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TRUSTS AND ESTATES FORUM

There's Nothing Defective About A Grantor Trust

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The rage of the tax planning community over the past few years has been a technique involving an installment sale to an "intentionally defective grantor trust." What's it all about? And why would anyone want a "defective" trust? This article will review this strategy, with an analysis of its continued viability in light of recent case law.

First, some background and observations on nomenclature. In tax vernacular, a "grantor" trust is one that is disregarded for income tax purposes. The trust's income, deductions, credits, and losses are treated as if received by or paid by the grantor of the trust (typically the settlor). I.R.C. §§671 – 678; Reg. 1.167-2(c)**.** While for income tax purposes the trust is disregarded, for transfer tax purposes (gift, estate, and generation-skipping tax), the trust is respected, and in fact, it is possible for the grantor to make a completed transfer to such a trust for transfer tax and property law purposes while at the same time retaining the income tax responsibilities.

Until the Tax Reform Act of 1986 changed the income tax rates for trusts, most taxpayers went to great lengths to establish trusts that were not grantor trusts, so that the income on the trust assets would be (at that time) taxed at the trust's lower income tax rates. Occasionally, such a trust would inadvertently be drafted with a provision (i.e., a "defect") which, under the grantor trust rules, would cause the trust to be a "grantor" trust and the income would be taxed to the grantor, contrary to the intended result. After the tax rate change, however, it actually became more beneficial in some cases to have a grantor trust rather than a trust which would be taxed independently, and so, many trusts designed to save estate or generation-skipping tax, for example, are intentionally structured as grantor trusts.

That the use of a grantor trust in the context of the installment sale transaction is now referred to (by some) as "defective", is as unfortunate as it is inappropriate. The transaction contemplated in this discussion requires a trust to qualify as a grantor trust. The term "defective grantor trust", then, would have to mean that the trust is not a true grantor trust on account of the "defect", and the plan would fail. Accordingly, we will refer to the trust in proper fashion as simply a grantor trust.

So how does the technique work? Simply stated, the grantor establishes an irrevocable trust with family members (or other individuals) as the trust beneficiaries, and in an arm's-length transaction sells assets (typically income producing property) to the trust in exchange for the trust's installment promissory note, calling for periodic interest and a balloon principal payment at maturity. The trick is to use specific provisions to render the trust a grantor trust without saddling the grantor with prohibited powers that might cause estate tax inclusion. Consider, for example, giving the grantor or a non-adverse person (not a fiduciary) the power to reacquire trust property by substituting other property of an equivalent value. I.R.C. §675(4)(c). The odd result is that the sale to the grantor trust is not recognized for income tax purposes because the trust is disregarded, and no income tax consequences can result when a taxpayer makes a sale to himself. Rev. Rul. 85-13, 1985-1 C.B. 184. That is, even though a legally binding, arm's length transaction has taken place, the grantor does not realize capital gain on the sale to the trust, and the interest payments to the grantor are not income, although the grantor remains taxed on the income produced by the trust property under the grantor trust rules. The effect is to freeze the value of the asset transferred for transfer tax purposes. Additionally, if the income earned by the trust property exceeds the interest payments, the excess income inures to the benefit of the trust beneficiaries, even though taxed to the grantor.

Note that the trust would acquire a cost basis in the assets which would likely be lower than if the grantor retained the assets until death and the "step-up" basis rules of I.R.C. §1014 applied (assuming death did not occur in 2010, the year of estate tax and "step-up basis" repeal under the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16).

As a simple illustration, say that Max has rental real estate appraised at $1 million, with a cost basis of $400,000 and no mortgage. The cash flow after all expenses is $85,000 per year. Max establishes an irrevocable trust for the benefit of his 3 children, and the trust contains provisions which cause it to be a grantor trust as to Max. He contributes $100,000 to the trust between December and January (allowing his and his spouse's $11,000 annual gift tax exclusions to render the gifts tax free). Subsequently, he sells the property to the trust for $1 million, in return for the trustee's promissory note (and mortgage) for $1 million, with interest at 6% per annum payable quarterly and a balloon principal payment in 2008.

The sale to the grantor trust will produce no capital gain to Max and there will be no tax to him on the interest payments on the note. The net rental income, however, will be taxed to Max and he would be entitled to the same deductions he enjoyed on the property before the sale to the trust. Nevertheless, it is important to remember that the sale is a "real" sale for all other purposes, so that the trust is the legal owner of the real estate and Max only owns the note, which has a fixed value. Thus, if the real estate has appreciated to, say, $2 million, by Max's death, the $1 million appreciation escapes estate tax.

The installment sale to a grantor trust was first envisioned as a method to avoid the special valuation rules of I.R.C. §§2701-2704. See Michael D. Milligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 1 (January 1996). Under those provisions, when a person gratuitously transfers property into trust for the benefit of certain family members and retains an interest in the property (such as an income interest for a term of years), the value of the retained interest will be deemed to be zero, with the result that the value of the gift of the remainder to the trust beneficiaries would be deemed to be the full fair market value of the property transferred. To avoid this harsh result, I.R.C. §2702 permits the use of a "grantor retained annuity trust" (GRAT). Under a qualified GRAT, the grantor's contribution to the GRAT is reduced by the present value of the annuity payments, thus lowering the value of the gift. In comparing the economics of a GRAT with those of a sale to a grantor trust, it is important to note the difference in the "assumed rate" that must be used for tax purposes. With the GRAT, however, the grantor's total contribution to the trust is calculated to earn income at least equal to the I.R.C. §7520 rate, which is 120% of the federal midterm rate as determined under I.R.C. §1274, whereas with the installment sale to a grantor trust, the income payments may instead be measured by the (typically) lower I.R.C. §1274 rate, which increases the chance that the trust property will produce income in excess of the required payments, and thus the amount left in the trust at the end of the term will far exceed the amount of the sale price.

