DEFECTIVE TRUSTS, GRANTOR TRUSTS, AND PRIVATE ANNUITIES

Sale to a Defective Grantor Trust:
A trust that is created as a defective grantor trust is an irrevocable trust that contains provisions that make the person who creates the trust taxable on all of the trust taxable income. Usually, the trust contains a provision that allows the person creating the trust to take back the property he contributes to the trust and substitute property of equal value.

<u>Estate, Gift, and GST Tax</u>:
A sale of property to an irrevocable defective grantor trust in return for an installment note, removes the property sold and any future appreciation of that property from your estate. However, the value of the installment note becomes an asset of your estate. As payments are made on the note, the value of the note in your estate is reduced and, if you survive the term of the note, there will be no remaining estate tax value. A sale of property to a defective grantor trust may be made with an installment note providing for interest-only payments with a balloon payment. However, if the balloon payment is not made before the death of the person selling the property to the trust, the entire principal value of the installment note would be included in the taxable estate.

When an irrevocable trust is created for the purpose of selling property to the trust with an installment note, the IRS requires that the trust have some assets other than the property sold to it. The concept is the trust must have some "seed money" that will be secured by the installment note in addition to the property sold to the trust. The "seed money" must be at least 10% of the value of the property being sold to the trust. The transfer of the "seed money" to the trust is a taxable gift to the trust. The transfer of "seed money" is also subject to GST tax or GST tax exemption must be allocated to make the transfer GST tax exempt.

<u>Income Tax</u>:
A defective grantor trust is not considered a separate tax entity from you. The sale of appreciated property to the trust would be treated as though you sold the property to yourself and no tax would be due. A sale of property to a defective grantor trust would not provide the trust with any step up in basis for the property sold. The lack of step up in basis could create an additional tax liability if any of the property sold to the trust needed to be sold by the trust to make payments on the note back to you. After the sale, any dividends or other income earned by the property sold to the trust would remain taxable to you. However, having trust income taxed to you allows the trust assets to grow more rapidly. With a defective grantor trust, interest paid to you on the loan will not be taxable income for you.

Grantor Retained Annuity Trust (GRAT):
A GRAT is a special irrevocable trust provided for under the Internal Revenue Code created by a person (the grantor) where the grantor transfers property to the trust and retains the right to receive a fixed annual payment from the trust for a term of years (GRAT term). The fixed annual retained payment can be expressed in a dollar amount or a percentage of the value of the property transferred to the trust. At the end of the GRAT term, the property will remain in the trust for the benefit of the designated remainder beneficiaries.

Estate, Gift, and GST Tax:
The transfer of property to a GRAT in return for the fixed annual payment, does not remove the trust property from your estate unless you survive the GRAT term of years. If you survive the GRAT term, none of the trust property is included in your estate. If the GRAT term is long enough, the value of the retained fixed annual payment reduces any taxable gift to the remainder beneficiaries to a very small amount. The obvious problem with the interrelationship of the estate and gift tax rules is choosing a long enough GRAT term to reduce the taxable gift to as small as possible but not too long as to increase the risk of death before the end of the term and cause estate tax inclusion.

A more serious disadvantage of a GRAT is the GST tax. Because the person creating a GRAT is retaining a fixed annual payment from the trust, GST tax exemption cannot be allocated to the trust until the GRAT term for the fixed annual payment is completed. Further, the GST tax exemption allocation at the end of the GRAT term must be enough GST tax exemption to cover the value of the trust property at the end of the GRAT term after it has increased in value during the GRAT term. The result is the GST tax exemption allocation must cover the original value of the property transferred to the trust plus all appreciation or other increase in the value of the trust property.

Income Tax:
A GRAT is a grantor trust with respect to the person creating it and all the income of the trust will be taxed to you. That would mean, if the income of the trust were greater than the fixed annual payment you received, the additional amount would be taxable income to you. Also, there is no step up in basis of the property transferred to a GRAT. The lack of step up in basis could create an additional tax liability for you if any of the property sold to the trust needed to be sold by the trust to make the fixed annual payments to you. However, having trust income taxed to you, allows the trust assets to grow more rapidly.

Private Annuity:
A private annuity can be used for a person to transfer property to an irrevocable trust and receive annuity payments from the trust in payment for the property transferred. The annuity payments are made over the remaining life expectancy of the person making the transfer or they can be made over a joint life expectancy of a husband and wife.

Estate, Gift, and Generation-Skipping Transfer (GST) Tax:
Upon the transfer of the property to the trust in return for an agreement by the trustee to pay the annuity payments, the entire value of the transferred property is removed from your taxable estate. All future appreciation of the property is also removed. The annuity payments only continue until the death of the person making the transfer or the second death of a husband and wife when the annuity is joint. There is no taxable gift involved in the private annuity sale of property to an irrevocable trust. There is also no generation-skipping transfer (GST) tax involved with a private annuity, because no gift occurs.

Income Tax:
The main disadvantage of a private annuity is the income tax consequences. Unless the trust

receiving the property is a grantor trust, a transfer of property to a trust in return for an annuity payment is treated as a sale of the property in the year of the transfer to the trust and capital gain is realized and taxable in that year. Also, the annuity payments are not entirely tax-free. A portion of each annual annuity payment will be tax-free because the transfer was a taxable sale and an income tax basis is established for the annuity. However, because the annuity is paid over an extended period, there is a taxable income component to the annuity payments. The taxable income aspect of the annuity payments is taxed as ordinary income, not as capital gain.

If the sale to the trust is a taxable event, the trust receives a step up in income tax basis for the property sold to the trust. That permits the trust to sell the property without a taxable gain and invest in a diversified portfolio that may allow a greater return for the trust than permitted with the original property sold to the trust.

If the trust receiving the property and paying the private annuity is a grantor trust with respect to the person creating the trust and transferring the property to it, there will be no taxable gain upon the transfer of property and payment of the annuity. However, there will be no step up in income tax basis for the property sold to the trust.