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PERSONAL FINANCIAL PLANNING

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

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One way to reduce estate tax is to make gifts, but many people are reluctant to part with property until they die unless they can retain strings. Even though lifetime transfers eliminate post-gift appreciation from the estate tax, many individuals are content to use the $650,000 credit shelter amount (which will be increased to $1,000,000 by 2006) with a bypass trust in a testamentary disposition. When a family business is involved, there may be uncertainty regarding the transition of ownership and control, and flexibility in the estate plan is necessary to take into account unforeseen events such as a child's death, disability, or a family dispute. A testamentary disposition may not deal with the nontax issues. With an intentionally defective irrevocable trust, an individual can effectively make a gift of property and retain the power to reacquire such property years later by substituting other property of equivalent value without any income tax being incurred by the grantor or the grantee.

An intentionally defective irrevocable trust is an irrevocable trust that is complete for Federal estate and gift tax purposes but incomplete for income tax purposes. The property transferred is removed from the grantor's gross estate but continues to be treated as owned by the grantor for income tax purposes. Since the grantor is treated as the owner of the grantor trust, the grantor's payment of the income tax due out of nontrust assets in subsequent years will reduce the grantor's potential estate without any gift tax liability.

The "defect" arises because of the possession by the grantor, the grantor's spouse, or others of certain powers with respect to the trust that cause the grantor to be deemed the owner for income tax purposes under the grantor trust rules in IRC sections 671678. The idea is to intentionally include in the trust those powers that will keep the grantor as the owner of the trust for income tax purposes. The defective trust takes advantage of the fact that the estate tax rules of IRC sections 20362038 relating to the inclusion of lifetime transfers differ from the grantor trust income tax rules in IRC sections 671678.

If the grantor trust rules apply, the trust is generally ignored for income tax purposes, and the income tax rules relating to trusts do not apply. The grantor will be taxed on the income of the trust as if received directly (likewise for items of deduction and credit). The grantor trust rules determine who should be taxed on an item. If these rules are followed, the IRS cannot rely on other principles of law, such as the assignment of income doctrine, to shift tax liability.

Why Is the Grantor the Owner?

The grantor is treated as the owner of trust property in a variety of situations. First, the grantor will be treated as the owner if she has a reversionary interest in the income or principal of any portion of a trust that exceeds five percent of such portion. This is a valuation test. It is not based on probabilities and is determined with commutation tables published by the IRS in Publication 1457, Volume Alpha.

Second, the grantor will be treated as the owner of the trust if she retains certain prohibited powers exercisable by the grantor or a nonadverse party or both that affect the beneficial enjoyment without the approval or consent of an adverse party (IRC section 674).

An "adverse party" is a person with a substantial interest in the trust that would be adversely affected by the exercise or nonexercise of the power that he possesses, such as the general power of appointment. A contingent interest may be adverse. A "related or subordinate party" is any nonadverse party who is the grantor's spouse, if living with grantor, or the grantor's father, mother, issue, brother, sister, employee, corporation, or any employee of a corporation in which the grantor has significant voting control. Half-brothers and half-sisters are related and subordinate (Rev. Rul. 59-19). The grantor's lawyers and accountants are not related or subordinate unless they are employed full-time by the grantor.

Third, the grantor will be treated as the owner of the trust if she retains certain prohibited administrative powers under IRC section 675 or the right to revoke the trust (IRC section 676) or if the income can be used to benefit the grantor (IRC section 677).

Finally, for transfers in trust after March 1, 1986, the grantor will be treated as the owner of the trust if her spouse holds any of the foregoing interests or powers under IRC section 672(e).

While certain of these powers will cause the inclusion of the trust assets in the grantor's estate, others do not. It is these latter powers, illustrated below, that will intentionally keep the grantor as the owner of the assets for income tax purposes.

1. The power exercisable in a nonfiduciary capacity to reacquire the assets by substituting assets of equivalent value, without the approval or consent of any person in a fiduciary capacity under IRC section 675(4)(C) (see Private Letter Rulings 9413045 and 9548013). The IRS's position is that recitation of such a power in the trust is not enough to cause grantor trust status; the facts and circumstances must show that the power is in fact exercisable in a nonfiduciary capacity [Treas. Reg. section 1.675-1(b)(4)]. The power of substitution does not cause inclusion for estate tax purposes. [See Jordahl v. Comm'r, 65 T.C. 92 (1975), acq. 1977-1 C.B., which is cited for this proposition, although in that case the power was held in a fiduciary capacity.] The power of substitution should not be used with closely held stock, because section 2036(b) requires estate tax inclusion if the grantor retains the right to vote closely held stock.

