# FIDUCIARY INCOME TAX BASICS
# AND THE
# USE OF INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

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## PART I - INTRODUCTION TO THE INCOME TAXATION OF TRUSTS AND ESTATES*

A. OVERVIEW

1. Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code (§§ 641-692) sets forth the system, at the federal level, for the income taxation of trusts, estates, grantors and beneficiaries.

2. A primary function of Subchapter J is allocating how the trust or estate and the beneficiaries share the tax attributable to the income.

   a. Like individuals, trusts and estates are taxpayers for income tax purposes and generally must file income tax returns every year.

   b. Unlike individuals, trusts and estates do not always have to pay all the tax on their income. Trusts and estates are entitled to an income tax deduction for certain distributions, and the income tax attributable to the distribution is taxed to the beneficiary.

   c. This income tax system, then, is a hybrid system where trusts and estates are taxed sometimes like individuals and sometimes like conduits, such as partnerships or S-Corps. In any given year a trust or estate may be liable for some, all or none of the tax on its income. But it is also important to recognize that someone is always liable for the tax: if not the trust or estate then one of its beneficiaries.

3. A second function of Subchapter J is to weed out those trusts that are not sufficiently independent from their grantors to be considered separate taxpayers for income tax purposes. Those trusts that are not sufficiently independent are called "grantor trusts" and the income generated by such trusts is taxed to the grantor.

B. THE ENTITY AS A TAXPAYER

1. §641(b) states "the taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part." "*This part*" is §§641-683. Thus, trusts and estates are taxed as individuals unless Subchapter J provides otherwise and it does provide otherwise in the following ways.

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* Part I is adapted with appreciation from an outline originally prepared by Paul E. Van Horn.

2. Compressed Rate Structure:

   a. §641(a) provides for computation of the income tax of an estate or trust under §1(e). §1(e) as modified by §1(j)(2), includes the same tax rates as the individual rates, but the brackets are much smaller, so the move through the brackets is quite rapid. For 2021 trusts and estates will reach the highest bracket of 37% at an income level of $13,050. (An individual needs $523,601 of income to be taxed at the 37% rate). If you figure a trust earns income at a rate of 4% on its assets, a trust with $326,250 of assets will be in the top income tax bracket.

   b. The rationale behind the compressed rate structure was to discourage wealthy taxpayers from engaging in income-shifting games. The ploy would be to scatter income-producing assets to several trusts each of which is a separate taxpayer, resulting in a lower aggregate income tax burden. The fact that trusts are now subject to the highest rate at a very low level severely curtails this practice. In addition, §663(f) will treat multiple trusts created by the same taxpayer as a single trust for tax purposes under certain circumstances. This rationale makes sense for trusts, but not for estates. It is rare that an individual will create an estate simply to minimize taxes.

3. *Special Personal Exemption*: Under §642(b), in lieu of the personal exemption under §151, an estate is entitled to a personal exemption of $600, a trust that is required to distribute all of its income currently is entitled to a personal exemption of $300, and a trust that is not required to distribute all of its income currently is entitled to a personal exemption of $100. Again, the reason for the piddly exemptions is to discourage the creation of artificial taxpayers.

4. *Special Charitable Deduction*: In lieu of the deduction allowed by §170(a), §642(c) provides a special deduction for amounts paid or permanently set aside for a charitable purpose.

   a. Trusts and estates escape the quantitative limits in §170. But the amount must be paid out of the gross income of the entity pursuant to the governing instrument.

   b. Estates are also entitled to a deduction for amounts permanently set aside for charity. Generally, trusts are not entitled to this deduction, unless they are irrevocable trusts created prior to Oct. 9, 1969 that meet certain other conditions.

5. *Depreciation and Depletion*: Estates and trusts may be entitled to a deduction for depreciation and depletion but only to the extent not allocable to a beneficiary.

