WHEN "DEFECTIVE" IS DESIRABLE – PRE-IMMIGRATION PLANNING FOR FAMILIES WITH U.S. PERSONS

Authors
Fanny Karaman
Nina Krauthamer

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When it comes to pre-immigration planning, there are greater opportunities when the individual moving to the U.S. is not yet a U.S. person for U.S. tax purposes: Various techniques are available to increase basis in non-U.S. assets. Trusts can be set up to shield assets from U.S. estate and gift tax exposure. Non-U.S. holdings can be restructured to avoid, for instance, holding shares in passive foreign investment companies or controlled foreign corporations. The list goes on.

However, when the non-U.S. person has a U.S. spouse, the scope of pre-immigration planning is substantially diminished for the assets held by the spouse.

This does not mean, however, that nothing can be done for U.S. tax purposes. One attractive tool is the intentionally defective grantor trust ("I.D.G.T.").

I.D.G.T.'s take advantage of the dychotomy that exists between the U.S. income tax and the U.S. estate and gift tax treatment of trusts:

- For U.S. income tax purposes, trusts are either treated as the taxpayer ("non-grantor trusts") or disregarded, with the settlor being treated as the actual taxpayer, ("grantor trusts").
- For estate tax purposes, a different set of rules exist. A grantor trust does not necessarily result in estate tax inclusion upon the death of the grantor.

An I.D.G.T. is a trust that is disregarded for income tax purposes but respected for estate tax purposes. In order to achieve this result, the trust (i) must fail one of the tests for non-grantor trust status, but (ii) cannot provide the grantor sufficient powers to cause an estate tax inclusion of the trust assets under Code §§2036 and 2038.

If set up correctly, the grantor is liable for income tax on the trust's income, but the trust assets are not included in the grantor's estate.

In addition, the income taxes paid by the grantor may constitute, in essence, a non-taxable gift from the grantor to the beneficiaries. Furthermore, assets that are expected to substantially increase in value during the grantor's life can be sold to the trust in exchange for an interest bearing note – a valuable estate freeze technique.

ACHIEVING AN ESTATE TAX EXCLUSION UNDER CODE §§2036 AND 2038

As a general rule, Code §2036 provides that property transferred during an individual's lifetime, by trust or otherwise, will be included in the taxable estate if the transferor retained certain rights in the underlying property.

This rule applies to transfers where the transferor has retained certain rights for any

of the following periods:

- The transferor's life
- Any period not ascertainable without reference to the transferor's death
- Any period that does not in fact end before the transferor's death

The retained rights must be either of the following:

- The possession or enjoyment of, or the right to the income from, the property
- The right, either alone or in conjunction with another person, to designate the persons who will possess or enjoy the property or the income therefrom

"Property transferred during an individual's lifetime, by trust or otherwise, will be included in the taxable estate if the transferor retained certain rights in the underlying property."

The retention of a right to directly or indirectly vote shares of stock in a controlled corporation constitutes a retention of the enjoyment of transferred property for this purpose.[1] In this context, a controlled corporation is a corporation in which the grantor, and those persons from whom ownership would be attributed under Code §318, own stock possessing at least 20% of the total combined voting power of all classes of stock of the corporation.[2] Code §318 attributes stock owned by an individual's spouse, children, grandchildren, and parents to that individual.[3]

Thus, Code §2036 applies to a transfer of property during an individual's lifetime (or within three years of death)[4] with the following retentions in said property:

- The right to, or the right to designate those entitled to, the possession of the property
- The right to, or the right to designate those entitled to, the enjoyment of the property
- The right to, or the right to designate those entitled to, the income of the property

Certain transfers are excluded from the Code §2036 inclusion rule. These include, but are not limited to, transfers that constitute a *bona fide* sale of the assets subject to the transfer.[5] These transfers must constitute actual sales for adequate and full consideration in money or money's worth.

Under Code §2038, the estate of a decedent must include the value of property transferred, by trust or otherwise, during the decedent's lifetime when certain conditions exist:

- The decedent possessed at death a power (in whatever capacity exercisable) to alter, amend, revoke, or terminate the transfer. This includes any power affecting the time or manner of enjoyment of property or its income,

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1 Code §2036(b)(1).

