ESTATES, TRUSTS, & GIFTS

Considerations and Consequences of Disclosing Non-Gift Transfers

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The purpose of the statute of limitations is to provide certainty to both taxpayers and the IRS. The interrelated nature of the gift and estate tax regimes, however, as well as special provisions affecting transfers by gift, will require practitioners to pay close attention to what may be disclosed on a Form 709, and how. For certain planning techniques, it may be that certainty cannot be achieved at all.

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Estate tax planning strategies frequently involve transactions not intended to produce taxable gifts. Examples include zero-gift grantor retained annuity trusts (GRATs) [1] and sales to trusts for descendants. Before entering into such transactions, taxpayers should consider all the ways in which they could (if challenged) be subject to gift or estate tax.

Surprising as it may seem, the IRS can take as many as four bites at the gift and estate tax apple. The Service potentially can argue that:

(1) The transaction is a taxable gift,

(2) The transaction is a prior gift that increases the amount of gift tax due in later years,

(3) The transaction is a prior gift that increases the amount of estate tax due at death, and/or

(4) The property transferred in the transaction is includable in the taxpayer's gross estate.

To advise their clients properly, planners must take into account all four possible avenues of attack.

Fortunately, Congress and the IRS have fashioned rules, briefly summarized below, that enable taxpayers to achieve at least some degree of repose. Although primarily intended to prevent gifts in prior years from being revalued, it seems that these "finality" rules also apply to zero-gift transfers. [2] For example, if a zero-gift GRAT is adequately disclosed on a gift tax return and the gift tax assessment period lapses, the IRS will be precluded in future years from taking the position that the GRAT could not have produced a gift of zero.

At the same time, the full implications of the finality rules are not always obvious. This article discusses in detail what taxpayers may or may not hope to accomplish by disclosing on their gift tax returns any zero-gift GRATs, sales to completed-gift trusts, or sales to incomplete-gift trusts. As we shall see, the planning implications of disclosure are sometimes surprising.

THE GIFT AND ESTATE TAX FINALITY RULES

In general, Section 6501(a) gives the IRS three years from the time a gift tax return is filed to assess gift tax. If a transfer made after 1996 is not adequately disclosed on a gift tax return (or a statement attached to a return), however, then gift tax may be assessed at any time. [3] The Regulations define detailed "safe harbor" disclosure tests that, if satisfied, will cause a transfer by gift [4] or a transfer reported in its entirety as not constituting a gift [5] to be considered to have been adequately disclosed. [6] Even if a post-1996 transfer is adequately disclosed, other exceptions to the general three-year rule may still apply. [7]

Meanwhile, the amount of gift tax due for a particular calendar year is based not just on the amount of gifts made during the year but also on the amount of gifts made in prior years. [8] Similarly, the calculation of estate tax is

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based in part on the value of a decedent's lifetime gifts. [9]

Given how the estate and gift taxes are calculated, the IRS can in some instances (e.g., if a gift was not adequately disclosed) reexamine prior year transfers throughout a taxpayer's lifetime and/or at death, even if they were reported many years earlier. [10] Fortunately, however, Congress has provided that, once the gift tax assessment period for a gift made after 8/5/97 has lapsed, [11] the finally determined value [12] of the gift also is the value that must be used for purposes of calculating both gift tax in future years [13] and estate tax at death. [14] Thus, notwithstanding the cumulative nature of the gift and estate taxes, it is possible, through adequate disclosure, to achieve complete repose as to value of one's lifetime gifts.

In addition, it seems that taxpayers can achieve complete repose as to whether a zero-gift transfer produces a gift at all. Sections 2504(c) and 2001(f) provide, respectively, that the value of any "transfer of property by gift" as finally determined for gift tax purposes also is the value that must be used to calculate gift tax in future years and estate tax at death. The Regulations interpret the phrase "transfer of property by gift" to include zero-gift transfers, such as a sale to descendants for full and adequate consideration. [15] Thus, even though a zero-gift transfer is not reported as a gift, the IRS still can be precluded from arguing in future years or at death that a gift occurred, provided that the transfer is adequately disclosed and the gift tax assessment period lapses. As we shall see, however, the finality rules cannot be invoked to eliminate all risks associated with zero-gift transfers.

INSTALLMENT SALES TO COMPLETED-GIFT TRUSTS

One popular zero-gift transaction that a taxpayer might wish to disclose on a gift tax return is a sale of property to descendants or to a trust created for their benefit. Such sales have several estate tax planning advantages:

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(1) If the grantor receives as consideration cash or other property (including, it seems, a secured

promissory note for the face value of the property [16]) having an FMV equal to the value of the property sold, the sale will not be treated as a taxable gift. [17]

(2) To the extent returns on the transferred property exceed the returns on the consideration received, the excess passes to descendants free of gift and estate tax. For example, if the taxpayer receives a promissory note in exchange for the transferred property, it seems that the returns earned by the taxpayer can be set as low as the applicable federal rate prescribed under Section 7872(f)(2). [18]

(3) If a sale is made to a trust that is structured as a "grantor trust" for income tax purposes, [19] the sale will not result in any gain recognition. [20]

(4) If the trust is made effectively exempt from GST tax through the allocation of GST exemption, returns earned by the trust can pass free not only of gift or estate tax but GST tax as well.

Gift Tax Risk

In contrast, a sale of property with donative intent often entails gift tax risk. There are generally two such risks. [21]

The first risk pertains to valuation: If the taxpayer receives as consideration cash or other property whose FMV is less than that of the property transferred, he or she may be subject to gift tax on the amount of the excess. [22] As the value of property is a question of fact that often depends on a number of factors, [23] it can be difficult to predict whether a sale will be treated in part as a gift, especially if the transferred property is sold at a valuation discount.

The second gift tax risk is that the form of the sale will not be respected. If property is transferred in exchange for a promissory note (or other form of deferred consideration, such as an annuity), the IRS may take the position that the note should be treated as a retained interest in the transferred property. [24] The consideration received by the taxpayer (once recharacterized as a retained interest) could then be valued at zero under the special valuation rules of Sections 2701 or 2702. [25] The taxpayer would then be treated as having made a gift of the entire value of the property sold, with no reduction for the value of the promissory note. [26]

These two risks will remain open indefinitely so long as the limitations period for assessment of gift tax has not lapsed. As discussed at the beginning of this article, under Reg. 301.6501(c)-1(f)(5) the limitations period does not begin to run until a transfer is adequately disclosed on a gift tax return. To achieve adequate disclosure, the taxpayer should attach a statement describing the property sold, the consideration received, the identity of the transferee, the relationship between the taxpayer and the transferee, and, if the sale was to a trust, the terms of the trust. [27] The statement also should provide the trust's taxpayer identification number. [28] Finally, the statement should explain why the sale was not a transfer by gift. [29]

An explanation along the following lines would appear to suffice: "The transfer of the property sold by the taxpayer to the purchaser is not a transfer by gift under Chapter 12 of the Internal Revenue Code because the value of the property transferred was equal at the time of sale to the value in money or money's worth of the consideration received by the taxpayer." If a statement attached to a gift tax return contains all of the

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foregoing, then the IRS would generally only have three years from the time of filing to assess gift tax.

After the gift tax assessment period for a zero-gift sale has expired, it seems that it may not be treated as a prior gift when calculating gift or estate tax in later years. As discussed above, the value of a prior transfer of property by gift, if the gift tax assessment period has run, is its "finally determined" value for the year of the transfer. [30] Under the Regulations, "transfer of property by gift" includes zero-gift sales. [31] Thus, if a sale is adequately disclosed on a gift tax return and the gift tax assessment period has lapsed, it seems that the Service may not treat the sale as a prior gift for later gift or estate tax calculation purposes.

On the other hand, it seems that adequate disclosure cannot eliminate altogether the risk that the form of the sale will not be respected. In particular, it appears that property sold by a decedent can in some cases be included in the gross estate even if the sale has been finally determined not to have produced a gift. As discussed below, notwithstanding the lapse of the gift tax assessment period, the IRS could argue at death that the property is included in the taxpayer's gross estate under Section 2036(a)(1).

That section provides that the decedent's gross estate includes all property, to the extent of any interest therein, in which the decedent at any time made a transfer and retained for life, or for a period not in fact ending before death (or a period not ascertainable without reference to the decedent's death), the right to the income, use, possession, or enjoyment of the transferred property. [32] If Section 2036(a)(1) applies to a sale, such that the sale is deemed to be a "transfer" and the right to the payment of a deferred purchase price is deemed to be a "right to income," then part or all of the sold property may be included in the transferor's gross estate at death, [33] provided that the deferred purchase price is not fully repaid. Such a result would in many cases defeat the estate tax benefits of the sale. [34]

It might seem that the IRS should not be allowed to include property sold during lifetime in a decedent's gross estate under Section 2036(a)(1) if the Service already has allowed the gift tax assessment period with respect to the sale to lapse. After all, if the sale really was a transfer subject to a retained interest, then the special valuation rules of Chapter 14 normally would have caused the consideration to have been valued at zero. [35] If the consideration had been valued at zero, then the sale would have produced a taxable gift during the decedent's lifetime equal to the full value of the property sold. [36] As the sale was instead finally determined not to have produced a gift, Sections 2701 and 2702 could not have applied. But if those sections did not apply, then the sale was not a transfer with a retained interest. In other words, to compress that logic, any attempt by the IRS to include property sold by a decedent in his or her gross estate under Section 2036(a)(1) is inconsistent with a final gift tax determination that the sale was not a gift.

