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Set It, But Don't Forget It

Practical tips to avoid the devil in the details after a transaction has closed

Perhaps it's a matter of managing expectations and responsibilities between attorneys and clients about who will have the ongoing responsibility to ensure that various technical requirements and administrative details of an estate-planning transaction will be properly handled after the transaction is implemented. We, as estate planners, are well aware that the most brilliantly structured transaction, designed to save substantial income and transfer taxes, will only be successful if the technical requirements are followed in the ongoing administration of the vehicle.

Sophisticated estate-planning structures are by no means "set it and forget it" vehicles, and the lack of proper administration can sink a transaction and result in unexpected tax and even non-tax consequences. While practitioners may not regard these administrivia as the most cutting-edge or intellectually stimulating issues, in fact they're crucial to the success of transactions. Let's look at a select few (but by no means all) of the issues of which practitioners and clients should be mindful when administering or delegating the administration of common planning techniques after a vehicle is created and funded, as well as the related consequences for failing to do so. While these issues aren't new to these techniques, it's always helpful to periodically remind ourselves of the administrative details to ensure that they don't fall through the cracks. It's also a good idea to set expectations before or at the time of the closing of the transaction as to who will be responsible for the ongoing maintenance of these vehicles once the transaction has closed and everyone has moved on to the next set of priorities on their respective to-do lists.

Grantor Retained Annuity Trusts

Grantor retained annuity trusts, or GRATs, are very popular estate-planning vehicles blessed by Internal Revenue Code Section 2702. They have the potential to transfer future appreciation out of a grantor's estate to next generation beneficiaries without imposition of gift tax by way of creating a "zeroed-out GRAT."[1] When compared to a sale to an intentionally defective grantor trust (IDGT), discussed later, the GRAT is often regarded as a "safer" or "more conservative" vehicle because it's statutorily blessed by the IRC. Nonetheless, there are certain technical requirements associated with a GRAT that, if violated, will result in a much harsher, statutorily mandated deemed gift by the grantor of his entire contribution of the assets to the GRAT from inception. Due to the depth of the mandatory downfall if any of a GRAT's technical requirements are violated, in some respects a GRAT may be an even riskier transaction than an IDGT if there's not proper oversight of the transaction following creation.

For instance, with a GRAT, the trustee has a grace period of 105 days to make the required annuity payment to the grantor.[2] If the trustee doesn't make the payment within this period, however, the GRAT will violate IRC Section 2702 and will have failed from day one, which will result retroactively in the initial transfer into the GRAT being a taxable gift with no reduction for the value of the grantor's retained annuity interest. In addition, once created, a GRAT must also prohibit additional contributions to it.[3] Thus, if the grantor inadvertently makes a subsequent contribution to a GRAT, the GRAT would fail from inception. While these traps seem easy enough to avoid, it's


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possible to inadvertently violate this rule. For example, if a grantor exercises a swap power, contributing cash to the GRAT in exchange for existing hard-to-value assets, and those assets are later determined to have a lower value than the value used in making the swap, the swap could constitute an additional contribution, thus making the GRAT fail from inception and causing a deemed gift of the initial GRAT contribution. Conversely, the regulations also prohibit a commutation of a grantor's annuity interest in a GRAT.[4] In the same swap scenario, if the grantor swapped assets into the GRAT that were ultimately determined to be valued at less than assumed at the time of the swap, the swap could constitute a commutation, which would also make the GRAT fail. Furthermore, a GRAT's annuity payment may not increase by more than 120 percent of the prior year's annuity.[5] And finally, the GRAT regulations prohibit the GRAT from issuing a promissory note to the grantor in satisfaction of its annuity payment.[6]

A violation of any of these provisions will cause the GRAT to have failed from inception, resulting in a taxable gift of the entire GRAT contribution. Thus, for example, if a grantor created a 10-year GRAT with a contribution of $2 million in year one and in year five, any of these provisions are violated, the violation will cause the grantor's $2 million gift to the GRAT to be entirely subject to gift tax as of the date of creation, and the retained annuity interest by the grantor will be valued at zero retroactively. In other words, what was intended to be a gift tax-free contribution into a "zeroed-out GRAT" would instead be fully subject to gift tax at creation.