6. The deductibility of expenses incurred by estates and trusts is subject to the limitation of §67(e).

7. *Amounts allowable as estate tax deductions under §§2053 and 2054*: §642(g) disallows "double deductions" for certain amounts that otherwise would be deductible for both estate tax and income tax purposes. Under §642(g), the income tax deduction is allowable only if the fiduciary files a statement waiving the amount as an estate tax deduction.

8. *The Distribution Deduction.* This is the biggest difference between the income taxation of individuals and that of estates and trusts.

C. THE DISTRIBUTION DEDUCTION

1. Subchapter J contains two separate, but similar, mechanisms for dispensing the distribution deduction and reallocating the entity's tax burden among the beneficiaries. One mechanism appears in §§651-652 and applies to Simple Trusts and the other appears in §§661-663 and applies to Complex Trusts and Estates.

   a. Simple Trust: any trust required to distribute all of its income currently during a taxable year in which it makes no other distributions and does not qualify for a charitable deduction.

   b. Complex Trust: any trust that is not a simple trust. Any estate.

   c. Example: Trustee is required to distribute all income currently and has discretion to make distributions of principal. In any year in which she makes no principal distributions, it will be a simple trust, in any year in which she makes a distribution of principal, it will be a complex trust.

2. *Distributable Net Income.* "DNI" is the key to Subchapter J. The distribution deduction cannot exceed DNI. No beneficiary can be taxed on an amount in excess of DNI. In order to calculate the entity's distribution deduction you first need to compute DNI. In order to calculate the taxable amount to a given beneficiary, you have to compute DNI. DNI is the trust's or estate's taxable income, modified in 6 ways:

   a. Distribution deduction is disregarded. Good thing since you can't compute the distribution deduction without knowing DNI.

b. Deduction for personal exemption is disregarded

c. Capital gains and losses. Generally excluded from DNI. Specifically, capital gains are excluded from DNI if they are allocated to principal (which they almost always are), unless they are "paid, credited, or required to be distributed to any beneficiary during the taxable year" or paid or permanently set aside for charity. However, regs under §643(b) broaden the definition of "income" in response to the movement toward total return and unitrusts. This broadening makes the allocation of capital gains to income more frequent.

d. Extraordinary dividends and stock dividends. In the case of simple trusts only, extraordinary dividends and taxable stock dividends are excluded from DNI if the trustee, acting in good faith, determines them to be allocable to principal under the governing instrument or local law.

e. Tax-exempt interest, less the expense of generating it, is excluded from DNI.

f. Foreign trusts. Section 643(a)(6) contains a special rule for foreign trusts.

3. Taxation of Simple Trusts.

   a. Basic Rule: The amount of income required to be distributed currently is deductible by the trust (whether actually distributed or not), but not to exceed DNI. Additionally, the trust cannot claim a deduction for any amount not includible in gross income. The character of the income passes through to the beneficiaries.

4. Taxation of Complex Trusts and Estates.

   a. Complex trusts categorize their beneficiaries into two groups:

      i. First Tier: beneficiaries (if any) to whom the entity is required to distribute income currently.

      ii. Second Tier: all other beneficiaries. Those who receive any other distributions. In other words, beneficiaries to whom the trustee makes discretionary distributions of income, or beneficiaries who receive distributions of principal.

iii. Basically, the tier system requires that DNI is carried out first by distributions made to Tier 1 beneficiaries, and then, to the extent there is DNI left over, it is carried out and allocated among the tier 2 beneficiaries.

b. There are additional rules to determine whether a distribution "carries out DNI" and is thus taxable to the beneficiary and deductible by the entity.

i. Gifts of specific amounts and general bequests, as long as it is paid all at once or in no more than three installments, such a distribution does not carry out DNI.

ii. Gifts of specific property and specific bequests do not carry out DNI.

iii. Real Estate. A bequest of real estate will not carry out DNI if under local law the title passes directly from the decedent to the devisees.

iv. IRD. Distributions of IRD do not carry out DNI.

c. Separate Share Rule. §663(c).

i. If there are separate and independent economic shares within a single trust or estate, DNI is allocated among the shares. The purpose of the rule is to achieve equitable income tax treatment among beneficiaries of separate shares.

