

# Advanced Trust Planning (and designing the Perfect Intentionally Defective Irrevocable Grantor Trust)

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## 1. Advanced Grantor Trust Planning.

### (a) Intentionally Defective Irrevocable Grantor Trusts – General considerations

- (1) Understand the difference between Code Sections 2031 through 2042 and Code Sections 671 through 679
- (2) Estate tax includability is governed by Code Sections 2031 through 2042.
- (3) Grantor trust rules are governed by IRC § 671 through 679.
- (4) Many grantor trusts are includible in the decedent's gross estate, such as a revocable trust under IRC § 2036 and which also is a grantor trust under IRC § 676.
- (5) The purpose of this section is to create an irrevocable trust that is out of the decedent's estate but yet defective for income tax purposes, also known as an intentionally defective irrevocable grantor trust.

### EXAMPLE

A grantor creates an irrevocable trust with a person other than the grantor as trustee (CPA, Attorney, Bank) with general trust provisions that state, "during the term of the trust, income and/or principal is payable to the class consisting of the donor's issue of all generations."

(b) How long can the trust last?

This depends upon the applicable state law rule of perpetuities. In New Hampshire, perpetual, in Massachusetts 90 years after the date of formation, or 21 years after the death of the lives in being at the time of creation of the instrument.

(c) Can the Donor be a beneficiary?

No, in Massachusetts, since the principles of *Ware v. Gulda* and *State Street Bank & Trust Company v. Reiser*, debtors can attach a donor's interest in a so-called self-settled trust and therefore the trust assets would be includible in the grantor's estate under IRC § 2036.

(d) Consider using a Domestic Asset Protection Trust in a state other than Massachusetts which permits such trusts.

(e) A New Hampshire Domestic Asset Protection Trust permits a Donor to be a beneficiary of the trust while protecting the assets from potential liabilities.

NH RSA 564-D - Qualified Dispositions in Trust Act

- New Hampshire resident must be trustee (usually a New Hampshire Bank or Trust Company) NH RSA 564-D:3
- New Hampshire law allows for investment and administrative responsibilities to be divided among trustees and third parties.
  - For example, in a directed trust, an investment manager can have the exclusive duty to invest the trust's assets while the trustee is only responsible for other aspects of administering the trust.
- Statute permits use of a trust advisor (a friend or trusted advisor) who can guide trustees in administering the trust. (NH RSA 564-D:4)
  - Even the donor can serve (NH RSA 564-D:5)
- No Rule Against Perpetuities applies when the trust expressly exempts the trust from the application of the rule. (NH RSA 564:24)
  - Creditors cannot reach assets of the trust unless pursuant to a claim under the Uniform Fraudulent Transfers Act. (NH RSA 564-D:9)
  - Creditors claims must be brought within four years of the transfer of assets to the trust. (NH RSA 564-D:10)

- Spouses and former spouses have no ability to make any claims against trust assets so long as the trust was established before the marriage. (NH RSA 564-D:1; NH RSA 564-D:15)
  - Trust can be a completed gift or an incomplete gift. To make the incomplete gift have the Donor reserve a testamentary limited power of appointment.
    - Usually a grantor trust during the Donor's life.
    - If a non-grantor trust, no state income tax on interest, dividends and capital gains.
- (f) SLATs: Spousal Limited Access Trust - Spouse can be a discretionary beneficiary but no gift-splitting is permitted in such a case. Donor is not and cannot be a beneficiary even after the spouse's death.

**PLANNING NOTE:**

*Life insurance may be purchased on the spouse's life for the benefit of the Donor if there is a concern over cash flow for Donor.*

- (g) Generation skipping considerations

The generation skipping tax exemption is \$5,450,000 (adjusted for inflation each year) as is the gift tax exclusion exemption. In the case of a transfer to a trust which will continue for one or more generation members below that of the grantor, a gift tax return should be filed and generation skipping tax exemption shall be allocation.

- (h) Is the generation skipping tax exemption automatically be allocated?

The answer is confusing, so a gift tax return should be filed in any event to either allocate GST or opt out of the automatic GST allocation rules.

- (i) What are the GST automatic allocation rules?

