Sales to Grantor Trusts:

Exponential Leverage Using Multiple Installment Sales

By Steven J. Oshins

The sale to a grantor trust, also commonly referred to as a "defective" trust, has become one of the primary leveraging techniques in the estate planning lawyer's arsenal. Lawyers and their clients should consider this technique for nearly every estate valued at more than $5 million and often for smaller estates as well. Although many authors have written about the use of this technique, none of these articles deals with the exponentially greater leverage that a family can obtain by making subsequent sales to the defective trust in future years. This article illustrates these results using hypothetical numbers and demonstrates that the exponential leverage is so great that even the wealthiest families can reduce their estates significantly without a comparatively large estate or gift tax. The article also explains the benefits of combining the sale technique with a dynasty trust by establishing the trust in a state with no rule against perpetuities.

The "Defective" Trust

For purposes of this article, a "defective" trust is a trust that Subpart E of Subchapter J of the Code treats as being owned by the grantor but that is not included in the grantor's gross estate. It is also possible to draft and fund a trust so that the beneficiary is the "owner" of the trust for income tax purposes under Code § 678, but this article does not discuss the use of that technique. Because the grantor is the owner of the trust for income tax purposes, he or she must report all trust income, deductions and credits on his or her personal income tax return. Code §§ 671-677.

A defective trust has three primary benefits. First, the grantor's payment of income taxes on income earned by the trust is the functional equivalent of a tax-free gift to the trust by the grantor. Second, because the trust pays no income taxes while the grantor is living, its assets accumulate income tax-free. For example, assuming a 40% income tax rate, a defective trust that earns income at a rate of 10% per year would have the entire amount of this income remaining in the defective trust. On the other hand, if the trust were not a defective trust, it would have only 6% of the earnings remaining in the trust after taxes. Finally, because the Code treats the grantor as the owner of the trust for income tax purposes, the IRS disregards transactions between the grantor and the trust for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184.

Valuation Discounts

The Code bases the value of assets for estate and gift tax purposes on what a willing buyer would pay a willing seller, neither having any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Treas. Reg. §§ 20.2031-1(b) & 25.2512-1. A client can often arrange his or her assets so as to transfer them at a discount from their underlying value. This in an important step in maximizing the leveraging possible with a sale to a defective trust. The most popular device used to create discounts is a family limited partnership (FLP). An FLP is a limited partnership among family members or trusts for their benefit. Consistent with state limited partnership laws, the general partners control the affairs of the partnership, and the limited partners do not participate in the operation of the

partnership. Appraisers generally value limited partnership interests at a discount from the pro rata value of the partnership's underlying assets because limited partners cannot participate in the management of the partnership and because there is no ready market for interests in a closely held family controlled entity.

An example will illustrate these concepts. Assume Husband and Wife each contributes assets valued at $500,000 (i.e., a combined $1 million) to an FLP, in exchange for a 1% general partnership interest and a 49% limited partnership interest. Assume further that Husband wishes to sell a 40% limited partnership to New Partner. If Husband asked New Partner to suggest a fair price for the 40% limited partnership interest, New Partner might initially conclude that $400,000 would be fair because $400,000 is 40% of the total partnership capitalization.

Due to the lack of voting control and marketability, however, the more appropriate sales price would be much less than $400,000. New Partner would quickly learn why limited partnership interests are not worth their pro rata value. Husband and Wife could decide to take somewhat large but reasonable salaries as general partners, leaving minimal income to be distributed to the partners. Husband and Wife may also decide not to distribute the income, although as general partners they may have a fiduciary obligation to distribute at least enough to pay the income tax on the partnership earnings. To make matters worse, New Partner would be liable for 40% of the income taxes attributable to the partnership even though the partnership distributes no income.

Sale to a Defective Trust

The sale to a defective trust technique combines the leveraging benefits of valuation discounts and deferred payment sales with the advantages inherent in being able to transact with a trust without income tax ramifications. The hypothetical transaction described below will be structured as an interest-only sale with a balloon payment, but clients and their lawyers might consider private annuity sales and self-cancelling installment note sales in appropriate circumstances.