ii. Separate shares exist when the governing instrument and local law create separate economic interests in one or more beneficiaries that do not affect and are not affected by the economic interests of other beneficiaries. The DNI carried out with respect to any given distribution must be properly allocated among a trust's or an estate's "substantially separate and independent shares."

iii. For example: Father's Will leaves half of his residuary estate to Son and half to Daughter. In a year in which the estate's DNI is $100,000, the executor distributes $100,000 to Son and nothing to Daughter. Because Son's and Daughter's shares are separate, $50,000 of the estate's DNI is allocable to each share. Thus, as to Son's share, the estate is entitled to a distribution deduction of only $50,000 and Son is subject to tax on only $50,000. As to

Daughter's share, the estate is entitled to no distribution deduction and Daughter is not subject to tax.

d. Distributions of Property in Kind Distributions of property in kind can carry out DNI, but they only carry out DNI to the extent of the lesser of: (1) the entity's basis in the property, or (2) the fair market value of the property on the date of distribution. But the fiduciary may elect to realize appreciation at the entity level, in which case the distribution carries out DNI to the extent of the fair market value. The beneficiary receiving the distribution takes a basis in the property equal to its basis in the hands of the fiduciary, increased or decreased by any gain or loss the entity realizes as a result of the distribution.

e. Qualified Revocable Trusts. Under §645, the executor of an estate and the trustee of a revocable trust may elect to treat the trust for income tax purposes as part of the estate rather than as a separate trust.

## D. ADMINISTRATIVE ISSUES

1. Taxable Year Strategies:

a. The taxable year of all trusts (except charitable trusts) is the calendar year. Estates may select their taxable year.

b. Distributions made by the trust or estate are deemed made on the last day of its taxable year.

c. Thus, where an estate has a taxable year ending January 31 and distributes $10,000 to the sole beneficiary on February 1, 2021, that distribution is deemed to have been made January 31, 2022, and the individual will not pay the tax attributable to it until April 15, 2023. In other words, strategic estate administration can result in a substantial deferral of income tax.

2. Income-Shifting Strategy:

Some income-shifting is available where an estate distributes principal (for accounting purposes) to a trust, which carries out DNI. Since the trust receives the distribution as principal, it does not have to distribute it to the beneficiaries. (The income is thus "trapped" at the trust level, and the trust will pay the income tax). However, the trustee may decide to distribute some of it, which carries out DNI.

## PART II – GRANTOR TRUSTS:
## NOW YOU SEE THEM, NOW YOU DON'T

A. HISTORY AND CONCEPT

1. The grantor trust rules of §§671-678 were enacted shortly after World War II in order to prevent the shifting within the family of taxable income to lower bracket taxpayers where there was not also a transfer of the underlying economic benefit. Under these rules, if certain direct or indirect "strings" are retained by the grantor, the trust income will be taxed to him rather than the trust (or its beneficiaries), even if he is not a beneficiary of the trust. These rules are completely independent of the rules regarding estate tax inclusion because of retained interests.

2. Under the current lower and compressed income tax rate structure, coupled with the "kiddie tax," there is much less advantage to shifting income within the family. In particular, the compressed rate structure applicable to trusts, whereunder the maximum income tax rate of 37% is reached at only $13,050 of taxable income, discourages the use of trusts as separate taxpayers. Note, however, that the favorable income tax treatment accorded capital gains and qualified dividends tends to make more comparable the income tax treatment of individuals and trusts.

3. However, there are several estate planning techniques that succeed only if a trust is treated as a grantor trust (but not included in the grantor's gross estate). Thus the use of an intentionally "defective" grantor trust (a "DGT," pronounced "dig it", or an "IDGT," pronounced "I dig it") has become an effective estate planning tool, which is particularly ironic because it takes advantage of the very rules which were intended to be used against the taxpayers.

