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ESTATE PLANNING MEMORANDUM

TO: CPAs, Clients & Associates

FROM: David L. Silverman, Esq.
Shirlee Aminoff, Esq.

DATE: April 2, 2010

RE: Sales of Assets to “Defective” Grantor Trusts

Please note: *The estate planning techniques discussed in this article could reduce estate taxes. However, since tax consequences may turn on a single provision in a trust or LLC agreement, sound legal and tax advice should be obtained prior to implementing any estate plan. Further, although the tax treatment for asset sales to grantor trusts discussed appears well-grounded in the tax law, there is no guarantee that the IRS will accept the interpretations set forth herein.*

Installment sales of assets to grantor trusts indirectly exploit income tax provisions enacted to prevent income shifting at a time when trust income tax rates were much lower than individual

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tax rates. Specifically, the technique capitalizes on different definitions of “transfer” for transfer tax and grantor trust income tax purposes. The resulting trusts are termed “defective” because the different definitions of “transfer” result in a serendipitous divergence in income and transfer tax treatment when assets are sold by the grantor to his own grantor trust.

A. Overview of Asset Sale

For income tax purposes, after an asset sale has occurred, the grantor trust holds property on which the grantor continues to report income tax. However, the grantor is no longer considered as owning the asset for transfer tax purposes, and the trust assets, as well as the appreciation thereon, will be outside of the grantor’s taxable estate. As a result of this odd juxtaposition of income and transfer tax rules, the grantor is taxed on trust income but will have depleted his estate of the value of the assets for transfer tax purposes.

To illustrate the mechanics, assume the grantor sells property worth \$5 million to a trust in exchange for a \$5 million promissory note, the terms of which provide for adequate interest payable over 20 years, and one balloon payment of principal after 20 years. If the trust is drafted so that the grantor retains certain powers, income will continue to be taxed to the grantor, even though for transfer tax purposes the grantor will be considered to have parted with the property.¹ This may over time reduce transfer taxes since the grantor is in effect making a tax-free gift to trust beneficiaries of money needed to pay the income tax liability of the trust.

Assume that the grantor has sold a family business worth \$5 million to the trust, and that each year the business is expected to generate approximately \$100,000 in profit. Assume further that the trust is the owner of the business for transfer tax purposes.² With the grantor trust in place, the grantor will pay income tax on the \$100,000 of yearly income earned by the business. If the business had instead been given outright to the children, they would have been required to pay income taxes on

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the profits of the business.

The result of the sale to the defective grantor trust (“IDT” or “trust”) is that the income tax liability of the profits generated by the business remains the legal responsibility of the grantor, while at the same time the grantor has parted with ownership of the business for transfer tax purposes. A “freeze” of the estate tax value has been achieved, since future appreciation in the business will be outside of the grantor’s taxable estate. Nonetheless, the grantor will remain liable for the income tax liabilities of the business, and no distributions will be required from the trust to pay income taxes on business profits. This will result in accelerated growth of trust assets.³

Achieving grantor trust status requires careful drafting of the trust agreement so that certain powers are retained by the grantor. The following powers, if retained over trust property, will result in the IDT being treated as a grantor trust:

¶ § 677(a) treats the grantor as the owner of any portion of the income of a trust if the trust provides that income may be distributed to the grantor’s spouse without the approval or consent of an adverse party;

¶ § 675(3), treats the grantor as owner of any portion of a trust in which the grantor possesses the power to borrow from the trust without adequate interest or security;

¶ § 674(a) treats the grantor as owner of any portion of a trust over which the grantor or a nonadverse party retains the power to control beneficial enjoyment of the trust or income of the trust. [Sec. 674(a) is subject to many exceptions; for example, the power to allocate income by a nonadverse trustee, if such power were limited by an ascertainable standard, would not result in the trust being taxed as a grantor trust]; and

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¶ § 675(4)(C) provides that if the grantor or another person is given the power, exercisable in a nonfiduciary capacity and without the approval or consent of another, to substitute assets of equal value for trust assets, grantor trust status will result.