In addition to the higher interest rate, a GRAT was considered disfavored because of the IRS's position that the GRAT could not be "zeroed-out". A zeroed-out GRAT is one in which the value of the grantor's retained annuity interest equals the value of the property transferred into trust (leaving a remainder valued at zero), so that no gift occurs upon the funding of the GRAT. The IRS position was that a gift must always occur on the creation of a GRAT because the value of the retained annuity interest must always be reduced below the value of the asset transferred due to the possibility that the grantor died within the retained annuity term. Reg. 25.2702-3(e), Example 5. If a GRAT could not be zeroed out, transfers to a GRAT involving property worth millions of dollars could trigger a significant gift tax, thus the installment sale, even with its required balloon payment of principal, was considered by many planners as a better deal.

This position now requires rethinking in light of the Tax Court's recent Walton decision which rejected the IRS view and sanctioned a zeroed-out GRAT. Walton v. Commissioner, 115 T.C. 589 (2000). If grandchildren are involved, the installment sale to a grantor trust remains the preferred technique because of the grantor's ability to allocate generation-skipping transfer ("GST") tax exemption to the trust property upon creation of the irrevocable grantor trust (to the extent there is a gift which is a generation-skipping transfer), as opposed to such allocation being effective for a GRAT only upon the expiration of the retained annuity term (and likely at a much higher tax cost). However, if generation-skipping is not an issue, the zeroed-out GRAT may be preferable to the installment sale to a grantor trust because of the perceived requirement that the grantor trust be seeded with additional property separate and apart from the sale property.

The reasoning behind the "seed" position is that if the only asset in the grantor trust is the sale property, the installment sale looks as if the grantor transferred property to the trust and retained the right to the income from that property (in the form of interest payments) in a manner which might trigger inclusion of the trust property in the grantor's estate under I.R.C. §2036(a)(1); PLR 9251004. By gifting cash or other property into the grantor trust prior to the sale, the income used to pay the interest on the installment note is not directly traceable to or solely dependent on the sale property. Commentators generally believe the grantor should gift property valued at about 10% of the sale property, although there is no magic in this subjective determination. If <u>Walton</u> is correct and it is possible to form a GRAT without making a taxable gift, and if the grantor believes the trust property will outperform the higher I.R.C. §7520 rate, then the GRAT may be preferable over the installment sale so that the taxpayer not only avoids making a taxable gift, but also avoids another potential tax problem discussed below.

It is impossible here to address all the issues attendant to the installment sale to a grantor trust, such as the tax effect of trust provisions which reimburse the grantor for the grantor's payment of the income tax on the income earned by the grantor trust (and the failure of the grantor to enforce reimbursement), and the requirement that the installment note be characterized as true "debt" rather than "equity" which itself triggers the debate on whether or not the installment note should be secured. However, one persistent area of concern involves the tax consequences of the death of the grantor prior to the payment or other discharge of the installment note. The general concern is that the death of the grantor terminates grantor trust status, and may trigger the realization of capital gain to the grantor's estate as if the grantor received the full proceeds, but without the corresponding advantage of allowing the trust a step up in basis. I.R.C. §1014(a).

The concern centers around a Regulation, a Revenue Ruling, and a Tax Court case which all appear to hold that the termination of grantor trust status should be treated as a transfer of the trust property from the grantor as the "owner" of the property to the trust as the new owner, with such transfer being a taxable event resulting in the realization of gain to the grantor, specifically where the grantor is relieved of liability for debt as a result of the deemed transfer. Reg. §1.1001-2(c), Example (5); Madorin v. Commissioner, 84 T.C. 667 (1985); Rev.Rul. 77-402, 1977-2 CB 222. From the standpoint of the principals of our tax system, this reasoning appears to have merit, but aside from the authorities cited (which are not directly on point) there are neither rulings nor cases that eliminate all doubt.

Of course, the issue of a potential gain on the grantor's death can be avoided by paying off the note during the grantor's lifetime, so there is no debt at the grantor's death. Even if there is a gain recognized at death, the income tax due will be a debt of the grantor's estate and therefore deductible, possibly reducing estate tax. And if all this isn't confusing enough, it is also important, if not interesting, to note that in both the GRAT and the sale to the grantor trust, the ultimate owner of the property (the transferee) will have an initial cost basis in the property equal only to the grantor's basis, so that a sale after the term of the GRAT or after the sale to the grantor trust will likely produce a large capital gain.

As is usually the case in estate planning, nothing is simple. Post-Walton the careful advisor will explore both the GRAT and the installment sale to the grantor trust whenever advising a client who owns rapidly appreciating income-producing property, and a taxable estate. And if nieces, nephews, or unrelated individuals are potential transferees, then there is even another alternative to the GRAT because such transfers are not covered by the special valuation rules, and the comparison is between the installment sale and a traditional grantor retained interest trust, or "GRIT". But we'll leave that for another day.

[*The authors acknowledge that with the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, new I.R.C. §2511(c) raises the issue of whether post-2009 it will be possible to make a completed gift to a wholly owned grantor trust. While I.R.C. §2511(c) may have implications for the techniques discussed here, the meaning (and future) of this Section is in doubt and therefore does not merit consideration at this time*.]