INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-165986-01/CC:PSI:B4

Taxpayer's Name:

Taxpayer's Identification No:

Date of Conference:

LEGEND:
Grantor A =
Grantor B =
Date 1 =
GRAT 1 =

GRAT 2 =

GRAT 3 =

GRAT 4 =

Citation 1 =
Citations 2 =

ISSUE:

Whether the revocable spousal interests provided under GRATs 1-4 are qualified interests for purposes of § 2702 of the Internal Revenue Code.

CONCLUSION:

The revocable spousal interests provided under GRATs 1-4 are not qualified interests for purposes of § 2702 of the Internal Revenue Code.

FACTS:

On Date 1, Grantor A and Grantor B, Husband and Wife, each created and funded 2 Grantor Retained Annuity Trusts (GRATs) with stock in a closely held

business. Grantor A created GRATs 1 and 2, and Grantor B created GRATs 3 and 4.

ARTICLE FIVE of GRAT 1 (created by Grantor A) provides for the disposition of the trust, as follows:

> **ARTICLE FIVE: Administration of Trust Estate.** Trustee shall hold, administer, and distribute the trust estate as follows:
>
> **A. Annuity Term**. During the period beginning on the date of this agreement and ending on the date two years thereafter (the "Annuity Term"), Trustee shall pay to me from the net income, or (to the extent that net income is insufficient) from the principal, of the trust an annuity (the "Annuity") in an amount equal to 51.2535 percent of the initial fair market value of the assets contributed to the trust as finally determined for federal tax purposes. The annuity will increase by twenty percent (20%) each year during the Annuity Term. . . . If I die before the expiration of the Annuity Term, the Trustee shall pay to my estate any part of the Annuity that is accrued and undistributed at my death, based on a daily proration through the date of my death. . . . The remaining trust assets are to be administered and distributed as provided elsewhere in this agreement. . . .
>
> **B. Termination of Trust**. Except as otherwise provided in this agreement, at the end of the Annuity Term, Trustee shall administered and distribute the remaining net income, if any, and principal of the trust not required to be paid out in satisfaction of the final Annuity payment, as provided in Article Six below. (Emphasis added.)

ARTICLE FIVE D provides as follows regarding compliance with the requirements of section 2702:

> **D. Qualified Annuity Interest**. I intend that my retained annuity interest in this trust (and the annuity interest of my wife if she survives me and receives the Annuity under paragraph E below) be a "qualified annuity interest" as defined in Code section 2702(b)(1) and Treasury Regulation Section 25.2702-3(b) and (d). All provisions of this agreement are to be interpreted accordingly and any provision of this agreement inconsistent with that intention is to be of no effect. . . . No power, right, or duty under this agreement will be effective or exercisable to the extent that it would cause my retained annuity interest (or my wife's interest, if any) hereunder to fail to qualify as a "qualified annuity interest" under Code section 2702(b)(1) and Treasury Regulation Section 25.2702-3(b) and (d).

Under ARTICLE FIVE E, a "Revocable Contingent Spousal Annuity Trust" is

provided for as follows:

> **E. Revocable Contingent Spousal Annuity Trust.** If, and only if, I die before the Annuity Term ends, my wife survives me, and I have not exercised my right to revoke all or a portion of my wife's interest under this agreement, then to the extent that I have not revoked such interest, Trustee shall hold the remaining trust assets in a marital trust for my wife. Trustee shall administer that marital trust for the lifetime of my wife as follows:
>
> 1. Trustee shall pay to my wife, or if she is deceased, to her estate, as an annuitant, the remaining Annuity which would have been paid to me if I had survived. . . .
>
> 2. During the Annuity Term, the Trustee also shall pay from the date of my death all the income that exceeds the Annuity to or for the benefit of my wife at least annually. After the Annuity Term, Trustee shall pay the income to or for the benefit of my wife for her lifetime at least annually. (Emphasis added.)

ARTICLE FIVE G provides for the disposition of the trust in the event Grantor A dies during the two year term and his wife predeceases him, or he has otherwise revoked her spousal interest. In particular, that provision provides:

> **G. If I Die During Trust Term and My Wife Does Not Receive Annuity.** If, and only if, I die before the Annuity Term ends, and either I have revoked in whole or in part my wife's interest under this agreement or my wife does not survive me, then the trust assets subject to such to such revocation or the remaining trust assets in the event my wife does not survive me, as the case may be, are to be distributed to or in trust for such appointees as I shall appoint by my Will. In the absence of such an appointment, the remaining trust assets shall be distributed to my estate. (Emphasis added.)