2 Code §2036(b)(2).

3 Code §318(a)(1). Note that Code §318 contains other attribution rules as well.

4 Code §2035.

5 Code §2036(a).

even though the identity of the beneficiary is not affected.[6]

- Such power (i) is exercisable by the decedent alone or by the decedent in conjunction with another person (without regard to when or from what source the decedent acquired such power) or (ii) was relinquished within three years of death.

As with Code §2036, exceptions exist to the application of Code §2038:

- Inter vivos transfers that constitute *bona fide* sales for adequate and full consideration in money or money's worth[7]
- Where the decedent no longer had the power at the time of death (and within three years from his or her death)[8]
- Where the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property and the power adds nothing to the rights of the parties under local law[9]
- Where the exercise of the decedent's power was subject to a contingency beyond the decedent's control that did not occur before death[10]
- Where the power held by the decedent was subject to an ascertainable standard[11]

ACHIEVING AN INCOME TAX INCLUSION UNDER GRANTOR TRUST RULES

A grantor of a grantor trust, or another person treated as the owner of any portion of a trust, must include all items of trust income, deduction, and credit in computing his or her taxable income, as if he or she had received the items of income or incurred the expenses directly.[12] A non-grantor trust, on the other hand, is treated as a separate taxpayer, and the grantor is not subject to tax on the trust's income. When setting up an I.D.G.T., the trust must be a grantor trust for income tax purposes.

Under the grantor trust rules, a U.S. grantor is generally treated as the owner of a U.S. trust, or portion of a trust, in respect of which the grantor or a non-adverse person (or both) has certain powers enumerated in Code §671 to §679.[13] As a

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[6] Treas. Reg. §20.2038-1(a), last paragraph.

[7] Code §2038(a)(1); Treas. Reg. §20.2038-1(a)(1).

[8] Code §2038(a)(1).

[9] Treas. Reg. §20.2038-1(a)(2).

[10] Treas. Reg. §20.2038-1(a)(3).

[11] *Jennings v. Smith*, 161 F2d 74 (2d Cir. 1947), April 14, 1947.

[12] Code §671.

[13] Code §672(a). For purposes of the grantor trust rules, a "non-adverse party" is any person that is not an "adverse party." An adverse party is any person that has a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of that person's power with respect to the trust. A general power of appointment constitutes a beneficial interest in the trust for this purpose.

result, when intentionally desiring grantor trust status, the trust instrument must be drafted as to confer at least one of the powers contained in Code §671 to §679 to the grantor. However, not all such powers can be used without also triggering estate inclusion under Code §§2036 or 2038. Among others, certain reversionary interests,[14] the power to dispose of beneficial enjoyment of trust assets or income,[15] and the power to revest title in the trust property should generally be avoided.[16]

Generally, the following constitutes a non-exhaustive list of powers that would not trigger the Code §§2036 or 2038 inclusion rules:

- More than half of the trustees are related to the grantor or are subordinate to the grantor's wishes and have the power to sprinkle income or corpus among the beneficiaries.[17]
- The grantor retains the power to borrow trust assets without adequate security.[18]
- The grantor, or any other person, has the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting property of equivalent value.[19]

  Pursuant to Revenue Ruling 2008-22, this type of right should not cause the value of the trust corpus to be included in the grantor's estate under Code §2036 or 2038 if the following conditions are met:[20]

  - The grantor holds the power to substitute assets in a nonfiduciary capacity.
  - The trustee has a fiduciary duty (under local law or the trust instrument) to ensure that the grantor complies with the terms of the power by the trustee's satisfaction that the substituted properties are of equivalent value.
  - The substitution power cannot be exercised in a manner that shifts benefits among the trust beneficiaries.

    This last requirement is only met if the trustee has either (i) both (a) the power (under local law or the trust instrument) to reinvest the trust corpus and (b) a duty of impartiality with respect to the trust beneficiaries, or (ii) the nature of the trust's investments or the level of income produced by any or all of suh investments does not impact the respective interests of the beneficiaries (such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.

