

Value Definition Clauses, Part 5: Taking Advantage of 'The 2010 Window'

We are now in the 2010 Window, one calendar year during which the generation-skipping transfer (GST) tax rate is effectively zero and the top federal gift tax rate is only 35 percent (compared to 45 percent in 2009 and a projected 55 percent in 2011 and beyond). Congress has threatened to shut the Window by reinstating higher rates prior to 2011, perhaps even retroactively to Jan. 1, 2010. Understandably, few people are willing to take advantage of the 2010 Window by making a taxable gift or a generation-skipping transfer without knowing what tax law may apply. Wouldn't it be great if there were a way to make such transfers now but not get burned if higher rates are enacted retroactively? Amazingly, there is just such a way.[1]

"No one thought Congress would allow the transfer tax laws to be so uncertain in 2010. But in the midst of the current chaos, an amazing opportunity exists for many of our wealthy clients."

Readers of this column know that I have long been bullish on the use of "value definition clauses" (VDC's)[2] that use a formula or dollar amount to determine how much is being transferred where. Two cases from late 2009 strongly affirm their effectiveness and deal a "one-two punch" to IRS attacks on them.[3] Here's how to use them right now during what may be a once-in-a-lifetime opportunity.

Consider several hypothetical situations, in all of which your Client has a large estate.

1. Avoid High Gift Tax Rate

Although the federal gift tax remains in effect during 2010 with a $1 million exemption, Client is willing to pay gift tax at a 35 percent federal rate[4] in order to avoid later federal gift or estate taxes at a higher rate.[5] The solution is for Client to make a completed gift of a certain asset, but use a VDC to divide the gift between two donees.[6] First, allocate to children whatever portion, if any, is subject to a gift tax rate no higher than 35 percent. Then allocate the remainder of the gift, if any, to a donee that does not trigger any gift tax, such as Client's wife[7] or a zeroed-out Grantor Retained Annuity Trust (GRAT) for children.[8]

Sample Form #1: Avoid High Gift Tax Rate

I hereby irrevocably transfer all of my 50 limited partnership units in XYZ, LP, assigning that portion which is subject to federal gift taxes at a rate no higher than 35 percent, as finally determined for federal gift and estate tax purposes, to my children outright, in equal shares, and assigning all other portion of such transfer to my wife outright.

If Client is married, another solution to avoid a high gift tax rate would be to make a gift to a trust for the benefit of Client's spouse for life, remainder to children (not grandchildren), that would qualify for QTIP marital deduction election if the gift tax were reinstated. If the gift tax is not reinstated retroactively, Client benefits from a low 35 percent gift tax rate on the transfer to an irrevocable trust. If the gift tax is reinstated retroactively, Client can make the QTIP election on his 2010 gift tax return to avoid any taxable gift, after which the Trustee can exercise its

discretion under the trust instrument to terminate the trust and distribute all the assets to wife. Client will have until April 15, 2011, plus any extensions, to make the QTIP election, if necessary.

2. Avoid Both High Gift Tax Rate and GST Tax

Same facts, except that Client also wants his gift to fund a generation-skipping trust if (and only if) there is no GST tax on the transfer.[9]

Sample Form #2: Avoid Both High Gift Tax Rate and GST Tax

I hereby irrevocably transfer all of my 50 limited partnership units in XYZ LP, assigning that portion which can pass free of any federal generation-skipping tax and is subject to federal gift taxes at a rate no higher than 35 percent, as finally determined for federal gift, estate and GST tax purposes, to the Trustee of my Irrevocable GST Trust for Grandchildren dated March 1, 2010, and assigning all other portion of such transfer to my wife outright.

3. Pay Gift Tax But Avoid Any GST Tax

Same facts, except that Client is willing to pay gift taxes at either 35 percent or 45 percent rate, because even a retroactively effective 45 percent rate will be better than the 55 percent gift or estate tax rate projected for 2011 or later. However, Client cannot tolerate paying any GST tax on his transfer to a generation-skipping trust. Therefore, any portion otherwise subject to GST tax must pass to children rather than to grandchildren.

Sample Form #3: Pay Gift Tax But Avoid Any GST Tax

I hereby irrevocably transfer all of my 30,000 shares of XYZ stock, assigning that portion which can pass free of any federal generation-skipping tax, as finally determined for federal gift, estate, and GST tax purposes, to the Trustee of my Irrevocable GST Trust for Grandchildren dated March 1, 2010, and assigning all other portion of such transfer to my children outright, in equal shares.

