



Advanced Planning Strategies

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Dear Reader,

No final agreement was reached on the budget and tax reconciliation package before Congress adjourned for its spring recess. The President wants the package to be completed soon with an emphasis on extending the lower tax rates on capital gains and dividends. We have mentioned the report of the President's Advisory Panel on Tax Reform from time to time, and you may have wondered what happened to its recommendations. Former Senator John Breaux, a key contributor, has expressed concern that the report has apparently been left out of current proposals. He indicated that simplification recommendations are necessary because \$140 billion is spent annually on tax compliance.

Recent news reports indicate that the death rate declined at a sizable rate last year and life expectancies are now at record levels: just over 75 years for males and 80 for females. According to most recent IRS data (2004), 62,718 estate tax returns were filed for estates over \$1 million reporting aggregate gross estates of \$192 billion. Slightly less than half the returns paid a tax with aggregate estate taxes of \$21.5 billion and generation-skipping taxes of approximately \$115 million. Deductible marital bequests were included on 42.6 percent of returns, and 17 percent included property left to surviving spouses in restrictive marital transfers, known as "QTIP" trusts. Deductible charitable transfers were included on 18.5 percent of the reported returns with an average charitable transfer of nearly \$1.3 million.

With the filing season in our recent memory, there has been some interesting discussion. There has been a call for free electronic filing to be made available from the IRS, but Treasury Secretary John Snow was emphatic that the IRS will not get into that business. In another note, apparently as many as one million returns were outsourced to India for preparation without the consent of taxpayers. Congress may address this in the near future.

Knowledge is not power. Only knowledge in use is power.

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

An estate planning technique that is garnering a lot of attention is the use of an intentionally defective grantor trust (IDGT). A grantor trust is a trust in which the grantor, or in some cases a beneficiary, is treated as the owner for income tax purposes; that is, all income tax consequences will fall on the grantor of the trust. Because the estate and gift tax rules are inconsistent with the income tax rules, it is possible to create a trust that is irrevocable and a completed gift for gift and estate tax purposes without removing the income tax benefits and burdens from the grantor. Thus, the shift of wealth to the next generation(s) is complete when the trust is funded, but the income tax on the trust income remains the grantor's responsibility. Because of this tax structure, transactions, such as a sale of property, between the grantor and the IDGT are ignored for income tax purposes, and income tax consequences, such as capital gains, can be avoided. Another often favorable result is that the grantor receives the benefit of all tax deductions and credits attributable to the trust.

WHAT MAKES TRUST “DEFECTIVE” FOR INCOME TAX PURPOSES

A trust is defective for income tax purposes for either the grantor or a beneficiary of the trust as a result of falling into the grantor trust provisions of Internal Revenue Code Secs. 673–679. In most of the estate planning uses of the IDGT technique, the grantor will become the owner of the trust for income tax purposes. Some examples of trust terms that would make an irrevocable trust defective for income tax purposes are the power the grantor holds to (1) borrow from the trust without adequate interest or security, (2) borrow trust funds without the obligation to repay principal in the same tax year, and (3) replace trust property with property of equal value while holding such powers in a nonfiduciary capacity. Other powers that would create a defective trust are the ability of the grantor to control beneficial enjoyment, the grantor's capacity to enjoy the income of the trust, and the power to use trust income to pay premiums for life insurance covering the life of the grantor or the grantor's spouse. (This discussion is intended only as a brief overview of the rules for grantor trusts. There are some pertinent details that have not been discussed. The terms of the IDGT must be designed by a qualified professional and tailored to meet the goals that are intended to be accomplished in the specific situation.)

MAKING IDGT EFFECTIVE FOR GIFT AND ESTATE TAXES

The IDGT technique is generally intended to be a completed gift (and removed from the grantor's gross estate) for estate, gift, and generation-skipping transfer tax purposes. For this reason, the IDGT must be irrevocable and the grantor should not have powers to change the initial terms, control beneficial enjoyment, or have income used for or distributed to the grantor. Thus, the IDGT is funded with the intent to make a completed “no strings attached” gift. (Again, this discussion is intended only as an abbreviated summary of the estate and gift tax rules.)

SALE OF PROPERTY TO IDGT AS WEALTH TRANSFER TECHNIQUE

Estate and Gift Tax Consequences. A sale of the grantor's property to an IDGT is designed to transfer appreciating property to a trust for the benefit of the next generation. If the transfer is designed as a sale for full and adequate consideration, there should be no gift or estate tax consequences as a result of this transfer.

Let's look at the steps in planning the sale to an IDGT. First, the grantor creates an irrevocable trust and transfers property as a completed gift. It is generally recommended that an initial gift be made to create a trust to provide legitimate independent planning goals for the IDGT. The initial contribution should be substantial. Otherwise, it is possible that the IRS would attack the sale transaction as having no substance because the trust had no other funding or purpose. The size of the gift will generally be equal to the grantor's available unified credit (applicable exclusion amount) or generation-skipping tax (GST) exemption; that is, somewhere between \$1 million and \$2 million (in 2006, 2007, and 2008). If the grantor is married and has the spouse's unified credit and GST exemption also available, the size of the initial contribution could be double these amounts. Any gifts in excess of \$1 million (\$2 million if the grantor's spouse splits the gift) would result in current gift taxes because the gift tax exclusion amount is \$1 million for each individual on lifetime cumulative taxable gifts.

