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Grantor Trusts: Supercharging Your Estate Plan

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Planners often use transfers to grantor trusts, such as outright gifts, GRATs and installment sales, as estate freeze techniques. Although the primary objective of these freeze techniques is to shift future appreciation in value to the trust, another tax-free, wealth shifting benefit arises through the grantor's payment of the grantor trust's Federal and state income tax liabilities. If grantor trust status continues for a significant period of time, this wealth transfer feature can transfer more wealth without tax than the freeze aspect or discounts. This article evaluates the benefit grantor trust status contributes to basic estate freeze techniques and illustrates how the grantor trust element "supercharges" the transfer tax savings provided by such techniques. Although not generally appreciated, grantor trust status is one of the most significant factors contributing to the overall success of an estate freeze transaction. Finally, this article describes the significant financial obligation imposed upon the grantor by grantor trust status and cautions that grantor trusts may eventually be detrimental to a client's overall financial needs.

GRANTOR TRUSTS: THE BASICS

Definition

The "grantor trust" is a Federal income tax concept governed by §§671 through 679 of the Internal Revenue

Code¹ and the underlying Treasury Regulations. If a trust (or some portion thereof) is deemed a grantor trust, then the grantor (or in limited circumstances, another person) is treated as the owner of the trust assets for Federal income tax purposes. Accordingly, as the deemed owner of a trust's asset, the grantor must include in computing his or her individual income tax liability all the items of income, gains, deductions, losses and credits to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as owner.²

The grantor must report all trust income and will be taxed on the trust's income at the Federal income tax rate for that individual, rather than at the compressed rate brackets applicable to trusts.³ Furthermore, since the Code treats the grantor as the owner of the trust assets for this limited purpose, the trust is a disregarded entity only for the limited purpose of disregarding any transactions between the grantor and the trust.⁴

Creating a Grantor Trust

In order for a trust, or for any portion of it, to be classified as a grantor trust for Federal income tax purposes, the grantor (or in some cases, a "nonadverse party")⁵ must have certain powers over the trust or the trust property, including any one (or more) of the following:⁶

¹ Subpart E of Part 1 of Subchapter J of the Internal Revenue Code.

² §671; Regs. §1.671-3(a)(1).

³ For 2007, a trust that accumulates income reaches the highest marginal income tax rate of 35% after \$10,450 of taxable income. A married couple or unmarried individual does not reach the 35% tax bracket until they report taxable income in excess of \$349,700. Rev. Proc. 2006-53, 2006-48 I.R.B. 996, at §3.01.

⁴ Rev. Rul. 85-13, 1985-1 C.B. 184 (cited as recently as September 2006 in PLR 200636086); see also Regs. §1.1001-2(c), Ex. 5. However, a grantor trust is *not* a disregarded entity within the context of the election under Regs. §301.7701-3.

⁵ Section 672(b) provides that the term nonadverse party "means any person who is not an adverse party." Section 672(a) defines an adverse party as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."

⁶ For a more thorough analysis of powers causing grantor trust status, see Donaldson, "Grantors Are from Mars, Grantor Trusts Are from Venus," *40th University of Miami Phillip E. Heckerling Institute on Estate Planning* (Jan. 2006). For a complete discussion on the creation and income tax treatment of grantor trusts, see Zaritsky, 858 T.M., *Grantor Trusts: Sections 671-679*.

- §673 — grantor's retained reversionary interest in the trust, at its inception, exceeds 5% of the trust's value.⁷
- §674 — the grantor and/or a non-adverse party may exercise a power of disposition over the beneficial enjoyment of the trust's principal or income, without the approval or consent of any adverse party.
- §675 — the grantor possess certain administrative powers that allow him or her to engage in certain transactions with the trust (e.g., transactions for less than full consideration, grantor's ability to borrow from the trust without adequate interest or security, power to reacquire trust assets by substitution exercised in a nonfiduciary capacity, etc.).⁸
- §676 — the grantor or a non-adverse party has the power to revest title to the trust property in the grantor.
- §677 — the trust income is, or may be, without the consent of an adverse party, distributed to the grantor or the grantor's spouse or may be applied to the payment of insurance premiums on the life of either of them.⁹

⁷ Note that a reversionary interest satisfying §673 should also cause inclusion in the grantor's gross estate under §2037. Thus, unless the planner specifically wants estate tax inclusion of the trust assets, a reversionary interest should not be used to create grantor trust status.

