The Zero-ed Out Term Interest

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The concept of a zero-ed out remainder interest is common place in the context of grantor retained annuity trusts ("GRATs"). In the case of a "zero-ed out GRAT," the annuity interest is set so that the present value of the annuity payments, using the rate under Section 7520 of the Internal Revenue Code of 1986, as amended (the "Code") as the discount rate, is exactly equal to the value of the assets transferred to the GRAT, and thus the value of the remainder interest is zero. It is equally possible, however, to "zero-out" a term interest.

Section I of this article provides an overview and technical analysis of a zero-ed out term interest. Section II of this article describes two types of trusts which use a zero-ed out term interest: (i) the spousal remainder trust ("SRT") and (ii) the reverse zero-ed out term interest trust ("RiZT Trust").

I. ALAYSIS OF ZERO-ED OUT TERM INTERESTS

Consider the following structure of a term interest in a trust:

> During the life of A, the trustee shall pay to the beneficiary at the end of each year an amount equal to the increase in value of the trust property in excess of x%, measured from the first day of such year to the last day of such year.

In the case of the foregoing example, if x% is the discount rate/assumed rate of return used to value the term interest for gift tax purposes, then the value of the term interest is zero; *i.e.,* if the trust assets are assumed to appreciate at a rate of x%, then no property will be distributed to the term interest holder.[1] And, as a corollary, if x% is the discount rate/assumed rate of return used to determine the value of the remainder interest for gift tax purposes, then the value of the remainder interest should equal the entire value of the property transferred to the trust. In other words, the remainder interest would comprise the initial value of the property contributed to the trust plus growth thereon at x% for the trust term, which, if discounted at x% would have a present value equal to the value of the property initially contributed to the trust.

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[1] Alternatively, the term interest could be structured to have a minimal value, *e.g.,* the excess growth plus $1,000 could be distributed each year. Further, payment periods of more than one year or less than one year (*e.g.,* monthly, quarterly, semi-annually) could also be structured.

A. Valuation of Interests in Trusts Under Section 7520

There are three general categories of interests that can be created under a trust: (i) an interest in the trust that lasts for a stated period of time (*e.g.*, a fixed number of years or the life of one or more individuals), (ii) a right to an amount that is a stated or pecuniary amount, and (iii) the right to receive all of the remaining trust property on termination of the trust. The first category of trust interests can take various forms: the right to receive a fixed amount annually (an "annuity"), the right to receive a certain percentage of the trust property annually (a "unitrust interest"), the right to receive the trust income (an "income interest"), or the right to receive payments for health, support and education, and/or discretionary payments. A common feature of such trust interests is that they are measured in time.

Section 7520 governs the valuation of interests in trust that are susceptible to actuarial valuation,[2] including any annuity, unitrust interest, life estate, term interest, remainder and reversion. Reg. Section 25.7520-1(a)(1) provides, in part:

> Except as otherwise provided in this section and in § 25.7520-3(b) (relating to exceptions to the use of prescribed tables under certain circumstances), in the case of gifts made after April 30, 1989, the fair market value of annuities, interests for life or for a term of years (including unitrust interests), remainders, and reversions is their present value determined under this section.

The basic components of actuarial valuation of the foregoing interests are (i) the "Section 7520 interest rate" and (ii) the mortality component.[3] The Section 7520 interest rate is a necessary component to the valuation of interests in trusts because income interests, unitrust interests, remainders and reversions ***require both a discount rate and an assumed rate of return in order to be valued***. An income interest is the right to receive the trust income during a stated term. A unitrust interest is a right to receive a share of the current trust assets plus a share of future appreciation. A remainder and reversion is the right to receive the remaining trust property following the termination of the preceding interests in the trust. The amount of income generated by trust property, the amount of appreciation in trust property and the amount of property that is left after the trust term are all dependent on the rate of return of the assets. In valuing such interests, the Section 7520 rate is used not only as the present value discount rate, but also as the assumed rate of return.[4]

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[2] If an interest is not "ascertainable," it is not capable of valuation using actuarial principles.

[3] Reg. Section 25.7520-1(b).

