Tax Management Memorandum
January 23, 2006, Vol. 47 No. 02
MEMORANDUM
Evaluating the Potential Success of a GRAT Against C...

Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth

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The following analysis will form part of the revision by Jonathan G. Blattmachr and Georgiana J. Slade of 836 T.M., *Partial Interests -- GRATs, GRUTs and QPRTs (Section 2702),* to be published in 2006.

PURPOSE OF USING A GRAT

Tax-efficient wealth transfer is an important goal of most sound estate planning strategies. A grantor retained annuity trust (GRAT) is a wealth transfer technique created by §2702[1] and corresponding Treasury Regulations. Taxpayers and practitioners therefore perceive the GRAT as a sanctioned means to transfer wealth at a reduced transfer tax cost. A GRAT may permit the transfer of wealth to or for others with little, if any, gift tax due and with no estate tax. The GRAT may accomplish that goal or purpose for one or more reasons. This article presents a framework to determine if and how it may be successful in accomplishing its purpose. It also provides some comparisons of a GRAT to a more direct transfer of wealth and to an installment sale to a grantor trust.

SOME GENERAL GIFT TAX VALUATION PRINCIPLES

As a general rule, when an individual makes a transfer of an interest in property that is regarded as complete for federal gift tax purposes, only the value of the interest transferred (and not the interest retained) constitutes a gift. Unless that transfer falls under some exception, exclusion or deduction, it will be subject to gift tax, although the tax will be offset by any unused unified credit (also known as the applicable credit amount) allowed under §2505(a). As indicated, the value of any interest that the transferor retains is not subject to gift tax so long as the donor's interest can be valued using generally accepted valuation principles. Usually, the value of the gift is determined by subtracting the value of the interest the transferor has retained in the property transferred from the value of the entire property so transferred.[2] However, under §2702(a), in determining if a transfer of property in trust for a member of the transferor's family [3] has resulted in a gift and the amount of the gift, the value of an interest retained by the transferor in the trust may be deemed to be zero, meaning that the value of the entire property, and not just the interest transferred, may be subject to gift tax.

GIFT TAX VALUATION OF CERTAIN ANNUITY INTERESTS

Nevertheless, under a special rule contained in §2702(b), the value of a retained annuity

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interest in a trust is not deemed to be zero but rather may be determined using "normal" actuarial valuation principles set forth in §7520. Regulations promulgated under §2702(b) set forth detailed rules as to the requirements to satisfy the special rule.[4] A trust in which the transferor (or grantor) has retained such an annuity interest usually is called a "grantor retained annuity trust" or "GRAT." With a GRAT, the value of the gift of the remainder interest (that is, the entitlement to receive property after the annuity is no longer payable) is determined by subtracting the actuarial value of the retained right of the grantor to the annuity from the value of the property transferred to the trust.

GOAL IN USING A GRAT: GIFT TAX FREE GIFTS

Typically, the goal in creating a GRAT is to transfer assets out of the grantor's gross estate for federal estate tax purposes while at the same time exposing, at most, only a small value of the assets transferred to gift tax. By retaining an annuity interest whose value is large compared to the value of the property transferred to the trust, the gift tax value of the remainder may be made small. In fact, under current Regulations, it seems that the value of the annuity may be made close to if not equal to the value of the property transferred to the trust.[5] In other words, the value of the remainder may be made relatively small if not actually zero. That occurs by having the annuity be large enough that it approaches the value of the property transferred to the GRAT. That is easier to do if the annuity is payable not only to the grantor, but if the grantor dies, to the grantor's estate (usually referred to as a "fixed term annuity"). A fixed term annuity removes the contingency of the grantor's death from the actuarial calculation of the value of the annuity, so that the annuity can be mathematically set to equal (or almost equal) the value of the property transferred to the GRAT. Thus, over the annuity term, the grantor or the grantor's estate is to receive from the trust, in annuity payments, the value or nearly the value of what he or she has transferred together with an interest factor equal to or close to the rate determined under §7520 (the §7520 rate) for purposes of valuing the annuity interest.

When GRAT Will Accomplish Its Goals: Growth Greater than §7520 Rate

The GRAT, as a general rule, will be successful in removing property from the owner's estate at no gift tax cost only when the return of income and appreciation (the total return) to the trust during the annuity term exceeds the §7520 rate. For example, an individual transfers property having a gift tax value of $1 million to a trust at a time when the §7520 rate is 5%. In determining the value of the gift, it is assumed for tax purposes that the trust will grow from its initial value of $1 million at inception to $1,050,000 at the end of one year. The grantor directs that at the end of the year, the trust must pay the grantor $1,040,000 and pay anything left in the trust to the grantor's children.[6] (because the trust is assumed to be worth $1,050,000 at year end and because the grantor is then to receive $1,040,000, it is assumed, for purposes of determining the value of the gift that the children will receive $10,000, no more and no less). The gift of the remainder is made for federal gift tax purposes when the GRAT is created, not when the annuity payments to the grantor end. That is because the transfer of the remainder interest in a GRAT is irrevocable upon creation, and therefore, a completed transfer. If it were not, §2702 would not be implicated.[7] The present value of the right to receive the remainder in one year is the present value of the right to receive $10,000 in one year using the §7520 rate as the discount rate (or 5% in this illustration). Hence, the gift is $9,524, which is the same as the $1,000,000 reduced by the present value (discounted at 5% of the right to receive the $1,040,000 annuity in one year which is $990,476 (that is, $1,000,000 - $990,476 = $9,524). If the GRAT earns exactly 5% for the year, the remainder beneficiaries will receive exactly what was projected, for tax valuation purposes, which in

this example is $10,000. Accordingly, for the estate planning purpose of a GRAT to be achieved, the GRAT would need to have a total return in excess of 5%.

Comparison of GRAT to Direct Gift

The result for the remainder beneficiaries of a GRAT if its assets grew exactly at the §7520 rate of 5% is essentially the same as what the beneficiaries would receive if the transferor instead had made a direct gift to them of $9,524 and it too had grown at 5% for the year (and, therefore, would have become $10,000). However, if the GRAT earns more than 5%, the remainder beneficiaries will receive more--even more than if they had received the direct gift of $9,524 and it too had grown at the greater rate. That is true because the GRAT captures for the remainder beneficiaries the outperformance[8] not just on the remainder interest, but also on the funds that will be used to pay the annuity. For example, if the property grows at 10% for the year, the direct gift of $9,524 would have grown to $10,476 rather than to only $10,000. But the GRAT at the end of the year would have become $1,100,000 if it grew at 10%. As a result, the remainder beneficiaries of the GRAT would not receive $10,476 but rather $60,000 ($1,100,000 minus the $1,040,000 annuity payment). On the other hand, if the GRAT earns less than 5%, the remainder beneficiaries of the GRAT will receive less than if a direct gift of $9,542 had been made to them and it too earned the same less-than-five percent rate. In fact, if the GRAT grows at no more than 4%, its remainder beneficiaries would receive nothing as the trust would be worth at year end no more than $1,040,000 all of which would have to be paid to the grantor in satisfaction of the annuity. Presumably, if they had received the direct gift of $9,542, they would still have something (unless the value declined to zero).

Comparison of GRAT to Direct Gift Is Not Pure

The comparison between a gift of the remainder through a GRAT and a direct gift of the amount that would constitute the value of the gift of the remainder is not "pure" for several reasons. For example, the gift of the remainder in a GRAT cannot qualify for the gift tax annual exclusion under §2503(b) because it is a future interest; a direct gift may so qualify. Also, it is the position of the IRS that the entire value of the GRAT, including any appreciation and income it earns, is included in the grantor's gross estate if he or she dies during the annuity term.[9] As a general rule, the direct gift usually is not so included. In addition, the annuity from the GRAT need not be paid until 105 days after the annuity is due.[10] If the trustee delays that payment for the 105-day term and the trust property continues to grow at an annualized rate of 5% for the 105 days, the remainder beneficiary would receive at that time approximately $25,000; if the beneficiary had received the direct gift, he or she would have only $10,144 if the gifted property continued to grow after the year at an annualized rate of 5% for the 105 days. Again, the remainder beneficiary of a GRAT benefits from the return not only on the remainder interest, but also on the property in the GRAT that will be used to fund the grantor's fixed annuity interest. Any delay in payment of the annuity amount after its due date, assuming the assets continue to appreciate in value, benefits the remainder beneficiaries because the 105-day payment delay is not taken into account for gift tax valuation purposes.

Another "real world" difference between a direct gift and a GRAT relates to investments. If a direct gift is made to an individual, the donee may invest the property in any lawful manner. Presumably, a transfer to a GRAT means the investments must be held or made in accordance with a fiduciary standard which may mean, at least in some cases, fewer or more restrictive investment choices than with a direct gift.[11]

Why Beneficiaries May Receive, for the Same Gift Tax Cost, So Much More from a GRAT than a Direct Gift: Leveraging

Thus, the reason the remainder beneficiaries of a GRAT receive so much more, when the earnings exceed the §7520 rate, than with a direct gift equal to what would be the value of the taxable remainder of the GRAT, relates to "leveraging." That is, the remainder beneficiaries of the GRAT receive all of the growth above the §7520 rate on the entire amount in the GRAT, not just the growth on the part of the GRAT that constitutes the taxable gift. The beneficiaries also absorb the effects of earnings lower than the §7520 rate on the entire amount in the GRAT, not just on the part that constitutes the gift. Hence, if the earnings are below the §7520 rate, the beneficiaries probably would have been better off with the direct gift. Accordingly, GRATs are typically viewed as successful only if the total return (from income and appreciation) exceeds the §7520 rate.

Exceptions to the Premise that GRAT Will Be Successful If, But Only If, Total Return Exceeds the §7520 Rate

There may be exceptions to the conclusion that a GRAT will be successful if its total return exceeds, and only if it exceeds, the §7520 rate.

Disparate Valuation Factors

One such exception may be where a special or disparate valuation factor comes into play. For example, a GRAT might be funded with such a large block of a publicly traded security that the stock is valued with a blockage discount.[12] Thereafter, the stock in the GRAT may be sold over a relatively long period at the same price at which it was trading in the marketplace and without a blockage discount or a smaller one. This, perhaps, would not be difficult to accomplish with a relatively long-term GRAT--for example, one that will make annuity payments over 10 years with each year's payment being 20% greater than the payment for the prior year. Indeed, if the annuity payments are to be made on the anniversary of the initial funding of the GRAT, the first payment need not be paid until approximately 15 1/2 months after that initial funding (that is, the 12 months to the anniversary plus the 105-days, or three-and-a-half months, delay payment term). In such a case, even if the value of the stock in the marketplace (adding in any dividends paid) does not increase over the life of the GRAT at a rate greater than the §7520 rate, it nonetheless may be successful from the perspective of the remainder beneficiaries. Similarly, those beneficiaries may receive more, even if the shares that were valued with a discount are not sold, if the blockage discount used in valuing the smaller blocks of stock used to satisfy the annuity is smaller than the blockage discount used with respect to the larger block that constituted the initial funding of the trust. The payment delay and the availability of a valuation discount can significantly reduce the hurdle rate of return for a successful GRAT.

For example, suppose a 10-year GRAT is funded with a $1 million asset that is eligible for a 15% valuation discount. For gift tax purposes only $850,000 has been contributed to the GRAT. Thus, the annuity and remainder gift will be computed on that value. This would leave $150,000 of excess value in the GRAT that could be delivered to the remainder beneficiaries. Suppose the annuity is set to produce a $1,000 initial gift. That gift has a future value in 10 years at a §7520 rate of 5% of $1,629. So if the initial transfer of $850,000 (for gift tax purposes) appreciates at the rate of 5% to $1,384,560 in 10 years, the amount in excess of $1,629 is assumed to be paid to the grantor in satisfaction of the annuity. However, the GRAT has $1,000,000 of underlying value. For that value to exceed the target future value of $1,384,560, the total return on the GRAT would need to be only slightly above 3.2%, approximately a 35% reduction in the return needed in order for the GRAT to be considered successful.

But the opposite result could also occur on account of special or disparate valuation factors--that is, the GRAT is unsuccessful even if the assets grow at a rate greater than

the §7520 rate. For example, a GRAT is funded with a controlling interest in a closely-held business. Such an interest almost certainly will not be valued with a discount for lack of control (that is, a minority discount).[13] However, if the trustee distributes minority interests in the business to the grantor in satisfaction of the annuity, a lack of control discount may apply, causing the trustee to have to distribute a disproportionately greater percent of the interests in the business the trustee owns.

