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Estate and Tax Planning Tools for U.S. Citizens

QPRT, GRAT and IDGT or on how to make a monkey of tax tables

U.S. citizens are subject to U.S. federal income tax at graduated rates of up to 39.6% on their worldwide income and gains. The IRS under the Clinton Administration has successfully shut down major loopholes through which U.S. citizens were able to avoid reporting on their income [1] by residing abroad or investing through foreign vehicles. The latest example in this development is the new withholding regime under the regulation to section 1441 of the Internal Revenue Code («IRC») which in effect ensures the tax reporting of income and gains of U.S. citizens and residents investing in the United States through foreign financial institutions [2].

Tax observations [3]

U.S. citizens are also subject to U.S. federal gift and estates taxes on their worldwide estates and transfers at rates of up to 55% (on taxable estates in excess of USD 3 million). The transfer taxes however start only for transfers, respectively estates which exceed the unified credit of currently USD 675000. The reporting requirements on the income assist the tax attorneys of the IRS to determine the estate. It comes therefore to no surprise that the political focus in Washington in the election year has shifted to more dramatic proposals regarding this extraordinarily high tax burden on wealth transfer: the repeal of the federal gift and estate tax. President-elect George W. Bush will guarantee that even the success of President's veto against such repeal will not make the issue disappear.

Notwithstanding the threat of repeal the advice of estate tax practitioners is experiencing high demand in a fast growing market of private wealth. Qualified Personal Residence Trusts («QPRT»), Grantor Retained Annuity Trusts («GRAT») and Sales to Intentionally Defective Grantor Trusts («IDGT») belong thereby to the standard weapons in the estate planner's arsenal. The basic mechanics of these weapons shall be explained below:

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Qualified Personal Residence Trusts or on how to eliminate transfer taxes on your holiday residence

Section 2702 (a)(3)(A) (ii)

Prior to the enactment in 1990 of section 2702 of the Internal Revenue Code of 1986, grantor retained income trusts (GRIT) were extremely popular. The basic technique involved the transfer of assets to a trust for a term of years. The grantor retained typically both an income interest and a reversion if the grantor died during the trust term. Since both the value of the income interest and the retained reversion were deemed retained by the grantor, the gift to the remainder beneficiary was substantially reduced.

Example:
John, a 65 year old grantor creates a ten year grantor retained income trust (pre 86 with a section 7520 ten year term rate at 8%) funded with USD 1000000. The value of the retained income interest was .48081 and the value of the retained reversion was .17799, making the total retained interest .65880. Thus the gift was 34.12 percent (USD 341200) of the value of the property transferred. Consequently, if the grantor outlived the trust term of ten years he transferred USD 658800 free of any wealth transfer tax.

This common law GRIT was too good to last. The actuarial tables valued correctly the income interest in a GRIT only if the transferred property actually produced income equal to the section

7520 rate which calculates the rate of return on 120 % of the mid-term AFR rate. The tables in the above example were assuming that 8 % would be added to the grantor's estate and that the remainder would be discounted by this amount. However, the GRIT rules were typically used for no or low income producing property (shares with no dividends) thereby making a monkey of the tables.

The enactment of Section 2702 IRC put a stop to most of such abusive schemes [4] but it excluded expressly GRIT funded with personal residences, so called Qualified Personal Residence Trusts («QPRT») [5]. QPRT are widely used for a primary or secondary residence in the United States to ensure the transfer of property to the next generation:

Example:
John, age 60, transfers his 1 million residence in Florida to a fifteen year QPRT in which he retains a contingent reversion in the event of his death before the end of the QPRT. Assuming 6.4 % to be the applicable Section 7520 IRC rate, John made a gift of USD 267520; however, the entire gift would be sheltered by the unified credit assuming that this credit has not been used up. If John reaches 75 years, the residence will not fall into his estate, but belongs to the remainder of the QPRT. If, however, John dies before the end of the term the value of the entire trust will fall into John's estate.

The QPRT must be a grantor trust i.e. the provision of the QPRT must be such to cause all income to be taxed to the grantor under the grantor trust rules set out in Section 671–678 IRC. It means that the grantor retains the income tax advantages also of residence ownership. Those advantages include allowing the grantor to deduct mortgage interest payments as specified under Section 163(h)(3). It also means that the grantor can roll over tax free gains realized upon the sale of the residence, as long as the gain is reinvested in a residence, Section 1034 IRC. A major drawback of the income tax treatment is that the remainder of the trust – likely the children – take the grantor's basis in the QPRT property and cannot take advantage of the automatic basis step-up granted to property which falls into the estate under Section 1014 IRC, thus this income tax feature makes a QPRT unattractive for property bought a long time ago at a lower value.

