

CH.15 – Non-Donative Property Transfers

- 1) Intrafamily installment sales**
- 2) Gift or sale & leaseback arrangements**
- 3) Tax-free exchanges with family members**
- 4) Private annuities with family members**
- 5) Grantor retained annuity trusts (GRAT)**
- 6) QPRTs**
- 7) Joint or split purchases**
- 8) Remainder interest sale**
- 9) Intentionally defective grantor trust**

Fundamental Objectives for these Transactions

- 1) Limit transfer (E&G) tax exposure.**
- 2) Transfer appreciation potential for the benefit of younger generation members.**
- 3) Gain recognition, if any, for FIT purposes:**
 - Capital gains (not ordinary income) treatment**
 - Deferral of any capital gain recognition.**
- 4) Leverage on the borrowing arrangements, e.g., low interest costs for the debt component (& interest-free loans; cf., §7872).**

Counter Considerations for Moderately Wealthy

1) Estate tax exclusion at \$11.4 million (in 2019) and increasing with inflation adjustment (but only until 2026). Few estates exposed to federal estate tax. But, further reduction in future legislation?

2) Income tax basis step-up at death (under §1014). Opportunity for (other than for liquid property) to exaggerate fair market value and thereby increase basis (and reduce future capital gain).

Family Installment Sales

§453

p.2-3

Older family member sells appreciated property to younger family member (e.g., earlier Maxwell case where a retained interest for estate tax purposes - § 2036)).

- Did a real sale occur? Cf., Rev. Rul. 77-299.
- Deferred payments & deferral for capital gains tax recognition (20%?).
- Eligible for §453 treatment - if not (i) listed stock, §453(k), or (ii) sale to related party - & related party sells acquired property. §453(e).
- Subsequent appreciation accrues to the buyer.
- Interest is to be paid by buyer to seller? §7872 importance when low interest rate conditions.

Alternative Approach – Gift Mortgage Funds p.4

Alternative to a family member property sale:

- Mortgage the property & retain the indebted property, subject to the mortgage debt. Cf., “reverse mortgage” situation.**
- Make a gift of the borrowed cash received.**
- Tax basis step-up (§1014) for the retained property at time of death.**
- Risk of greater value of the mortgaged property at the time of death (through appreciation) - but offset by existing (& increasing) debt.**

Sale to a Grantor Trust

p.4

Intentionally defective grantor trust (IDGT), also p. 108:

- 1) Trust is effective for transfer tax purposes – to eliminate estate tax exposure.
- 2) But, grantor trust for FIT purposes, and, therefore, no sale for federal income tax purposes. See Rev. Rul. 85-13.

What happens when grantor trust powers are terminated? Treated as a property sale.

But, no estate tax inclusion means no tax basis step-up at death. If estate below 11.400 mil.?

Sale for a Self-Cancelling Installment Note (SCIN)

Installment sale from parent to child, but the promissory note specifies its cancellation at the time of the death of the seller. Issues include:

- Increase the interest (or principal?) amount to include an actuarial component in payment?
- What inclusion of the transferred property in the estate for estate tax purposes? None?
- Installment sales treatment?
- Income tax treatment at death? IRD?
- Income recognition to the decedent or estate?

See CCA, p.7 (& next slide).

Sale for a Self-Cancelling Installment Note (SCIN)

CCA201330033

1) Federal estate tax inclusion (Issue 3, p. 13).?

Notes are not included in the gross estate for federal estate tax purposes.

Moss case (p.13) – assume an arm's length/real transaction for transfer tax purposes.

2) But, a gift for gift tax purposes, when full value for the transaction value not received (in the form of the promissory note).

Estate of Frane p.16

Cancelled debt at death

Installment obligations are cancelled at death:

Issue – income tax: (1) IRD (under §691), or (2) an installment debt disposition recognition (§453B), or (3) no income event?

Tax Court: Income on final income tax return - §453B(f) cancellation. Issue re the six year S/L?

Tax Court dissent: no income event occurring; Est. of Moss (p.31 re estate tax) – no ownership interest in the notes held at time of death.

Ct. of Appeals (p.34): §691(a)(2) applies – an IRD item on the estate's first income tax return

4/25/2019 when cancellation occurred at death. © William P. Steyer

Estate of Johnson, p.34 (settled on appeal)

Gain on the cancellation of the note is reported on the decedent's final income tax return.

FIT liability then created a debt for estate tax.

Tax Court in *Frane* had held that income was on last individual FIT return, but reversed by Eighth Circuit (income on Estate's income tax return (IRS Form 1041)).

Johnson case was appealable to the Tenth Circuit & therefore is the Tax Court position the national law (except in the 8th Circuit)?

Planning the SCIN Transaction

Essential: Clear documentation required – see Costanza, 6th Circuit, (p. 12), where sloppy administration occurred (but treated as valid).

