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Lifetime Transfers: PART TWO:

Preferred Equity Interests, GRATs, and Private Annuities

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Preferred Equity Interests

Similar benefits to those achieved with an installment sale to a grantor trust may be derived through the use of either a preferred equity interest transaction or a GRAT.

In a preferred equity interest transaction, the older family member will receive pursuant to the creation or recapitalization of a partnership or corporation a preferred interest in the entity that will not increase in value, even though the entity's assets, including intangible assets, do increase in value after the recapitalization.

The holder of the preferred interest will be entitled to receive a preferred distribution on an annual basis. Because a preferred equity interest involves the creation of two classes of equity interests, an S corporation cannot be the subject of a preferred equity interest transaction. In addition, because the preferred payment by a C corporation will be a dividend that will be includible in the recipient's taxable income and not deductible by the corporation, resulting in a double tax (once on the income earned by the corporation to pay the dividend and once to the recipient when he or she receives the dividend), a C corporation is usually not a good candidate for a preferred equity interest transaction. Consequently, today most preferred equity interest transactions involve limited partnerships and limited liability companies (LLCs), which, because they are pass-through entities for federal income tax purposes, avoid two layers of tax.

I.R.C. § 2701 ignores the value of applicable retained interests in a partnership or LLC for purposes of determining the value of subordinate equity interests transferred to the transferor's spouse and descendants and spouses of descendants of the transferor and the transferor's spouse. I.R.C. § 2701(a)(1), (a)(3)(A), and (e)(1). "Applicable retained interests" are certain senior equity interests (*i.e.,* equity interests that carry a preferred right to income or capital distributions) retained by the transferor and the transferor's spouse and ancestors and spouses of ancestors of the transferor or the transferor's spouse. I.R.C. § 2701(a), (b), and (e)(2); Treas. Reg. § 25.2701-3(a)(2)(ii).

A "senior equity interest" is an applicable retained interest to the extent it gives the holder (1) an extraordinary payment right or (2) a distribution right (the right to receive distributions from the entity) if the transferor and members of the transferor's family control the entity. I.R.C. § 2701(b)(1) An extraordinary payment right is the right to put or call the interest (*i.e.*, to force the entity to purchase the interest from the holder or to require the entity to sell an interest in the entity to the holder), to convert the interest into a subordinate equity interest, or to compel the liquidation of the interest (essentially a put right). I.R.C. § 2701(b)(1)(B); Treas. Reg. § 25.2701-2(b)(2).

The transferor and members of the transferor's family (defined for this purpose as including descendants of the parents of the transferor or the transferor's spouse, as well as ancestors and spouses of ancestors of the transferor

and his or her spouse) control an entity if any of them is a general partner in a limited partnership (or presumably a member-manager in a manager-managed LLC) or together they own 50% or more of the equity interests in the entity. I.R.C. § 2701(b)(1), (b)(2).

A distribution right does not include (i) a right to distributions with respect to any interest that is junior to the rights of the transferred interest, (ii) any liquidation, put, call, or conversion right, or (iii) any right to receive any I.R.C. § 707(c) guaranteed payment of a fixed amount. I.R.C. § 2701(c)(1)(B) However, the value of distribution rights which are qualified payment rights is not ignored. I.R.C. § 2701(a)(3)

A qualified payment right is the right to receive a fixed amount or an amount based on a fixed interest rate from the entity at least annually, or, if the amount is not paid in the current year, to receive the accumulated unpaid amounts in subsequent years before other equity interest holders receive distributions from the entity. I.R.C. § 2701(c)(3), Treas. Reg. § 25.2701-2(b)(6). For example, a holder of cumulative preferred stock has a qualified payment right. Although a qualified payment right is valued at fair market value for purposes of determining the value of the initial transfer unless it is combined with an extraordinary payment right, the entity's subsequent failure to pay the qualified payment on a timely basis may result in an increase in the holder's taxable gifts if he or she transfers a qualified payment right during life or in the holder's taxable estate if the right is held at death. Treas. Reg. §§ 25.2701-2(a)(4), 25.2701-4(a), and (c).