Experiencing Large Losses Before Even Larger Gains

Another case where the GRAT may "fail" even though the total return during the annuity term is greater than the §7520 rate is where large losses are experienced by the time the first annuity payment or payments are made leaving insufficient assets to pay the next annuity payment or payments. For example, a taxpayer creates a two-year GRAT funding it with property worth $1 million. The GRAT is to pay the taxpayer $530,000 at the end of both years. It is anticipated that the contributed property will grow by the end of two years by 25%. But at the end of the first year, the property has declined by 25% to $750,000. The trustee distributes $530,000 worth of the property to the grantor in satisfaction of the annuity leaving the trust with only $220,000. By the end of the second year, the property contributed to the GRAT has increased in value to its target of $1,250,000, a 66 1/3% increase over the value the year before. But the property in the GRAT would be worth only $366,666, less than what is need to make the second annuity payment, so nothing will pass to the remainder beneficiaries. Hence, the GRAT fails to accomplish its goal of transmitting wealth to the remainder beneficiaries. The grantor could have placed the first year annuity in a second GRAT and, perhaps, that one would be successful as its property would have grown from $530,000 to $883,333 by the end of the second GRAT's first year. That may indicate a strong likelihood that the second GRAT will be successful although if the grantor dies before the end of its second year, the IRS would likely take the position that all of the property in the GRAT is included in the grantor's gross estate for federal estate tax purposes.

When comparing a direct gift to a GRAT, the recipient is "trading" the entire return for the period on the amount of the gift for the return above the §7520 rate experienced by the GRAT for the period although, as explained, a return below the §7520 rate in an earlier year or years of the GRAT may so offset the return above that rate in a later year or years that the remainder beneficiaries of the GRAT may receive less than by a direct gift. In other words, in determining if the GRAT experiences a return above the §7520 rate, one must look at the return based upon the entire amount transferred to the trust and not just the return experience year-by-year on the amount remaining in the GRAT. For example, suppose the §7520 rate when the GRAT begins is 5.0%. The grantor creates a two-year GRAT with $1 million and provides for the grantor to receive $537,000 at the end of each year. If the GRAT earns exactly 5.0% each year, it will grow to $1,050,000 at the end of the first year, the grantor then will receive $537,000, leaving $513,000 in the GRAT which will grow to $538,650 at the end of the second year, when the grantor will receive another $537,000 payment, leaving $1,650 for the remainder beneficiaries. Suppose instead, the trust earns only 2% in the first year and 10% in the second. The average return is 6% but the GRAT will fail. Here is why. The first year, the GRAT grows by 2% to $1,020,000. It pays the grantor $537,000, leaving $483,000 in the GRAT which grows by 10% the second year to $531,300 which is insufficient to make the second $537,000 payment to the grantor. Hence, it is not the average return experience by the GRAT over the annuity term that determines whether it will be successful but rather the "blended" return based upon the amounts remaining in the GRAT from time to time.

Comparisons of GRAT to Installment Sale to Grantor Trust

It also could be contended that the GRAT should be viewed as effective only by comparing it to other estate planning arrangements including (1) direct gifts to others

(whether outright or in trust) without any interest being retained for the grantor, which was discussed above, and (2) a so-called "installment sale to a grantor trust."[14]

Description of Installment Sale to Grantor Trust

An installment sale to a grantor trust is a sale by the grantor to a trust that is a grantor trust in its entirety for federal income tax purposes under subpart E of part 1 of subchapter J of Chapter 1 of subtitle A of the Code with respect to its grantor. Such a trust is one that has its income, deductions and credits against tax attributed to the grantor essentially as though the trust does not exist for income tax purposes.[15]

Under Rev. Rul. 85-13,[16] the IRS announced, in effect, that no gain (or loss) is recognized by the grantor when the grantor sells assets to a grantor trust even if the assets sold are appreciated (or depreciated).[17] The trust usually pays for all or part of the assets by issuing a note payable to the grantor bearing appropriate interest at the applicable federal rate (AFR).[18] Also, as a result of Rev. Rul. 85-13, the interest paid or accrued on the note should not be included in the grantor's gross income because the trust and the grantor are considered to be the same taxpayer for federal income tax purposes, and there can be no income tax realization event as a result of a transaction with oneself.

Comparisons of GRATs to installment sales to grantor trusts are, in many ways, difficult to make and the results derived from the comparisons at least to some degree, are difficult to analyze. Although the "mathematical" results of each may be compared in a somewhat objective manner, other factors do not as readily lend themselves to such objective comparison.

Comparing Complexities of Implementation of GRAT vs. Installment Sale

Different people will view certain estate planning arrangements as more complicated than other ones and will disagree as to which is more complex. In addition, some people more readily accept complexity than others do. Each of the GRAT and the installment sale strategies presents different complexities in implementation and administration. Some view GRATs as simple to understand, implement and administer. Others do not. Some think that installment sales are very complex arrangements. Others do not. Moreover, a client and his or her lawyer's view on those subjects may differ. To some clients, the number of legal documents and entities involved, and the associated legal costs, dictate the client's view of whether the proposed estate planning transaction is complex. Those clients may view a GRAT as less complicated. Other clients may find the purchase and sale and entity documents needed to implement an installment sale familiar, and find a GRAT more difficult to grasp.

Other complexities in implementing a GRAT may be demonstrated by the following discussion.

Many married persons provide for all property included in their gross estates for federal estate tax purposes to pass in a form qualifying for the estate tax marital deduction (except for any unused federal estate tax exclusion amount). That is done to provide the maximum base of wealth for the surviving spouse, and postpones all wealth transfer tax on the assets until after the death of the spouse last to die. As stated above, if the grantor of a GRAT dies during the annuity term, the entire trust property is included in the grantor's gross estate, according to the IRS. If the grantor is married, he or she may want the GRAT property (both any annuity payments due to the estate of the grantor and whatever else will be left in the GRAT after those annuity payments are made) to qualify

for the marital deduction so the maximum base of wealth is available for the surviving spouse.[19] Almost without question, the grantor will have structured the GRAT pursuant to the *Walton* regulations [20] and, therefore, will have provided that the annuity payments will be made to the grantor for a fixed term (such as five years) or to the grantor's estate for the balance of the fixed term if the grantor dies during the term. The structure of a GRAT apparently required to fall under the *Walton* regulations administratively may be "at odds" with the structure required to make the GRAT qualify for the marital deduction. Prior to the adoption of the *Walton* regulations, many practitioners simply provided for the property in the GRAT to revert to the grantor's probate estate if the grantor died during the annuity term. The GRAT property then could pass under the grantor's will to or for the surviving spouse in a manner qualifying for the estate tax marital deduction. But it seems fairly certain that such a reversion upon death structure will not comply with the *Walton* regulations, which require that the annuity payments continue for the entire fixed term, either to the grantor or the grantor's estate. If the GRAT does not comply with those regulations, a much larger gift probably will be made when the GRAT is created since the annuity would be valued as if it were payable only until the grantor's death. Hence, if the GRAT is structured to fall under the *Walton* regulations, both any remaining annuity payments due to the grantor's estate and the balance of the GRAT property that will remain after those annuity payments are made must be structured to qualify for the marital deduction. And, at least some practitioners believe that the balance of the GRAT (that is, what will remain after the annuity payments are made to the grantor's estate) cannot revert to the grantor's probate estate either, as that would make both the annuity payments and the balance payable to the estate which might be tantamount to a reversion in violation of the *Walton* regulations.

Another somewhat metaphysical question raised by the problem of how to qualify the estate tax includible GRAT for a marital deduction is whether the GRAT should be considered a single or multiple property interests. It is at least conceivable that at the grantor's death, a GRAT consists of two separate property interests, the continuing annuity payments and the GRAT remainder, each of which must separately qualify for the marital deduction from the date of the grantor's death. The consequence of treating the annuity and the GRAT remainder as separate property interests could be that because the GRAT remainder cannot be paid to the surviving spouse or converted to a marital deduction trust until the annuity obligation ends, it cannot qualify for the marital deduction as of date of the grantor's death, as would be required.

Nevertheless, it would seem conceptually incorrect to view a GRAT upon the grantor's death as two separate interests. Rather, the GRAT should be viewed as a single trust, and that trust needs to qualify for the marital deduction. Thus, all that should be required for marital deduction purposes is for all the net income of the GRAT to be paid to the surviving spouse, and that no portion of the trust estate may be paid to anyone other than the surviving spouse during his or her lifetime. Separately, to be a valid *Walton* GRAT, the annuity payments must continue to the grantor's estate without collapsing the GRAT. Thus, to satisfy both requirements, the annuity payments must be paid to the grantor's estate and, to the extent they consist of net income of the GRAT, must be paid, in turn, from the estate to the surviving spouse. Any excess annuity payment over the net income must be paid either to the surviving spouse or to a trust that qualifies for the marital deduction. If the annuity payments fall short of the GRAT's net income, that shortfall must also be distributed to the surviving spouse from the GRAT (again, through the grantor's estate[21]). And lastly, the GRAT remainder at the end of the annuity term must either be paid to the surviving spouse or held in a continuing trust that qualifies for the marital deduction.

Although it seems possible to have a GRAT structured under the *Walton* regulations and also to qualify any part of the GRAT included in the grantor's estate for the marital

deduction, the matter is complex and not well developed under decided law.[22] In contrast, if the grantor dies while the note he or she received in an installment sale to a grantor trust is still outstanding, if properly structured and administered, the property in the grantor trust should not be included in the grantor's gross estate. That obviates any complexity in obtaining the estate tax marital deduction with respect to those assets. Although the note itself presumably would be included in the grantor's gross estate, it should be a relatively simple matter to make the note qualify for the estate tax marital deduction. In addition, even if the assets in the grantor trust that made the installment purchase are included in the grantor's gross estate, it seems that the estate tax marital deduction would be simple to achieve by merely having the trust agreement of the grantor trust provide that any assets in the trust that are included in the grantor's estate shall pass in a form qualifying for the marital deduction.

Comparing Legal Risks and Certainties

Each arrangement (that is, the GRAT and the installment sale to a grantor trust) presents at least some different level of legal certainties and risks. Legal certainties and risks, perhaps even more so than apparent complexities, may be especially difficult to quantify and opinions may vary as to which arrangement or form of arrangement has more certainty or risk in legal results.

GRATs May Be Viewed as More "Statutory" than Installment Sales

The grantor's retained annuity interest in a GRAT (referred to in §2702(b) as a type of "qualified interest") is expressly "authorized" in the Code and regulations. That is, the arrangement and its principal gift tax consequences are explicitly described in the statute and regulations. An installment sale to a grantor trust is not authorized by the Code and regulations but, in the opinion of many commentators and practitioners, is based on sound although multiple and complex rules.[23] Also, under the *Walton* regulations,[24] the value of the remainder in a GRAT may be determined by providing for the annuity to be paid for a fixed term (e.g., ten years) by specifying for it to be paid to the grantor for the entire term or, if the grantor dies during the term, to the grantor's estate for the balance of the term.

But Basic Legal Questions about GRATs Remain

Despite the fact that GRATs are "statutory," some important questions about them remain. Depending upon the answer to one or more of those questions, the GRAT may not accomplish its purpose of transmitting wealth free of estate tax and with little, or perhaps no, gift tax.

How Small Can the Remainder in a GRAT Be?

Although regulations have adopted the holding in *Walton*,[25] that does that mean the value of the (taxable) remainder in the GRAT may be structured to be zero or even "too" small, at least in the view of the National Office at one time. In TAM 200245053, issued after *Walton* was decided but before the IRS announced its acquiescence in the case,[26] the IRS stated that the value of the remainder in a GRAT could not be very small (such as one percent). Although many practitioners may conclude that the risk is remote that a GRAT is not a "qualified interest" under §2702(b) by reason of the value of the remainder being very small (if not zero), some advisors or taxpayers may conclude that the possibility that the courts might agree with the conclusion in the TAM should not be ignored.[27]

It also should be noted that the IRS will not issue a private letter ruling on the qualification of a GRAT where the value of the remainder interest is less than 10% of the value of the contributed property.[28] That, also, may indicate that the IRS may challenge any GRAT the remainder of which is "too small."