Include an actuarial premium in the amount being paid to seller? This is an additional asset includible in the seller's estate (unless spent after its receipt).

Alternative: provide a contingent bequest to the note issuers to fund the unpaid balance on the promissory note owing to decedent?

Gift or Sale/Leaseback

p.35

Sale – gain recognition & basis to buyer is fmv.

Gift – carryover tax basis to donee.

Transferor: (1) pay (deductible) rent to the new property owner; (2) receive interest income & principal if a sale & a capital gains event;

cf., §1239, seller's cap gain is transformed into ordinary income in limited situations.

Transferee: (1) rental income; (2) pays interest expense (& principal), (3) gets an investment interest expense deduction (& depreciation?) to offset rent income received, & (4) appreciation.

Tax-free exchanges & family members p.36

Code §1031 re gain postponement on like-kind exchanges: is the exchange eligible for §1031?

Why do this? Exchange high appreciation potential property for income producing property on tax-free basis? & get gross income.

Transferor holds the replacement property for a tax basis step-up at death - §1014.

Note: §1031(f) limitation on related party like-kind exchanges when sale of exchange property is then made by the related person. Why?

Private Annuity **p.38**

Non-commercial Obligor

Objectives in implementing the “private annuity” transaction? Tax issues:

- 1) Gain recognition on transferred property at the time of the annuity transaction (or later)?
- 2) If deferral, how report the annuity proceeds for FIT purposes? Annuity income, capital gain and tax basis recovery?
- 3) Estate tax inclusion at the time of death of the annuitant? A retained life interest? Or, does the annuity expire with no value to annuitant?

PLR 9009064

p.41

Private annuity a with school for the transfer of a coop apartment remainder interest.

Minimum (250x, refund feature) & COLI

See reliance on Rev. Rul. 69-74, p.42

Possible elements in each payment:

- 1) tax basis recovery,**
- 2) capital gain (& depreciation recapture?)**
- 3) ordinary income (interest), plus compensation for the actuarial risk.**

Abandoning “Open Transaction” Treatment

IR 2006-161 (2006), p.45 – announcement & proposed regulations & an immediate effective date; but, no final regs. (13 years later). Wait how long for the final regs?

Prop. Reg. §1.1001-1(j) – the receipt of the annuity contract is the “receipt of property.”

Prior Stern case (p.46) & “closed transaction”? §677 (grantor trust issuing a private annuity obligation); not closed here since no security for assuring payment of annuities. But, Prop. Reg. 1.1001-1(j) to the contrary.

Shortened Life Expectancies

p.49

Private annuity transaction by a terminally ill person (assuming no reg.)? McLendon case, p. 50 – private annuity transaction with a family trust; transfer of remainder interests in a partnership in exchange for an annuity.

Actuarial life expectancy: 15 years

Adequate & full consideration? See old Rev. Rul. 80-80 allowing use of tables? 10% survival probability? See Reg. §1.7520-3(b)(3) – 50% chance of dying within one year; but, rebutted if living for 18 months.

Grantor Retained Annuity Trust (GRAT) p.59

What is the primary tax planning objective for implementing a “GRAT” (i.e., annuity trust)?

Answer: Transfer value into a trust while

- Retaining the lead interest (no gift)**
- Remainder interest to beneficiaries (& small value for gift tax – based on valuation tables)**
- Donor to live past the end of the term for the lead interest (no §2036 inclusion)**
- The value of trust corpus during the term for years increases more than the applicable §7520 interest rate**

Grantor Retained Annuity Trust (GRAT) p.59

Cf., a “GRIT” (grantor retained income trust).

See Code §2702(a)(2) & (b)(1) – the retained interest must be a “qualified interest” – or the retained interest is treated as having zero value (i.e., all value is then transferred as a gift).

“Qualified interest” as defined – a right to receive fixed amounts payable at least annually.

How long a term is required? See Obama proposal (fn.58, 2017 budget) re a possible minimum 10 year term.

GRAT Established

- 1) Income tax – (a) Grantor trust treatment – §§674 (P/A) & 677 (discretion to pay all income), & (b) Rev. Rul. 85-13 treatment – & no gain for asset transfer for annuity payments.
- 2) Grantor trust - Qualified for Sub S stock.
- 3) For gift tax, a “qualified interest” – since right was held to receive fixed amounts. Gift tax value excludes the qualified annuity interest.
- 4) Estate tax - not includible (cf., §2036 Maxwell case) in grantor’s gross estate – if the grantor survives the term of the GRAT.

Objective of the “Zeroed-Out” GRAT p.68

PLR 9717008 (p.69) – short term (two year) GRAT and payments to be funded with a promissory note. Held: not a qualified GRAT. Funded with shares which appreciated and latter annuity payments were made with shares.

No IRS ruling re a “zeroed out” GRAT (p.76) –

- 1) The remainder interest must be at least 10 percent of the initial net market value, &
- 2) Annual annuity not more than 50% of value.