Certain payment rights fall outside the definition of distribution rights completely and thus are not ignored in valuing a retained interest. These rights include mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under I.R.C. § 707(c), and nonlapsing conversion rights. Treas. Reg. § 25.2701-2(a)(4). A guaranteed payment right, which entitles the holder to receive a fixed amount at a specified time, is also valued at fair market value when determining the value of a transferred subordinate equity interest. Treas. Reg. § 25.2701-2(b)(4)(iii). For example, an individual has a guaranteed payment right if he or she is entitled to receive $2,000 a year from the entity for his or her lifetime. I.R.C. § 2701 does not apply if the retained interest or transferred interest is readily marketable. I.R.C. § 2701(a)(1) flush language and (a)(2)(A).

The effect of I.R.C. § 2701 is to reduce the value of interests older family members continue to hold and increase the value of interests transferred to younger family members by applying the subtraction method of determining the value of a transferred interest when I.R.C. § 2701 applies. Under this method, the value of any equity interests retained by the older family members, disregarding extraordinary payment rights and distribution rights that are not qualified payment rights, is subtracted from the value of all family-held interests in the entity. The remainder is the value assigned to the subordinate equity interests and other equity interests held by the family in the entity. Treas. Reg. § 25.2701-1(a)(2); s*ee also* Treas. Reg. § 25.2701-3 for the specific method. Because in most cases it is the subordinate equity interests that have been transferred to younger family members, the amount of taxable gifts by the older transferring family members is increased by the same amount that the value of their retained equity interests is reduced.

Transfer tax savings may be obtained by transferring to younger family members equity interests that will absorb the future growth in the entity's value. For example, an older family member starting a new business with little initial value will incur a small taxable gift if he or she gives all the residual interests to younger family members and retains a senior equity interest that is valued at zero because it is not a qualified payment right. Any subsequent increase in value will inure to the younger family members without further gift tax consequences. Likewise, a tax-free shift in value occurs if the value of a business increases at a rate that exceeds the discount rate used in determining the value of a qualified payment right or guaranteed payment right retained by the older family member. Although the value of the qualified payment right or guaranteed payment right will reduce the value of the taxable gift, any payments actually made will be included in the older family member's estate unless consumed.

In most situations the family can best achieve its tax and nontax goals by avoiding the application of I.R.C. § 2701 altogether. I.R.C. § 2701 is not operative if there is only one class of equity interest in the entity, despite differences in voting rights, rights to manage the entity, or exposure to liability. Treas. Reg. § 25.2701-1(c)(3). Only one class of entity will exist if distributions of operating revenue and liquidating proceeds are based on capital accounts and the capital accounts are maintained in a manner that reflects the financial investment of the owners in the enterprise from time to time, taking into account profits retained in the entity and losses allocated to the owners. Treas. Reg. § 25.2701-1(c)(3). For example, if Smith's capital account has a balance of $10,000 and the capital account balances of all the owners is $100,000, Smith would receive ten percent of all distributions and would be allocated ten percent of all tax items.

If capital accounts are properly maintained, basing distributions on relative capital account balances of the owners will ensure that only one class of equity exists. The disadvantage of a preferred equity interest transaction is that a qualified business appraiser must determine the preferred interest's value using a rate of return based on market conditions. This rate may be considerably higher than the applicable federal rate that would be used for determining the interest rate in an installment sale to a grantor trust or the rate that would be used for valuing the retained annuity interest in a GRAT. In addition, if the qualified payments are not actually made to the transferor, the transferor's estate will be increased by the amount of the unpaid payments plus interest, compounded annually from the due date of each unpaid payment, subject to the cap described in the regulations.