Nevertheless, it appears that the IRS *can* have it both ways. That is, the Service may take the same position for purposes of Section 2036(a)(1)-namely, that a sale was really a transfer with a retained interest-that it failed timely to pursue under Sections 2701 or 2702. For one thing, Section 2036(a)(1) is an estate tax section, whereas Sections 2701 and 2702 are gift tax valuation sections. Although estate and gift tax provisions should be construed "in pari materia," [37] there is no guarantee that the principles for determining whether Sections 2701 or 2702 apply to a purported sale are identical to the principles for determining whether Section 2036(a)(1) applies.

More important, just because a statute of limitations bars the IRS from challenging a reported position does not mean that the Service may not challenge the same position when it is reported in a later period or by a different taxpayer. The Supreme Court has held that "statutes of limitation ... must receive a strict construction in favor of the government." [38] Not surprisingly, therefore, the cases are legion where the IRS has been permitted to re-raise arguments that had been barred for other periods [39] or with respect to other taxpayers. [40]

Whether an item transferred during lifetime is later includable in a decedent's gross estate concerns not only a different taxpayer than the donor (namely, the donor's estate) but a whole new tax (namely, the estate tax, as opposed to the gift tax). Under the rule that statutes of limitations are to be construed in the government's favor, therefore, the lapse of a gift tax assessment period should not, absent a provision to the contrary, bar the IRS from raising

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gross estate inclusion arguments at death.

Section 2001(f) does not appear to afford any relief. Prior to the enactment of that section, courts had cited the rule of strict construction for the proposition that Section 2504(c) did not prevent the IRS from revaluing a decedent's lifetime gifts at death, even when the period for assessment of gift tax had expired. [41] Section 2001(f) now provides on the contrary that the IRS may not adjust lifetime gifts whose values have been finally determined. The holding of earlier cases that Section 2504(c) must be construed in the government's favor, however, remains undisturbed. In other words, while Section 2001(f) has overturned the *result* of earlier cases that refused to incorporate Section 2504(c) into the estate tax, those cases remain good law on the section's proper interpretation. [42]

By the same token, Section 2001(f), the estate tax sister of Section 2504(c), must be strictly construed as well. Indeed, applying the rule of strict construction, courts have held that the lapse of a gift tax assessment period is irrelevant to determining the size of a decedent's taxable estate. [43] While Section 2001(f) precludes the IRS from adjusting the value of a lifetime transfer after the gift tax assessment period has lapsed, it does not on its face prevent the Service from including the transferred property in the donor's gross estate at death. Just as it took TRA '97, which added Section 2001(f), to prevent the IRS from adjusting the value of lifetime taxable gifts, it also would seem to require legislation to prevent the Service from asserting that property transferred during lifetime is includable in the transferor's gross estate. In the meantime, that the IRS did not treat a sale as a transfer with a retained interest during a decedent's lifetime does not mean that the IRS may not so treat the sale at death for purposes of Section 2036(a)(1).

Nevertheless, one provision in the Regulations *does* preclude the Service from raising certain gross estate inclusion arguments after the gift tax assessment period has lapsed. Under Reg. 301.6501(c)-1(f)(5), a transfer reported as a completed gift, if the period for assessment of gift tax has expired, "will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included," even if the transfer should have been reported as an incomplete gift. The Regulation alludes to the fact that property transferred by gift, even though already subject to gift tax, may in some instances still be included in the donor's gross estate.

For example, a completed gift is includable in a donor's gross estate if (1) the donor retained the right to income for life, [44] (2) the donor retained a power to affect the timing of the enjoyment of the gift, [45] (3) the donor retained the power, in conjunction with an adverse party, to revoke the gift, [46] or (4) the donor did not retain any power to change beneficial enjoyment of the gift but happened to hold such a power at death. [47]

Conversely, if a transfer remains incomplete for gift tax purposes, there is no escape from estate tax at death, as the transferred property will be included in the donor's gross estate under Sections 2033, 2038, and/or 2036(a). [48] If a transfer of property has been finally determined to have been a completed gift, Reg.

301.6501(c)-1(f)(5) bars arguments for gross estate inclusion that would only succeed if the transfer had been incompletely transferred for gift tax purposes. [49]

Reg. 301.6501(c)-1(f)(5) represents a lone exception to the provisions of Sections 2033 through 2042 that otherwise cause property to be included in a decedent's gross estate. The exception applies by its terms only to the transfers that are adequately disclosed as completed gifts, not transfers reported instead as a zero gifts. The rules for adequate disclosure of zero gifts are instead set forth in Reg. 301.6501(c)-1(f)(4), which says nothing about the whether the lapse of a statute of

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limitations has any effect on the determination of a decedent's gross estate. Even apart from the rule of strict construction, therefore, it seems that, by negative implication, a taxpayer cannot, through adequate disclosure, prevent property sold in a zero-gift transfer from being included in the gross estate.

In any event, the rule of strict construction should prevent Reg. 301.6501(c)-1(f)(5) from being interpreted broadly enough so as to bar Section 2036(a)(1) from applying at death to a sale. As the sale would have been reported, if at all, as a zero-gift transfer rather than a completed gift, [50] it appears that Reg. 301.6501(c)-1(f)(5) could not be interpreted so as to preclude gross estate inclusion arguments otherwise available to the IRS. Indeed, that Reg. 301.6501(c)-1(f)(5) was published at all suggests that there is a background general principle that the lapse of a gift tax assessment period has no effect on whether transferred property can be included in the transferor's gross estate. [51] In sum, a taxpayer should not assume that by adequately disclosing a sale of property on a gift tax return, he or she potentially can prevent the property from later being included in the gross estate at death.

The conclusion that adequate disclosure does not eliminate the risk of gross estate inclusion somewhat undercuts the conventional wisdom among estate tax planners as to whether zero-gift sales should be disclosed. It is sometimes said that it makes more sense for older taxpayers to disclose zero-gift sales, for the IRS will likely review such sales anyway at their deaths. Adequate disclosure at least starts the clock ticking, so that if the taxpayer survives the assessment period, the sale (many planners may assume) is no longer an issue. By contrast, when a relatively young taxpayer sells property for full and adequate consideration, the sale may never attract IRS scrutiny. Therefore, under this reasoning, only elderly taxpayers should adequately disclose sales of property to descendants, as they are the ones who have the most to gain.

This advice is sound as applied to valuation risk. On the other hand, as discussed, mere lapse of the gift tax assessment period does not prevent the Service from invoking Section 2036(a)(1) at the taxpayer's death. The risk of gross estate inclusion may be less significant for a younger taxpayer, as the purchase price may be more likely to be fully repaid prior to the taxpayer's death. [52] Older clients, by contrast, may be legitimately concerned that property transferred by sale will be included in their gross estates. As adequate disclosure cannot fully allay their concerns, older clients may not wish to disclose their sales, lest they increase the risk of audit during lifetime yet still not eliminate the gross estate inclusion risk. In any event, it is important for planners and clients to understand that adequate disclosure addresses valuation risk only. It does not bar all challenges to the structure of a sale.

INSTALLMENT SALES TO INCOMPLETE-GIFT TRUSTS

A second non-gift or zero-gift transaction that a taxpayer may wish to disclose on a gift tax return is a sale to a trust (referred to herein as an "incomplete-gift trust") in which he or she has been given a special power to appoint the trust property to persons other than the taxpayer, his or her estate, his or her creditors, or the creditors of his or her estate. [53] Such a power causes any transfer to the trust by the taxpayer to be considered to be incomplete for gift tax purposes. [54]

Normally, any property so transferred would be included in the taxpayer's gross estate under Sections 2036(a)(2) and/or 2038(a). [55] Both those sections contain an exception, however, "in case of a bona fide sale for an adequate and full consideration in money or money's worth." If property is sold for at least approximately full and adequate consideration, it will not be included in the transferor's gross estate at death, even if the property otherwise is includable under Section 2036(a) or 2038(a). [56]

Advantages. A sale to an incomplete-gift trust can have many of the same estate tax advantages as a "traditional" sale to a completed-gift trust. For example, if the property sold earns returns that exceed those

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earned on the consideration received, the excess can pass free of gift and estate tax to the beneficiaries. In addition, if the incomplete-gift trust is made effectively exempt from GST tax through the allocation of GST exemption, the property sold can pass free of GST tax as well. (GST exemption can be allocated only if the trust was created by a taxpayer other than the donee of the special power.) Finally, if the trust is treated as "owned" for income tax purposes by the taxpayer, the sale does not result in any recognition of gain. [57]

Normally, only the grantor can be treated as the owner of trust property for income tax purposes. [58]

Nevertheless, even if an incomplete-gift trust was not created by the taxpayer, it seems possible to structure the trust so that it is treated as owned by him or her for income tax purposes. [59]

A sale to an incomplete-gift trust also has unique advantages. First, as any transfer by the taxpayer would be incomplete for gift tax purposes, there is no gift tax risk if the value of the property transferred exceeds the value of the consideration received. Second, the taxpayer, if a beneficiary of the trust, can retain unlimited access to the property sold without risk of gross estate inclusion, provided that the sale was for full and adequate consideration in money or money's worth. [60]

Finally, if the trust is funded initially by a third party, the trust property may be protected against the claims of the taxpayer's creditors. [61] (An additional benefit if an incomplete-gift trust is created by a third party is that the taxpayer's executors can take the position that no part of the trust, not even the property with which the trust was initially funded, is included in the taxpayer's gross estate. [62]) For these reasons, some planners now view a sale to an incomplete-gift trust of which the taxpayer is the beneficiary yet also the owner for income tax purposes as a nearly ideal estate tax planning strategy.