All the advantageous estate tax effects of a QPRT depend on the grantor outliving the trust term. The more risk friendly the grantor is the longer the trust term is. It becomes at the end a mild form of gamble on outliving the trust term. The more chances the client takes with regard to outliving his life expectancy the more likely it is that the gift at the inception of the QPRT is sheltered completely from tax by the unified credit.

Most clients are willing to take higher risks, but at the same time are horrified by the prospect of having to pay rent to the new owner of the residence, often their children, once the trust term ends. To avoid any such obligation the modern QPRT have as beneficiary not directly the children of the grantor, but provide instead for an intentionally defective grantor trust as remainder.

Zeroed out Grantor Retained Annuity Trusts or on how one should leverage on success

Section 2702(b)(1)

In a grantor retained annuity trust (GRAT) the grantor creates an irrevocable trust and retains the right to receive for a specified term an annuity based on a specified sum or a fixed percentage of the value transferred to the trust. The amount of such annuity must be paid at least annually.

Example:
John transfers USD 2400000 to a trust and retains a right to receive annual annuity payments of 10 % for a term of 15 years. John also retains a reversionary interest in case he should die before the trust term expires (discount rate 9.6). The factor for the retained annuity interest is .7783 on the USD 2400000, therefore, the total value of the retained annuity interest is USD 1867920 and the remainder interest is USD 532080. The gift tax applies only to the remainder interest. By retaining an annuity interest, John's gift was reduced by the present value of the annuity.

The idea underlying the introduction of Section 2702(b)(1) was that the annuity payment would take any incentive (as existing under a GRIT) to invest the trust property one way or the other and would impede to undermine the actuarial tables by skewing the investment [6]. Certainly it was not foreseen that the GRAT would be used as a riskless gamble in as much the remainder value approaches zero. Nevertheless it is exactly this feature of structuring a GRAT (at least theoretically) in such a manner that there is little or no up-front gift which made it utmost successful.

If a GRAT has a remainder interest equal to zero, it is called a zeroed out GRAT. Therefore no gift tax is due because the value of the gift is zero. In order to achieve such result, the annuity interest has to approximate the value the transfer into the trust and its Section 7520 IRC return rate. Since the valuation of the retained and the remainder interest is performed at the time of transfer to the trust, the grantor bets that the trust property will appreciate by more than the discount factor provided by the Section 7520 tables of the IRC. If this occurs, the excess valuation will go to the beneficiary free of any transfer tax. In order to limit the risk of falling into the estate of the grantor, the zeroed out GRAT is usually for a short term, but even without being completely zeroed out it can already have a substantial leverage effect:

Example [7]:
John transfers 910000 shares of a publicly traded company (of which John's family controls 47.5 %) too a two year GRAT reserving an annuity of 54.8 % of the initial fair market value of the property in the trust, remainder to his children on termination. If John died during the term, the balance of the annuity would pass to his wife, provided John does not revoke her interest. John's retained annuity comes to 12.2 million per year and John reports a gift of USD 121000 which he shelters through the unified credit. Two years later the publicly traded shares are worth USD

20186000 which pass to the children without any transfer tax or income tax (as explained below) [8].

In a highly leveraged GRAT as in the example of the TAM above, the annuity will be so large and will exceed the section 7520 rate return to such an extent that it won't be possible to satisfy the annuity from current yield. Trust property must be sold or distributed in kind to the grantor. Since the GRAT enjoys grantor trust treatment i.e. the trust income is taxed on the grantor, any transaction between the trust and the grantor will be regarded as a non-event for tax purposes by the IRS under Rev. Ruling 85–13. Without income tax consequences, therefore, the trust may satisfy the grantor's annuity by returning, in kind, shares to the grantor that he originally transferred.