ARTICLE SIX provides for the ultimate distribution of the trust as follows:

> **Ultimate Distribution**. Upon the expiration of the Annuity Term, all the remaining income and principal of this trust, if any, are to be divided into equal shares and distributed outright and free of trust to my then living children. . . .

The terms of GRAT 1 and GRAT 2 are identical, except that under GRAT 2 the annuity term is 4 years and the initial annual annuity payment is 22.9876 percent of the

initial fair market value of the assets (increasing 20 percent per year thereafter). The terms of GRAT 3 and GRAT 4 created by Grantor B are generally identical to those of GRATs 1 and 2, respectively, except that with respect to each trust, the annuity is to be paid to Grantor B, and Grantor A is the beneficiary of the revocable contingent spousal annuity trust.

Grantors A and B each timely filed Form 709 reporting as taxable gifts the remainder interest in each GRAT, the value of which they reported as the value of the property transferred into the pertinent GRAT less the value of the retained interest in that GRAT. The grantors calculated the value of the retained interest with respect to each trust as the present value of an annuity for a term of years or the prior death of two individuals (the grantor and grantor's spouse).

LAW AND ANALYSIS:

Section 2501 provides that a tax is imposed on the transfer of property by gift. Section 25.2512-5(a)(1)(i) provides the general rule that where the donor transfers property in trust and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest.

Section 2702 provides the method for valuing a donor's gift when the donor makes a transfer in trust to or for the benefit of a family member and the donor retains an interest in the trust. Section 2702(a)(1) provides that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a family member of the transferor's family is a gift (and the value of the transfer), the value of any interest in the trust retained by the transferor or any applicable family member shall be determined as provided in § 2702(a)(2).

Section 2702(a)(2) provides, in part, that the value of any retained interest which is not a qualified interest shall be treated as being zero. The value of any retained interest which is a qualified interest shall be determined under section 7520.

Section 2702(a)(3)(i) (as amended by section 1702(f)(11)(B) of the Small Business Job Protection Act of 1996) provides that section 2702 does not apply to a transfer if the entire transfer is an incomplete gift. See, H.R. Rep. No. 586, 104th Cong., 2d Sess. 155 (1996). Section 2702(a)(2)(B) defines an incomplete gift as any transfer which would not be treated as a gift whether or not consideration was received for such transfer.

Section 2702(b) provides, in part, that the term "qualified interest" means:

> (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually,
>
> (2) any interest which consists of the right to receive amounts

which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

(3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2).

Section 25.2702-1(c)(1) of the Gift Tax Regulations provides that section 2702 does not apply to a transfer, no portion of which would be treated as a completed gift without regard to any consideration received by the transferor.

Section 25.2702-2(a)(3) provides that the term “retained” means held by the same individual both before and after the transfer in trust. In the case of the creation of a term interest, any interest in the property held by the transferor immediately after the transfer is treated as held both before and after the transfer.

Section 25.2702-2(a)(4) provides an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift under chapter 12.

Section 25.2702-2(a)(5) provides that the term "qualified interest," for purposes of section 2702(b), means a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest. Further, the retention of a power to revoke a qualified annuity interest (or unitrust interest) of the transferor's spouse is treated as the retention of a qualified annuity interest (or unitrust interest).

Section 25.2702-3(b)(1) provides, in part, that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest for each taxable year of the term. Under section 25.2702-3(d)(3), the governing instrument must fix the term of the annuity interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Section 25.2702-3(c) provides similar rules applicable to a unitrust interest (a right to receive a fixed percentage of the net fair market value of the trust assets, determined annually.)

Under section 2702(a)(3)(i) and section 25.2702-1(c)(1), a revocable interest is generally subject to the rules of section 2702 and must qualify as a qualified interest in order to avoid valuation at zero when determining the amount of any gift, unless the entire gift is incomplete. Section 25.2702-2(a)(5) provides an exception to this general rule. That is, a revocable interest is valued under section 7520, if the interest is a qualified annuity or unitrust interest of the donor's spouse. Section 25.2702-2(d)(1), Examples 6 and 7 illustrate the application of this exception. In Example 6, A transfers property to an irrevocable trust, retaining the right to receive the income for 10 years. Upon expiration of 10 years, the income of the trust is payable to A's spouse for 10

years if living. Upon expiration of the spouse's interest, the trust terminates and the trust corpus is payable to A's child. A retains the right to revoke the spouse's interest. Because the transfer of property to the trust is not incomplete as to all interests in the property (i.e., A has made a completed gift of the remainder interest), section 2702 applies. A's power to revoke the spouse's term interest is treated as a retained interest for purposes of section 2702. Because no interest retained by A (i.e., A's income interest and the spouse's revocable income interest) is a qualified interest, the amount of the gift is the fair market value of the property transferred to the trust.

