New Twist on Popular Technique

If an asset is revalued in an audit, clients could end up paying huge gift taxes. How to plan for—and avoid—that liability.

By **Steven J. Oshins**, *partner, Oshins & Associates, Las Vegas, Nev.*

The installment sale to a defective trust technique has become an increasingly popular wealth transfer strategy.[1] This technique is generally used to sell noncontrolling interests in such entities as limited partnerships, limited liability companies and corporations to defective dynasty trusts to take advantage of valuation discounts to leverage the value of the assets in the trusts.

However, the sale of a hard-to-value asset to a defective trust is a bomb waiting to explode. Many advisors do not plan for the possibility that the asset will be revalued on an audit. This lack of planning for an unexpected gift tax liability often is a huge mistake.

But there are ways to avoid this potential problem. As the installment sale technique has increased in popularity, variations on the technique have evolved. This article introduces a twist that protects against unexpected adverse gift tax liability. In this strategy, a hard-to-value asset is transferred pursuant to a formula allocation between a defective dynasty trust and a simultaneously created Walton grantor retained annuity trust (GRAT). Not only is the gift tax issue avoided, but as a secondary benefit, the residuary amount of the transfer flows into a Walton GRAT, where it can be leveraged.

Popular Move

The trust is set up as a defective trust by intentionally violating one or more of the grantor trust rules. The grantor must make a gift to the trust to provide the trust with sufficient substance prior to the installment sale. The rule of thumb that most practitioners follow is to fund the trust with a minimum of 10 percent of the fair market value of the assets that will be sold to the trust.[2] The trust then purchases—from its grantor—an asset highly likely to appreciate in value over time.[3] Rather than pay a lump sum for the asset, the trustee gives the grantor/seller a promissory note structured to pay over a specified period of time, at a specified rate of interest. The note is typically structured as interest-only with a balloon payment at the end of the term and a right of prepayment without penalty.

The Internal Revenue Service has opined in Revenue Ruling 85-13, and in several private letter rulings, that transactions between a trust and whomever is its "owner" for income tax purposes will be ignored. Thus, the "owner" of the trust, for income tax purposes, can sell an asset to the trust without any income tax ramifications.[4] In addition, the trust can satisfy its ongoing obligations to the seller with appreciated assets without income tax consequences. For income tax purposes, it is as if the trust did not exist. This technique was approved in PLRs 9436006 and 9535026.

Unhappy Clients

Although the benefits of an installment sale to a defective trust can

be significant, the sale of a hard-to-value asset to the trust can trigger an unexpected gift tax problem. Because the general rule of thumb that most practitioners follow is to fund the trust with a minimum of 10 percent of the fair market value of the assets that will be sold to the trust, the potential gift tax liability is magnified by 10 times that of a gift.

Assume, for example, that a limited partnership interest is sold to a defective trust at a 40 percent valuation discount in exchange for a promissory note with a face value of $6 million (discounted from $10 million). Further assume that the IRS audits the transaction and settles with the taxpayer at a discount of 20 percent, thereby changing the transaction to a part sale of $6 million and a part gift of $2 million. At a 50 percent gift tax rate, the taxpayer would owe a gift tax of $1 million on the $2 million gift. Needless to say, most of our clients would not be ecstatic with this result.

A more extreme example occurs with a pre-IPO company that has a value with the potential to explode upon going public. If the company goes public soon after the installment sale transaction, and soon increases to a value 100 times the appraised value used for the sale transaction, the IRS could argue that the company was worth 100 times more than its appraised value at the time of the sale. The gift tax then due could be in the tens of millions of dollars.

Walton GRAT

One of the key ingredients used to solve this potential gift tax problem is the Walton GRAT. A GRAT is an irrevocable trust in which the grantor retains the right to receive an annuity for a fixed term, after which the remaining trust assets pass to the remaindermen, or to trusts for their benefit, without any further gift tax implications.[5] The annuity payments are "qualified interests" pursuant to IRC Sec. 2702(b), so that the value of the gift is reduced by the present value of the retained stream of annuity payments. For maximum leverage, the GRAT is usually structured so that the value of the gift is close to zero. This is referred to as a zeroed-out GRAT.