[4] It is important to note that Section 2702 provides for a subtraction method of valuing certain interests. In particular, a "retained" interest is subtracted from the value of the property transferred to a trust. Such retained interest may be either a term interest or a remainder interest. If the retained interest (whether a the term interest or remainder interest) is "qualified" then it is valued under 7520.

B. Limitations on the Application of Section 7520

As indicated above, Reg. Section 25.7520-3(b) sets forth certain limitations on the application of Section 7520. Reg. Section 25.7520-3(b)(1) describes "ordinary" annuity, income, remainder and reversion interests, and sets forth a "standard section 7520 factor" for each such interest. Reg. Section 25.7520-3(b)(2) then provides for limitations on the use of such "standard section 7520 factors." The fact that a "standard section 7520 factor" is not provided does not mean that Section 7520 and its basic components of valuation (*i.e.,* the Section 7520 rate and the mortality component) do not apply to valuing an interest. Such an interpretation of "ordinary" interests is contrary to the broad statutory scope of Section 7520, which governs the valuation of "*any* annuity, *any* interest for life or a term of years, or *any* remainder or reversionary interest." In fact, the preamble to the Section 7520 regulations states that the actuarial tables provided are those "most frequently needed by taxpayers," and "[o]ther special section 7520 actuarial factors that may apply to more unusual situations may be computed by the taxpayer or, upon request, by the Internal Revenue Service for the taxpayer, by using actuarial methods consistent with those used to compute the standard section 7520 actuarial factors that appear in the tables in the regulations and in the Service's publications."

The examples illustrating the use of "actuarial methods consistent with those used to compute the standard section 7520 actuarial factors" apply the Section 7520 rate and the mortality component. In particular, Reg. Section 25.7520-3(b)(2) contains specific examples of interests that are not "ordinary" but are nevertheless valued based on the Section 7520 rate and the mortality component. For example, Section 25.7520-3(b)(2)(ii) provides a "standard section 7520 factor" may not be used to value an annuity, income, remainder or reversionary interest that is subject to any contingency, power or other restriction, but that "a special section 7520 annuity, income, or remainder factor may be used to valued a restricted beneficial interest under some circumstances."[5] Reg. Section 25.7520-3(b)(2)(v) *Example 4* illustrates the use of a special section 7520 factor with respect to a restricted beneficial interest. In that example, a trust provided child with all the income for life and the remainder passed to grandchild. The trust also provided child with the right to withdraw up to $5,000 per year. The example states that the child's interest is not an "ordinary income interest" due to the right of withdrawal; nevertheless, because the right of withdrawal was limited to an ascertainable result, "the present value of the child's income interest is ascertainable by making a special actuarial calculation that would take into account not only the initial value of the trust corpus, the section 7520 interest rate for the month of the transfer, and the mortality component for the child's age, but also the assumption that the trust corpus will decline at the rate of $5,000 each year during the child's lifetime." (The $5,000 annual withdrawal right was valued separately as an "ordinary annuity".)

In addition, Reg. Section 25.7520-3(b)(2)(i) provides that a standard section 7520 annuity factor may not be used if the trust will "exhaust." Nevertheless, Reg. Section 25.7520-3(b)(2)(v)

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[5] Reg. Section 25.7520-1(c) provides guidelines for requesting a "special section 7520 factor."

Example 5 sets forth a "special section 7520 factor" to be used to value such an annuity, which is based on the Section 7520 rate and the mortality component.

The foregoing illustrate that the Section 7520 components of valuation, *i.e.,* the Section 7520 rate and the mortality component, are intended to apply as a general rule to any term interest and remainder interest that is capable of actuarial calculation based on an assumed rate of return and mortality rate, *and not only to "ordinary" interests.*

C. Valuation of Zero-ed Out Term Interest Trusts

Section 7520 does not provide for a subtraction method of valuing trust interests, *i.e.,* the value of one or more interests is not determined thereunder and then the value of other interests calculated by subtracting such determined amounts from the value of the property transferred to the trust . Thus, the zero-ed out term interest and the remainder interest must be each be valued separately. *However,* the fact that these interests are valued separately does not mean that the sum of the parts can equal more than the whole. In other words, if a grantor transfers $100 to the trust, there is nothing in Section 7520 that would permit the IRS to argue that the grantor really made a gift of $120 because the value of the remainder interest was $100 and the value of the term interest is $20.