In Example 7 of section 25.2702-2(d)(1), the facts are the same as in Example 6, except that both the term interest retained by A and the interest transferred to A's spouse (subject to A's right of revocation) are qualified annuity interests. The example concludes that the amount of the gift is the fair market value of the property transferred to the trust reduced by the value of both A's qualified interest and the value of the qualified interest transferred to A's spouse (subject to A's power to revoke).

Cook v. Commissioner, 269 F. 3rd 854 (7th Cir. 2001), aff'g 115 T.C.15 (2000), considered an issue similar to that presented in the instant case. In Cook, the Grantors (a husband and wife) each created trusts intended to qualify as GRATs under § 2702. Each of the GRATs provided for the payment of an annual annuity amount equal to 23.999 % of the initial value of the trust corpus, to be paid to the Grantor for a term of 5 years or until the Grantor's earlier death. If the Grantor survived the 5-year term, then the remaining trust property was to be used to establish a separate trust for the Grantor's son. However, if the Grantor died before the expiration of the 5-year term and was married to Grantor's spouse at the time of death, all remaining trust property was to pass to a Contingent Marital Annuity Trust, pursuant to which the Grantor's spouse would receive the annuity amount that would have been paid to the grantor if the grantor had survived the remainder of the 5-year term of the GRAT. Upon the earlier of the expiration of the 5-year term or the death of the Grantor's spouse, the remaining trust assets were to be used to establish a separate trust for the Grantor's son. In each trust, the Grantor reserved the power to revoke the successor interest of the spouse.

The Seventh Circuit, in affirming the Tax Court, concluded that the revocable spousal interest (the right of the Grantor's spouse to receive an annuity for the balance of the five year term of the trust provided the Grantor died within the five year term and was married to the spouse at that time) was not a qualified interest, and therefore was not to be taken into account in reducing the value of the gift. First, the Seventh Circuit noted that the spouse's interest might never vest and allowing a reduction for tax purposes of a gift made in trust for an "ephemeral interest" would invite abuse. Cook v. Commissioner, 269 F. 3rd at 858. See also, Cook v. Commissioner, 115 T.C. at 19. The Seventh Circuit concluded that the spousal interest was contingent, and not fixed and ascertainable, because the spouse was entitled to receive the interest only if the spouse survived the grantor, and only then, if the spouse and grantor remained married.

The court also concluded that the spouse's interest did not satisfy section 25.2702-3(d)(3), requiring that the annuity be payable for the life of the term holder, a specified term of years, or for the shorter of these periods, because the spousal interest could be paid for the life of the grantor or for a term of years, regardless of which period is shorter. The IRS argued in Cook that the spousal interest was contingent, and that it did not satisfy the durational requirements of the regulations because the spousal annuity was payable, if at all, only if the Grantor died prior to the termination of the term of the trust. Further, if payable at all, it was payable for an unspecified period dependent on the point during the term of the trust that the Grantor died. Thus, at the inception of the GRAT, the spousal interest was not fixed and ascertainable, but rather was contingent, and at the inception of the GRAT, the interest was not payable for the life of the term holder, or a specified term of years. This is in contrast to section 25.2702- 2(d)(1), Example 7, where the 10-year revocable spousal interest is payable to the spouse beginning at the end of the grantor's 10-year term in all events. In this example, the interests of both the grantor and his or her spouse, at the creation of the trust, are fixed, ascertainable interests payable for a specified term of years, and the spousal interest is not contingent upon the grantor's death at a particular time. See Cook v. Commissioner, 115 T.C. at 23; Schott v. Commissioner, T.C. Memo 2001-110, appeal docketed, No. 02-7007 (9th Cir. December 21, 2001).

