USE OF THE GRANTOR TRUST AS A PLANNING STRATEGY

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Grantor Trust Strategies

A grantor trust is a trust under which the grantor holds certain powers which under the Internal Revenue Code results in the grantor being considered as the owner of all or a portion of the trust for income tax purposes. Grantor trust powers include such things as (i) use of trust income to pay premiums on life insurance on the life of the grantor (or grantor's spouse) or (ii) grantor power to affect beneficial enjoyment of trust income or principal. Under Code Section 675(4), a trust is a wholly-grantor trust for income tax purposes if the grantor retains the power, exercisable in a non-fiduciary capacity, to substitute trust assets for assets of equal value. The power to substitute assets does not cause estate tax inclusion under any of the estate tax statues and thus is a popular means of creating a grantor trust. This power causes the trust to be treated as a wholly-owned grantor trust and is not includable in the grantor's estate for estate tax purposes.

The Internal Revenue Service recognized in <u>Revenue Ruling</u> 2004-64 that the payment of income tax by the grantor on the trust income from a grantor trust is not to be treated as a gift by the grantor. In <u>Revenue Ruling</u> 2008-22, the Internal Revenue Service further ruled that a grantor's power to substitute assets (which results in grantor trust status) does not result in the trust assets being includible in the grantor's estate for estate tax purposes.

With the enhanced lifetime gift limits in effect at least for 2011 and 2012, effective planning may combine lifetime gifting with a grantor trust. One advantage of transferring assets now is to remove the appreciation in value of the asset from the donor's estate. Although the value of the gift is effectively included in the estate tax calculation, any appreciation in value of that asset is not. Substantial transfer tax benefits can be achieved by making gifts of appreciating assets. Additionally, the income produced by the assets, such as interest, dividends, and rents, will be shifted from the estate for estate tax purposes.

The ability of a donor to pay the income taxes on income from a grantor trust can further leverage the gift and estate tax benefits of a current gift. The ability to create generation-skipping trusts and allocate the new larger GST exemption can also provide significant benefits.

A fundamental assumption about gifting is that assets will appreciate. A substantial disadvantage of current gifting arises if the assets decline in value after the date of the gift. Because gifts by their nature are irrevocable, the possibility that gifted assets may actually decrease in value is something that must be considered.

If the estate tax exemption amount is reduced below the current $5,000,000 amount in the future, a 2011 or 2012 gift may incur some estate tax at the death of the donor (or of the spouse in the case of gift splitting) because the date of death exemption amounts and estate tax rates may apply to the gift. If, for example, the estate tax rate were to increase to 50% and the exemption amount returned to $3,500,000, an estate tax of $750,000 could be due with respect to a gift of $5,000,000. This estate tax could be due on the death of the first spouse.

If the current gift does incur a future estate tax, the current gift may not result in more transfer tax than would have been incurred without making the gift. A lifetime gift may change the timing of the tax payment, but all other gift tax advantages would still be realized. The law is currently unclear on this issue and further guidance from the Internal Revenue Service or further Congressional actions are needed.

A. Sale to a grantor trust

The installment sale of property to a "defective" grantor trust is a popular estate planning strategy. The intended effect of the strategy is to "lock in" or "freeze" the current value of the property which is sold to the trust. That is, by effecting the sale transaction, future appreciation in the value of the property sold is intended not to be in the grantor's estate for estate taxation and may thereby reduce the family's overall estate tax burden.

The strategy involves a defective grantor trust and an installment sale of property to such trust. A discussion of the key terms and the tax effects follows.

A defective grantor trust is an irrevocable trust (substantially similar in form to a traditional irrevocable insurance trust). It is "defective" in the sense that the trust is considered to be owned by the grantor for income tax purposes, but not for estate and gift tax purposes. The defective nature of the trust is accomplished by including certain provisions (Code Sections 673-679) which cause it to be considered a grantor trust for income tax purposes, e.g. grantor power to substitute assets of equivalent value and trustee power to use income of the trust to pay premiums for life insurance on the life of the grantor.

Since the trust is classified as a grantor trust for income tax purposes, income of the trust is taxed to the grantor. (This is the effect whether or not the grantor receives cash distributions from the trust.)

Since the defective grantor trust is considered a grantor trust, the sale of property to the trust by the grantor is a nonrecognition event for income tax purposes. It is considered as a transaction between the grantor and himself. As such, no gain or loss is recognized on the "sale."

In addition, payment of interest on the installment note is not includible in the grantor's income when received nor is the interest deductible to the trust for income tax purposes.

Income derived from assets held by the defective grantor trust is taxable to the grantor. Such income is reportable on the grantor's Form 1040 for the year.

Taxing the trust income to the grantor will have an additional estate planning effect for the family. The income is property of the trust but the income tax liability is that of the grantor. By the grantor paying the income tax obligation, the property which will ultimately pass to the trust beneficiaries may be enhanced. This feature can be particularly important since there may be substantial income tax liability as a result of the grantor trust assets.

