ACTEC

3415 South Sepulveda Boulevard
Suite 330
Los Angeles, California 90034-6060
(310) 398-1888 Fax (310) 572-7280
www.actec.org

THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

Please Address Reply to:

DANIEL H. MARKSTEIN, III
Maynard, Cooper & Gale, P.C.
1901-6th Avenue N.
2400 AmSouth-Harbert Plaza
Birmingham, AL 35203-2618
Direct Dial: (205) 254-1043
dmarkstein@maynardcooper.com

September 5, 2007

Via United States Mail

Internal Revenue Service
CC:PA:LPD:PR (REG-119097-05)
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Via Electronic Mail

Re: Comments of the American College of Trust and Estate Counsel on Proposed Regulations issued on the Application of Sections 2036 and 2039 to Grantor Retained Interest Trusts (REG-119097-05) on June 7, 2007

Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College') is pleased to submit these comments on the proposed regulations that were issued on June 7, 2007 with respect to the application of Sections 2036 and 2039 to grantor retained interest trusts. The College recognizes that drafting regulations is a difficult task. The College appreciates the efforts of the Internal Revenue Service and the Treasury Department to clarify the uncertainty that exists under present law regarding the potential application of both Section 2036 and Section 2039 to retained interests in property transferred to a grantor retained interest trust. The College believes that the proposed regulations adopt the correct approach by applying Section 2036, rather than Section 2039, to such interests.

The College is a professional association of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities.

Comments to the Supplementary Information

The first two sentences of the first paragraph of the Supplementary Information provide as follows:

> The proposed regulations provide guidance on what portion of a trust is includible in the deceased grantor's gross estate under section 2036 if the grantor **retained the right to use property** in the trust or the right to receive from that trust an annuity, unitrust, or **other income payment** for the grantor's life, for any period not ascertainable without reference to the grantor's death, or for any period that does not in fact end before the grantor's death. In addition, the proposed regulations provide guidance on the possible application of section 2039 to trusts in which the decedent **has retained the use of property held** in the trust or has retained an annuity, unitrust, or **other income interest** that is includible in the decedent's gross estate under section 2036. (emphasis added).

The College is not certain why the phrase "the right to use property" is used in the first sentence and the phrase "the use of property held" is used in the second sentence, but suggests the same phrase be used to avoid uncertainly. The College is also uncertain why the words "other income payment" are used in the first sentence and the words "other income interest" are used in the second sentence. Indeed, neither an annuity nor a unitrust is necessarily an "income" payment or interest because an annuity or unitrust could be payable from a trust that has no income for fiduciary accounting purposes. The College understands that one of the purposes of the proposed regulations is to treat as an income interest a stream of payments made from a trust that is economically similar to an income interest for purposes of the provisions of Section 2036. Accordingly, the College suggests that in both places the phrase be changed to "income interest or equivalent periodic payments." The College does not believe that Section 2036 could be applied to periodic payments other than those equivalent to an income interest in a trust.

Comments on Specific Provisions of the Proposed Regulations

1. Proposed Regulation § 20.2036-1(c)(1)(ii)

The example set forth in this proposed regulation provides as follows:

> Example. In 2001, Decedent (D) creates an irrevocable intervivos trust. The terms of the trust provide that all of the trust's income is to be paid to D and E, D's spouse who is a US citizen, in equal shares during their joint lives and, on the death of either of them, all of the income is to be paid to the survivor of them. On the death of the survivor of D and E, the remainder is to be paid

> to another individual, F. In 2006, D dies with E still surviving. A portion of the trust's corpus is includible in D's gross estate because D retained the right to receive a portion of the income from the trust for a period that does not in fact end before D's death. The portion of the trust's corpus includible in D's gross estate bears the same ratio to the entire corpus as D's income interest in the trust bears to the entire income interest in the trust. Therefore, in this case, because D and E share equally in the trust's income, 50 percent of the trust's corpus is includible in D's gross estate under section 2036. If instead E had predeceased D, D would have died while entitled to all of the income from the trust, so that the entire trust corpus would have been includible in D's gross estate under section 2036.