Presumably in the case of an installment sale to a grantor trust, if a payment is not made, the grantor will simply be treated as making a gift of the unpaid amount to the trust, with no additional gift or estate tax consequences, unless the trust has no assets to make the payment, in which case there may be no income or gift tax consequences. There should be no discharge-of-indebtedness income because the trust is a grantor trust. There should be no gift because the trust has no assets to use to pay the remaining principal.

GRATs

In General

In a GRAT, an older family member transfers an asset to a trust and retains the right to receive a fixed dollar amount for a period of time, after which the transferor's interest terminates and either the asset is distributed to the beneficiaries, usually younger family members, or the trust continues on for some period. Under I.R.C. § 2702, the value of the gift is the value of the transferred asset less the value of the retained annuity interest, provided the requirements contained in I.R.C. § 2702 and the regulations thereunder relating to a qualified annuity interest are satisfied.

The present value of the retained interest in a GRAT for transfer tax purposes is determined using 120% of the federal mid-term rate under I.R.C. § 2702(a)(2)(B). Consequently, if the value of the asset transferred to the GRAT does not increase in value by more than 120% of the federal mid-term rate, there is no tax-free shifting of value to the remainder beneficiaries of the trust.

A qualified annuity interest is an irrevocable right to receive a fixed amount, which must be payable to or for the benefit of the term holder for each taxable year of the term. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. The annuity payment may be made after the close of the taxable year, provided that the payment is made no later than the date by which the trustee is required to file the income tax return of the trust for the taxable year (without regard to extensions), or, in the case of a payment date other than the end of the trust's taxable year, 105 days after such date. Treas. Reg. § 25.2702-3(b)(1)(i).

The fixed amount must be either a stated dollar amount payable periodically, but not less frequently than annually, or a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually. Treas. Reg. § 25 .2702-3(b)(1)(ii). However, the stated dollar amount payable in subsequent years is a qualified interest only to the extent it does not exceed 120% of the stated dollar amount payable in the preceding year. Treas. Reg. § 25 .2702-3(b)(1)(ii). Any excess will not be taken into account in determining the value of the retained interest. Treas. Reg. § 25.2702-3(b)(1)(iii). Although income of the trust in excess of the annuity amount may be paid to or for the benefit of the holder of the qualified annuity interest, the right to the excess income will not be taken into account in valuing the qualified annuity interest. Treas. Reg. § 25.2702-3(b)(1)(iii).

If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Treas. Reg. § 1.664-2(a)(1)(ii) and (iv), relating to adjustments for any incorrect determinations of the fair market value of the property in the trust, and the computation of the annuity interest in the case of short taxable years and the last taxable year of the term. Treas. Reg. § 25.2702-3(b)(2) and 25.2702-3(b)(3). A modification made to the final regulations eliminates the necessity of making a payment of a pro rata portion of the fixed amount for the first taxable year when the trust is created on a date other than January 1. Of course, a pro rata payment is required for the final year if it is a short year. T.D. 8536 (May 4, 1994), amending Treas. Reg. § 25.2702-3(b)(3).

Governing Instrument Requirements

The governing instrument must prohibit additional contributions to the trust. Treas. Reg. § 25.2702-3(b)(5). The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the annuity interest. Treas. Reg. § 25.2702-3(d)(3). The governing instrument must also fix the term of the annuity interest. The term chosen must be one of the following: the life of the term holder, a specified term of years, or the shorter of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest. Treas. Reg. § 25.2702-3(d)(3).

The governing instrument must prohibit commutation of the interest of the holder of the qualified interest. Treas. Reg. § 25.2702-3(d)(4). The governing instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation. Treas. Reg. § 25.2702-3(d)(6).

Structuring the GRAT

The so-called two-year rolling zeroed-out GRAT has been suggested as a means of transferring substantial amounts of future appreciation to children of the grantor. Two years is the minimum term of a GRAT under the regulations because the regulations refer to an annual payment. If the amount of the annuity payment is set high enough to establish a value for the retained interest almost equal to the value of the property transferred, there will be a very small taxable gift. Under this technique, the grantor transfers any assets distributed to him or her to satisfy the annuity payment obligation of the GRAT to another two-year zeroed-out GRAT. At the end of the term, any remaining assets (presumably equal to the sum of the income from the assets and any increase in the value of the assets, less the 7520 rate) pass transfer tax-free to the remainder beneficiaries.

