The Reverse DGT: Achieving Estate Tax Exclusion Without Loss of Financial Security[1]

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The amount one can pass transfer tax-free currently is $11.58 million and without further Congressional action this exemption amount drops by 50% after year 2025.[2] However, the likelihood such exemption is reduced prior to 2025 has increased with the prospect of Vice President Biden winning the Presidency in 2020.[3] But, other than ultra-wealthy clients who have more assets than they will ever consume, many are being advised by their financial advisors that a married couple cannot afford to irrevocably gift up to $23.16 million of their net worth and sustain their current lifestyle.[4] Additionally, in order to get *any* benefit of the increased exemption amount, a couple may need to gift over $11.58 million in 2020 to the extent Congress simply returns the exemption amount to $5.79 million per person.[5] Therefore, unless a couple can afford to give away nearly $23.16 million in assets, gifting in 2020 simply to utilize the increased exemption amount may not be advisable.[6] If Congress does not act to reduce the exemption amount, gifting in 2020 may have other negative consequences without any estate tax benefit. Specifically, if a couple passes away with less than twice the exemption amount in net assets, gifting in 2020 may achieve no estate tax benefit but would cost the couple a step-up in income tax basis on their entire estate at death. What if there existed a relatively simple structure that allowed a couple to take full advantage of the $23.16 million exemption amount in 2020 to reduce future estate tax, did not impact their use of their assets to support their lifestyle, and allowed a full step-up in income tax basis on all their assets at death? Such structure exists today – a Reverse Defective Grantor Trust.

I. The Reverse DGT

A Reverse Defective Grantor Trust or "Reverse DGT" is a novel twist on the relatively common estate planning transaction – a sale to a defective grantor trust.[7] The first step in implementing a Reverse DGT is the creation of an irrevocable grantor trust. A grantor trust in its most simple form is a trust containing certain "prohibited" provisions causing all income of the trust to be taxed to the taxpayer who transferred property to the trust.[8] In addition, the transferor or "grantor" and grantor trust are treated as one entity for all income tax purposes so that transfers between the grantor and the grantor trust have no income tax consequences.[9] As a result, not only are transfers between the grantor and grantor trust not recognized for income tax purposes during the grantor's lifetime, but payments of interest on promissory notes between the grantor and grantor trust are also not taxable during the grantor's lifetime. In fact, a separate income tax return is not even necessary for the grantor trust during the grantor's lifetime minimizing administration and complexity.[10] The beneficiaries of the irrevocable trust can be the grantor's children or grandchildren to the extent the grantor wishes to do dynastic planning.[11]

The next step in a Reverse DGT is to irrevocably gift assets to the trust. Unlike a traditional sale to a DGT wherein the gift is typically 10% of the overall value of the assets being transferred, the gift to the Reverse DGT will be up to the grantor's entire remaining exemption amount. The gift can include any type of asset. To ease valuation questions and expense, it is preferable to gift liquid assets since this structure does not rely at all on fractional interest valuation discounts. As discussed below, however, it is preferable to gift assets with as little current appreciation as possible.[12] Whether the grantor will need access to the gifted assets for future lifestyle spending is not an impediment to using the assets for the gift.

To complete the Reverse DGT, it is contemplated at some point in the future that the grantor will purchase some or all of the assets in the grantor trust ("Reverse Assets") in exchange for a promissory note. The purchase would be an arms-length transaction for full fair market value as with any traditional sale to a DGT, but unlike the traditional DGT sale the buyer and seller would be reversed. The promissory note ideally would provide interest-only payments annually and a balloon payment of principal in 20 or 30 years. The note could be secured with any of grantor's property including the Reverse Assts.

Unlike a traditional DGT sale where the lowest possible interest rate is preferred,[13] a higher interest rate is most beneficial from an estate tax perspective since the interest payments paid to the trust would escape estate tax at the grantor's death. While the applicable federal rate rules serve as a minimum rate on an interfamily loan to prevent imposition of gift tax,[14] it does not serve as a maximum. Instead, the appropriate rate depends on several factors such as credit worthiness of the grantor, any collateral provided, and the debt-value ratios of the grantor. It is conceivable a fair market value interest rate on the loan may be closer to 4-6% per year.