Also, at the end of the GRAT term, to the extent that the GRAT was designed to pay out into an ongoing trust for the benefit of children as a generation-skipping transfer (GST) trust under the GST tax automatic allocation rules, it's important to consider whether to make a proper election out of GST automatic allocation on a timely filed gift tax return.[7] If the value of the GRAT's assets have increased dramatically by the time the GRAT annuity term terminates and if the value of the GRAT's assets exceed the value of the grantor's remaining GST tax exemption at that time, failure to elect out of the automatic allocation rules could result in the ongoing trust having a mixed inclusion ratio between zero and one, which isn't ideal. For GRATs terminating in 2011 or 2012, the increased GST tax exemption may, however, provide an opportunity for some GRATs to be made GST tax-exempt, if the value of the GRAT at the end of the estate tax inclusion period is less than the grantor's then-available GST tax exemption.

While there are other examples of unintended results that can occur due to the lack of administration of a GRAT, the critical point is that these aren't vehicles that can just be established and then garaged; rather, proper ongoing administration is critical to the success of these techniques.

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It should be noted that the House and Senate have introduced or passed several proposals that would add restrictions to the GRAT planning vehicle. Current proposed restrictions include a minimum 10-year term, that the annuity payment can't be reduced from one year to the next and that the remainder interest at the time of transfer has "a value greater than zero." If the grantor dies during the trust term, the trust assets will be included in the grantor's estate; the imposition of a minimum 10-year term increases this risk. A requirement that the remainder interest at the time of transfer have "a value greater than zero" would force some portion of the assets transferred to the GRAT to be subject to gift tax at the time of the GRAT's creation.[8]

QPRTs

Qualified personal residence trusts (QPRTs) are also statutorily blessed vehicles under IRC Section 2702, and they can provide for the efficient transfer of a personal residence out of one's taxable estate, particularly in environments in which interest rates are high or real estate values are depressed. However, practitioners should pay attention to certain pitfalls associated with these vehicles. A QPRT must prohibit the trust from selling or transferring the residence to the grantor, the grantor's spouse or a controlled entity.[9] Any attempted sale will cause the QPRT to fail and will cause the gift of the residence into the QPRT from inception to be a fully taxable gift, with the grantor's retained term interest being valued at zero for gift tax purposes.

Furthermore, if the trust ceases to be a QPRT, the trust instrument must require the trust's assets to be distributed to the term holder or be converted into a GRAT.[10]

In addition, after the QPRT term expires, if the grantor and the children or an ongoing trust for their benefit decides to enter into a lease for the grantor to rent the residence, it's imperative that a lease agreement be negotiated imposing rent on a fair market value (FMV) basis and that the grantor actually make rental payments to the new owner of the residence on a timely basis. And, to the extent that the remainder beneficiaries of the residence trust are individuals or non-grantor trusts, any rental payments made by the grantor should be reported on the remainder beneficiary's income tax return consistent with the lease. Failure to properly negotiate and respect the formalities of a lease agreement may give rise to an Internal Revenue Service argument that the grantor's transfer of the property into the QPRT initially was subject to a retained interest, thus causing inclusion of the assets in the gross estate under IRC Section 2036(a)(1).[11]

As discussed with respect to GRATs, the same GST tax automatic allocation issue exists upon the termination of a QPRT term and the termination of an estate tax inclusion period, so it's important to be mindful of these implications.

Sales to IDGTs

Sales to IDGTs have become popular over the past several years as an alternative to the GRAT technique. The pros and cons distinguishing the two transactions are beyond the scope of this article. However, it's worth noting that IDGTs aren't statutorily blessed under the IRC and, therefore, aren't subject to the strict 20 percent increase ceiling that applies to a GRAT annuity, nor are they subject to the other strict prohibitions discussed above. In addition, IDGTs are generally thought to be transactions to which GST tax allocation may be made by the grantor at inception, thus enabling the grantor to transfer assets by gift or by sale into a trust that can grow on a GST tax-exempt basis. Poor administration of an IDGT can result in the IRS raising certain gift and/or estate tax issues, which too can result in negative tax consequences. But unlike with a GRAT, these consequences aren't statutorily mandated.