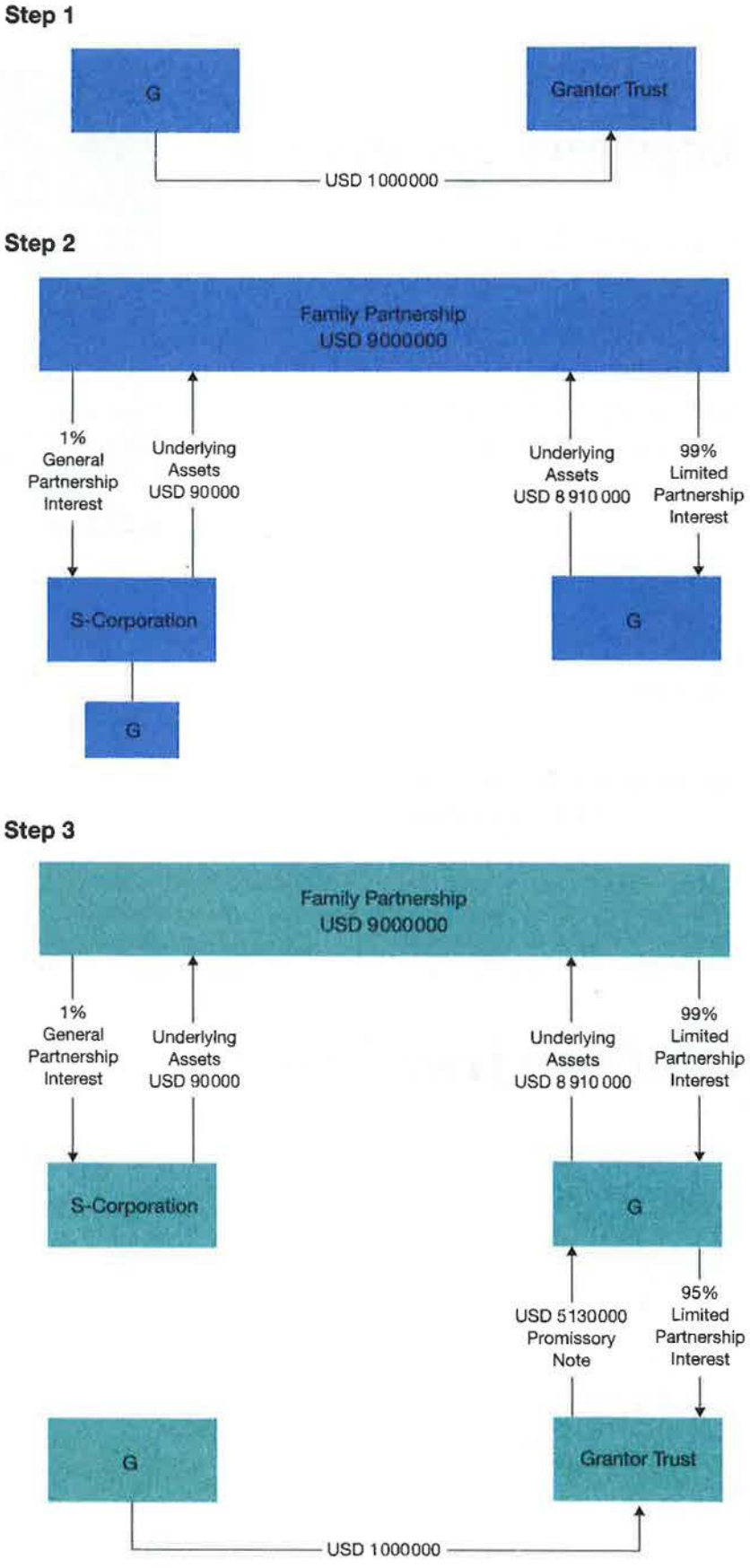
It is astonishing that the use of highly leveraged GRAT as a tax and estate planning tool has not yet been challenged by the IRS, and the change of law is about the only risk one takes by creating a zeroed out GRAT. There is no gift at the inception and no downside to it; in case the property does not produce the appreciation expected in excess of the 7520 rate, the grantor is in the same position as before the creation because of the annuity, he furthermore can even follow up the short term GRAT with a new one.

The GRAT territory is hence one of the very, very few «tax payer paradises» remaining for a U.S. citizen on this planet.

