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THE DEFECTIVE GRANTOR TRUST AS AN ESTATE PLANNING STRATEGY

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Generally, a defective grantor trust is an irrevocable trust for the benefit of children and/or grandchildren in which the grantor does not retain any income interest. The trustee is someone other than the grantor. The spouse may be the trustee.

The trust is structured so that the grantor is treated as the owner of the trust for income tax purposes only under the rules set forth in Internal Revenue Code §§ 671-678. These are known as the grantor trust rules; they were designed to impose income tax on the grantor even though the grantor is not the income beneficiary of the trust. This unique taxing feature provides planning opportunities to achieve gift and estate tax benefits for the grantor. The most significant of these benefits is to "freeze" the value of a closely-held business interest or real estate owned by the grantor.

Estate Tax Consequences of the Defective Trust

The grantor trust rules do not apply for gift and estate tax purposes. This means that even though the grantor is taxed on the trust income, the trust assets will not be included in the grantor's estate, provided the grantor does not retain any interest, power or right which would cause inclusion under the provisions of Code §§ 2036 (transfer with a retained life estate) or 2038 (revocable transfers).

When the trust is made defective, it is flawed in a manner so as to result in income tax inclusion but not estate tax inclusion. The difference in treatment between the income tax laws and

the estate tax laws presents planning opportunities for grantors using intentionally defective trusts for income tax purposes but without gift and estate tax consequences.

Using the Defective Grantor Trust as an Estate Freezing Technique

The intentionally defective grantor trust (IDGT) is most effectively used as an estate freezing device. The grantor creates a trust which is defective for income tax purposes (but not for estate and gift tax purposes) for the benefit of his or her children and/or grandchildren. The grantor sells assets (stock in a closely held or family business, real estate, marketable securities, limited partnership interests) to the trust in exchange for an installment note with interest. The IDGT works best if the sold assets are subject to discounts in determining their fair market value and if it is expected that the sold assets will appreciate in value at a rate greater than the interest rate payable on the note.

The installment note should be for a term of years (i.e., 10 or 15 years), and may be self-liquidating or payable in installments with a balloon or an interest-only note with a balloon payment on the due date. If the IDGT purchases life insurance on the grantor's life, then the note should be an interest-only with a balloon payment and, if possible, the note should be renewed and kept outstanding until death.

When the grantor dies, only the fair market value of the note is included in the grantor's estate. That value will be less than the outstanding principal of the note depending on several

factors, including the payout of the note, the interest rate, the absence of security, default provisions, covenants and other note terms.

The IDGT technique freezes the value of the note in the grantor's estate. Any increase in value of the sold assets will not be taxed in the grantor's estate and will inure to the benefit of the trust beneficiaries.

Creating the IDGT

Before selling assets to the IDGT, the grantor should initially contribute property having a value equal to about ten percent of the fair market value of the assets to be sold. The reason is to avoid having the sold assets constitute the sole source of payment for the note and to avoid any sham transaction argument by the IRS. If the sold assets are the sole source of payment, then it might be argued that the transaction is a transfer with a retained interest causing the property to be included in the grantor's estate.

The Gift Tax Consequences of the IDGT

With respect to the sold assets, there should be no gift tax consequences since there is no gift or generation-skipping transfer. The contributed assets represent a taxable gift to the remainder persons for which the \$10,000 annual gift tax exclusion is not available since the contribution is a gift of a future interest. If the sale is at a price less than fair market value, then there would be a gift of the difference. It is therefore important that a qualified appraisal be obtained.

No gift is made by the grantor if the safe harbor interest rate prescribed by Code § 7872 (the Applicable Federal Rate or AFR) is used. If the note does not provide for adequate interest, then, under Code § 7872, the loan is recharacterized as part loan and part "gift loan." A gift loan is a loan where the foregone interest is in the nature of a gift. If the note does not provide for adequate interest, then there is a gift based upon the discount rate in effect at the date of the loan.

It is important that the note provide for adequate interest to avoid a gift loan. If there is a gift loan, the effect of the discounting may mean that a substantial portion of the note will be treated as a taxable gift. For term loans, Code § 7872 requires use of a discount equal to the applicable federal rate (AFR) in effect at the time the loan is made.

Benefits of Taxing Trust Income to the Grantor

Although the grantor is taxed on income that

he or she does not receive, the grantor is reducing his or her estate by the amount of the tax. The payment of tax by the Grantor on trust income amounts to a tax-free gift to the beneficiaries. The trust benefits from using pretax dollars to pay the installment note.

The Income Tax Consequences on the Transfer to IDGT

There are no income tax consequences on the sale of the asset to the trust. The IRS position is that there is no gain or loss recognized in transactions between the grantor and the trust when the grantor is treated as the owner of the trust for income tax purposes. [Rev. Rul. 85-13, 1985-1 CB 184; IRS Letter Rulings 9010065 and 9211026.] It should be noted that this position is contrary to the decision in **Rothstein v. U.S., 735 F.2d 704, 84-1 U.S. Tax Cas. (CCH) &9505, 54 A.F.T.R.2d (P-H) &84-5072 (2d Cir. 1984)**, which held that the transaction was a sale.

