

**IVEN R. TAUB**

ATTORNEY AT LAW

Timothy P. Fisher  
Of Counsel  
Schwartzman Garelik  
Walker & Troy, P.C.<sup>Δ</sup>  
Of Counsel

<sup>Δ</sup>Members Admitted in  
New York and New Jersey

355 LEXINGTON AVENUE  
20<sup>TH</sup> FLOOR  
NEW YORK, NEW YORK 10017

TEL: (212) 286-7700  
TEL: (212) 686-6866

FAX: (212) 481-2488  
E-mail: lvenesq@aol.com

**WESTCHESTER OFFICE**  
550 MAMARONECK AVENUE  
SUITE 510  
HARRISON, NEW YORK 10528

TEL: (914) 381-7400  
FAX: (914) 381-7406  
**BY APPOINTMENT ONLY**

**TECHNIQUES FOR TRANSFERRING PROPERTY AT ADVANTAGEOUS LOWER  
ESTATE AND/OR GIFT TAX COST**

Set forth below are some techniques for transferring property to your children at advantageous lower estate and/or gift tax cost. (Terms such as "him" or "her" as used herein are intended to be gender neutral.)

**A. TECHNIQUES FOR TRANSFERRING PROPERTY TO THE NEXT  
GENERATION OF FAMILY MEMBERS AT LOW (OR RELATIVELY LOW)  
ESTATE AND GIFT TAX COST INCLUDE:**

- 1) Grantor Retained Annuity Trusts and Unitrusts (GRATS and GRUTS);
- 2) Personal Residence GRIT (PRTGRIT);
- 3) Sale for Self Canceling Installment Note (SCIN);
- 4) Partnership Freezes;
- 5) Family Limited Partnerships;
- 6) Charitable Trusts, and
- 7) Sale to Grantor Trust.

**B. GRANTOR RETAINED ANNUITY TRUSTS AND GRANTOR RETAINED  
UNITRUSTS**

A grantor retained annuity trust (GRAT) and the companion grantor retained unitrust (GRUT) may be availed of for the purpose of gifting income producing assets with little or no

gift tax while retaining for the transferor all or most of the income from the property for a specified term of years.

A GRAT is a gift of a remainder interest in a trust, which, because the donor retains an annuity interest for a term of years, has a reduced value for gift tax purposes. Thus, the donor can give away the remainder interest with reduced gift tax liability.

To create a GRAT the donor transfers assets to an irrevocable trust and retains an annuity interest for a specified term of years. The annuity interest is described either as a dollar amount, a percentage of the trust's assets (GRAT) or a fixed percentage of the annual value of the trust (a grantor retained unitrust, or GRUT). The amount of the annuity is set according to IRS actuarial tables.

When the income term ends, the donor's right to annuity payments terminates and the assets are either distributed outright to the beneficiaries or continue to be held in trust for their benefit.

The transfer of assets to a GRAT is a taxable gift only to the extent of the value of the remainder interest. Depending on the annuity rate assumed, the remainder interest will have little or no gift tax value.

### **Advantages**

As an immediate gift is made of a remainder interest in the entire assets, any future appreciation inures to the benefit of the remainder beneficiaries.

The grantor retains much, most or all of the income generated by the property. If a return exceeding the annuity percentage is realized, the additional income will be accumulated for the remainder beneficiaries without additional gift tax. If the property generates less income than the annuity percentage, principal will have to be invaded and the beneficiaries will receive less than the full amount of the initial gift.

### **Disadvantages**

1. The grantor is taxed on all trust income and gains, even if they exceed the amount paid as annuity.
2. The grantor must outlive the annuity to obtain any estate tax advantage. If the grantor does not outlive the annuity term, the trust assets are includible in his gross estate for federal estate tax purposes. Of course, even if the property is included in the grantor's gross estate, the estate is no worse off than if no gift had been made.
3. As a high percentage annuity is required to reduce the value of the remainder interest significantly, only high-yield assets are suitable for a GRAT or GRUT. If the trust assets yield only eight (8%) percent but the trust pays the grantor a ten (10%) percent annuity,



the remainder will have been partially or fully consumed at the end of the trust term. Thus, the trust investment should yield as much or nearly as much income as the annuity.