Sales to Intentionally Defective Grantor Trusts or on how to make a mouse out of an elephant

Section 671–679 IRC

The grantor trust rules of the Internal Revenue Code determine when a grantor is treated as owner of all or a portion of a trust, Section 671–679 IRC. To the extent the grantor trust rules apply, the trust entity is for the most part ignored for income tax purposes and



the regular rules governing the taxation of trusts are inapplicable, Reg. 1.641 (a)-0.

The rules governing the ownership of trust income are not conterminous with the rules governing ownership of assets for federal estate tax purposes. It is indeed this lack of symmetry between the codified federal income and estate taxes which is exploited by the creation of an intentionally defective grantor trust (IDGT).

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Example:
The discretionary power of the grantor's spouse, as trustee, to sprinkle income and principal among the grantor's descendants makes a trust a grantor trust for income tax purposes. Because the grantor has not retained any powers exercisable by the grantor, the gift is complete and the trust is not includable in the grantor's estate.

A popular estate planning freeze transaction involves a sale, usually an instalment note, to an IDGT. The value of the assets is «frozen» at the value of the note received in the sale so that future appreciation in the value of the assets sold to the IDGT will be transferred to the beneficiaries of the IDGT without gift or estate tax. Since transactions between the owner and the trust are not taxable events for income tax purposes [9], the assets, for example shares before or after an initial public offering, can at any time be sold to the grantor for cash. This is extremely helpful in case a grantor does not want the beneficiaries to get all the appreciated shares. Contrary to a GRAT the appreciation does not have to beat any Section 7520 rate since the grantor has not retained an annuity or any other reversion, an IDGT is therefore the more aggressive tool in shifting appreciation tax free to the next generation.

The estate practitioner in the United States is not stopping with the creation of an IDGT which allows, as it is also achieved by an outright gift, to shift the appreciation tax free to the next generation, but he exploits such a tool to the utter limit by combining it with other discrepancies in the tax law. The most popular scheme is the creation of a family limited partnership and the sale of the limited partnership assets to the IDGT for an instalment note. The reason for such transaction is that the freeze of the value of the property sold to the IDGT can happen at much lower value.

Example:
John has cash and marketable securities of USD 10000000. He creates an IDGT for the benefit of his children and makes a taxable gift of USD 1000000 cash to it largely sheltered by the unified credit. He also creates an S-corporation and contributes USD 90000 cash to it. John and his S-corporation form a family limited partnership under Delaware law, the corporation contributes for an 1% equity interest and John contributes without any tax consequences his remaining USD 8910000 of marketable securities in return for the 99% limited partnership interest. Subsequently John and his S-corporation obtains an appraisal of 95% of the limited partnership interest, showing a fair market value of USD 5130000 after minority and lack of marketability discounts aggregating to 40% which is typical under the closely held business valuation rules. He then sells a 95% limited partnership interest to the IDGT for USD 5130000 for a promissory note bearing interest only at a low interest rate for ten years with the principal due at the end of ten years.

Since transactions between a grantor trust and a grantor are a non-event for income tax purposes, John has frozen in the above example most of his 10000000 marketable securities and cash at a value of USD 5130000 with the appreciation going tax free to his children.

It is not clear how long the Internal Revenue Service will tolerate such schemes as GRAT and IDGT that it created itself by asymmetries in its tax laws. But there is a likelihood that the Government will react to schemes pushed to the limits by the tax planner.

However, there in no doubt that anytime the Government enacts changes to its complex tax system, it will nourish the creativity of tax planners. So even a possible phase out of the federal transfer taxes until the year 2010 under a Republican President would be a blessing for the tax planner in as much as it

will shift the creativity of the tax lawyer to other areas of the tax law. ☰

Notes

1 Small Business Job Protection Act of 1996 (closed many opportunities for foreign trusts of U.S. citizens).

2 Reg. 1.1441-1.

3 Tax laws observed as of July 2000 by the author.

4 For transactions among family members special valuation rules now apply.

5 Section 2702 (a) (3) (A) (ii).

6 Leo L. Schmolka: FLPs and GRATs: What to do?, Tax Notes, Special Supplement, Mar. 13, 2000, p.1473.

7 TAM 9717008 (technical advice memorandum of the IRS).

8 Through full deployment of the unified section 2505 credit a couple in the above example could have passed USD 200 mio! of wealth to their children without paying a nickel of tax, Schmolka, Tax Notes, Special Supplement, Mar. 13, 2000, p.1473.