1. <u>The Remainder Interest</u>

Reg. Section 25.7520-3(b)(1)(i)(B) defines an "ordinary" remainder or reversion interest as "the right to receive an interest in property at the end of one or more measuring lives or some other defined period." The remainder interest in a trust with a "zero-ed out term interest" meets the foregoing definition of an "ordinary remainder interest." Such interest represents the right to receive the remaining trust property upon termination of the trust.

Reg. Section 25.7520-3(b)(1)(i)(B) defines a "standard section 7520 remainder factor" for an ordinary remainder or reversionary interest as the "present worth of the right to receive $1.00 at the end of a defined period, using the interest rate prescribed under 7520 for the appropriate month." Under Reg. Section 25.7520-3(b)(1)(ii), a standard Section 7520 remainder factor cannot be used if the remainder interest is subject to any contingency, power or other restriction. In addition to the foregoing, Reg. Section 25.7520-3(b)(2)(iii) provides that a standard Section 7520 remainder factor may not be used:

> unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar during, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (*e.g.*, from erosion, invasion, depletion or damage) until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the

> arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest.

In the case of the remainder interest in a trust with a zero-ed out term, no contingency, power or restriction exists. The term interest holder is only entitled to the increase in value in the trust property during a given year in excess of the Section 7520 rate—no other distributions or withdrawals are allowed, and thus all other income and capital appreciation accrue to the benefit of the holder of the remainder interest. In light of the foregoing, a standard Section 7520 factor should be used to value the remainder interest in a trust with a zero-ed out term interest.

As discussed above, an assumed rate of return, as well as a discount rate, are prerequisites for valuing any remainder interest—including an "ordinary" remainder interest. Thus, Section 7520 is the assumed rate of return and discount rate used to value an "ordinary" remainder interest. The value of a remainder interest in a trust with a zero-ed out term interest, using the Section 7520 rate as the rate of return and the discount rate, will equal the entire value of the property transferred to the trust:

> **Example. A transfers $100 to a trust which will pay B at the end of each year an amount equal to increase in value of the trust property in excess of 5%, measured from the first day of such year to the last day of such year. At the end of 10 years, the trust will terminate and the remaining property will be distributed to C. The Section 7520 rate on the date of transfer is 5%.**
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> - **Based on the assumption that the property will grow at 5%, the trust will have $163 at the end of the trust term.**
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> - **Using 5% as the discount rate, the value of receiving $163 at the end of ten years is $100.**

Note that in valuing the interests in the above example, if the rate of return on the trust assets was assumed to be less than the discount rate, then the value of the remainder interest logically still should equal the entire $100 because the term interest holder would receive nothing. But this would not be the present value of such interest. Further, if the rate of return on the trust assets were assumed to be greater than the discount rate, the value of the remainder interest still would equal $100, but term interest should also have value. This produces the absurd result that the grantor made a gift with a value greater than the $100 transferred. The foregoing illustrates that the rate of return of assets and the discount rate are really two sides to the same coin: an actuarial valuation of trust interests is dependent upon the rates being the same.

2. <u>The Term Interest</u>

A zero-ed out term interest is not an "ordinary" income, annuity or unitrust interest. Nevertheless, for the reasons discussed above, the fact that it is not an "ordinary interest" does not preclude its valuation under Section 7520. Such an interest is capable of actuarial valuation, if there is an assumed rate of growth and a discount rate—no different than what is required for the valuation of an "ordinary" remainder interest under Section 7520. Section 7520 provides these assumptions for purposes of valuing "any term interest." Thus, although the Section 7520 regulations do not provide a "section 7520 factor" that would be applicable to a zero-ed out term interest, a "special section 7520" factor using the Section 7520 rate as the rate of return and the discount rate can be used to value the term interest; and the resulting value equals zero because all "assumed growth" accrues to the benefit of the remainder interest.

