Chapter 27

DEFECTIVE TRUST

WHAT IS IT?

An intentionally "defective" trust is an irrevocable trust designed to have the following characteristics:

1. Transfers of property to the trust are completed gifts for federal gift tax purposes.

2. The trust assets will not be included in the taxable estate of the grantor or grantors.

3. The income of the trust is taxed to the grantor, who is treated as the "owner" of the trust for federal income tax purposes.

Such a trust is created by intentionally violating one or more of the grantor trust rules found in IRC Sections 671 to 677. Under IRC Section 671, trust income or deductions will be attributed to the grantor of the trust if the grantor is treated as the owner of the trust under the provisions of IRC Sections 672 to 677. These rules are discussed in Chapter 19 in connection with the Income Taxation of Trusts and Estates.

The grantor trust rules were enacted to prevent taxpayers from using trusts to shift income tax liabilities to a lower bracket taxpayer while retaining control or beneficial enjoyment of the trust property. Thus, a violation of the grantor trust rules was traditionally viewed negatively in that the grantor of the trust was, for income tax purposes, the owner of the trust assets, and was personally responsible for all items of income (ordinary income and capital gains) attributable to the trust assets. This personal responsibility existed whether or not the income and/or principal was actually distributed to the grantor.

The use of intentionally defective grantor trusts (IDGTs) has become increasingly popular as an estate planning technique. Since the estate tax inclusion rules are applied separately from and independently of the income tax rules, unique opportunities are available to shift assets to a succeeding generation at no transfer or income tax cost and to otherwise reduce the grantor's estate.

IDGTs are not supported by any statute and are based solely on interpretations of IRS rulings and case law. Because they may be eliminated by an act of Congress or a change in IRS position, they should be considered only for clients who are not risk adverse and used only after a thorough explanation of the potential downsides and costs.

WHEN IS THE USE OF SUCH A DEVICE INDICATED?

Defective trusts are particularly useful when the grantor wishes to remove an appreciating asset from his estate without making a taxable gift. A gift may be undesirable for many reasons–e.g., the grantor's gift tax unified credit equivalent (applicable exclusion) amount may not be sufficient to cover the value of the gift, the grantor may desire to retain a stream of income, etc.

By using a defective trust, the appreciating assets can be sold to the trust in exchange for an installment note without a gift being made.[1] In addition, the grantor will not recognize any taxable gain on the sale of the appreciating asset to the trust since the grantor and the trust are treated as one for income tax purposes.[2] Alternatively, the grantor can create a grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT), or a qualified personal residence trust (QPRT), all of which are grantor trusts. See Chapter 26.

Grantor trusts can also be used to hold stock in an S corporation. In this case, it is particularly important that the grantor be treated as the owner of both the income and corpus of the entire trust. This is often more favorable than making an election for the trust to be treated as a qualified subchapter S Trust (QSST).

In addition, because the grantor pays the income taxes incurred by the trust, the assets held in the trust grow, in essence, tax free. In addition, by paying the income tax on the income that will pass to the beneficiaries, the grantor is reducing his estate without making a taxable gift to the beneficiary.

Taxing income to the grantor rather than the trust will almost always result in a substantial income tax savings because of the compressed tax rates applied to trusts.

Consider the following income tax rates for estates and trusts in 2006:

Taxable income not over $2,050	15%
Over $2,050 but not over $4,850	$307.50 + 25% of excess
Over $4,850 but not over $7,400	$1,007.50 + 28% of excess
Over $7,400 but not over $10,050	$1,721.50 + 33% of excess
Over $10,050	$2,596 + 35% of excess

Conversely, if the grantor is in a higher income tax bracket than the trust beneficiary, higher income taxes could be paid than if the income were taxed to the beneficiary. Of course, if the grantor's estate is reduced by the payment, the estate tax savings may justify this technique. Obviously, a comparative analysis should be made.

In the case of a personal residence trust, if the grantor is treated as the owner and the residence is sold, the benefits of IRC Section 121 (the $250,000 gain exclusion, $500,000 for certain married taxpayers) may be applied to exclude gain from the sale of the residence. Note that the trust must be defective as to both income and corpus.

