The Estate Planner's Passthrough or Passback Entity of Choice – the Grantor Trust (Part Two)

1. A Tree is not a Tree When You call it a Bush

This column discussed in the ________edition of the JPTE the importance of the irrevocable grantor trust, set up during the grantor's lifetime, in the context of the recent Revenue Ruling, 2008-22. This month, the column discusses the estate tax strategies for which the grantor trust planning should be considered, including lifetime use of the applicable credit amount, the qualified personal residence trust (QPRT), postmortem use of grantor trusts in the credit shelter trust context, grantor retained annuity trusts (GRATs), and sales to a grantor trust.

2. Better to Give Now than die with It: Lifetime Use of the Applicable Credit Amount

In a straight gifting situation, in which the grantor gifts property equal to or in excess of the applicable lifetime gifting credit amount ($1,000,000 in 2009), a gift to a grantor trust is preferable to a gift outright. For example, if a gift is made outright of appreciated assets, the donees will realize the capital gain in the future when the assets are sold. However, if the gift is to a grantor trust for income tax purposes, in which the grantor retains no interest other than that necessary to make it a grantor trust, then future capital gains can be reallocated from the trust -- the donees -- to the grantor. In addition, ordinary income and other taxable income incurred annually can be allocable to the grantor of the trust. This has the effect of increasing the estate tax free property in the hands of the donees while decreasing the estate includible property in the hands of the donor.

This strategy, straightforward as it may seem, was viewed as so egregious by the Service that it tried to stop it by issuing PLRs 94-44033 and 95-04021. In those rulings, the Service ominously hinted that in a GRAT, the grantor must be reimbursed for any income tax allocable to the grantor (because of the grantor trust status) but attributable to trust corpus (e.g., capital gains).

The reasoning of the rulings was too contrary to the well established grantor trust rules of the Code. After much criticism of its approach, the Service within twelve months repealed the rulings and in effect indicated that the payment of income taxes by the grantor of a grantor trust would not be treated as a taxable gift.[1] As discussed in the _____column, Revenue Ruling 2008-22 continues to evidence the Service's validation of this technique.

[1] 95-43049 (The Service actually withdrew the ominous paragraph in PLR 94-44033.)

3. **Qualifying a House as Not Yours (QPRTs)**

The qualified personal residence retained interest trust (often referred to as "a QPRT"[2]) is a retained interest trust funded with a personal residence.

Because a QPRT is irrevocable and the grantor retains no right to alter the terms of the trust, the transfer of funds to the trust is a completed gift.[3] The value of this gift for gift tax purposes is the value of the property transferred less the value of the grantor's retained interests.[4] The grantor's retained interests are the right to receive the use of the property for a certain number of years, or for a period ending on the first to occur of the grantor's death or the expiration of the term of years. The grantor may also retain a reversion in or general power of appointment over the property if the grantor dies prior to the expiration of that certain number of years. The greater the value for gift tax purposes of these retained interests, the lower the value of the taxable gift.

If the grantor survives the term of years during which she has the retained interests, the remaining property in the trust passes to the beneficiaries, free of additional gift or estate tax. The only estate or gift tax cost associated with the transfer is the gift tax imposed at the time the trust was established.[5] If the grantor dies prior to the expiration of his or her retained property interest, then all of the then value of the trust is included in the grantor's gross estate pursuant to section 2036(a)(1) if the retained property interest was an income or use interest.[6]

During the retained interest term, the trust is automatically a grantor trust. This is important should the residence be sold and there is a capital gain. In that event, the exclusion

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[2] Treas. Reg. § 25.2702-5(b). If the trust holds both a personal residence and cash, or the document allows for the sale of the personal residence during the retained interest term or conversion of the trust to a grantor retained annuity trust, this is formally referred to as a "qualified personal residence trust," Treas. Reg. §25.2702-5(c).

[3] Treas. Reg. § 25.2511-2.

[4] For gift tax purposes, a gift is technically incomplete as to the value of that portion of the interest transferred which is retained by the grantor. Id.; See also Treas. Reg. §§ 25.2511-1(e), 25.2511-1(h) (7).

[5] Technically the gift is of the remainder interest, which is a future interest. Therefore, the gift does not qualify for the gift tax annual exclusion. I.R.C. § 2503(b).

