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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.

extend the comparison for each of the GRAT and the installment sale to cover (1) the trust's performance over the course of the Seniors' joint life expectancy but terminate grantor trust status at the end of the 20-year freeze term and (2) the trust's performance when grantor trust status continues until death of the surviv-

ing spouse.¹⁵

¹⁵ The objective is to determine how much will remain in the trust at the end of the grantor's life. The transfer tax savings occurs because the grantor trust's assets are not exposed, at the death of either spouse, to any transfer taxes.

Table 1
GRAT

	No Tax Plan	Termination of Grantor Trust Status After 20-Year Term		Continuation of Grantor Trust Status After 20-Year Term	
	Seniors without GRAT	Seniors with GRAT	GRAT	Seniors with GRAT	GRAT
Beginning Principal	\$13,333,333	\$0	\$13,333,333	\$0	\$13,333,333
Annuity Payments	N/A	\$17,154,865	(\$17,154,865)	\$17,154,865	(\$17,154,865)
Income Earned	\$65,852,417	\$23,469,903	\$44,611,402	\$19,849,386	\$48,231,919
Income Taxes Paid	(\$25,930,267)	(\$17,101,425)	(\$7,751,242)	(\$24,852,667)	N/A
Ending Principal	\$53,255,483	\$23,523,344	\$33,038,628	\$12,151,584	\$44,410,387
Transfer Taxes	(\$23,964,967)	(\$10,585,505)	N/A	(\$5,468,213)	N/A
Net To Children	\$29,290,516	\$12,937,839	\$33,038,628	\$6,683,371	\$44,410,387
Total Tax Benefit¹⁶	N/A	\$16,685,951		\$21,803,242	

Table 2
Installment Sale to Grantor Trust

	No Tax Plan	Termination of Grantor Trust Status After 20-Year Term		Continuation of Grantor Trust Status After 20-Year Term	
	Seniors without installment sale	Seniors with Sale	Installment Sale	Seniors with Sale	Installment Sale
Beginning Principal	\$13,333,333	\$0	\$13,333,333	\$0	\$13,333,333
Annuity Payments	N/A	\$19,800,000	(\$19,800,000)	\$19,800,000	(\$19,800,000)
Income Earned	\$65,852,417	\$8,303,929	\$59,333,129	\$3,400,258	\$64,422,358
Income Taxes Paid	(\$25,930,267)	(\$15,780,047)	(\$10,834,416)	(\$26,685,602)	N/A
Ending Principal	\$53,255,483	\$12,323,882	\$42,032,046	(\$3,485,344)	\$57,955,691
Transfer Taxes	(\$23,964,967)	(\$5,545,747)	N/A	\$1,568,405	N/A
Net To Children	\$29,290,516	\$6,778,135	\$42,032,046	(\$1,916,939)	\$57,955,691
Total Tax Benefit	N/A	\$19,519,666	\$26,748,236		

¹⁶ Result equals the total of the net amount left to children left by both the Seniors and the trust, less the net amount left to children if the Seniors do not implement the proposed strategy.

Based on these results, continuing grantor trust status after expiration of the freeze term provides significant value for both the GRAT and installment sale to a grantor trust, although the installment sale technique will generally outperform the GRAT.¹⁷ Note that by

continuing grantor trust status past the initial 20-year

¹⁷ Particularly if the grantor trust holds assets less affected by volatility, such as marketable securities. See Blattmachr and Zey-

del, "Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth," 31 *Tax Mgmt. Est., Gifts and Tr. J.* 115, 122 (May-June 2006). However, this article notes that some studies show that "rolling" GRATs (in which each successive annuity payment received by the grantor is contributed to a new GRAT) may make the economic performance of the GRAT's comparable to an installment sale (although these studies

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freeze-term, and for the rest of the grantor's joint life

did not account for the impact of GST taxes). See also Bernstein Wealth Management Group, *Keeping It in the Family: Planning for Efficient Wealth Transfer* (Feb. 2005), which can be found at <https://www.bernstein.com/CmsObjectPC/pdfs/>

expectancy, the additional wealth transfer to desired descendants is \$7,228,570 (or 37% more).

B20249_050228_WealthTransferBlackbook.pdf.