In any case, if the grantor's retained annuity in a GRAT is not a "qualified interest" under §2702(b) by reason of the value of the remainder being very small, the consequences of making it that small are uncertain. One possibility is that the gift would be deemed to be equal to the minimum value permitted for a remainder in a GRAT (such as 10%). Another possibility is that making the value of the remainder in the GRAT too small causes the annuity to fail to constitute a qualified interest under §2702(b).[29] That could mean the value of the entire property contributed to the GRAT is subject to gift tax. That possibility may seem exceptionally remote to many practitioners, but some taxpayers might find the risk to be unacceptable and may only create a GRAT if the value of the remainder is at least 10% of the value of the property contributed to the trust, which, as indicated, is the minimum size of a remainder in a GRAT upon which the IRS will issue a private letter ruling that the annuity interest in a GRAT is a qualified interest under §2702(b).

For How Short a Term May a GRAT Last?

Another uncertainty with respect to a GRAT, at least in the view of some practitioners, is how short the annuity term can be. At one time, the IRS would not issue a ruling that the retained annuity in a GRAT would be a qualified interest under §2702(b) unless the annuity term was at least five years long.[30] Some practitioners are confident a GRAT of at least two years may be a qualified interest. This view is likely supported in no small measure by the fact that the GRATs in the *Walton* case were two-year GRATs, even though the sole issue for decision in *Walton* was the valuation of the gifts. Others are not so certain. If the GRAT must be of a minimum term to be a qualified interest, the entire amount transferred to the trust might be subject to gift tax if the annuity term is shorter than that minimum.

What Is the Effect of Improper Administration of a GRAT?

A third uncertainty is the consequence, if any, if the GRAT is not administered in accordance with its terms that are required by the regulations. For example, suppose the annuity for the year is not paid within 105 days of the close of the year (or the anniversary of the commencement of the GRAT), as appears to be required by the regulations.[31] In *Atkinson v. Comr.,* [32] the court stated that a trust was not a "qualified" charitable remainder annuity trust under §664 where the trust was found not to have made any annuity payments to the grantor-annuitant. That statement may be so-called *dicta* (the equivalent of a statement that does not constitute precedent) because the courts found an independent reason why the trust was not qualified. Nevertheless, it may be difficult for practitioners and taxpayers to conclude that there is no risk of an adverse effect if the GRAT is found not to have been administered in accordance with its terms that are required by the regulations (e.g., an annuity payment is made more than 105 days after its payment due date) or that there is no risk that such a mistake in administration may occur.

Many Questions Also Remain for Installment Sales

The scope or number of legal uncertainties with respect to an installment sale may be as great or even greater and as significant as or more significant than they are with respect to a GRAT.

Does Either or Both of §2701 or §2702 Apply to an Installment Sale to a Grantor Trust?

Essentially, under both §§2701 and 2702, certain interests in a partnership, corporation or trust owned or retained by a transferor are treated as having no value thereby causing the entire amount involved in the transfer to or acquisition by members of the transferor's family to be treated as a gift. If either section applies to an installment sale, the result would be adverse. In the Tax Court case involving taxpayer Sharon Karmazin, Docket 2127-03, the IRS took the position that both §§2701 and 2702 may apply to an installment sale because, in the IRS's view, the note received in the sale did not constitute debt for purposes of those sections. That case was settled with the IRS and, according to taxpayer's counsel, on grounds other than that either section applied. As long as the note, in fact, represents debt, it seems, as is discussed below, that neither section should apply.[33]

Are the Trust Assets Included in the Grantor's Estate if the Grantor Dies While the Note Is Outstanding?

It is at least strongly arguable that, in general, property sold on the installment basis is not included in the seller's gross estate because the seller has not retained an interest in the property sold, but has received only the buyer's promise to pay for the property as evidenced by the note.[34] The value of the buyer's note would be included in the seller's gross estate. However, in the case of an installment sale of property to a trust created by the seller which will continue to hold the property and the earnings thereon (together with any assets initially contributed by the seller), the trust's potential inability to satisfy the note other than with the property itself or the return thereon might support the argument that the seller has retained an interest in the property sold. The seller's retained interest would cause estate tax inclusion under §2036.

For purposes of §2036, as well as §§2701 and 2702, the critical question would appear to be whether the debt is bona fide. If it is, the seller should not be viewed as having retained an interest in the transferred property, which should preclude the IRS from invoking any of those sections. Indeed, the IRS appears to concede as much in PLR 9515039. That ruling focused on the resources available to the obligor with which to make payments on the note, finding no retained interest where the daughter/obligor had sufficient wealth but reaching a contrary conclusion where the trustee/obligor had no other assets. It would seem, therefore, that if the obligor (or guarantor) has sufficient independent wealth or, in the case of a trust, the trustee has other assets, the note ought to be respected as a bona fide one.[35] Moreover, if the asset subject to the installment sale and its anticipated total return are sufficient to satisfy the obligation on the note, the note should not fail as debt. Rather, if the trust is reasonably expected to be able to satisfy the note by making all payments when due, even if those payments must be made from the asset purchased and the total return thereon, the note obligation should be viewed as debt and not equity.[36]

The IRS has issued several PLRs and TAMs which, it seems, bear on this issue of possible gross estate inclusion. In the earliest such ruling, TAM 9251004, the donor transferred stock to a trust for the benefit of his grandchildren in exchange for a 15-year note bearing current interest with all principal due upon maturity. Because the value of the stock exceeded the value of the note, the donor intentionally made a part sale/part gift to the trust. The National Office stated that, because the trust had no other assets, it must use the dividends on the stock to make interest payments on the note. The National Office characterized this as a "priority right to the trust income," and also noted that although the trustee was not prohibited from disposing of the stock, "the overall plan

as established by the tenor of the trust is that the trust will retain the closely held shares for family control purposes." The National Office concluded that under the circumstances the donor made a transfer with a retained life estate under §2036.

This TAM, in the view of some, is poorly reasoned and, perhaps, may be distinguished because the transfer was simultaneously donative in part. Moreover, subsequently, in PLR 9639012, the IRS appeared to adopt a somewhat different view. In PLR 9639012, the donors established qualified subchapter S trusts (QSSTs)[37] for their children, and then partly sold and partly gifted nonvoting stock to the trusts. Apparently, dividends would be used first to pay interest and principal with respect to the stock purchase, with the full price to be paid within three years.[38] The IRS ruled that the agreement to use cash dividends to pay interest and principal on the note would not be considered a transfer or assignment of the income interest of the QSST beneficiaries, or cause them to fail to qualify as QSSTs, and also ruled that no part of the trust would be included in the donor-sellers' estates.

In PLR 9535026, a donor contributed assets to a trust, and then sold stock to the trust in exchange for a 20-year note bearing current interest at the AFR under §7872, with all principal payable at maturity. The note was secured by the stock sold. The IRS does not indicate whether there was any request by the taxpayer for a ruling with respect to inclusion in the estate under §2036. However, the IRS held that if the fair market value of the stock equals the principal amount of the note, the sale would not result in a gift. This conclusion is stated to be "conditioned on the satisfaction of both of the following assumptions: (i) no facts are presented that would indicate that the note will not be paid according to its terms, and (ii) the [trust's] ability to pay the notes is not otherwise in doubt."[39] In addition, the IRS concluded that the note would not be an "applicable retained interest" under §2701 (and, therefore, the section will not apply), and that §2702 would not apply because the note would be debt, rather than a term interest. Although both §§2701 and 2702 are gift tax provisions, these rulings (particularly the ruling under §2702, which deals with valuation of transfers in trust to or for the benefit of family members when interests in the transferred property are retained) would seem analogous to any reasoning under §2036 for estate tax purposes. This conclusion was, however, stated to be "void if the promissory notes are subsequently determined to be equity or not debt. [The IRS] expressed no opinion about whether the notes are debt or equity because that determination is primarily one of fact."[40] Interestingly, the trusts were self-settled, discretionary trusts; the ruling does not analyze the potential estate and gift tax consequences of that fact.

The IRS has also issued rulings involving what may be viewed as somewhat analogous situations, wherein property is transferred to a trust in exchange for payments for life (an annuity). In PLR 9644053, a husband and wife owned as community property stock of a corporation which, in turn, owned a partnership interest. As part of a property settlement incident to divorce, the wife was to receive the stock and was to make annuity payments to a trust for the husband's benefit for the husband's lifetime. The IRS stated that "it appears that the amount of the annual payments to [husband] under the annuity agreement and the obligation of [wife] to make the annual payments are independent of the value of the stock or the income generated by the stock although the taxpayer agrees that the source of the annuity payments will be the payments of partnership profits to [corporation]. In order to prevent the immediate dissolution of the partnership to effect the property settlement, the payments to [husband] are secured by the guarantee of [partnership]. . . . Default by [wife] may only indirectly result in the sale of [corporation] stock by [wife]. Thus, it appears that [husband] has not retained any control over the stock ... and that the transfer of property and property interests between [husband] and [wife] will be a bona fide exchange for full and adequate consideration." However, the IRS concluded that whether §2036 applies can best be determined upon consideration

of the facts as they exist at the transferor's death, and so did not rule on that issue.

In PLR 9515039, the taxpayer entered into what purported to be a split purchase with a trust, with the taxpayer acquiring a life estate and the trust acquiring the reminder interest in a general partnership interest. The IRS first recharacterized the transaction as a transfer of property to the trust in exchange for the right to receive a lifetime annuity. The IRS reached this conclusion under §2702 which the IRS concluded applies whenever two or more members of the same family acquire interests in the same property with respect to which there are one or more term interests. The IRS then concluded that because the trust held no assets other than the remainder interest, not only did the annuity interest retained by the taxpayer fail as a qualified annuity interest, but also, "the obligation to make the payments is satisfiable solely out of the underlying property and its earnings. Thus, the interest retained by [taxpayer] under the agreement, being limited to the earnings and cash flow of Venture [the investment held by the family entity subject to the joint purchase] will cause inclusion of the value represented by the [trust's] interest to be includible in [taxpayer's] gross estate under section 2036 (reduced, pursuant to section 2043, by the amount of consideration furnished by [the trust] at the time of the purchase)."[41]

There seems to be little case law addressing the gift and estate tax effects of an installment sale to a trust. However, in a series of cases which involved what might be viewed as a somewhat analogous issue under the income tax law,[42] the Ninth Circuit has repeatedly taken the position that the transactions were properly characterized as sales in exchange for annuities rather than transfers with retained interests in trusts, except in one case where the annuity payments were directly tied to the trust income.[43] The Ninth Circuit relied on the fact that any trust property (not just the income) could be used to pay the annuity, the transaction was properly documented as a sale, and the taxpayer/seller did not continue to control the property after the sale to the trust.[44] In *Fabric v. Comr.,*[45] a case which was appealable to the Ninth Circuit, the Tax Court (albeit with expressed reluctance) applied the analysis of the foregoing cases in the estate tax context under §2036, observing that "the rationale of these cases is fully applicable to the case at bar."

In *Moss v. Comr.,*[46] the decedent sold his stock in his closely held company to the company in return for an installment note that would be canceled upon his death, and the note was secured by a stock pledge executed by the other shareholders. The Tax Court observed that "[e]ven should we consider the payments to decedent as an `annuity' the value of the notes would still not be includible in his gross estate... . While the notes were secured by a stock pledge agreement this fact, alone, is insufficient to include the value of the notes in decedent's gross estate."[47] It seems that a sale to a trust is somewhat analogous to a sale secured by the transferred property.

Although, perhaps, there may be some possibility that the assets in the trust will be included in the grantor's gross estate for federal estate tax purposes if the grantor dies while the note received in exchange for the assets sold is still outstanding at the grantor's death, that risk, in the judgment of at least some practitioners, is remote. In fact, it seems that any such estate tax inclusion risk may be entirely eliminated if the note is paid in full before the grantor dies. Moreover, it seems the estate tax inclusion risk might be completely eliminated as a practical matter by selling or even giving the note to a trust for the grantor's spouse that the grantor has created.[48] Hence, the risk of the assets in the trust being included in the gross estate of the grantor seems considerably lower than with a GRAT, which the IRS contends will be included in its entirety in the grantor's gross estate if the grantor dies during the annuity term.

What Is the Effect if the Installment Sale Is Not Administered in

Accordance with Its Terms?