The College believes the example may create confusion for a number of reasons. First, the example recites that D's spouse, E, is a US citizen. That fact appears irrelevant unless the example intends to suggest that a portion of the trust might qualify for a gift tax marital deduction under Section 2523, in which case, a marital deduction would be available only if E were a US citizen due to the provisions of Section 2523(i) disallowing such a deduction in the case of a non-citizen spouse. However, in order for a marital deduction to be available, a number of additional requirements would need to be met. The example states that all of the trust's income is to be paid to D and E in equal shares during their joint lives and, on the death of either of them, all of the income is to be paid to the survivor of them. Thus, potentially one-half the transfer to the trust could qualify for a gift tax marital deduction under either Section 2523(e) (known as a general power of appointment trust) or Section 2523(f) (known as a qualified terminable interest property (QTIP) trust). But giving E the right to one-half the trust income would not be sufficient to qualify for a marital deduction. In addition, one-half the trust would need to satisfy the requirements of a specific portion under Treasury Regulation § 25.2523(e)-1(c) and that portion would need otherwise to satisfy the requirements of Section 2523(e) or (f).

If the trust were a QTIP trust, the example would be correct in its conclusion that if D predeceases E only one-half the trust would be included in D's gross estate under Section 2036. Treasury Regulation § 25.2523(f)-1(d) provides that the retention by a transferor of an interest in qualified terminable interest property does not cause the property to be included in the transferor's gross estate. Example 10 of Treasury Regulation § 25.2523(f)-1(f) illustrates this principle with an example of a QTIP trust which provides income to D's spouse S for life, then income to D for life, then principal to D's children. The example concludes that if D dies before S no part of the trust property will be included in D's gross estate because of D's election to treat the trust as qualified terminable interest property.

In order to avoid raising the foregoing issues, the College believes the example would be clearer if the hypothetical trust were for the benefit of D and D's child, C. In that case, however, under the final paragraph of Treasury Regulation § 20.2036-1(a) (which is to become § 20.2036-1(c)(1)(i) under the proposed regulations), the portion of the trust that would be included in D's gross estate if D predeceases C would be the entire trust, reduced only by the actuarial value, on

the date of D's death, of C's income interest in the trust. The relevant paragraph from Treasury Regulation § 20.2036-1(a) provides in part as follows:

> If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. If the decedent retained or reserved an interest or right with respect to a portion of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding portion or the amount described in the preceding sentence.

Although the second sentence quoted above might make it appear that D had a right to only one-half the income at the time of D's death. But D in the example had more than the right to one-half the income, D also had the right to the entire income in the event of E's death prior to D's death. In that case, D's greatest interest in the income would be used to determine the portion of the trust includible in D's gross estate under Section 2036, reduced, however, by the actuarial value, correctly computed in the example, of the surviving income beneficiary's interest.

2. Proposed Regulation § 20.2036-1(c)(2)

The proposed regulation is entitled "Retained annuity and unitrust interests in trusts," but it applies to other trusts as well. The College suggests that the heading be changed to "Retained annuity, unitrust and other income interests in trusts."

The proposed regulation uses the terms "grantor retained annuity trust (GRAT)" and "grantor retained unitrust (GRUT)" even though no such terms are used in either the Internal Revenue Code or existing Treasury Regulations. In order to avoid taxpayer confusion, the College recommends that appropriate references be made to Treasury Regulation § 25.2702-3(b) and (c) to indicate that those terms mean a trust in which the grantor has retained a qualified annuity interest (in the case of a GRAT) or a qualified unitrust (in the case of a GRUT).