Estate tax risks. A sale to an incomplete-gift trust poses a greater estate tax risk, however. As discussed, unless the property is transferred to an incomplete-gift trust in a bona fide sale for at least approximately full and adequate consideration, [63] it will be included in the transferor's gross estate under Sections 2036(a)(2) and/or 2038(a). [64] In addition, the consideration received by the transferor also will be included under Section 2033. In other words, potentially both the consideration received and the property sold can be subject to estate tax at death. As the consideration in a sale to an incomplete-gift trust automatically reduces the net value of the trust, however, it seems that, economically, there is no potential for double taxation. [65]

In light of the more salient gross estate inclusion risks posed by sales to incomplete-gift trusts, taxpayers may not wish to enter into such sales unless certainty can be achieved during lifetime that they will not result in taxation at death of both the property sold and the consideration received. Unfortunately, it does not seem possible to achieve such

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certainty during the taxpayer's lifetime. As noted, the taxpayer's special power of appointment will cause property that he or she transfers to an incomplete-gift trust to be included in the gross estate under Sections 2036(a)(2) or 2038(a), unless the transfer was made in a bona fide sale for full and adequate consideration in money or money's worth. To avoid gross estate inclusion, therefore, a taxpayer who sells property to an incomplete-gift trust must find some way to bar the IRS from arguing at the taxpayer's death that the sale was made for less than full and adequate consideration within the meaning of Sections 2036(a) and 2038(a).

It does not appear that a taxpayer can in fact compel the Service to acknowledge that the "bona fide sale" exception to Sections 2036(a) and 2038(a) applies. First, as discussed below, it is not possible to trigger the statute of limitations for assessment of gift tax. Second, even if the statute of limitations can be triggered, Section 2001(f) cannot be invoked so as to prevent the IRS from adjusting the value of property sold. Third, even if Section 2001(f) does apply to transfers to incomplete-gift trusts, the value of the property sold cannot be "finally determined" within the meaning of Section 2001(f)(2). Fourth, a final determination of the value of the property sold would not necessarily preclude gross estate inclusion under Sections 2036(a)(2) or 2038(a). Each of these four obstacles to ensuring that a sale to an incomplete-gift trust will qualify at death for the bona fide sale exception is examined below.

Obstacle 1: The Gift Tax S/L

The first obstacle hindering any attempt to bind the IRS to the position that a sale to an incomplete-gift trust was bona fide and for full and adequate consideration is that the taxpayer cannot cause the statute of limitations for assessment of gift tax to begin running.

Reg. 301.6501(a)-1(a) states in general that tax shall be assessed within three years of filing, subject to a number of "exceptions and additional rules." One such exception is found in Reg. 301.6501(c)-1(f)(1), which provides that gift tax may be assessed or collected at any time if a transfer of property is not adequately disclosed on a gift tax return. Regs. 301.6501(c)-1(f)(2) and 301.6501(c)-1(f)(4) go on to create safe harbor tests that, if satisfied, will cause completed gifts and non-gift transfers, respectively, to be considered to have been adequately disclosed. If one of the tests is met, then the "at any time" exception of Reg. 301.6501(c)-1(f)(1) does not apply.

Just because a taxpayer avoids Reg. 301.6501(c)-1(f)(1), however, does not mean that some other exception to the general three-year assessment period does not apply. For example, Reg. 301.6501(c)-1(f)(5) provides that if a transfer is reported as an incomplete gift, then the gift tax assessment period remains open indefinitely, even if the transfer is adequately disclosed. To achieve adequate disclosure of a sale to an incomplete-gift trust, it is likely the taxpayer will have to reveal (either by providing a copy of the trust instrument or a description of its terms) that he or she has been given a special power of appointment over the trust property. Although not certain, it may be that by revealing the existence of the special power of appointment, the taxpayer will be considered to have reported the sale as an incomplete gift within the meaning of Reg. 301.6501(c)-1(f)(5). If so, then the statute of limitations for assessment of gift tax will not begin to run, even if the sale has been adequately disclosed.

The taxpayer, in other words, faces a dilemma:

- The taxpayer can fail to adequately disclose a sale to an incomplete-gift trust, in which event the gift tax assessment will not begin to run pursuant to Reg. 301.6501(c)-1(f)(1).
- Alternatively, the taxpayer can adequately disclose the sale, in which event he or she will likely need to reveal the existence of the special power of appointment and thereby be deemed to have reported the sale as an incomplete gift. As a result, the gift tax assessment period would not begin to run pursuant to Reg. 301.6501(c)-1(f)(5).

In short, the taxpayer may not have the ability to report a sale to an incomplete-gift trust in any manner that will cause the statute of limitations for assessment of gift tax to begin running.

But perhaps Reg. 301.6501(c)-1(f)(5) does not apply to sales to incomplete-gift trusts. In particular, it may be that "incomplete gift" as used in that Regulation does not extend to sales for full and adequate consideration. As we have seen, however, elsewhere Regulations take the position that zero-value gifts are still in a sense transfers by gift. [66] Likewise, "incomplete gift" may be construed broadly enough to encompass incomplete gifts of zero value.

The Supreme Court has repeatedly held that an agency's interpretation of its own ambiguous regulations is controlling. [67] (Indeed, courts have been inclined not to find an ambiguity in Treasury Regulations in the first place, so long as they can be interpreted consistent with the Service's own position. [68]) To the extent that Reg. 301.6501(c)-1(f)(5) is ambiguous, therefore, the IRS remains at liberty to interpret it in its own favor. The taxpayer, in other words, does not have the power to trigger the gift tax assessment period. On the contrary, the assessment period for a sale to an incomplete-gift trust will remain open for so long as the IRS wishes.

Obstacle 2: 2001(f) Does Not Apply

The second obstacle hindering any attempt during lifetime to prevent property sold to an incomplete-gift trust from being included in a taxpayer's gross estate at death is that Section 2001(f) does not appear to apply to transfers to incomplete-gift trusts. That section provides that the value of any "transfer of property by gift," if the gift tax assessment period has run, is its finally determined value for gift tax purposes. Examples in the Section 2504(c) Regulations conclude that a transfer for full and adequate consideration, even it does not produce a gift, can still be a "transfer of property by gift." [69] Although the Regulations do not explain how a zero-gift transfer can be considered a "transfer of property by gift," it seems that, as the amount of a gift by sale is normally reduced by the value of any consideration received, a transfer for full consideration is a "transfer of property by gift" in the sense that the "gift" in question is equal to zero.

It takes an additional leap, however, to construe "transfer of property by gift" broadly enough so that it extends to transfers to incomplete-gift trusts. The value of any consideration received in exchange for a transfer to an incomplete-gift trust is irrelevant to determining whether the transfer is a gift, as the donor does not relinquish sufficient dominion and control for it to be considered a gift in the first place. While two examples in the Regulations under Sections 2001(f) and 2504(c) address zero-gift transfers, [70] there is no example which implies that a transfer to an incomplete-gift trust can qualify as a "transfer of property by gift." Given that incomplete gifts seem by definition not to constitute transfers of property by gift, Section 2001(f) apparently does not preclude the Service from adjusting the value of any lifetime transfer to an incomplete-gift trust.

Obstacle 3: The Transfer Cannot Be 'Finally Determined'

Next, even if Section 2001(f) does apply to lifetime transfers to incomplete-gift trusts, it still would not be possible during lifetime to cause the value of any such transfer to be "finally determined." The value of a gift becomes "finally determined" for purposes of Section 2001(f) if:

(1) The IRS does not contest its reported value before the assessment period has expired,

(2) The IRS redetermines the value before the assessment period has expired and the taxpayer does not timely contest the value specified by the IRS, or

(3) The value is determined by a court or pursuant to a settlement agreement with the IRS. [71]

We have already seen that the gift tax assessment period for a sale to an incomplete-gift trust does not (it appears) begin to run, even if the sale is adequately disclosed. For that reason alone, the value of property sold to an incomplete-gift trust cannot become finally determined during the taxpayer's lifetime.

Even if the gift tax assessment period did lapse, it still is unclear how the value of the property could be finally determined within the meaning of Section 2001(f). Normally, if the IRS and the taxpayer cannot agree on the value of a transfer and neither party is willing to concede, the value ultimately can be determined by a court. [72] At the same time, the Tax Court does not generally issue declaratory judgments as to value. It is unlikely, in particular, that the Tax Court would accept jurisdiction to determine the value of property transferred to an incomplete-gift trust.

