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Use of Grantor Trusts in Estate Planning

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Planning With Trusts



Planning with Trusts

Trusts are devices for estate planners to use to assist their clients in achieving goals that cannot be achieved through the "outright" disposition of assets to the clients' heirs.

These goals include:

- Privacy
- Professional management of assets
- Protection of assets from the client's creditors
- Avoidance of probate and its costs
- Management of assets in multiple jurisdictions



Planning with Trusts

- Minimizing estate taxes
- Minimizing generation-skipping taxes
- Preserving assets for later distribution to future generations
- For "second marriage" couples, ensuring that both the "second family" and the "first family" are provided for and protected
- Protection of assets from the creditors of children and further descendants
- Income tax planning
- Forum shopping



Planning with Trusts

- Trusts can be established during lifetime or at death.
 - Lifetime trusts ("living trusts") are either revocable or irrevocable
 - Testamentary trusts are always irrevocable
- Transfers to revocable trusts do not have any immediate income, estate or generation-skipping tax consequences.
 - Revocable trust is considered an alter ego of grantor
 - Grantor is treated as the taxpayer for income tax purposes
- Transfers to irrevocable trusts do have an immediate gift, estate and generation-skipping tax consequence.
 - Transfer will be considered a gift for gift tax purposes
 - May qualify for the annual \$12,000 per donee exclusion from gift taxes
 - Gifts in excess of the annual exclusions will count towards the \$1 million gift tax exemption



Planning with Trusts

- Lifetime transfers to irrevocable trusts are best when the donor has an estate that would generate federal or state estate tax and the donor can part with the use of the property transferred.
 - The current federal estate tax exemption is \$2 million per individual; cumulative lifetime taxable gifts count as part of the \$2 million total
- If transferred assets will pass eventually to the grantor's grandchildren or further descendants, the transfer will be a generation-skipping transfer, subject to the generation-skipping tax, unless sheltered by use of the generation-skipping tax exemption.
 - The generation-skipping tax exemption is currently \$2 million; cumulative lifetime taxable gifts to grandchildren count as part of the \$2 million total
- The best assets to transfer during lifetime to an irrevocable trust are assets that have the greatest potential for appreciation.
 - The future appreciation in the assets transferred will pass to heirs without taxation in the donor's estate



Planning with Trusts

- Lifetime transfers to irrevocable trusts can be structured as both
 - An estate tax "effective" trust - grantor is not treated as the owner of the trust property for estate and generation-skipping tax purposes; and
 - An income tax "defective" trust - grantor is treated as the owner of the trust for income tax purposes.
 - Such a trust is commonly known as an intentionally defective grantor trust (an "IDGT")
 - An IDGT allows for planning that leverages upon, and in some cases saves for future use, the \$1 million gift tax and the \$2 million estate and generation-skipping tax exemption amounts.
 - We will explore in more detail how grantor trusts accomplish these goals, after we discuss how they are created.



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Creating a Grantor Trust



Creating a Grantor Trust

- A trust becomes a grantor trust by intentionally being subjected to the grantor trust rules set out in Internal Revenue Code Sections 671-679.
- A trust becomes subject to these rules if the grantor, or other “subordinate” or “nonadverse” party (defined below), retains certain specified powers with respect to the trust that cause the grantor to be deemed the owner of the trust for income tax purposes.
- It may be important to select grantor trust powers which can be released by the powerholder so that the trust may at some point in the future terminate its grantor trust status.



Creating a Grantor Trust

- A "related or subordinate party" is any nonadverse party who is
 - (i) the grantor's spouse if living with the grantor, or
 - (ii) any one of the following:
 - the grantor's father, mother, issue, brother or sister;
 - an employee of the grantor;
 - a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or
 - a subordinate employee of a corporation in which the grantor is an executive.



Creating a Grantor Trust

- 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 which such party possesses in respect of the trust.
 - A person holding a general power of appointment over the trust will be deemed to have a beneficial interest in the trust.