3. Proposed Regulation § 20.2036-1(c)(2)(ii) Example 1

Example 1 concerns a charitable remainder annuity trust (CRAT). Its facts are as follows:

> In 2000, Decedent (D) transferred $100,000 to a trust that qualifies as a CRAT under section 664(d)(1). The trust agreement provides for an annuity of $12,000 to be paid each year to D for D's life, then to D's child (C) for C's life, with the remainder to be distributed upon the survivor's death to N, a charitable organization described in sections 170(c), 2055(a), and 2522(a). The annuity is payable to D or C, as the case may be, annually on each December 31st. D died in 2006, survived by C who was then age 40. On D's death, the value of the trust assets was

> $300,000 and the section 7520 interest rate was 6 percent. D's executor did not elect to use the alternate valuation date.[1]

The example computes the amount includible in D's gross estate under Section 2036 by determining the portion of the trust, based upon an assumed Section 7520 interest rate of 6 percent, that would be necessary to produce income in the amount of $12,000 annually, and concludes that two-thirds of the trust, or $200,000, would be includible in D's gross estate for federal estate tax purposes. The example then calculates the actuarial value of C's annuity interest ($169,975.20) based upon the applicable annuity factor for an individual of C's age, subtracts the entire value of the annuity interest from the portion of the trust included in D's gross estate, and concludes that D's estate is entitled to a charitable deduction of only $30,024.80.

This conclusion would be correct only if it could be assumed that the annuity payments to be made to C will be paid entirely from the portion of the trust that is included in D's estate. It seems to the College that there is no basis for making this assumption. The annuity payments will be made from the trust as a whole and should be allocated between the included and excluded portion of the trust in proportion to the relative values of each. As a result, the charitable deduction should be $86,683, $200,000 reduced by two-thirds of the value of C's annuity.[2]

On the other hand, if D had retained the power to revoke by will C's continuing annuity interest as permitted under Treasury Regulation § 1.664-2(a)(4), the result should be different. If

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[1] The College points out that under the facts as stated the CRAT does not appear to meet the definition of a charitable remainder annuity trust under Section 664(d) for two reasons. The example posits that the CRAT was created in the calendar year 2000 when C would have been 34 years old. Relative to any applicable Section 7520 rate in the calendar year 2000, the actuarial value of C's annuity interest would have reduced the value of the remainder interest in the CRAT to below 10 percent in violation of the requirements of Section 664(d)(1)(D). In addition, Treasury Regulation §25.2522(a)-2(b) prohibits a charitable deduction unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. Revenue Ruling 77-374, 1977-2 C.B. 329, provides that a charitable deduction is not allowable if the probability exceeds 5 percent that the noncharitable income beneficiary will survive the exhaustion of the fund in which charity has a remainder interest (the so–called "exhaustion test"). The facts of the example as stated would also cause the CRAT to fail the exhaustion test.

[2] The College notes that if C's annuity interest is properly treated as payable from the entire CRAT, then the portion of C's annuity interest payable from the includible portion of the CRAT is less than five percent of the value of the includible portion at the time of D's death ($8,000 is only 4% of $200,000). The College believes that if an individual creates a CRAT that satisfies the definition of a charitable remainder annuity trust under Section 664(d) at the time it is created and the CRAT is subsequently included in the individual's gross estate for federal estate tax purposes, the CRAT need not be retested for qualification under Section 664(d) at the time of the individual's death for purposes of determining whether the individual's estate is entitled to a charitable deduction for the value of the remainder interest in the CRAT. It would be helpful if the example would so state.

D retains the right to revoke C's annuity interest, two-thirds of the CRAT would be includible in D's gross estate under Section 2036(a)(1) (as well as Section 2036(a)(2)) as stated in the example. However, the entire CRAT would be included in D's gross estate under Section 2038 because by revoking C's continuing annuity interest D would be able to affect the timing of the enjoyment by charity of the remainder interest in the CRAT. In that case, the transfer of C's annuity interest would be deemed to take effect on D's death, and it would be appropriate to deduct the entire value of C's annuity interest from the included portion of the CRAT, in this case being the entire trust, for purposes of determining the charitable deduction to which D's estate would be entitled.