Under applicable State law, the intention of the testator as expressed in the trust controls the legal effect of the dispositions under the instrument. Citation 1. On the other hand, when the terms of the instrument are clear and unambiguous, there is no reason to engage in construction. Citations 2. Finally, as a general rule of construction, words used in an instrument generally are given their ordinary meaning and in the absence of a clear intention to the contrary on the face of the instrument, should be taken in their ordinary and grammatical sense. 76 Am. Jur 2d Trusts, §39.

In the present case, with respect to each GRAT 1-4, the right of the Grantor's spouse to receive annuity payments is contingent upon the Grantor's death prior to the expiration of the two- or four-year term of the GRAT, as the case may be. The spouse's interest is essentially the same as the spousal interest considered in Cook and Schott, which the courts determined were not qualified interests within the meaning of section 2702 and the regulations thereunder. Accordingly, the revocable spousal interest created in GRATs 1-4 are not qualified retained interests for purposes of § 2702(b). These spousal interests, therefore, valued at zero in determining the value of the Grantors' gifts for gift tax purposes. As discussed below, the only qualified interest retained by the Grantors under each GRAT, 1-4, is the Grantor's individual right to receive the annuity until the expiration of the stated term of years or the Grantor's prior death, whichever occurs first. This retained qualified interest is valued under section 7520 in determining the value of each gift.

The Grantors argue that the instant case is distinguishable from Cook and Schott because, under the terms of the trusts involved in those cases, if the Grantor died

before the term of the GRAT ended and either the spouse predeceased the Grantor, or the Grantor revoked the spousal interest, then the trust terminated and the corpus passed to the remainder beneficiaries. In contrast, the Grantors argue that under ARTICLE FIVE G of each trust here, if the Grantor dies before the two- or four-year annuity term ends and if the spouse predeceases the Grantor or the Grantor revokes the spousal interest, then the annuity is payable for the balance of the two or four year term to whomever the Grantor appoints by will, or in default of appointment, to the Grantor's estate. Then, at the end of the two- or four-year term, the remaining balance of the trust corpus is to be paid, in accordance with ARTICLE SIX, to the remainder beneficiaries. Thus, the Grantors argue that the GRATs in this case are "fixed" term GRATs similar to the trusts considered in Walton v. Commissioner, 115 T.C. 41 (2000).

As noted above, ARTICLE FIVE G provides that if the Grantor dies before the two or four year term of the trust ends, and if either, the Grantor has revoked, in whole or in part, the spousal interest, or the spouse has predeceased the Grantor,

> then the trust assets subject to such to such revocation or the remaining trust assets in the event my wife does not survive me, as the case may be, are to be distributed to or in trust for such appointees as I shall appoint by my Will. In the absence of such an appointment, the remaining trust assets shall be distributed to my estate. (Emphasis added.)

As we understand the Grantors' argument, the phrases "trust assets" and "remaining trust assets" as used in ARTICLE FIVE G actually refer only to the annuity payments due for the balance of the two- or four-year annuity term, whichever is applicable. Accordingly, under this interpretation of ARTICLE FIVE G, if the Grantor dies prior to the expiration of the stated two or four year term of the GRAT, then only the remaining annuity payments (and not the "remaining trust assets") are paid in accordance with the exercise of the Grantor's general power of appointment, or if the donor fails to appoint the annuity payments, to the Grantor's estate. In support of this interpretation, the Grantors cite ARTICLE FIVE A, which provides that with respect to each trust, the annuity is to be payable for the "Annuity Term", defined as either a two- or four-year period, with no provision that otherwise limits this payment period. Further, under ARTICLE 6, the trust corpus is to be distributed to the remainder beneficiaries only at the expiration of the "Annuity Term," and this provision contains no reference to any prior distribution of corpus to the Grantor's estate or pursuant to the exercise of a general power. It follows, the Grantors argue, that in view of these provisions, the Grantors intended that the annuities be paid for the specified Annuity Term in all events, and, as a matter of internal consistency, "remaining trust assets" as used in ARTICLE FIVE G must refer only to the remaining annuity payments.

We disagree with this interpretation of the GRAT instruments. ARTICLE FIVE A, ARTICLE FIVE E and ARTICLE FIVE G all repeatedly refer to the disposition of the "remaining trust assets". The plain unambiguous meaning of the phrase is the balance

of the assets held in the trust. To give the phrase a totally different and unnatural meaning, as the Grantors propose, would simply create a series of internal inconsistencies. For example, as noted above, under ARTICLE FIVE A, if the Grantor dies prior to the expiration of the specified term, after providing for certain payments to cover the Grantor's income tax liability, the "remaining trust assets" are to be administered as provided elsewhere in the agreement. Clearly, this phrase comprehends the entire remaining balance of the trust.