Under Treasury Regulations §25.2702-3(e), Example 5, a completely zeroed-out GRAT is not possible because Example 5 says that a GRUT (or GRAT) payable to the grantor or the grantor's estate (a "term" GRAT or GRUT) is valued as a "shorter of term or life" GRUT (or GRAT). Example 5 states that person A "transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death."

In *Walton v. Comm'r,*[6] filed Dec. 22, 2000, the Tax Court declared Example 5 invalid. Theoretically, therefore, a term GRAT can now be zeroed-out. However, a prudent practitioner should never completely zero-out a GRAT, because the IRS may use a public policy argument to claim that the attempted gift is invalid. Planners also should factor in possible rounding by the software program used to calculate the gift. To be conservative, planners should aim for a gift of at least $1.

Theoretically, a term GRAT can be zeroed-out now. But the prudent practitioner should never do it.

Walton Facts

Walton's facts are interesting. On April 7, 1993, Audrey Walton (ex-wife of Wal-Mart founder Sam Walton's brother) established two substantially identical GRATs, each having a term of two years and each funded with 3,611,739 shares of Wal-Mart stock. Wal-Mart shares were priced at $27.6875 each on that date. Thus, the fair market value of the stock transferred to each GRAT was $100,000,023.56.

According to the provisions of each GRAT, the grantor was to receive an annuity amount equal to 49.35 percent of the initial trust value for the first 12-month period of the trust term and 59.22 percent of such initial value for the second 12-month period. In the event that she died before the end of the two-year period, the remaining annuity amounts were to be paid to her estate. The assets of each GRAT were exhausted upon the final payment, as all income and principal had been distributed to the grantor pursuant to the scheduled annuity payments. In fact, each GRAT had a shortfall of $14,465,475.01. There were no assets left for the remainder beneficiaries.

Audrey Walton filed a gift tax return reporting each gift at a value of zero. The commissioner of Internal Revenue issued a notice of deficiency determining that she made a taxable gift to

each GRAT of $3,821,522.12. She conceded in her brief that the gift to each GRAT should be $6,195.10. The exact value of the gifts is being argued still. However, because Example 5 was declared invalid, the gifts should be valued at some figure equal to or close to the value claimed by the grantor.

Formula Gifts and Sales[7]

Practitioners often express gift and sales transfers by formula to avoid unexpected adverse gift tax ramifications if the value of the transferred asset is changed during an audit. There are generally two types of formula clauses: value adjustment clauses and value definition clauses.

A value adjustment clause provides for either an increase in the price of an asset or a return of a portion of the transferred asset if the value of the transferred asset is determined to be greater than anticipated at the time of the transfer. However, this technique generally does not work. A number of courts have ruled that, because it is a subsequent condition that would have the effect of undoing a portion of a gift, it is against public policy and therefore void.[8]

Unlike a value adjustment clause, which attempts to take advantage of a subsequent condition to avoid a transfer in excess of that which is contemplated, a value definition clause defines the value of the gift or sale at the time of the transfer. In a value definition clause, as noted in more detail below, the agreement between the parties does not require a price adjustment or an adjustment in the amount of property transferred. Rather, it provides that the transaction is complete, but the extent of the property sold or given is not fully known at that time. Therefore, an adjustment on a revaluation by the IRS will be upheld and will simply cause an adjustment of the interests allocated between the transferor and transferee(s).

Many commentators have correctly stated that the GRAT may be preferable to the sale technique if the transaction involves a hard-to-value asset.[9] In the governing instrument, the GRAT annuity interests may be expressed as either a dollar amount or as a percentage of the initial value of the asset transferred. By expressing the annuity as a percentage, the gift tax issue is finessed.[10] Under Treasury Regulation §25.2702-3(b)(1)(ii), the GRAT document must include a revaluation provision in case the asset gifted to the GRAT is valued incorrectly. Any shortfall or overpayment must be paid back with interest. Conversely, such a protective provision is not available for an installment sale to a defective trust.