In *Grynberg,* TC Memo 2000-15, RIA TC Memo ¶2000-015 , for example, the Tax Court held that certain assignments of mineral interests by the taxpayer did not constitute gifts. Having held for the taxpayer on that issue, the court refused to determine the value of taxable gifts made by the taxpayer for the years in question, as, by virtue of the unified credit, he would not have owed gift tax regardless of their value. The court acknowledged that "the correct value of the [gifts] continues to divide the parties and may be the subject of future litigation...." Nonetheless, citing an earlier case where the court had held that it lacked jurisdiction to issue an "advisory opinion," [73] the Tax Court declined to settle the dispute over valuation.

Section 7477 overturned the result of *Grynberg* by giving the Tax Court the power to make a declaration of the value of a gift shown on a gift tax return. The section creates a remedy, however, only "[i]n a case of an actual controversy involving a determination by the Secretary of the value of any gift shown" on a gift tax return. If the IRS does not make a determination that results in an actual controversy, a proceeding under Section 7477 is not available. [74]

For example, if the Service agrees (as it should) that a sale to an incomplete-gift trust cannot produce a gift, it does not appear that the taxpayer could bring a petition in Tax Court to determine the value of the property sold. [75] (On the contrary, the Section 7477 Regulations generally permit the IRS to defer consideration of the value of any transfer that does not result in any gift tax due. [76])

As Section 7477 does not overturn the broader holding of *Grynberg* and the cases cited therein that the Tax Court may not issue advisory opinions, any attempt to obtain a determination as to the value of a sale to an incomplete-gift trust would likely result in a dismissal for lack of subject matter jurisdiction.

To be sure, by issuing an advisory opinion, the Tax Court could in theory settle during a taxpayer's lifetime

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whether a sale will qualify for the bona fide sale exception of Sections 2036(a) and 2038(a) at the taxpayer's death. Section 7477, however, gives the Tax Court jurisdiction to declare the value of a gift only for gift tax purposes. It does not give the Tax Court jurisdiction to declare the value of property that might be subject to estate tax at the taxpayer's death. Once again, therefore, the Tax Court under *Grynberg* apparently would not have the power to determine that a sale to an incomplete-gift trust was made for full and adequate consideration in money or money's worth.

Read literally, Section 2001(f)(2) still provides that the value of a transfer can be finally determined if (1) the gift tax assessment lapses and the Service has not contested the reported value or (2) the taxpayer has not contested the value as determined by the IRS. Nevertheless, the concept of a "final determination" implies that a court *could* have determined the value of a gift, even if the parties ultimately agree or one party concedes. After all, if the value of a sale to an incomplete-gift trust were contested in court but the court declined jurisdiction, it is unclear whose position-the taxpayer's or the Service's-would be the finally determined value.

To avoid the absurdity of a gift tax assessment period lapsing without the value of a sale having been finally determined, it is likely that a court would hold, consistent with Reg. 301.6501(c)-1(f)(5), that the gift tax assessment period with respect to a sale to an incomplete-gift trust never begins running in the first place. Obstacle 1 and Obstacle 3, in other words, are mutually reinforcing: As no court even has the power to "finally determine" the value of a sale to an incomplete-gift trust, the gift tax assessment period should not be considered to have run.

Obstacle 4: 2001(f) Does Not Bar Gross Estate Inclusion

The final reason that a taxpayer cannot be certain that property sold to an incomplete-gift trust will not be included in the gross estate is that Section 2001(f) merely affects the value of lifetime gifts. It does not preclude the IRS from arguing that property transferred during lifetime is includable in a decedent's gross estate. As we already have seen in the context of a sale to a completed-gift trust, Section 2001(f), just like Section 2504(c), must be construed in the government's favor. As Section 2001(f) does not on its face preclude the IRS from raising gross estate inclusion arguments at death, it is unlikely that a court will construe it so expansively as to prevent the Service from including in a decedent's gross estate property transferred during lifetime. [77]

Indeed, the argument for barring gross estate inclusion based on Section 2001(f) is weaker with a sale to an incomplete-gift trust than with a sale to a completed-gift trust. As discussed earlier, if the IRS fails to challenge a taxpayer's position that a sale to a completed-gift trust for a deferred purchase price did not produce a gift, it implicitly concedes that the sale was bona fide and was not a transfer with a retained interest. At least a moral or equitable argument can be made in that situation that the Service should not be permitted to take a position at the taxpayer's death that it had implicitly rejected during lifetime.

In a sale to an incomplete-gift trust, by contrast, all the IRS has to do, in order to decide not to challenge the taxpayer's reported position that the sale does not produce a gift, is to conclude that the transfer is incomplete for gift tax purposes. The Service even may conclude, correctly, that any excess value (plus appreciation) would be included in the taxpayer's gross estate at death anyway. As the IRS need not determine during the taxpayer's lifetime whether a sale to an incomplete-gift trust was for full and adequate consideration, there is no reason to think that the Service should not be able to challenge the taxpayer's valuation position at death.

In sum, a taxpayer who sells property to an incomplete-gift trust runs the risk that both the property sold and the consideration received will be included in the gross estate. It does not appear that it is possible, through adequate disclosure, to compel the IRS to recognize that the sale qualifies for the bona fide sale exception to inclusion under Sections 2036(a)(2) and 2038(a). Therefore, there does not appear to be any advantage to disclosing a sale to an incomplete-gift trust on a gift tax return. Taxpayers who enter into such a sale should be advised that the property sold may be subject to estate tax, no matter how the sale is reported during lifetime.

ZERO-GIFT GRATs

A final example of a zero-gift transfer that a taxpayer may wish to disclose on a gift tax return is the creation of a zero-gift GRAT.

In general, a GRAT is a trust in which the grantor retains a right to the payment of an annuity for a term of years. If the remainder is payable to or for the benefit of members of the grantor's family but the interest retained by the grantor is a "qualified interest" within the meaning of Section 2702(b), then the value of the grantor's taxable gift is calculated by subtracting the value of the retained annuity [78] from the total value of the property transferred. [79] To the extent

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that the property of the GRAT earns returns greater than necessary to pay the annuity to the grantor, wealth passes to the remainder beneficiaries free of gift or estate tax, provided that the grantor survives the fixed term.

A 2005 amendment to the Section 2702 Regulations provides that amounts payable from a GRAT to the grantor's estate (if the grantor does not survive the fixed term) still can be "qualified interests" that reduce the value of the grantor's initial taxable gift. [80] The ability to treat annuity payments to the grantor's estate as qualified interests makes it mathematically possible for the grantor's retained interest to be set equal in value to the total property transferred to the GRAT.

For example, a grantor may transfer $5 million to a GRAT and retain the right to an annuity for a term of years (payable to the grantor or the grantor's estate) having a present value at the time of transfer of $5 million. The value of the grantor's taxable gift in that case would be zero, provided that the grantor's retained interest is indeed a qualified interest.

It is unclear, however, to what extent the IRS will treat the grantor's retained annuity interest in a zero-gift GRAT as a qualified interest. In the Preamble to the final Regulations under Chapter 14, the IRS stated that "'zeroing out' a gift while still effectively transferring the appreciation on all the property during the term to the remainder beneficiary ... would be inconsistent with the principles of section 2702." [81]

Later, in TAM 200245053, the IRS stated that a grantor could not define the retained annuity interest by means of a formula that would automatically "zero out" a GRAT. (The Service ordinarily will not rule, meanwhile, on whether an interest is a qualified interest if the value of the remainder is any less than 10% of the value of the property transferred. [82]) Although the IRS has not given any examples of the kind of clause it would reject, it seems, under the Service's position, that a GRAT instrument could not define the amount payable to the grantor as "the smallest percentage of the initial fair market value transferred to the trust such that the value of the remainder as finally determined for gift tax purposes is zero." [83]

Consequently, some highly cautious planners recommend against fully zeroing out a GRAT. [84] As an alternative, they may advise their clients to create nearly zeroed-out GRATs that produce very small taxable gifts. If a taxpayer creates a nearly zeroed-out GRAT, he or she either will use up a small amount of the applicable exclusion amount or, if the applicable exclusion already has been used up, pay a small amount of gift tax. Either consequence seems like a small price to pay to avoid an IRS challenge to a fully zeroed-out GRAT, however unlikely it may be that the challenge would succeed.