Under ARTICLE FIVE E, if the spouse survives the donor and the donor dies during the annuity term, without having revoked the spousal interest, the trustee is to hold "the remaining trust assets" in a marital trust. From this trust, the trustee is directed to pay to the spouse "the remaining annuity that would have been paid to me if I had survived." Again the phrase "remaining trust assets" clearly references the remaining balance of the trust corpus. Further, the language of ARTICLE FIVE E clearly differentiates between the remaining trust assets, on the one hand, and the remaining annuity payments, on the other. Thus, it is doubtful that, the phrase "remaining trust assets" as used two paragraphs later in the instrument in Article FIVE G, could be viewed as somehow referencing the remaining annuity payments, when the language used in ARTICLE FIVE E clearly articulates the two distinct concepts.

Further, we do not believe that ARTICLE SIX can properly be read to preclude final distribution of the trust corpus at any time prior to the expiration of the two or four year "Annuity Term". For example, ARTICLE FIVE B provides that ARTICLE 6 is to govern the distribution of the remaining income if any and all of the principal of the trust "except as otherwise provided in agreement." ARTICLE SIX specifically applies to all the "remaining" income and principal of the trust. Thus, contrary to the Grantors' argument, we believe the language of ARTICLE FIVE A and ARTICLE SIX clearly contemplates that the other provisions of the trust, such as ARTICLE FIVE G might become operative to govern the ultimate disposition of the trust corpus prior to the expiration of the specified annuity term.

Thus, we do not believe that the phrase "remaining trust assets" as used in ARTICLE FIVE G can properly be construed as referring only to the remaining annuity payments payable during the balance of the specified two- or four-year term. Such a construction would conflict with the plain meaning of the phrase and would be inconsistent with the other trust provisions. Further, we do not agree that, even if the GRATs could be interpreted to provide for payment of the remaining annuity to the Grantor's estate or pursuant to a general power of appointment, that the trust would come within the purview of the Walton decision. Walton involved an annuity that was payable for a specified term either to the Grantor or the Grantor's estate. We question whether the estate's annuity interest in this case, which would be payable to the estate only if either the spouse predeceases the Grantor or the Grantor revokes the spousal interest, would satisfy the standard enunciated by the court in Walton.

In this regard, the Grantors argue that under ARTICLE FIVE D, "[n]o power, right, or duty" under the agreement "will be effective or exercisable to the extent that it would cause my retained annuity interest (or my wife's interest, if any) hereunder to fail to qualify as a "qualified annuity interest" under Code section 2702(b)(1). . ." Grantors argue that, if the ARTICLE FIVE G revocable spousal interest causes the Grantor's retained interest to fail to constitute a qualified annuity interest, then this provision would operate to invalidate the ARTICLE FIVE G spousal interest. Each trust would then be a "fixed" term GRAT, as described in the Walton decision (assuming the Grantors' interpretation of the trust instrument is sustained.)

Grantors' argument suggests that, should a determination be made that the revocable contingent spousal interest causes the Grantor's retained interest to lose qualified annuity interest status to the extent payable to the Grantor's estate, then the spousal gift is revoked. Such a "savings clause" is ineffective for federal transfer tax purposes. See, Commissioner v. Procter, 142 F. 2d 824 (4th Cir. 1944), cert. den. 393 U.S. 756 (1944); Ward v. Commissioner, 87 T.C. 78 (1986); Harwood v. Commissioner, 82 T.C. 239 (1984); Rev. Rul 65-144, 1965-1 C.B. 442.

Lastly, the donors argue that GRATs 1-4 are distinguishable from the GRATs considered in Cook and Schott because the trusts involved in this case provide that if the spouse becomes entitled to receive the annuity and then dies prior to the expiration of the specified term, the annuity is payable to the spouse's estate for the balance of the specified term. However, as discussed above, section 25.2702- 2(d)(1), Example 7, illustrates that the right to receive annuity payments contingent on the grantor's death prior to the expiration of the grantor's retained term interest is not a qualified interest. The fact that the spousal annuity, if it commences at all, may be payable to the spouse's estate does not negate this initial contingency. As discussed above, both the Seventh Circuit and the Tax Court opinions in Cook v. Commissioner, admonished against reducing the value of the gift for interests that may never take effect.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.