For as long as grantor trust status continues, trust income is taxed to the grantor. A corollary of the grantor trust rules would logically provide that no taxable event occurs on the sale of assets to the grantor trust because the grantor has presumably made a sale to himself of trust assets.⁴ If this hypothesis is correct, the grantor can sell appreciated assets to the grantor trust, effect a complete transfer and freeze for estate tax purposes, and yet trigger no capital gains tax on the transfer of the appreciated business into the trust.

B. The Note Received For Assets

Consideration received by the grantor in exchange for assets sold to the IDT may be either cash or a note. If a business is sold to the trust, it is unlikely that the business would have sufficient liquid assets to satisfy the sales price. Furthermore, paying cash would tend to defeat the purpose of the trust, which is to reduce the size of the grantor's estate. Therefore, the most practical consideration would be a promissory note payable over a fairly long term, perhaps 20 years, with interest-only payments in the early years, and a balloon payment of principal at the end.⁵ This arrangement would also minimize the value of the business that "leaks" back into the grantor's estate. For business reasons, and also to underscore the bona fides of the arrangement, the grantor could require the trust to secure the promissory note by pledging the trust assets.

The note issued in exchange for the assets must bear interest at a rate determined under § 7872, which references the applicable federal rate (AFR) under §1274.⁶ In contrast, a qualified annuity interest such as a GRAT must bear interest at a rate equal to 120 percent of the AFR. A

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consequence of this disparity is that property transferred to a GRAT must appreciate at a greater rate than property held by an IDT to achieve comparable transfer tax savings. As with a GRAT, if the assets fail to appreciate at the rate provided for in the note, the IDT would be required to “subsidize” payments by invading the principal of the trust.

C. Consequences of Transferred Basis

While no taxable event occurs when the grantor sells assets to the IDT in exchange for the note, if grantor trust status were to terminate during the term of the note, the trust would no longer be taxed as a grantor trust. This would result in the immediate gain recognition to the grantor, who would be required to pay tax on the unrealized appreciation of the assets previously sold to the trust. Note that for purposes of calculating realized gain, the trust will be required substitute the grantor’s basis: Even though the assets were “purchased” by the trust, no cost basis under § 1012 is allowed since no gain will have been recognized by the IDT in the earlier asset sale. Another situation where gain will be triggered is where the trust sells appreciated trust assets to an outsider. One way of mitigating this possibility would be for the grantor to avoid initially selling appreciated assets to the trust. If this is not possible, the grantor could also substitute higher basis assets of equal value during the term of the trust, as discussed below.

Care should be exercised in selling highly appreciated assets to the grantor trust for another reason as well: if the grantor were to die during the trust term, the note would be included in the grantor’s estate at fair market value. However, the assets which were sold to the trust would not receive the benefit of a step-up in basis pursuant to § 1014(a). Any gift tax savings occasioned by the transfer of assets could be negated by the failure of the trust to receive an increase in basis. To avoid this result, the trust might either (i) authorize the grantor to substitute higher basis assets of equal value during his lifetime; or (ii) make payments on the note with appreciated assets. [Note that

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if the grantor received appreciated assets in payment of the note, those assets would be included in the grantor's estate, if not disposed of earlier. However, they would at least be entitled to a step-up in basis in the grantor's estate pursuant to § 1014.]

D. Avoiding Sections 2036 and 2702

The rules of Chapter 14 must also be considered. If § 2702 were to apply to the sale of assets to a grantor trust, then the entire value of the property so transferred could constitute a taxable gift. However, it appears those rules do not apply, primarily because of the nature of the promissory note issued by the trust. The note is governed by its own terms, not by the terms of the trust. The holder in due course of the promissory note is free to assign or alienate the note, regardless of the terms of the trust, which may contain spendthrift provisions. Ltr.Ruls 9436006 and 9535026 held that neither § 2701 nor § 2702 applies to the IDT promissory note sale, provided (i) there are no facts present which would tend to indicate that the promissory notes would not be paid according to their terms; (ii) the trust's ability to pay the loans is not in doubt; and (iii) the notes are not subsequently determined to constitute equity rather than debt.