9 PLR9736038, Rev. Rul. 85-13.

ZUSAMMENFASSUNG

Steuer- und Nachlassplanungsinstrumente für amerikanische Bürger

US-Bürger sind sowohl auf ihrem weltweiten Einkommen wie auf ihren weltweiten Vermögensüberträgen (Schenkung oder Erbschaft) steuerpflichtig. Die Steuerbehörden haben unter der Clinton Administration die meisten Steuerschlupflöcher gestopft. Umso mehr erfreut sich der Steuer- und Erbschaftsplaner einer grossen Nachfrage in einer Zeit des wachsenden privaten Reichtums.

Qualified Personal Residence Trusts (QPRT), Grantor Retained Annuity Trusts (GRAT) und Verkäufe an Intentionally Defective Grantor Trusts (IDGT) gehören dabei zu den Standardinstrumenten des amerikanischen Nachlassplaners. Ihnen gemeinsam ist, dass sie versuchen, die im Steuergesetz vorhandenen Disparitäten oder Steuertabellen auszunutzen.

Qualified Personal Residence Trusts (QPRT)

Durch einen Qualified Personal Residence Trust wird Grundeigentum in einen zeitlich begrenzten Trust übertragen, wobei der Übertragende sich das Einkommen am Trust bzw. das Wohnrecht zurückbehält und das Trustkapital (Remainder) an einen weiteren Trust oder an die Kinder geht. Die Schenkung in der Höhe des Verkehrswertes des Eigentums wird dabei durch das zurückbehaltene Trusteinkommen diskontiert; der steuerlich vorgesehene Diskontierungssatz stützt sich dabei auf die Lebenserwartung des übertragenden Grantors. Als Folge wird nicht nur die Schenkung über eine Diskontierung erheblich verkleinert, sondern gleichzeitig behält der Übertragende aufgrund der Grantorstellung alle Vorteile unter dem Einkommenssteuergesetz wie zum Beispiel den Abzug von Hypothekarzinsen während der Laufzeit des Trusts.

Grantor Annuity Trust (GRAT)

Mit einem Übertrag von Vermögenswerten in einen zeitlich begrenzten Grantor Annuity Trust behält sich der Übertragende ein Recht an einer äusserst hohen Rentenauszahlung oder einer Prozentuale des transferierten Wertes vor. Die zurückbehaltene Annuity (Rente), welche mindestens jährlich ausgezahlt werden muss, wird gemäss den Gesetzestabellen um 125 % der Bundeszinsraten, welche als Messinstrument für die zu erwartende Wertsteigerung genommen wird, diskontiert. Meist wird dabei eine so hohe Annuity gewählt, dass der Schenkungsbetrag praktisch auf null hinunter diskontiert ist (Zeroed Out Grantor Annuity Trust). Alle Werterhöhungen, welche den auf die Annuity angewandten Zinssatz übersteigen (beispielsweise Aktien in einem IPO), sind dabei vor den Schenkungs- und Erbschaftsteuern geschützt. Gleichzeitig erlauben die Grantor Trust Rules die Annuity durch Trustassets auszubezahlen. Da Transaktionen zwischen einem Grantor und einem Grantor Trust für steuerliche Zwecke neutral sind, können so Millionenbeträge ohne die geringste Steuerkonsequenz übertragen werden.

Verkauf an einen Intentionally Defective Grantor Trust (IDGT)

Ein Intentionally Defective Grantor Trust ist ein Trust, der für Einkommenssteuerzwecke die Besteuerung beim Grantor belässt, für Transfersteuern (Erbschafts- und Schenkungssteuern) jedoch von einem vollständigen Übertrag ausgeht und entsprechend die Trustassets der Erbschaftsmasse des Grantors entzieht. Dieser durch die Inkongruenz zwischen Einkommen und Schenkungs- und Erbschaftssteuerrecht geschaffene IDGT wird meistens im Zusammenhang mit einem Value Freeze benutzt. Äusserst populär ist dabei die Einbringung von Titeln in eine Family Partnership, welche durch die bestehenden Bewertungsgrundsätze von erheblichen Diskontierungen (Minority und Marketability Discounts) profitieren kann. Anteile der Limited Partnership werden anhand dieser tiefen (frozen) Bewertung an einen IDGT verkauft. Die Titel in der Limited Partnership können so durch den IDGT eine steuerfreie Wertsteigerung erfahren.

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