It is at least arguable that the installment sale cannot be so "automatically" treated as "ineffectual" if there is some administration not in accordance with its terms as occurred with respect to the charitable remainder trust in *Atkinson.* Nevertheless, such "misadministration" of an installment sale might be used as evidence that the note received by the grantor should not be treated as debt for federal gift tax purposes. That might be true particularly if the note is not paid in accordance with its terms, and is not enforced by the grantor as a valid debt.[49] It might also be true if the terms of the note do not provide for repayment within the grantor's life expectancy. The authors understand that a condition of obtaining a favorable ruling in PLR 9535026 was that the debt be restructured for repayment within the grantor's life expectancy.

Is Gain Recognized by an Installment Sale of Appreciated Assets?

As indicated, a basic premise of an installment sale to a grantor trust is that the sale will not result in the recognition of gain even if the assets sold are appreciated and the interest accrued or paid on the note received by the grantor will not be included in the grantor's gross income for federal income tax purposes.[50] It is therefore critical that the purchasing trust be treated as a wholly grantor trust for income tax purposes. Grantor trust status may be difficult to secure without risking estate tax inclusion. Although some provisions seem to require the trust be treated as a grantor trust (e.g., the grantor's spouse is a beneficiary of the trust to whom the trustee may distribute the income and corpus), the court might find that the provisions are illusory (e.g., the spouse is not really intended to be a beneficiary but is mentioned only for purposes of attempting to make the trust a grantor trust). Another possibility is the use of §675(4)(C). That section provides that if someone acting in a non-fiduciary capacity has the power to "reacquire" the property in the trust by substituting property of equal value, the trust is a grantor trust. The IRS in private letter rulings has held that the determination of whether or not the person holding the power is acting in a fiduciary capacity is a question of fact.[51] In addition, the IRS has indicated to at least one practitioner involved in a request for ruling that if the power described in §675(4)(C) is held by the grantor at death, the property may be included in the grantor's gross estate for federal estate tax purposes.[52] Other possibilities to obtain grantor trust status are the power to add to the class of beneficiaries, the power to lend to the grantor with or without adequate security and the use of related and subordinate trustees with broad discretionary distribution powers. Each of these may be viewed as creating some risk of estate tax inclusion, and may also run the risk of failing to confer grantor trust status if they are determined to be illusory powers because their exercise is inhibited by conflicting fiduciary duties.

Some Other Potential Legal Differences Between GRATs and Installment Sales

In addition to the foregoing, other differences in legal effect or certainty exist between GRATs and installment sales.

Death During the Term

It is the position of the IRS that the entire GRAT is included in the grantor's gross estate for federal estate tax purposes if the grantor dies during the annuity term.[53] Although it is at least questionable whether the entire GRAT is included where it contains more than enough assets to satisfy the annuity, it nonetheless has been the long-standing view of

the IRS that at least a portion of the trust will be so included.[54]

Although it is not certain, it seems, as explained above, that the property in the grantor trust to which the grantor has sold property for an installment note is not so included in the grantor's gross estate even if the note is outstanding at the grantor's death.

Generation-Skipping Transfer Taxation

The grantor's GST exemption cannot be used to "leverage" property in a GRAT under the so-called "estate tax inclusion period" or ETIP rule of §2642(f). Under that section, GST exemption under §2631 cannot be effectively allocated to property during the period that the property would be included in the grantor's gross estate, if the property is so includible immediately after the transfer (other than by reason of the transfer-within-three-years-of-death rule of §2035). There are some commentators who contend that GST exemption leveraging with respect to a GRAT nonetheless can be achieved by having the remainder in the GRAT transferred by the remainder beneficiary who allocates GST exemption to that transfer.[55] In PLR 200107015, however, the IRS ruled with respect to a charitable lead annuity trust (CLAT) that the sale of a vested remainder interest by the transferor's child would not be effective in leveraging GST exemption. The IRS concluded that the purposes of the special rule under §2642(e) (which provides for an adjusted GST exemption in the case of a CLAT based upon the value of the CLAT when charity's interest ends) would be avoided by permitting the child to be treated as the sole transferor of the child's one-sixth interest in the CLAT remainder. Instead, the child was treated as the transferor of only the present value of one-sixth of the remainder interest, and the original transferor was treated as the transferor of the balance of the trust. Perhaps, a GRAT should be viewed as analogous to a CLAT, in that a GRAT also has a special GST rule, namely the ETIP rule, which prevents a transferor from making an effective GST exemption allocation. It is not clear, however, why that fact should affect the transfer of a remainder interest in the GRAT by the remainder beneficiary. If the remainder beneficiary is treated as the donor of a transfer of the remainder interest in a GRAT for federal gift tax purposes, then the remainder beneficiary should also be treated as the transferor of the entire remainder interest for GST purposes under §2652(a)(1)(B). In PLR 200442020, the IRS ruled that multiple transfers of various remainder interests in a grandfathered GST exempt trust did not affect the trust's GST exempt status, and agreed that the values of those remainder interests were properly computed using the appropriate actuarial factors under §7520(a) for federal gift tax purposes. In the PLR, a charity with a remainder interest in the trust sold its interest to trusts to the transferor's great grandchildren. Each trust was to terminate in favor of the great grandchild in 20 years and the IRS treated the transfers as transfers to the great grandchildren. One of the transferor's grandchildren created additional trusts for two of his sons, and those sons sold a portion of the remainder interests that they purchased from the charity to their father's trusts. Notwithstanding that the grandchild's trusts were funded in part by the purchase of a remainder interest from the grandfathered trust, the IRS noted that the grandchild would be treated as the transferor of the two new trusts for GST purposes.

A separate problem with the sale of a remainder interest in a GRAT is whether §2702 applies to the transfer. If it does, would the grantor's retained interest be treated, for purposes of the sale of the remainder, as a qualified interest that could be subtracted for purposes of determining whether the remainder beneficiary has made a gift by making the sale? If it cannot, the consequences of the sale would be disastrous as the remainder beneficiary could be deemed to have made a gift of the entire GRAT, reduced only by the consideration given for the remainder interest.

On the other hand, it seems relatively certain that a grantor trust that is exempt from generation-skipping transfer tax[56] may make an installment purchase from the grantor

and that does seem to offer the capacity to leverage the GST exemption with much greater certainty than with respect to a GRAT.

Use of Assets with Inherent Discounts in Valuation

Another factor (which could be viewed as an economic difference rather than a legal one) relates to the valuation of assets transferred to the trust. It seems to be relatively well accepted that the time within which any non-marketable asset (such as limited partnership units in a closely-held partnership) transferred can or is, in fact, liquidated may affect the value of such an asset for gift tax purposes. For example, if limited partnership units are transferred by gift but the partnership is liquidated relatively soon thereafter, there is a risk that little or no substantial discounts attributable to the partnership structure will be allowed unless, perhaps, it can be established that there was no real expectation that the liquidation would occur.

With a GRAT, where substantial distributions must be made to the grantor each year, the chances of being able to sustain a large discount may be diminished if the partnership, limited partnership units of which were contributed to the trust, makes regular distributions to the trust so it can use the distribution to satisfy the annuity payments due the grantor. Although the partnership units themselves could be returned to the grantor in payment of the annuity, presumably about the same valuation discount used when the assets were contributed to the trust would have to be used in satisfying the annuity due the grantor. If units are distributed back to the grantor in satisfaction of the annuity payments, little, if any, real benefit from the valuation discount is likely to be achieved. If substantial distributions from the partnership are made to the trust to allow it to pay the annuity, those distributions might be used as evidence that little, if any, discount should be allowed because, arguably, a substantial return to the limited partners was planned when the units were contributed to the GRAT. Another option to try to secure the discount is for the trust to borrow funds with which to pay the annuity each year. The Treasury regulations prohibit the annuity to be satisfied directly or indirectly with a note or other debt instrument.[57] Presumably, a loan from the grantor to the GRAT to allow payment of the annuity would be inconsistent with the regulations. Perhaps, funds could be borrowed from a third party but additional cost would be incurred and that cost is effectively born by the remainder beneficiaries of the GRAT, not the grantor.[58] Also, without a guarantee by someone, it seems doubtful much could be borrowed.[59]

On the other hand, if the assets contributed to the GRAT carry a discount due to inherent restrictions on transferability, which restrictions will be lifted by their own terms before the first annuity payment is due, the opportunity for leverage as a result of the discount would seem viable.

With an installment sale, large annual distributions to the grantor are not compelled to be made and that probably increases the chances of a discount or a larger discount being sustained than if the same asset were contributed to a GRAT.

Risk of Large Inadvertent Taxable Gift

Both the GRAT and the installment sale are intended to transfer property with relatively small gift tax exposure. An inadvertent taxable gift could arise with respect to a GRAT in several possible ways. One is that the GRAT fails to contain a required provision or contains a provision that makes the grantor's retained annuity fail to qualify as a "qualified interest" (e.g., provides for the payment of the lesser of the trust's income or a defined annuity). Unlike "split-interest" charitable trusts, the Code contains no provision that allows the retained annuity in a GRAT to be reformed or construed to make it qualify.[60] This "danger" might be overcome by having the grantor express the intent that the interest created is to constitute a qualified retained interest within the meaning of

§2702(b) and require the GRAT to be construed and the trust administered to carry out that intent.[61] Although most GRATs contain a provision authorizing the trustee to amend the GRAT in whatever manner necessary to cause the grantor's retained interest to be construed as a "qualified interest," such language may be ineffectual because the amendment would by definition occur after the taxable gift to the GRAT has already been made.

Another potential risk of an inadvertent gift is where the property contributed to the GRAT is determined to be worth more, perhaps much more, than the value reported by the grantor on his or her United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). That risk can probably be minimized by having the annuity payments be described as a percentage of "the value of the property transferred to the GRAT as finally determined for federal gift tax purposes" or a similar word formula provision. It may even be possible to use a "word" formula so that the annuity payments are defined relative to the desired taxable gift--e.g., "the annuity payment shall be an amount, expressed as a percentage of the fair market value of the property transferred to the trustee as finally determined for federal gift tax purposes, such that the value of the remainder as finally determined for federal gift tax purposes shall equal $1,000."[62] A third possible risk, which is mentioned above, is that the GRAT is not "properly" administered--for example, the annuity payments are not made within 105 days of the prescribed payment date.

The risk of an inadvertent gift being made with respect to an installment sale to a grantor trust may be greater than it is with a GRAT. If the property is sold to the grantor trust for less than its gift tax value, the value above sales price may be a gift. It is not certain that a formula may be used, as it can in a GRAT (such as defining the annuity payments as a percent of the value of the property transferred to the GRAT as finally determined for federal gift tax purposes) to avoid a large gift in the case of an installment sale. In *McCord v. Comr.,*[63] a transfer was made comprised of a certain fractional value of interests in a partnership the numerator of which was a fixed dollar amount. The Tax Court rejected, for federal gift tax purposes, the use of the formula transfer but indicated the result could have been otherwise if the dollar amount had been described by reference to the property's value "as finally determined for Federal gift tax purposes." That case currently is on appeal before the Fifth Circuit. There may be other ways to reduce the risk of a large inadvertent gift with an installment sale[64] but none seems as certain as with a GRAT where the annuity is defined as a percent of the value of the property as finally determined for federal gift tax purposes. Hence, there seems to be a greater risk of an inadvertent taxable gift attributable to the undervaluation of the property with an installment sale to a grantor trust than with a GRAT. A key question is whether either or both risks are acceptable to a particular taxpayer.

SOME CONCLUSIONS ABOUT COMPLEXITIES AND LEGAL RISKS

The foregoing discussion of legal risks, perhaps, merely illustrates that there are no certainties with respect to tax matters (or legal matters in general). Some taxpayers may be willing to implement estate tax reduction arrangements of a particular type and others will not. In fact, some undertake none. That makes comparisons of legal certainty and risk of these arrangements (whether a GRAT, installment sale to a grantor trust or other arrangement) challenging.

But the taxpayer's views about complexities and legal risks may be critically important to consider in determining if a particular arrangement should be implemented by that taxpayer. Those are subjective matters and provide little certainty in forecasting what all taxpayers should do.

Comparisons of the "Economics" of GRATs and Installments Sales to Grantor Trusts

Other factors, however, lend themselves to a more objective analysis although, as will be explained, some of the "ingredients" that are used in analyzing these other factors seem subjective.