[6] I.R.C. § 2036(a) (1). Section 2036(a)(1) includes in the value of a decedent's gross estate the value of all property which the decedent has transferred for less than full and adequate consideration under which the decedent has retained the enjoyment of or income from the property. Inclusion in the gross estate may also be mandated by section 2037(a). Generally, section 2037(a) (2) includes in the value of a decedent's gross estate the value of all property which the decedent has transferred for less than full and adequate consideration, under which the decedent retained a reversionary interest in the property which exceeded 5 percent of the value of the property immediately before the decedent's death. There is no three year rule pursuant to section 2035 of the Code when the grantor's income or reversionary interest expires. This is because there is no "transfer" at that time; it is merely treated as a "lapse."

under section 121 would apply to eliminate the first $250,000 (or $500,000 if the grantor is married) of the gain because of the grantor trust status.

After the retained term, the grantor of the trust will often desire to retain use of the trust. This is almost an automatic assumption in the case of personal residences transferred to a QPRT. In that event, the grantor must pay fair market value rent, to avoid adverse estate tax consequences with residing there.[7]

The payment of rent will be another means to transfer property to the beneficiaries without additional gift tax concerns. Ordinarily, however, the payment of rent results in taxable income to the lessor, the children.

If the trust is structured as a grantor trust after the retained term expires, the payment of rent will be between the grantor and the grantor trust. Under the reasoning of revenue ruling 85-13,[8] this is a non recognition event for income tax purposes. As a result, the grantor will pay rent -- a tax free transfer to the remainderpeople of the QPRT -- without having that rent treated as taxable income.

4. **Looking Ahead: Post Mortem Use of Section 678**

The grantor trust strategy should be considered in credit shelter trusts. The concept behind the credit shelter trust is to allow the $3,500,000 amount (reduced by any lifetime use) to pass free of estate tax at both the passing of the first spouse and the subsequent passing of the surviving spouse. The $3,500,000 amount will pass to the credit shelter trust free of estate tax at the first spouse's death because of the applicable credit amount. Upon the death of the surviving spouse the credit shelter trust will pass free of estate tax because it is not part of the surviving spouse's estate. In fact, as long as the credit shelter trust remains in existence, it will not be subject to estate taxes.

If the spouse is a beneficiary of the credit shelter trust this **does not** preclude the spouse from acting as trustee. However, if the spouse acts as trustee, the standard of principal distributions needs to be limited to an ascertainable one relating to health, support, maintenance or education.

Ideally, the goal of a credit shelter trust after the first spouse has passed away and the trust has been created is to accumulate wealth in the trust that will be passed on free of estate tax at the surviving spouse’s passing. To the extent the trust generates income, and the income taxes are paid out of non trust assets -- e.g., by the surviving spouse out of his or her assets -- this

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[7] See, e.g., PLRS 98-29002 and 98-27037. See also Rev. Rul. 70-155 and Estate of McNichol, 265 F.2d 667 (1959).

[8] The importance of revenue ruling 85-13 is to the grantor trust strategy in much the same way as section 2056 is to the marital deduction. It is the pivotal authority underpinning the planning strategies. The ruling, in essence, reflects the Service’s view that transactions between a grantor, individually, and that person’s grantor trust, are to be ignored. Revenue Ruling 85-13 did not accept Rothstein v. United States, 735 F.2d 704 (1984), which had held to the contrary.

increases the estate tax free amount in the credit shelter trust, at the cost of decreasing the estate taxable amount held by the surviving spouse. This is an excellent result from an estate tax reduction perspective.

The strategy involves the surviving spouse acting as trustee of this type of trust. If the surviving spouse is the trustee and a beneficiary, the question is whether the literal language of Code section 678 is met:

> “A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."

Treasury regulation section 1.678(b) provides that"[s]ection 678 treats a person as an owner of a trust if he has a **power** exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations" (emphasis added).

The issue arises in the typical language in the credit shelter trust providing the surviving spouse, as trustee, with the right to distribute income or principal to the surviving spouse if needed for that spouse's "health, support, or maintenance." The power to pay pursuant to this standard would encompass that spouse’s creditors, and fall within the language of the above cited regulation. Further, the right to distribute income or principal to oneself is perhaps the power to vest the corpus or income in that person.

The argument to the contrary is that the power is not exercisable unless the standard of distribution is met, e.g., the spouse is in need of the funds pursuant to that standard. In that event, although the trust would be a grantor trust, it would also arguably be included in the gross estate under section 2041.[9]

The issue also becomes important if the credit shelter trust is holding a personal residence. In that situation, the need to be a grantor trust is highlighted by the residence exclusion under section 121.[10] A non grantor trust would not be entitled to this exclusion. A grantor trust should, however, be entitled to the exclusion.

