Price & Farrington's Estate and Tax Planning *Fast*Facts

June/July, 2008

Estate, Tax and Family Wealth Planning for Advisors and Clients

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There's Nothing Defective About A Defective Grantor Trust: *Tax Burning*

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The rage of the tax planning community over the past decade has been a technique involving an installment sale to an ***"intentionally defective grantor trust"***. What's it all about? And why would anyone want a "defective" trust anyway? Let's briefly review the viability of this estate and tax planning strategy

Background. First, some background and clarification on terminology. In tax vernacular a ***"grantor" trust*** is one that is disregarded for *income tax* purposes. The trust's income, deductions, credits and losses are treated as if received by or paid by the *grantor* of the trust (i.e., the settlor or trustmaker) rather than by the *trust* itself. (IRC 671-678). While for *income tax* purposes the trust is disregarded, for *transfer tax* purposes (gift, estate and generation-skipping tax), the trust is respected. In fact, *it is possible for the grantor to make a completed gift to such a trust for transfer tax and property law purposes while at the same time the grantor retains the income tax responsibilities.*

The "defect". Until the Tax Reform Act of 1986 changed the income tax rates for trusts, most taxpayers went to great lengths to establish trusts that were <u>*not*</u> grantor trusts, so that the income on the trust assets would be (taxed at the trust's lower (at that time) income tax rates. Occasionally, such a trust would inadvertantly be drafted with a provision (i.e., a "defect') which, under the grantor trust rules, would cause the trust to be a "grantor" trust and the income would be taxed *to the grantor*, contrary to the intended result. After changes in the law which allowed trust income to be taxed at a much higher marginal rate than personal income, it actually became more beneficial in some cases to have a grantor trust rather than a trust which would be taxed independently. Thus, many trusts designed to save estate or generation-skipping tax, for example, are intentionally structured as grantor trusts.

The use of a grantor trust in the context of the installment sale transaction is now referred to as "defective". Because this term is misleading, we will refer to the trust as simply a grantor trust. Let's take a look at how the technique works.

How it works. Simply stated, the grantor establishes an ***irrevocable trust***t with family members (or other individuals) as the trust beneficiaries, and in an ***arms-length transaction*** sells assets (typically income-producing property) to the trust in exchange for the trust's ***installment promissory note***, calling for periodic interest and a balloon principal payment at maturity.

The odd result is that the sale to the grantor trust is not recognized for income tax purposes because the trust is disregarded, and *no income tax consequences can result when a taxpayer makes a sale to himself*. (Rev. Rul. 85-13) So, even though a legally binding, arms-length transaction has taken place, the grantor *does not realize capital gain on the sale to the trust and the interest payments to the grantor are not income*, although the grantor remains taxed on the income produced by the trust property under the grantor trust rules. The effect is to ***freeze the value of the asset transferred for transfer tax purposes***. Also, if the income earned by the trust property exceeds the interest payments, the excess income inures to the benefit of the trust beneficiaries, even though taxed to the grantor.

NOTE: the trust takes the *grantor's* ***cost basis*** in the asset, *not* the *stepped-up basis* that would have occurred if the grantor died owning the asset. (IRC Section 1014)

Example. Max has rental real estate apprqaised at $1 million, with a cost basis of $400,000 and no mortgage. The cash flow after all expenses is $85,000 per year. Max establishes an irrevocable trust for the benefit of his three children and the trust contains provisions which cause it to be a grantor trust as to Max. He contributes $100,000 to the trust

Wisdom and Experience

Do not learn how to react, but how to respond. — The Buddha

What may be done at any time will be done at no time. — Scottish proverb

To the wise, nothing is alien or remote. — Antisthenes

At 20 years of age the will reigns, at 30 the wit, at 40 the judgment. — Benjamin Franklin

Wise men learn many things from their enemies. — Aristophanes

One thorn of experience is worth a whole wilderness of warning. —Lowell

between December and January (allowing his and his wife's $12,000 annual gift tax exclusions to render the gifts tax-free). He then sells the property to the trust for $1 million in return for the trustee's promissory note (and mortgage) for $1 million with interest at 6% per year payable quarterly and a balloon principal payment due in a few years.