IRC § 2632 provides that if any individual makes an indirect skip during such individual's lifetime, any unused portion of such individual's GST exemption shall be allocated to the property transferred to the extent necessary to make the inclusion ratio for such property zero. If the amount of the indirect skip exceeds such unused portion, the entire unused portion shall be allocated to the property transferred.

- (j) What is an indirect skip?

IRC § 2632(c) provides that the term "indirect skip" means any transfer of property (other than a direct skip) made to a so-called GST trust.

- (k) What is a GST trust?

IRC § 2632(c)(3)(B) provides that a “GST Trust” means a trust that could have a generation skipping transfer with respect to the transferor unless... the trust is a trust, any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. (IRC § 2632(c)(3)(B)(iv))

**PLANNING NOTE:**

*In the example above, so-called “Crummey Notices” were not included so this provision would not be applicable but the result would be different if the trust included so-called Crummey withdrawal powers to make gifts to the trust eligible for the annual exclusion. In such a case, the following provisions of IRC § 2632 may change the result.*

IRC § 2632(c)(3)(B) provides that “the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in IRC § 2503(b) (\$14,000) with respect to any transferor and it shall be assumed that powers of appointment held by non-skip persons will not be exercised.

**PLANNING NOTE:**

*This means that if the irrevocable trust contains so-called Crummey withdrawal powers, and those powers are held by a non-skip person such as the children, even if also held by grandchildren, IRC § 2632(c)(3)(B)(iii) and (iv) can get out of the automatic allocation rules, but the remaining Section § 2632 kept this by stating that essentially Crummey withdrawal powers, to the extent they do not exceed \$14,000 per annum, will be ignored thereby bringing it back into a so-called GST trust and thereby resulting in an automatic allocation. The problem here is where the Crummey withdrawal beneficiaries have the right to withdraw greater than \$14,000 attributable to a carryover from the prior year, in which case the trust would not be considered a GST trust and would not be eligible for the automatic allocation.*

(l) Resolution:

File a gift tax return and either elect in or elect out of a GST treatment.

(m) Sample Withdrawal Powers:

- (1) From and after the addition by gift of any property to the trust, who’s beneficiary shall be entitled to withdraw a pro rata share of the gift for 30 days. Each such beneficiary shall be provided reasonable notice to make this withdrawal.
- (2) Notwithstanding the foregoing, a beneficiary’s right to withdraw property from the trust in any one calendar year shall not expire as to more than the greater of \$5,000 or 5% of the aggregate value of the assets out of which or the proceeds of which a beneficiary’s withdrawal right may be satisfied. To the extent of

such excess, the withdrawal power shall not lapse, but rather shall be continued into the next succeeding calendar year.

#### **PLANNING NOTE**

*This so-called 5 and 5 limitation is derived from Code Section 2514(e), which recognizes the right to withdraw is the equivalent of ownership and failure to exercise the right to withdraw represents a gift back to the trust and therefore would be a gift by the donee beneficiary not eligible for the annual exclusion.*

- (n) Will this cause adverse gift tax consequences to the donee beneficiaries who do not withdraw their funds?

IRC § 2514(e) provides that there would only be a gift by the donee beneficiary with respect to the lapse of the powers during any calendar year only to the extent of the property which could have been appointed by exercise of such lapsed power exceeds in value the greater of the following amounts, \$5,000, or 5% of the aggregate value of the assets out of which, or the proceeds of which the exercise of the lapsed powers could be satisfied.

## **2. Flexibility of Irrevocable Grantor Trusts**

- (a) Can the donor reserve the right to remove and replace a trustee?

Yes. Pursuant to Rev. Rul. 95-58, the donor may reserve the right to remove and replace a trustee provided the replacement trustee must be an individual or an entity not related to or subordinate to the donor within the meaning of Section 672(c) of the Internal Revenue Code.

- (b) Can the donor retain any powers of appointment to affect the final disposition of the property?

No. Pursuant to IRC § 2036, the gross estate of the donor shall include all property to the extent of any interest therein transferred of which the decedent has at any time made a transfer by trust or otherwise, under which he has retained for his life... either (1) the possession or enjoyment of or the right to the income from the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

- (c) How do Crummey withdrawal powers affect grantor status?