The importance of the valuation of the property being sold to the trust cannot be underestimated. A professional valuation of assets may be warranted. The sale is intended to be at the market value and therefore is intended to contain no element of gift. (If there is an element of gift on the sale, this would be reportable as an additional taxable gift; also, if the installment promissory note is not fully repaid prior to death, it is possible the IRS might argue for inclusion of the sale property in the grantor's taxable estate for estate tax purposes at the appreciated date of death value rather than the date of sale value.)

With respect to the promissory note, it is important that it bear adequate interest in order to avoid some gift characterization. It has been ruled that no gift is involved if the stated interest rate is at least the applicable federal rate. The mid-term applicable federal rate (for nine year loan) is 1.20% for November, 2011.

It is important in the gift context that the grantor trust actually have the ability to pay the installment note for which it is obligated. The grantor will not incur any gift tax with respect to the gift made to the trust if it does not exceed the lifetime gift tax exemption remaining (up to $5,000,000 in 2011). The size of the initial gift to the grantor trust should give the trust economic viability. It is also anticipated that the dividends/distributions from the trust assets which are gifted and/or sold to the trust will be sufficient to service the payments due under the promissory note received from the sale of additional assets to the grantor trust.

The grantor will be responsible for the income tax liability for the trust income. Payment of such tax amount by the grantor might in some sense be considered an indirect gift each year by the grantor to the trust beneficiaries since the value of the trust property is enhanced by not having to pay the income tax.

Example

> Craig has shares of CLH, Inc. worth $2,000,000. He establishes a DGT and gifts $500,000 of the shares and sells $1,500,000 of the shares to the DGT. CLH, Inc. is taxed under Subchapter S. CLH, Inc. has $400,000 of annual income and distributes half of that ($200,000) in cash each year to shareholders. To purchase the $1,500,000 of shares from Craig, the DGT gives Craig a promissory note payable over nine years with interest at 1.20% and annual payments of $176,825.
>
> Craig pays income tax on the $400,000 annual income attributed to the shares in the DGT. ($176,825 annual cash payments should be adequate to cover his income tax payments.)
>
> DGT terminates after nine years and trust assets, i.e. CLH, Inc. shares and accumulated cash, distributed to LJ (Craig's son) as beneficiary of the DGT. Value of assets to LJ – in excess of $4,500,000 (assuming 10% annual increase in value of shares).

B. Gift to family trust

Another gifting/grantor trust technique involves an irrevocable trust structured as a grantor trust for which the grantor's family – e.g. spouse, children – are its beneficiaries. The trust's design would be

- Spouse as trustee or co-trustee.
- Spouse and children as current beneficiaries (with distributions restricted to those needed for health, education, maintenance, or support).
- Grantor continues to pay income tax on income generated from trust investments (because of grantor trust status). Trustee may terminate grantor trust status.
- Family trust funded with gift of up to $5,000,000.
- Spouse has limited power of appointment exercisable by Will.

In effect, this technique is like funding during lifetime the "credit trust" which is very typically created and funded at death with the estate tax exemption amount. With the gift tax lifetime exemption amount increasing to mirror the estate tax exemption amount, the credit tr5ust can be prefunded during lifetime. Also, grantor trust status will serve to enhance the value of the gifting assets.

Example

> David establishes a Family Trust with Carolyn and his children as current (but discretionary) beneficiaries. The Trust is funded in 2011 with a $5,000,000 gift. The Trust is a "grantor" trust. Trust assets generate 3% annual income and appreciate at an annual rate of 4%. Distributions are not made during David's lifetime. At David's death 20 years later, the assets in the Family Trust have grown to $19,348,422. The $14,348,422 of growth is not subject to estate tax in David's estate.

C. Gifting for grandchildren trust

The Tax Relief Act of 2010 ("Act") increases the Federal estate and gift tax exemption amounts to $5,000,000 for 2011 (and 2012). The Act also increases the generation-skipping tax exemption to $5,000,000. This creates opportunities for making taxable gifts to grandchildren, especially through irrevocable trusts. And when the trust is structured as a grantor trust, the value of the gift is leveraged further. (And the gifts made to the grandchildren's trust will not be includible in the taxable estate of their parents.)

Example

> David establishes a Grandchildren's Trust for the benefit of LG and Rosalie. It is funded with $2,000,000. It is a "grantor" trust for 20 years. No distributions are made for 20 years, and thereafter distributions are made to LJ and Rosalie over the next 25 years. Trust assets earn 3% income and 4% appreciation annually. After 20 years the Trust assets have grown to $7,740,000. (David pays the income tax.)

Results:

- David pays income tax on Trust income for 20 years.
- $5,740,000 of growth escapes estate taxation in David's estate.
- David's estate is also reduced by the amount of income tax paid by him on Trust income.
- $7,740,000 (plus any future growth) is excluded from Craig's estate. (Craig is the father of LJ and Rosalie.)
- No generation-skipping tax.
- Annual distributions of $332,000 to each of LJ and Rosalie.

D. Caveats

1. Consider the possibility that assets transferred to the grantor trust decline in value, rather than appreciate.

2. Consider the possibility of "clawback" if future estate and gift tax exemption amount decreases.

3. Carryover basis for gifted assets.

4. With respect to the family trust technique, consider the effect of divorce.

5. With respect to the family trust technique, consider the effect of the death of the grantor's spouse.