what was intended to be a remainder purchase GRUT. However, the interests received by the term interest holder failed to meet the requirements of a qualified interest (the GRUT was not structured properly), and thus Section 2702 applied to preclude the use of the Section 7520 factors.

K. Income Tax Issues

During the settlor's life, the RPM Trust should be structured as a "grantor trust." Section 677 will make most if not the entire trust a grantor trust, but one might also include other powers, such as the power to substitute or borrow trust property, to ensure the entire trust is treated as owned by the settlor. As such, the income, gains and losses realized by the trust will be reported on the settlor's income tax return, and the settlor will be liable for any resulting income taxes.

No capital gain is realized upon funding annuity payments with appreciated property while both spouses are living. If any portion of the annuity is paid using assets that have unrealized gains, the RPM Annuity Trust will be deemed to have sold such assets, triggering a capital gains tax. This is based on Rev. Rul. 83-75. Under that ruling, when a trust funds an annuity payment with appreciated assets, the recipient of the annuity, who has a right to a specific dollar amount, is exchanging that right for the appreciated assets. Thus, the trust would recognize gain on the exchange with the annuitant. However, when the trust is a grantor trust and the annuitant is the grantor (e.g., in the case of a GRAT), the exchange is between the grantor and himself, and no gain is recognized.[30] Similarly, no gain is recognized when the RPM Annuity Trust is a grantor trust and the annuity is payable to his or her spouse, because the exchange would be between the grantor and his or her spouse which cannot result in gain under Section 1041.

If the settlor dies during the term of an RPM Income Trust, it will cease to be a grantor trust and thereafter will be liable for its own income taxes. The income will be taxable to the spouse-beneficiary under the "DNI rules," and the trust would be liable for taxes on capital gains.

If the settlor dies during the term of an RPM Annuity Trust, it will cease to be a grantor trust and thereafter will be liable for its own income taxes. In this case, if any portion of the annuity is paid using assets that have unrealized gains, the RPM Annuity Trust will be deemed to have sold such assets, triggering a capital gains tax.[31] The capital gains will be taxable to the spouse-beneficiary who receives the annuity payment under the "DNI rules." Fortunately, the spouse-beneficiary will be receiving distributions with which to pay the tax. Nonetheless, capital gains may be realized sooner than expected. This will be avoided, however, if the trust has sufficient cash flow to fund the annuity and avoids using appreciated securities for such purpose, or if the trust borrows cash from another source to pay the annuity. Alternatively, the RPM Trust could be structured to terminate at the settlor's death, thereby avoiding any annuity payments while it is a non-grantor trust.

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30 See PLRs 9441031 (July 12, 1994) and 9345035 (Aug. 13, 1993).

31 The spouse-annuitant, who is entitled to a fixed dollar amount, is deemed to have exchanged that right for the appreciated assets. As a result, the trust is deemed to have sold the assets. Rev. Rul. 83-75.

Finally, the remainder trust should be a grantor trust with respect to the settlor of the RPM Trust to avoid triggering any gain if the RPM Trust is funded with appreciated property. Otherwise, the remainder trust's purchase of the remainder would trigger recognition of some of the gain.

L. Estate Tax Consequences at Spouse's Death

If the spouse dies during the term of the RPM Trust, the income or annuity of a fixed term RPM Trust will continue to be paid to her estate and the present value of the remaining payments will be included in her estate under Section 2033. If the grantor survives the spouse, she could leave the income or annuity interest to the grantor under her will. The remaining payments are not a "terminable interest" and should qualify for the marital deduction because the Dynasty Trust paid for its interest.[32] If the grantor does not survive the spouse, the present value of the income or annuity interest will be subject to estate tax (unless left to charity). It is possible that the Service would allow the payment of the estate tax due on the income or annuity interest to be deferred under Section 6161 due to the fact that the estate may not have the funds to pay the tax until the payments are actually received.

Section 2039 will not apply to the RPM Annuity Trust at the spouse's death. Section 2039 provides that the gross estate shall include the value of an annuity or other payment receivable by any beneficiary (the Dynasty Trust) by reason of surviving the decedent (the spouse) under any contract or agreement, if under such contract or agreement, an annuity or other payment was payable to the decedent. The interest held by the spouse in the RPM Annuity Trust falls within the scope of Section 2039. However, Section 2039(b) states that only the amount of property proportionate to the consideration paid by the decedent is includible in her gross estate. Because the spouse does not pay any consideration for her interest in the trust, none of the trust property will be includible in her estate under Section 2039.

In addition, Section 2036 will not apply to either form of RPM Trust at the spouse's death. Section 2036 provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--
>
> (1) the possession or enjoyment of, or the right to the income from, the property. . .

[32] See Section 2056(b)(1)(A).