Similarly, if D had retained the right to change the identity of the charities entitled to receive the remainder interest as permitted under Revenue Ruling 76-7, 1976-1 C.B. 179, the entire CRAT would be includible in D's gross estate under Sections 2036(a)(1), 2036(a)(2) and 2038, because D would have retained not only an income interest in two-thirds of the CRAT, but also the right to determine who would receive the balance of the income as well as the right to alter or amend the disposition of the remainder interest. In that case, D's estate would be entitled to a charitable deduction of $130,025 ($300,000 minus the value of C's annuity interest of $169,975). The College notes that although the proposed regulations appear to have been issued exclusively under Section 2036(a)(1), a complete analysis shows that depending on the terms of the CRAT, Sections 2036(a)(2) and 2038 could apply, and may cause a greater portion of the CRAT to be includible in D's gross estate than indicated in the example.

The example mentions the possible use of alternate valuation under Section 2032, but does not mention the possible use of the Section 7520 interest rate for the two months prior to the month of death under Section 7520(a) for purposes of calculating the estate tax charitable deduction. The College suggests that the example confirm that if D's executor elects to use the interest rate component for either of the two months preceding the month of death for purposes of determining the charitable deduction available with respect to the CRAT, then consistent with Treasury Regulations § 1.664-2(c) and § 1.7520-2, the month so elected is the valuation date not only for purposes of determining the interest rate and mortality tables to be used to calculate the amount of the charitable deduction, but also for purposes of determining the portion of the CRAT that is includible in D's gross estate.

The College suggests that the example also confirm, consistent with Treasury Regulations § 1.664-2(c) and § 1.7520-2(a)(2), that if D's executor elects the alternate valuation date, the alternate valuation date will be the valuation date for purposes of determining the Section 7520 interest rate and the mortality tables applicable to determining not only the charitable deduction but the portion of the CRAT includible in D's gross estate. In addition, the College suggests that the example confirm that if D's executor also elects to use the interest rate component for either of the two months prior to the alternate valuation date, the month so elected is the valuation date not only for purposes of determining the interest rate and mortality tables to

be used to calculate the amount of the charitable deduction, but also for purposes of determining the portion of the CRAT that is includible in D's gross estate.

To recapitulate, in addition to changing the facts so that the CRAT qualifies as a CRAT (see footnote 1), the College suggests the following three changes be made to Example 1 to take the foregoing comments into account: (a) Example 1 should be changed to reflect that the value of only two-thirds of C's continuing annuity interest should be treated as paid from the portion of the CRAT included in D's gross estate; (b) Example 1 should state that if D retains the right to revoke C's continuing annuity interest or to change the identity of the charities entitled to the remainder interest, then the entire trust would be includible in D's gross estate under Sections 2036(a)(1), 2036(a)(2) and 2038, and the entire value of C's continuing annuity interest should be subtracted for purposes of determining the charitable deduction to which D's estate is entitled; and (c) Example 1 should state that if D's executor elects to use the alternate valuation date under Section 2032 and also elects to use the interest rate component for either of the two months preceding the alternate valuation date, then under Treasury Regulation § 1.664-2(c), the Section 7520 interest for that month and the mortality table for that month should be used for purposes of determining (i) the portion of the CRAT included in D's gross estate, (ii) the value of C's continuing annuity interest and (iii) the charitable deduction available with respect to the portion of the CRAT so included.

4. Proposed Regulation § 20.2036-1(c)(2)(ii) Example 2

Example 2 concerns a grantor retained annuity trust (GRAT). Its facts are as follows:

> D transferred $100,000 to a GRAT in which D's annuity is a qualified interest described in section 2702(b). The trust agreement provides for an annuity of $12,000 per year to be paid to D for a term of ten years or until D's earlier death. The annuity amount is payable at the end of each month in twelve equal installments. At the expiration of the term of years or on D's earlier death, the remainder is to be distributed to C, D's child. No additional contributions were made to the trust after D's transfer at the creation of the trust. D dies prior to the expiration of the ten-year term. On the date of D's death, the value of the trust assets was $300,000 and the section 7520 interest rate was 6 percent. D's executor did not elect to use the alternate valuation date.