4. As discussed in more detail below, the use of IDGT's for wealth transfer planning purposes has been at times frowned upon by the IRS, but in more recent years has been blessed by the Service. However, the proposed tax legislation currently (as of 9/22/21) pending in the House of Representatives includes a provision designed to prevent the use of grantor trusts to transfer significant wealth without transfer tax consequences. In short, the legislation provides that to the extent that any trust is treated as a grantor trust, the assets of the trust would be included in the grantor's estate, and sales between grantor trusts and their deemed owner would be treated the same as sales between the owner and a third party. The proposal would apply to trusts created on or after the date of enactment and to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment.

The provisions of the proposal are very broad and would indirectly eliminate the use of estate planning techniques otherwise specifically authorized by the code and regulations, such as GRAT's. The author points out that there is a long way to go before Congress passes any tax-increase legislation, and such legislation may well not include the anti-grantor trust provision. However, it is certainly possible, depending in large part on the political climate from time to time, that a provision will be enacted at some point significantly reducing the estate planning benefits of IDGT's – ergo the title of this outline.

B. <u>BENEFITS OF THE IDGT.</u>

1. Because of the rapidity with which trusts reach the highest income tax bracket there will be many instances where grantor trust status will cause trust income to be taxed to the grantor at a lower rate than it would have been taxed to the trust.

2. If a parent makes a completed gift to a trust for children, and the trust has no strings which would cause it to be subject to estate tax, but does have the necessary strings to cause it to be a grantor trust for income tax purposes, all of the income earned by the trust will be taxable to the grantor even though it is distributed or accumulated for the children (or grandchildren).

   a. The result is that the parent is able (in fact, forced) to make what is effectively an additional tax free "gift" each year of the amount of the income tax liability.

   b. In numerous private letter rulings in the '90s, the Service required as a condition of issuing a favorable ruling that grantor trusts contain provisions requiring the grantor to be reimbursed for taxes paid on income in which he had no economic interest.

      i. In PLR 9444033 (8/5/94), dealing with a GRAT, the Service explicitly stated that taxable gifts would occur if there was not mandatory reimbursement, but that under the facts of that ruling there was a reimbursement provision, resulting in a ruling that "the income tax paid by the grantor on trust income not paid to the grantor will not constitute an additional gift to the remainderpersons of the Trust."

      ii. This ruling resulted in a storm of protest over the IRS National Office approach of attempting to "legislate" by private ruling, and about a year later the ruling was reissued as PLR 9543049 (8/3/95) with the taxable gift dictum deleted. In its place there was a simple statement in the fact section of the ruling that the trust contained a provision that "the trustee shall distribute to the grantor, each year during the trust term, the amount necessary to reimburse the grantor for the income tax liability with respect to the income received by the trustee and not distributed to the grantor." Thus, although the position of the IRS appears to have been that taxable gifts should occur when the grantor pays tax on income which he will never get, there was never any published authority stating that position.

c. The Service finally conceded the issue in 2004 with Revenue Ruling 2004-64. In that ruling the Service explicitly held that the payment by the grantor of the income tax resulting from trust income does not constitute a gift to the trust or the remaindermen, because the grantor is merely paying his statutory income tax liability.

i. Ironically, after requiring as a condition of obtaining a private ruling that the grantor retain a reimbursement right, the ruling provided that such a retained reimbursement right would cause inclusion of the entire trust in the grantor's gross estate under §2036(a). However, the ruling provided that such gross estate inclusion would only apply to trusts created after October 4, 2004, well after the issuance of the ruling.

ii. For trusts where the trustee is authorized but not required to reimburse the grantor for his tax liability attributable to trust income not received by him, the ruling provided that there would not be estate tax inclusion unless there was an understanding or pre-existing arrangement that the grantor would be reimbursed, or unless local law would subject the trust assets to the claims of the grantor's creditors.

d. The potential benefits from an IDGT can be enormous. To illustrate, assume: (1) a grantor and a remainder beneficiary (presumably a child or grandchild of the grantor) who both are in a 40% state and federal combined effective tax bracket, (2) an income tax-defective trust that is not estate tax-defective, (3) annual trust taxable income of 4%, all of which is accumulated each year, and (4) a flat combined federal and State estate tax bracket of 50% on the grantor's estate.