Before the grantor sells the discounted assets to the defective trust, it is important that he or she give assets to the trust that have a fair market value of at least 10% of the value of the assets that the grantor plans to sell to the trust. The purpose for independently funding at least 10% is to decrease the likelihood that Code § 2036(a)(1) will apply to the sales transaction and cause those assets to be returned to the grantor's taxable estate. If the trust owns little or no assets independent of the sales transaction, there is a greater danger that the IRS could recast the transaction as a disguised transfer with a retained interest.

The grantor should file a gift tax return allocating GST exemption to the trust so that it is wholly exempt from generation-skipping taxes. If the gift is less than the grantor's applicable exclusion amount under Code § 2505, no gift tax will be due. After the gift, the grantor enters into a sales agreement with the trustee of the trust whereby the trustee agrees to purchase limited partnership interests or other assets subject to a valuation discount, such as minority interests in a business. The grantor conveys those assets to the trust in exchange for a promissory note with a face value equal to the fair market value of the assets. If the purchase price equals the fair market value of the purchased assets, there will be no taxable gift or transfer subject to the GST tax. Thus, no additional gift or GST exemption must be allocated to the trust.

The parties will structure the promissory note to pay the grantor interest for a term of years with a balloon payment of principal at the end of the term, using the Code § 1274 interest rate for the month of the sale so that there is no imputed gift under Code § 7872. The payments from the trust to the grantor are usually very low in comparison to the income earned by the asset being sold to the trust. The Code § 1274 rate is typically low, and that low rate applies to the discounted value of the asset sold rather than against the pro rata value.

Hypothetical Scenario

The following example illustrates the benefits that can be achieved not only by making the initial installment sale to a defective trust, but also by making subsequent installment sales, each time staying within the parameters of the general rule that the trust must have "seed money" of at least 10% of the assets being purchased. The example assumes that the grantor sells limited partner interests in an FLP and that the FLP distributes all of its income to the partners, including the defective trust, each year. The purpose of these distributions is to avoid the income, after being used to make installment payments on the promissory notes, being valued at a discount for purposes of using the 10% general rule in computing subsequent sales. Note, however, that a pattern of distributing all of the income each year may reduce the valuation discount.

The example assumes that the partnership assets earn 10% income each year with no growth and that an appraiser discounts the limited partnership interests by 50% from the prorata value of the FLP's underlying net assets. This article uses a 50% discount to simplify the example, but the transaction also works well with a much more conservative discount. The Code § 1274 interest rate for the transaction is assumed to be 6%. Sales will be made to the trust one year apart.

The grantor will make an initial gift of $625,000 to the trust, so there is no gift or GST tax after taking into account the grantor's $625,000 applicable exclusion amount (the amount permitted in 1998) and $625,000 of the grantor's $1 million GST exemption. For purposes of simplicity, further increases in the applicable gift tax exclusion

amount, which will gradually increase to $1 million in 2006, will not be added to the trust in the example.

Year one. In the beginning of the first year, the grantor gives $625,000 to the defective trust and sells $6.25 million worth of limited partnership interests to the trust. The limited partnership interests actually represent $12.5 million of underling value but receive a 50% discount. In exchange for the limited partnership interests, the trust gives the grantor an interest only promissory note paying 6% per annum with a balloon payment of $6.25 million at the end of the ninth year.

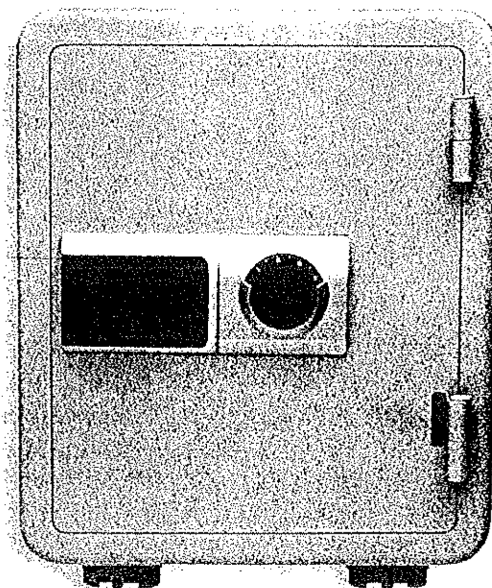
During the first year, the $625,000 earns $62,500, and the $6.25 million worth of limited partnership interests, discounted from $12.5 million, earns $1.25 million for a combined total earnings of $1,312,500. After the trustee pays interest of $375,000 (i.e., 6% of $6.25 million) to the grantor, $937,500 in additional value remains in the trust. This $937,500 figure will be used in the beginning of the second year for purposes of staying within the 10% general rule of independent funding to determine how much the grantor can sell to the trust in the second year.