Where a GRAT or GRUT is involved, it is possible that the trust may not generate sufficient income or cash flow to make the annuity or unitrust payments. The GRAT or GRUT distribution may be "in kind" (i.e., of the trust assets), without any income tax consequences to the trust.

A defective trust may facilitate the transfer of installment notes to the trust without accelerating the gain.[3] This technique may be used to set up an income tax deduction for transfers to charitable lead trusts.[4]

Additionally, if a residence is owned by a defective grantor trust, payments of rent by the grantor may not be taxable gifts, since the trust is considered the tax alter ego of the grantor (who can't make taxable gifts to himself). This may be one way to fund a life insurance trust that makes premium payments, without making gifts to the trust.

Since the grantor is treated as the owner of the trust assets for income tax purposes, the grantor can sell assets to the trust without incurring taxable gain. In addition, interest payments from an installment sale to the trust will not be treated as taxable income to the grantor.[5]

WHAT ARE THE REQUIREMENTS?

The trust must be irrevocable. Either the grantor or a trustee that is not adverse retains certain powers. The grantor can retain the power in a nonfiduciary capacity to remove trust assets from the trust and substitute other assets of equal value. This apparently has no adverse estate tax consequences to the grantor. Note that the IRS has refused to rule on this in all cases, because it is a question of fact whether or not the grantor is acting in a nonfiduciary capacity.

A nonadverse party, acting in a fiduciary capacity, can be granted certain powers. One of these, which triggers the grantor trust rules of IRC Section 674, is to add beneficiaries other than afterborn children, so long as the grantor does not control this decision. In one private ruling[6], a trust provided that the trustee could, in its discretion, add as beneficiaries persons who were lineal descendants of the parents of the grantor. This brought the trust under the provisions of IRC Section 674, making it a grantor trust, eligible to hold S corporation stock.

In the case of an installment sale to an intentionally defective grantor trust, it is important that the assets that are the subject of the sale not be the sole source of the payments on the installment note. Thus, prior to the sale, the grantor should make a gift to the trust of cash or assets worth somewhere between 10% and 20% (more a rule of thumb than a statutory number) of the value of the asset being sold.[7] This can help to avoid an argument by the IRS that the grantor retained an interest in the asset that is includable in the grantor's estate under IRC Section 2036. If the trust is a generation-skipping or dynasty trust, the grantor can allocate some of the generation-skipping exemption to this initial gift so that the purchased asset will be excluded from the beneficiary's estate.

The trust beneficiary should *not* have any Crummey withdrawal right over the initial gift, so as to avoid any argument that the beneficiary, rather than the grantor, is the owner of the assets for income tax purposes.[8]

It is also important that adequate (at least a market rate) interest be charged on the installment note, so as to avoid any gift component. No gift should be deemed to have been made, if the asset is sold at fair market value and the applicable federal rate (AFR) of interest is used.

HOW IT IS DONE – AN EXAMPLE

Example 1. Francis Osborne owns all of the stock in a corporation that is electing to be taxed under Subchapter S of the Internal Revenue Code. He would like to make a gift of several shares of nonvoting common stock in trust for his children, but he also wants to retain a substantial part of the income stream from that stock for a period of years. It is explained to him about the possible use of a grantor retained annuity trust (GRAT) for a term of years. However, a GRAT is not a qualified shareholder in an S corporation, since there is no guarantee that all of the trust income would be paid to the grantor. The annuity could be more or less than that amount.

It is proposed that the trust contain a provision that Francis has the power, at any time during the term of the trust, to remove the trust assets and substitute other assets of equal value. Under IRC Section 675(4), if this power is exercisable in a nonfiduciary capacity, the trust will be classified as a grantor trust. Since S corporation stock can be held in a grantor trust, the S election will not be lost during the grantor's lifetime. Further, if the grantor does elect to swap trust assets, or repurchase assets from the trust at fair market value, such a swap or purchase will have no income tax consequences to either the trust or to Francis.

Example 2. George establishes an intentionally defective grantor trust for the benefit of his children, Sam and Dorothy. George owns a business that he expects will significantly increase in value over the next 10 years. He desires to sell this business to the defective trust in order to remove the anticipated increase in value from his estate, but does not wish to incur any income tax consequences on the sale.