Table 3
Freeze Techniques: Additional Wealth Transferred to Descendants

	Net to Children	Advantage of Freeze Techniques v. No Plan	Advantage of GRAT v. Installment Sale
No Tax Plan	\$29,290,516	—	—
GRAT	\$51,093,758	\$21,803,242	—
Installment Sale to Grantor Trust	\$56,038,752	\$26,748,236	\$4,944,994

Further, although not illustrated in these calculations, if the clients want to reduce their exposure to GST taxes, the GRAT is almost always inferior to the installment sale to a grantor trust.¹⁸ Thus, from a transfer tax saving perspective, the installment sale to a grantor trust almost always provides the superior benefit.

¹⁸ Hesch and Manning, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Est., Gifts and Tr. J.* 3 (Jan.-Feb. 1999). Generally, GRATs are not an effective tool for GST tax planning.

Continuing Grantor Trust Status — Impact on Grantors

Extending grantor trust status for the rest of the Seniors' joint life requires them to continue to pay the income taxes on the income earned by the grantor trust's assets for several more years, continuing the additional, indirect wealth transfers each year (all transfer tax free). The following table illustrates the additional transfers that occur after the 20-year term of the freeze technique ends:

Table 4

Year After End of Freeze Term	Income Taxes Paid by the Seniors	
	GRAT	Installment Sale
21	\$493,068	\$698,081
22	\$529,585	\$749,739
23	\$568,742	\$805,220
24	\$610,829	\$864,806
25	\$656,031	\$928,802
26	\$704,577	\$997,533
27	\$756,715	\$1,071,351
28	\$812,713	\$1,150,630
29	\$872,853	\$1,235,777
30	\$937,445	\$1,327,225
31	\$1,006,815	\$1,425,439
32	\$1,081,319	\$1,530,922
Total	\$9,030,692	\$12,785,525
Gift Taxes Saved (45% rate)	\$4,063,811	\$5,753,486
Gift and GST Taxes Saved (69.75% rate)¹⁹	N/A	\$8,917,904

¹⁹ Assumes a 45% GST tax rate.

Note that the continued payment of income tax liability on the grantor trust's income causes a corresponding depletion of Seniors' wealth. Any subsequent sale of appreciated assets by the grantor trust will exacerbate this depletion by forcing the grantor to pay the resulting income tax on the capital gains. Although these payments of the income taxes on trust income contribute to the further success of the estate plan, they could cause a substantial burden on the grantor's finances, especially if they live too long.

COMPARISON OF FREEZE TECHNIQUES

As shown above, the combination of a grantor trust with a freeze technique is extremely powerful. The estate planner, however, must still determine which of the techniques works best for the particular client.²⁰ In addition to the tax performance analysis of the GRAT and the installment sale to a grantor trust, planners should also review the following issues with clients when selecting between these techniques:

GRATs

Benefits. As a freeze technique, GRATs have several advantages, including the following:

- Section 2702 codifies the GRAT, which should limit its exposure to IRS attack [Note that it is a different issue whether the valuation of the asset transferred to the GRAT will be the subject of scrutiny.]
- A GRAT can be "zeroed-out" (i.e., the future value of the client's retained interest

²⁰ A detailed comparison of a GRAT and an installment sale to a grantor trust is beyond the scope of this article. For an in-depth financial comparison of these techniques, see Blattmachr and Zeydel, "Evaluating the Potential Success of a GRAT," at note 18. For a thorough tax analysis of each technique, see Hesch and Manning, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," above note 19. See also Mulligan, "Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note — An End Run Around Chapter 14?," *32nd Annual University of Miami Phillip E. Heckerling Institute on Estate Planning*, Ch. 15 (1998); Abbin, "[S]He Loves Me, [S]He Love Me Not — Responding to Succession Planning Needs Through a Three Dimensional Analysis of Considerations to Be Applied In Selecting from the Cafeteria of Techniques," *31st Annual University of Miami Phillip E. Heckerling Institute on Estate Planning*, Ch. 13 (1997); Oshins and Wickett, "Installment Sale to a Defective Trust vs. GRAT Remainder Sale: An Economic Comparison," *Trusts & Estates* (June 2000); Akers, "Update of Transfer Planning Issues: Lifetime Transfer Strategies — GRATs, Installment Sales to Grantor Trusts, Defined Value Clauses, Inter Vivos QTIP Trust Planning Flexibilities, and Planning Family Limited Partnerships in Light of §2036 Attacks" (May 2004), which can be found at http://www.abanet.org/rppt/meetings_cle/spring2004/pt/trasferplanning/akers.pdf.