Creating a Grantor Trust

Sections 671-679 of the Code set forth the retained powers which will cause the grantor to be treated as the owner of the trust for income tax purposes. Here are some of the retained powers commonly used to create a grantor trust:

- **Right to Substitute Assets** - if the grantor has retained the right, exercisable in a non-fiduciary capacity, to reacquire trust assets by substituting assets of equivalent value [Code Section 675(4)]
- **Premium Payment Power** - if the grantor or a nonadverse person (or both) may apply trust income to pay premiums on life insurance policies on the life of the grantor or the grantor's spouse [Section 677(a)(3)]



Creating a Grantor Trust

- **Power to Change Beneficial Interest** - if a grantor or a nonadverse party (or both) has the power, without the approval or consent of an adverse party, to dispose of the beneficial enjoyment of trust income or principal [Section 674(a)]
- **Power to Borrow** - if a grantor or a nonadverse party (or both) is allowed to borrow from the trust without adequate interest or without adequate security [Section 675(2)]



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Benefits of Using a Grantor Trust as an Estate Planning Vehicle



Benefits of Using a Grantor Trust as an Estate Planning Vehicle

- **Freezing Value of Appreciating Property** - freeze value of an asset for determining grantor's total adjusted taxable gifts during lifetime and total value of grantor's taxable estate at death
- **Grantor Taxable on Income** - as the grantor is taxable on the income of the trust, the income tax paid by the grantor is in effect a tax-free gift to the trust beneficiaries
- **Grantor Trust Can Accumulate or Distribute Income Tax-Free** - as the trust pays no taxes on its income, distributions are tax-free to the beneficiaries and accumulations are tax-free to the trust



Benefits of Using a Grantor Trust as an Estate Planning Vehicle

- **Transferring Discounted Income Producing Assets** - a grantor may transfer an already discounted asset, such as an interest in a family limited partnership or family limited liability company, which produces an income stream
 - The income from the transferred asset is taxable to the grantor, and in addition, may be used, in a sale transaction to fund the loan payments on the note to the grantor, and in a GRAT, to fund the annuity payments
- **Grantor Trust Qualifies as an S Corporation Shareholder** - a trust is not a permissible shareholder of S corporation stock, with certain exceptions
 - A trust which is treated as owned by an individual United States citizen is a permissible S corporation shareholder
 - Although other trusts can qualify as S corporation shareholders, a grantor trust is the simplest permissible trust



Benefits of Using a Grantor Trust as an Estate Planning Vehicle

- **Grantor Trust Enables Grantor to Take Deductions and Qualify for Exclusions on Transferred Property** - because the trust is ignored for income tax purposes, the grantor is entitled to the same exclusions and deductions to which he or she would be entitled if the property was held individually
 - grantor is entitled to the Section 121 exclusion of gain from the sale of a principal residence owned by the trust
 - grantor is allowed to take the Section 163(h)(3) mortgage interest deduction with respect to real property owned by the trust



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Income Tax Consequences of Certain Transactions between the Grantor and the Trust



Income Tax Consequences of Certain Transactions between the Grantor and the Trust

For income tax purposes, a grantor trust is ignored as a taxable entity. As a result, transactions between the grantor and a grantor trust will not be taxable.

- **Sale to Grantor Trust** - The Internal Revenue Service's position is that no gain or loss is recognized in transactions between the grantor and the trust when the grantor is treated as the owner of the trust [Rev. Rul. 85-13].
 - Grantor's sale of life insurance policy to grantor trust will be disregarded under "transfer-for-value" rule [PLR 200636086]
- **Interest Payments to Grantor from Trust** - not includable in income by the grantor nor deductible by the trust
- **Rent Payments** - not taxable rental income to the trust; much like income tax payments, they are in effect tax-free gifts to the beneficiaries



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Estate Planning Techniques using Grantor Trusts

Sale to a Grantor Trust
Grantor Retained Annuity Trust
Qualified Personal Residence Trust



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Sale to a Grantor Trust



Sale to a Grantor Trust

- Rather than using the annual gift tax exclusion (currently \$12,000 per donee) or the lifetime exemption (currently \$1 million) to shelter a gift of an asset to a grantor trust, a grantor may instead choose to sell the asset to the trust in exchange for an installment note.
- With a sale, the grantor is able to transfer the future appreciation of the asset without any income or gift tax consequences, and preserve his or her \$1 million exemption for later use during life or at death.



