Estate Planning Using Sales To "Defective" Trusts

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On February 1, 2000, the U.S. economy began its 107th consecutive month of expansion setting a new record for the longest economic expansion in our nation's history. With this booming economy have come increased business profits and sizable stock market gains enabling many individuals to amass considerable amounts of wealth. Such prosperity often reminds people of the potentially disastrous impact that taxes may have on their accumulated assets. Estate taxes can be particularly devastating. Federal estate tax rates can be as high as 55%. In order to accomplish the personal goals of clients and their families while minimizing income, estate, gift and generation-skipping taxes, lawyers are often called upon to use techniques more advanced than simple wills and trusts.

The sale of assets to a grantor trust, also commonly referred to as "defective" trust, has become an increasingly popular technique used by estate planning attorneys. Even the wealthiest families can reduce their estates significantly without a comparatively large estate or gift tax. Recent legislation in Ohio creates additional benefits by allowing the sale technique to be combined with a "dynasty trust" not subject to the longstanding rule against perpetuities. While the advantages of a properly structured sale to a defective trust are many, the tax laws are complex and risks do exist. Proper care should be taken in the planning and implementation of such a transaction.

The term "defective" trust usually refers to a trust as being owned by the grantor for federal income tax purposes. Because trusts were often used for income tax planning, and grantor trusts require that the grantor report the income from the trust assets on his personal income tax return, they were considered defective for that purpose. For transfer tax purposes, however, grantor trusts can be extremely beneficial. The assets of the trust are not included in the grantor's gross estate, and therefore, they are not subject to estate tax.

Several important characteristics make defective trust particularly useful for estate planning. The grantor's payment of income taxes on income earned by the trust creates the functional equivalent of a tax-free gift to the trust by the grantor. Additionally, because the trusts pays no income taxes while the grantor is living, its assets accumulate income tax-free. Moreover, because the Code treats the grantor as the owner of the trust for income tax purposes, transactions between the grantor and the trust are disregarded for income tax purposes. Therefore, when a grantor sells assets to such a trust, he is treated, for income tax purposes, as having sold the assets to himself. For estate and gift tax purposes, however, the assets have been transferred to the trust.

Transfers to defective trusts work best with assets held by "pass through" entities such as S corporations, partnerships, or limited liability companies. If the grantor holds an interest in such a family business entity, the sale of his interest to a defective trust can be a key piece of the family's business succession plan. If the grantor's assets are not already in such a form, an entity may be formed to hold the assets.

Nonvoting interests in the entity are commonly used to allow assets to be transferred at a discount from their underlying value. This is an important step allowing maximum leveraging with a sale to a defective trust. A qualified business appraiser will normally establish the fair market value of the interest being sold using a valuation discount based upon the lack of voting control and a lack marketability.

Before the grantor sells the discounted assets to the defective trust, however, cash or other assets should be given to the trust. The gifted assets should have a fair market value of at least 10% of the value of the assets that the grantor plans to sell to the trust. Without such a gift, the trust would own little or no assets independent of the sales transaction, and the IRS may consider the transaction a disguised transfer with a retained interest. Such a classification would cause the assets to be returned to the grantor's estate.

After the gift, the grantor may file a gift tax return allocating his generation-skipping transfer (GST) tax exemption to the trust, making the trust wholly exempt from GST tax. For very large estates, where the grantor uses his entire GST exemption for the initial gift to the trust, a gift tax would be due. The amount of

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tax paid, however, would be small when compared to the amount of additional value that the grantor would be able to remove from his estate.

Once a value has been ascertained and the trust has been properly funded, assets may be sold to the trust. If the purchase price equals the fair market value of the purchased assets, there will be no taxable gift or transfer subject to the generation-skipping tax. The trust will typically provide a promissory note to the grantor, and the trustee will make the note payments to the grantor from the trust income. Ideally, the transaction will be structured so that the trust assets generate cash flow equal to or in excess of the note payments to the grantor. Prepayment of the note is allowed.

The defective trust may be drafted to include "dynasty trust" provisions. In Ohio, trusts may elect not to be subject to the rule against perpetuities. Consequently, a dynasty trust may last forever without a transfer tax. At a 55% estate tax rate, grandchildren save $550,000 for every $1 million that is owned by a properly structured multigenerational trust. If the trust continues in perpetuity, this tax savings occurs at each generational level.

Attorneys should consider sales to defective trusts when advising wealthy clients. The leverage clients can obtain from this technique will allow them to transfer significant wealth to their descendants with little or not gift or GST taxes. The technique combines the leveraging benefits of valuation discounts and deferred payments sales with the advantages inherent in being able to transact with a trust without income tax ramifications.

Furthermore, clients may enhance the benefits of sales of defective grantor trusts by extending the trust for multiple generations. In Ohio, these benefits can last forever.

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