George obtains an appraisal of the business and, thereafter, makes a gift of 20% of this value to the trust to serve as seed money for the anticipated purchase. George then sells the business, at its appraised fair market value, to the defective trust in exchange for a 20-year promissory note. Depending upon George's need (or desire) for income, the note can be structured to be interest-only (at the current AFR) with a balloon payment at the end of the term, or principal and interest can be amortized over the 20-year term. The income produced by the initial gift and the purchased business will be used to make the note payments.

During the term of the note, George receives a stream of income that is not taxable to him. At the end of the term, neither the business (at its increased value) nor the promissory note will be included in George's estate. If, however, George dies before the note is paid off, the value of the promissory note at the time of his death will be included in his estate. In addition, because the trust's grantor trust status would terminate at George's death, the IRS *may* argue that the sale occurred at the time of death and that gain is taxable to George (on his final return) or to his estate.

WHAT ARE THE TAX IMPLICATIONS?

The following is a summary of the income tax rules pertaining to grantor trusts:

1. IRC Section 672 contains important definitions relating to adverse and nonadverse parties, and related and subordinate parties. Under the remaining sections, whether the grantor is treated as the owner of the trust may depend on whether certain powers are conferred on persons fitting these categories.

2. IRC Section 673 imposes the grantor trust rules where the grantor retains a reversionary interest in the trust, that is, a right to some future benefits.

3. IRC Section 674 covers the retention of control over the enjoyment of the trust by the grantor or certain other persons. It is one of the most complex provisions of the Internal Revenue Code.

4. IRC Section 675 treats the grantor as the owner of the trust if the grantor retains certain administrative powers over it. It is the provision most used in defective trust planning.

5. IRC Section 676 provides that the grantor is treated as the owner of the trust if the grantor can revoke it.

6. IRC Section 677 imposes the grantor trust rules where the grantor or grantor's spouse retains beneficial enjoyment of the trust, or its income is used to pay premiums on life insurance on the grantor or the grantor's spouse.

Note that the grantor could be the owner of only a portion of the trust, all or part of the trust income, or all or part of the trust corpus. Also note that, as a general rule, the grantor trust provisions apply if certain powers are retained by the spouse of the grantor.

Many grantor retained powers that cause the grantor to be treated as the owner for income tax purposes will also cause the trust to be included in the grantor's taxable estate, WHICH SHOULD BE AVOIDED. For example, the trust will be included in the grantor's taxable estate if:

1. The grantor retains a reversionary interest that is valued at more than 5% of the trust corpus.[9] Even where the reversionary interest is valued

at over 5% of the value of the trust, determined at date of death, IRC Section 2037 will not apply if beneficiaries could have received distribution of trust assets without surviving the grantor.

2. The grantor personally retains control over the enjoyment of the trust.[10]

3. The grantor retains certain administrative powers, such as the power to vote stock transferred to the trust.[11]

4. The grantor retains the income.[12]

However, many powers can be granted to a nonadverse party other than the grantor (including a spouse, but that is *not* recommended) that will cause the grantor to be treated as the owner of the trust for income tax purposes. A nonadverse party is someone other than an adverse party, defined as a person with a substantial interest in the trust that would be adversely affected by the exercise or non-exercise of the power.[13]

There are special rules for related or subordinate parties, who are presumed subservient to the wishes of the grantor. Related or subordinate parties are the grantor's spouse, mother, father, issue, brother, sister, an employee of the grantor, an employee of a corporation where the stock of the grantor and the trust is significant from the standpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive.[14]

Under IRC Section 674(c), certain powers granted to an independent trustee who is nonadverse do not trigger these rules; an independent trustee consists of a trustee or trustees, none of whom are the grantor or grantor's spouse, and no more than half of whom are related or subordinate and subservient to the grantor.

In creating defective trusts, the following are powers most frequently granted to a trustee who is someone other than the grantor, but who is a nonadverse party:

1. Powers to control beneficial enjoyment of the trust under IRC Section 674(a), but note the exceptions for certain powers under IRC Section 674(b), and exception for powers of an independent trustee under IRC Section 674(c).