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[9] Although the surviving spouse can act as trustee of a credit shelter trust with an ascertainable standard relating to health, support or maintenance (or related standard), without running afoul of the section 2041 power of appointment rules, there is one important caveat. If the standard of distribution is met, and the trust is drafted in a way that would mandate the distribution of funds if the standard is met, arguably the funds are de facto distributable to the spouse and included in that spouse’s gross estate under either section 2041 or 2033. Not to worry, the Service has not yet made this argument.

[10] I.R.C. § 121. Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating two years or more. See Rev. Rul. 66-159; PLR 90-26036.

The case law is not enlightening on this area. A conservative route is to assume that grantor trust status does not apply. However, the practitioner should not the argument to the contrary.

5. **Better Than a Federal Bailout of the Car Industry-GRATs**

With the stock market dropping faster than the Chicago Cubs in the MLB pennant race, are all of our wealthy clients out there doing what they should be doing — GRATs? Nope, because there is a Catch 22 — clients feeling less wealthy versus gifting when the stock market is low — ahhh, irrational actions which again point to the importance of understanding behavioral economics in understanding clients' actions. [11]

The goal of GRATs is to zero out (or as another school of thought teaches (why?), "near zero out" so that there is a reportable gift) the valuation for gift tax purposes, and transfer upside appreciation greater than the section 7520 rate (See [insert prior JPTE articles discussing GRATs) to the children.

Since the GRAT permits payment of both income and trust principal to satisfy the annuity payments the grantor has retained, the GRAT will be treated as a grantor trust for income tax purposes. This means the grantor is taxed on income and realized gains on trust assets even if these amounts may be greater than the trust's annuity payments.

This further enhances this tool's effectiveness as a family wealth-shifting and estate-tax-saving device. In essence, the grantor is effectively allowed to make gift tax-free gifts of the income taxes that are attributable to assets backing the remainder beneficiary's interest in the trust.

In addition, creating back end grantor trusts for the remainder interest, after the retained term, will continue the strategy of the grantor paying income taxes on assets owned by an irrevocable trust, not subject to estate taxes in the grantor's gross estate.

6. **Sell that Asset to My Grantor Trust**

The sale to a grantor trust for a partial promissory note has become an increasingly popular substitute for the GRAT. If it works, it has in most circumstances features that are more attractive than a GRAT:

a. estate tax inclusion if the grantor dies before the note is paid off less than the estate tax inclusion if the grantor dies before the retained annuity term,

b. an interest rate that is lower than the section 7520 rate,

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[11] *See, e.g.*, Thaler, The Winner's Curse (1998).

c. superior generation skipping planning because unlike a GRAT there is no estate tax inclusion period (GRATs should not be used for generation skipping planning), and

d. the possibility of creative structuring as to the annual repayment amounts.

The sale is structured by the owner of the asset, such as the business interest ("business owner"). He or she initially establishes a trust that is effective as a "grantor trust" for income tax purposes, but which is not controlled by the business owner or otherwise subject to an estate tax taint. This trust will benefit the grantor's beneficiaries.

After the grantor trust is established, it should be funded with a certain amount of cash. The cash is often contributed to the trust, via a taxable gift, by the grantor. Thereafter, the business interest is sold to the grantor trust; and the owner takes back cash as a down payment and a promissory note for the difference. Depending on the length of the promissory note, it will carry interest at the prescribed federal rate for short, mid-term or long term loans. I.R.C § 1274.[12]

Because the trust is structured as "grantor trust" for income tax purposes, there will be no recognition of gain on the sale of the asset to the trust. Thus, the difference between the grantor's basis in the asset, and the sales price to the trust, will not currently be taxed as a capital gain.

More importantly from a transfer tax gain perspective, the grantor will pay income taxes on taxable income received by the trust because of the assets the trust owns. In this regard, it is as if for income tax purposes the grantor still owns the assets sold to the trust. Importantly, the payment by the grantor of those taxes will not constitute a gift to the trust.

Interest paid to the grantor on the promissory note is in essence ignored for tax purposes because it is from the grantor trust to the grantor.

After the loan is paid off, the business interest is owned by the trust, at essentially a carryover basis, and the interest is no longer in the grantor's gross estate. The trust can continue to be a grantor trust, thereby having taxable income allocated to the grantor.

Conclusion

At the upper echelon of estate tax planning is the use of the irrevocable grantor trust. Parts one and two of this column have explored a few of the creative estate tax uses of this effective technique.

[12] See PLR 92-51004