As noted above, since the assets are being transferred to the grantor trust in a bona fide sale, those assets should be excluded from the grantor's taxable estate. However, since the grantor is receiving a promissory note in exchange for the assets, the IRS could take the position that under § 2036, the grantor has retained an interest in the assets which require inclusion of those assets in the grantor's estate.⁷ In order to minimize the chance of the IRS successfully invoking this argument, the trust should be funded in advance with assets worth at least 10 percent as much as the assets which are to be sold to the IDT in exchange for the promissory note.⁸

In meeting the 10 percent threshold, the grantor himself should make a gift of these assets so that after the sale in exchange for the promissory note, the grantor will be treated as the owner

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of all trust assets. The IRS stated in PLR 9515039 that § 2036 could be avoided if beneficiaries were to act as guarantors of payment of the promissory note.⁹ To enhance the bona fides of the note, all trust assets should be pledged toward its repayment. To accentuate the arm's length nature of the asset sale, it is preferable that the grantor not be the trustee.

E. GST Tax Considerations

The sale of assets to a grantor trust has particularly favorable Generation Skipping Transfer (GST) tax consequences. Since the initial transfer of assets to the grantor trust is a complete transfer for estate tax purposes, there would be no possibility of the assets later being included in the grantor's estate. The transfer would be defined as one not occur during the "estate tax inclusion period" (ETIP). Accordingly, the GST tax exemption could be allocated at the time of the sale of the assets to the grantor trust¹¹. In sharp contrast, the GST exemption may not be allocated until after the term of a GRAT has expired.¹² If the grantor of a GRAT were to die before the expiration of the trust term, all of the assets in the GRAT would be included in the grantor's estate at their appreciated value. This would require the allocation of a greater portion of the GST exemption to shield against the GST tax. The inability to allocate the GST exemption using a GRAT is quite disadvantageous when compared to the IDT, where the exemption can be allocated immediately after the sale, and all post-sale appreciation can be protected from GST tax.

F. Choice of Trustee

Trustee designations should also be considered: Ideally, the grantor should not be the trustee of an IDT, as this would risk inclusion in the grantor's estate, especially if the grantor could make discretionary distributions to himself. If discretion to make distributions to the grantor is vested in

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a trustee other than the grantor, then the risk of adverse estate tax consequences is reduced. The risk is reduced still further if the grantor is given no right to receive even discretionary distributions from the trust. If the grantor insists on being the trustee of the IDT, then the grantor's powers should be limited to administrative powers, such as the power to allocate receipts and disbursements between income and principal. The grantor may also retain the power to distribute income or principal to trust beneficiaries, provided the power is limited by a definite external standard.

The grantor as trustee should not retain the right to use trust assets to satisfy his legal support obligations, as this would result in inclusion under §2036. However, if the power to satisfy the grantor's support obligations with trust assets is within the discretion of an independent trustee, inclusion in the grantor's estate should not result. However, if the grantor retains the right to replace the trustee, then the trustee is likely not independent, and inclusion would probably result. Note that despite the numerous prohibitions against the grantor being named trustee, the grantor's spouse may be named a beneficiary or trustee of the trust without risking inclusion in the grantor's estate.¹⁰

G. Death of Grantor

The following events occur upon the death of the grantor: (i) the IDT loses its grantor trust status; and (ii) presumably, assets in the IDT would be treated as passing from the grantor to the (now irrevocable) trust without a sale, in much the same fashion that assets pass from a revocable living trust to beneficiaries. For reasons similar to those discussed above with respect to sales of appreciated trust assets, the basis of trust assets would not be stepped-up pursuant to §1014(a) on the death of the grantor, because the assets will not be included in the grantor's estate. This is in sharp contrast to the situation obtaining with a GRAT, where the death of the grantor prior to the expiration of the trust term results in the entire amount of the appreciated trust assets being included in the grantor's estate.