It is interesting to note that even if the grantor died immediately after entering into this transaction, the grantor's estate would be reduced by the $12.5 million pre-discount value of the assets in the limited partnership. The estate would instead include the promissory note with a face value of only $6.25 million. Additionally, it is possible that the grantor's executor could discount the promissory note from its face value. See M. Read Moore & D. Alan Hungate, *Valuation Discounts for Private Debt in Estate Administration*, 25 Est. Plan. 5 (June 1998) (analyzing discounts for promissory notes received in non-family transactions). Therefore, even without any time having passed, the taxable estate would be reduced at a minimum by $6.25 million and possibly even more if the grantor's estate can discount the promissory note.

Year two. In the beginning of the second year, the trust has $937,500 worth of additional value with which to base a purchase in the second year. Using the general rule that the amount of seed money must be at least 10% of the value of the asset sold to the trust in this later sale, the grantor can sell $9,375,000 more of limited partnership interests to the trust, discounted by 50% from $18,750,000. In exchange for the limited partnership interests, the trust gives the grantor an interest only promissory note paying 6% annual interest, with a balloon payment of $9,375,000 at the end of the ninth year.

During the second year, the $937,500 earns $93,750, and the $9,375,000 worth of limited partnership interests, discounted from $18,750,000, earn $1,875,000 for a combined total earnings of $1,968,750. After the trustee makes an interest payment of $562,500 (i.e., 6% of $9,375,000) on the promissory note to the grantor, $1,406,250 in additional value remains in the trust. This $1,406,250 figure plus

WHERE DO YOUR CLIENTS STORE THEIR ADVANCE DIRECTIVES?



You probably recommend that they give copies of their advance directive to their doctor and family members. However, when the document is actually needed, it is often unavailable or outdated.

The solution is to advise your clients to register their advance directive with the U.S. Living Will Registry. The Registry is a national service which electronically stores advance directives (living wills and health care proxies) and makes them available to hospitals 24 hours a day through an automated fax-back system. Your client is contacted annually to confirm that the document has not been changed or revoked. The original advance directive is stored in the Registry's archives.

Because only hospitals have access to the Registry, the documents remain safe, secure and confidential. Your client will have peace of mind knowing that their advance directive will be available wherever and whenever it is needed.

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U.S. Living Will Registry

"With the exponential increases in the amount that the grantor can move in each successive installment sale, the benefits that can be achieved from additional installment sales in future years are astounding."

the $937,500 in excess earnings in the second year from the assets given and sold in the beginning of the first year (the same result computed for the first year) total $2,344,000. That total will be used in the beginning of the third year for purposes of staying within the 10% general rule of independent funding to determine how much the trust can buy in the third year.

Year three. In the beginning of the third year, the trust has $2,344,000 worth of extra value with which to base another purchase. Using the 10% general rule, the grantor can now sell an additional $23,440,000 worth of limited partnership interests to the trust, discounted by 50% from $46,880,000. In exchange for the limited partnership interests, the trust gives the grantor an interest only promissory note paying 6% annual interest, with a balloon payment of $23,440,000 at the end of the ninth year.

Summary of Hypothetical

Staying within the parameters of the example, using three separate sales one year apart, without any gift tax or GST tax, the grantor was able to reduce his or her estate by (1) $12,500,000 in exchange for a promissory note with a face value of $6,250,000, (2) $18,750,000 in exchange for a promissory note with a face value of $9,375,000 and (3) $46,880,000 in exchange for a promissory note with a face value of $23,440,000. Estate reduction would increase exponentially in future years with subsequent installment sales.

The grantor was also able to move the income from the transferred assets out of his or her estate in exchange for interest payments that are low relative to the value of the asset transferred because of the favorable Code § 1274 rate and because of the valuation discount. With the exponential increases in the amount that the grantor can move in each successive installment sale, the benefits that can be achieved from additional installment sales in future years are astounding.

If a client's estate is extremely large, a lawyer might recommend that the client use his or her entire GST exemption for the initial gift to the trust. This strategy would cause a small gift tax, but the amount of tax paid would be small in relation to the amount of additional value that the client would be able to remove from his or her estate.