  Delaware law, for instance, has been modified in order to provide that trustees

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14 Code §673.

15 Code §674.

16 Code §676.

17 Code §674(c).

18 Code §675(2).

19 Code §675(4).

20 Rev. Rul. 2008-22, 4/17/2008.

have a fiduciary duty to make certain that the exchanged assets are of equivalent nature, thereby making it easier to meet the requirements of Revenue Ruling 2008-22.[21]

However, and as stated previously, the power to reacquire voting stock in a controlled corporation may result in estate tax inclusion under Code §2036. As a result, caution is required at the time of drafting the trust instrument.

- Trust income may be paid to the grantor's spouse. [22]
- The income may be used to pay insurance premiums on the grantor's life.[23]

ACHIEVING A GIFT TAX EXCLUSION FOR INCOME TAXES PAYED BY GRANTOR

In Revenue Ruling 2004-64 (the "Ruling"), the I.R.S. examined the gift tax consequences of income tax payments made by the grantor of a grantor trust.[24]

In the Ruling, the I.R.S was presented with the following facts: A U.S. grantor ("Grantor") created an irrevocable intervivos trust for the benefit of Grantor's descendants. The trustee could not be a person related or subordinate to Grantor and the appointed trustee met these requirements. The transfers into trust were not incomplete gifts and were not considered as being subject to Code §§2036 or 2038, but the trust was a grantor trust for income tax purposes.

The I.R.S. concluded that Grantor's income tax payment for trust income did not constitute a gift to the beneficiaries. Further, as long as the trust instrument or the applicable local law did not require the trustee to reimburse the grantor for the payment, the value of the trust's assets was not includible in Grantor's estate. Finally, if the trust instrument or the applicable local law gives the trustee the discretion to reimburse the grantor for such payments, the existence of such disrection (whether exercised or not) will not, by itself, cause the value of the trust's assets to be included in the grantor's gross estate.

ACHIEVING A STEP UP IN BASIS: SALE IN EXCHANGE FOR NOTE

If the grantor first contributes funds or income producing assets into the trust and subsequently the I.D.G.T. acquires assets from the grantor in exchange for a promissory note with interest at the appropriate applicable Federal rate, only the value of the note at the time of the grantor's death will be included in the grantor's taxable estate. The note must reflect the fair market value of the acquired property and a valuation is thus advised. The grantor's initial contribution would constitute a gift for U.S. gift and estate tax purposes, thus decreasing the grantor's lifetime exemption

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21 12 Del. C. §3316.

22 Code §§677(a)(1) and (2).

23 Code §677(a)(3).

24 Rev. Rul. 2004-64, 07/01/2004.

amount. Generally, a contribution of 10% of the property value is acceptable,[25] although some practitioners suggest as much as 50%. The note must provide interest payments to the grantor during the grantor's life. It is important that the note bears all attributes of a debt instrument for it to be respected and for this estate freeze technique to work. This technique is especially interesting for assets expected to substantially increase in value during the grantor's lifetime since it essentially freezes the assets' value at the value of the note.

The upsides of the technique are the following:

- An estate tax inclusion is available up to the value of the note at the time of death, and not for the full value of the property, as increased post-sale.[26]
- The lifetime exemption amount is considerably optimized.
- A sale between the grantor and the grantor trust generally does not result in any capital gain or loss, since the trust is disregarded for Federal income tax purposes.[27]

The downside of this technique is the absence of a step-up in basis upon the grantor's death, since the assets are not included in the grantor's estate and the sale is disregarded.

CONCLUSION

"Only the value of the note at the time of the grantor's death will be included in the grantor's taxable estate."

While planning options are available for high net worth U.S. individuals, instruments such as the I.D.G.T. must be carefully drafted and analyzed in order to avoid future backfalls.

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25 PLR 9535026.

26 Code §1014(f), requiring basis consistency with the estate tax return.

27 Rev. Rul. 85-13, not following *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984).

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