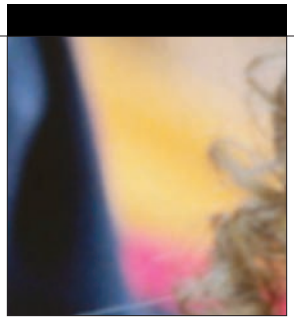

Using a Crummey Trust and a Defective Trust as Part of an Estate Plan

When one or more, but not all, of a business owner's children work in the business, a vexing estate planning dilemma is how to treat all the children fairly. A good strategy is to use a defective grantor trust combined with a life insurance trust.

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Two of the most powerful estate planning tools have names that cause clients to wonder whether they hired the wrong people as planners! Wouldn't you worry if you're paying good money to a planner who tells you that the heart of your plan is both defective and crummy? This article analyzes how to pair (1) an intentionally defective irrevocable trust ("IDIT"), with (2) an irrevocable life insurance trust ("ILIT") with Crummey provisions to benefit clients and their heirs in a substantial way.

Background

Consider a typical scenario facing many estate planners. The clients are a husband and wife who own a successful real estate development business which they operate though a Subchapter S corporation. Their son is active in the family business. Their two daughters and the daughters' husbands do not work in the business. Having some children involved in the family business and others not seems to be a common occurrence in many estates we plan.

The couple is at the point in their career where they feel that it is time to semi-retire and turn the reins of the business over to their son. At the same time, they do not want simply to give it to Junior. They want to keep at least some of the business's revenue to fund their retirement years. Complicating the matter, they want to treat all three children fairly.

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Although not the subject of this article, one of the most difficult problems estate planners face is the clients' desire to treat all the children equally when some are active in the family business and others are not. As both of us attempt to point out, "equity is not synonymous with equality." In other words, "fairness" does not necessarily mean treating all children equally.

Children who work in the business often create sweat equity at the cost of current lower salaries. When the business assets represent such a large proportion of the estate that it is impossible to leave those assets to the child or children who have been active business participants while leaving an equal value of non-business assets to the other children, the clients are faced with either an unequal division of assets or the use of life insurance to equalize wealth among the children. And the client needs to take into consideration the grim statistics that

show that many family businesses fail to survive the transition to the next generation. As a result, a child who receives an interest in a business frequently is at greater risk than children who receive financial assets of lesser value.

In addition to the real estate development business, assume that the couple in the above example own several parcels of commercial real estate—a good asset when easy to sell, but as we all know, very illiquid at times through the course of holding title.

An IDIT combined with life insurance would be the best course of action in passing the business to the son while treating the daughters fairly.

Defective trust

An IDIT is an irrevocable trust typically established by a grantor for the benefit of the grantor's family. It is "defective" only in the sense that, as a grantor trust, the grantor is treated as the owner of the trust for income tax purposes and reports all items of income, deduction, and credit attributable to the trust on his income tax return. In order for the trust to be treated as a grantor trust, the attorney drafts the trust agreement so that the grantor or trustee possesses one or more of the powers delineated in the grantor trust rules of the Internal Revenue Code.

Two important results occur. First, transactions between the grantor and the trust have no income tax consequences because the grantor is treated as dealing with himself or herself.[1] Thus, neither gain nor loss is recognized when the grantor engages in an installment sale of appreciated property to the grantor trust. Similarly, the grantor does not recognize income when the grantor trust pays interest on the installment note. Second, payment of the trust's income tax by the grantor is not treated as a taxable gift to the trust's beneficiaries.[2] Under current IRS ruling standards, payment of income taxes by the grantor is not a gift unless the grantor trust provides the grantor with a right to be reimbursed for such taxes, and the grantor waives such right.[3]

A sale to a grantor trust results in estate and gift tax savings if the property sold to the grantor trust produces an after-payment return in excess of the interest rate on the note. It should be relatively easy to produce an excess return when property is sold to a grantor trust because the grantor pays the income taxes on the trust's income.