Under the holdings in *Proctor*[11] and *McLendon*,[12] the IRS most likely would ignore a revaluation clause in a sales agreement. In both cases, the courts held that a revaluation savings clause was ineffective in avoiding a taxable gift, ruling that such a provision was against public policy. But there is a substantial difference between the way the IRS has treated the value definition and the value adjustment clauses. As Carlyn S. McCaffrey and Mildred E. Kalik noted in the October 1986 issue of *Trusts & Estates*: "The IRS does not seem to have focused on valuation definition clauses to the same extent as it has focused on adjustment clauses. To the extent it has dealt with them, it has not indicated an opposition to their use. These kinds of clauses ... may be more effective as a means of reducing the gift tax risk associated with the transfer of hard to value assets than are adjustment clauses."

> A value adjustment clause generally does not work...A number of courts have found it against public policy.

Residue to Walton GRAT[13]

A strategy that combines the sale to a defective trust, the Walton GRAT and the defined value transfer leverages the value of the assets transferred to a dynasty trust, yet avoids an unexpected gift tax on an audit, while also moving a portion of the assets into a leveraged GRAT. With this technique, the transferor makes a defined value sale to the defective dynasty trust with a residuary amount passing to a GRAT. For example, the transferor could assign an X percent limited partnership interest to be allocated $Y worth to the defective dynasty trust in exchange for a promissory note, and the rest (whatever amount that may be) to a simultaneously created GRAT. The GRAT would be nearly zeroed-out using a Walton GRAT so that the value of the gift is a small fraction of the value of the asset transferred into the GRAT. Thus, if the value of the transferred asset were changed on an audit, the transferees (the defective dynasty trust and the GRAT) would simply reallocate the percentage owned by each party.

Because of the self-adjusting nature of a GRAT with an annuity payment drafted as a percentage of the initial principal, the potential gift tax liability is minimized

significantly. For example, if the value of the transferred assets is increased by $100 million on an audit, a GRAT that is nearly zeroed-out so that the value of the gift is one-hundredth of 1 percent of the value of the asset would minimize the additional gift to one hundredth of 1 percent of $100 million, or $10,000. The gift tax due on the $10,000 gift is small relative to the $50 million gift tax that otherwise could have been due had the GRAT safety net not been used. Admittedly, this is an extreme

The Walton GRAT not only provides a safety net for a dispute over valuation. It also will dissuade the IRS from auditing.

example, but the same principles apply to a leveraged sale transaction in which even just a few million dollars are involved.

Whenever there is a valuation issue, the prudent advisor will consider the technique I have described. Not only will the Walton GRAT provide a safety net to protect against a valuation dispute, but it also will provide a disincentive to the IRS to audit the transaction. If there are nearly zero gift taxes to collect, even if the value of the asset is changed, the IRS will likely concentrate its audits on more lucrative transactions. ◆

For their review of this article and helpful comments, Steven Oshins thanks William H. Van Pelt IV, senior vice president at The Mid-Continent Companies, Ltd. in Houston, Texas and Stephan R. Leimberg, CEO of Leimberg Information Services, Inc. in Bryn Mawr, Pa.