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Tax consequences of the unpaid balance of the note must also be considered when the grantor dies. Since the asset sale is ignored for income tax purposes, the balance due on the note would not constitute income in respect of a decedent (IRD). The remaining balance of the note would however be included in the grantor's estate and would acquire a basis equal to the value included in the estate.¹³

[Note: It might be possible to avoid inclusion of the note in the seller's estate if a self-canceling installment note (SCIN) feature were included in the note. A SCIN is an installment which terminates on the seller's death. Any amounts payable to the seller would be cancelled at death, and would be excluded from the seller's estate. However, since the seller's death during the term of the note will result in cancellation of liability under the terms of the note, the note payments would have to be increased accordingly to avoid a deemed gift at the outset. As a result of these increased payments, if the seller did survive the full term of the note, the amount payable to the seller from the trust utilizing the SCIN would be greater than if a promissory note without a SCIN had been utilized. This would tend to increase the seller's taxable estate.]

H. Possible IRS Objections

Aside from the lack of unfavorable estate tax consequences resulting from the early death of the grantor, the asset sale technique also permits the grantor to effect a true estate freeze by transferring assets at present value from his estate without being subject to the limitations imposed by Secs. 2701 or 2702, to which the GRAT is subject. In addition, as noted, the GST exemption may be allocated to the assets passing to the trust at the outset, thus removing from GST tax any appreciation in the assets as well. In these respects, the IDT is superior to the GRAT. The principal disadvantages are that (i) no step-up in basis is received at the death of the grantor for assets held by the trust (or if the trust sells appreciated assets during its term); and (ii) the technique, though sound in theory, has not been tested in the courts.

The general principles governing the tax consequences of the asset sale seem firmly grounded in the Code and the law, and their straightforward application appears to result in the tax

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conclusions which have been discussed. Nevertheless, the IRS could challenge various parts of the transaction, which if successful, could negate some (or all) of the tax benefits sought. In particular, the IRS could attempt to assert that (i) the sale by the grantor to the trust does not constitute a bona fide sale; (ii) § 2036 applies, with the result that the entire value of the trust is includible in the grantor's estate; (iii) the initial asset "sale" is actually a taxable sale which results in immediate tax to the grantor under IRC § 1001; or (iv) that § 2702 applies, the annuity is not qualified, and a taxable gift occurs at the outset.

I. LLC Combined With IDT Asset Sale

By combining the LLC form with asset sales to grantor trusts, it may be possible to achieve even more significant estate and income tax savings. LLC membership interests are entitled to minority discounts since the interests are subject to significant restrictions on transfer and management rights. If the value of the LLC membership interest transferred to the IDT is discounted for lack of marketability and lack of control, the value of that interest will be less than a proportionate part of the underlying assets. Consequently, in the case of an asset sale to the IDT, the sale price will be less than if the assets had been directly sold to the IDT.

To illustrate, assume the following events: (1) parent transfers real estate worth \$1 million to a newly formed LLC of which parent is the Manager; (2) parent gives 10 percent membership interests to each of two children; (3) parent gives a 10 percent membership interest to a newly-formed grantor trust; and after a reasonable period of time (4) parent sells a 50 percent membership interest in the LLC to the grantor trust for fair market value. After the dust settles, parent will own a 20 percent interest in the LLC outright, the children will each will own a 10 percent interest, and the trust will own a 50 percent interest in the LLC.

In determining the FMV of the LLC interest sold to the trust, parent engages the services of a professional valuation discount appraiser and a real estate appraiser. It is determined that the value of the real estate is to be discounted by 50 percent after application of the lack of control and lack of marketability discounts. Therefore, the 50 percent membership interest is sold to the trust for

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\$250,000 (i.e., \$500,000 x .5). Parent agrees to accept a promissory note bearing interest at the rate of 6 percent, pursuant to § 1274, or \$15,000 per year, with a balloon payment of principal at the end of the promissory note's 15-year term.

If the underlying business appreciates at a yearly rate of 10 percent, the value of the underlying assets purchased by the trust in exchange for the promissory note would increase by \$50,000 in the first year (i.e., \$500,000 x .10). Had the LLC membership interests not been discounted, the real estate would have commanded a purchase price by the IDT of \$500,000, and the required yearly interest payments would have instead been \$60,000 (i.e., \$500,000 x .06). By discounting the property purchased by the IDT to reflect minority discounts, the required interest payments to parent have been reduced from \$30,000 to \$15,000. If the underlying assets grow at a rate of 10 percent, then 70 percent of the growth (i.e., \$35,000/\$50,000) can remain in the trust. It is apparent that more value can be transferred to family members if the property purchased by IDT in exchange for the promissory note can be discounted.