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We advised the clients in our example to recapitalize the S corporation in order to create one share of voting stock and 99 shares of non-voting stock. Although an S corporation may not have more than one class of stock, differences in voting rights are disregarded.[4] Once the recapitalization was completed, we recommended that the clients obtain an appraisal of the 99 shares of non-voting stock which would take into consideration the non-controlling and non-marketable nature of the shares. The clients would then make a cash gift equal to at least 10% of the appraised value of the 99-share block to an IDIT for the benefit of their son, his wife, and their children. Their son would serve as trustee of the IDIT and would use the cash gift as the down payment for an installment sale of the 99 shares at the appraised value.

We concluded that an installment sale of an interest in the real estate development company was preferable to using a grantor retained income trust ("GRAT") to transfer the shares to the son for a number of reasons.

- *Discount/interest rate.* A GRAT must use the Section 7520 rate, which is 120% of the federal midterm rate under Section 1274 for the month in which the gift occurs. On the other hand, if the installment sale is for more than three years, but not more than nine years, the minimum interest rate that must be used for the installment note is the federal midterm rate under Section 1274. Using the lower Section 1274 rate reduces the return to the grantor that is included in his or her estate.
- *End-loading.* Reg. 25.2702-3(b)(1)(ii) prevents end-loading a GRAT. In an end-loaded transaction, the payment to the seller/grantor is delayed until the end of the trust term. In a GRAT, the amount payable in any year may not exceed 120% of the amount paid in the preceding year. In contrast, if an installment sale is made to a grantor trust, the note may provide for the payment of all principal at the end of the term in a single balloon payment. If the assets sold/transferred produce a return in excess of the Section 7520 rate, end-loading—a balloon payment at the end of the term—leaves more value in the

[1] Rev. Rul. 85-13, 1985-1 CB 184.

[2] See Rev. Rul. 2004-64, 2004-27 IRB 7.

[3] For a discussion of this issue, see Practical Drafting, pp. 3923-4 (Jan. 1995).

[4] Reg. 1.1361-1(l).

trust than would occur if payments were made on a regular basis.

- *Estate tax inclusion*. The grantor's death during the term of a GRAT causes some or all of the assets in the GRAT to be included in the grantor's estate. On the other hand, when an installment sale is made to a properly drafted and administered grantor trust and the grantor dies before the note is paid in full, only the unpaid balance of the note is included in the grantor's estate.
- *GST exemption may be allocated*. Section 2642(f) prevents allocation of generation-skipping transfer ("GST") tax exemption to a GRAT, which makes a GRAT an inappropriate vehicle to be used to transfer family wealth to grandchildren. In contrast, GST exemption may be allocated to an IDIT. Moreover, GST exemption must be allocated only to property transferred to the IDIT by gift. Since the 99 non-voting shares will be sold to the trust for fair market value ("FMV"), the only transfer by gift consists of the seed money transferred to the trust to be used for the down payment.

Because the clients retain the one share of voting stock, they are able to continue to maintain control of the S corporation without running afoul of Section 2036(b), which causes inclusion of transferred voting stock in the transferor's gross estate if the transferor retains the right to vote such stock as a trustee or otherwise. It has been our experience, both personal and anecdotal, that the value of the one share of voting stock will reflect a control premium of 10%-15% at the client's death. However, that premium will be applied to stock representing only 1% of the value of the company.

If we are successful in avoiding of Section 2036(b), under what other circumstances—if any—could the IRS argue that the 99 shares of non-voting stock sold to the IDIT should be included in the client's gross estate?