i. Given these parameters, a one-time gift of $1,000,000 to the trust will generate "additional" estate tax savings of $8,000 even if the grantor dies immediately after year 1.

ii. This amount is calculated by taking 50% of $16,000, the amount of income taxes paid by the donor on trust income (40% x 4% x $1,000,000). Had the trust not been income tax-defective, the donor's gross estate would have been $16,000 bigger; the estate tax savings are 50% of that amount.

iii. Using this same approach, the aggregate savings over time compounded at 4% grow to more than $600,000 if the donor lives 35 more years.

iv. Note – this is just the estate tax saving from the IDGT status, and does not reflect the estate tax savings from keeping the actual income and growth out of the grantor's estate.

e. What if the benefits are so enormous that the grantor feels he has done enough (or perhaps too much) estate planning and would like to turn off the faucet? This is often the case when a significant tax realization event is about to occur in the trust.

i. If the trust or applicable law permits discretionary reimbursement to the grantor by an independent trustee for the grantor's income tax liability attributable to income not received by the grantor, such reimbursement will have the effect of turning off the faucet for that year.

ii. Depending on the particular basis for the trust's grantor trust status, in most cases grantor trust status can be "turned off" (and in some cases turned back on at a later date).

iii. If a §675(4) reacquisition power (or another administrative power) is the key provision, there seems to be no reason why it cannot be released by the grantor, particularly if the instrument explicitly permits the release of administrative powers.

iv. If the trust is a grantor trust under §674 because certain powers are held by a related trustee, the trustee can resign in favor of an independent trustee (and presumably the independent trustee can later resign in favor of the related trustee).

v. If the defective trust is a "sprinkle" or "spray" trust of which the grantor's spouse and descendants are discretionary beneficiaries, the independent trustee can simply make distributions "upstream" to the spouse sufficient to offset the grantor's unwanted income tax liability. N.B., this is essentially what is now commonly referred to as a SLAT (spousal life access trust). The author often refers to it as a "safety valve" trust

f. Note that similar benefits can be obtained where the grantor does not make substantial gifts to the DGT, but instead lends money and/or sells assets to the trust.

3. Pursuant to §1361(c)(2)(A)(i), a trust which is a grantor trust as to both ordinary income and corpus income (capital gains) is permitted to be a shareholder of an S corporation.

a. Many practitioners incorrectly believe that a Qualified Subchapter S Trust ("QSST") and an Electing Small Business Trust ("ESBT") are the only trusts permitted to be S corporation shareholders.

b. Because of this rule S corporation stock often makes an ideal asset in an IDGT.

4. An otherwise taxable transaction (such as purchase and sale of an asset) between a grantor and a grantor trust will normally be considered a transaction between the grantor and himself for income tax purposes, and thus not a taxable event.

a. The Service has so ruled in Rev. Rul. 85-13. In that ruling the Service stated that it would not follow Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984) where it was held that a grantor trust must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor.

b. CAVEAT: The Service could withdraw Rev. Rul. 85-13 at any time, leaving Rothstein as persuasive authority. However, IRS representatives have consistently stated that no such action is contemplated.

c. Under the holding of Rev. Rul. 85-13, a grantor can buy appreciated assets from the trust without realizing capital gain (although he would of course not get a cost basis on the purchase). This can be particularly effective where the grantor is elderly or terminally ill and the appreciated asset will get a basis step-up at his death. In effect, he is exchanging flat-basis property (cash) for appreciated property of the same value.

d. Based on Rev. Rul. 85-13, and assuming that a GRAT will be a grantor trust (see below), a GRAT can be funded with appreciated property without recognition of gain, and the annuity payments back to the grantor can be made in kind, also without capital gain recognition.

e. Based on Rev. Rul. 85-13, a grantor can leverage the value of a gift if the trustee uses the gift property as a down payment to purchase assets from the grantor on an installment sale basis. In such case there is no capital gain on the sale, and interest paid by the trust to the grantor has no income tax consequences. (See discussion below.)

f. Similarly, if the grantor pays rent to the trust in order to live in a residence owned by the trust (thus avoiding the application of §2036), the rent payment will have no income tax consequences.