⁸ A recent private letter ruling caused some concern that a §675(4)(C) power of substitution may cause estate tax inclusion under §2036. In PLR 200603040 the grantor created an irrevocable trust and retained a power of substitution in a fiduciary capacity. The IRS ruled that the grantor's retained power of substitution would not cause the trust to be included in his taxable estate under §§2033, 2036(a), 2036(b), 2038 or 2039, emphasizing that the power could be exercised only in a *fiduciary* capacity. The concern is whether the IRS meant to imply that §675(4)(C) power exercisable in a *nonfiduciary* capacity would cause estate tax inclusion.

⁹ See FAA 20062701F (Aug. 4, 2006). In this Field Attorney Advice, the IRS seems to provide a "bright-line" rule that the mere authority in the trustee to use income for the payment of insurance premiums on the life of the grantor will cause the grantor to be treated as the owner of the trust under §677(a)(3). *But see* PLRs 8126047, 8118051, 8112087, 8103074, 8007080; *Corning v. Comr.*, 104 F.2d 329 (6th Cir. 1939); *Rand v. Comr.*, 40 B.T.A. 233 (1939), *acq.* 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1940), *cert. denied*, 313 U.S. 594 (1941); *Connor v. Gagne*, 42 F. Supp. 231 (D.N.H. 1941); *Weil v. Comr.*, 3 T.C. 579 (1944), *acq.* 1944 C.B. 29; *Iversen v. Comr.*, 3 T.C. 756 (1944); *Chandler v. Comr.*, 41 B.T.A. 165 (1940), *aff'd without discussion on this point*, 119 F.2d 623 (3d Cir. 1941); *Rieck v. Comr.*, 118 F.2d 110 (3d Cir. 1941), that, in part, either determined grantor trust status only where an actual policy was owned by the trust or only taxed the

If a trust contains any of the above powers, then, arguably, the grantor has retained sufficient benefit from or control over the trust property to justify the grantor's payment of the income tax liability generated by the income produced from the trust's assets.

Grantor Trusts — The Income and Estate Tax Disparity

Although the grantor trust rules may treat a grantor as the owner of a trust for Federal income tax purposes, this treatment does not affect the determination of ownership for Federal gift, estate and generation skipping transfer ("GST") tax purposes.¹⁰ Consequently, it is possible to structure a trust where the grantor is deemed the owner for Federal income tax purposes, but the transfer of assets to the trust is a completed gift for Federal gift tax purposes and removes the assets from the grantor's estate for Federal estate tax purposes.¹¹ It is this disparity between the Federal income tax and transfer tax rules that provides the significant transfer tax benefits of the grantor trust.

THE IMPACT OF GRANTOR TRUSTS IN TYPICAL PLANNING TECHNIQUES

From a Federal transfer tax standpoint, using grantor trusts to transfer wealth provides considerable transfer tax savings. As noted, the properly structured grantor trust removes the assets from the grantor's estate for transfer tax purposes but requires the grantor to pay any income tax on the income generated by the grantor trust's assets. For example, if the grantor trust has \$100,000 of ordinary income subject to a combined state and Federal income tax rate of 40%, then the grantor must pay the \$40,000 income tax liability. Since the grantor's payment of income taxes is in discharge of his or her liability, such payment does not constitute an additional gift to the trust for Federal gift tax purposes.¹² Thus, the grantor has effectively made a tax-free contribution of \$40,000 to the trust, and the trust assets continue to grow, *income tax-free*, as long as grantor trust status applies. The longer a trust remains a grantor trust, the more the trust assets can

grantor on the income required to pay the premiums on the policy(ies) owned by the trust, but not the excess income earned by the trust.

¹⁰ For purposes of this article, reference to the phrase "Federal transfer tax" means, collectively, the Federal gift, estate and GST taxes.

¹¹ Most practitioners refer to this type of trust as a "defective" grantor trust, although the trust is intentionally drafted to qualify as a grantor trust under the grantor trust rules. Thus, a better term for this type of grantor trust might be the intentional or deliberate grantor trust.