4. As the gift portion of a GRAT or GRUT is a remainder interest which is a future interest for gift tax purposes, no part of any taxable gift to a GRAT or GRUT qualifies for the gift tax annual exclusion.
5. It is important that the assets given to a GRAT or GRUT be susceptible of accurate valuation.

### **PERSONAL RESIDENCE GRANTOR RETAINED INCOME TRUST**

Personal residence grantor retained income trusts (PRTGITs) are similar to GRATS and GRUTS because they involve a gift of a remainder interest in trust following a retained interest for a specified number of years. PRTGRITs differ, however, because the grantor of a PRTGRIT is regarded as retaining an income interest for a term of years, rather than an annuity or unitrust interest. The value of the remainder interest for gift tax purposes is measured by the IRS's actuarial tables, issued pursuant to Section 7520 and are not subject to the special valuation rules of Section 2702 discussed hereinafter in the Partnership Freeze section of this memorandum.

#### **Advantages**

1. As an immediate gift is made of the remainder of the entire asset, all future appreciation inures to the remainder beneficiaries.
2. There is no fixed dollar payout to the grantor, as the grantor has retained merely the right of use for a period of time.

#### **Disadvantages**

1. The Grantor obtains the desired estate tax benefits only if he is alive when the income interest terminates. If the grantor dies during the income term, the trust's assets will be includible in his gross estate as if owned outright.

Nevertheless, the PRTGRIT is a relatively low-risk technique. Only the remainder is taxable for gift tax purposes and, if the trust principal is ultimately includible in the grantor's gross estate, credit will be allowed for any gift taxes paid by the grantor on the trust's creation.

2. The gift on the creation of the GRIT does not qualify for the gift tax annual exclusion as it is a future interest ineligible for the annual exclusion.

### **Considerations for Structuring**

1. The term of the income interest should be short enough so that the grantor is likely to survive it.
2. Proper valuation is critical as the IRS will likely try to increase the valuation on audit.

### **SELF-CANCELING INSTALLMENT NOTE (SCIN)**

A self-canceling installment note is a debt obligation created on the sale of property by the owner to a buyer. The note has a fixed term shorter than the life expectancy of the seller and contains a provision that automatically cancels all future payment obligations on the seller's death.

The buyer must pay a risk premium for the right to obtain the property transferred at a reduced price if the seller dies during the note's term, which risk premium must take into account the age and health of the seller, the sufficiency of any collateral, the size of the transaction, the down payment and the duration of the installment payment period.

The risk premium may be reflected in either an above market interest rate or increased sales price.

### **Gift Tax Consequences**

Assuming that (i) the sales price is based on an independent appraisal of fair market value, (ii) the risk premium is reasonable based on the facts and circumstances of the transaction and (iii) the note bears a reasonable interest rate, gift tax problems should be minimized.

### **Estate Tax and Income Tax Consequences**

The canceled note will not be included in the seller's taxable estate.

The sale will be eligible for installment reporting by the seller for income tax purposes, so that gain may be reported over the period during which payments are received. Each payment is divided into the following elements: a return of basis, gain (Capital gain if the property sold is a capital asset), and interest income. The relative components are determined by assuming that the maximum price will be received and that payments will be accelerated to the earliest date.

The buyer-obligor includes the full face value of the note as the basis of the property acquired in the transaction.

Interest paid or accrued on a SCIN is deemed to be interest for all purposes including original issue discount and below market rate rules.



### **Seller's Treatment of Gain at Death**

The Fifth Circuit Court of Appeals has recently held that the deferred gain implicit in the unpaid balance of the note is recognized as income when the self-cancellation provision becomes operative and that such income will be taxable to the estate as income in respect of a decedent. Thus, the accompanying income tax liability may be deducted as an estate liability on the decedent's estate tax return, thus reducing the estate tax otherwise due.