It would be a grantor trust as to the beneficiaries under IRC § 678. IRC § 678(a) provides that "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 invest the corpus of the income therefrom in himself, or (2) such person has previously partially released or modified such a power and, after the

release or modification, retained such control, with in the principles of Section 671 through 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

- (d) What happens if power to withdraw is not extended?

While the beneficiaries have the power to withdraw, they would be considered the grantor under IRC § 678(a). To the extent such person has “partially released or otherwise modified such a power, and after the release and modification retained such control within the principles of Section of 671 through 677, inclusive, subject to grantor of a trust for treatment as the owner thereof”, the beneficiary would remain grantor.

Here, however, there is an open question as to whether the failure to exercise a withdrawal power is the same as either “partially releasing or otherwise modifying” such a power. While the IRS does not seem to make a distinction between the two in certain Private Letter Rulings, it seems unfair to make the beneficiaries with grantor trust status when they do nothing rather than take an affirmative act to either partially release or otherwise modify such power.

- (e) How do you make it a grantor trust as to the grantor where there are Crummey withdrawal powers?

Use an IRC § 675(4)(c) power to reacquire trust assets. IRC § 678(b) provides that “Section 678(a) will not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom 679 applies) is otherwise treated as the owner under the provisions of this subpart, other than this section.”

#### **PLANNING NOTE**

*It is important that the trust be a “wholly grantor trust” as to the grantor.*

- (f) How do you make an irrevocable trust a “wholly grantor trust” as to the grantor using the power of acquisition under IRC § 675?

Under IRC § 675, the grantor shall be treated as the owner of any portion of the trust with respect to which a power of administration is exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity to “(C) reacquire the trust corpus by substituting other property of an equivalent value.”

- (g) Are you sure that the power to reacquire trust corpus will not result in estate tax includability?

Yes. In Rev. Rul. 2008-16, the IRS ruled that, when the grantor of an inter vivos trust has a non-fiduciary power to substitute property held in trust, the value of the trust corpus is not includible in the gross estate under 2036 or 2038 as long as the

trustee has some fiduciary obligations that insure the grantor's compliance with the trust terms. It has been held to determine there is a fiduciary obligation to assure that the property is exchanged for its equivalent value and the trustee has a duty of impartiality concerning the trust beneficiaries.

- (h) Would the answer be the same if the trust held life insurance governed by IRC § 2042?

Yes. In Rev. Rul. 2011-28, the IRS ruled that the grantor's retention of the power, exercisable in a non-fiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of an equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under Section 2042, provided the trustee has a fiduciary obligation (under local law of the trust instrument) to insure 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.

- (i) Pursuant to Rev. Rul. 85-13, a transfer between a grantor and his wholly owned grantor trust is not an income taxable event, with the following tax consequences.

- (1) While the transferee trust takes a carryover basis, the sale to the trust is income tax free.
- (2) Any interest paid by the trust to the grantor pursuant to the promissory note also is income tax free.
- (3) If the trust owns property and the grantor is paying rent, the payment of rent to the trust is income tax free.
- (4) The transferor can reacquire trust assets by substituting property of an equivalent value to obtain a step-up in basis upon death by exchanging cash for zero or no basis assets.

- (j) Will a grantor trust be considered the insured for purposes of the transfer for value rules?

Yes. In Rev. Rul. 2007-13, the IRS ruled that the transfer (by sale) of a policy from one wholly irrevocable grantor trust to another as well as a policy from a non-grantor trust to a wholly grantor trust would be ignored since it was a transaction between the grantor and the grantor trust.

If the trust owns the individual's home and the home is sold, the trust does not report the gain but, rather, the gain is reported on the transferor's personal tax return and therefore would be eligible for the \$250,000 (or \$500,000 capital gain tax exclusion in the case of a married couple filing jointly). PLR 199912026

- (k) Who pays income taxes with respect to income earned by the irrevocable trust?

The Grantor. Pursuant to IRC § 671, all items of income, deductions, and credit will not be reported on the trust income tax return, but, rather, shall be reported on the return of the grantor.