[the retained annuity] equals the present value of the assets contributed to the trust), so that the client does not make a taxable gift upon creation (i.e., the remainder interest has a zero value).

- The annuity payment under the GRAT can automatically adjust to reflect any changes in the valuation of the GRAT assets for Federal gift tax purposes.²¹
- The GRAT provides the client with an income stream in the form of the annual annuity payments.
- The GRAT can delay the annual payments by up to 105 days after the close of the tax year, allowing such assets to earn a return for a longer period of time.

Drawbacks. As with all tax planning techniques, the GRAT exposes the grantor to some risks, such as:

- If the trust document fails to comply with all the specific requirements of Regs. §25.2702-3, the grantor's retained interest will be valued at zero, and the entire amount of the transfer will constitute a taxable gift to the remainder beneficiaries.
- Over the GRAT term, if the trust fails to earn an aggregate investment return in excess of the applicable §7520 rate, then the remainder beneficiaries will not receive any assets from the trust.
- The GRAT alone is not efficient for GST planning, due to the estate tax inclusion period under §2642(f).²²
- If the grantor fails to survive the GRAT term, the value of the trust assets will be in-

²¹ See Regs. §§25.2702-3(b)(2) and 1.664-2(a)(1)(iii) regarding adjustments for incorrect determinations of the fair market value of the trust property.

²² Note however, that some practitioners have proposed a sale of the GRAT's remainder interest to a second grantor trust that is GST-exempt. See, Handler & Oshins, "GRAT Remainder Sale to a Dynasty Trust," 138 *Tr. & Est.* 20 (Dec. 1999) and Kwon, McCaffrey and Hesch, "Deciding Upon The Appropriate Estate Freeze Technique and Enhancing Its Performance Through Careful Structuring, Investing and Monitoring," Section of Real Property, Probate and Trust Law, American Bar Association (April 29, 2005); Handler & Dunn, "Guaranteed GRATs": GRATs Without Mortality Risk," *Tr. & Est.* 30 (Dec. 1999). But see PLR 200107015, where the IRS ruled that a child's sale of his vested remainder interest in a CLAT would be ineffective in leveraging GST tax exemption; But see the response of one of the co-authors to the PLR at Steinberg and Oshins, "Ruling on Assignment of Vested Remainder Interest May Have Reached Wrong Conclusion," 26 *Tax Mgmt. Est., Gifts & Tr. J.*, (Sept.-Oct. 2001).

cluded in the grantor's gross estate for Federal estate tax purposes.²³

- No seed money is needed.

Installment Sale to Grantor Trust

Benefits. The installment sale to a grantor trust offers several benefits as a freeze technique, particularly when compared to a GRAT:

- The installment sale generally has a lower investment return threshold than the GRAT, since the long-term AFR, rather than the §7520 rate, applies to the promissory note governing the installment sale. The long-term AFR is almost always lower than the §7520 rate.
- Due to the fact that the AFR is generally below market rates, the interest payments under the note will also be smaller, leaving excess income to accumulate in the trust.
- The planner can structure the promissory note to provide for interest only payments for the entire note term (with a balloon principal payment at the end). The annual interest payments will generally be less than the annual annuity payments required by the GRAT, again leaving significantly more assets in the trust on which to earn an investment return.
- An installment sale to a grantor trust may also provide for GST tax planning, if the grantor trust making the purchase is GST tax-exempt.
- The installment sale method immediately removes the assets sold from the grantor's estate. Thus, if the grantor dies while the promissory note is outstanding, only the value of the note should be included in the grantor's estate.²⁴

²³ See TAM 200210009; PLR 9451056. See also Rev. Rul. 82-105, 1982-1 C.B. 133.