Example 2 contains the following sentence: "No additional contributions were made to the Trust after D's transfer at the creation of the trust." The College believes this statement may confuse taxpayers into believing that additional contributions to a GRAT are permitted. The College suggests that the sentence be rewritten to provide as follows: "Consistent with the requirements of Treasury Regulation § 25.2702-3(b)(5), additional contributions to the trust were prohibited, and none was made." Alternatively, the sentence could be deleted because the result under Section 2036 should not be affected by the trust's adherence to the requirements of Treasury Regulation § 25.2702-3(b)(5).

Many GRATs and GRUTs are drafted as a trust for a fixed term of years (a term GRAT or a term GRUT) and provide for continuing payments to the grantor's estate if the grantor dies within the term, consistent with Treasury Regulation § 25.2702-3(e) *Example 5*, and *Walton v. Comm'r,* 115 T.C. 589 (2000).), *acq.* IRS Notice 2003-72, 2003-44 I.R.B. 964 The actuarial value of the right to receive post-death annuity payments is includible in the grantor's gross estate under Section 2033. It would helpful to taxpayers if the regulations were to provide an example showing the proper calculation of the portion of the trust that is includible in the grantor's gross estate under Sections 2033 and 2036(a)(1) in the case of a term GRAT or GRUT with continuing payments to the grantor's estate. The application of two different inclusion sections to the same property interests should not result in a double estate tax. In order to avoid this result, and because the amount of trust corpus that is necessary to yield the annual annuity payment to D must always be greater than the actuarial value of the post-death annuity payments, the amount included should be limited to the amount included under Section 2036(a)(1).

Indeed, the College believes that the portion of a term GRAT or GRUT that is includible in the grantor's gross estate under Section 2036(a)(1) if the grantor dies within the term and payments continue to the grantor's estate should be the same as the computation of the includible portion of a GRAT or GRUT with payments terminating upon the grantor's death. This is so because the includible portion as computed under the proposed regulations will be that portion of the trust necessary to support the annuity or unitrust payment in perpetuity as if those payments constituted an income interest in the trust. Accordingly, whether the payments terminate upon the grantor's death or terminate a period of years later should not affect the amount of property included in the grantor's estate under Section 2036(a)(1).

Many GRATs are drafted so that the annuity payments increase annually to 120 percent of the preceding year's annuity payment as permitted under Treasury Regulation § 25.2702-3(b)(ii). It would be helpful to taxpayers if the regulations explained how the includible portion of a GRAT should be computed if the terms of the trust provide for increasing payments. The College believes that a proper method to determine the includible portion of a GRAT with increasing payments is not entirely clear under the law; therefore, we have set forth below two possible alternative methods of computing the includible portion based upon the following example:

Suppose that the grantor creates a three-year term GRAT providing for the grantor to receive the following fixed payments: $100,000 on the first anniversary, $120,000 on the second anniversary and $144,000 on the third anniversary, when the GRAT will terminate. The grantor dies on the first day of the second year when the GRAT is worth $2 million and the Section 7520 rate is 7.2%. (Alternate valuation is not elected.)

The College believes that, consistent with the general statement in Proposed Regulation § 20.2036-1(c)(2), the includible portion of a GRAT with increasing payments could be

determined by calculating that amount of corpus that would be necessary, taking into account income only (deemed to be earned at the applicable Section 7520 rate) to yield the annuity payments. Under that approach, the portion of the $2 million GRAT included under Section 2036 would be that portion required, when invested at 7.2%, to yield the two future annuity payments, one of $120,000 and one of $144,000. That amount, which takes account of accumulations of income which would be deemed available to make annuity payments in subsequent years, would be $1,827,542, calculated as follows:

Year	Initial Principal	Income @ 7.2%	Annuity Payment	Remaining Principal
1	$ 1,827,542	$ 131,583.01	$ 120,000.00	1,839,125
2	$ 1,839,125	$ 132,416.99	$ 144,000.00	1,827,542