Structuring a Sale to a Grantor Trust

- Include at least one of the grantor trust powers listed in Sections 671-679 in the trust agreement.
- Select the beneficiaries – including the grantor’s spouse as a beneficiary ensures that the grantor will have sufficient assets to pay the income taxes due on trust income
- Select the term of the trust – given the benefits conferred by the trust (and the allocation of generation-skipping tax exemption to the trust), consider creating a perpetual trust
 - Multiple jurisdictions, including Alaska and Delaware, allow a grantor to create a self-settled, asset protection trust, not subject to the applicable Rule Against Perpetuities
 - By using a grantor trust as a dynasty trust, a grantor may transfer appreciating assets for the benefit of future generations, and protect such assets from the creditors of the grantor and of the beneficiaries



Structuring a Sale to a Grantor Trust

- Create some flexibility by giving a beneficiary a limited power of appointment over trust property during the grantor's life
- Selecting the Assets to Sell
 - The best assets to transfer to a grantor trust are assets with a current low valuation that have great appreciation potential
 - Obtain a fair market value appraisal for the assets
 - Corporate stock, limited liability company membership interests, limited partner interests, residences, insurance policies



Structuring a Sale to a Grantor Trust

- Avoid recharacterization as a retained interest by ensuring the sale transaction is respected as such and that the debt is bona fide.
- The following criteria are important in establishing that the debt is bona fide:
 - **Promissory Note:** have a promissory note or other evidence of indebtedness which qualifies as bona fide debt:
 - the amount of the payments should not be based on the amount of income produced by the trust;
 - the obligation should not be chargeable to the transferred property; and
 - the promise should be a personal obligation of the transferee.



Structuring a Sale to a Grantor Trust

- **Interest Rate:** equal to or greater than the AFR and not tied to the potential or expected earnings from the property
- **Payments under the Note:** the payments should be made on time, without regard to the trust's income; if not made, the seller should make demand for payment
- **Repayment Schedule:** the note should have a fixed repayment schedule; balloon notes appear to satisfy this requirement