²⁴ There is some debate, however, as to whether the grantor, or the grantor's estate, must recognize gain from the installment sale upon the grantor's death (and the resulting termination of grantor trust status). Compare Dunn & Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," *J. Tax'n* 49 (2001) (arguing that gain will be recognized by the grantor's estate if the note is outstanding at death) with Blattmachr, Gans, & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," *J. Tax'n* 149 (Sept. 2002), Kwon, McCaffrey and Hesch, "Deciding Upon the Appropriate Estate Freeze Technique," above note 22; and Hesch, "Installment Sale, SCIN, Private Annuity Sales to

Drawbacks. Unlike GRATS, installment sales have the following limitations:

- The Code does not specifically sanction installment sales to grantor trusts (although the IRS has addressed the income tax consequences of this technique in various rulings).²⁵
- Since the installment sale to a grantor trust relies on the trust's ability to satisfy its note payments, the grantor trust should have sufficient initial capitalization, or "seed money" to evidence that it can meet its financial obligations, as they become due.²⁶ Funding the trust with seed money may require the grantor to make an initial taxable gift, and pay a gift tax if the grantor has used his/her entire \$1,000,000 lifetime gift exclusion (or if the grantor is married, then if both spouses have used their entire lifetime gift tax exclusions).²⁷
- If the installment sale technique fails to pass wealth to the remainder beneficiaries (e.g., the investment return on the trust assets fails to exceed the AFR on the note), the grantor will have wasted the use of their taxable gift to provide the seed money.
- If the IRS determines that assets sold to the trust were undervalued, it is not clear that the installment sale technique can make the

a Grantor Trust: Income Taxes and Transfer Tax Elements," *23 Tax Mgmt. Est., Gifts & Tr. J.* 114 (May/June 1998) (arguing that the death of the grantor is not a realization event, so gain is not recognized by the grantor or the grantor's estate). See also Peebles, "Death of an IDIT Noteholder," *144 Trusts & Estates* 28 (Aug. 2005) (adding a third position that carryover basis applies under Regs. §1.1015-2(a)(1) upon the sale to the grantor trust and no gain is reportable by the noteholder under §691 when post-mortem payments are received on the note).

²⁵ Most notably, Rev. Rul. 85-13, above note 4.

²⁶ Many practitioners rely on a mythical 10% funding rule, providing that the grantor should fund the grantor trust prior to the sale with an amount equal to 10% of the value of assets ultimately sold to the trust. However, no tax or legal authority expressly requires or sanctions 10% as a sufficient amount. Thus, the real test for capitalizing the trust should be based on the realities of the sale, meaning that, based on all the facts and circumstances, the trust, as capitalized, can reasonably expect to meet its financial obligations on the note in a timely manner as they come due. See Hesch & Manning, "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," *34th Annual University of Miami Philip E. Heckerling Institute on Estate Planning*, Ch 1601.1 (2000).

²⁷ Alternatively, the seed money could be transferred from other vehicles, such as a GRAT, or, the clients could use an existing grantor trust, if they have one. Beneficiary guarantees have also been suggested as a possible alternative to seed money. See Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," *92 J. Tax'n* 152 (2000).

same adjustment in valuation as the GRAT.²⁸

Final Decision

The ultimate selection of which freeze technique to use depends not only on the tax and legal issues discussed above, but also on the client's specific circumstances, such as the type and amount of assets available for planning, the client's annual income needs, and the client's risk preferences, just to name a few. Practitioners must consider all these factors when determining the appropriate technique for a specific client.

ADDITIONAL FACTORS AFFECTING PERFORMANCE

As shown, the success of freeze transactions involving grantor trusts relies in large part on the grantors' payment of the income taxes on the grantor trust's income. In addition, the following two factors also affect the overall success of a wealth transfer to junior family members:

- (1) valuation discounts; and
- (2) an investment rate of return that exceeds the AFR or the §7520 rate, as applicable.

²⁸ *But see McCord v. Comr.*, 120 T.C. 358 (2003), *rev'd*, 461 F.3d 614 (5th Cir. 2006), where the Fifth Circuit upheld the use of a defined value gift and allowed offsetting the value of the gift by the estate's contingent assumed liability for estate tax should the donor die within three years of the gift.

Of these factors, the valuation discount is the most subjective. Even a brief overview of the case law in this area shows that expert appraisers can differ radically as to the appraisal amount and the appropriate valuation discount.²⁹ Clients may see this perceived flexibility as an opportunity to maximize the valuation discount. Not surprisingly, the IRS views valuation discounts as a potential area for abuse and considers the size of discount as a significant factor in deciding whether to audit a gift (or estate) tax return.