The two-year period avoids the dilution of high-growth years by low-growth years. However, the use of a short-term GRAT risks the possibility that Congress may eliminate the tax advantages of the GRAT prospectively. In addition, the short term GRAT does not lock in what may be a very low 7520 rate.

Using a separate GRAT for each type or class of asset will prevent the failure of some of the assets to appreciate in value from affecting those assets that do appreciate in value. If the asset in a separate GRAT becomes exhausted because the annuity payment requirement exceeds the amount of assets in the trust, the trust will simply terminate. If the asset were included as part of a trust containing other assets, the appreciation of other assets would have to be used to make the required payment.

If the transferor dies before the end of the annuity term, some or all of the assets in the GRAT will be included in the transferor's estate under I.R.C. § 2036(a) because he or she has retained the right to enjoy the income from the transferred assets. Treas. Reg. § 20.2036-1(c)(2).

Benefits of a GRAT

The benefit of a GRAT is the potential shift of value to younger beneficiaries free of transfer tax. This objective may be accomplished with minimal gift tax liability if the value of the donor's retained annuity interest is close to the value of the asset transferred to the trust. Because the retained qualified annuity interest in a GRAT may be valued as an annuity for a specified term of years, rather than as an annuity for the shorter of a term certain or the period ending upon the grantor's death, it is possible to fix the value of the donor's retained annuity interest at the same value as the value of the transferred asset (hence the zeroed-out GRAT), although many commentators suggest that there be at least a small gift element. *Walton v. Commissioner*, 115 T.C. No. 41 (2000). Treas. Reg. § 25.2702-3(e), example 5.

It is also possible to fix the value of the remainder interest for gift tax purposes with relative certainty by tying the amount of the annuity payment to a percentage of the transferred asset's value as finally determined for gift tax purposes, because any increase in value on audit would cause a corresponding increase in the amount of the annuity payment, resulting in a very small increase in the value of the remainder interest, which is the measure of the gift. Unlike a sale to a grantor trust in exchange for an installment note, there is no need to make a gift to the trust of so-called "seed money". Finally, because the requirements of a GRAT are spelled out in the Code and the regulations, there is greater certainty that the desired tax consequences will be achieved.

Disadvantages of a GRAT

If the grantor dies during the term of the GRAT, the value of some or all of the assets in the GRAT will be includible in the grantor's estate. In addition, the value of the retained interest is based on 120% of the federal mid-term rate, which in most cases will be higher than the applicable federal rate used for determining the minimum interest to be paid on the installment note in the case of an installment sale to a grantor trust to avoid any taxable gift in connection with the sale. Also, the grantor cannot allocate his or her GST tax exemption to the transfer of assets into a GRAT until his or her interest terminates. Finally, distributions from a GRAT may only be made to the holder of the annuity interest during the term of the interest, while in the case of an installment sale to a grantor trust there are no restrictions on who may receive distributions from the trust before or after the note has been satisfied, although the grantor should not be a beneficiary to avoid inclusion of the trust assets in the grantor's estate.

SELF-CANCELING INSTALLMENT NOTES (SCINS)

Generally

In some cases, the grantor may be willing to take back a SCIN in connection with a taxable sale to a younger family member or a sale to a grantor trust. Under such a note, the principal amount outstanding at the time of the grantor's death is extinguished. Because this feature will depress the value of the note, either the principal amount or the interest rate, or both, may have to be increased in order to avoid a taxable gift upon the date of the initial transfer. Furthermore, if the term of the note extends beyond the grantor's life expectancy, the transaction will be treated as a private annuity rather than an installment note. GCM 39503 (1986) 1986 IRS GCM LEXIS 42. See CCA 201330033 where the IRS held that the installment notes in a SCIN transaction should be valued based on a method that takes into account the willing-buyer willing-seller standard of I.R.C. § 25.2512-8 and should also account for the decedent's medical history on the date of the initial transfer. The income tax consequences of a SCIN were unclear before the Installment Sales Revision Act of 1980 extended installment sale treatment to contingent sales. I.R.C. § 453(j)(2); Temp. Treas. Reg. § 15A.453-1(c).