2. Certain administrative powers under IRC Section 675, including: the power to deal with the trust for less than full consideration; the power to borrow from the trust under certain circumstances; the power, in a nonfiduciary capacity, to vote or control investments where the trust includes stock where voting control held by the grantor and trust is significant; and the power to remove assets and substitute assets of equal value. Note that if the grantor retains the power in a nonfiduciary capacity to remove assets and replace them with assets of equal value, the grantor is treated as the owner for income tax purposes, but should not be for gift or estate tax purposes.

3. The power to revoke the trust in favor of the grantor under IRC Section 676, or to distribute income to the grantor under IRC Section 677. However, since this may subject the trust to the grantor's creditors, it is not recommended.

4. The power to apply income to the payment of premiums on life insurance on the grantor or grantor's spouse under IRC Section 677(a)(3).

There is a legal distinction between defects that apply to income and those that apply to corpus transactions (such as sales or other capital gain events). If the trust is defective only as to its income, the grantor will be income taxed on the income, but gains on sales or exchanges or other events of a principal nature will be taxed to the trust under normal fiduciary income tax rules. Such a trust would not be fully defective.

Grantor trust status may be terminated by a number of actions, including renunciation of the power by which the grantor is treated as the owner, the death of the grantor, etc. Termination of grantor trust status *may* also result in the recognition of gain by the grantor.[15]

In an installment sale situation, upon the grantor's death, the value of the promissory note will generally be included in the grantor's estate.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Where assets transferred to defective trusts are community assets, the planner should be aware of the fact that the "grantor" of such a trust will be each spouse as to his or her community interest. For example, if a nonadverse trustee is used, be certain that person is nonadverse as to both spouses. If the grantor retains the power to remove and replace assets, consider the fact that if only one spouse has that power, the grantor trust rule might not apply to the other spouse as to his or her community interest.

In general, the grantor trust rules apply to powers retained by either spouse, and this may not be a serious problem. However, it would be wise to consider this aspect, and also the potential impact of a divorce on the defective trust plan.

As noted previously, grantor trust status is normally terminated by death. In the case of community property, however, grantor trust status will continue with respect to the portion of the trust contributed by the surviving spouse.

QUESTIONS AND ANSWERS

Question – Can the grantor pay the income tax that arises from the trust's income?

Answer – The payment of income tax by the grantor that arises from the trust's income is not a gift by the grantor. Also, no portion of the IDGT will be included in the gross estate of the grantor under Section 2036 if the grantor must pay the income tax of the IDGT without reimbursement from the trust. Grantors of a properly-structured IDGT are encouraged to pay the income tax arising from the trust and may achieve significant gift tax savings and income shifting for the benefit of their children, grandchildren, or other loved ones. Nevertheless, IDGTs should be considered aggressive planning tools and must be attempted with the utmost in care and by only the most competent of practitioners.[16]

Question – What are the implications if an IDGT requires the trust to pay back the grantor for any income tax liability generated by the trust?

Answer – An interest has been retained under IRC Section 2036 and gross estate inclusion will result if the trust must reimburse the grantor for the income tax liability that the grantor incurs. Mandatory payment obligations could arise under the terms of the trust or state law. The IDGT, therefore, should expressly prohibit such payments while it is an intentionally defective grantor trust. Inclusion may also result if the independent trustee has discretion to reimburse the grantor for income taxes and there was a pre-existing agreement to reimburse. This suggests a fact and circumstances analysis on a case-by-case basis. Even with an independent trustee, some may find the approach under which the trustee has discretion to reimburse the grantor for income taxes arising on income received by the trust to be too risky an approach given the large estate tax savings potential with an IDGT.[17]

Question – What are some of the ways a client can pay income tax on trust-generated income?

Answer – Consider including a provision in the trust authorizing a termination of the defective trust character of the trust to bring the trust under general fiduciary income tax principles, so that the trust will thereafter pay its own income tax. It may also be feasible to grant an independent trustee discretion to reimburse the grantor for income taxes and hope that the IRS will not be successful in its likely argument that a pre-arranged deal exists or was evident from a pattern of conduct under Section 2036. Advise the client that these trusts are best suited for individuals who have so much income and wealth that the potential for payment of income tax is not a concern. Finally, rather than creating an IDGT, wait until a parent dies and construct a direct sale by the surviving parent to the loved ones when the gifted property has received a step-up in basis. This will minimize or eliminate the need for an IDGT from the standpoint of recognition avoidance on sale because there is little or no gain. The trust could then be structured as a standard trust. This strategy benefits the younger generation when the cash flow on the asset sold is greater than the payment required on the promissory note, while enabling the grantor / seller to not have to pay income tax on income that others receive.