The sale to the grantor trust will produce no capital gain to Max and there will be no tax to him on the interest payments on the note. The net rental income, however, will be taxed to Max and he would be entittled to the same deductions he enjoyed on the property before the sale to the trust. Nevertheless, it's important to remember that the sale is a "real" sale for all other purposes, so that the trust is the legal owner of the real estate and Max only owns the note, which has a fixed value. Thus, if the real estate has appreciated to, say, $2 million by Max's death, the $1 million appreciation escapes estate tax.

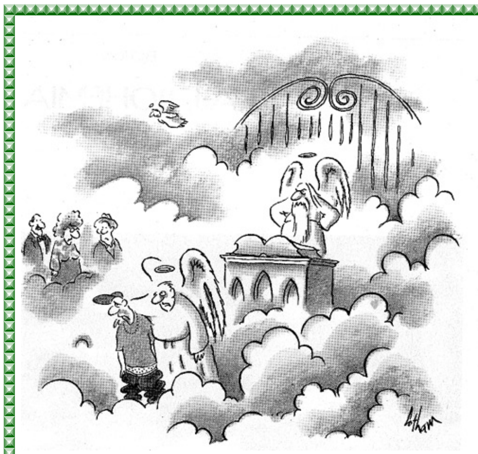
Tax "burning". Here is another way to look at this is. A *tax burn* is the reduction of a grantor's taxable estate that results when the grantor is forced to pay the income tax liability generated by a grantor trust.The *grantor* takes assets that would eventually be included in his or her taxable estate and instead uses them to pay the income or capital gains tax while the grantor *trust* retains all of the income or gain from the transaction that created the income or gain. The economic result of this transaction is a significant tax-free shift in wealth to the beneficiaries of the grantor trust, which are typically the grantor's family members. Tax burning can be very effective, particularly when coupled with maximum annual gift tax esclusions.

At first blush, most of our clients won't be attracted to the notion of paying the income tax liability on income they didn't receive. But these same clients likely *won't object* to the idea of paying their children's income tax liability for them. If the grantor's child is in a higher income tax bracket than the grantor, the family actually reduces its overall income tax liability. If the child is in the same income tax bracket, the transaction is income tax-neutral. If the child is in a lower income tax bracket than the parent, we need to *compare the income tax cost to the potential estate tax savings* before structuring a tax burning transaction.

Example. Tax burning can be used in a variety of situations. Here's just one example. Client couple, both in their early 50s, have a net worth of aprroximately $7 million. The primary objective is to pay as little estate tax as possible. They are very conservative and have read articles on how aggressively the I.R.S. is attacking family limited partnerships.

Husband establishes an irrevocable grantor trust for the benefit of Wife and their three sons, to which Clients contribute $1.5 million, leaving them with $5.5 million (Wife elected to "gift-split" the amount contributed to the trust, thereby leaving Clients with additional gift tax credit remaining to allow them to do additional gifting in the future). Since Wife is a beneficiary of the trust, Husband can still (indirectly) benefit from any future appreciation in the corpus of the trust. The intent is to use the trust as a "rainy day" fund, accessing it only when necessary and allowing it to grow over the years.

Conservative projections demonstrate that over the Clients' remaining life expectancy their payment of the *income tax liability attributable to the grantor trust*, in addition to *maximum annual gift tax esclusions*, will slowly erode their taxable estates to the point where their estates will not be subject to estate taxes. This is the case even assuming that the current EGTRA tax law sunsets and the estate tax credit reverts to just $1 million under the Taxpayer Relief Act of 1997. ▣



"Try coming back tomorrow with your pants pulled up."

One Among Many

What the crowd requires is mediocrity of the highest order.

— Auguste Preault

Those who think they have no need of others become unreasonable.

— Vauvenargues

People who cannot bear to be alone are generally the worst company.

— Albert Guinon

One can acquire anything in solitude except character.

— Stendahl

To do just the opposite is also a form of imitation. — Lichtenberg

Trouble Revisited

Remember Leona Helmsley's little Maltese dog, *Trouble*? The litle pooch inherited a trust fund worth a whopping $12 million when the real estate magnate died at age 87 last August. (See our September 2007 *Fast*Facts,"Wacky Will Provisions", for the background of this story). Well, Leona's dog isn't quite as well-heeled as she used to be. A Manhattan judge has reduced the trust fund to $2 million. The remaining $10 million now goes to Leona's charitable foundation. The appointed caregiver put Trouble's *annual* cost at $190,000, including a $60,000 guardian's fee, $100,000 for security, $8000 for grooming, $3000 for miscellaneous expenses, $1200 for food and $2500-$18,000 for medical care. ▣