This holding interprets and regards the transaction as though the buyer had fully paid the note as of the moment of the decedent's death, followed by a bequest of the cash back to the buyer.

### **PARTNERSHIP FREEZE**

A partnership freeze is another technique designed to shift appreciation of property from an older generation while limiting estate and gift tax. Such a freeze fixes the value of preferred partnership interests (typically retained by the parent), and transfers appreciation in the form of growth interests, to the younger future generation.

Properly structured, the appreciation generally escapes taxation in the parent's estate.

A partnership is created with two classes of partners: preferred or "frozen" partners (similar to preferred stockholders) and one or more regular or "unfrozen" partners (similar to common stockholders). The preferred partners may be both general partners and limited partners.

A frozen or preferred partner has a right to a guaranteed annual payment, which is not limited to profits, and a preference as to a specific dollar amount or percentage of liquidating distributions. An unfrozen or common partner has a traditional partnership interest and a right to a proportionate share of partnership income and distributions, including liquidating distributions, after the preferred partners have received their distributions. Because the amounts the preferred partners can receive are fixed by the partnership agreement, the value of their interests is fixed, and all future growth in partnership earnings and appreciation in the value of the partnership assets inure to the common partners.

### **Effect of IRC Section 2701 (the "Anti-Freeze Provision")**

IRC Section 2701 applies whenever a junior interest in a partnership is transferred to or for the benefit of a member of the family of the transferor. (For this purpose a "member of the family" means, generally, the descendants of the transferor and of the transferor's spouse) and a distribution, liquidation, put, call, or conversion right in the partnership is retained by the transferor. A right to guaranteed payments, whether or not determined with reference to net earnings, would be such a retained distribution right.

## **Valuation of Partnership Interest Under Section 2701**

The anti-freeze provisions of the Internal Revenue Code require that the value of the unfrozen interests in a family partnership be determined by subtracting the value of all outstanding frozen interests from the total appraised value of the partnership. A frozen interest having a right to payments other than "qualified payments" is attributed a value of zero for purposes of valuing the frozen interest.

Amounts distributed as "qualified payments" with respect to a frozen partnership interest cannot be contingent on partnership earnings and must be paid from capital if earnings are inadequate. They are taxed as ordinary income to the preferred partner without regard to the preferred partner's income tax basis and capital account, and regardless of the character of the partnership income or gains for the year. Failure to pay the preferred distributions (subject to a four year grace period) results in the inclusion in the parent's taxable estate of an amount equal to the value of the unpaid distributions together with an amount equivalent to an actuarially determined income yield thereon.

Section 2701 further precludes the reduction of the value of the unfrozen partnership interests below ten (10%) percent of the total value of the partnership no matter what the appraised value of such interest is in actuality.

The value of the parent's estate will, of course, be increased by preferred distributions that remain unexpended at death; however, if no transfer takes place, the cash generated by the business or property involved would in any event augment the estate along with the growth and appreciation in the business or property itself. Careful planning and accurate forecasting of future appreciation are required before a partnership freeze is undertaken. If the partnership assets appreciate less than the preferred return, a reverse freeze occurs; that is, the growth interest does not grow and either remains fixed in value or loses value.

## **FAMILY LIMITED PARTNERSHIPS**

A Family Limited Partnership ("FLP") is a limited partnership created by a parent, who serves as general partner, with the parents' children serving as limited partners. The parent contributes property, whether realty or a portfolio of securities or both, to the FLP in exchange for a general partnership interest (perhaps one (1%) percent) and a limited partnership interest (typically ninety-six (96%) percent to ninety-eight (98%) percent). The children each receive one (1%) percent limited partnership interests in return for modest investments of cash or securities. Limited partnership interests are gifted to the children over a period of time. The value of FLP interests can incorporate a minority interest discount and a discount for lack of marketability to reflect the interest's economic value, resulting in a substantially lower transfer tax value for the limited partners' interests than their pro rata shares of the partnership's enterprise value. The value of the transferred interests is typically reduced through the application of minority interest and lack-of-marketability discounts in the range of twenty (20%) percent to forty (40%) percent for minority interest and twenty-five (25%) percent to forty-five (45%) percent for lack of marketability.