With a traditional DGT, most estate planners choose a shorter term and recommend the grantor trust payoff the entire promissory note prior to the grantor's death. With a Reverse DGT, it is more likely that due to the length of the note, the note will remain outstanding at the grantor's death. However, the note will serve as a valid deduction against the grantor's other assets at death, including the assets purchased from the grantor trust. Normally, a decedent may not claim an estate tax deduction for the value of a note to the extent the note was not received as part of a transaction wherein the grantor received full and adequate consideration.[15] But, since the grantor issued the note to the grantor trust in an arms-length sale for consideration, the note should not be disregarded.[16] Additionally, since the Reverse Assets are included in the grantor's estate, the basis of those assets is increased to fair market value.[17] This is different than a traditional DGT whereby the assets of the trust are not included in the grantor's estate and thus do not receive any increase in basis at death.[18]

For example, assume a single grantor has $16 million of liquid assets but may need some or all his assets to support his lifestyle. He would create a Reverse DGT and use up his remaining exemption amount in 2020 by gifting $11.58 million of liquid assets into the grantor trust and later purchase those assets from the trust for a $11.58 million promissory note. If the grantor passes away holding $11.58 million or less of the original $16 million in assets, the notes would completely offset the value of the remaining assets and no estate tax would be due regardless of the size of the exemption amount at his death. Additionally, any appreciation in those assets would be erased since the assets would receive a step-up in basis to fair market value. But, most importantly, the grantor would have retained the use of the liquid assets during life to support his lifestyle.

II. <u>Potential Issues with Reverse DGT</u>

A. <u>Inclusion Due to Retained Use of Trust Assets</u>

Under basic estate tax law, to the extent a grantor transfers assets to an irrevocable trust and retains the use of the trust assets, the trust assets are included in the grantor's estate.[19] In the case of the Reverse DGT, the grantor receives back the assets gifted to the trust and has full use of them. However, the grantor exchanges the gifted assets with a promissory note of equal fair market value. An exception exists to the retained use rules for transfers resulting from bona fide sales for full and adequate consideration.[20] Therefore, as long as the value of the promissory note equals the value of the assets purchased from the trust, the retained use rules should not create any estate tax inclusion.

Even if the grantor does not retain any direct ownership in the trust assets, the grantor's use of trust assets may be implied from the facts surrounding the actions of the trust. This argument has been successful in challenging the use of family limited partnerships where the actions of the partnership suggest that the transferor continued to retain the same rights and use of the transferred assets.[21] It has also been applied to trusts where the existence of an implied agreement between the grantor and Trustee was found – especially where the grantor transferred substantially all of his property to the trust.[22]

In the case of the Reverse DGT, it might appear that some implied agreement existed to allow the grantor to use the trust assets. But, the trust assets are being purchased for full fair market value and being replaced with a promissory note. The Reverse Assets are being included in the grantor's estate and including both the assets and the note in the grantor's estate would amount to double counting. To include the trust assets in the estate, the Service would have to find an implied agreement that the grantor would be given access to the assets held by the trust. At the date of death of grantor when the retained use argument would be tested, the only assets in the trust would be the outstanding balance of the note and any accumulated note payments. To the extent payments are made as scheduled under the terms of the note and the note payments are not made available to the grantor, it would be difficult to find any implied agreement to access the trust assets.

Alternatively, the Service might argue that the purchase of assets was not for full fair market value by attempting to disregard the note owed by the grantor as a valid debt. In determining whether a bona fide creditor-debtor relationship exists, transactions between family members are presumed to be a gift.[23] However, the presumption can be rebutted by establishing a real expectation that the debt will be repaid and the terms of the loan enforced.[24] While little or no authority exists for recharacterizing debt owed by the grantor to a prior donee as a taxable gift, several cases have disregarded debt as a valid obligation in the reverse situation where the grantor received a note from someone in exchange for property.[25]

Courts consider several factors in determining whether a real expectation of payment exists, including (1) a written promissory note, (2) imposition of interest, (3) existence of security for the note, (4) fixed maturity date, (5) whether the creditor demanded payment when due, (6) whether the debtor repaid the debt when required, (7) the creditors ability to repay the note, (8) extraneous documents reflecting the transaction as a debt, and (9) whether the note was reported consistently for tax purposes.[26] In a 2012 Tax Court case, the court examined these factors and found a valid debtor-creditor relationship between a taxpayer's sons and the taxpayer's family limited partnership despite the fact that no payments were made on the notes, no collateral was provided, the notes did not contain a maturity date, and it was unclear whether the sons had the ability to repay the notes.[27] The Tax Court concluded that a reasonable expectation of repayment existed because actual promissory notes were created and the extraneous evidence confirmed the existence of such notes. In prior Tax Court cases, the Court examined the above factors and determined the creditor did not have a reasonable expectation of payment because the notes were not interest bearing, the notes were not secured, the terms were not respected, and the extraneous records were not consistent with the position that the transfers were loans.[28]