There are, however, some pressure point issues to consider when administering an IDGT transaction. When a grantor has sold assets to an IDGT in exchange for a valid promissory note that reflects full and adequate consideration, no taxable gift should result. Of course, the promissory note that the grantor receives will still be fully included in the grantor's taxable estate as an asset, but the assets sold and future appreciation thereon should be excluded from the estate. Critical to the transaction and resulting absence of gift tax due, is that the note issued by the IDGT to the grantor must be a valid debt and treated as such and the sale must be for FMV. Perhaps the most important factor as to the validity of the debt is whether the parties intended at the time of its creation to recognize it as a true debt obligation based upon the facts and circumstances surrounding the issuance of the note, as well as the subsequent actions of the parties. Were the terms of the note reasonable and was adequate interest imposed? Did the trust make payments to the grantor on a timely basis as required under the note? Were interest payments properly reported for income tax purposes (assuming a non-grantor trust)? In the case of a late payment or non-payment, did the grantor take legal steps to demand and enforce payment of the note? Were notice provisions included in the note complied with?

While there's no clear rule as to whether the IRS will respect the note as a valid debt, it has raised various arguments in the past that practitioners should consider. First, if there's a poor record of the parties complying with the note's payment terms, the IRS could argue that under traditional gift tax principles, the note issued by the trust to the parent was illusory and therefore the parent made the entire sale transaction for no consideration. Essentially, the argument would be that the parties never truly intended from inception for the borrower to pay the debt and the lender to enforce payment. Second, the IRS could argue that the note should be recharacterized as disguised equity in the entity being sold. For example, if a grantor sold limited partnership (LP) interests to an IDGT, the IRS could argue that the note the grantor received from the trust wasn't a valid debt, but rather was a form of disguised preferred equity in the LP and, as such, would be ascribed a value of zero for gift tax purposes under the "subtraction method" of valuation under IRC Section 2701. The result, the IRS could argue, is that the recharacterized note the grantor received would be valued at zero for gift tax purposes, and, consequently, the LP interests that the grantor sold to the IDGT weren't transferred for valid consideration and would be a taxable gift.

Alternatively, the IRS could argue that the transfer of the LP interests to the IDGT in exchange for the note constituted a transfer into a trust with a retained interest and that, because the note wouldn't satisfy the requirements of a "qualified interest" under IRC Section 2702, the retained interest would be valued at zero for gift tax purposes and the transfer of the LP interests to the IDGT would be fully subject to gift tax.[12]

In the context of an IDGT transaction, these details are critical, as the success of the transaction not resulting in gift tax on the sale is based upon the assumption that the note is respected as a debt. If the transaction is poorly administered so that the note is considered to be invalid or recharacterized, then the transaction is significantly compromised.

There are also valuation issues that can have gift tax consequences in an IDGT sale, which are outside the scope of this article.

LPs

In the LP arena, there are a number of "bad fact" cases and "good fact" cases that have provided significant guidance to practitioners as to factors that can make or break LPs for estate and gift tax purposes. While the IRS has raised numerous arguments in challenging partnership transactions, IRC Section 2036 has, of course, been the IRS' strongest argument to date. When a parent's initial contribution of assets into an LP has been determined to constitute a transfer with a retained interest (whether express or implied), the transferred assets are fully included in the parent's gross estate under IRC Section 2036(a)(1), despite the fact that the parent may have transferred partnership interests out of his estate during his lifetime for state property law purposes. While the courts have considered a number of factors over the years in evaluating the merits of an LP, it's clear that properly administering a partnership and respecting the formalities of the partnership arrangement after it's formed are essential.

While not a comprehensive list, some practical tips to consider in the post-formation administration of a partnership are:

- Make sure that legitimate non-tax reasons existed for the formation of the partnership in the first place, and operate the partnership business consistent with these reasons.