Choosing the "Best" Asset for a GRAT or Installment Sale

One apparently obvious point is that, in order to achieve its maximum effectiveness in transmitting wealth to others at minimum or no gift tax cost, a GRAT should be funded with the asset owned by the grantor that will achieve the greatest total return during the annuity term and that is available for transfer to the GRAT.[65] However, that statement needs to be refined. For example, even accepting that premise, the grantor presumably must decide whether to fund the GRAT with the asset most likely to have the greatest total return above the §7520 rate or with the asset most likely to have a total return above that rate? In other words, a particular asset (e.g., a growth oriented publicly traded stock or an interest in a so-called "hedge fund") may be the one most likely to achieve the highest return, but the chances of that occurring may be sufficiently unlikely that another asset (such as a bond producing a yield above the §7520 rate) might be a better choice because that asset (e.g., a bond) is very likely to have a total return greater than the §7520 rate even though it is unlikely to achieve the maximum overall return that the other investment (e.g., a stock or hedge fund investment) may achieve. Even that comparison might be refined. For example, an investment advisor may be able to complete an analysis as to which asset is most likely, based upon all reasonable probabilities, to have the highest total return. This is sometimes referred to as a "Monte Carlo simulation."[66] There is no one widely-accepted Monte Carlo simulation. Different analysts use different models and use different data in doing what is called a Monte Carlo simulation.

Introduction to Monte Carlo Simulation

Monte Carlo is one of the world's most famous gambling "capitals." In many gambling activities, probabilities are used to ensure that the "house" will eventually win--e.g., what is the chance that the sum of two dice will be the number 7, which usually means that the house will lose. A Monte Carlo simulation represents a forecast or simulation of the likely outcome of investment choices based, at least in part, upon probabilities. Usually, these probabilities are derived from historic data (including market prices of the property involved and economic movement of markets themselves) and specific methodologies selected by the analyst (which may be regarded as proprietary by the enterprise performing the simulation). The process can involve tracking the hypothetical performance of the asset through thousands of historical market periods (as well as, in some cases, forecasting its future performance based on expected markets) to establish the probability of a particular economic performance over a designated period of time.

Such a Monte Carlo simulation may be helpful in determining whether the GRAT may be expected to be successful. It may be used, among other ways, to compare the expected results from asset classes (such as fixed income, domestic equities, foreign equities, private capital investments and various classes of hedge funds).

As indicated above, subjective ingredients are involved in performing the Monte Carlo simulation. Some of these include the creation of asset classes (e.g., whether short-term U.S. government obligations is a separate class of fixed income or a member of a broader class of assets that is used in the simulation), the allocation of specific assets to a class (e.g., placing a building subject to a long-term triple net lease with a class A tenant into a real estate class or into a fixed income class), the classification of markets

(e.g., using the S & P 500 as one market even though stocks are regularly taken off that list and others added in their place rather than following the specific stocks that comprised the S & P 500 as of the time when the S & P 500 "market" was first used even with respect to those stocks that are taken off the S & P 500 list), and determining whether or what weighted average will be used (e.g., values and market movement in years closer to the present time are given more weight in the mathematical model that produces the forecast than less recent years). The fact that some of these ingredients are subjective is borne out by the fact that some investment banks, brokerage firms and others claim that their forecast methods, used by them in their Monte Carlo simulation, are "proprietary."[67]

In any event, a Monte Carlo simulation may be appropriate for a taxpayer considering either a GRAT or installment sale to a grantor trust. It may inform the taxpayer as to the most likely economic result (in the opinion of the analyst performing the Monte Carlo analysis). That likelihood will be forecast in terms of probabilities of a particular outcome, and is therefore superior to a linear analysis based upon an assumed rate of return. That, in turn, may help the taxpayer decide whether to implement either strategy or which strategy to implement.

Regardless of which asset or asset class is or which assets or asset classes are selected for funding the GRAT, the taxpayer probably will create the GRAT only if there is, in the mind of the taxpayer (presumably, a subjective determination), a sufficiently high probability of success (that is, total return above the §7520 rate). As mentioned, at least with respect to some assets or asset classes, certain investment advisers may be able to forecast the most probable return using their Monte Carlo simulation. It is, perhaps, worth noting that the trustee of the GRAT is not usually "locked in" to holding the asset contributed to the GRAT for the entire annuity term. Hence, if the trustee concludes that the asset held is not the "best" one for the balance of the term, the trustee normally could dispose (e.g., sell) that asset and acquire another.[68]

Why a Direct Gift May Be Best if an Extraordinarily High Return Is Expected

In some cases, where the grantor is certain that the yield on a particular asset will be extraordinarily high, the best strategy may simply be to make a taxable gift of it. Although gift tax may be payable, the gift tax may represent a relatively small percentage of the amount of the gift, even on a present value basis. For example, suppose the grantor has an asset worth $1 million that the grantor anticipates will appreciate to $8 million in three years. Suppose the grantor would have to pay gift tax to give the asset currently. Notwithstanding the current payment of tax, a direct gift might be superior to both a GRAT and an installment sale even if each were structured to produce a zero gift. In both the GRAT and the installment sale, $1 million (on a present value basis) would be returned to the grantor. It can be assumed that the estate tax on that amount would be comparable to the gift tax paid on the direct gift either by ignoring the time value of money or alternatively treating the time value of money as offset by the tax inclusive nature of the estate tax. Although the taxpayer might be able to transfer the asset through a GRAT or by an installment sale at a lower gift tax cost, both the GRAT and the installment sale raise legal issues and uncertainties that should not arise for the gift. For example, if the grantor dies during the annuity term, the value of the entire GRAT, according to the IRS, will be included in the grantor's gross estate for federal estate tax purposes. As mentioned elsewhere, there are uncertainties with an installment sale as well, including the possibility, regarded by at least some practitioners as remote, that the assets in the trust to which the asset is sold would be included in the grantor's gross estate for federal estate tax purposes if death occurs while the installment note is still outstanding. Of course, the foregoing example may not be realistic because the asset

may not realize its anticipated performance. But some people have "hunches" that consistently prove to be very accurate; therefore, a direct gift should not be ruled out as inferior in all cases to a GRAT or installment sale to a grantor trust.

Installment Sale May Produce Superior Economic Results for the Beneficiaries than a GRAT if Total Return Exceeds §7520 Rate

In comparing a GRAT to an installment sale to a grantor trust, it is likely that the economic benefits to the beneficiaries will be greater if there is investment "success"--that is, sufficiently high return so that the beneficiaries (other than the grantor) will receive more than the amount of any taxable gift made in setting up the structure--with an installment sale than a GRAT for at least two reasons.

Interest Payable to Grantor with Installment Sale Is Lower than for GRAT

One reason is that the interest that must be paid to the grantor is lower for an installment sale, as a general rule, than the interest computed on a GRAT.[69] A GRAT must pay the grantor interest at the §7520 rate on the grantor's retained interest in the GRAT to avoid having that interest constitute a gift. When the installment sale is used the grantor trust that makes the purchase need pay the grantor only the AFR interest determined under §1274 (the §1274 rate), which usually is lower than the §7520 rate. The lower interest rate payable to the grantor on the installment sale means more is left for the trust beneficiaries than with a GRAT. Hence, all other things being equal, the installment sale will produce a better estate planning result than will a GRAT.[70]

Greater Leverage with Installment Sale than GRAT

Second, the major "driver" of a successful GRAT or installment sale is the ability to cull for the remainder beneficiaries (e.g., descendants) the return above the interest rate due to the grantor. Even though the taxable gift made with a GRAT or an installment sale may be small (perhaps, one percent with a GRAT and 10% with an installment sale), [71] the remainder beneficiaries receive the extra return (above the amount of interest due the grantor) on the whole amount in the trust. That may provide great leveraging. The amount of the taxable gift may be considerably smaller with a GRAT than an installment sale,[72] indicating greater leverage (although a lower return for the ultimate beneficiaries as just explained) for the GRAT than for an installment sale. However, the GRAT must be dissipated each year by the annual annuity payments, leaving fewer assets in the GRAT to continue the leverage. On the other hand, there appears to be no reason why the note in an installment sale could not be structured as a so-called "interest only" note until maturity, ultimately creating higher leverage for the installment sale than for the GRAT. In order to improve the performance of a GRAT, commentators suggest the use of so-called "rolling" GRATs. In a rolling GRAT, each annuity payment received by the grantor is contributed to a new GRAT.[73] One study suggests that a "rolling" GRAT approach can provide superior economic results to an installment sale.[74] That study admits, however, that it does not take into account the effect of the inability to allocate GST exemption to a GRAT, which would likely reverse the results in favor of the installment sale, if the remainder beneficiaries were to include grandchildren and more remote descendants.

Why Choosing the Potentially Highest Yielding Asset May Not Be Appropriate

As indicated above, it seems that the grantor should fund a GRAT with or make an installment sale to a grantor trust of the asset that is expected, through a Monte Carlo simulation or otherwise, to have the highest return. But, as explained, the chances of that highest yield occurring may suggest another asset be chosen to fund the GRAT or to sell on the installment basis. The reason, as indicated above, is variation in probable outcomes. That relates to what is called "standard deviation." That deviation indicates how certain each outcome is. For example, one asset may be forecast, using a Monte Carlo simulation or other analysis, to be the one most likely to achieve the highest total return but the prospect of that occurring may not be sufficiently great to make it the most appropriate asset to select. The risk of the total return being less than the §7520 rate (if a GRAT is being considered) or less than the AFR (if an installment sale is being considered) with that asset may be sufficiently great that it may suggest the use of another asset whose yield is more likely to exceed the hurdle rate (although perhaps by a lesser margin) because that increased likelihood may significantly improve the probability of success in the strategy (meaning delivery of at least some assets to the remainder beneficiaries without transfer tax).

Capturing the Outperformance and Mitigating the Effects of Underperformance -- Why an Installment Sale Is Superior

One problem in all gifting strategies is that the asset transferred may perform well for a period of time, but may perform poorly for another period of time, thereby substantially diluting or even eliminating the transfer tax benefits. Both a GRAT and an installment sale to a grantor trust offer an opportunity to mitigate the potentially offsetting effects of fluctuating asset performance.[75] The reason for this is that both a GRAT and the purchasing trust in an installment sale are grantor trusts. Therefore, as previously explained, under Rev. Rul. 85-13, the grantor has the opportunity to engage in transactions with the trust without negative income tax consequences. Suppose the asset transferred to a GRAT or in an installment sale to a grantor trust performs exceptionally well in the first few years after the transfer. Suppose, however, that the grantor is less optimistic about the continued growth of the asset, or even anticipates a potential downturn. The grantor has the opportunity to recover the asset from the trust, by substituting an asset of equal value that either is less volatile or, in the grantor's view, is more likely not to offset the positive performance in the early years. Presumably (assuming correct valuation), the grantor can substitute the asset without negative income or transfer tax effects. The opportunities to do this successfully appear to be greater with an installment sale than with a GRAT. That is because the installment sale requires much smaller payments back to the grantor during the period that the note is outstanding (which as previously explained could be interest only) than the payments that must be made to the grantor during the annuity period in a GRAT. This means that with the installment sale, the grantor has more choices in the assets that can be used in the substitution and a greater opportunity for leverage in those assets, increasing the probability that it can be done successfully.[76]

How the 105-Day GRAT Payment Delay Provision May Make It More Advantageous

As indicated above, the regulations permit the payment of the annuity to be delayed for 105 days after the close of the year.[77] The opportunity to delay payment of the annuity may, in some cases, make certain very short-term GRATs more advantageous economically than an installment sale to a grantor trust.