There appear to be two tests that need to be met. First, the trust must be adequately capitalized with an independent net worth equal to at least 10% of the purchase price. Second, the note payments should not be tied to the cash flow produced by the 99 shares sold to IDIT. If both the timing and the amount of payments on the note are substantially equivalent to the timing and payment of distributions with respect to the 99 shares, the IRS will argue that the transaction is not really an installment sale but rather is a transfer in trust in which the grantor has retained an income interest, and that the "sold" assets and not the promissory note are includable in the grantor's gross estate under the retained life estate provisions of Section 2036(a)(1).[5]

The grantor's death while the note is outstanding converts the trust from grantor trust status to a separate taxpayer. That change in status would apparently result in a deemed installment sale of the property to the trust for the promissory note immediately prior to the deceased grantor's death.[6] Under Section 691, the deferred gain on the sale would ultimately be recognized either by the estate or by the beneficiaries, and the basis of the property to the trust or an acquiring beneficiary should be the deemed sale price. Consistent with this reasoning, the post-death basis of the property to the trust or to any beneficiary acquiring it from the trust should equal the sale price to the trust.

In the scenario described in our earlier example, the clients agreed to the recapitalization. The 99 shares of non-voting stock were appraised at $1.6 million after taking into consideration discounts for lack of control and lack of marketability. The clients made a gift of $200,000 to the IDIT, which the trust used as the down payment to acquire the non-voting shares. The balance of the purchase price was represented by an installment note, which was debt serviced by a portion of the S corporation dividends received by the IDIT.

Irrevocable life insurance trust

To provide for their daughters, the clients also created an ILIT, which owned second-to-die insurance on the clients' lives. Until both clients had passed away, the ILIT was to be administered as a pot trust for the two daughters, their spouses, and the six grandchildren. Because ten beneficiaries were entitled to present benefits from the ILIT, each client could give a maximum of $120,000 in annual exclusion gifts to the ILIT to provide funds for the payment of insurance premiums through inclusion of a Crummey withdrawal right.

Named for *Crummey*,[7] such a right typically permits a beneficiary to withdraw property of a specified value whenever a contribution is made to the trust. Withdrawal rights are customarily non-cumulative and will lapse if not exercised within the time limits set forth in the trust instrument. The power of withdrawal constitutes an unrestricted right to the immediate use or possession of the property subject to the power, and the donor is

[5] See Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 ETPL 3 (Jan. 1996). See also Cain, 37 TC 185 (1961), *acq.*; Estate of Bergan, 1 TC 543 (1943), *acq.*; Estate of Becklenberg, 273 F.2d 297, 5 AFTR2d 1821 (CA-7, 1959); Rev. Rul. 77-193, 1977-1 CB 273.

entitled to the gift tax annual exclusion for gifts of a present interest.

The Service has held that a Crummey withdrawal right does not create a present interest "if the donor's conduct makes the withdrawal power illusory and effectively deprives the donee of the power."[8] In essence, the Service's position boils down to three requirements: First, the beneficiary must receive adequate notice of the withdrawal right. Second, the beneficiary must have a "reasonable" period of time within which to exercise the right. It is generally agreed by most estate planners that written notice of the withdrawal right given to the beneficiary at least 30 days in advance of the withdrawal date satisfies both requirements. Third, the asset must be income-producing or, if withdrawn, the beneficiary must be able to convert the asset into one that is income-producing.[9]

In our example, the clients elected to use a portion of the cash flow produced by the note payments to fund the ILIT through annual cash gifts. Had they not sold all 99 shares of non-voting S stock of their real estate development business to the IDIT, the clients might have transferred enough shares to the ILIT to allow the S dividends paid with respect to the transferred shares to fund the insurance premiums. Had they done so, the ILIT would have been a grantor trust with respect to such payments.[10]

The bottom line is that being defective and Crummey is often in your clients' best interests! ■

6 See Madorin, 84 TC 667 (1985); Reg. 1.1001-2(c), Example 5.

7 397 F.2d 82, 22 AFTR2d 6023 (CA-9, 1968).

8 See, e.g., Rev. Rul. 81-7, 1981-1 CB 474.

9 Hackl, 335 F.3d 664, 92 AFTR2d 2003-5254 (CA-7, 2003).

10 Use of the income of an irrevocable trust to pay premiums on insurance policies on the life of the grantor or the grantor's spouse results in the trust becoming a grantor trust with respect to such payments. Section 677(a)(3).

If the grantor dies before the installment note is paid in full, only the unpaid balance of the note is included in the grantor's estate.