The LLC asset sale to the IDT would result in the following favorable tax and economic consequences: (i) \$500,000 would be transferred out of the grantor's estate for estate tax purposes; (ii) future appreciation on the \$500,000 would be transferred permanently out of the estate; (iii) unlike the situation obtaining with a GRAT, the results in (i) and (ii) would not depend on the grantor surviving the trust term; (iv) since the promissory note could bear a lower rate of interest, fewer funds would be brought back into the grantor's estate, resulting in a more perfect "freeze" for estate tax purposes; and (v) since the LLC assets are discounted, the purchase price by the trust would reflect that discount, making the effective yield of assets within the LLC even higher.

1 A grantor trust is a trust defined in Secs. 671 through 679 of the Code. To be taxed as a grantor trust, the grantor must reserve certain powers, the mere reservation of which in the trust instrument will confer grantor trust status, unless and until those powers are released.

2 IRC Secs. 2036 and 2038, which cause the retention of interests or powers to result in estate inclusion

must be avoided when funding an IDT. The retention by a grantor-trustee of administrative powers, such as the power to invest and the power to allocate receipts and disbursements between income and principal will not result in inclusion, and will not negate the transfer for transfer tax purposes, provided the powers are not overbroad and are subject to judicially enforceable limitations. See *Old Colony Trust Co.*, 423 F2d 601 (CA-1, 1970).

3 The IRS has indicated displeasure with the payment of income taxes by the grantor of a grantor trust when the grantor receives no distributions. However, as the payment of taxes by the grantor is mandated by the grantor trust provisions themselves, it is doubtful that the IRS would prevail on this issue were it to litigate.

4 The IRS takes the position that a wholly grantor trust is disregarded for income tax purposes, and that transactions between the trust and the grantor have no income tax consequences. Rev. Rul. 85-13, 1985-1, C.B. 184.

5 Treas. Reg. § 25.2702-3 prohibits this type of “end loading” with respect to a GRAT. That regulation provides that an amount payable from a GRAT cannot exceed 120 percent of the amount paid during the preceding year. However, if § 2702 does not apply to the IDT, which appears likely, then the promissory note could provide for a large principal payment at the conclusion of the term of the note.

6 A promissory note given in exchange for property must bear interest at the rate prescribed by § 1274. Sec. 1274(d) provides that a promissory note with a term of between two and ten years should bear interest at the federal midterm rate.

7 *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), held that where a decedent, not in contemplation of death, transfers property in exchange for a promise to make periodic payments to the transferor, those payments are not chargeable to the transferred property, but rather constitute a personal obligation of the transferee. Accordingly, the property itself is not includible in the transferor's estate under § 2036(a)(1).

8 In an analogous situation, § 2701 requires that the value of common stock, or a “junior equity interest,” comprise at least 10 percent of the total value of all equity interests.

9 Presumably, if the beneficiaries were to guarantee the note and if the value of the assets which secure the note were to decline, there would still be a realistic prospect of the note being repaid.

10 Sec. 677(a), which treats the grantor as owner of any portion of a trust whose income may be distributed to the grantor or the grantor's spouse, has no analog in the estate tax sections of the Internal Revenue Code.

11 Sec. 2642(f) prohibits allocation of any portion of the Generation Skipping Transfer tax exemption to a transfer during any estate tax inclusion period (ETIP). Sec. 2642(f)(3) defines ETIP as any period during which the value of transferred property would be included in the transferor's estate if the transferor were to die.

12 The period during which the grantor receives annuity payments from a GRAT is an ETIP. Therefore,

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no part of the GST exemption may be applied to the GRAT until after its term; at that point, the property inside the GRAT will have appreciated, requiring a greater allocation of the GST exemption.

13 Some argue that a sale occurs immediately before the death of the grantor, causing capital gain to be recognized by the grantor's estate to the extent the balance due on the note exceeds the seller's basis in the assets sold to the trust. This view is inconsistent however, with the central premise that the sale by the grantor of assets to the IDT produces no taxable event.