4. Remove GST Tax Exposure on Existing GST Trust

Client and his descendants are discretionary beneficiaries of an existing generation-skipping trust created by his parents. The Trust is not exempt from GST tax, meaning that it has an "inclusion ratio" greater than zero. Except during the 2010 Window, any transfers out of the Trust to Client's descendants during Client's life will trigger GST tax, and the entire Trust will be subject to tax when Client dies or is for any other reason no longer a beneficiary (either an immediate GST tax or else estate tax in Client's estate if the Trust gives Client a testamentary general power of appointment). Client is willing to relinquish his interest in the Trust, and to let the trust assets pass during the 2010 Window for benefit of only his descendants, if (and only if) both GST tax and estate tax can be permanently avoided. There are a couple of possible solutions.

One solution is for Client to use a VDC to disclaim his interest in the non-exempt GST Trust but only to the extent that it generates no GST tax. If the GST tax is not reinstated retroactively, a tax worth at least 45 percent of the Trust has been saved. If the GST tax is reinstated retroactively, the disclaimer will simply have been ineffective.[10]

Sample Form #4: Non-Exempt GST Trust Disclaimer

I hereby disclaim my interest in my parent's GST Trust dated July 1, 1996, to the maximum extent that such disclaimer will not cause a taxable termination under Code §2612, as finally determined for federal gift, estate, and GST tax purposes.

Another solution is for the Trustee to use a VDC. Let's call this trust GST

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Trust #1. The goal is to terminate GST Trust #1 and allocate its assets by formula between two new trusts. First, some third party[11] creates new GST Trust #2, substantially identical to GST Trust #1.[12] Second, Client creates a separate Grandchildren's Trust #3 for his descendants, the key being that he is not a beneficiary. Finally, Trustee of Trust #1 exercises his discretion to terminate Trust #1 using a VDC that allocates to Grandchildren's Trust #3 the maximum amount that can pass free of GST tax, with the rest to pass to GST Trust #2. If the GST tax is not reinstated retroactively, grandchildren will receive the trust assets in the Grandchildren's Trust #3 free of both GST tax and estate tax. If the GST tax is reinstated retroactively, the assets reappear in GST Trust #2, effectively right back where they were.

Sample Form #5: Non-Exempt GST Trustee's Exercise of Discretion

As Trustee of the Parents' Non-Exempt GST Trust, I hereby exercise the discretion granted to me under the trust instrument to distribute income and/or principal to or for the benefit of any of the descendants of the Parents by terminating the Trust, allocating the maximum amount of the trust estate which will not cause the imposition of any generation-skipping tax, as finally determined for federal gift, estate, and GST tax purposes, to the Trustee of Grandchildren's Trust #3, and allocating the balance of the trust estate to the Trustee of GST Trust #2.

No one thought Congress would allow the transfer tax laws to be so uncertain in 2010. But in the midst of the current chaos, an amazing opportunity exists for many of our wealthy clients. Although the IRS may continue challenging value definition clauses despite recent taxpayer victories, such clauses, when used carefully in the manner suggested by the facts in the successful cases, are powerful tools to recommend to our clients both during the 2010 Window and beyond.

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Notes

1. One might think you could simply make a gift or GST transfer subject to a condition that the gift or transfer be returned if the tax law later changes. Unfortunately, such a "condition subsequent" is not enforceable for federal tax law, under *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), which held that a contingent reversion (a "savings clause") would violate public policy and frustrate the collection of taxes. Any gift or GST transfer must be irrevocable in order for the taxpayer to obtain the potential tax benefits.

2. See my columns in March and April 2001, December 2006, and April 2008. Briefly, a VDC is useful when an irresistible force (i.e., a transfer of wealth, especially when difficult to value, such as a family limited partnership) encounters an immovable object (i.e., a fixed exemption or exclusion such as the annual gift tax exclusion, federal estate tax exemption, or GST exemption). The best known example is a marital deduction formula clause under a will, allocating a fixed dollar amount such as the federal estate tax exemption to family (e.g., a "credit shelter trust") and the balance to a marital share. A VDC, either inter vivos or testamentary, can also be either (1) a "formula transfer clause," which allocates a fixed dollar amount to family; or (2) a "formula allocation clause," which completely transfers a certain asset but allocates a fixed (defined) portion to family and the balance to another entity that causes no further gift or estate taxation, such as spouse outright, marital trust, charity, "zeroed-out" Grantor Retained Annuity Trust (GRAT), or "zeroed-out" Charitable Lead Annuity Trust (CLAT). Recent taxpayer victories have involved formula allocation clauses with two or more donees, not formula transfer clauses.