Tax Consequences

If the grantor dies before the entire principal has been paid, the remaining balance, although not includible in the grantor's estate, will be treated as a disposition by the estate for income tax purposes, resulting in recognition of any remaining gain to the estate. *Estate of Frane*, 93-2 USTC ¶ 50,386, 72 AFTR 2d ¶ 93-5067 (1993), reversing the Tax Court 98 T.C. 341 (1992), and affirming the Internal Revenue Service's position as expressed in GCM 39503 and Rev. Rul. 86-72, 1986-1 C.B. 253 Note that the Internal Revenue Service had already agreed that the balance of the note was not includible in the transferor's estate. See GCM 39503, which agreed with the holding in *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980) *acq. in result*, 1981-1 C.B. 2.

The Tax Court's position, that the gain should have been recognized by the decedent, would have resulted in a deduction to the estate of the income tax liability on the gain, while the IRS and the Eighth Circuit's position, that the gain is recognized by the estate, results in no income in respect of a decedent deduction under I.R.C. 691(c) because the balance of the note is not included in the estate. If the note had not been self-canceling at death, the balance of the gain would have been taxed either to the estate or to the recipient of the payments, since the unrecognized gain is an item of income in respect of a decedent. I.R.C. § 691(a)(4). A deduction for the estate tax attributable to the gain would be available. I.R.C. § 691(c). The recognition of gain and concomitant tax liability may expose the estate to an unexpected liquidity problem. The purchaser's basis is the full purchase price, including any cash paid as a down payment and the principal of the note, even if the grantor dies before the full amount is paid.

Planning

One of the problems with using a SCIN is valuing the property and the note. The face amount of the note, the interest rate, or both, should be increased to take into account the risk that the transferor will die before all the payments have been made. In addition to the transferor's life expectancy, the transferor's health condition should also be taken into account. Whether to increase the principal of the note or the rate of interest depends on the relative tax situations of the seller and purchaser. Interest payments may be deductible to the purchaser, but will be ordinary income to the

seller, while principal payments will not be deductible to the purchaser and will be capital gain, in most cases, to the seller. The purchaser may have larger depreciation deductions if the principal is increased.

PRIVATE ANNUITIES

Generally

In certain cases the transfer of property to a grantor trust in exchange for a private annuity may result in a significant reduction in the size of the annuitant's gross estate, with no increase in the annuitant's adjusted taxable gifts. The term "private annuity" generally refers to an annuity (a payment in cash of a sum certain at least annually) for the lifetime of the annuitant by a purchaser of the property who does not otherwise issue annuities. Although a private annuity may consist of payments for a certain period of years or over the lives of more than one annuitant, the typical private annuity is a lifetime annuity only. The principal estate tax savings in connection with a private annuity is the immediate exclusion of the value of the transferred property from the transferor's transfer tax base, subject to an increase in adjusted taxable gifts if the present value of the annuity is less than the fair market value of the transferred property. Proposed regulations require the recognition of income on any unrealized appreciation in the assets transferred in exchange for the private annuity. Prop. Treas. Reg. § 1.1001-1(j), generally effective for exchanges of property for an annuity contract after October 18, 2006.

Transfer Tax Consequences

The transfer of property in exchange for a private annuity will result in a taxable gift to the extent that the fair market value of the property exceeds the present value of the annuity. Fortunately, for purposes of determining the present value of the annuity, the valuation tables issued under the Internal Revenue Code are used. I.R.C. § 7520. Because these tables ignore the annuitant's health (unless the annuitant is terminally ill) and are based on an interest rate that may not reflect the current market interest rate under the circumstances, the annuity may be overvalued, resulting in a tax-free transfer if the annuitant dies before his or her life expectancy or the return on the transferred asset exceeds the I.R.C. § 7520 rate. This risk element is not reflected in the determination of the value of the annuity.