This conclusion is supported by Revenue Rulings 66-86[33] and 70-84[34], in which the Service held if a decedent at no time held any interest in property other than a life interest which terminates at the decedent's death, no portion of the value of the property is includible in the decedent's gross estate as the subject of a transfer with a retained life estate under Section 2036.[35]

M. Generation-Skipping Tax (GST) Issues

At the conclusion of an RPM Trust, the Service could argue that the distribution of the remainder to the Dynasty Trust constitutes an addition to the trust, affecting the trust's "inclusion ratio" and potentially causing GST tax in respect of future "taxable distributions" (distributions to grandchildren) or causing GST tax at "taxable terminations" (such as the death of the grantor's last living child). Nevertheless, the Service should not prevail in making such arguments for the following reasons.

First, a generation skipping transfer can only occur if property is received by a person two or more generations younger than the "transferor." The transfer of property to the RPM Trust would not make the grantor a "transferor" of such property to the Dynasty Trust for GST purposes. Reg. Section 26.2652-1(a) states that the "transferor" is the person with respect to whom the property was most recently subject to Federal estate or gift tax. A transfer for full and adequate consideration is not a transfer subject to Federal gift tax.

Moreover, from a policy perspective, the sale of the remainder of the RPM Trust and the subsequent distribution of the remainder to the Dynasty Trust are not events to which the GST tax should apply: they are not gratuitous transfers subject to transfer tax. Rather, the technique represents simply an investment by the Dynasty Trust in an asset just like any other. Put differently, the sale of the remainder interest does not take property outside the GST tax net. That is, the GST tax will apply to the property the grantor receives from the Dynasty Trust if and when it is transferred to a "skip person" (e.g., a grandchild). The grantor sold the remainder interest for full and adequate consideration, and the proceeds received will remain potentially subject to GST tax. Just as there would no transfer tax consequences to the Dynasty Trust resulting from the maturity and redemption of a bond purchased at fair market value, there should be no transfer tax consequence to the Dynasty Trust when its investment in the RPM Trust matures at the end of the annuity term.

However, unlike the estate and gift tax regime, the GST tax regime is not expressly limited to gratuitous transfers: in other words, there is no express exception for transfers

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[33] 1966-1 C.B. 219.

[34] 1970-1 CB 188.

[35] See also PLR 9515039 (Jan. 17, 1995).

for full and adequate consideration. The effect of this gap is to provide an opening for the Service to argue that when the RPM Trust terminated and its property is added to the Dynasty Trust, the Dynasty Trust's inclusion ratio changed from zero to some fraction greater than zero.

Such an argument would be contrary to Congressional intent in adopting Chapter 13 (which contains the GST provisions of the Code). The entire thrust of Chapter 13 is to make generation-skipping transfers subject to tax on principles similar to those underlying the gift and estate taxes. In explaining the purpose of Chapter 13, the Joint Committee on Taxation stated:

> The Congress believed, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) was not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect.[1]

The Joint Committee also said, "Estate tax rules apply to generation-skipping transfers occurring as a result of death, and gift tax rules apply in other cases."[36] Extending the generation-skipping tax beyond gratuitous transfers would not create uniformity with the gift and estate taxes, and therefore would be contrary to the legislature's intent in adopting Chapter 13.

Moreover, the application of the GST regime to transactions for full and adequate consideration could lead to palpably absurd results. For example, applying the literal definition of a taxable termination, if a person made a gift of a house in trust for the benefit of children and grandchildren, and if the trustee subsequently sold the house to an unrelated person born more than 37 ½ years after the grantor of the trust (thus making the purchaser a "skip person" as to the grantor), the transaction would be subject to GST tax: there has been a termination of an interest in property held in trust (the residence) and immediately after the termination, no non-skip person has an interest in such property. Alternatively, if the trustee contracted with a roofer who was born more than 37 ½ years after the grantor, application of the literal definition of "taxable distribution" would subject any payment the roofer receives from the trust to be subject to GST tax: the payment literally is a distribution from a trust to a skip person.

Requiring a change in inclusion ratios to reflect investment performance produces results just as absurd. Under such a view, any transfer whatsoever would alter the inclusion ratio of an otherwise GST-exempt trust. For example, if the trust purchased a building and received fair market rent, the rental payments would not affect the inclusion ratio even though, in some sense, they represent transfers or additions to the trust. There has never been a suggestion in the Treasury Regulations, rulings or any commentary we have seen

[36] Joint Committee at 1266-1267; see also House Report, 1986-3 C.B. at 827.

that a return on an investment of the trust should cause a change in the trust's inclusion ratio.

N. Conclusions

RPM Trusts add a new dimension to wealth transfers. RPM Income Trusts are highly efficient and not dependent on superior investment returns, and RPM Annuity Trusts have all the advantages of a GRAT, and then some. They should be considered in planning your clients' wealth transfers.

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