5. The Service has consistently ruled that the advantages of home ownership, such as the ability to deduct real estate taxes and mortgage interest, and the right to a capital gain exclusion under §121, flow through to the grantor where the home is owned by a QPRT or other grantor trust.

6. Pursuant to <u>Swanson v. Commissioner</u>, 518 F.2d 59 (8th Cir. 1975), a sale of a life insurance policy to the insured's grantor trust will be considered a transfer to the insured and thus will not be a transfer for value, permitting the ultimate life insurance proceeds to be excludable from income tax under §101(a)

## C. <u>METHODS OF MAKING A TRUST A DGT.</u>

1. Under §675(4)(C) the trust will be a grantor trust if the grantor (or another person) in a nonfiduciary capacity has a "power to reacquire the trust corpus by substituting other property of an equivalent value."

a. This is very simple to use, particularly in a routine trust for children and other family members.

b. This power should be avoided in QPRT's because it would violate the regulations prohibiting repurchase, and should also be avoided in irrevocable life insurance trusts to avoid giving the grantor any incidents of ownership.

c. If the grantor is considering purchasing appreciated assets from the trust at a later date a reacquisition power would allow him to do so even without the consent of the trustee.

d. If terminating the grantor trust status becomes desirable, this power could presumably be renounced without adverse tax consequences.

e. There are many outstanding older private rulings holding that a §675(4)(C) power causes grantor trust status. However, although the Service has not in any published guidance determined that a §675(4)(C) reacquisition power does not cause grantor trust status, there is a longstanding ruling policy that the effectiveness of such a power will not be approved in advance, and will depend on whether the facts and circumstances surrounding the creation and administration of the trust show that the power is exercisable in a nonfiduciary capacity. It is unclear what facts and circumstances will carry the day on this question, but perhaps the grantor should make some nonfiduciary reacquisitions just to establish a pattern.

f. Note that the sample grantor charitable lead trust forms issued by the IRS in 2007 (Rev. Proc. 2007-45) utilize a §675(4)(C) substitution power, exercisable only in a nonfiduciary capacity, to cause grantor trust status, but, consistent with the ruling policy, the annotations to the forms state: "The circumstances surrounding the administration of a CLAT will determine whether a § 675(4) substitution power is exercised in a fiduciary or nonfiduciary capacity. This is a question of fact." Interestingly, the substitution powers in the IRS sample forms are given not to the grantor, but to an individual other than the donor, the trustee or any disqualified person. Presumably this was to avoid the issue of whether a retained § 675(4) substitution power creates estate tax inclusion problems – an issue dealt with directly the following year.

g. The case of Jordahl v. Commissioner, 65 T.C.92 (1975), was traditionally cited, with some reservation, for the proposition that the inclusion of a §675(4)(C) reacquisition power will not result in estate tax inclusion. However, in 2008 the Service went further than Jordahl in Revenue Ruling 2008-22, explicitly providing that "a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries."

h. Although the use of a §675(4) power now appears to be an easy, painless and definitive way to achieve grantor trust status in most cases, the author suggests that its nonsubstantive nature leaves it vulnerable to future challenge or revision, and that it is always desirable, if feasible, to have a more substantive provision as the basic "trigger" for grantor trust status.

2. Under §675(2) a trustee's power to permit the grantor to borrow without adequate interest or security causes grantor trust treatment. However, care must be taken in using this technique because of the danger that the retained strings might be sufficient to inadvertently cause estate tax inclusion.

3. Under §674 the trust will normally be a grantor trust if related or subordinate trustees (spouse or siblings, e.g.) have the power to sprinkle or spray income and principal among various beneficiaries. This can be a very effective technique with significant non-tax consequences, and thus avoids the artificiality of the §675 powers. The section requires that the related or subordinate parties be subservient to the wishes of the grantor, but §672(c) presumes such subservience absent a preponderance of evidence to the contrary.