Nevertheless, while there is little gift tax cost to creating a nearly zeroed-out GRAT, a nearly zeroed-out GRAT is normally not an effective GST tax strategy. A nearly zeroed-out GRAT results in a small taxable gift by the grantor, which in turn causes the grantor to be treated for GST tax purposes as the transferor of all property of the GRAT. [85] The grantor can make a GRAT effectively exempt from GST tax by allocating GST exemption. [86] But it is almost never efficient to allocate GST exemption to a GRAT, as most if not all the GRAT property will be paid to a

"non-skip" person-namely, the grantor-in the form of annuity payments. [87]

By contrast, it is possible that property transferred to a zero-gift GRAT is entirely exempt from GST tax, provided that the GRAT does not produce a taxable gift and the grantor survives the fixed term. In general, the "transferor" of property for GST tax purposes is the person who was last subject to gift or estate tax with respect to the property. [88] Whether property has been subject to gift or estate tax is determined without regard to deductions or credits. [89] No rule prevents retained interests from being taken into account. As a zero-gift GRAT does not produce a gift, even without taking deductions or credits into account, the grantor arguably is not "subject" to gift tax when creating a zero-gift GRAT. [90] And, if the grantor survives the fixed term, the grantor is not subject to estate tax with respect to a zero-gift GRAT. [91]

Thus, if the grantor survives the fixed term of a zero-gift GRAT, it may be that he or she never becomes the transferor of the GRAT property for GST tax purposes. While the IRS may resist the conclusion that a zero-gift GRAT does not have a transferor, without a gift or gross estate inclusion, it is difficult to see how a transferor can be created. [92]

Nonetheless, a zero-gift GRAT will work for GST tax purposes only if the IRS concedes that the grantor does not make a taxable gift when the GRAT is funded. As discussed, the Service seems to believe that a GRAT may not be completely "zeroed out" through the use of a formula. There are several strong reasons to believe, however, that ultimately many zero-gift GRATs will be upheld.

First, contrary, perhaps, to popular belief among estate tax professionals, the IRS does not seem to object to all forms of zero-gift GRATs. In TAM 200245053, the IRS cited *Procter,*32 AFTR 750, 142 F2d 824 (CA-4, 1944), for the proposition that the GRAT Regulations "should not be viewed as sanctioning the utilization of the formula to 'zero out' a gift." In *Procter,* the court held void as against public policy a provision that purported to return property to the donor if a court ultimately determined that the donor's transfer was subject to gift tax. TAM 200245053 apparently interprets *Procter* to mean that word formulas may not be used to zero-out a GRAT.

Not all zero-gift GRATs, however, actually use zeroing-out formulas. For example, instead of defining the annuity amounts payable to the grantor to be equal to a percentage of the property initially transferred, the GRAT instrument could define the annuity payable to the grantor as a series of fixed dollar amounts. If the value transferred to the GRAT is known in advance (for example, if the grantor expects to transfer cash or publicly traded securities [93]), then it should be possible, without relying on a word formula, to set the present value of the grantor's retained interest equal for gift tax purposes to the value of the property transferred.

In short, a distinction should be drawn between zeroed-out GRATs (which attempt to use formulas to produce a taxable gift of zero) and zero-gift GRATs (which happen to produce a taxable gift of zero but do not use formulas to achieve this result). As the Service's objections seem to apply only to GRATs that zero-out gifts through the use of formulas, it seems that the IRS would not object to a zero-gift GRAT that does not contain a zeroing-out formula.

Second, the Code and Regulations appear to compel the IRS to acknowledge the validity of at least some class of zero-gift GRATs. Section 2702(a)(2) provides valuation rules that, according to Section 2702(a)(1), are to be used "*[s]olely* for the purposes of determining whether a transfer of an interest in trust to (or for the benefit) of a member of the transferor's family is a gift (and the value of such transfer)...." (Emphasis added.) If the very purpose of the valuation rules is (in part) to determine whether transfers produce gifts, then they must, it seems, allow for the possibility that some transfers to which Section 2702 applies are *not* gifts.

Similarly, Reg. 25.2702-1(b) states that if Section 2702 applies to a transfer, then "[t]he amount of the

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gift, *if any,* is ... determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property." The words "if any" here would be superfluous if it were not possible to conclude, after applying the valuation rules of Section 2702, that the taxpayer had made no gift. As a provision must "be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant," [94] it ought to be the case that a transfer can be simultaneously subject to the valuation rules of Section 2702(a)(2) and produce a gift of zero.

The statute provides only two such rules. First, under Section 2702(a)(2)(A), if a retained interest is not a "qualified interest," its value will be treated as being zero. As a retained interest of zero cannot (as a matter of arithmetic) reduce the value of a gift, it is not possible to apply this valuation rule and conclude that the value of a gift to family members is zero. The second valuation rule is that the value of any "qualified interest" is determined under Section 7520. The only type of retained "qualified interest" that, as a mathematical matter, can produce a gift of zero is a qualified annuity interest. (It is not mathematically possible for a grantor to retain either of the other two types of qualified interests-namely, qualified unitrust interests and qualified remainder interests-and make a zero gift. [95]) Therefore, by process of elimination, it seems that the IRS has no choice but to recognize the validity of zero-gift GRATs.

Finally, the Service's hostility to even zeroed-out GRATs may no longer be tenable in light of recent case law. The IRS has unsuccessfully raised *Procter*-type objections to formula clauses in several recent cases. [96] Notably, the courts have (so far) rejected IRS arguments that formula clauses purporting to result in zero tax due are void as against public policy insofar as they remove the Service's financial incentives to audit returns. (The argument was probably never persuasive to begin with, given that, by design, the gift tax asks the IRS to examine gifts up to the applicable exclusion amount that do not result in any gift tax liability.) On the contrary, as the Eighth Circuit put it in *Estate of Christiansen,* 104 AFTR 2d 2009-7352, 586 F3d 1061

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(CA-8, 2009), "the Commissioner's role is to enforce the tax laws," not merely to maximize receipts. As a provision in a GRAT that zeroes out any possible taxable gift would indeed, if respected, inhibit tax collection, the opinion in *Christiansen* undercuts what could have been a promising line of attack on zeroed-out GRATs. [97]

Pending further developments in the law, [98] any taxpayer who creates a zero-gift or zeroed-out GRAT should consider reporting the creation of the GRAT on a gift tax return. While the GRAT cannot be reported on a gift tax return as a completed taxable gift, it seems that, by adequately disclosing the creation of a zero-gift or zeroed-out GRAT on a statement attached to a gift tax return, a taxpayer may give the IRS a limited time to challenge its validity. [99]

To achieve adequate disclosure, the statement should describe the transferred property, the identity of the transferee (in this case, the trust), the terms of the GRAT (or provide a copy of the GRAT instrument), and provide the GRAT's tax identification number. In addition, to satisfy certain special disclosure requirements that apply to transfers subject to the Chapter 14 valuation rules (including GRATs), the statement should describe the method used to arrive at a gift of zero.

Finally, the statement should provide an "explanation as to why the transfer is not a transfer by gift" for gift tax purposes. [100] The explanation why a zero-gift or zeroed-out GRAT is not a gift would seem to be as follows: "The transfer to the trust is not a taxable gift because the taxpayer retained a qualified annuity interest in the trust within the meaning of Reg. 25.2702-2(a)(7) that is equal in value to the value of the property transferred." Adequate disclosure in this manner should cause the statute of limitations for assessment to begin running. [101]

Moreover, if the assessment period lapses, it seems that a transfer to a zero-gift or zeroed-out GRAT cannot, under Sections 2503(c) or 2001(f), be treated as a prior gift. A sale for full and adequate consideration in money or money's worth is a "transfer of property by gift" within the meaning of those sections. [102] Although the Regulations under Sections 2504(c) and 2001(f) address only zero-gift sales, it appears that zero-gift transfers in trust also should be treated as "transfers of property by gift," as, in both cases, the value of the property received or retained by the grantor reduces to zero the potential gift by the grantor. Therefore, by adequately disclosing the creation of a zero-gift GRAT, an individual should be able to achieve complete finality as to whether it results in a taxable gift.

CONCLUSION

The implications of the finality rules of Sections 2504(c) and 2001(f) are not obvious and perhaps even counterintuitive. Although, by their terms, these sections apply only to "transfers of property by gift," they have been construed to apply to zero-gift transfers as well. Examples include sales to completed-gift trusts for descendants and zero-gift GRATs. To achieve finality as to whether a zero-gift GRAT or sale to a completed-gift trust produces a gift or not, a taxpayer should consider adequately disclosing it on a gift tax return.

But adequate disclosure can achieve only so much. It does not appear that adequate disclosure of a transfer can reduce the risk of gross estate inclusion at death. For example, a taxpayer who sells property to an incomplete-gift trust cannot achieve certainty during lifetime that the property sold will not be included in the gross estate under Section 2036(a)(2) or 2038(a), even if the sale is adequately disclosed on a gift tax return. Taxpayers contemplating such a sale should understand that whether they will have saved estate tax will not be known until after their deaths.

Practice Notes

The limitations period does not begin to run until a transfer is adequately disclosed on a gift tax return. To achieve adequate disclosure, the taxpayer should attach a statement describing the property sold, the consideration received, the identity of the transferee, the relationship between the taxpayer and the transferee, and, if the sale was to a trust, the terms of the trust. The statement also should provide the trust's taxpayer identification number. Finally, the statement should explain why the sale was not a transfer by gift.

An explanation along the following lines would appear to suffice: "The transfer of the property sold by the taxpayer to the purchaser is not a transfer by gift under Chapter 12 of the Internal Revenue Code because the value of the property transferred was equal at the time of sale to the value in money or money's worth of the consideration received by the taxpayer." If a statement attached to a gift tax return contains all of the foregoing, then the IRS generally would have only three years from the time of filing to assess gift tax.