With the note issued by the Reverse DGT, it is expected all the note formalities would be followed since there is a valid expectation that the note will be repaid in the future. A note instrument providing adequate interest and possibly security will be executed by the grantor. Ideally, the interest rate would be based on commercially reasonable terms and could be as high as 4-6% per year. The grantor will make regular interest payments on the note and unlike most of the prior examples, the note will definitely be repaid – either during the grantor's lifetime or after the grantor's death. Additionally, it is expected that the note will be properly recorded as debt for federal tax purposes on the estate tax return, if held until death, and a non-taxable gift on the gift tax return. As a result, if the promissory note in the Reverse DGT were respected as valid debt, then the sale of the asset for the promissory note would qualify as a transfer for fair and adequate consideration and the assets of the trust should not be included in the estate as a retained interest.

B. Step Transaction Doctrine

The step transaction doctrine is a judicial doctrine typically used to prevent income tax avoidance strategies but has been applied in limited circumstances to the transfer tax area.[29] Under the step transaction doctrine, if a taxpayer enters into several transactions that are so interdependent they cannot be viewed separately, a court may collapse the steps into one single integrated transaction. A court may invoke this doctrine when (1) each step is connected by a binding commitment, (2) each step has no independent significance without consideration of the integrated transaction, or (3) a series of separate steps were part of a prearranged plan agreed to by all the parties prior to the transaction.[30] If the Service recharacterized the transfer to the trust and later repurchase as the issuance of the promissory note by the grantor to the trust without consideration, then the promissory note would not be deductible as an expense of the estate upon death of the grantor.[31] Additionally, if the Service did not respect the sale of the assets from the trust to the grantor and treated the grantor as retaining an interest in the trust, then it could include the trust assets in the grantor's estate.[32]

As some commentators note, applying the step transaction doctrine to estate planning techniques under a prearranged plan or "end result test" would cause almost all estate strategies to fail.[33] But, in the limited cases where the Service successfully challenged an estate strategy with the step transaction doctrine, there has been a very short period of time between the steps.[34] In the cases where the passage of time between the steps results in some non-tax consequences, the Service has been less successful in collapsing the transactions. However, even in the cases where the Service has been successful, the step transaction doctrine has not been used to disregard the separate transactions but instead treat them as one transaction for discount valuation purposes. In fact, in one recent step transaction "victory" where the Service collapsed the gift and sale into one transaction, the Service did respect the sale by reducing the transfer by the value of the note issued as part of the sale.[35] In the case of the Reverse DGT, we are not relying on valuation discounts and instead prefer to use undiscounted assets to minimize valuation concerns.

Additionally, assuming there is some time between the gift and the sale in the Reverse DGT, significant non-tax consequences can occur to the grantor and trust from the time of the initial gift and later sale. If the value of the property depreciates between the gift and the sale date, the trust bears the risk of loss. On the contrary, if the value of the property appreciates between the gift and the sale date, the grantor will have to issue a promissory note to the trust in excess of the original gift amount. In either case, the grantor will have added a debt to his balance sheet by entering into the transaction that could affect his later ability to get credit and therefore cannot be ignored. The Service has been unsuccessful in cases where the two transactions were only days apart but there was "real risk of economic change" between the two transactions.[36] To the extent desired, the time period between the gift and the purchase by the grantor could be separated by sufficient time to create real risk of economic change in the value. In fact, only the gift needs to take place in 2020 to take advantage of the increased exemption amount and any purchase of the Reverse Assets could take place in 2021 or at some time in the future when the grantor wants to acquire the assets from the trust. However, since as little as five days has been held to prevent the application of the step transaction doctrine, to the extent the assets contributed bear the risk of appreciation or depreciation then an extended time period between the gift and sale with the Reverse DGT should not be necessary.[37]

C. Income Tax Consequences at Death

An unresolved issue with a traditional sale to a defective grantor trust is the income tax effect at death if some of the original promissory note remains outstanding. It is relatively clear that the trust must recognize gain if grantor trust status terminates during the grantor's life to the extent the outstanding liabilities owed by the trust exceed the trust's basis in the assets.[38] The gain arises because the grantor is treated as having transferred the trust assets to the trust upon termination of the grantor trust status in exchange for being "discharged" of any trust liabilities.[39] Upon the death of the grantor, however, no statutory authority, ruling, or case law exists definitively providing whether gain is recognized if the trust holds promissory notes owed by the trust to the grantor.[40] In fact, many commentators conclude that death should not be an income realization event and no gain is recognized due to the existence of the promissory notes.[41]

To the extent the grantor must recognize any income upon termination of the grantor trust status either during life or at death, the gain only arises to the extent the liabilities of the trust exceed the basis of the trust assets.[42] In the case of the Reverse DGT, the trust does not owe any liabilities that are potentially being discharged at death and instead any debt associated with the prior transfer between the grantor and the trust remains with the grantor upon termination of the grantor trust nature. Therefore, termination of the grantor trust status upon the death of the grantor in a Reverse DGT should not be an income realization event.