4. If a non-adverse party (other than the grantor) has a power to add beneficiaries (other than after-born children) the trust will be a grantor trust.

    a. The power to add charitable organizations as beneficiaries appears to be sufficient. See Madorin, 84 T.C. 667 (1985).

    b. In Madorin the Court also held that the trustee could renounce his power and thus terminate grantor trust status.

    c. If a trust is a completely discretionary trust, i.e., no beneficiary is entitled to any distribution of income or principal except in the exercise of the trustee' discretion, the author questions whether the power to add beneficiaries to the class of permissible beneficiaries has sufficient substance to trigger grantor trust status.

5. Merely making the spouse a discretionary beneficiary where an independent trustee can sprinkle or spray income and principal to her will trigger grantor trust status pursuant to §677(a), and probably also under §676(a), coupled with §672(e). This also can have significant non-tax advantages by providing a "safety valve" through which assets can pass back upstream if necessary. A drawback to this technique is that the death of the spouse (or a divorce) would cause the termination of grantor trust status. For this reason there should generally be another grantor trust "trigger," such as a §675(4) reacquisition power. Another drawback is that gifts to the trust do not qualify for "gift splitting" pursuant to §2513, because the property that will ultimately pass to recipients other than the grantor's spouse cannot be ascertained. See PLR 200551009.

6. A QPRT will be a wholly grantor trust as to income because of §677(a) and as to principal because of the contingent reversion covered by §673(a), so long as the value of the reversion is at least 5% of the entire corpus value. This will be the case unless a relatively young grantor establishes a relatively short QPRT.

7. Under what was previously the ruling position of the Service (see, e.g., PLR 9504021 (1/27/95)), a GRAT should be a wholly grantor trust because of §677(a), on the rationale that payment of both income and principal might be necessary to satisfy the annuity obligation. However, the Service is no longer issuing rulings on that issue.

8. Under §677(a)(3) a trust will be a grantor trust if the income may be used to pay insurance premiums on the grantor's life. However, notwithstanding the explicit provisions of the section, it has been held to apply only where there are in fact insurance premiums being paid by the trust, and the Service has a long standing non-ruling policy on this issue.

9. Under §679(a)(1) a trust will be a grantor trust if it is a foreign trust and has a U.S. beneficiary for the year in question. Under §§7701(a)(30) and (31), as amended by the Small Business Job Protection Act of 1996, trusts which might appear to be routine domestic trusts may in fact be considered foreign trusts merely because of having a foreign trustee.

10. It should be noted that none of the above techniques will cause the trust to be included in the grantor's gross estate, but care must be taken not to inadvertently include other "strings" which would cause inclusion.

D. INSTALLMENT SALE TO DEFECTIVE GRANTOR TRUST.

1. The installment sale to a DGT is an effective way to leverage the amount of a gift and thereby allow a trust for descendants to obtain the benefit of future growth on a larger asset base than would be the case through the use of a straightforward gift.

   a. In substance, the trust is borrowing funds from the grantor at the lowest permissible rate under §7872, in order to purchase assets that are expected to yield a higher total rate of return.

   b. The installment sale to a DGT is often compared to a GRAT, in that both involve a transfer of assets for a fixed and determined series of payments. In the case of a GRAT, however, the §7520 rate must be used in determining the annuity amount, which is less advantageous than the lower §7872 rate.

2. The following example illustrates the structure of a typical installment sale to an IDGT.

a. The grantor creates a DGT for the primary benefit of his grandchildren. He makes it a totally discretionary sprinkle trust as to both income and principal, and names his wife as trustee.

b. The grantor initially funds the trust by making a gift of $2,000,000 cash. This will of course be reported on a gift tax return. Gift splitting will be elected and GST exemption will be allocated.

c. Subsequently, the trust purchases from the grantor a 40% interest in the grantor's business, which is an S corporation. The 40% interest is appraised by a professional business valuation firm at $6,000,000, after applying applicable minority and lack of marketability discounts. The trust pays a $1,200,000 down payment, and signs a $4,800,000 purchase money note for the balance, with interest only payable for the first five years (at the appropriate applicable federal rate), and the principal to be paid at the rate of $800,000 per year for the following six years. The note permits prepayment of principal without penalty.