Given the significant litigation regarding valuation discounts, particularly with regard to freeze transactions, practitioners should consider the actual impact of valuation discounts on the performance of such techniques. An analysis of the long-term effects of all the factors affecting grantor trust freeze transactions shows that the valuation discount provides the smallest benefit. To illustrate, consider the installment sale transaction above. In that case, extending grantor trust status for the Seniors' joint life expectancy increases the value of the trust by almost \$16 million. Now compare what happens to the total value of the trust if we increase the investment rate of return on the trust assets by 0.5% (from 7.4% to 7.9%) and increase the valuation discount by 10% (from 25% to 35%) (assuming grantor trust status continues for Seniors' life expectancy):

²⁹ The application of valuation discounts is a highly debated issue particularly in the case of the appraisal of family limited partnership interests. See e.g., *Knight v. Comr.*, 115 T.C. 506 (2000); *McCord v. Comr.*, 120 T.C. 358 (2003), *rev'd* 461 F.3d 614 (5th Cir. 2006); *Lappo v. Comr.*, 86 T.C.M. 333 (2003); *Peracchio v. Comr.*, 86 T.C.M. 412 (2003); and *Kelley Est. v. Comr.*, 90 T.C.M. 369 (2005).

Trust 1 vs. Trust 2	Trust 1 Value	Trust 2 Value	Difference
Return: 7.4 % vs. 7.9% <i>Note:</i> The additional .5% rate of return represents a 6.76% increase in the overall investment return.	\$57,955,691	\$71,793,267	\$13,837,576 Yields a 24% increase in the overall wealth transfer.
Discount: 25% vs. 35% <i>Note:</i> The additional 10% discount represents a 40% increase in the overall discount.	\$57,955,691	\$67,687,069	\$9,731,378 Only yields a 17% increase in the overall wealth transfer.

Accordingly, the cumulative effect of the ability to arbitrage the investment rate of return against the AFR or the §7520 rate, and the continuation of grantor trust status, have a far greater impact in the long run on the overall value in the trust. For example, just the continuation of the grantor trust status alone produced an additional wealth transfer of more

than 37%. The valuation discount, on the other hand, is essentially a one-time, tax-free transfer to the trust, which increases the overall return of the trust on a much more limited basis. Of course, all three factors work together, such that maximum value is achieved with a potential 35% valuation discount, a higher rate of return and the continuation of grantor trust status

as long as possible. However, since the IRS may be more inclined to audit gift tax returns with larger valuation discounts, risk-adverse clients who want to minimize exposure to an IRS audit may want to consider using a conservative valuation discount for their freeze transactions, since, in the long run, a reduced discount has much less effect on the overall performance of the trust.³⁰

USE OF GRANTOR TRUSTS — WORDS OF CAUTION

Basis Issues

While a grantor trust provides significant transfer tax planning benefits, grantor trust status terminates at the grantor's death, and the trust becomes a separate entity for Federal income tax purposes. Note that the basis of the trust assets will not receive a step up to fair market value at the grantor's death because there is no inclusion in the gross estate of the grantor/decedent. Thus, for transfer tax planning purposes, the trust should try to realize most of its gain prior to termination of grantor trust status. Alternately, the trustee could sell low-basis assets to the grantor in exchange for cash or high basis assets. A similar result could be achieved if the trust provides the grantor with a power of substitution.³¹

Financial Burden to Grantor

The client's circumstances may change such that continuing grantor trust status becomes a burden or otherwise no longer meets the client's needs. For example, as shown in Table 4 above, the continued payment of the income tax liability on the grantor trust's income will continue to deplete the grantor's wealth.

³⁰ The authors acknowledge that the example described above focuses solely on the total amount of wealth transferred to judge the economic affects of the use of valuation discounts. However, the use of valuation discounts may be even more pernicious in the context of the administration of GRATs — particularly short-term GRATs — than installment sales to grantor trusts. For example, since the GRAT annuity must be paid in all events, and, if property subject to a valuation discount upon funding is returned to the grantor of a GRAT in payment of the required annuity, then the property used to satisfy the payment must be valued taking into account all applicable valuation discounts at that point. Thus, the revaluation (at a discount) lessens the leverage of the initial discount upon contribution. In an installment sale to a grantor trust, the parties have more flexibility with the financing (such as making the note interest only, or re-financing the note in years where performance has lagged or returns are negative), so that the effect of the use of a valuation discount is mitigated, and the discount may be overcome with the passage of time and the overall growth in the value of the assets owned by the grantor trust.

³¹ *But see* the caution at note 8 above regarding concerns of potential estate tax inclusion if the grantor holds a power of substitution in a nonfiduciary capacity.