Even if the Service were to argue that the death of the grantor was an income realization event to the extent of the notes owed by the grantor to the trust, the grantor trust's basis in the assets sold to the grantor should have basis equal to the face value of the notes. It is clear that upon the gift of assets to any irrevocable trust, the trust takes the donor's basis in those assets.[43] To the extent the assets gifted to the trust are not appreciated, the principal balance on the note should equal the basis of the trust assets at the time of sale.[44] Therefore, the possible discharge of liabilities would not exceed the basis of the assets sold and no gain would result.[45]

Whether any gain must be recognized upon repayment of the interest and principal of the note by the estate *following the death of the grantor* is a separate issue. If the property gifted to the trust was not appreciated, then no gain would have been recognized at the time of sale regardless of whether the trust was a grantor trust. As a result, later repayment of the principal balance on the debt after death likewise should not bring rise to any gain. For that reason, it is better to gift non-appreciated property to the Reverse DGT. To the extent appreciated property were gifted to the Reverse DGT, gain presumably would need to be recognized upon repayment of such notes following death. However, the Reverse Assets would be included in the grantor's estate and receive a step-up in basis at death to help mitigate this negative result.[46] Additionally, it is not only the appreciation on the Reverse Assets at the time of the gift that gets stepped-up to fair market value at death, but any appreciation in the Reverse Assets after it were sold to the grantor would also receive a step-up in basis. The gain on the repayment of the note, on the contrary, is limited to any pre-gift appreciation.

Another potential source of income tax issues following death is accrued but unpaid interest on the promissory notes issued to the trust. Nothing prevents the grantor from accruing some or all of the interest on the note to the trust.[47] But, satisfaction of such interest post-death will be an income tax realization event to the trust.[48] For that reason, it is best not to accrue interest on the Reverse DGT but instead pay interest regularly on the note. If the grantor does not have the liquid assets to service the interest regularly, then the interest rate could be reduced as long as the interest rate at least equals the applicable federal rate for the month of sale.[49] To the extent such interest is current at the time of death, only future interest payments made on the note would bring rise to income tax.

To the extent the grantor has sufficient liquid assets, the best way to minimize all the negative income tax consequences on the transfer would be for the grantor to gift cash into the trust. The grantor could then borrow the cash from the trust as needed in the future in exchange for an interest bearing promissory note. The trust's basis in the cash and thus the trust's basis in the note would be equal to the principal balance of the note. As long as the grantor services the interest on the note regularly, no income tax should result from the entire Reverse DGT transaction upon repayment following the grantor's death. However, to the extent the grantor does not have sufficient cash to fund the gift and must use property, any negative income tax consequences can be minimized if the property used is not highly appreciated.

D. Fiduciary Responsibilities of Trustee

Like any estate planning transaction involving irrevocable trusts, a reverse DGT also must deal with the issue of who should serve as trustee. And, as with all irrevocable trusts, it's often recommended that the grantor not serve as sole trustee.[50] At a minimum, a reverse DGT should have an independent loan director approve the sale to the grantor to help insulate the grantor from retained interest arguments and to provide additional legitimacy to any loan. Regardless of who is serving as trustee, however, the trustee is subject to fiduciary responsibilities to the beneficiaries under local trust law, including the duty to make suitable investments as a prudent investor.[51] To the extent the grantor purchases assets from the estate using a promissory note and consumes so much of his estate that he is unable to satisfy the full legal obligation at death, the trustee may then be subject to claims from beneficiaries of mismanagement.

One option to minimize this risk is to have the terms of the trust document lessen the fiduciary standards applicable to the trustee with respect to these types of transactions.[52] Eliminating such responsibilities altogether may increase the possibility of retained interest claims by the Service, especially if the grantor is serving as trustee. However, in many grantor trusts, the grantor retains the right to borrow trust assets without adequate security, and it is likely that existence of such right wouldn't cause the estate tax inclusion.[53] To the extent borrowing without adequate security doesn't cause a problem, then borrowing with some security, presumably, should not create an issue. But, it is good practice to provide full and adequate security for any loan owed by the grantor to the reverse DGT, and such collateral may include the grantor's other non-liquid assets. Another way to protect the trustee is to fully indemnify him from claims by a beneficiary for such actions if taken in good faith, and the indemnification likely is warranted even if the loan is properly collateralized.