2. The power to make loans to the grantor or the grantor's spouse without adequate interest or security where the trustee does not have the power to make such loans to any person as part of the trustee's lending power under section 675(2). To avoid estate tax inclusion, the grantor should not have the power to require the trustee to make a loan. Section 672(e) extends the rule to the grantor's spouse.

3. Powers exercised by the grantor's spouse, e.g., the power to sprinkle income and corpus held by related or subordinate trustees under IRC section 674(c) and the power to add beneficiaries. If the grantor's spouse holds the sprinkle power, the trust is a grantor trust because IRC section 672(e) attributes powers held by the grantor's spouse to the grantor. The grantor should not retain sprinkle powers because of IRC section 2036. For example, the power of the grantor's spouse as a trustee to sprinkle income among the grantor's descendents without reference to an ascertainable standard (health, education, support, maintenance) makes the trust a grantor trust under IRC sections 674(c) and 672(e). But if the grantor does not retain any powers, the gift is complete and the trust principal is not includable in the grantor's estate.

4. The power to use trust income under IRC section 677(a), without the consent of an adverse party, for the payment of premiums on policies of insurance on the life of the grantor or her spouse or held or

accumulated for future distribution to the spouse. Under IRC section 672(e), powers held by the grantor's spouse are attributed to the grantor.

If the grantor is named as a beneficiary of a trust eligible to receive income in the discretion of a trustee other than the grantor, estate tax inclusion under IRC section 2036(a)(1) has been held not to apply unless there is an express or implied agreement that income would in fact be paid to the grantor. However, if state law permits the grantor's creditors the right to reach an irrevocable trust established by the grantor to satisfy their claims, the trust will be included in the grantor's Federal estate. Therefore the grantor should not be named as a trust beneficiary.

Ordinarily, the grantor should not be named as a trustee unless the trustee's powers are limited. The prudent course is to name an independent trustee. However, the grantor can retain the power to appoint and remove independent trustees (Rev. Rul. 95-58, 1995-2 C.B. 191).

If the grantor, for example, is named as trustee and the trust contains any discretionary powers, the trust will be included in the grantor's estate. Administrative powers such as the power to invest and the power to allocate receipts and disbursements between income and principal should not cause estate tax inclusion provided the powers are not unlimited and are subject to enforcement by the courts. A power to distribute income or principal to trust beneficiaries will not cause inclusion if the power is limited by an ascertainable standard (i.e., health, education, support, maintenance) that is enforceable by the courts unless the distribution satisfies the grantor's legal obligation. If the grantor is to act as trustee, the trust should prohibit her from using trust assets to satisfy a legal obligation.

Crummey powers should be included in a defective trust to take advantage of the annual gift tax exclusion.

The power that makes the intentionally defective irrevocable trust a flexible tool for estate planners is the power to substitute assets of equivalent value exercisable in a nonfiduciary capacity. If the grantor has the power to substitute, she is deemed to be the owner of the trust for income tax purposes, and the subsequent transfer of trust assets for other property of equivalent value cannot be considered a sale or exchange of the property for income tax purposes. In Rothstein v. U.S., 735 F. 2d 704 (2d Cir. 1984), the grantor purchased stock from a trust created by him in exchange for his promissory note. The court refused to ignore the trust entity and held that the grantor's tax basis in the stock was the face value of the note. The grantor was treated as the owner of the trust under IRC section 675(3) because in exchanging his unsecured note for the trust's principal, he effectively had "borrowed" the trust corpus. The IRS has announced that it will not follow Rothstein (Rev. Rul. 85-130). (Also see Private Letter Ruling 9010065.)

A defective grantor trust allows an individual who has transferred assets to a grantor trust to retrieve these assets, which may have appreciated in value over the years, by substituting cash or other property without causing a taxable event to the grantor or grantee. Since the trust permits the business owner to change the trust's assets when she is more certain as to her plans, the business owner can begin the transition process of transferring ownership and control much earlier than she might otherwise be comfortable doing, and as a result, produce greater estate tax savings. *

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