In addition, if the grantor includes the grantor trust's income in calculating his income tax liability, he will increase his adjusted gross income, thus increasing the phase-out of his medical expense deduction under §213, itemized deductions under §68, miscellaneous itemized deductions under §67 and one's personal exemption deductions under §151(d)(3), since the phase-out is based on an individual's adjusted gross income.³² Furthermore, the additional income can cause exposure to the alternative minimum tax (although, conversely, the increase in the grantor's adjusted gross income raises the useable limit on his charitable deductions).

Planners can address these issues in numerous ways. The trust can give the trustee and/or the grantor the right to "toggle off" or release the powers that cause the trust to be a grantor trust. The trust could also provide for a tax reimbursement clause (but be careful to consider the applicable state law) or include the grantor's spouse as a beneficiary (or give the trustee the discretionary power to add the spouse as a beneficiary in the future).³³ It is best that the estate planner consider the continuation of grantor trust status at the inception of the freeze technique. If the grantor does not want grantor trust status to continue after the note is paid, or after the GRAT term, the safest approach is to state in the trust agreement that the power which creates grantor trust status only lasts for the freeze term. Whatever approach is used, planners must consider and plan for the full financial impact of grantor trust status (including the continuation of such status during the grantor's entire life) at the inception of the grantor trust.

When a Nongrantor Trust May be Better

Certain situations may recommend the use of a nongrantor trust, such as planning for state income tax issues. For example, certain states tax a trust based on the residence of the grantor and will not impose state

³² The "applicable amount" of adjusted gross income, above which otherwise allowable itemized deductions are reduced under §68 is \$156,400 for 2007. Rev. Proc. 2006-53, 2006-48 I.R.B. 996, at §3.12. *See* Donaldson, above note 6.

³³ *See* Handler, *The Power of Grantor Trusts*, above note 13, noting that if the trust contains a reimbursement clause, practitioners must determine whether it makes the grantor a beneficiary of the trust. State law may then allow the grantor's creditors to reach the trust assets, causing the grantor's gift to the trust to be incomplete for gift tax purposes. Thus, the trust property would be includible in the grantor's estate and subject to estate tax. However, several states (such as Delaware and New York) have responded to Rev. Rul. 2004-64 by enacting statutory amendments to their laws specifically exempting property subject to discretionary tax reimbursements from the reach of creditors. *See e.g.*, Del. Code Ann. tit. 12 §3570(10)b.(9) and New York E.P.T.L. §7-3.1(d).

income tax on a trust if the grantor does not reside in the state, there are no-in-state trustees, no real or tangible property is located in the state and no income is sourced in that state upon which a non-resident would be taxable.³⁴ Thus, a client who is anticipating a large capital gain may want to establish an out-of-state nongrantor trust to own the asset that will generate the capital gain, thereby taking advantage of the low 15% Federal tax rate for capital gains income (which still applies to trust) and avoiding state income tax exposure.³⁵

CONCLUSION

Grantor trusts are powerful tools that maximize the ability of clients to transfer significant wealth on a transfer tax-free basis. Combining a grantor trust with

an estate planning strategy, such as an estate freeze, and continuing grantor trust status for as long as the grantor is alive, maximizes the transfer tax savings that could be achieved as compared to the use of a nongrantor trust. However, due to the substantial financial impact grantor trust status imposes on the grantor, practitioners must structure grantor trusts to protect their clients from being overwhelmed by this future financial burden. Practitioners should review and provide methods to terminate grantor trust status or alleviate the income tax impact to the grantors (such as reimbursement clauses or increased interest rates on the installment note). Further, the substantial financial savings provided by the continuation of grantor trust status, particularly when combined with an arbitrage of the investment return rate, removes some of the importance placed on valuation discounts in generating substantial tax savings. Due to the significant uncertainty involving the appropriateness of large valuation discounts, planners may be wise to recommend more conservative discounts in order to safeguard the overall transfer tax savings provided by the planning strategy.

³⁴ E.g., New York Tax Law §605 (b)(3)(D) and New York Reg. §105.23.

³⁵ See also Steiner, "The Accidentally Perfect Non-Grantor Trust," 144 *Trusts & Estates* 28 (Sept. 2005) and PLRs 200502014, 200612002, and 200637025 which have approved the creation of a nongrantor, incomplete gift trust for the apparent purpose of planning for state income tax issues.