D. Disregarded Basis Step-up

In order to prevent taxpayers from gifting appreciated property to a person whose death is imminent for the purpose of obtaining a step-up in basis when the property is bequeathed back to the donor, the Internal Revenue Code prevents a decedent's assets from receiving a step-up in basis at death when the decedent dies within one year of the gift.[54] In the case of the Reverse DGT, even if the grantor passes away within a year of acquiring the assets from the trust, the assets should be entitled to a step-up for several reasons. First, this provision applies to gifts and although the trust will have received the property by gift, the grantor re-acquires the Reverse Assets through a sale in exchange for a promissory note. Even if the Service characterized the DGT sale as a gift transaction, the trust is not the beneficiary of the grantor's estate. The beneficiaries of the trust and the recipients of the grantor's estate may be similar persons, but it is contemplated the trust provisions would differ from the terms of the estate bequest. In either case, if the property gifted to the trust initially is not appreciated or the grantor survives more than one year after the DGT sale, the prohibition would not have any consequence even if applicable.

III. Reasons Reverse DGT Not Applicable

No estate planning transaction is applicable for every situation. The Reverse DGT is no exception. There are three non-tax considerations that must be accounted for in evaluating the merits of the Reverse DGT for a particular taxpayer.

A. Size of Estate

The first relates to the size of the grantor's estate – either too low or too high. If the grantor's estate is not likely to exceed the grantor's remaining exemption amount, using the Reverse DGT will provide no estate tax benefit. Instead, the grantor will have incurred costs to create and administer the structure as well having to deal with the added complexity without any corresponding estate tax savings. The problem in 2020 will be in determining whether a grantor will eventually be subject to estate tax. If a single grantor's estate is less than $5.79 million and not expected to increase in value, then it is not clear any estate tax will be due absent the exemption amount being reduced even further than expected by Congress. In that case, the grantor and her advisors are left to guess on the eventual size of the exemption amount and whether Congress will eventually pass legislation to change the exemption amount. Plus, for many people, their assets are likely to increase over time so that the grantor with an estate of $5.79 million today may have an estate of $9 million in 10 years and that size estate may exceed the exemption amount at that time.

On the flip side, if the grantor's estate is so large that it will likely be subject to estate tax regardless of the size, returning the assets to the grantor may not be prudent. If the property gifted to the trust is likely to appreciate at a higher rate than the prescribed interest rate, returning the assets to the grantor only increases the estate tax due at death. Locking in the future appreciation on the assets at the low applicable federal rate may provide a better estate tax result. However, the prescribed rate for the Reverse DGT may be much higher than the applicable federal rate and the grantor may be willing to lock-in an automatic 4-6% return on notes depending on the type of assets being contributed. For example, if a grantor gifts cash to a DGT in the current low interest rate environment, the return may be as small as 1% versus the guaranteed 4-6% return on the notes to the extent such higher interest rate is justifiable.

B. Administration of Interest Payments

Depending on the expected estate tax due at the grantor's death, the administration of making regular interest payments on the note may be too burdensome on some grantors. As discussed above, to avoid income taxation of the accrued interest upon payment following the death of the grantor, it is recommended that the grantor make regular interest payments on the notes annually. These payments serve to further reduce the grantor's estate for estate tax purposes but may create cash flow issues for illiquid grantors. One option would be to reduce the interest rate on the notes to the minimum applicable federal rate upon the date of transfer. While this is not ideal from a wealth transfer perspective, to the extent the grantor's estate is not going to be subject to estate tax because of existence of the note to the trust, then using the lower interest rate will be preferable. Alternatively, to the extent interest payments accumulate in the trust, the grantor could also enter into another exchange or loan with the trust in the future to recover some or all of the accumulation. For example, if the grantor has other illiquid assets, she may sell those assets to the trust in exchange for the accumulated interest payments using a traditional sale to a DGT transaction. In either case, making regular interest payments will create some administrative responsibilities and for some grantors who are not likely to have a large estate tax bill, subjecting oneself to those responsibilities may not be worth the hassle.

C. Inability to Change Terms of Trust

For the promissory note held by the trust to be excluded from the grantor's estate, the trust must be irrevocable and the grantor cannot retain rights to alter the beneficiaries. This is the same for any irrevocable trust but may become more important with the Reverse DGT to the extent the majority of a grantor's assets are passing through the trust at the death of the grantor following repayment of the debt. To the extent the grantor would not otherwise be subject to substantial estate tax because her taxable estate without the Reverse DGT is unlikely to greatly exceed the exemption amount at death, minimizing the control a grantor would have to change their estate plan at death may not be worth the estate tax savings. But, the estate tax savings for a grantor who does have a large taxable estate may be worth the limitations.