3. This transaction would result in the following significant estate planning benefits.

a. All the income and growth on the trust's assets (net of the interest payable to the grantor) will escape taxation in the estate of the grantor (or his wife). So long as the total rate of return on the purchased stock exceeds the interest rate, the use of the installment sale will achieve better results than simply giving a smaller percentage interest in the company to the trust.

b. Because of the grantor trust status, all of the trust's gross income, including the trust's distributive share of S corporation income, and any capital gains realized upon the sale of the business to a third party, will be instead taxed to the grantor and reportable on his Form 1040.

4. Note that because the installment sale is for the fair market value of the asset as determined by a professional appraiser, there is no requirement that the transaction be reported on a gift tax return. However, in that case there will be no running of the statute of limitations on the Service's ability to challenge the accuracy of the appraisal and assert that a taxable gift was made. Note also that pursuant to Revenue Ruling 85-13, the transaction is not recognized for capital gain purposes, and will not be reported on an income tax return.

5. In the event that the grantor dies during the term of the installment note, thus terminating the grantor trust status, the income tax consequences are not clear. It is the author's opinion that, since the sale was consummated at a time when Rev. Rul. 85-13 applied, and the concept of installment sale treatment for income tax

purposes was inapplicable, the post-death principal payments on the note would not have any income tax consequences. The trust would of course continue to have the grantor's original basis (subject to any routine post-sale adjustments) and would not be entitled to a new basis either because of the sale or because of the grantor's death. Also, any post-death death interest would be subject to the normal rules as to both taxability and deductibility. Some practitioners have suggested that post-death installment payments would be subject to capital gains tax (with a corresponding step-up in the trust's basis), and a suggestion has even been made (without justification, in the author's opinion) that the entire transaction (including pre-death installments) would be subject to tax upon the grantor's death.

6. There is a concern that if the trust has no capability of making the note payments other than out of the income to be generated by the purchased asset, the grantor might be deemed to have retained an income interest in the trust for purposes of §2036. Accordingly, it is prudent to keep a "cushion" of cash or liquid assets in the trust so that there will be an independent source of payment of the trust's note obligations for a reasonable period of time. This should avoid the §2036 or §2702 exposure.

7. As with any other DGT, the grantor can at any time prior to his death purchase appreciated assets from the trust for their then fair market value without any capital gains recognition, and can thereby cause those assets to pass through his gross estate and receive a stepped-up basis pursuant to §1014.

8. If considering a sale to a DGT, also consider using a zeroed-out GRAT, which also provides for the gift-tax-free transfer of future growth to a lower generation. Perhaps the biggest advantage to using a zeroed-out GRAT in connection with hard-to-value assets is that a revaluation by the IRS upon audit will mandate larger annuity payments back to the grantor, but will not result in a substantial taxable gift. On the contrary, a revaluation of property sold to a DGT will ordinarily result in a dollar-for-dollar increase in taxable gifts, with potentially disastrous consequences.

## E. <u>CLOSING THOUGHTS</u>

1. The estate planning benefit of almost any trust can be enhanced by structuring it as an IDGT.

   a. A typical inter vivos trust used as a vehicle for making gifts to use a client's applicable exclusion amount is made all the better if it is a grantor trust. Not only is the value of the remainder enhanced by the grantor's obligation to pay the income tax liability, but the ability of the grantor to purchase appreciated assets without capital gain recognition, and the ability of the grantor to enter into other transactions with the trust without income tax consequences, are very powerful. Lastly, the punitive trust income tax rates on undistributed income can be avoided.

b. These techniques are so taxpayer friendly that they have attracted the attention of an administration sensitive to closing loopholes. It is very possible that they will not last forever. However, unless and until Congress takes action to the contrary, the IRS has conceded that it has no basis on which to challenge their use.