A wholly grantor trust is an eligible S corporation shareholder without the need to make any election. IRC § 1361

- (l) What about life insurance trusts?

Under § 677(a)(3), the grantor shall be treated as the owner of any portion of the trust, whether or not he is treated as such owner under 674, who's income, without the approval or consent of any adverse party, is or, in the discretion of the grantor or a non-adverse party, or both, may be... applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse."

#### **PLANNING NOTE**

*In Iverson v. Commissioner, 3 T.C. 756 (1944), the Tax Court ruled that this provision would apply only to the extent the trust actually owned a life insurance policy and used income to pay premiums. (Caveat, this section would certainly make the trust a grantor trust as to the grantor as to "income" but probably not as to principal and therefore would not be sufficient to allow this trust to be an eligible S corporation shareholder as a "wholly grantor trust.")*

- (m) What if my spouse is a beneficiary?

Under 677(a)(1), the grantor shall be treated as the owner of any portion of the trust whether or not he is treated as such owner under 674, who's income, without the approval or consent of any adverse party, is, or under the discretion of the grantor or a non-adverse party, or both, may be distributed to the grantor or the grantor's spouse. This would be the case where a grantor sets up an irrevocable trust where the provisions provide that income and principal may be payable to or for the benefit of the class consisting of the surviving spouse and the issue, in an independent trustee's sole and absolute discretion.

#### **PLANNING NOTE**

*There are other ways to make a trust an intentionally defective grantor trust, but these do not have the protections of Private Letter Rulings as to the estate tax includibility under IRC § 675(4)(C).*

- (n) What if the grantor does not have sufficient funds to pay the income tax attributable to the grantor trust earnings?

More good news! Under Rev. Rul. 2004-64, the IRS ruled that a trustee, or any other individual who is not related to or subordinate to the donor as defined in IRC §

672(c), in the trustee's or such person's sole and absolute discretion may make distributions to the donor in order to satisfy any federal estate income tax liability incurred by the donor pursuant to the laws of the United States of America or any state which is attributable to income of the trust or any share thereof. The amount of such payments shall not exceed the excess of the donor's personal income tax liability over his or her income tax liability computed as if the trust was not a grantor trust under IRC § 671, et seq.

### **3. Summary of Tax Considerations of Intentionally Defective Irrevocable Grantor Trust**

- (a) Trust is irrevocable for estate tax purposes. See, Rev. Rul. 2008-22 (excluded under IRC § 2038 & § 2041) and Rev. Rul. 2011-28 (excluded under IRC § 2042).
- (b) Trust is ignored for income tax purposes. See, Rev. Rul. 85-13
- (c) In the event the trust owns residential real estate, the grantor must pay rent to keep the asset out of the estate, but the rent paid to the trust by the grantor is nontaxable.
- (d) Property taxes paid by the trust are deductible by the grantor.
- (e) Sale of assets to the trust or the use of appreciated assets by the trust to pay off the grantor are nontaxable.
- (f) Grantor can retain the right to remove and replace the trustee, provided the replacement trustee is not related to or subordinate to the grantor. See, Rev. Rul. 95-58
- (g) The trustee can reimburse the grantor for any incremental income taxes caused by grantor trust status. See, Rev. Rul. 2004-64

### **4. Compare QPRT vs. Gift/Sale of Residential Property to Intentionally Defective Irrevocable Grantor Trust**

- (a) QPRT
  - (1) ETIP (Estate Tax Inclusion Period) causes assets to be includible until expiration of QPRT term. IRC § 2036
  - (2) GST exemption cannot be allocated until conclusion of ETIP period. IRC § 2642(f). See, *Simches v. Simches*, 423 Mass. 683 (1996) (A Massachusetts case in which a reformation proceeding was permitted to change a QPRT remainder beneficiary from the grandchildren to the children.)
  - (3) Grantor cannot repurchase property to obtain a step up in basis. Regs. 25.2702-5(c)(9)

- (b) Intentionally Defective Grantor Trust
  - (1) No ETIP period needs to be considered.
  - (2) Generation skipping transfer tax can be allocated at time of the gift.
  - (3) Trust can permit the repurchase of the property. See, IRC § 1014; IRC § 1015.
  - (4) Rent payable to the trust is income tax free and can serve to reduce the estate.