IV. Conclusion

The potentially changing tax rules in 2021 create unique problems for taxpayers. To the extent a future Congress decreases the current exemption amount by 50%, couples with an estate of more than $11.58 million will have missed a great opportunity to substantially reduce their estate tax by utilizing such increased exemption amount through taxable gifts. However, most taxpayers are unable to fully take advantage of the full $11.58 million exemption amount, even couples with over $20 million in assets, because of a reluctance to give up access to the gifted assets. Plus, if Congress does not act and no changes are made to the current estate tax rules, making taxable gifts in 2020 may produce an overall negative tax result. For those taxpayers caught in this quandary, the Reverse DGT may be the answer since it allows full use of the increased exemption amount in 2020 without severely limiting the taxpayer's access to the gifted assets and preserves the possibility of a step-up income tax basis at death.

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[1] A prior version of this article appeared as "The Reverse Defective Grantor Trust," Trusts & Estates, October 2012.

[2] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, also known as the Tax Cuts and Jobs Act, provided that the unified credit equivalent doubled starting in 2018 although such increase expires and the prior law is reinstated after 2025. P.L. 115-97 (12/22/2017). All references to unified credit equivalent in this comment will be referred to as "exemption amount" throughout this article.

[3] Karen Hube, "Here's How Much You Would Pay Under Biden's and Trump's Tax Plans," Barron's, October 23, 2020.

[4] To increase a married couple's access to gifted assets, some estate planners are considering the use of two nearly identical trusts whereby each spouse is a potential beneficiary of the other spouse's gift trust. Paul Sullivan, "To Give or Not to Give, Up to $5.12 Million," N.Y. Times, June 22, 2012. Aside from the need to avoid the reciprocal trust doctrine, the surviving spouse still loses access to half the gifted assets upon the first death and none of the gifted assets receive a step-up in basis at death. *See supra* note 17 and accompanying text.

[5] If Congress sets the exemption amount back to $5 million per person (or $10 million per couple) and indexes it for inflation, which is the amount it would automatically return to after 2025, and a couple together can only afford to gift away $10 million in 2020, then the couple will simply have used up their entire $10 million exemption by gifting in 2020. They will be in no different position with respect to the exemption if they had not gifted anything in 2020. Therefore, unless the couple can afford to give away more than $11.58 million in assets, gifting less may not utilize any of the 2020 increased exemption amount. For a couple to not lose any of the increased exemption, they would need to gift the full $23.16 million in asssets.

[6] One option to reduce the need to gift a full $23.16 million is to have only one spouse make gifts of up to $11.58 million with separate property during 2020 so that he fully uses his available exemption amount. The non-gifting spouse will then have preserved her remaining exemption amount in full for use on future gifts. However, the non-gifting spouse will still lose the ability to fully utilize her exemption amount to the extent the exemption amount at her death is less than $11.58 million.

[7] Sales to DGTs have grown in popularity and usage since first introduced in a 1996 Estate Planning article. Michael D. Mulligan, *Sale to a Defective Grantor Trust: An alternative to a GRAT*, 23 Estate Planning 3 (January 1996). *See also* Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, 4 No. 2 Bus. Entities 28 (March/April 2002).

[8] *See* IRC § 671. The taxpayer must create the irrevocable trust and include certain provisions, like the power of the grantor to exchange trust property for other property of equal fair market value or the power of an independent person to add charitable beneficiaries, which causes the trust to be treated as a grantor trust. *See* IRC §§ 675(4); IRC § 674(a).

[9] Rev. Rul. 85-13, 1985-1 C.B. 184.

[10] Treas. Reg. § 1.671-4(b)(1).

[11] Assuming the grantor desires the trust be held for multiple generations, the grantor would want to allocate his generation-skipping transfer ("GST") tax exemption to any gift to insulate future distributions from GST tax. To the extent a sufficient portion of the grantor's generation skipping transfer tax exemption is allocated to the original gift to the trust so that the trust has a zero inclusion ratio, then the assets of the trust – including any future growth – can eventually pass to the grantor's grandchildren in trust without estate or generation skipping transfer tax.

[12] *See infra* notes 41-52 and accompanying text.