IRS Guidance for Structuring IDGT

A 1995 private IRS ruling provides guidance for structuring an IDGT. In IRS Letter Ruling 9535026, parent established an irrevocable trust for the benefit of his three children with his wife and a bank as trustees. The trust was divided into three separate shares, one for each child. Each child also made transfers to his or her respective trust. Each child's trust has been divided into two trusts, one holding property contributed by the father and the other holding property contributed by the child. The beneficiaries of each separate share are the child, the child's spouse and descendants and their spouses. Trust income and principal may be sprinkled among the beneficiaries as determined by the trustees.

In the ruling, each child proposes to sell to his or her respective separate trust (RST) stock in an installment sale. The RST will give each child a promissory note equal to the fair market value of the stock with sufficient interest such that the loan will not be characterized as a below market loan under Code § 7872. The note will pay interest only for 20 years. The principal will be due at the end of the 20-year term. The note is secured by the stock.

The IRS ruled as follows:

1. Each RST is a grantor trust since the income of each RST may be distributed to the grantor and the grantor's spouse (without the consent of an adverse party). Code § 677(a).
2. The transfer of assets to a RST is not rec-

ognized as a sale for federal income tax purposes. Therefore, any gain or loss on the sale of the stock to the RST is not recognized.

3. Interest on the note is not deductible by the RST and is not taxable income to the grantor child. The grantor's basis in the stock carries over to the RST. If an RST sells any stock, the gain or loss is taxed to the respective grantor child.
4. If the note does not provide for adequate interest, then, under Code § 7872, the loan is recharacterized as part loan and part "gift loan."

IDGT Example

Parent creates an IDGT funded with a contribution of \$100,000. Grantor thereafter sells limited partnership interests to the IDGT for its fair market value (after appropriate discounts) of \$1 million taking back an installment sale note with an adequate interest rate. When parent dies 10 years later, the balance owing on the note is \$500,000, but the limited partnership interests have increased in value to \$2 million. Parent's estate includes the discounted fair market value of the note (which should be less than \$500,000 with discounting). All of the increased value of the stock escapes any tax in the grantor's estate.

Defective Trust Structures

The grantor trust rules contain several structures which are used for creating a defective trust for income tax purposes. This list is not exhaustive, but may be helpful:

1. The grantor has the power, in a nonfiduciary capacity, to reacquire the trust corpus by substituting property of equivalent value.
2. The grantor retains the right, in a nonfiduciary capacity, to either sell trust assets or change the nature of trust assets.
3. If more than half of the trustees are related or subordinate to the grantor's wishes and have the power to sprinkle income or corpus among the beneficiaries.
4. If a non-adverse party has the power to add beneficiaries, other than after-born and after-adopted children.
5. If the income may be used to pay insurance premiums on the grantor's life, provided the trust actually holds such insurance.
6. If trust income may be paid to the grantor's spouse.

7. The grantor retains the power to borrow trust assets without adequate security.

Comparing the IDGT and the SCIN

The defective trust strategy may seem to be similar to the self-canceling installment note (SCIN). The major difference is that a SCIN is treated in the same manner as an installment sale with a capital gain and interest component as part of each payment. With the IDGT, gain is not recognized because of the grantor trust rules.

The main advantage of the SCIN is that the unpaid balance of the note is not included in the seller's estate, although the unrecognized or deferred portion of the gain is recognized in full by the estate at the time of death. [*Frane v. C.I.R.*, 998 F.2d 567, 93-2 U.S. Tax Cas. (CCH) &50386, 72 A.F.T.R.2d (P-H) &93-5268 (8th Cir. 1993).] With the defective trust, although the value of the note is included in the estate, none of the gain is recognized. Since the grantor trust is not subject to tax, it uses pretax dollars to pay the note. The taxes paid by the grantor reduce his or her estate. There are no comparable benefits with the SCIN.

Comparing the IDGT to GRATs and GRUTs

With a grantor retained annuity or unitrust (GRAT or GRUT), the grantor retains an income interest, either for a term of years or life. In order for the property and its appreciation to be excluded from the grantor's estate, the grantor must survive the term of the trust. Additionally, the GRAT or GRUT usually results in a gift to the remaindermen. A gift tax return must be filed and gift tax paid, when applicable.

Conclusion

The impact of defective trust planning is substantial estate shrinkage and the transfer of asset appreciation from the parents to the children and/or grandchildren. While the defective grantor trust is a cutting edge idea, it is not for everyone. It is an additional planning tool that should be considered along with other planning ideas. Risks and rewards should be assessed with the assistance of planning professionals.

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