In designing the terms of the IDGT, the grantor will retain no powers that cause estate or gift tax problems after the trust is funded. However, the grantor will retain a power that will make the trust defective for income tax purposes. For example, the grantor might retain the power to borrow from the trust without adequate security or interest or have no obligation to repay the loan within the tax year. Of course, any proceeds or installment note the grantor receives in the sale transaction will be includible in the grantor's estate if he or she continues to hold such assets at the time of death.

Second, the grantor sells an asset expected to appreciate to the IDGT's trustee in exchange for an installment note. For example, the grantor might create a family limited partnership (FLP) with appreciating assets and sell the FLP interest at an appropriate discount to the trust. By using the discounting potential of an FLP, the grantor has the ability to shift larger amounts of family wealth to the IDGT for the specified sale price. The installment note will be interest only, and a balloon payment will be provided for the principal at the termination of the trust. Another advantage is that the required interest rate will generally be lower than the valuation interest rate provided by Sec. 7520 for grantor-retained annuity trusts or similar transactions. If the appreciation on the property exceeds the interest rate paid back to the seller, the appreciation escapes estate or gift taxes.

Sale Ignored for Income Tax Purposes. One important income tax feature of the IDGT is that transactions between the IDGT and the grantor are not recognized for income tax purposes. Thus, the grantor will not have capital gains tax consequences when his or her appreciated property is sold to the IDGT. In a private ruling, the IRS recently held that the sale of property between two grantor trusts for a promissory note is ignored for income tax purposes (Ltr. 200434012).

An additional wealth-shifting advantage is the requirement that the grantor be responsible for the trust's income tax liability. Due to the nature of the gift, estate, and income tax structure of the IDGT, the grantor is able to pay the income taxes out of other assets and not cause the IDGT to be diminished each year by income taxes. This creates a greater wealth shift to the IDGT's beneficiaries without gift or estate tax consequences. In fact, the IRS approved the payment of income taxes by the grantor in a recent published Revenue Ruling (2004-64, 2004-27 IRB 7).

Life Insurance to Enhance Wealth Transfer. The IDGT's assets could be supplemented by the purchase of life insurance on the grantor's life. The trustee could use the cash flow from the property sold to the trust along with the initial gift proceeds to provide for premium payments. Because the sale of property to the trust avoids gift taxes, there should be no further gift tax consequences for the purchase of the life insurance by the IDGT's trustee. This solves some of the gift tax problems created by a traditional life insurance trust because the size of the annual premium does not have to be limited

to the grantor's available annual gift tax exclusions (currently \$12,000 per beneficiary).

Using Private Annuity in Lieu of Installment Sale. A variation of the sale to the IDGT involves the payment by the trustee in the form of a private annuity. The annuity is a fixed annual payment that continues for the remainder of the grantor's lifetime. The present value of the annuity must be equal to the value of the property sold to the IDGT. In this instance, the annuity is determined by the valuation principles of Sec. 7520 and the applicable federal midterm interest rate in effect for the month of the sale. Because a life annuity is based on mortality tables, the usual Sec. 7520 rules for valuing the annuity cannot be used if the grantor is terminally ill and has at least a 50 percent probability of dying within one year. A sale structured in this manner should remove the property and subsequent appreciation from the seller's gross estate, avoid capital gains taxes, and create a stream of retirement income for the grantor that will be paid for the remainder of the seller's life.

USING IDGT TO REPLACE EXISTING IRREVOCABLE TRUST

An obvious concern of any grantor is the inability to amend an irrevocable trust. To achieve the goals of removing death benefits from a life insurance policy from an insured's gross estate, an irrevocable trust is often used as a policyowner and benefit distribution vehicle. A number of private rulings have addressed the use of a newly created IDGT as a method to transfer life insurance from an irrevocable trust that no longer meets the grantor's goals. For example, the grantor may have created an irrevocable trust that provides benefits to one or more individuals whom the grantor no longer wishes to benefit from the death proceeds. Or perhaps the grantor may desire to change the manner in which beneficiaries benefit. In the private rulings, the taxpayers have funded a new life insurance trust with the desired terms and used the new trust to purchase the policy from the existing trust for the policy's fair market value as provided by the tax regulations. If both trusts are grantor trusts, no adverse income tax consequences occur. Of course, the funding of the new trust has gift tax consequences that must be addressed through the use of the grantor's annual exclusions and, if necessary, his or her \$1 million applicable gift tax exclusion amount. In addition, the terms of the original trust will continue to provide for the distribution of the purchase price received for the life insurance policy.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

***Positioning our clients
for the future***



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