1

A GRAT is a trust in which the grantor retains the right to a series of fixed dollar payments, typically for a term of years. As discussed later in the text, it seems that-warnings by some planners to the contrary-it is possible to set the value of the grantor's retained annuity interest exactly equal to the value of the property transferred, thereby producing a "gift" of zero.

2

A "zero gift" is a transfer with respect to which the donor retains or receives property that is equal in value to the property transferred. See Regs. 25.2511-1(e) and 25.2512-8. It is to be distinguished from a "non-gift" transfer, such as an incomplete gift or a transfer in the ordinary course of business, which is not a gift by virtue of the nature of the transfer.

3

Section 6501(c)(9); Reg. 301.6501(c)-1(f)(1).

4

Reg. 301.6501(c)-1(f)(2).

5

Reg. 301.6501(c)-1(f)(4).

6

A gift may be adequately disclosed even if it does not satisfy one of the safe harbor tests. See the Preamble to TD 8845, 12/3/99 ("it is not intended that the absence of any particular item or items would necessarily preclude satisfaction of the regulatory requirements, depending on the nature of the item omitted and the overall adequacy of the information provided").

7

Sections 6501(c) and (e); Regs. 301.6501(c)-1 and 301.6501(e)-1(b).

8

See Section 2502(a).

9

See Section 2001(b).

10

An increase in prior taxable gifts can affect the amount of gift tax due in later years either by pushing the taxpayer into a higher bracket or by absorbing more of the taxpayer's unified credit under Section 2505. Similarly, an increase in lifetime gifts can affect the amount of estate tax due at death either by pushing the estate into a higher bracket or absorbing more of the unified credit available under Section 2010. In today's era of increasing unified credit and lower rates, it may be that only nonresident aliens have to worry about being taxed at a higher gift or estate tax rate. Inadvertent loss of the unified credit, however, remains a concern for many taxpayers.

11

The value of a gift made before 8/6/97 does not become finally determined for purposes of calculating future gift taxes until the assessment period has lapsed for a year when gift tax was actually due. See Reg. 25.2504-2(a); Rev. Rul. 84-11, 1084-1 CB 201. Even if finally determined for gift tax purposes, the value of a gift made before 8/6/97 is not binding for purposes of calculating estate tax. Estate of Smith, 94 TC 872 (1990), *acq.*; Reg. 20.2001-1(a).

12

A final determination of value is made in one of four ways. First, if the IRS does not contest the value of a gift within the assessment period, the finally determined value is the reported value. See Sections 2001(f)(2)(A) and 2504(c); Regs. 20.2001-1(c)(1) and 25.2504-2(c), Example 1. Second, if the IRS does timely contest the value of a gift, its finally determined value is the value as specified by the IRS, if not timely contested by the taxpayer. See Sections 2001(f)(2)(B) and 2504(c); Regs. 20.2001-1(c)(2), 25.2504-2(b), and 301.7477-1(b)(3). Third, if the taxpayer brings a timely Tax Court proceeding to contest a gift tax deficiency (or pays gift tax and timely sues for a refund) or to determine the value of a gift, the finally determined value is the value as determined by the court. See Sections 2001(f)(2)(C) and 2504(c); Regs. 20.2001-1(c)(3) and 25.2504-2(b). Finally, the value of a gift can be finally determined by a settlement agreement between the taxpayer and the IRS. See Sections 2001(f)(2)(C) and 2504(c); Regs. 20.2001-1(c)(4) and 25.2504-2(b).

13

Section 2504(c).

14

Section 2001(f)(1). In addition, if the gift is made to a trust, the finally determined value also must be used for purposes of calculating the trust's "inclusion ratio" for generation-skipping transfer (GST) tax purposes; see Section 2642(b)(1)(A). The inclusion ratio is used to calculate the rate of GST tax. Generally, the lower the value of the property transferred to a trust, the less GST exemption has to be allocated in order to reduce the rate of GST tax. See Sections 2641 and 2642.

15

See Reg. 25.2504-2(c), Example 3. The example involves the gift tax calculation consequences of a sale made prior to 8/6/97. It seems clear, however, that the example's interpretation of the phrase "transfer of property gift" also should apply to zero-gift transfers made after 8/5/97 and should apply for estate as well as gift tax purposes. See Ratzlaf, 510 US 135, 126 L Ed 2d 615 (1994) ("A term appearing in several places in a statutory text is generally read the same way each time it appears"); Merrill v. Fahs, 33 AFTR 587, 324 US 308, 89 L Ed 963, 1945 CB 418 (1945) (similar words used for both gift and estate tax purposes should be construed the same way).

16

See Ltr. Rul. 9535026 (the value of secured notes bearing interest at the rate prescribed by Section 7872 was equal to the value of the property transferred); *cf.* Ltr. Rul. 9644053 (a secured right to an annuity was equivalent in value to the property transferred); see also Reg. 25.2504-2(c), Example 3; but see Dallas, TC Memo 2006-212, RIA TC Memo ¶2006-212 (valuing promissory notes with self-cancelling provisions at less than the value of the property sold).

17

Section 2512(b); Reg. 25.2512-8.

18

See Ltr. Rul. 9535026; *cf.* Prop. Reg. 20.7872-1 (for estate tax purposes, the value of a term note is the lesser of (1) principal plus accrued interest or (2) the present value of all payments due under the note).

19

A "grantor trust" is in general a trust all of whose income, deductions and credits are attributed to the grantor for income tax purposes. See Sections 671-677 and 679.

20

Rev. Rul. 85-13, 1985-1 CB 184; but see Rothstein, 54 AFTR 2d 84-5072, 735 F2d 704 (CA-2, 1984). Although a grantor trust is treated as owned by the grantor for income tax purposes, the Service strongly rejects the view that appreciated grantor trust property is entitled to a "step up" in basis at the grantor's death under Section 1014(a); see CCA 200937028. The IRS does appear to have concluded, however, that there will be no recognition of gain at death, as death is not a recognition event. See CCA 200923024.

21

For further discussion of these and other risks, see Aucutt, "Installment Sales to Grantor Trusts," 4 Business Entities No. 2 (March/April 2002), page 28.

22

Section 2512(b); Reg. 25.2512-8. To mitigate valuation risk, many planners nowadays use formula clauses that essentially prevent the taxpayer from transferring sufficient property to produce a taxable gift. See McCaffrey, "Formulaic Planning to Reduce Transfer Tax Risks," 45 Ann. Heckerling Inst. on Est. Plan., Chapter 7. It remains to be seen to what extent such clauses are void as against public policy under Procter, 32 AFTR 750, 142 F2d 824, 44-1 USTC ¶10110 (CA-4, 1944).

23

See Rev. Rul. 59-60, 1959-1 CB 237; Reg. 25.2512-2(f).

24

See, e.g., TAM 9251004; but see Ltr. Rul. 9535026 (Sections 2701 and 2702 did not apply to a sale of stock in exchange for an interest-bearing note); Ltr. Rul. 9436006 (same); Pierre, TC Memo 2010-106, RIA TC Memo ¶2010-106 (valuing property sold to trusts for promissory notes without reference to Sections 2701 or 2702, even though the court seems to have accepted the Service's theory that the trusts were funded with nothing other than the property sold to the trusts). Although much estate tax planning depends on the distinction between a sale and a transfer with a retained interest, there is surprisingly little authority discriminating between the two. The classic example is a footnote in Fidelity-Philadelphia Trust Co. v. Smith, 1 AFTR 2d 2151, 356 US 274, 2 L Ed 2d 765, 1958-1 CB 557 (1958), which states that a transfer for a deferred consideration had been treated as a sale for purposes of Section 2036(a) where "the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made." Authorities citing this test include Rev. Rul. 77-193, 1977-1 CB 273, Estate of Moss, 74 TC 1239 (1980), and Cain, 37 TC 185 (1961).

25

Under Sections 2701(a)(3)(A) and 2702(a)(2)(A), the value of certain interests retained by a donor are valued at zero.

26

See Regs. 25.2701-1(a)(2) and 25.2702-1(b). In addition, an "estate tax inclusion period" under Section 2642(f) would likely prevent effective allocation of GST exemption to the trust.

27

Regs. 301.6501(c)-1(f)(4)(i) and 301.6501(c)-1(f)(2)(i)-(iii). In lieu of a description of the terms of the trust, the taxpayer may attach a copy of the trust instrument.

28

Reg. 301.6501(c)-1(f)(2)(iii).

29

Reg. 301.6501(c)-1(f)(4)(ii). To ensure compliance with the special disclosure rules governing transfers subject to Chapter 14 of the Code, it may be prudent in addition to state that the value of the property received by the taxpayer was determined without regard to the valuation rules of Chapter 14. See Reg. 301.6501(c)-1(e)(iii).

30

Sections 2001(f) and 2504(c).

31

See Reg. 25.2504-2(c), Example 3.

32

There is an exception to Section 2036(a) inclusion in the case of a bona fide sale for full and adequate consideration in money or money's worth.

33

See TAM 9251004; but see Fidelity-Philadelphia Trust Co., Rev. Rul. 77-193, Moss, and Cain, all *supra* note 24.

34

If the assets sold had appreciated in value, however, they would be entitled to a step-up in basis at death under Section 1014(a).