D. Departure from Section 7520

The IRS could assert, and the courts may agree, that Section 7520 tables should not be used to value a zero-ed out term interest if it produces a "manifestly unreasonable result."[6] Nevertheless, the IRS would have "the substantial burden of demonstrating that the tables produce an unreasonable result."[7]

Such an assertion by the Service must apply to both the valuation of the term interest and the remainder interest. As demonstrated above, a zero-ed term interest cannot be deemed to have value without departing from Section 7520 with respect to both the term interest and the remainder interest—to do so would increase the total gift above the actual value of the property transferred.

In attempting to depart from Section 7520, the Service could argue that it is "manifestly unreasonable" that the term interest has zero value. However, the same argument could be made with respect to a zero-ed out remainder interest in a GRAT. The fact that Section 2702 says that a "qualified" retained interest is valued under Section 7520 does not necessarily insulate one from the argument that Section 7520 should not apply to the valuation of a "qualified" retained interest if that would produce a manifestly unreasonable result. Section 7520 says it applies to value any term interest. If a court is willing override the application of Section 7520 directly, there is no reason to think that it would not do the same where the application of Section 7520 is prescribed by another section.

II. ESTATE PLANNING WITH ZERO-ED OUT TERM INTERESTS

A zero-ed out term interest allows for the structure of unique trusts that provide significant estate planning benefits. Two of such trusts, the SRT and the RiTZ are discussed in this section.

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6 *See* O'Reilly v. Comm'r., 973 F.2d 1403, 1407 (8th Cir. 1992).

7 *Id.* at 1409.

A. Overview of the SRT

In a SRT, the grantor creates a trust in which the zero-ed out term interest is held by his children (or a trust for their benefit) for a term a years or the life of the grantor and the remainder interest is held by the spouse. For the reasons discussed below, the spouse's remainder interest (the value of which equals the initial value of the property contributed to the trust) qualifies for the marital gift tax deduction. Thus, no gift tax is triggered upon the creation of such trust.

Below is an example of a SRT:

> **Example. Husband transfers $1 million to a trust which will pay Child at the end of each year an amount equal to increase in value of the trust property in excess of 5% (the Section 7520 on the date of transfer), measured from the first day of such year to the last day of such year. At the end of 10 years, the trust will terminate and the remaining property will be distributed to Wife or her estate.**

No gift tax should be triggered with respect to the creation of a SRT. For the reasons discussed above, the term interest transferred to or for the benefit of children should have a value for gift tax purposes of zero, and, as discussed below, the remainder interest (which thus comprises the entire value of the property transferred to the trust) should qualify for the gift tax marital deduction.

1. Transfer Tax Analysis

a. Marital Deduction. Section 2523(a) generally provides that a transfer by gift of an interest in property to a donor's spouse qualifies for the gift tax marital deduction. However, Section 2523(b) provides that if an interest in property transferred to a spouse will terminate upon the occurrence of an event or on lapse of time (such as an annuity that terminates after 10 years), no marital deduction is allowed if the donor transfers an interest in the same property to someone other than the spouse for less than an adequate and full consideration in money or money's worth, and such other person may possess or enjoy the property after the spouse's interest terminates.

A spousal remainder interest, however, is not a terminable interest: the spouse's interest does not terminate upon the occurrence of an event or upon lapse of time. Rather, the remaining trust property will be distributed to the spouse (or her estate) at the end of the trust term. The fact that a remainder interest qualifies for the marital deduction has been expressly recognized by the Service. In Revenue Ruling 54-470, 1954-2 C.B. 320, the Service ruled that "a gift of a vested indefeasible remainder interest such as would be includible in the gross estate of the donee spouse under section 811(a) of the Internal Revenue Code of 1939 qualifies for the gift tax marital deduction." The current regulations implicitly recognize this as well: Reg. Section

25.2523(a)-1(e) provides that if income is payable to the grantor or someone else with the remainder to spouse or her estate, the marital deduction is computed as the present value of the remainder interest under Section 7520.[8]