[13] For most traditional sale to DGT transactions, the promissory note is often structured as a 9-year note so that the interest rate can be set at the minimum applicable federal rate for a mid-term loan.
[14] *See* IRC § 7872(e) (providing that a gift loan is only a below market loan if the interest rate on the note is less than the applicable Federal rate under I.R.C. § 1274(d)).
[15] *See* IRC § 2053(c)(1)(A); Treas. Reg § 20.2053-4(d)(5).
[16] *See infra* notes 21-30 and accompanying text.
[17] See IRC 1014(b)(1); Treas. Reg § 1.1014-2(a)(1). This is different than a traditional sale to a DGT where the trust assets are not included in the estate of the grantor. In that case, there is some uncertainty as to the basis of such assets, but it is likely that the assets of the trust will not receive a step-up in income tax basis. *See infra* note 18 and accompanying text.
[18] *See* Roy M. Adams, "2001: An Estate Planning Odyssey," Ninth Annual Estate & Charitable Gift Planning Institute, 106-115 (2001); *see also* Elliott Manning and Jerome M. Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements, 24 Tax Mgmt., Estate, Gifts & Trusts J. 3 (1993); *but see* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death." 97 J. of Tax'n 149 (1992).
[19] IRC § 2036.
[20] *Id*.
[21] Estate of Strangi v. Comm'r, T.C. Memo 2003-145, 2003 Tax Ct. Memo LEXIS 144, 85 T.C.M. (CCH) 1331 (T.C. 2003).
[22] Est. of Paxton v. Commissioner, 86 T.C. 785 (1986) (finding an implied understanding that the grantor would receive distributions when requested).
[23] *See* Harwood, 82 T.C. 239, 258 (1984).
[24] *See* Est. of Van Anda, 12 T.C. at 1162.
[25] *See* e.g., Est. of Maxwell, 98 T.C. 594, 603-604 (1992); aff'd 3 F.3d 591 (2nd Cir. 1993); Est. of Kelly, 63 T.C. 321, 324-325 (1974); Est. of Van Anda, 12 T.C. 1158, 1162 (1949), aff'd per curiam, 192 F.2d 391 (2nd Cir. 1951).
[26] Est. of Lockett, T.C. Memo 2012-123; see Zimmerman v. U.S., 318 F.2d 611, 613 (9th Cir. 1963); Est. of Maxwell, 98 T.C. at 604; Est. of Kelly, 63 T.C. at 323-324; Est of Van Anda, 12 T.C. at 1162-1163.
[27] Est of Lockett, T.C. Memo 2012-123 (2012).
[28] Belli, Melia, T.C. Memo 1989-403 (1989)
[29] *See* Jay A. Soled, Use of Judicial Doctrines in Resolving Transfer Tax Controversies, 42 B.C. L. Rev 587, 588-596 (May 2001).
[30] *Id*. at 596; *see also* Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 191 (D. Conn. 2004) (discussing the end result test).
[31] *See infra* note 54 and accompanying text.
[32] *See supra* notes 20-31 and accompanying text.
[33] *See* Soled, *supra* note 29 at 607 (arguing that all marital trusts could be subject to question by a broad application of the step-transaction doctrine).
[34] See Pierre v. Comm'r, T.C. Memo 2010-106, 2010 Tax Ct. Memo LEXIS 143, 99 T.C.M. (CCH) 1436 (T.C. 2010) (combine same day gift and sale of interests); Driver vs. U.S., 76-2 U.S. Tax Cas. (CCH) P13, 155, at 85,695 (W.D. Wis. 1976) (collapse two transactions two days apart); Blanchard v. United States, 291 F. Supp. 348, 348-50 (S.D. Iowa 1968) (gift and sale collapsed when separated by three weeks); Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (same day sale and stock redemption collapsed); Shepherd v. Commissioner, 115 T.C. 376, 389 (2000), aff'd 283 F.3d 1258 (11th Cir. 2002) (same day transfers of interests collapsed); Senda v. Commissioner, T.C. Memo 2004-160, affd. 433 F.3d 1044 (8th Cir. 2006) (same day funding of partnership and gifts of interests collapsed).