35

Sections 2701(a)(3)(A) and 2702(a)(2)(A). Sections 2701 and 2702 do not apply to transfers other than to members of the transferor's family.

36

Regs. 25.2701-1(a)(2) and 25.2702-1(b).

37

Estate of Sanford, 23 AFTR 756, 308 US 39, 84 L Ed 20, 1939-2 CB 340 (1939); Merrill v. Fahs, *supra* note 15; Harris, 39 AFTR 1002, 340 US 106, 95 L Ed 111, 1950-2 CB 77 (1950).

38

Badaracco, 53 AFTR 2d 84-446, 464 US 386, 78 L Ed 2d 549, 1984-1 CB 254 (1984).

39

Id. (filing a nonfraudulent return does not trigger the statute of limitations with respect to an earlier fraudulent return).

40

See, e.g., Bufferd, 71 AFTR 2d 93-573, 506 US 523, 122 L Ed 2d 306, 1993-2 CB 300 (1993) (statute of limitations for assessment begins to run with the filing of a Subchapter S corporation shareholder's return, not with the filing of the corporation's return).

41

See, e.g., Estate of Levin, 71 AFTR 2d 93-2167, 986 F2d 91 (CA-4, 1993); Evanson, 74 AFTR 2d 94-7459, 30 F3d 960 (CA-8, 1994); Estate of Smith, 94 TC 872 (1990).

42

See also Reg. 20.2001-1(a) ("if [a] gift was made prior to August 6, 1997, the value of the gift may be adjusted at any time, even if the time within which a gift tax may be assessed has expired under section 6501"); *cf.* Rev. Rul. 81-15, 1981-1 CB 457 (explaining that Byrum, 30 AFTR 2d 72-5811, 408 US 125, 33 L Ed 2d 238, 1972-2 CB 518 (1972), remains good law on the interpretation of Section 2036(a)(2) even though its result was overturned by the enactment of Section 2036(b)).

43

In Estate of Flandreau, 72 AFTR 2d 93-6711, 994 F2d 91 (CA-2, 1993), for example, the court held that notes payable by the decedent to members of her family were not deductible from the gross estate under Section 2053(a)(3) where the consideration received by the decedent consisted of funds that she herself had given to family members during her lifetime. The court rejected the estate's argument that because the decedent's gifts had been reported as completed transfers, the IRS was precluded from arguing at death that the loans back to her were not bona fide.

44

Section 2036(a)(1).

45

Reg. 20.2038-1(a); Alexander, 81 TC 757 (1983) (a retained right to affect the timing of enjoyment triggers gross estate inclusion under Section 2036(a)(2)). By contrast, a retained power to affect timing of enjoyment does not prevent a completed gift; see Reg. 25.2011-2(d).

46

Reg. 20.2038-1(a). By contrast, a retained power to revoke, exercisable only in conjunction with an adverse party, does not prevent a completed gift; see Reg. 25.2011-2(e).

47

Reg. 20.2038-1(a).

48

See Estate of Sanford, *supra* note 37 ("It is true, of course, that ... gift taxes will not be imposed on transactions which fall short of being completed gifts. But if for that reason they are not taxed as gifts they remain subject to death taxes ... and the Government gets its due, which was precisely the end sought by enactment of the gift tax"); Reg. 25.2511-2(f) ("The relinquishment or termination of a power to change the beneficiaries of transferred property, *occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors),* is regarded as the event which completes the gift and causes the tax to apply") (emphasis added).

49

Reg. 301.6501(c)-1(f)(5) opens up interesting planning opportunities. For example, it may be that a taxpayer could create a "self-settled" trust even in a jurisdiction where the assets would be subject to the taxpayer's creditors, yet prevent the trust from being included in the gross estate under a "creditors' rights" theory, so long as the creation of the trust is reported as a taxable gift and the gift tax assessment period has lapsed. See, e.g., Estate of Paxton, 86 TC 785 (1986). The trust still could be so included if other facts suggest that there was an express or implied understanding that the decedent would retain access to the property of the trust. See Reg. 20.2036-1(c)(1); see also Rev. Rul. 2004-64, 2004-2 CB 7; Ltr. Rul. 200944002.

50

If the sale is reported as having produced a small taxable gift, then the exception of Reg. 301.6501(c)-1(f)(5) might apply, but it would not aid the taxpayer, as Section 2036(a)(1) could nevertheless cause gross estate inclusion of property that was transferred in a completed gift.

51

Cf. Estate of Flandreau, *supra* note 43 (rejecting the estate's argument that the gift tax reporting of certain transfers affected how they are treated for purposes of determining whether the estate was entitled to a deduction under Section 2053).

52

Repayment in full of the deferred purchase price should prevent Section 2036(a)(1) from applying at death, as the decedent will then not have retained an interest for life or for a period not in fact ending before death, even if the sale can be recharacterized as a transfer with a retained interest. The mere termination of a retained interest also should not trigger gross estate inclusion under Section 2035(a); see Ltr. Rul. 9109033.

53

For a defense of this strategy, see Oshins, Brody, and McBride, "The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented," LISI Estate Planning Newsletter #1824 (6/22/11). For a more skeptical view, see U.S. Trust, *Practical Drafting* (July 2011), at 10471-10490. The discussion in this article is consistent with the latter, more skeptical view.

54

Reg. 25.2511-2(b).

55

Regs. 20.2036-1(b)(3) and 20.2038-1(a).

56

Estate of Davis, 27 AFTR 2d 71-1726, 440 F2d 896 (CA-3, 1971); Estate of Magnin, 84 AFTR 2d 99-5227, 184 F3d 1074 (CA-9, 1999). A "transfer" for purposes of Section 2036(a) can occur even if it was for full and adequate consideration. Estate of Jorgensen, TC Memo 2009-66, RIA TC Memo ¶2009-066 , *aff'd*107 AFTR 2d 2011-2069, 431 Fed Appx 544 (CA-9, 2011) (the decedent made a "transfer" by exchanging assets for interests in a family limited partnership that were proportionate to the value of the assets contributed); Estate of Turner, TC Memo 2011-209, RIA TC Memo ¶2011-209 (same).

57

Rev. Rul. 85-13, *supra* note 20.

58

Sections 671-677 and 679.

59

See Section 678(a)(2); Ltr. Ruls. 200949012 and 201039010.

60

By contrast, a taxpayer who creates a trust for his or her own benefit runs the risk that all of the trust property will be included in the gross estate if, under state law, creditors could reach the assets of the trust. See, e.g., Estate of Paxton, *supra* note 49.

61

See Restatement (Second) of Trusts, section 155. For creditor protection purposes, however, it is unclear whether state courts will respect a sale of property by a beneficiary to a trust for his or her own benefit at substantial, artificial discounts. Although such discounts generally must be respected for gift and estate tax purposes under the "willing buyer/willing seller" test of Reg. 25.2512-1, it is possible that, for creditor protection purposes, state courts would treat the beneficiary as having funded the trust to the extent of the discount. In that event, the trust would not, under traditional principles of trust law, be fully protected from the beneficiary's creditors. Restatement (Second) of Trusts, section 156; see also N.Y.E.P.T.L., section 7-3.1(a). To ensure creditor protection, and to prevent the taxpayer from being treated as having a general power of appointment over the trust property triggering gift or estate taxation under Sections 2014 and/or 2514, an incomplete-gift trust to which a taxpayer makes a sale should always be created in a jurisdiction that generally protects self-settled trusts from the claims of the settlors' creditors.

62

This "reporting" advantage appears to be the only reason that an incomplete-gift trust should be created by a third party. The other advantages of a sale to an incomplete-gift trust-fixation of the value of the property sold, avoidance of gain recognition, elimination of gift tax risk, retention of beneficial access, and even creditor protection-all appear to be available if the trust is created by the taxpayer who enters into the sale.

63

In the case of a capital contribution to a family limited partnership, the Tax Court has held, controversially, that the contribution is not "bona fide" unless it had a legitimate and significant nontax business purpose. See, e.g., Estate of Jorgensen and Estate of Turner, both *supra* note 56. Perhaps this court-devised gloss on the meaning of "bona fide," which finds little basis in the statutory language or case law prior to 2002 and is not imposed on the term as it appears elsewhere in the estate and gift tax provisions, might be used even outside the family limited partnership context to attack other types of transfers that the Tax Court views as abusive.

64

See Estate of Davis, *supra* note 56; Estate of Magnin, TC Memo 2011-31, RIA TC Memo ¶2011-031 . Any attempt to avoid gross estate inclusion by renouncing the power of appointment during lifetime would cause the gift of the excess (if any) to be completed for gift tax purposes. Reg. 25.2511-2(f); see also Section 2035(a) (triggering gross estate inclusion if the taxpayer dies within three years of such renunciation).