For billionaires, an additional strategy would be to set up another trust designed to last for only one generation. Because this trust will not be multigenerational, the initial gift to the trust would be limited only by the amount of gift tax the billionaire is willing to pay. For example, if the billionaire is willing to give $10 million to the trust and pay a gift tax of $5.5 million, he or she could sell up to $100 million worth of limited partnership interests to the trust after the appropriate discount. Assuming a 50% discount, $200 million worth of assets can be removed from his or her estate in exchange for a promissory note with a face value of $100 million. Therefore, $110 million (i.e., the $100 million difference between the assets removed from the estate and the face value of the promissory note, plus the original $10 million gift) would be removed from the estate for a gift tax of only $5.5 million even if the billionaire were to die immediately after entering into the sales agreement. This equates to a proportionate gift tax rate of only 5%.

The promissory note may also be subject to a discount in the estate, causing this proportionate rate to be even lower. Additionally, the longer the seller survives, the lower this effective gift tax rate becomes, due to the difference between the amount of earnings by the trust assets versus the amount of interest on the note to be paid each year.

The Dynasty Trust

Leveraging can be broken down into two dimensions: (1) leveraging the amount of assets that are transferred to

the trust and (2) leveraging the duration of the trust. This article has already addressed a technique that can be used to leverage the amount of assets that can be transferred to the trust. In designing such a plan, however, the lawyer should also consider the tax and creditor benefits that can be achieved by extending the trust for multiple generations.

A trust that continues until state law requires it to terminate is commonly known as a dynasty trust. Almost every state requires a trust administered under its laws to terminate within the state's rule against perpetuities. This rule typically requires the trust to terminate after approximately 80 to 120 years. Thus, state law effectively limits the estate tax, creditor and spousal protection benefits of the trust vehicle to this period of time.

Eight states—Alaska, Arizona, Delaware, Idaho, Illinois (provided the trust instrument elects out of the rule), Maryland, South Dakota and Wisconsin—have no rule against perpetuities. A trust, the validity of which is governed by the laws of one of these eight states, can theoretically last forever without a transfer tax. In choosing among these eight states, state income tax considerations often influence the decision.

Arizona, Idaho, Maryland and Wisconsin have high state income taxes, so clients should avoid these states. Delaware and Illinois both have state income tax but do not apply their taxes to trusts established by nonresident grantors. Neither Alaska nor South Dakota has a state income tax. Therefore, the selection is usually made among Alaska, Delaware, Illinois and South Dakota, although clients might avoid Delaware because it has a rule against perpetuities for real property.

At a 55% estate tax rate, for every $1 million that is owned by a properly structured multigenerational trust, the grandchildren save $550,000. If the trust continues in perpetuity, this tax savings occurs at each generational level. If a trust of the magnitude discussed in this article were to be terminated and distributed free of trust to the grantor's children and taxed at each generational level, more of it would pass to the IRS than to or for the benefit of the grantor's descendants.

Assets owned by a trust created by anybody but the beneficiary are protected from creditors and spouses under state spendthrift laws. A few states, however, have statutory exceptions to this general rule, and one state recently made an exception to the common law spendthrift protection by allowing a creditor to satisfy a tort judgment with the assets in a spendthrift trust set up by the debtor/beneficiary's mother. *Sligh v. First National Bank of Holmes County*, No. 96-CA-00033-SCT, 1997 WL 620799 (Miss. Oct. 9, 1997).

Conclusion

Clients with large estates should consider sales to defective trusts. The leverage the clients can obtain from this technique will allow them to transfer significant wealth to their descendants without any gift or GST taxes. Future sales to the defective trust provide even more leverage than the initial sale because, presumably, the value of the assets in the trust has increased so that the client can make larger sales in subsequent years.

The client can enhance the estate tax, creditor and spousal protection benefits of sales to defective grantor trusts by extending the trust for multiple generations. If the trust is domiciled in one of the eight states with no rule against perpetuities, these benefits can last forever. In choosing among the eight states, clients should favor the states with no state income tax because of the additional tax saving opportunities that are available.

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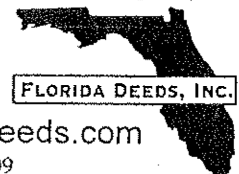

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