5. **Selling Assets to the Intentionally Defective Grantor Trust in Exchange for a Promissory Note or Private Life Annuity**

(a) Tax Considerations

(1) Summary of Transaction

- A. The trust is a grantor trust for income tax purposes by including the power of substitution under IRC § 675(4)(C), which provides: “The grantor shall have the right to reacquire trust corpus by substituting property of an equivalent value.”
- B. The trust’s basis is a carryover basis since no taxable gain was recognized at the time of the sale.
- C. Determine applicable interest rate using applicable federal rate, which is as follows for the month of April, 2016:

Item	Applicable Rate	Annual Rate
3 years or less	federal short term rate	.70%
4 to 9 years	federal midterm rate	1.45%
9 years or greater	long term rate	2.25%

See, *Frazee v. Commissioner*, 98 T.C. 554 (1992)  
 IRC § 1374(d)

- (b) Consider using a self-cancelling note so that no amount is includible in the grantor’s estate, but any deferred gain (to the extent such gain needs to be recognized) will be taxed to the estate and not on the grantor’s final return. See, *Frane v. Commissioner*, 998 F.2d 567 (8<sup>th</sup> Cir. 1993)
- (c) Consider the use of a private life annuity. See, *Estate of Kite*, T.C. Memo. 2013-43 (2013)

(d) 65 year old taxpayer transfers cash (\$5,000,000 each) in exchange for a private life annuity and wishes to zero out the gift. See, GCM 39503

(e) Computation of Annuity

(1) Assume the IRC § 7520 Rate is 2.2%

(2) Annuity factor 14.0065

(3) Annual Annuity \$356,977

## **6. Grantor Trust Return Preparation**

(a) General Approach – Reg. § 1.671-4(a)

Items of income, deduction and credit attributable to any portion of a trust which, under Subpart E, is treated as owned by a grantor or another person, are not reported by the trust on an IRS Form 1041, but are shown on a separate statement to be attached to the trust's Form 1041. (In other words, the Form 1041 is blank and there is a statement attached to it reflecting the items of income, deduction and credit attributable to the grantor trust portion.) If this approach to grantor trust reporting is utilized, the trust must have its own taxpayer identification number.

(b) Alternative Approaches

Treas. Reg. § 1.671-4 also permits two alternative approaches to grantor trust reporting, both of which are available only if the trust is treated as owned in its entirety by a single grantor or another person. (In other words, these alternate approaches cannot be used if the trust is treated as owned by more than one person, even if the trust is a grantor trust in its entirety.) In addition, neither of the alternative approaches can be used for a qualified subchapter S trust, a foreign trust, a trust with foreign situs assets, or a trust that is a grantor trust as to a foreign person. If either of the two alternative approaches is available, the trust does not need its own taxpayer identification number; rather, it can use the social security number of the grantor.

(1) Alternative approach 1:

The reporting obligations of a grantor trust will be fulfilled if:

- a. the grantor or other person treated as owner furnishes a W-9 to the trustee;  
and
- b. the trustee furnishes to payors the following items of information to all payors:

(i) the name of the grantor (or other person treated as owner), (ii) the TIN of the grantor (or other person treated as owner), (iii) the address of the trust; and

- c. if the grantor (or other person treated as owner) is not a trustee or co-trustee, the trustee must meet the additional requirements of Treas. Reg. § 1.671-3(b)(2)(ii), which include furnishing the grantor (or other person treated as owner) with a statement showing all items of income, deduction and credit for the taxable year. (If the grantor is a trustee or co-trustee, the requirements in this paragraph VIII.B.I.c do not need to be satisfied.

(2) Alternative Approach 2:

The reporting obligations of a grantor trust will be fulfilled if:

- a. the grantor or other person treated as owner furnishes a W-9 to the trustee; and
- b. the trustee furnishes the name, TIN, and address of the trust to all payors during the taxable year; and
- c. the trustee files appropriate Forms 1099 with the IRS, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor (or other person treated as owner of the trust) as payee.