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

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

Despite use of the word "purchase" in the heading of Section 2702(c)(2), the rule's application is not limited to situations in which both parties purchase their interests. The operative language of Section 2702(c)(2) (as opposed to the heading) states that it applies to situations in which two or more members of a family "acquire" interests in the same property in the same transaction, and no common definition of the word "acquire" implies that consideration is paid.[9] One can "acquire" property via gift, bequest or purchase, and this fact is recognized in the Code: for example, Section 2039 contains the phrase, "[W]here any property has been acquired by gift, bequest, devise . . . ." If the word "acquire" required consideration, one could not acquire property by gift, bequest or devise.

[8] *See also* Reg. Section 2523(d)-1, Example; *Federal Tax Coordinator* ¶ Q-6109 (2nd edition); *American Jurisprudence*, ¶ 148,411, 34B Am. Jr. 2d Federal Taxation; *Handling Federal Estate and Gift Taxes* § 16:108 (6th edition); Stephens, Maxfield, Lind, *Federal Estate & Gift Taxation* ¶ 11.03; Seftenberg, "Kiss Your Crown (Loan) Goodbye: Below-Market Rate Loans After the Tax Reform Act of 1984," 74 Ill. B.J. 34 (1984).

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

The word "acquire" is used throughout the Code to refer to situations that include acquisitions by gift or bequest, and not merely purchases. Section 2703(a) provides, "For purposes of this subtitle, the value of any property shall be determined without regard to (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property . . ." The phrase "or other right to acquire" is intended to be a catch-all for any other scenario, with or without consideration, that allows one to obtain ownership of property for less than adequate consideration. Other Code sections refer to situations in which property is "acquired by purchase," which would be a redundant phrase if all "acquisitions" were purchases.[10] Whenever the Code or regulations intend to refer to a "purchase" in the gift, estate and GST regime, they do so by referring to a "bona fide sale for an adequate and full consideration in money or money's worth."[11]

This, in turn, brings Section 2702(a) into play, which determines the value of the property received by each party in the transaction. Under Section 2702, the value of the children's term interest is determined, and then subtracted from the value of the property transferred to the SRT to determine the value of the spouse's remainder interest. Because the children's interest is not a "qualified interest" it is valued at zero. Nevertheless, the children still will not be treated as having made a gift to the spouse. The last sentence of Regulation Section 25.2702-4(c) states that, for purposes of Section 2702, the amount of the gift caused by the joint purchase rule "will not exceed the amount of consideration furnished by [the term holder] for all interests in the property." Because the children receive their interest as a gift and have furnished no consideration for that interest, the deemed gift by the children under Section 2702 will be zero.

c. <u>Generation-Skipping Transfer Tax Analysis of SRTs.</u> If the term interest is transferred to a trust for the benefit of the grantor's descendants, the grantor should not allocate generation-skipping transfer ("GST") tax exemption to such interest. The allocation of GST tax exemption is not effective during the "estate tax inclusion period" ("ETIP"), *i.e.,* the period during which the "value of the property involved in the transfer" would be includible in the estate of the grantor or the grantor's spouse.[12] Under the regulations, there is, as a general rule, an ETIP exist when any right or power in the transferor's spouse exists immediately after the transfer that would cause any part of the trust to be includible in the spouse's estate.[13]

Nevertheless, it should be possible to have the benefits of a SRT pass to a trust that is exempt from GST tax (a "Dynasty Trust") by have such a trust purchase its interest in the SRT

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

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

[12] Section 2642(f).

[13] Reg. Section 26.2632-1(c)(3).

from the grantor. To do so, the term interest should be structured to have a minimal value, *e.g.,* the excess growth plus $1,000 could be distributed each year.[14] In such case, distributions from the SRT to the Dynasty Trust represent a "return" on the Dynasty Trust's investment.