[35] Pierre v. Comm'r, T.C. Memo 2010-106, 2010 Tax Ct. Memo LEXIS 143, 99 T.C.M. (CCH) 1436 (T.C. 2010) (explicitly providing that the step transaction only applied to treat two same transactions as one and not to disregard the creation or funding the entity or the note issued in exchange for the assets sold).
[36] Holman v. Commissioner, 601 F.3d 763, 770, 772 (8th Cir. 2010) (noting that there the value could have changed in the six days between the two transactions); *see* Gross v. Comm'r, T.C. Memo 2008-221, 2008 Tax Ct. Memo LEXIS 218, 96 T.C.M. (CCH) 187 (T.C. 2008) (finding that 11 days was sufficient to prevent the transaction from being collapsed).
[37] For additional ways to avoid the application of the Step-Transaction Doctrine, *see* Steve R. Akers, Donaldson, Samuel A., Fox, Charles D. Fox IV, Pennell, Jeffrey N., Zaritsky, Howard M., "Recent Developments – 2010," 45 Inst. on Est. Plan. 1, ¶ 102 (2011).
[38] *See* Treas. Reg. Section 1.1001-2, ex. 5 (treating grantor trust termination as a transfer and requiring recognition of gain to the extent liabilities exceed basis); Madorin v. Commissioner, 84 TC 667 (1984) (same for income tax shelter); Rev. Rul. 77-402 (same). The ruling was also applied in non-tax shelter cases, including estate planning transfers, where grantor trust status was terminated during the grantor's lifetime. See TAM 200010010; TAM 200010011; TAM 200011005.
[39] *See* Treas. Reg. 1.1001-2(a); Treas Reg. 1001-1(c) ex. 5.
[40] *See* Ascher, Mark L., "The Grantor Trust Rules Should Be Repealed," 96 Iowa L. Rev. 885, 922-924 (2011).
[41] *Id. See also* Blattmachr, Gans & Jacobson, *supra* note 18, at 149-54; Milford B. Hatcher, Jr. & Edward M. Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, 92 J. Tax'n 152, 163 (2000); Fred Nicholson, Sale to a Grantor Controlled Trust: Better than a GRAT?, 37 Tax Mgmt. Memorandum (BNA) No. 8, at 102-103 (Apr. 15, 1996); Michael D. Mulligan, Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note - An End Run Around Chapter 14?, 32 Inst. on Est. Plan. P 1509.2 (1998);
[42] *See* Ascher, Mark L., When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction, 41 Tax L. Rev. 253, 273 (1986).
[43] IRC § 1015.
[44] *See* Blattmachr, Gans, & Jacobson, *supra* note 18 (discussing the three competing theories of taxation post-death with a grantor trust – all of which would provide a basis in the transferred asset of at least the seller's original basis in the property).
[45] If the measuring date for the asset transfers was the date of death, one might consider whether the basis of the assets retained by the grantor at that time determines the amount of gain. But, what if the grantor no longer holds those assets or has consumed them, how might the basis be determined? It is difficult to see how the Service could then argue the transfer of the remaining assets took place upon death and measure the debt against the basis of the remaining assets.
[46] *See supra* note 17 and accompanying text.
[47] See Milford Hatcher, Jr., "Planning for Existing FLPs," 35 Inst. on Est. Plan. 3, ¶ 302.4(A)(2) (2001) (discussing how backloading interest payments is permissible but may cause the Service to recharacterize the debt as equity if not paid somewhat regularly).
[48] But see Elliott Manning and Jerome M. Hesch, "Beyond the Basic Freeze: Further Uses of Defined Payment Sales," 32 Inst. on Est. Plan. 16, ¶ 1601.2(a)(5)(E) (2000).
[49] *See supra* note 14 and accompanying text. Other more complicated options exist to lessen the burden of servicing the interest. Specifically, if the grantor made several interest payments to the trust and the trust later decides to make an additional loan to the grantor of some of those funds, the trust should have a basis in the new notes equal to the face value of the new notes and repayment of those additional loans post-death should not bring rise to gain.
[50] To the extent the trust terms provide the trustee with unfettered control or enjoyment of the trust assets, either directly or indirectly, the grantor, if serving as trustee, could have

the trust assets included in the grantor's estate under IRC Sections 2036 or 2038. *See* Darin N. Digby, "What Powers Can a Donor Retain Over Transferred Property?", 24 Estate Planning 318 (Aug./Sept. 1997). But, if the grantor's retained powers are limited by an ascertainable standard and subject to fiduciary responsibilities, then serving as trustee should not cause estate tax inclusion. *See* U.S. v. Byrum, 408 U.S. 125 (1972).

[51] Under the Uniform Prudent Investor Act (UPIA), which most states have adopted in some form, a trustee must manage the trust solely for the benefit of the beneficiaries and not his own and must exercise proper skill, care, and caution. *See* UPIA Sections 2, 5 (1994).

[52] *Ibid.* Section 1(b).

[53] *See* Jay A. Soled, "Reforming the Grantor Trust Rules," 76 Notre Dame L. Rev. 375, 412 (2001) (noting that while not certain, the inclusion of such power shouldn't cause estate tax inclusion since there is no corresponding estate tax code section to that grantor trust power).

[54] IRC § 1014(e).