### **Advantages**

6. Creation of a FLP is simple; requiring only a partnership agreement and instruments of assignment transferring the applicable property to the partnership.
7. The donor, as general partner, can retain control of the property until transfer to the heirs (minority limited partners) has been completed.
8. The partnership is a pass through vehicle for tax purposes, paying no tax on its income.
9. The application of the double layer of valuation discounts is available on the gifts of limited partnership interests.

### **Disadvantages**

Annual gifts of limited partnership interests are valued as of the date of each gift. Appreciating assets continue to appreciate until the gifting process has been completed.

### **CHARITABLE TRUSTS**

A charitable trust provides a way to transfer income or assets to children/grandchildren and at the same time satisfy philanthropic desires. In a charitable remainder trust (CRT) assets are transferred to a trust for a term of years. The assets can then be sold by the CRT tax-free and reinvested to generate a higher annual return on the asset than may otherwise have been generated. The income during the trust term can be gifted to children/grandchildren with the remainder at the end of the term passing to charity. Since the transfer of assets to the trust creates a charitable income tax deduction, parents may use the tax savings associated with this deduction to purchase a life insurance policy through an irrevocable trust, where the children are named beneficiaries. This replaces the assets that would otherwise have passed to the children that now would go to charity.

#### **Use of CRT's — Qualified Retirement Plan Assets**

It is also possible to use charitable remainder trusts to receive either a lump sum or annual distribution from qualified retirement plans. Although one cannot presently avoid liability for income taxes on retirement plan distributions, careful planning can greatly reduce tax liability, preserving more of the distributions for contribution to the trust. By making calculations that interrelate the income taxes payable upon the distribution with the income tax charitable deduction generated by the gift to the trust, a net value can be calculated for the assets to be contributed to the trust from the plan. In effect, the cash savings resulting from the income tax deduction help pay for the taxes due upon the distribution from the plan. Where cash is contributed to the charitable remainder trust, the annuity may, in the discretion of the trustee, be payable to the income beneficiaries tax-free from the trust's tax-exempt investments under the

four-tier distribution system provided by the Internal Revenue Code, further enhancing the benefits of the plan.

As stated above, the donor may replace the assets contributed to the trust for the benefit of his or her heirs through the purchase of a life insurance policy by making excludible gifts to the heirs, who would pay the premiums on the policy and own it themselves. The insurance proceeds will then pass to the heirs directly upon the death of the donor, free of estate taxes.

### **SALE TO A DEFECTIVE GRANTOR TRUST**

A deferred payment sale of appreciating assets to a Defective Grantor Trust, effected through a Self Canceling (at death) Installment Note, a Private Annuity or an Installment Note, offers significant estate planning advantages (assuming a bona fide sale for fair market value) namely (1) an estate freeze in the amount of the then fair market value of the asset sold, (represented by the note), (2) elimination of capital gains tax relative to payments on the note received during the Grantor's lifetime, and (3) elimination of gift tax.

All income derived from the Trust assets is taxable to the Grantor and the Grantor is also taxable on interest payments on the note (at the applicable federal rate); if a Self Canceling Note is utilized, the interest rate will be greater than the AFR. However, the Grantor is not taxable on the capital gain realized on the sale to the Trust, either while the Trust remains a Grantor Trust during lifetime or, under a somewhat aggressive interpretation of the law, perhaps even after death.

Upon death of the Grantor, during the term of the note, if a Self Canceling Note has been utilized, there is authority to the effect that the value of the note is not includible in the taxable estate; however, the gain would be includible in the Grantor's final income tax return.