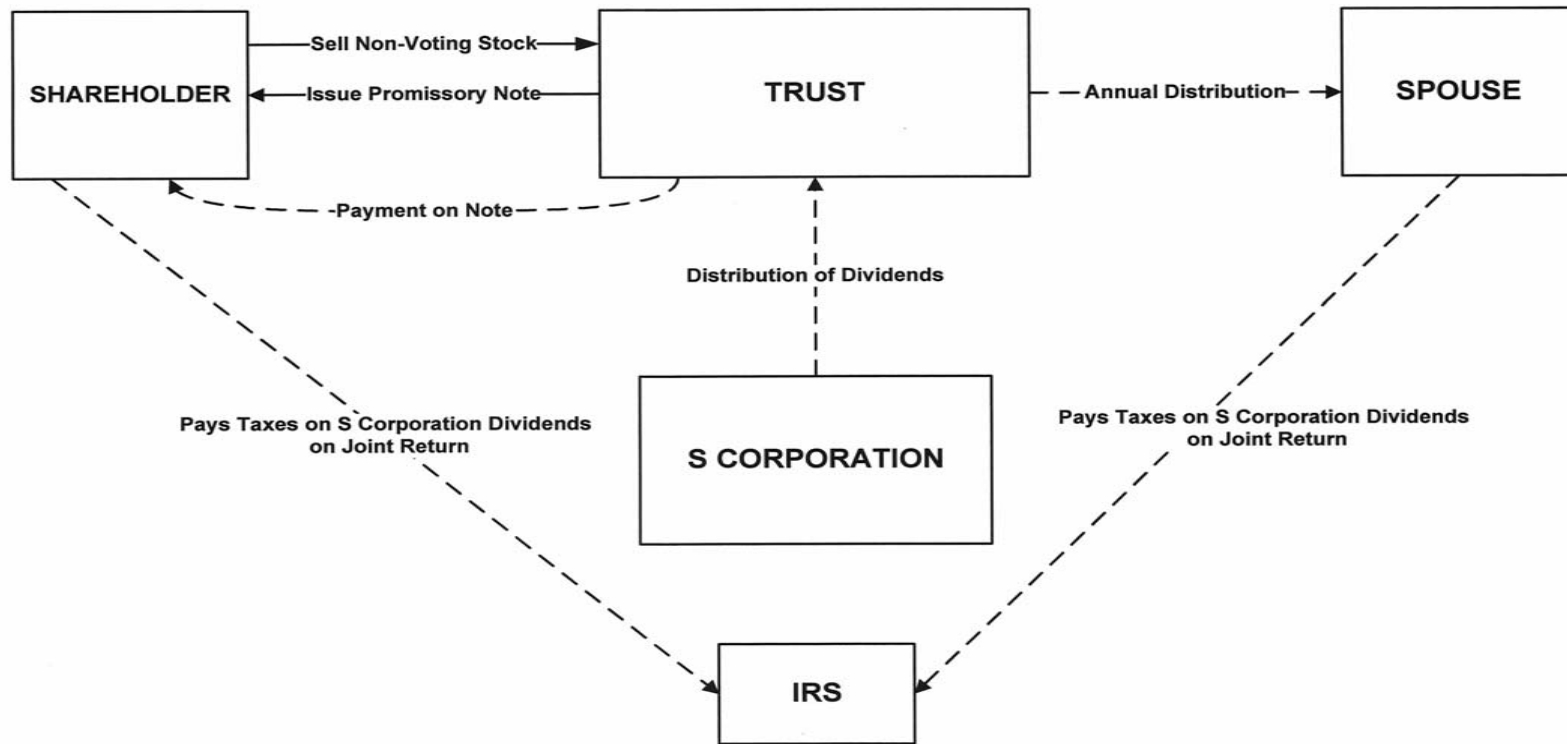


Structuring a Sale to a Grantor Trust

- **Security:** the obligation of the trust should be secured or guaranteed
- **Seed Money:** the trust should have assets, other than the purchased property, equal to at least 10% of the value of the property sold to the trust
- **Beneficiary Guarantees:** if the trust does not have seed money, or sufficient seed money, beneficiary guarantees may be used



SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUST





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Grantor Retained Annuity Trust (“GRAT”)



Grantor Retained Annuity Trust (“GRAT”)

- A GRAT is created by a grantor transferring one or more high-yield assets into an irrevocable trust and retaining the right to an annuity interest for a fixed term of years or for the shorter of fixed term or life.
- When the retention period ends, assets in the trust (including all appreciation) go to the named "remainder" beneficiaries.
- The annuity may be defined by a formula related to the value of the transferred property.
- This ability will allow an adjustment if the value of the property for gift tax purposes is higher than originally reported, the annuity will increase accordingly and prevent a taxable gift by “zeroing out” the transfer.