Again using a one year GRAT and with a "zeroed out" remainder for illustration purposes only, assume the grantor creates a GRAT with an asset worth $10 million at a time that the §7520 rate is five percent. The grantor directs that at the end of the year, the trust is

to pay the grantor $10,500,000, exactly what is forecast to be the value of the trust at that time using the §7520 rate of five percent. The trust actually grows at six percent for the year, so it is worth at year end $10,600,000. The grantor will get $10,500,000 and the remainder beneficiaries will receive $100,000. As an alternative, the grantor could have sold the $10 million asset to a grantor trust in exchange for a one year note bearing AFR interest at four percent. Again, the asset grows at six percent, meaning the trust will be worth $10,600,000 at year end, at which time the trust will give the grantor $10,400,000 paying off the note, leaving $200,000 for the trust beneficiaries. That suggests the installment sale is preferable to the GRAT. But the GRAT may delay the payment of the annuity from year end for 105 days as the regulations permit. The property in the GRAT continues to grow at six percent a year, meaning that after the 105 days, the GRAT is worth about $10,783,000. The grantor is paid the $10,500,000 annuity at that time, leaving about $283,000 for the remainder beneficiaries, which is more than the trust beneficiaries would have received with an installment sale. Of course, earnings will accrue on the excess left in the grantor trust to which the installment sale was made. That would increase the amount for the remainder beneficiaries of that trust to $203,456 by the 105th day after the year. Even if the actual growth in the property is much higher (e.g., 15%), this 105-day delayed payment date advantage will mean the one-year GRAT will provide more for the remainder beneficiaries than will a one-year installment sale. In fact, the higher the growth (*assuming* it continues for the 105 days following the end of the year), the more the GRAT will provide for the remainder beneficiaries than will the installment sale. Thus, because principal and interest on the installment note must be paid (or interest must accrue) to the grantor sooner than the annuity payment in the GRAT, the one-year GRAT must perform better that the one-year installment sale whenever the return on the property exceeds the §7520 rate and the spread between the §7520 and the AFR is modest.

The foregoing, however, is not an "apples to apples" comparison. First, many practitioners feel it is too legally "dangerous" to use a one year GRAT. If it is more than one year, there is "downloading" of the leverage because an annuity payment must be made each year which consists of interest and principal. Many think the entire leverage may be maintained with an installment sale. Although each annuity payment could be "rolled" into a new GRAT, the §7520 rate may be higher than when the GRAT was initially created or GRATs may be "outlawed" by that time. Second, it seems likely that attempting to leverage the GST exemption is much more legally "risky" with a GRAT than with an installment sale. Third, if the AFR declines during the period of the installment sale, the parties probably can use that lower AFR for the balance of the installment sale term; it does not seem that such a substitution of a lower rate may be done with a GRAT.

In any case, there are several other factors which may offset the 105-day payment delay feature available for GRATs but not available to installment sales to grantor trusts. One is the flexibility is choosing the AFR interest rate to be used in an installment sale. The annuity payments from a GRAT must be based on the §7520 rate which is 120% of the mid-term AFR rounded to the nearest two-tenths of 1%. On average, the mid-term AFR is about 83% of the §7520 rate, although on account of rounding it could be a much smaller or somewhat larger percentage of the §7520 rate. Moreover, and perhaps of more importance, the grantor and the trust may choose in effecting an installment sale not just the mid-term AFR but either the short-term or long-term AFR.[78] Historically, the short-term AFR or, at some times, the long-term AFR, is lower than the mid-term AFR. Even if the short-term or long-term AFR is used for the installment sale, prepaying without penalty or extending the debt means that the grantor and the trust can function as though the note was a mid-term one. This means there is a greater "spread" in favor of the installment sale over the GRAT, often completely overtaking the 105-day payment delay opportunity for the GRAT.

The bottom line seems to be that the 105-day delay payment option is important to

consider using for a GRAT but is unlikely, when all other factors are considered, to make the GRAT economically advantageous over the installment sale.

How a Monte Carlo Simulation May Suggest Using a GRAT Instead of an Installment Sale

The risk of the yield of an asset being less than the §7520 rate (if a GRAT is being considered) or less than the §1274 rate (if an installment sale is being considered) may suggest, in turn, the use of a GRAT rather than an installment sale even though, as explained above, the installment sale almost certainly will produce a better estate planning result if the yield on the asset exceeds the §1274 rate. The "loss" if earnings are poor with a GRAT is that the remainder beneficiaries receive less than the amount of that gift (or nothing at all). As mentioned earlier, some practitioners think the value of the corpus of the grantor trust that makes the installment purchase should be at least 10% of the value of the assets so purchased. This is likely to be much greater than the amount of the taxable gift made with the GRAT. If so, much more would be lost to the beneficiaries if the investment performance is poor--the entire trust, including its original corpus, could be lost because that corpus would have to be paid to the grantor in satisfaction of the note received from the trust in the installment sale.

What One Monte Carlo Simulation Forecast with Respect to a GRAT v. Installment Sale Comparison

One Monte Carlo simulation prepared by an investment bank was based upon a forecast of value for property that would be contributed to a GRAT or sold to a grantor trust for a note bearing AFR interest. In the comparison, the AFR payable on the note received in the installment sale was lower (as it almost always would be) than the §7520 rate used to value interests in the GRAT. The simulation forecast a total return on the assets in excess of the §7520 rate. The installment sale produced a better result for the ultimate beneficiaries than the GRAT did for precisely the reasons set forth above--that is, less interest is paid to the grantor with the installment sale than with the GRAT and the leverage on the installment sale became greater than the leverage on the GRAT.

The simulation then compared the results to "rolling" two-year GRATs. That is, it was assumed that the initial GRAT provided for only two years of payments to the grantor and that each annuity payment received from the GRAT would be added to another two year GRAT. The two-year rolling GRAT strategy (which also assumed a "side car" gift trust equal to the assumed 10% funding needed in an installment sale) produced a better result for the remainder beneficiaries than the longer term installment sale. The reason relates to fluctuations in value during the term the strategy stays in place. As explained above, a GRAT may fail even if the total return over the annuity term exceeds the §7520 rate because it experiences poor performance during the initial year or years. The Monte Carlo simulation forecasted that happening. The effect is to have poor performance offset good performance, both with respect to the GRAT and the installment sale. By limiting the GRATs to two years, a good two-year investment performance (total return during the two years in excess of the §7520 rate) is not offset by a bad two-year investment performance (total return during another two years lower than the §7520 rate).

The simulation did not compare the results of a two-year "rolling" installment sale so that good performance during one period would not be offset by bad performance in another period. If it had, the installment sale would have had to have produced a better result for the ultimate beneficiaries.

The simulation also did not compare what might be called "separate GRATs for separate asset classes." As explained above, good investment performance is offset by poor

investment performance inside a GRAT or in the grantor trust that has purchased the assets from the grantor on an installment basis. Shortening the period for which those arrangements are outstanding and continuously "rolling" the property into new arrangements tends to reduce the offsets. There is another type of offsetting that may reduce the benefits of a GRAT or an installment sale: poor investment performance of one asset or asset class offsets the good investment performance of another asset or asset class in the trust. Just as rolling short-term GRATs or short-term installment sales likely will produce a better result, so will separating assets or assets classes into different GRATs or installment sale arrangements.[79]

CONCLUSIONS

A GRAT generally will be successful in transmitting more to the remainder beneficiaries than a direct gift would only if the total return on the property exceeds the §7520 rate. Even if it does, the GRAT may fail to be successful if the grantor dies during the annuity term. It may fail for other reasons as well. If the total return is in excess of the §7520 rate, an installment sale to a grantor trust likely will produce a better overall result for the remainder beneficiaries and almost certainly will do so if passing the remainder to successive generations of descendants without generation-skipping transfer tax is an important goal. Whether a GRAT or installment sale is selected, short-term "rolling arrangements" and using separate trusts for separate asset classes likely will increase the chances of success for either. However, GRATs, direct gifts and installment sales present different complexities in implementation and administration and different perceived legal and economic risks and certainties. Comparative analysis of those risks is complicated but necessary in order to give any comprehensive advice concerning the appropriateness of implementing any particular strategy.

Footnotes

* The authors wish to thank Professor Mitchell M. Gans of Hofstra University for his careful review of a draft of this article and his insightful comments.

[1]Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[2]*See* Regs. §25.2511-2(c).

[3]Members of the transferor's family are defined in §2704(c)(2). *See* §2702(e).

[4]*See* Regs. §25.2702-3(b). Although it is beyond the scope of this article to compare GRATs to GRUTs, §2702 provides that both annuity streams (paid from GRATs) and unitrust streams (paid from grantor retained unitrusts or "GRUTs") may constitute qualified interests, and it is virtually certain that GRATs produce a superior estate planning result if the total return exceeds the §7520 rate. However, if the value of the GRAT or GRUT drops during the first year but increases significantly during the second year, the GRUT may produce a better result than a GRAT. For example, a grantor creates a two-year $1 million GRAT to pay the grantor $537,000 at the end of each year. The grantor also creates a two-year $1 million GRUT to pay the grantor at the end of each year 90% of the value of the trust at year end. Each trust drops in value to $500,000 at the end of the first year. The entire amount in the GRAT would be paid at that time to the grantor in satisfaction of the grantor's entitlement to the $537,000 annuity. Nothing will pass from the GRAT to the remainder beneficiaries. The GRUT will pay the grantor at the end of the first year 90% of $500,000, or $450,000, leaving $50,000 in the GRUT at that time. During the next year, unless the GRUT drops to zero, 90% of the year end value will be paid to the grantor and 10% will be paid to the remainder beneficiaries--clearly, a better result than with the GRAT. *See generally* Blattmachr et al., "GRATs v. GRUTs: GRATs Win as an Important Estate Planning Strategy," *The Chase Review* (July 1994).

[5]*See* Regs. §25.2702-3(e), *Exs. 5* and *6*.

[6]It is not certain if a GRAT may fall under the exception in §2702(b) if the annuity is payable for only one year. A one year GRAT is used here only for purposes of illustration.

[7]§2702(a)(3)(A)(i).

[8]By "outperformance" the authors mean that the total return on the assets contributed to the GRAT exceeds the §7520 rate.

[9]*See, e.g.,* TAM 200210009; PLR 9451056. *See also* Rev. Rul. 82-105, 1982-1 C.B. 133. For a more thorough discussion, see generally, Whitty, "Repercussions of *Walton* Estate Tax Inclusion of GRAT Remainder," *Prob. & Prop.* (May/June 2005). Under §6110(k)(3), neither a private letter ruling nor a National Office technical advice memorandum may be cited or used as precedent. However, a private letter ruling or a technical advice memorandum often provides valuable guidance on the IRS's thinking on particular issues and both private letter rulings and technical advice memoranda constitute "substantial authority" to abate the §6662 substantial understatement penalties.

[10]Regs. §25.2702-3(b)(4). The annuity payment(s) must be based on a calendar year or on the anniversary of the initial funding of the GRAT.

[11]A direct gift could be to a grantor trust (although not a GRAT) or to another estate tax "savings" trust.

[12]*See* Regs. §25.2512-2(e) (third sentence).

[13]*See, e.g., Bright Est. v. U.S.,* 658 F.2d 999 (5th Cir. 1981). *See also* Rev. Rul. 93-12, 1993-1 C.B. 202.

[14]*See generally* Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 *Est. Plan.* 3 (Jan. 1996); Shore & McClung, "Beyond the Basic Superfreeze -- An Update and Additional Planning Opportunities," 75 *TAXES* 41 (Jan. 1997).

[15]§671.

[16]1985-1 C.B. 184.

[17]*But see Rothstein v. U.S.,* 735 F. 2d 704 (2d Cir. 1984). In Rev. Rul. 85-13, the IRS announced that it would not follow *Rothstein.*

[18]For an installment sale, the minimum interest rate that must be paid to the grantor to avoid the imputation of a gift of foregone interest is the rate determined under §1274(d) (the so-called §1274 rate or the Applicable Federal Rate (AFR)). §7872. *See Frazee v. Comr.,* 98 T.C. 554 (1992).

[19]Wanting one's spouse to benefit from all one's property is not inconsistent with creating a GRAT. Although the GRAT may be successful in removing assets from the gross estate of the grantor (if, among other conditions, the grantor survives the annuity term), the grantor's spouse may benefit from the assets remaining after the annuity term. That may occur, for example, if the remaining assets are placed in a trust from which the grantor's spouse may benefit without having the assets be included in the gross estate of the grantor's spouse. In contrast, assets transferred to or for a property owner's spouse under the protection of the marital deduction and, therefore, free of estate and gift tax attributable to that transfer, are usually included in the gross estate of the surviving spouse.

[20]*See* Regs. §25.2702-3(e), *Exs. 5* and *6*; *Walton v. Comr.,* 115 T.C. 289 (2000),

acq. Notice 2003-72, 2003-44 I.R.B. 964.

[21]Caution would dictate requiring that the income in excess of the annuity amount be paid to the surviving spouse through the grantor's estate because the regulations prohibit distributions from the GRAT to or for the benefit of any person other than the holder of the qualified annuity during the term of the qualified annuity. Regs. §25.2702-3(d)(2).