Alternatively, the includible portion of the GRAT could be determined based upon the highest annuity payment the grantor would have been entitled to receive. Hence, the includible portion of the trust would tentatively be computed based upon the last scheduled annuity payment of $144,000 yielding 100% inclusion ($144,000/7.2% = $2,000,000). However, that computation assumes the grantor would receive $144,000 in each year. But the grantor was entitled to only $120,000 in the year of death. This means that the difference between the payment of $120,000 and the assumed income payment of $144,000, or $24,000, would be accumulated in the trust. Therefore, the fair market value of the trust would be $2,024,000 at the end of the second year. Because the $144,000 annuity due at the end of the third year would represent only 98.81% of the $145,728 in income that would be projected to be earned on a trust of $2,024,000 (assuming a 7.2% earning rate), that same percentage should be applied to determine the portion of the date of death value to be included in the grantor's gross estate. Therefore, under the second method only 98.81% of the $2 million trust, or $1,976,285 of the GRAT, should be included in the grantor's gross estate.

The College acknowledges that in the case of an income interest, if the entitlement to income were to become 100% at some point in the future (even if only after the occurrence of a contingency beyond the grantor's control such as the death of another individual), 100% of the trust would be includible in the grantor's gross estate under Section 2036(a)(1). However, in the case of a GRAT with increasing annuity payments, the grantor's entitlement to receive property from the trust is fixed at inception, and does not increase or decrease with the value of the trust estate. Instead, any income in excess of the annuity payment would be accumulated and added to corpus. Therefore, the College believes that it would be fair to take those accumulations into account in some manner. In the first proposed method, the hypothetical accumulations would be treated as available to make future annuity payments. Under the second proposed method, the hypothetical accumulations would be taken into account solely for purposes of determining the value of the trust estate from which the largest annuity payment would be made.

The College believes that it would be very helpful to taxpayers if an example were included in the final regulations setting forth which of the alternative computations proposed herein is proper for a GRAT with increasing annuity payments.

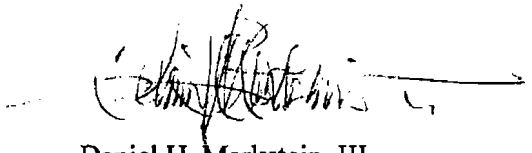
5. Proposed Regulation § 20.2036-1(c)(2)(ii) Example 3

The College has the same comments with respect to Example 3 as it has with respect to Example 1 regarding the valuation date to be used for purposes of Section 2036(a)(1). Example 3 should state that if D's executor elects to use the alternate valuation date under Section 2032 and also elects to use the interest rate component for either of the two months preceding the alternate valuation date, then under Treasury Regulation § 1.664-4(e)(4), the Section 7520 interest for that month and the mortality table for that month should be used for purposes of determining (i) the portion of the CRUT included in D's gross estate, (ii) the value of C's continuing unitrust interest and (iii) the charitable deduction available with respect to the portion of the CRUT so included. The example should also clarify that if only one-half the CRUT is includible in D's gross estate, and D did not retain the power to revoke C's unitrust interest or to designate the charities that are entitled to receive the remainder interest in the CRUT, then only one-half of C's continuing unitrust interest should be treated as payable from the portion of the CRUT that are included in D's gross estate.

Conclusion

These comments were prepared by Turney P. Berry, Jonathan G. Blattmachr, Mitchell M. Gans, Linda B. Hirschson, Lawrence P. Katzenstein, Carlyn S. McCaffrey, Paul I. Rosenberg, Robert M. Weylandt and Diana S.C. Zeydel, as representatives of the Estate and Gift Tax Committee and were approved by the Executive Committee of the College. We appreciate this opportunity to comment on the proposed regulations and would be pleased to offer additional comments if desired.

Very truly yours,



Daniel H. Markstein, III
President

cc: Executive Committee of The College
Ms. Gerry A. Vogt, Executive Director of The College