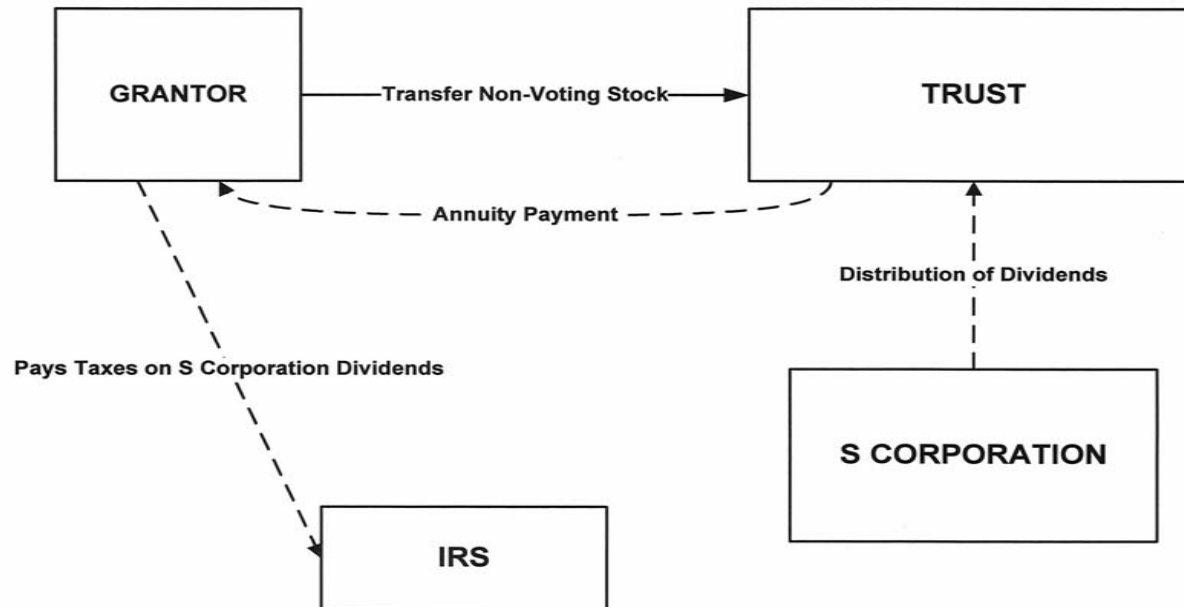


Grantor Retained Annuity Trust (“GRAT”)

- To zero out the GRAT, the annuity must be computed so that over the trust term, the value of the original trust property plus a yield equal to the Section 7520 rate will be returned to the grantor.
- If the trust earns a greater rate, something will pass to the remaindermen without the grantor making a taxable gift.
- The gift tax value of the transferred assets is determined at the time the trust is created and funded using the "subtraction method," by subtracting the value of the annuity interest from the fair market value of the assets transferred in trust.
 - How the annuity interest and any other retained interests are valued depends on who the remainder beneficiaries are and who retains the annuity and other interests relative to the transferor.



TRANSFER TO GRANTOR RETAINED ANNUITY TRUST





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Comparison of GRAT to Sale to a Grantor Trust



Comparison of GRAT to Sale to a Grantor Trust

- The GRAT is statutory, requirements are clear and easy to follow; the sale is not statutory and has greater uncertainty
- In a sale, adjustment mechanisms to prevent a gift if the sold assets are determined to have greater value on audit have uncertain outcome; the ability to zero out a GRAT by formula is certain
- In a sale, the income tax consequences if the grantor dies while the note is outstanding are uncertain
- For sale treatment to be upheld, it may be necessary for the trust to have other assets out of which the note could be satisfied, but how much is uncertain
- The sale, but not the GRAT, may require valuation of the note at inception or at the grantor's death



Comparison of GRAT to Sale to a Grantor Trust

- The GRAT, but not the sale, requires that the grantor survive the fixed term
- GST exemption cannot be allocated to a GRAT until after the GRAT term has ended, using the full value of remaining assets at that time
- The required interest rate on the note in a sale will be lower than the Code Section 7520 rate applicable to a GRAT, resulting in a lower cost to the trust
- For a sale, interest only payments may be made; for a GRAT, each payment includes principal and interest, and may be less affordable



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Qualified Personal Residence Trust (“QPRT”)



How a QPRT Works

- The grantor places a house into a trust reserving the right to use or live in the house for a fixed term of years.
- At the end of the term, the residence passes outright to the beneficiaries (typically, the grantor's children), or alternatively, remains in trust for their benefit.
- The grantor can reserve the right to rent the house back from the trust after the term of years expires, but must pay fair market value rent, which allows the grantor to further reduce his or her estate through tax-free payments to further benefit the trust beneficiaries.
- If the grantor dies before the end of the fixed term of years, however, the trust terminates, and the house comes back into the grantor's estate, where it will be included at its full fair market value.