3. The Eighth Circuit unanimously affirmed a prior Tax Court decision in *Estate of Christiansen*, 104 AFTR2d 2009-XXXX (8th Cir. Nov. 13, 2009, corrected Nov. 18, 2009). The Tax Court upheld a VDC in *Petter v. Commissioner*, T.C. Memo 2009-280 (Dec. 7, 2009), specifically stating that there is "indeed no overarching public policy against these types of arrangements in the first place." Says one commentator: "The 'one-two' punch of *Christiansen* and *Petter,* rejecting the IRS's vehement objections to these types of clauses, may represent the most important estate planning development in 2009. These types of clauses have been used for years, but we have been waiting for years for cases to address the IRS's public policy objection to the clauses." Steve R.



Akers, "Petter v. Commissioner," *Bessemer Trust Publication*, also cited as *LISI Estate Planning Newsletter* #1578 (Jan. 14, 2010) at http://www.leimbergservices.com.

4. This ignores Tennessee gift taxes, which must be reckoned separately.

5. Gift taxes are more tax-effective than estate taxes if the taxpayer survives more than three years beyond the gift, since the gift tax itself is then removed from the taxable estate, making the gift tax a tax on only the net amount received by the family (i.e., the gift tax is "tax-exclusive"). The estate tax base includes the estate taxes themselves, (i.e., the estate tax is "tax-inclusive"), making it a significantly higher effective tax rate than the gift tax. Lifetime gifts also remove future appreciation from the taxable estate at death.

6. One might wonder about practical issues, such as income allocations and tax reporting, of dividing an asset between two donees when the final allocation is as yet uncertain. Attorney Bryan Howard of Nashville has suggested first contributing the gifted assets to an LLC, then gifting the LLC interests under a VDC, and making no distributions until after 2010, when the effect of the clause will be known.

7. One concern might be that a transfer to spouse that is in effect contingent on a subsequent retroactive change in the tax law will not qualify for a gift tax marital deduction. Internal Revenue Code §2523(b) disallows a marital gift tax deduction where the interest to spouse will terminate or fail on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. But here the interest to spouse begins at zero if current law stays in effect, and blossoms only if Congress acts retroactively. The marital interest cannot be said to "terminate or fail" as a result of any subsequent event or contingency.

8. There is insufficient space to define all tax terms and techniques used herein, such as "generation-skipping transfer," "zeroed-out GRAT," "QTIP," and the like, but there is ample literature available to all readers merely by Googling.

9. Attorney Richard Franklin, of Washington, D.C., has calculated that for the same amount of total federal gift and GST tax paid at the top tax rates, a gift to grandchildren in 2010 under current law will transfer 3.15 times as much wealth from a taxpayer's estate as a gift to grandchildren under 2009 law.

10. This would not be a "qualified disclaimer" for federal or Tennessee gift tax purposes, but that would not matter if the value of the resulting gift from Client to the remaining beneficiaries is valued at zero. If distributions from the GST trust are completely within the Trustee's sole and absolute discretion, and if there is neither a clear pattern of prior distributions nor any express or implied obligation by the Trustee to make any distributions to Client, then the value of Client's taxable gift by disclaiming is at least arguably zero. Alternatively, even if there

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is a valuable gift component, Client may deem gift taxes on only a portion of the trust equal to the actuarial value of Client's interest in the Trust to be preferable to either GST or estate taxes on the entire Trust. One other concern about this disclaimer approach is that the IRS might deem it to be a formula transfer clause rather than a formula allocation clause, and thus subject to a Procter challenge, pursuant to the discussion in footnotes 1 and 2.

11. Parents, if still living, or any other non-beneficiary family member, should be amenable to creating GST Trust #2 with $10. If neither parents nor other family members are available, the Trustee may be able to create new GST Trust #2 by using the Tennessee "decanting" statute, *Tenn. Code Ann.* §35-15-816(27).

12. There should probably be some differences between Trust #1 and Trust #2, such as the identity of the Trustee, or the distribution provisions, to reduce any challenge that this is really a reversion to the same trust or should be disregarded as substance over form.

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