[22]It seems that there are at least three ways the GRAT property included in the grantor's estate could be made to qualify. One is to have the GRAT property revert to the grantor's probate estate and then pass under the grantor's will in a form qualifying for the marital deduction. That arrangement could be used, it appears, even if the surviving spouse is not a United States citizen. Although a transfer to or for the decedent's surviving spouse, who is not a United States citizen, normally may not qualify for the estate tax marital deduction (see §2056(d)), a transfer to a "qualified domestic trust" described in §2056A may so qualify. However, such a reversion from the GRAT to the grantor's probate estate upon the grantor's death would appear to mean that GRAT will not qualify for the favorable treatment under the *Walton* regulations. A second manner to make the GRAT property qualify for the marital deduction is to structure it as a so-called "estate trust" described in Regs. §20.2056(c)-2(b)(1)(iii). However, with an estate trust, the property remaining in the trust must be paid to the probate estate of the surviving spouse. The grantor of the GRAT may not want such a disposition for at least two reasons. First, making the property in the estate trust payable to the estate of the surviving spouse makes it subject to the claims of the creditors of the surviving spouse's estate. Second, the estate trust also allows the surviving spouse to control the ultimate disposition of the property. A third method of making the GRAT property qualify for the estate tax marital deduction would be to qualify the GRAT itself for the marital deduction as a qualified terminable interest property (QTIP) trust which may be accomplished as follows. First, the annuity payable from the GRAT to the grantor's estate should be defined as the greater of: (1) the annuity amount that would have been paid to the grantor if he or she had lived; or (2) the GRAT's accounting income. Second, the grantor's will should provide for such annuity payments received by the GRAT after the grantor's death to be paid immediately to the grantor's surviving spouse to the extent of the GRAT's accounting income or such greater amount to allow the GRAT property to qualify for the marital deduction. Third, any portion of the annuity payments in excess of the GRAT's accounting income should pass to a QTIP trust under the grantor's will. Fourth, the balance of the GRAT should pass to a QTIP trust other than one under the grantor's will upon the conclusion of the annuity term.

[23]Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 *Est. Plan.* 3 (Jan. 1996); Shore & McClung, "Beyond the Basic Superfreeze -- An Update and Additional Planning Opportunities," 75 *TAXES* 41 (Jan. 1997).

[24]Regs. §25.2702-3(e), *Exs. 5* and *6*.

[25]In *Walton*, the Tax Court held that the value of the interest retained by the grantor for purposes of §2702 could include the value of the annuity payable for a specified term if the annuity was payable to the grantor for the term or to the grantor's estate for the balance of the term if the grantor died during the term.

[26]Notice 2003-72, 2003-44 I.R.B. 964.

[27]Given the assertion in the TAM that the preamble to the §2702 regulations contemplates that a GRAT cannot be zeroed out, it can be expected that the IRS will pursue this position. Should this occur, the IRS would presumably make two arguments: that any ambiguity in the regulation itself can be resolved by focusing on the underlying purpose as expressed in the preamble (*see Stepnowski v. Comr.*, 124 T.C. 198, 212 (2005)); and that the IRS is entitled to deference when it proffers a reasonable resolution of an ambiguity in a regulation. *See* Gans, "Deference and the End of Tax Practice," 36 *Real Prop. Prob. & Tr. J.* 731 (2002).

[28]Section 4(50) of Rev. Proc. 2005-3, 2005-1 I.R.B. 118 includes the following as an area under which the IRS ordinarily will not issue a ruling or determination: "Section 2702.--Special Valuation Rules in Case of Transfers of Interests in Trusts.--Whether annuity interests are qualified annuity interests under §2702 if the amount of the annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10 percent of the initial net fair market value of the property transferred to the trust. For purposes of the 10 percent test, the value of the remainder interest is the present value determined under §7520 of the right to receive the trust corpus at the expiration of the term of the trust. The possibility that the grantor may die prior to the expiration of the specified term is not taken into account, nor is the value of any reversion retained by the grantor or the grantor's estate."

[29]Note that under §664(d)(1)(D) and (d)(2)(D), a trust is not a "qualified" charitable remainder trust if the actuarial value of the remainder when the trust is created (or a permitted addition made) is less than 10% of the value of the property contributed to the trust. This disqualification was added to the Code in 1997. Moreover, §2055(e)(3) permits the taxpayer either to restructure the trust so the minimum 10% threshold is met or to "call off" the trust (and forfeit any tax benefits it otherwise produced). Some may argue that, because there is no such Code provision with respect to GRATs, none logically can be inferred. In fact, none is suggested in the regulations governing GRATs. Others may contend that the 10% minimum value rule added to the Code for charitable remainder trusts suggests that a comparable rule is to be inferred for GRATs. One distinguishing factor supporting the rule for a charitable remainder trust is that charity's interest in a charitable remainder trust creates a significant additional tax benefit for the taxpayer due to the tax-exempt status of a charitable remainder trust for federal income tax purposes. A charitable remainder trust's tax-exempt status allows the taxpayer to defer the payment of income tax on taxable income earned in the trust that is not distributed to the taxpayer until a later tax year. Thus, the IRS has a reason to require that charity's interest have real substance with a strong likelihood that charity will benefit from the remainder interest. The same concern is not present in a GRAT. A GRAT is a grantor trust, and therefore, cannot confer additional income tax benefits on its grantor. Assuming the appropriate use of applicable actuarial factors, the fact that the remainder interest in a GRAT is small does not imply abuse of the transfer tax system. The taxpayer is making a small gift only by retaining a larger interest, which interest is included in the grantor's estate for tax purposes. Moreover, outperformance of the GRAT assets confers a tax benefit whether the remainder interest is small or large.

[30]In PLR 9239015, the IRS ruled that a GRAT providing for annuity payments to the grantor for two years was a qualified interest. It may be appropriate to note that the minimum five-year annuity term now required by the IRS before it will rule whether the grantor's annuity interest in a GRAT is a qualified interest was announced after PLR 9239015 was issued. In *Kerr v. U.S.*, 113 T.C. 449 (1999), *aff'd,* 292 F.3d 490 (5th Cir. 2002), the IRS did not challenge the grantor's interest in a GRAT as not being a qualified interest under §2702(b) where the annuity term was 366 days. However, the issue of the length of the annuity term was not discussed in the case. The failure of the IRS to challenge an aspect of an arrangement in one case does not foreclose it from raising it in another. *Stewart v. Comr.*, T.C. Memo 2005-212.

[31]Regs. §25.2702-3(b)(4).

[32]115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002).

[33]*See generally* Keebler & Melcher, "Structuring IDGT Sales to Avoid Section 2701, 2702, and 2036," *Est. Plan. J.* (Oct. 2005).

[34]*See Moss v. Comr.*, 74 T.C. 1239 (1980); *Cain v. Comr.*, 37 T.C. 185 (1961) (both involving so-called self-canceling installment notes). A similar rule applies in the case of a transfer of property in exchange for a private annuity. *See* Rev. Rul. 77-193, 1977-1 C.B. 273. The basic test was set forth in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274

(1958), which holds that where a decedent has transferred property to another in return for a promise to make periodic payments for the decedent's lifetime, the payments are not income from the transferred property so as to cause inclusion of that property in the decedent's estate, if the payments are (1) a personal obligation of the buyer, (2) not chargeable to the transferred property, and (3) not measured by the income from the transferred property.

[35]*Cf. Costanza Est. v. Comr.*, 320 F.3d 595 (6th Cir. 2003) (analyzing whether the note was bona fide in the gift tax context).

[36]Bootstrap sales have long been upheld by the courts, despite IRS challenges asserting that they represent another relationship. *See Frank Lyon Co. v. U.S.,* 435 U.S. 561 (1978); *Comr. v. Clay Brown*, 380 U.S. 563 (1965).

[37]§1361(d).

[38]The facts are somewhat complex, because the donors had previously purchased voting stock of the corporation from a third party and then distributed the nonvoting stock as a dividend with respect to that voting stock, and from the facts it is not clear whether the interest and principal payments referred to were being made to the donors or directly to the third party.

[39]The practitioners who submitted the ruling have advised that the IRS also required that the trust have other assets of at least 10% of the value of the assets sold as a condition to the issuance of the ruling.

[40]*Cf.* PLR 9436006, involving an installment sale of partnership units and marketable securities to a trust in exchange for a 35-year note with interest at the AFR. The IRS ruled, without further caveats, that §§2701 and 2702 would not apply because the seller would hold debt.

[41]This may be compared with the conclusion in PLR 9515039 that a transfer of assets by the taxpayer to her daughter in exchange for a lifetime annuity would not cause inclusion of the transferred property in the taxpayer's estate because the daughter held sufficient personal wealth to satisfy her potential liability for payments to the taxpayer, and neither the size of the payments nor the obligation to make those payments related to the performance of the underlying property. *See* Rev. Rul. 77-193, 1977-1 C.B. 273 (payments will not represent a retained interest in the transferred property causing estate tax inclusion under §2036 so long as the obligation is a personal obligation, the obligation is not satisfiable solely out of the underlying property and its earnings, and the size of the payments is not determined by the size of the actual income from the underlying property at the time the payments are made).

[42]In those cases, taxpayers transferred property to trusts in exchange for annuity payments for life, which they claimed were taxable under the special rules of §72 relating to annuities; the IRS contended that the transactions were not, in fact, sales in exchange for annuities, but rather were transfers with retained interests resulting in grantor trust status for income tax purposes.

[43]In *Lazarus v. Comr.*, 58 T.C. 854 (1972), *aff'd*, 513 F.2d 824 (9th Cir. 1975), the court held that the taxpayer made a transfer with a retained interest based largely on the fact that the trust immediately sold the transferred stock for a note, the income of which matched exactly the payments due to the grantor and, because it was non-negotiable, the income from which represented the only possible source of payment. The Ninth Circuit also cited the fact that the arrangement did not give the taxpayer a down payment, interest on the deferred purchase price or security for its payment as indicative of a transfer in trust rather than a bona fide sale. However, in subsequent cases the court repeatedly distinguished *Lazarus* (and reversed the Tax Court) to reach the opposite result. *See, e.g., Stern v. Comr.,* 747 F.2d 555 (9th Cir. 1984); *La Fargue v. Comr.*, 689 F.2d 845 (9th Cir. 1982). For example, in *La Fargue*, the taxpayer transferred $100 to a trust and a few

days later transferred property worth $335,000 to the trustees in exchange for a lifetime annuity of $16,502. While noting that, as in *Lazarus*, the transferred property constituted the bulk of the trust assets, the court held there was a valid sale because there was no "tie in" between the income of the trust and the amount of the annuity.

[44]The Tax Court has been particularly attentive to this control issue in applying the *La Fargue* rationale to subsequent cases. *See, e.g., Weigl v. Comr.*, 84 T.C. 1192 (1985); *Benson v. Comr.*, 80 T.C. 789 (1983). *See also, Samuel v. Comr.*, 306 F.2d 682 (1st Cir. 1962).

[45]83 T.C. 932 (1984).

[46]74 T.C. 1239 (1980).

[47]The court cited *Fidelity-Philadelphia Trust Co.,* discussed at note 34. The IRS has acquiesced only in the result in *Moss* (1981-2 C.B. 2), indicating a disagreement with at least some part of its reasoning.

[48]The trust the grantor creates for his or her spouse may be a grantor trust with respect to the grantor, preventing any gain recognition by reason of the transfer of the note. Even the sale of the note to the grantor's spouse likely would not, on account of §1041, result in gain recognition.

[49]*See Miller v. Comr.*, T.C. Memo 1996-3, *aff'd*, 113 F.3d 1241 (9th Cir. 1997) ("The mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise would not be enforced is not afforded significance for federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth... . The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances, including whether: (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual payment was made, (7) the transferee had the ability to repay, (8) records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for federal tax purposes is consistent with a loan"). See, also, *Santa Monica Pictures, LLC v. Comr.,* T.C. Memo 2005-104.

[50]*Compare* Dunn & Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," *J. of Tax'n* 49 (2001) (gain will be recognized at the death of the grantor if the note received in the installment sale of appreciated property is outstanding at death) *with* Blattmachr, Gans, & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," *J. of Tax'n* 149 (Sept. 2002) (gain will not be recognized at the death of the grantor if the note received in the installment sale of appreciated property is outstanding at death).