Leverage of QPRT

- For gift tax purposes, the parent has given away only a “contingent remainder interest” in the house, which is worth much less than the actual value of the house.
- A further discount is allowed because of the possibility that the parent might die before the term of years is up and the children will never get the house at all.
- The IRS regulations dictate what interest rates must be used to value such a gift. When interest rates are high, the gift tax value of a QPRT gift is low. When interest rates are low, the gift tax value is higher.



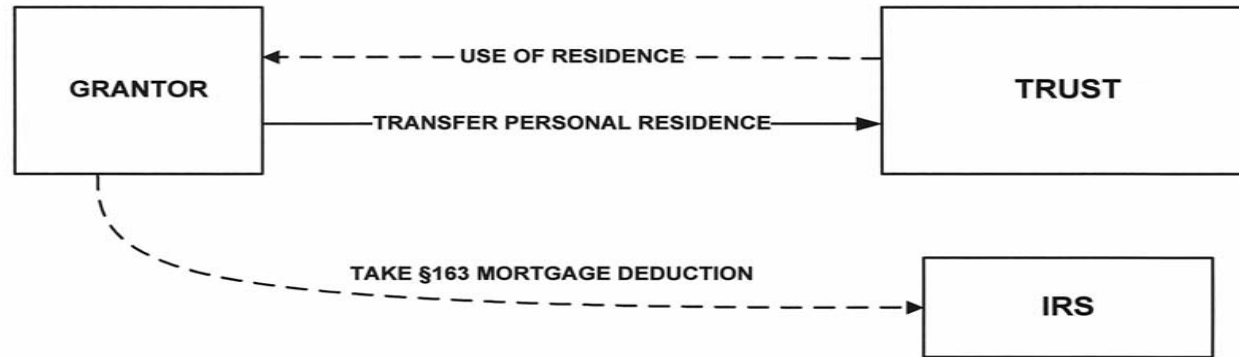
Other Factors to Consider in Creating a QPRT

- If the house has a low income tax basis, and if it is likely the children will ultimately sell the house, the income tax drawbacks can outweigh the estate tax advantages.
- The donor should choose a term of years which he or she is most likely to survive - the way the IRS valuation tables operate, a QPRT “works” to save estate taxes as long as the donor lives to the end of the specified term of years.
- The typical candidate to set up a QPRT is an individual of any age who owns a valuable home and is willing to give the home to his or her children to reduce estate taxes; and whose health is at least average for his or her age group. If the home has a high income tax basis, this candidate is ideal.

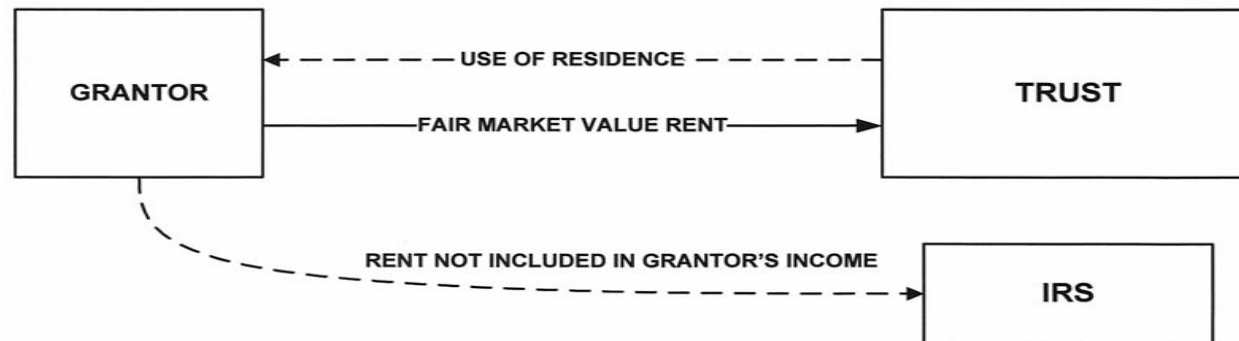


TRANSFER TO QUALIFIED PERSONAL RESIDENCE TRUST

DURING THE INITIAL TERM OF THE TRUST:



DURING THE CONTINUING TERM OF THE TRUST:





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