THE BERNSTEIN REPORT

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RICHARD S. BERNSTEIN

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Dear Reader,

We've been watching the tax reform situation carefully and probably expected more concrete proposals at this point. The economy is probably having some impact on the thinking relative to tax increases. Treasury Secretary Geithner indicated that President Obama is not likely to seek any major tax increases until 2011. Of course, many of the tax relief provisions from the Bush Administration will expire after 2010 and tax increases will occur automatically unless Congress takes action to extend or amend these provisions. The timing will be interesting. Action taken at that time will be either from a lame-duck Congress or a new legislature following the next mid-term election. Clearly, the election results may make a difference in the tax policy.

One provision that will probably have earlier resolution is the federal wealth transfer tax. The estate and generation-skipping transfer taxes would be repealed for 2010 without some Congressional action in 2009. The proposals to reform this system are already in bill form in the House and Senate. The latest IRS data available indicated over 38,000 federal estate tax returns were filed in 2007. However, the exemption amount was $2 million at that time and is currently $3.5 million. In a recent interview, Bill Gates and Warren Buffet stated that only 12,000 estates would file returns annually. Based on 2007 data, the number would have been over 14,000 with a $3.5 million exemption. Generally, slightly less than half the returns filed report federal estate tax due to the marital deduction and other deductions and credits. However, the total federal estate tax collected is expected to be about $25 billion annually.

Another important issue for the Government is performance of the Pension Benefit Guaranty Corporation (PBGC). The agency insures pension benefits (up to $54,000 annually in 2009) for failed and terminated pension plans of the private sector. The agency will have an estimated $33.5 billion deficit for the first half of 2009. Fortunately, its disbursements are over an extended time period (the lifetimes of covered retirees) and there is not an immediate cash flow problem. Obviously, the final resolution of the auto manufacturers could have a significant impact on the PBGC.

Cordially,

Richard S. Bernstein

A Second Opinion Costs You NOTHING,
But Could Save You MILLIONS!

WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION, SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?

Planning Using Intentionally Defective Grantor Trusts

An estate planning technique that has garnered 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 upon the grantor of the trust. Since 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 The 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 include the power held by the grantor 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, or (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 include the ability of the grantor to control beneficial enjoyment, enjoy the income of the trust, or if trust income could be used on premiums for life insurance covering the life of the grantor or the grantor's spouse. This discussion was 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 The 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 payable to) the grantor or his or her spouse. Thus, the IDGT is funded with the intent to make a completed "no strings attached" gift. Again, this is intended only as an abbreviated summary of the estate and gift tax rules.

The Sale Of Property To IDGTs As A 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 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 since the trust had no other funding or purpose. The size of the gift will generally be equal to the grantor's available gift-tax or generation-skipping tax exemptions; that is, somewhere between $1 million and $3.5. If the grantor is married and also has the spouse's gift-tax and GST exemptions 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 since the gift-tax exclusion amount is $1 million for each individual on lifetime cumulative taxable gifts.

In the design of 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 received by the grantor 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.

In the second step, the grantor then 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 interest rate required will generally be lower than the valuation interest rate provided by Sec. 7520 for grantor-retained annuity trusts (GRATs) 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.

The current economic situation makes this transaction particularly favorable due to lower interest rates and depressed asset values. For example, the applicable federal interest rate for a mid-term installment note this month is only 2.24 percent. The underlying asset sold to the IDGT must appreciate in excess of this rate for the technique to yield the greatest wealth transfer benefits. This excess appreciation would seem to be much more likely with assets that have currently reduced values due to the economic conditions.

Sale is 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 Could Enhance the 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. Since 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 since the size of the annual premium does not have to be limited to the grantor's available annual gift-tax exclusions (currently limited to $13,000 per beneficiary).

Using An IDGT To Escape An 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 that the grantor no longer wishes to benefit from the death proceeds. Or, perhaps, the grantor may desire to change the manner in which the 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 Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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