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

First, a generation skipping transfer can only occur if property is received by a person two or more generations younger than the "transferor." The transfer of property to the SRT would not make the grantor a "transferor" of such property to the Dynasty Trust for GST purposes. Reg. Section 26.2652-1(a) states that the "transferor" is the person with respect to whom the property was most recently subject to Federal estate or gift tax. A transfer for full and adequate consideration is not a transfer subject to Federal gift tax.[15]

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

However, unlike the estate and gift tax regime, the GST tax regime is not expressly limited to gratuitous transfers: in other words, there is no express exception for transfers for full and adequate consideration. The effect of this gap is to provide an opening for the IRS to argue that when the RPM Annuity Trust terminated and its property is added to the Dynasty Trust, the Dynasty Trust's inclusion ratio changed from zero to some fraction greater than zero.

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[14] As indicated above, Section 2702(c)(2)'s joint purchase rule may be deemed to apply to the SRT; however, pursuant to the last sentence of Regulation Section 25.2702-4(c) the gift caused by the joint purchase rule "will not exceed the amount of consideration furnished by [the term holder] for all interests in the property." Accordingly, if the Dynasty Trust pays $1,000 for its interest in the SRT, the beneficiaries thereof could be treated as having made a $1,000 gift to the spouse.

[15] Section 25.2511-1(g)(1).

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

> The Congress believed, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) was not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect.[16]

The Joint Committee also said, "Estate tax rules apply to generation-skipping transfers occurring as a result of death, and gift tax rules apply in other cases." Joint Committee at 1266-1267; see also House Report, 1986-3 C.B. at 827. Extending the generation-skipping tax beyond gratuitous transfers would not create uniformity with the gift and estate taxes, and therefore would be contrary to the legislature's intent in adopting Chapter 13.

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

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

d. Estate Tax Analysis. If the spouse dies during the term of the SRT, the remainder interest will be payable to her estate. Accordingly, the present value of such interest will be includible in her estate under Section 2033. Nevertheless, no Code provision will cause the value of the term interest to be includible in her estate. If the spouse dies following the

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[16] Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 at 1263 (1987); see also H.R. Rep. 99-426, reprinted in 1986-3 C.B. 820.

term of the SRT, any property received by the spouse from the trust will be includible in the estate of the spouse to the extent it has been expended prior to death. (However, the property transferred to the SRT would have been includible in the grantor's estate.)

2. <u>Benefits of a SRT</u>

The SRT has significant advantages over other estate planning strategies:

- Unlike a GRAT, there is no mortality risk. Only the actuarial value of the remainder interest will be includible in the spouse's estate under Code Section 2033 if she dies during the trust term.

- Compared to the GRAT, the SRT allows for easier GST planning.

- Unlike a remainder purchase marital trust ("RPM trust")[17], there is no issue with respect to the adequacy of consideration paid for the remainder interest in order to qualify the spouse's interest for the marital gift tax deduction.

- Compared to both a GRAT and an RPM trust, the SRT has the potential to transfer more wealth. First, because the spouse's interest is paid by the trust upon the termination of the trust, the trust does not have to make large annuity payments to either the grantor (as in a GRAT) or the spouse (as in an RPM trust) during the trust term. Thus, during the entire term of the trust, the trust's assets can be invested and possibly earn returns in excess of the Section 7520 rate for the benefit of the grantor's children (*i.e.*, the term interest holders). Second, because the excess return is measured each year (*i.e.,* based on the increase in value of the trust assets from the beginning of one year to the end of that year) the effect is the same as having a one-year GRAT or RPM trust in that to the extent that the hurdle was not met in one year, it does not place the trust "under water" for purposes of meeting the hurdle the next year.

- The SRT can be structured such that there is no valuation risk, without an adjustment clause. A remainder interest, by its very nature, absorbs excess value caused by an adjustment by the IRS. In the case of the SRT, the remainder interest is equal to the entire value of the property transferred to the trust and such entire interest qualifies for the marital gift tax deduction. It is possible to avoid any "adjustment payments" on account of a revaluation by providing that the first payment period for the term holder is at least three years (*i.e.,* past the statute of limitations).

B. Overview of the RiZT Trust

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[17] *See, e.g.,* David Handler and Deborah V. Dunn, *RPM Trusts: Turning the Tables on Chapter 14,* Trusts & Estates, July 2000.