Pay the GRAT with a Promissory Note? P.77

Regs.: A promissory note can not be used to pay the annual GRAT obligation – the transferor’s retained interest will be valued at zero (for gift tax purposes).

The note is not a “payment” of the annuity obligation.

The annuity agreement must prohibit the use of a promissory note to pay the annuity.

Estate Tax Inclusion – Death before GRAT Ends

What value is includible in the gross estate if the grantor dies before the expiration of the specified term of the GRAT? P.78.

Inclusion in the gross estate of only an amount necessary to fund the annuity for the remaining term based on §7520 rates. Reg. §20.2036-1(c)(2). P.78.

No inclusion of the full value of the trust as measured at the time of death (possibly occurring under §2039). Only §2036 applies.

Use “staggered GRATs”? See p. 79.

Qualified Personal Residence Trust

p.79

Code §2702(a)(3)(A)(ii) – re personal residence trust as an exception to “qualified interest.”

Choices under the tax regulations:

- Personal residence trust, or,
- Qualified personal residence trust (QPRT).

Valuation of the gift of the remainder interest is based on: (1) the FMV of the property, (2) the client’s age, and (3) the §7520 interest rate (120% of mid-term AFR).

PLR 200241039

p.80

What is the “personal residence”?

Adjoining property? Guesthouses? Beach?

This ruling specifies:

1. All property (including other structures) is used for residential purposes.
2. The trust agreement includes all the required provisions to enable QPRT treatment. See Reg. §25.2702-5(c).

Residential Property Management Issues

QPRT & property managements issues:

Who deals with the maintenance costs?

Real estate taxes? Insurance?

Cost of improvements – who pays?

**Who has the replacement cost obligation for a
casualty loss if the loss is not covered by
casualty insurance?**

Rev. Proc. 2003-42

p.85

See sample form for QPRT agreement with one term holder, as provided by IRS.

“Safe harbor” trust agreement format – the agreement must be “substantially similar.”

But, also a possible PLR concerning the status of the residential property as being QPRT eligible? See p. 86.

What Happens When QPRT Term Ends?

Where does the QPRT trust grantor live after the expiration of the QPRT term?

- Sale of the property back to grantor? No. P.86.
- But, possible lease back (without a §2036(a) estate tax inclusion)? Yes.
- Use a “return QPRT”? Yes (see PLRs, p. 85) re beneficiaries creating a QPRT for the benefit of the original donor. But, §2036 applicable?

How to reduce the gift tax values?

- 1) Spouses partition their interests and put (then discounted) fractional shares into several QPRTs? See p. 87.
- 2) Retention of a contingent reversion if dying within the specified QPRT period – since the asset is included in grantor's gross estate in this situation (under §2036). P. 87. This can reduce the value of the gift to the remainderman.

Retain the QPRT Technique?

See (p. 87-88) proposal to terminate QPRT
exception of Code § 2702(a)(3)(A)(ii).

Is this a “loophole”?

Is the use of the residence the equivalent of a
specified annuity interest (e.g., a GRAT)?

Joint Purchases

p.88

Code §2702(c)(2) – two or more family members acquire interests in property where one interest is a term interest.

The person acquiring the term interest is treated as acquiring the entire property (less any consideration provided by the other party).

Therefore, the transaction is an entire gift of the property, less any consideration provided by the remainderman.

PLR 9206006

p. 90

This private letter ruling was issued before Code §2702 enactment.

Purchase of condo unit: Parent acquires life interest & child acquires the remainder interest.

Issue re Code §2036(a) estate tax inclusion.

Result: Inclusion of most of the value.

Problems: (1) failure to use the correct actuarial factor and (2) borrowings from the parent to purchase the remainder interest.

Joint Purchase of a Personal Residence?

P. 95.

Reg. §25.2702-1(c)(2) states that Code §2702 does not apply to a “transfer in trust that meets the requirements of §25.2702-5.”

Sale of a Remainder Interest in Property p.95

Remember the forced widow's election re the widow's sale of a remainder interest.

See Reg. §25.2702-4(d), Example 2: Sale by parent of remainder interest to child, retaining income right for 20 years. Even if value paid by child is equal to §7520 value, the parent's retained interest is not a "qualified interest" and, therefore, the value of the retained interest is zero. Therefore, a gift of entire property value (less consideration from child).

D'Ambrosio case

p. 96

Cf., Gradow case

Transfer by 80 year old person of (1) a remainder interest in preferred shares in exchange for an annuity and (2) retained the income interest.

Inclusion of full value of shares in the estate?

Tax Court: inclusion of full share value, offset only for annuity payments received.

3rd Circuit: Held: inclusion of remainder interest less the value of the annuity (paid for the remainder interest).

Intentionally Defective Grantor Trust (IDIT) p.108

Trust as: (1) an effective transfer to avoid estate tax inclusion, but

(2) defective for income tax purposes.

Purpose of this arrangement?