- Make sure that assets contributed into the partnership have been properly retitled in the name of the partnership.

- Make sure that a partnership account is properly established and funded and that partnership revenues are properly distributed into the account (rather than directly to the individual partners).

- Make sure that partnership distributions are made on a pro rata basis to all partners if the partnership agreement requires it.

- Don't allow any partner direct access to partnership assets.

- Don't allow a partner's personal assets to be commingled with partnership assets.

- Have partnership management actively engage in investment decisions with respect to the deployment of the partnership's assets.

- Regularly review investment performance and make investment decisions.

- Follow the specific formalities required in the partnership agreement. For example, if required under the partnership agreement, management should provide annual reports to partners within the required time frame.

- Prepare a list of the various administrative tasks required under the partnership agreement and follow it.

- Comply with any notice or consent provisions with respect to any transfers of partnership interests or partnership meetings.

This list represents some (but by no means all) of the more notable factors that the Tax Court and other courts have considered over the years in determining whether entity assets should be included in a decedent's estate under IRC Section 2036(a)(1). While there are no guarantees, strict adherence to the formalities of the partnership entity after its formation can only strengthen the merits of the structure.

Buy-Sell Agreements

While buy-sell agreements are intended to provide for certainty as to how a shareholder's or partner's interest in an entity will be disposed of and valued in the event of death (or other events), they can cause unanticipated tax and non-tax consequences if the agreements aren't properly structured and kept current. A buy-sell agreement is, in its basic form, an agreement between two or more owners of an entity that will govern how shares are disposed of in the event of certain triggering events, such as death, disability or withdrawal. Unfortunately, when a stockholder or partner dies, the decedent's estate and the surviving owner are often surprised to learn that the buy-sell agreement in effect provides for a disposition of the deceased's shares in a manner that was unanticipated and often inadequate. The results can sometimes be disastrous from both an economic and an estate tax standpoint.

An outdated buy-sell agreement may inadvertently provide a windfall to one or the other of the surviving partners and/or the estate, and very often the buy-sell agreement can provide for an unsatisfactory result to all parties. At minimum, a buy-sell agreement should establish certainty as to exactly what will happen to a party's shares or equity interests at death and should provide a clear means to determine the valuation of those interests and a funding mechanism for any buy-out to occur. Often, a buy-sell agreement is negotiated and a valuation and funding mechanism (for example, life insurance) is set based upon the circumstances and values existing at that time, and then the parties file away the agreement and move on with their business activities. As time goes by, however, and the circumstances, value of the company and buy-out funding requirements change, unless the buy-sell agreement is properly kept up-to-date, dramatic unanticipated results can occur if a partner dies.

Practitioners can achieve certainty from a tax and non-tax perspective by periodically reviewing the buy-sell agreement and ensuring that it's consistent with the parties' intent and that funding mechanisms are sufficient and properly structured. The agreement should consistently apply the terms to all of the parties and each party should have separate representation to ensure a fair negotiation before a triggering event occurs. TE

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Endnotes

1. Internal Revenue Code Section 2702(a)(2)(A).
2. Treasury Regulations Section 25.2702-3(b)(4).
3. Treas. Regs. Section 25.2702-3(b)(5).
4. Treas. Regs. Section 25.2702-3(d)(5).
5. Treas. Regs. Section 25.2702-3(b)(1)(ii)(B).
6. Treas. Regs. Section 25.2702-3(d)(6).
7. Treas. Regs. Section 26.2632-1(b)(2)(iii)(A).
8. The most recent proposal is included in Senate Bill 1286, which, if enacted, would apply to transfers made after Dec. 31, 2010.
9. Treas. Regs. Section 25.2702-5(c)(9).
10. Treas. Regs. Section 25-2702 5(c)(8).
11. *See generally Estate of Riese*, T.C. Memo. 2011-60.
12. *See generally* Jerome A. Deener, "After *Karmazin*," *Trusts & Estates* (October 2006) at p. 18.