In a RiZT Trust, children or a trust for their benefit create a trust, retaining the zero-ed out term interest and selling the remainder interest to parent. Because the term interest is zero-ed out, the actuarial value of the remainder interest purchased by the parent is equal to the entire value of the property transferred to the trust. In addition, because the term interest is a "retained interest" for purposes of Section 2702 and such interest is not a qualified interest, it would also be valued at zero under the special valuation provisions of such section.[18]

Below is an example of a RiTZ Trust:

> **Example. Child transfers $1 million to a trust which will pay Child at the end of each year an amount equal to increase in value of the trust property in excess of 5% (the Section 7520 on the date of transfer), measured from the first day of such year to the last day of such year. At the end of 10 years, the trust will terminate and the remaining property will be distributed to Parent. Parent purchases the remainder interest from Child for $1 million.**
>
> - **The Child's interest is not a qualified interest under Section 2702, and thus both under Section 7520 and under Section 2702's special valuation rules, the value of Child's interest is zero.**
> - **The value of Parent's remainder interest is thus $1 million ($1 million -$0), *i.e.,* the purchase price paid by Parent for such interest.**

The end result of the above transaction is that the Child has a zero-ed out term interest in the trust *and* receives $1 million in cash from the Parent. Thus, from an economic standpoint, the Child has given up nothing and gained the term interest in the RiZT Trust.[19]

1. Transfer Tax Analysis of the RiZT Trust

[18] The RiTZ Trust essentially is a variation of the "Reverse GRAT" with the term interest structured as a zero-ed out term interest. *See* Deborah V. Dunn and Lucy Park, "The Reverse GRAT: Hoisting the IRS Upon Its Own Petard?" *Estate Planning,* January 2005. Nevertheless, because the value of the term interest (*i.e.,* zero) is the same under both Section 7520 and Section 2702 it is less subject to attack by the Service.

[19] If the Parent makes a gift or loan of the property used by the Child to fund the RiZT Trust, the Service could use the step transaction doctrine to argue that the gift or loan to the Child, followed by its funding of the trust and sale of the remainder interest therein, should be treated as a transfer by the Parent to the trust and a gift of the term interest to the Child.

a. Section 2702. In the case of a RiZT Trust, the valuation is the same under Section 2702 and Section 7520. As indicated above, Section 2702 provides that where an interest in a trust (or trust equivalent) is transferred to certain family members and another interest is retained by the transferor (or by other family members), a *subtraction method* is used to determine the value of the transferred interest, and the retained interest is valued at zero unless it is a "qualified interest" (*i.e.*, an annuity or unitrust interest that meets certain requirements). Thus, if an interest retained by the transferor (and/or an "applicable family member") is not a qualified interest, then *nothing* is subtracted from the value of the entire property when determining the value of the transferred interest under the subtraction method. Rather, the non-qualified retained interest is ignored, and the interest transferred is valued as if the entire property had been transferred.

Although Section 2702 is generally aimed at "downstream" transfers, *i.e.*, the transfer of a remainder interest in a trust by a parent to his children, its provisions apply equally to "upstream" transfers by younger generations. In particular, Section 2702 borrows its definition of "member of the family" from Section 2704(c)(2), which includes the transferor's ancestors.

However, in the case of a RiTZ Trust, the application of Section 2702's special valuation rules has no effect. The "retained interest" is the zero-ed out term interest, which has an actuarial value of zero: thus, that fact that it is not a "qualified interest" is irrelevant.

b. Income Tax Analysis. In the above example, the funding of the RiZT Trust should not give rise to any income tax liability for the Child. Such trust would be structured as a "wholly" grantor trust as to the Child and in such case, whether funded with cash or with appreciated property, the trust is disregarded for income tax purposes. Nevertheless, the Child would be taxed on any income or capital gains attributable to the RiZT Trust.

The Child's sale of the remainder interest to the Parent, however, could trigger gain. The gain triggered would equal the amount of the purchase price for the remainder less the Child's basis in such interest. Also, to the extent that the Parent uses appreciated property to purchase the remainder, capital gain will be triggered. With respect to the property received by the Parent upon the termination of the RiTZ Trust, the Parent's basis should equal the purchase price paid therefor.