[51]*See, e.g.,* PLR 9126015.

[52]In *Jordahl v. Comr.*, 65 T.C. 92, *acq.,* 1977-1 C.B. 1, the Tax Court held that a power of substitution held by the grantor would not cause the trust assets to be included in the grantor's estate for federal estate tax purposes. The IRS, in several private rulings, has cited *Jordahl* as authority for the conclusion that the assets held in a trust over which the grantor holds a power described in §675(4)(C) are not included in the grantor's gross estate. Not analyzed in the subsequent rulings is the fact that the power held in *Jordahl* was held in a fiduciary capacity--under §675(4)(C), but to obtain grantor trust status, the power must be held in a non-fiduciary capacity.

[53]*See, e.g.,* PLR 9451056.

[54] *See* TAM 200210009; Rev. Rul. 82-105, 1982-1 C.B. 133. For a more thorough discussion, *see* Whitty, "Repercussions of *Walton* Estate Tax Inclusion of GRAT Remainder," *Prob. & Prop.* (May/June 2005).

[55] *See, e.g.,* Handler & Oshins., "GRAT Remainder Sale to a Dynasty Trust," 138 *Tr. & Est.* 20 (Dec. 1999).

[56] A trust may be exempt from generation-skipping transfer tax in at least one of two ways. First, it may be "grandparented" from the tax. *See* Regs. §26.2601-1(b). Second, it may be exempt by reason of the allocation of GST exemption to the trust property that causes the trust to have an "inclusion ratio" (within the meaning of §2642(a)) of zero.

[57] Regs. §25.2702-3(d)(5).

[58] The preamble to the final regulations indicates that the step transaction doctrine will be applied to any transaction or series of transactions that is inconsistent with the prohibition on issuing debt in satisfaction of the annuity. This would include borrowing from a bank if the grantor is required to deposit an amount equal to the loan as a prerequisite. T.D. 8899, 65 Fed. Reg. 53587 (9/5/00).

[59] The guarantee itself may have tax or other ramifications unless it can be established that the trust secured the guarantee in an arms-length transaction for value.

[60] Section 2055(e)(3) permits reformation/construction of certain split-interest trusts (such as charitable remainder trusts and charitable lead trusts) so they can "qualify" for the treatment accorded qualified split-interest charitable trusts prescribed in the Code. The Code contains no such provision for GRATs.

[61] *See, e.g., Lepore Est.,* 128 Misc.2d 250, 492 N.Y.S.2d 689 (Surr. Ct. Kings Cty 1985); *cf. Reid Est. v. Comr.,* T.C. Memo 1982-532.

[62] Note, however, that some practitioners have expressed concern that making the value of the remainder zero or always equal to a fixed dollar amount (e.g., $1,000) violates the principles enunciated in *Procter v. Comr.,* 151 F. 2d 603 (4th Cir. 1945), and therefore, would be ignored for federal gift tax purposes.

[63] 120 T.C. 358 (2003).

[64] One method may be to provide that any gift made after a certain date must pass in a form so that it will not constitute a taxable gift. This date would fall before the date of the installment sale so that if the sale resulted in a gift it would pass in a form that would not be subject to tax. Another way is to divide the transfer to the trust into two portions, the first of which would be equal to the grantor's remaining GST exemption and the second would be any other transfers. Hence, if any gift would exceed the amount of the remaining GST exemption it would pass in a non-gift taxable form (e.g., to the grantor's spouse under the protection of the marital deduction or to a trust for the grantor transfers to which are not complete and, therefore, not subject to federal gift tax, under the principles of Regs. §25.2511-2). Another method (which would mitigate but might not eliminate any additional taxable gift) would be to include a purchase price adjustment clause in the purchase and sale documents comparable to one that would be used by parties to an arms-length transaction.

[65] A particular asset may not be appropriate to use for that purpose for one or more reasons. For example, a property right of another may restrict or inhibit the transfer of the asset to the GRAT.

[66] *See, generally*, Ambrose, "Retirement Planning Less of a Gamble with Monte Carlo; Monte Carlo Illuminates the Variables in Planning," *The Baltimore Sun* (12/3/2000); Ameriks, Veres and Warshawsky, "Making Retirement Income Last a Lifetime," 14 *J. Fin.*

Plan. 60 (2001); Barnett, "Monte Carlo -- It's Not Just Gambling," 55 *Tax Executive* 31 (2003); Bell and Rauf, "Monte Carlo Retirement Analysis, part 2: Assessing and Accommodating Monte Carlo Analysis," 96 *Advisor Today* 48 (Jan. 1, 2001); Bell and Rauf, "Predicting and Pondering Probably Futures," 95 *Advisor Today*, 64 (Dec. 2000); *Cf.* Condren, "Advising with Confidence: Using Stochasic: Analysis in Financial Planning." *Proceedings of the 2004 Crystal Ball User Conference.*

[67]*See, e.g.,* Moore & Badlani, "Evaluate the Economics of Charitable Remainder Trusts," 74 *Practical Tax Strategies* 213, 216 (Oct. 2005) ("Expected returns based on indices are Citigroup Asset Management...forecast of expected returns for specific asset classes...These forecasts are made using a *proprietary* methodology....") (*Emphasis supplied*).

[68]Although trustees usually must consider the tax consequences of changing investments (e.g., that gain would be recognized for tax purposes upon a disposition of the asset), in most cases involving a GRAT any income or gain would be attributed and taxed to the grantor under the grantor trust provisions of the Code. *See* §§671-679.

[69]The interest that must be paid to the grantor in a GRAT is equal to the §7520 rate for the month the GRAT is created. For an installment sale, the minimum interest rate that must be paid to the grantor to avoid the imputation of a gift of foregone interest is the rate determined under §1274(d) (the §1274 rate or the AFR). §7872. *See Frazee v. Comr.,* 98 T.C. 554 (1992). There are three AFRs: one for notes payable on demand or after a term of no more than three years (the "short-term AFR"); one for notes with a term more than three but no more than nine years (the "mid-term AFR"); and one for notes with terms over nine years (the so-called "long-term AFR"). The §7520 rate is 120% of the mid-term AFR, rounded to the nearest even two-tenths of one percent, and, therefore, always would be higher than the mid-term AFR. In other words, the mid-term AFR will be 83.33% of the §7520 rate on average but the rounding may make the mid-term AFR a smaller or larger percentage of the §7520 rate. But it is possible that the §7520 is lower than the short-term AFR or long-term AFR, so if the installment note were a short-term or long-term note, the §7520 rate might be lower indicating a better result for the remainder beneficiaries with a GRAT than an installment sale. But that, historically, has been rare to occur. Another factor changes the analysis somewhat. Interest under the installment sale must be paid for each day the debt is outstanding to avoid an imputed gift. With a GRAT, the payment of the annuity (including the interest component built into it) may be delayed for 105 days from the end of the calendar year or anniversary date of the start of the GRAT and it seems relatively certain that interest need not be paid on that delayed payment for the 105 days. Regs. §25.2702-3(b)(4).

[70]For a further discussion of the advantages of a GRAT as an estate planning strategy, see Gans, "GRIT's, GRAT's and GRUT's: Planning and Policy," 11 *Va. Tax Rev.* 761 (1992).

[71]Although it seems no definite authority has developed, many practitioners counsel that the value of the grantor trust making the installment purchase should be at least 10% of the purchase price. *Cf.* Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 *Est. Plan.* 3 (Jan. 1996); Shore & Craig, "Beyond the Basis Superfreeze -- an Update and Additional Planning Opportunities," 75 *TAXES* 41 (Jan. 1997).

[72]It may be that a "pre-existing" grantor trust could make the installment purchase so no (additional) gift need be made to effect the installment sale strategy. So viewed, there is "infinite" leverage for the installment sale. There also is "infinite" leverage if the law permits the GRAT to have a zero value remainder and the GRAT is so structured.

[73]Of course, when the annuity payment is rolled into the new GRAT, the §7520 rate may be higher (perhaps, considerably higher) than it was when the first GRAT was created meaning more interest must be paid to the grantor from the new GRAT. Of course, it might be lower as well. In any case, a new gift of the remainder interest is made with each GRAT. But it also seems that the interest rate on the installment sale note also

could be "reset", so there will be a continuous interest rate advantage for the installment sale in almost all cases. One of the potential disadvantages of relying on rolling GRATs is that GRATs may have been "outlawed" or more heavily taxed by the time the annuity is to be added to a new GRAT.

[74]Kwon & Loewy, "GRATS: On a Roll," 144 *Tr. & Est.* 33 (June 2005).

[75]This opportunity is available with a direct gift as well, if the gift is made to a grantor trust.

[76]This strategy could also be used if the asset used in the transfer to a GRAT or in an installment sale to a grantor trust underperforms in the early years. The ability to "stop the bleeding" again appears greater in an installment sale to a grantor trust because the installment note could be prepaid, thus capturing any benefits obtained in the transaction and eliminating the continuing need to pay a rate of return back to the grantor in the form of interest. The same opportunity is not available in a GRAT because the regulations require a GRAT to contain a provision prohibiting commutation or prepayment of the retained annuity. Regs. §25.2702-3(d)(4).

[77]Specifically, the payment may be delayed until the due date for filing the trust's income tax return without regard to extensions (normally, April 15 after the close of the calendar year) if annuity payments are based on a calendar year or 105 days after the anniversary of the commencement of the GRAT if annuity payments are based on such commencement date. Regs. §25.2702-3(b)(4). In fact, it may be appropriate to state expressly in the GRAT that the payment of the annuity may be delayed, as the regulations permit, for the 105-day period. It appears, although it may not be absolutely certain, that the delay in payment for the 105 days constitutes an interest-free loan that does not trigger the interest-free loan provisions of §7872. If that is so, delaying the payment for the 105 days provides an additional advantage to a GRAT. Although it is beyond the scope of this article to discuss the matter in greater detail, the regulations promulgated under §664 seem to support the conclusion that delaying the payment of the annuity from the GRAT to the grantor for the permitted 105-day period is not an interest-free loan for purposes of §7872. GRATs are somewhat similar to charitable remainder annuity trusts ("CRATs") described in §664(d)(1). *See, e.g.*, Regs. §25.2702-3(b)(2) which expressly refers to Regs. §1.664-2(a)(1)(iii). Indeed, §664 was the model Congress used in structuring §2702. *See Walton v. Comr.,* 115 T.C. 589 (2000). The CRAT regulations generally have permitted an annuity due for one year to be paid by April 15 (normally, about 105 days from the beginning of the calendar year) without adverse tax effect and without any suggestion that interest should or even may be paid on account of that regulatorily allowed deferral of payment of the annuity and without the possibility of actually taking such a delay in payment into account for purposes of valuing the annuity. *See* Regs. §1.664-2(a)(1)(a) and (c). *See also* 62 Fed. Reg. 19072 (4/18/02); Notice 97-68, 1997-2 C.B. 330; T.D. 8791, 63 Fed. Reg. 68188-01 (12/10/98); T.D. 8926, 66 Fed. Reg. 1034 (1/5/01). Of course, in the case of a charitable remainder trust, the position that the payment delay is ignored for valuation purposes benefits the charity without giving the taxpayer an increased charitable deduction. In a GRAT, ignoring, for valuation purposes, the delay in payment benefits the taxpayer by undervaluing the taxable gift of the GRAT remainder.

[78]For example, for Jan. 2005, the §7520 rate was 4.6% and the short-term AFR was 2.78%. The advantage in favor of the one-year installment sale made in Jan. 2005 using the short-term AFR compared to a one-year "zeroed out" GRAT begun in Jan. 2005, using $100 as the amount contributed to the GRAT or sold to the grantor trust and assuming a five percent actual growth for the year plus for the 105 days following the year is:

What Is Left in the GRAT	What is Left in the Grantor Trust
{100 × 1.05 × [1 + (.05 × .288)]} - 104.60	(100 × 1.05) - 102.78
or	or

1.191	2.22

However, if the actual growth in the assets is considerably higher (e.g., 10%) for the year plus the following 105 days, the advantage falls back in favor of the one-year GRAT.

[79]It should be noted that because an installment sale often involves interests of a family entity, there may be a negative valuation implication (meaning a reduced discount) if the family entity holds fewer different types of assets unless it can be demonstrated that there was a specific business purpose for doing so. *See, e.g.*, *Schutt Est. v. Comr.,* T.C. Memo 2005-126.

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