DEFECTIVE GRANTOR TRUST

The distinguishing characteristic of a defective grantor trust is that the income in the trust is taxed to the grantor, the person who created the trust. A defective grantor trust can be any type of trust. The defective grantor trust can have any term and have any beneficiary. One benefit of using a defective grantor trust is to avoid the high income tax rates applicable to trusts. In addition, by paying the income tax on the income earned in the trust, all of the income is preserved in the trust for distribution to the grantor's family. The trust got its name when trusts were being used as income tax savings devices and structuring a trust in a manner which caused the income to be taxed to the grantor was a mistake, a defect.

All bad things are good if you just look at them in a different light. Historically, frequently trusts were created to save income taxes. Income tax rates have been as high as 90% for the top brackets. A trust had the same income tax rate structure as a married person filing separately. By creating a trust and transferring high income assets to the trust, you could ride up a whole new set of tax brackets. The benefit of having another tax bracket was dramatic. To prevent individuals from shifting income to a trust, a set of rules were developed which would cause the income earned on assets held in a trust to be taxed to the grantor, the person who created the trust. When the purpose of the trust was to shift income, if these rules were triggered, the purpose of creating the trust was defeated. A trust which violated one of these rules was "defective".

> A defective grantor trust is a trust which is structured so that the grantor is taxed on all of the income earned in the trust.

The top income tax bracket is now 35%, thereby minimizing the benefit of shifting income to a trust. Even more importantly, the income tax rate structure for trusts has been changed. Trusts reach the top income tax bracket at under $10,000 ($9,250 in 2003 adjusted annually for inflation). The maximum benefit which can be derived from shifting income to a trust is minimal. In general however, you don't want to be taxed on income that you don't receive. True, but everything can be looked at differently. In the situation with a "defective grantor trust", the trust can be looked at in two different ways.

Let's assume you create a trust for the benefit of your children. You would like to transfer as much to this trust as possible. The more you transfer to the trust, the less your estate tax will be. If you pay the tax on the income in the trust, the trust will not be reduced by the payment of the income taxes. More property is preserved

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in the trust for distribution to your children or other beneficiaries.

For example, let's assume you have transferred $500,000 to a trust for the benefit of your children and grandchildren. Let's also assume that the income earned in that trust is $40,000, all taxable income. If the trust pays the tax on the income, about $14,000 will be paid in income tax leaving assets valued at $526,000 in the trust at the end of the year. If the grantor pays the tax on the income, then the trust will have $540,000 in assets at the end of the year. Payment of the income taxes has the same effect as an additional contribution to the trust. In fact, the IRS has tried to argue that it is an additional gift to the trust. However, since the payment of the tax is required by the IRS, it cannot be deemed to be a voluntary transfer of money. The IRS has backed off this position.

Trusts reach the top income tax bracket at under $10,000.

Another benefit of the grantor trust is that there is no tax on a transaction with the grantor. For example, let's assume that the trust leases property to the grantor. The grantor cannot deduct lease payments made to himself, nor can he be taxed on lease payments made to himself. If the grantor sells property to the trust, no gain is recognized. If the trust later sells the property, the grantor will recognize a gain on the sale at that time. The trust will have the same basis as the grantor for purposes of determining the amount of gain.

Any trust which is created can be structured to be a defective grantor trust. The technique which has been used recently is to sell property with a high appreciation potential to a defective grantor trust. The sale can be made by giving the grantor an installment note. In July, 2003, the interest rates reached an all time low, with the rate required to be charged on a three to nine year note with interest payable annually is 2.55% The result of the technique is to transfer all of the appreciation in the asset over the interest on the note to the trust free of transfer tax.

Some advisors feel this technique is one of the most beneficial estate planning techniques available. The effect of the installment sale to a defective grantor trust is similar to the effect of a Grantor Retained Annuity Trust (GRAT). The GRAT was discussed earlier. The GRAT pays the grantor an annuity for a term of years. The term of the GRAT is similar to the term of the note. The annuity paid to the grantor is similar to the installment payment on the note. A GRAT is a defective grantor trust. All of the income on the assets held in a GRAT is taxed to the grantor.

If you pay the tax on the income in the trust, more property is preserved in the trust for distribution to your children (or other beneficiaries.)

What's the difference? What are the advantages of one over the other? The interest rate applied in determining the amount of the annuity is higher than the interest rate required to be paid on the installment note. The note can continue

beyond the grantor's lifetime and the assets will not be included in the grantor's estate. These two differences favor the use of an installment sale to a defective grantor trust.

There are also two differences which favor GRATs over installment sales to defective grantor trusts. First, the impact of a redetermination of the value of the asset sold to the defective grantor trust results in the grantor making a gift to the trust of the difference between the value of the asset and the amount of the note. Second, the defective grantor trust must have other assets. Most advisors are comfortable with assets equal to at least 10% of the amount of the note. This requirement is one of the disadvantages of the sale to a defective grantor trust. There is a downside. If the assets decrease in value, the benefits are lost. There are also some thorny income tax questions if the grantor dies while the note is outstanding. Bear with me for a technical tangent. Does the trust have the same basis as the grantor? If so, all of the payments made on the note did not give the trust any additional basis for determining gain. If the basis of the asset is the value on the date of death, the only way that could occur is if the grantor recognized gain on the sale at the time of his death.

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I mention these differences. They are problems. Sometimes they can be opportunities. The uncertainty of the income tax treatment of the note on the sale to a defective grantor trust is illustrative of a number of unclear areas in the tax law, and in the estate tax area in particular. Any technique which is beneficial will be analyzed by the IRS for possible arguments to reduce the benefits. If the technique becomes popular and gains a wider use, the IRS will redouble its efforts to minimize or eliminate the benefits. The use of family limited partnerships is a good example of an estate planning structure which has beneficial tax consequences which the IRS is seeking to curtail.

Like the Family Limited Partnership and the GRAT, the use of an installment sale to a defective grantor trust is another tool in the estate planner's toolbox.