If the annuitant is terminally ill, the actuarial tables may not be used. Treas. Reg. § 20.7520-3(b) (3). An individual who is known to have an incurable illness or other deteriorating physical condition is terminally ill if there is at least a 50% probability that the individual will die within one year. However, if the individual survives for 18 months, the individual will be presumed to not have been terminally ill unless the contrary is established by clear and convincing evidence. Consequently, if the proposed annuitant is in poor health but is not terminally ill, the use of a private annuity may significantly reduce the annuitant's estate.

The entire value of the property exchanged for the private annuity should be excluded from the annuitant's estate and if the annuitant dies soon after the transfer, only a small number of annuity payments will have been paid. However, the IRS has been successful in having the value of the transferred property included in the annuitant's estate in the following situations:

The annuity payments are substantially the same as the income generated by the property transferred. *Greene v. United States*, 237 F.2d 848 (7th Cir. 1956); *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq*. 1973-2 C.B. 2, *aff'd* 513 F.2d 824 (9th Cir. 1975); Rev. Rul. 79-74, 1979-1 C.B. 296).

The transferee is not personally liable for the annuity payments. Rev. Rul. 68-183, 1968-1 C.B. 308).

The transferee has no possible economic means to make the annuity payments. *La Fargue v. Commissioner*, 73 T.C. 40 (1980), *rev'd*, 689 F.2d 845 (9th Cir. 1982); *Estate* of *Schwartz v. Commissioner*, 9 T.C. 229 (1947), *acq*. 1947-2 C.B. 4.

The transferor retains control over the property transferred and its disposition by the transferee. *Estate of Holland v. Commissioner*, 47 B.T.A. 807 (1942).

Planning Considerations

From the annuitant's standpoint, the purchaser should have the financial ability to make the annuity payments, particularly if the annuitant will be dependent upon the annuity payments for his or her continuing needs. If the

purchaser is a trust, it is likely that the annuitant will be treated as the grantor of a grantor trust and will be taxed on all the income in the trust. The trust assets also may be includible in the annuitant's estate under I.R.C. § 2036(a)(1) because he or she has retained an income interest in the property. In addition, I.R.C. § 2702 may apply if the transfer is to a trust. However, the right to the annuity payments should qualify as a qualified interest. Before the issuance of the proposed regulations requiring immediate recognition of gain, if the purchaser was a corporation, the Internal Revenue Service might have determined that the annuitant had sufficient security to treat the transaction as closed at the time of the transfer, causing immediate recognition of all the gain inherent in the transferred property, the same result as if the property were sold to a commercial annuity company for an annuity contract.

With respect to the type of property that should be transferred, it must be recognized that the property will not receive a step-up in basis under the Internal Revenue Code provision regarding the basis of property acquired from a decedent. I.R.C. § 1014. Instead, the purchaser obtains a basis equal to the payments made to the annuitant. Consequently, the more the purchaser pays to the annuitant, the higher the purchaser's basis will be. The advantage of an increased basis probably does not offset the disadvantages of the drain on the purchaser's cash flow and the increase in the annuitant's gross estate. Property that has an adjusted basis in excess of its fair market value should not be used for purchasing a private annuity because no loss will be recognized to the annuitant in most cases because the obligor will be a related party under I.R.C. § 267. Note the surviving spouse should consider transferring in exchange for a private annuity property that the surviving spouse has inherited from the deceased spouse, which will receive an adjusted basis equal to its fair market value under I.R.C. § 1014, thereby eliminating any taxable capital gain. The surviving spouse in a community property state should also consider transferring the surviving spouse's share of community property, because it will also receive an adjusted basis equal to its fair market value.

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