¹² Rev. Rul. 2004-64, 2002-2 C.B. 7.

grow. It is this continued tax-free growth of the grantor trust assets that can "supercharge" the value of almost any estate planning strategy.¹³

Continuing Grantor Trust Status — Supercharging the Results

The substantial benefits of continuing grantor trust status in an estate planning strategy become apparent by analyzing its impact on the typical estate freeze transactions, which are outright gifts to a grantor trust, a grantor retained annuity trust ("GRAT"), and an installment sale to a grantor trust. All three are freeze techniques that shift future appreciation in value to the trust without gift tax liability.

An outright gift to a grantor trust of an asset that does not appreciate in value illustrates the impact of grantor trust status on the estate plan. Suppose Senior, a resident of California, transfers a portfolio of corporate bonds valued at \$2,666,666 to a family limited partnership in exchange for a limited partnership interest. Using a conservative 25% valuation discount, assume that the fair market value of the limited partnership interest is \$2,000,000. Senior proceeds to gift the entire limited partnership interest to a trust for his descendants, and the trustee has the power to accumulate and reinvest all trust income. Although Senior has made a \$2,000,000 taxable gift, there is no gift tax because both Senior and Senior's spouse have available their entire \$1,000,000 gift tax exemption under the unified credit and a split-gift election is made. Assume that the \$2,666,666 bond portfolio is invested to produce a 6.0% rate of return and that each year all trust income is reinvested in the same bond portfolio. If the trust was not a grantor trust, it would have to pay all income taxes (including state income taxes) on its income and would only be able to reinvest the after-tax amount. At the end of 20 years, the non-grantor trust would have grown to \$4,944,066. If the trust was a grantor trust, it would not have to pay any Federal or state income taxes on its income and would be able to reinvest its gross income each year. At the end of 20 years, the grantor trust would have grown to \$8,552,359. By structuring this simple gift in trust to a grantor trust, an additional \$3,608,293 is passed on to the trust beneficiaries free of all transfer taxes, including the GST tax if the GST exclusion was available when the gift in trust was made.

One should also consider the benefits of the continuation of the trust's grantor trust status after the estate freeze term has expired, such as after the installment note reaches maturity or after the end of the GRAT term.

¹³ For a related discussion of this topic, see Handler, "The Power of Grantor Trusts," 145 *Trusts & Estates* 24 (Mar. 2006).

To illustrate the transfer tax savings provided by extending the duration of grantor trust status, we will compare the consequences to clients of having no tax plan to (1) creating a GRAT, and (2) entering into an installment sale to a grantor trust, where grantor trust status (1) terminates at the end of the freeze transaction, and (2) continues for the entire life expectancy of the grantor(s). For purposes of this analysis, we use the following facts:

Clients. As of December 2006, Mr. and Mrs. Senior are ages 60 and 55, respectively, with a joint life expectancy of 32 years. They have a diversified portfolio of marketable securities valued at \$13,333,333, with a cost basis of \$9,833,333. These assets are in a family limited partnership. Since they intend to continue buying and selling marketable securities, it is assumed that the portfolio will completely turn over during the next seven years, and that they will report \$3,500,000 of long-term capital gains, \$500,000 each year over the next seven years.

Investment Return. Seniors anticipate a 7.4% rate of return on their investment portfolio, 60% of which will be ordinary income and the remainder will be long-term capital gains realized from the appreciation in value of the partnership's portfolio.

Valuation Discounts. Using a conservative valuation discount of 25%, their limited partnership interest will be valued at \$10,000,000 upon the transfer to the trust.

GRAT. The GRAT will be a zeroed-out GRAT, for a 20-year term. The applicable §7520 rate for December 2006 is 5.8%.

Installment Sale to Grantor Trust. The installment sale will be for a 20-year note, annual payments of interest only, with a final balloon payment of principal at the end of the note term. For December 2006 the applicable long-term Federal rate ("AFR") for the note is 4.9%.¹⁴

Since the Seniors' joint life expectancy is 32 years, any projection of tax savings is incomplete if it covers only the 20-year term of the freeze technique. To determine the full impact of these planning techniques, and the value of grantor trust status, we must

¹⁴ The term of the GRAT and the note under the installment sale are the same for comparison purposes only. The length of the note term and, in the case of a GRAT, a shorter annuity term, are factors that must be considered in connection with a client's particular circumstances.