Nevertheless, it should be possible to avoid the triggering of income tax upon the creation of a RiZT Trust by having the trustee of a grantor trust for the benefit of the grantor's descendants (the "Trust") (i) fund a RiTZ Trust and (ii) sell the remainder interest to the grantor of the Trust for the value of such interest.

c. GST Tax Analysis. The GST tax does not apply to transfers to persons who are generations above the transferor. This is due to the fact that a "skip" person is defined as a person assigned to a generation that is two or more generations *below* the transferor.[20] Thus, if a RiTZ Trust were funded by a grandchild (*i.e.,* the transferor for GST purposes), the grandparent's purchase of the remainder interest should not be subject to GST tax.

d. Estate Tax Analysis. The estate inclusion issues presented by the RiTZ Trust are two-fold: (i) inclusion in the estate(s) of the Child/Trust beneficiaries and (ii) inclusion in the estate of the Parent/grantor. In the case of the non-grantor trust version of the RiTZ Trust, if the Child dies during the trust term and the Child's term interest does not terminate at the Child's death, the actuarial value of the Child's remaining interest will be includible in his estate under Section 2033.

The property held by the Ritz Trust should not be includible in the Child's estate under Section 2036 because the Parent paid adequate and full consideration for his remainder interest. Some courts have held that, for purposes of the estate tax, in determining whether a transferor has received adequate and full consideration for a remainder interest, the measure is *not* the actuarial value of the remainder but the full value of the property.[21] Such position, however, has been rejected by the last three Courts of Appeals to consider it: The Ninth Circuit in *Magnin v. Comm'r*,[22] the Fifth Circuit in *Wheeler v. U.S.*[23] and the Third Circuit in *D'Ambrosio v. Comm'r*.[24]

The foregoing should be irrelevant in the case of the grantor trust version of the RiTZ Trust so long as the Trust itself is not includible in the estates of the beneficiaries thereof.

If the Parent/grantor dies during the RiTZ Trust term, the value of the remainder interest will be includible in his estate under Section 2033. For purposes of Section 2033, the value of such interest should be its actuarial value.[25] Nevertheless, the inclusion of the remainder interest in the estate of the Parent/grantor also is not a downside of the RiTZ Trust. The purchase price of the remainder interest would have been includible in the estate of the Parent/grantor had it not

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[20] *See* Section 2613(a).

[21] *See e.g.,* Gradow v. U.S., 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990); United States v. Past, 347 F.2d 7 (9th Cir. 1965); Pittman v. United States, 878 F.Supp. 833 (E.D.N.C. 1994); Parker v. U.S., 95-1 USTC ¶60,199 (N.D. Ga. 1995); Estate of Magnin, 71 TCM 1856 (1996).

[22] 184 F.3d 1074 (1999).

[17] 116 F.3d 749 (1997).

[24] 101 F.3d 309 (1996).

[25] Of course the property distributed to the Child from the RiTZ Trust and the purchase price paid to the Child will be includible in his estate under Section 2033 to the extent such property has not been expended prior to death. However, the purpose of the RiTZ Trust (and estate planning in general) is to transfer property to the younger generation, *i.e.*, the Child. Property so transferred will necessarily be includible in such the Child's estate (or subject to the generation skipping-transfer tax).

been paid the Child/Trust. If the Parent/grantor dies following the RiTZ Trust term, any property received by the Parent/grantor from the trust will be includible in the estate of the Parent/grantor to the extent it has not be expended prior to death.

2. Benefits of a RiZT

The RiZT Trust has the same economic advantages of the SRT, but can be used where the grantor has no spouse or does not wish to transfer property to his spouse. However, the children (or a trust for their benefit) must already have assets.

III. CONLCUSION

As illustrated above, it possible to "zero-out" a term interest in a trust just as in the case of a zero-ed out GRAT. A zero-ed out term interest allows for the structure of unique trusts such as the SRT and the RiTZ that provide significant estate planning advantages over other types of trusts.