Endnotes

1. See Michael D. Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," *Estate Planning* (Jan. 1996); Frederic A. Nicholson, "Sale to a Grantor Controlled Trust: Better Than a GRAT?," *Tax Management Memorandum* (Feb. 22, 1996); H. Allan Shore and Craig T. McClung, "Beyond the Basic SUPERFREEZE—An Update and Additional Planning Opportunities," *Taxes* (Jan. 1997); Steven J. Oshins, Al King III and Pierce McDowell, III, "Sale to a Defective Trust: A Life Insurance Technique," *Trusts & Estates* (April 1998); Steven J. Oshins, "Sale to a Defective South Dakota Dynasty Trust: Leveraging your Trust into Perpetuity," *Communique* (April 1998); Jerome M. Hesch, "Installment Sale, SCIN and Private Annuity Sales to a Grantor Trust: Income Tax and Transfer Tax Elements," *Tax Management Estates, Gifts and Trusts Journal*, Vol. 23, No. 3 (May 14, 1998); Richard A. Oshins, "Defective Trusts Offer Unique Planning Opportunities," *CCH—Financial and Estate Planning* (Aug. 20, 1998); Steven J. Oshins, "Sales to Grantor Trusts: Exponential Leverage Using Multiple Installment Sales," *Probate & Property* (Jan./Feb. 1999); Jerome M. Hesch and Elliott Manning, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," *Tax Management Estates, Gifts and Trusts Journal* (Jan./Feb. 1999); Michael D. Weinberg, "Reducing Gift Tax Liability Using Intentionally Defective Irrevocable Outstanding Trusts," *Journal of Asset Protection* (Jan./Feb. 1999); David T. Lewis and Maureen C. Lanning, "Estate Freezes and Grantor Trusts for Business Owners," *Business Entities* (Mar./Apr. 1999); Robert J. Travers, "Sale of Stock to a Defective Irrevocable Grantor Income Trust," *Journal of Financial Service Professionals* (Jan. 2000); Louis A. Mezzullo, "Freezing Techniques: Installment Sales to Grantor Trusts," *Probate & Property* (Jan./Feb. 2000); Milford B. Hatcher, Jr. and Edward M. Manigault, "Freeze Partnerships Against the World—Is My Freeze Better than Your Freeze?," *Estate & Personal Financial Planning* (Part One—Aug. 2000 and Part Two—Sept. 2000); Michael D. Mulligan, "The Reinvigorated GRAT: Is a Sale to a Defective Trust Still Superior?" *Estate Planning* (Aug 2002). Numerous other articles on this technique can be read online at www.oshins.com.
2. Byrle M. Abbin, "[S]he Loves Me, [S]he Loves Me Not—Responding To Succession Planning Needs Through a Three-Dimensional Analysis Of Considerations To Be Applied In Selecting From The Cafeteria Of Techniques," 31 U. of Miami Inst. on Est. Plan., Ch. 13 (1997) who commented: "...[i]nformally, IRS has indicated that the trust should have assets equal to 10 percent of the purchase price to provide adequate security for payment of the acquisition obligation," pp. 13-19.
3. This technique also can be used when one of the beneficiaries is treated as the "owner" of the trust for income tax purposes. In such cases, the beneficiary would be the seller.
4. Rev. Rul. 85-13, 1985-1 C.B. 184.
5. IRC §§2702(a)(2)(B), 2702(b). For a more complete explanation of GRATS, see Leimberg, *The Tools and Techniques of Estate Planning* (800-543-0874), Leimberg, *The Cutting Edge* (610-924-0515), and Leimberg, Plotnick, and Evans, *The New New Book of Trusts* (610-924-0515).
6. *Walton v. Comm'r*, 115 T.C. 41 (2000).
7. See McCaffrey and Kalik, "Using Valuation Clauses to Avoid Gift Taxes," 125 *Trusts & Estates* 47 (October 1986); see also McCaffrey, "Some Tips on Tax Tuning Gifts," 137 *Trusts & Estates* 87 (August 1998).
8. See *Comm'r v. Proctor*, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944); *Estate of Gordon McLendon v. Comm'r*, *T.C. Memo* 1993-459; *Ward v. Comm'r*, 87 T.C. 78 (1986); *Harwood v. Comm'r*, 82 T.C. 239 (1984), affirmed, 786 F.2d 1174 (9th Cir. 1986); TAM 9309001; TAM 9246007; TAM 9133001; TAM 8549005; TAM 8531003. But see *King v. United States*, 545 F.2d 700 (10th Cir. 1976) which is the only reported case in which a value adjustment clause was accepted.
9. Richard B. Covey, *Practical Drafting*, pp. 4365-4367.
10. The opposite approach was used in *Estate of J. Howard Marshall, II v. Comm'r.*, Tax Ct. Docket No. 543-98, where the IRS has asserted an additional gift in excess of $18 million.
11. *Comm'r. v. Proctor.*
12. *Estate of Gordon McLendon v. Comm'r.*
13. Stacy Eastland is responsible for the development of this technique.