TAKING MAXIMUM ADVANTAGE OF ESTATE PLANNING OPPORTUNITIES THROUGH THE USE OF INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

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This Article explains the effective use of the tax and estate planning technique known as the "Intentionally Defective Grantor Trust". This technique is a cost-efficient way to realize significant income, gift and estate tax savings.

A person (the "Grantor") creates a Trust for the benefit of children and/or grandchildren and sells assets to the Trust in exchange for a low annual rate interest-bearing installment note (currently around 1% - see discussion below). The sale is made for fair market value established through independent real estate or closely held business appraisals and reduced for IRS recognized discounts for lack of control and lack of marketability. Therefore, the sale by the Grantor to the Trust is ***not*** treated as a gift to the children or grandchildren. The trustee of the Trust must be an independent trustee; i.e. not the grantor, the grantor's spouse and preferably not the grantor's children.

The Trust is drafted such that the Grantor is treated as the owner of the Trust for income tax purposes but not for estate tax purposes. This is accomplished by including certain administrative powers in the Trust to be retained by the Grantor (such as the power to substitute Trust assets in a nonfiduciary capacity for others of equivalent value) which cause the Grantor to be treated and taxed for income tax purposes as the Trust owner but not to be treated as the Trust owner for estate tax purposes (the retained powers fall short of the powers required for inclusion in the Grantor's estate). The Trust is thus "defective" because it leaves the Grantor subject to income tax, but "intentionally" so, since this was done purposefully.

With the Trust so prepared, the sale of assets by the Grantor to the Trust avoids capital gain taxes on the sale to the Trust and income tax on the note interest received by the Grantor from the Trust. These tax advantages result from the fact that the law treats the transaction as a sale by the Grantor to himself or herself as the owner of the Trust for income tax purposes. Appreciation on the assets sold by the Grantor to the Trust grows outside the Grantor's estate. All of the appreciation on the property sold to the Trust by the Grantor inures to the benefit of the Trust beneficiaries – the children or grandchildren of the Grantor. If the Grantor dies before the note is paid in full ***only*** the unpaid balance of the note is included in the Grantor's estate – not the then value of the property sold to the Trust.

The only gift tax element of this transaction arises from the requirement that the Trust be capitalized ("seeded") with sufficient equity assets (other than the assets to be acquired from the Grantor in exchange for the note) to establish the independence of the Trust from the assets to be sold by the Grantor to the Trust. The capitalization is generally 10% of the value of the installment note so that there is a debt (the balance due on the note) to equity (the amount of the gift) ratio within the Trust of not more than 10:1. The seed money gift is required to avoid an IRS challenge to the Intentionally Defective Grantor Trust on the grounds that there is insufficient equity in the Trust. If they have sufficient assets of their own it is recommended that the Trust beneficiaries guarantee the note. This guarantee serves to enhance the equity component within the Trust.

In addition to the above tax benefit of freezing the value of hopefully appreciating property in the Grantor's estate at the current principal amount of the note, another advantage of this technique is that the Trust Grantor can (but is not obligated to) pay the income tax on the Trust's income from the Grantor's own personal funds. This allows the Grantor to further reduce his or her estate by the payment of the income taxes. As long as the independent trustee of the Trust is not **obligated** to reimburse the Grantor for these income tax payments, the Grantor will not be treated as retaining an interest in the property transferred to the trust. If the Trust contains such a required reimbursement provision, it will be viewed as a "retained interest" and all of the property contained in the Trust will be considered to be part of the Grantor's estate thereby defeating the intent of this arrangement. Not requiring reimbursement to the Grantor from the Trust of income taxes paid assures that this tax benefit will be preserved for the beneficiaries of the Grantor. Conversely, if the Grantor wants or needs the income stream from the assets sold to the Trust the interest rate on the installment note can be increased so that the loan interest payments approximate that income stream.

If minority interests in real estate and/or closely held business entities are sold to the Trust, IRS recognized valuation discounts are utilized to further reduce the value of the property sold.

By way of example, the Grantor owns a multi-family apartment building in New York that as of early 2019 had a fair market value of $5,000,000. As a result of the tenant favored changes in the rent laws in June 2019 and the impact of Covid-19, the current appraised value of the building has been reduced to $2,500,000. The building is owned by a limited liability company which is owned solely by the Grantor or by the Grantor and the Grantor's spouse. The Grantor has three children and wants to transfer the building to the three children in equal shares. If the Grantor utilizes an Intentionally Defective Grantor Trust, the Grantor will likely be able to obtain a valuation discount of the minority 1/3 interests transferred to the Trust for the benefit of each of the children in the range of 40% of the value of the limited liability company's net assets, resulting in a net value of $1,500,000[1] ($2,500,000 x .60). Of this amount approximately $150,000 would constitute the "seed money" gift in order to provide the needed capitalization (10% of $1,500,000 – see above). The balance, namely $1,350,000 ($1,500,000 – 150,000) will constitute the sales price and will be paid for with an installment note. Based on annual interest rates in effect for June, 2021 (see below), the minimum annual interest in the above

1 Assumes no mortgage debt encumbering the real property. If mortgage debt does exist there would be a further reduction of the sales price.

example would amount to $13,770 ($1,350,000 x 1.02%). This interest in paid by the Trustee of the Trust from the rental income on the building. The interest rate can be increased based on the needs of the Grantor.

The use of an installment sale to an Intentionally Defective Grantor Trust allows the appreciation on the property above the applicable federal interest rate on the note balance to inure to the benefit of the Trust beneficiaries. The applicable federal annual interest “mid-term rate” (obligations with maturities of between 4 and 9 years) for June, 2021 is 1.02%. Thus, even modest appreciation over time will deliver a significant tax advantage to the Grantor’s children and grandchildren. Combine this advantage with the rules discussed above (no income tax liability imposed upon the Grantor upon the sale and the Grantor having the opportunity to pay the income tax liability arising from the assets held in the Trust without being charged with a gift to the Trust beneficiaries) and the installment sale to an Intentionally Defective Grantor Trust is an excellent estate planning technique. The amount of the required seed money gift can typically be structured to easily fall within the Grantor’s current lifetime gift tax exemption which as of 2021 is $11.70 million.

Consideration also needs to be given to other issues such as ways in which the Grantor may retain control of the limited liability company or other entity after the transfers to the Intentionally Defective Grantor Trust and the use of the excess cash flow above the amount needed to service the debt on the installment note to purchase life insurance on the life of the Grantor.

The recent significant declines in real estate, marketable securities and closely held business values caused by the Covid-19 pandemic makes these estate planning opportunities even more advantageous. The current high Federal estate tax exemption is scheduled to expire at the end of 2025 or may be repealed sooner if the Biden Administration is successful in lowering the exemption.

It is also important to note that the Democratic Party has long pushed for the elimination of estate planning techniques that favor the transfer of wealth at reduced levels of income, gift or estate taxation such as the Intentionally Defective Grantor Trust. The tax initiatives of the Biden Administration and the Democratic Congress may well result in the elimination effective as of January 2022 of the Intentionally Defective Grantor Trust as an effective estate planning tool. Prompt action is required now to take advantage of this technique while it is still available under current law.

Please contact us for a no obligation telephone consultation.

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