65

Section 2043(a) provides inter alia that if a decedent made a transfer during lifetime for a consideration that was less than full and adequate and the transferred property is included in the gross estate under Sections 2036 or 2038, then the amount so included is reduced by the value of the consideration received. In some circumstances, such as a sale of a remainder interest, the offset under Section 2043(a) may not be sufficient to prevent double taxation of both the transferred property and the consideration received, as Section 2043(a) does not take into account returns on the consideration that the decedent may have earned prior to death. See Past, 15 AFTR 2d 1422, 347 F2d 7 (CA-9, 1965) (Ely, J., dissenting: "I would interpret 'value of the consideration,' as provided in Section 2043(a), as the proportion of the value of the corpus at death which is attributable to the consideration received by decedent"). See also Estate of Magnin, *supra* note 56 ("Although it would perhaps be most fair to both taxpayers and the government if a proportional approach were adopted, [citing the Ely dissent in Past], this approach is not the one Congress has adopted in this statute"). By contrast, in the case of a sale to an incomplete-gift trust for less than full and adequate consideration, a literal reading of Section 2043(a) is quite friendly to taxpayers, in that it might permit the amount included under Section 2036(a)(2) or 2038 to be reduced by the value of the consideration, even though the consideration may already have been paid out of the very property so included. The better reading, however, is that the limitation of Section 2043(a) is satisfied automatically by the fact that any consideration paid to the decedent necessarily reduces the net value of the incomplete-gift trust at death. Thus, there should be no further reduction of the value of the trust under Section 2043(a).

66

Reg. 25.2504-2(c), Example 3.

67

Talk America, Inc. v. Michigan Bell Telephone Co., 180 L Ed 2d 96 (2011); Chase Bank USA, N.A. v. McCoy, 178 L Ed 2d 716 (2011); Auer v. Robbins, 519 US 452, 137 L Ed 2d 79 (1997).

68

See, e.g., Dickow, 108 AFTR 2d 2011-5874, 654 F3d 144 (CA-1, 2011) (interpreting Reg. 20.6081-1 so as not to permit any more than one extension of time to file, despite that "the regulations do not themselves explicitly say that there may be only one extension").

69

Reg. 25.2504-2(c), Example 3.

70

Id., Examples 2 and 3.

71

Section 2001(f)(2).

72

Section 2001(f)(2)(C).

73

LTV Corp., 64 TC 589 (1975).

74

Reg. 301.7477-1(d)(3).

75

*Cf.*Reg. 301.7477-1(e), Example 4 (permitting a proceeding under Section 7477 where the taxpayer and the IRS disagree as to whether a transfer was complete for gift tax purposes).

76

Regs. 301.7477-1(d)(2) and 301.7477-1(e), Example 5.

77

In addition, as Reg. 301.6501(c)-1(f)(5) bars gross estate inclusion arguments only with respect to transfers reported as completed gifts, and must be strictly construed, it does not bar the IRS from including in a decedent's gross estate property transferred to an incomplete-gift trust.

78

The value of the annuity is determined using a discount rate prescribed under Section 7520.

79

Regs. 25.2511-1(e) and 25.2702-1(b).

80

TD 9181, 2/24/05 (revising Reg. 25.2702-3(e), Examples 5 and 6); see also Walton, 115 TC 589 (2000), *acq.*Notice 2003-72, 2003-2 CB 964.

81

TD 8395, 2/4/92. A close reading of the Preamble suggests that the IRS merely objected to structuring

GRATs so as to backload the annuity payments, a strategy that the final Regulations effectively foreclose. See Reg. 25.2702-3(b)(1)(ii) (treating as nonqualified an annuity amount to the extent that it exceeds 120% of the previous year's annuity amount).

82

Rev. Proc. 2011-3, 2011-1 IRB 111, section 4.01(54).

83

Not long before the IRS issued TAM 200245053, the Tax Court in Walton, *supra* note 80, had struck down earlier Regulations that did not recognize an annuity interest payable to the grantor's estate as "qualified." Walton did not, however, reach the question of whether a zero-gift GRAT was permissible, as the taxpayer in that case conceded that the GRAT she created produced a small taxable gift. Thus, although TAM 200245053 was issued before the Service's eventual acquiescence in the result in Walton, it seems that the IRS is still opposed to the creation of zeroed-out GRATs.

84

See Blattmachr and Zeydel, "Comparing GRATs and Installment Sales," 41 Ann. Heckling Inst. on Est. Plan., Chapter 2, at 2-22.

85

Reg. 26.2652-1(a)(1).

86

Under Section 2631, every individual is allowed a GST exemption amount (currently, $5 million), which may be allocated to any property of which such individual is the transferor. An allocation of GST exemption effectively reduces the rate of tax imposed on a generation-skipping transfer, often to as little as zero.

87

The complete "proof" that nearly zeroed-out GRATs do not make good GST tax planning vehicles can be found in Bramwell, "Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers," 114 JTAX 260 (May 2011). See also Reg. 26.2652-1(a)(5), Example 9 (holding that a taxpayer who consents to "split" gifts to a GRAT is deemed to be the transferor of one-half of the entire property transferred to the GRAT).

88

Reg. 26.2652-1(a)(1).

89

Reg. 26.2652-1(a)(2).

90

The view that the grantor is not subject to gift tax could perhaps be reinforced by creating a "negative-gift" GRAT, i.e., a GRAT in which the grantor retains an annuity interest whose value exceeds the value of the property transferred. In that event, a "special Section 7520 annuity factor" that takes into account the probable exhaustion of the trust would have to be calculated. See Reg. 25.7520-3(b)(1)(iii).

91

A portion or all of the GRAT property also may be includable in the grantor's gross estate under Section 2036. See Reg. 20.2036-1(c)(2)(i). Although property transferred in a bona fide sale for full and adequate consideration in money or money's worth is not included in a decedent's gross estate under Section 2036(a), the IRS takes the position that a zero-gift GRAT does not qualify for this exception. See the Preamble to TD 9414, 7/11/08.

92

To defer a dispute with the IRS on this issue, it may be prudent to designate a non-skip person, such as a trust for all descendants, including non-skip persons, as the remainder beneficiary of a zero-gift GRAT.

93

The value for gift tax purposes of publicly traded securities is equal to the mean of the high and low quoted traded prices for that day; see Reg. 25.2512-2(b). During trading hours, it often will be impossible to know what the dollar amount of the retained right to annuity payments must be so as to set the gift to remainder beneficiaries equal to zero. If, however, an individual declares a trust of publicly traded securities after the close of trading, the exact dollar amounts that will be needed to create a zero-gift GRAT apparently can be determined.

94

TRW Inc. v. Andrews, 534 US 19, 151 L Ed 2d 339 (2001) (quoting Duncan v. Walker, 533 US 167, 150 L Ed 2d 251 (2001)).

95

A retained qualified unitrust interest cannot produce a gift of zero, for no matter how large the percentage of the property paid to the grantor each year, there always will be some amount left over each year for the other beneficiaries. A retained qualified remainder interest cannot produce a gift of zero, as the lead beneficiaries still would receive some amounts from the property transferred.

96

Estate of Christiansen, 104 AFTR 2d 2009-7352, 586 F3d 1061 (CA-8, 2009); Estate of Petter, TC Memo 2009-280, RIA TC Memo ¶2009-280 , *aff'd*108 AFTR 2d 2011-5593, 653 F3d 1012 (CA-9, 2011); Hendrix, TC Memo 2011-133, RIA TC Memo ¶2011-133 ; see also Succession of McCord, 98 AFTR 2d 2006-6147, 461 F3d 614 (CA-5, 2006), *rev'g*120 TC 358 (2003).

97

The IRS could distinguish a zeroing-out formula in a GRAT from the provision in question in Christiansen, *supra* note 96, on the grounds that a zeroing-out formula in a GRAT not only prevents the IRS from collecting tax but prevents any gift from being deemed to occur. In Christiansen, by contrast, a valuation increase would have caused the portion of the transferred property passing to charity to increase. It would not have effectively cancelled the amount transferred by gift.

98

Procter, *supra* note 22, is by no means dead. Although Petter, *supra* note 96, purports to provide a definitive criterion for determining whether a clause is void under Procter or not-a criterion which, if sound, would permit a wide variety of formula clauses-recent cases distinguishing Procter can themselves be distinguished on the grounds that the transferees in those cases who benefitted from any increase in the valuation of the transferred property (1) had independent fiduciary duties to prevent an undervaluation and (2) were charities, donations to which Congress has a policy of encouraging. With a zeroed-out GRAT, by contrast, the person who benefits from any increase in the valuation of the transferred property is the grantor. The grantor, *qua* the recipient of the annuity payments, does not have a fiduciary duty to ensure that he or she is receiving all that he or she is entitled to. Further, there is no public policy of encouraging gifts to oneself (other than, perhaps, the public policy of encouraging savings for retirement).

99

Reg. 301.6501(c)-1(f)(5).

100

Id.

101

Query whether the IRS may treat the retained interest in a GRAT as nonqualified on the theory that the GRAT is later improperly administered. See Reg. 25.2702-3(d) ("To be a qualified interest, [a qualified annuity interest] must ... function exclusively as a qualified interest from the creation of the trust"). *Cf.* Atkinson, 90 AFTR 2d 2002-6845, 309 F3d 1290 (CA-11, 2002) (denying an estate tax charitable deduction for a charitable remainder annuity trust because the trust was improperly administered). It would seem that, if the assessment period has lapsed, the Service could not challenge a GRAT on grounds of improper administration, even if the term of the GRAT has not ended.

102

Reg. 25.2504-2(c), Example 3.

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