Question – Can the defective trust be used in connection with irrevocable life insurance trusts where trust income is to be used to pay insurance premiums?

Answer – Under IRC Section 677, the use or possible use of trust income to pay life insurance premiums will cause the grantor trust rules to apply to the trust. This would enable the client to transfer income-producing property to the irrevocable life insurance trust, which then acquires the life insurance, using the income from the property to pay the premiums. Since the payment of the premiums is not deductible, the effect is that the income will be taxed to the grantor. If properly planned, this will remove both the life insurance proceeds and the income-producing property from the grantor's estate. Note that the IRS will not presently rule on the income tax consequences of this technique.

Question – Can the defective trust concept be used to shift the income taxation of trust income to beneficiaries?

Answer – If trust beneficiaries are given a general power of appointment over a trust, they will be taxed on its income under IRC Section 678 whether or not they exercise that power. The beneficiaries may well be in a lower income tax bracket than the trust. This could also be considered where the beneficiaries are minors. However, if they are under 18, consideration must be given to the imposition of the "kiddie tax," under which the income would generally be taxed at the rates of the parent.

It should be noted that, although a beneficial withdrawal right to trust principal that is equal to the greater of $5,000 or 5% of the trust corpus will not be a taxable lapse if unexercised, such a right is likely to constitute a general power of appointment for purposes of IRC Section 678. Thus, the gift of $5,000 to a Crummey-type trust may result in the beneficiary being treated as the grantor of the trust corpus.

Question – Why might a power of substitution be used with an IDGT?

Answer – One popular technique of making an irrevocable trust intentionally defective for income tax purposes is to include a retained power to substitute property of equivalent value. This will not cause the trust property to be included in the grantor's gross estate under IRC Sections 2033, 2036, 2038, or 2039. Nor will it constitute a gift to the trust by the grantor, for federal gift tax purposes. Furthermore, such a trust is a grantor trust under IRC Section 671 in its entirety with respect to the grantor. Also, neither the grantor nor the trust will recognize any income or loss by reason of the grantor's exercise of the power of substitution.[18]

CHAPTER ENDNOTES

1. It is extremely important that the fair market value be accurately determined so as to avoid any argument that a gift was made.
2. IRC Secs. 674, 675, 677; Rev. Rul. 85-13, 1985-1 CB 184.
3. Rul. 74-613, 1974-2 CB 153.
4. IRC Sec. 170(f)(2)(B).
5. See footnote 2.
6. Let. Rul. 9301020.
7. Byrle M. Abbin, *[S]he Loves Me, [S]he Loves Me Not – Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to Be Applied In Selecting From the Cafeteria of Techniques*, 31 U. of Miami Inst. On Est. Plan., Ch. 13 (1997) (setting forth IRS's informal representation that assets equal to 10% of purchase price should provide adequate security for the payment of the acquisition indebtedness). Some practitioners feel that 20% will provide a better defense.
8. IRC Sec. 678(a)(1).
9. IRC Secs. 673, 2037(a)(2).
10. IRC Secs. 674, 2036, 2038.
11. IRC Secs. 675, 2036(b).
12. IRC Secs. 677, 2036(a).
13. IRC Sec. 672.
14. IRC Sec. 672(c).
15. See Treas. Reg. §1.1001-2(c), Example 5; *Madorin v. Comm.*, 84 TC 667 (1985).
16. Rev. Rul. 2004-64, 2004-2 CB 7.
17. Rev. Rul. 2004-64, 2004-2 CB 7.
18. Let. Rul. 200603040. The letter ruling generally addressed these issues relative to powers of substitutions. However, the ruling only mentions that income is payable to the spouse under IRC Section 677(a) as a reason for the trust being fully taxable to the grantor.