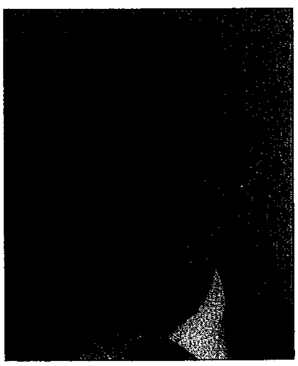
NYSBA SPRING 2009 | VOL. 42 | NO. 1

Trusts and Estates Law Section Newsletter

A publication of the Trusts and Estates Law Section
of the New York State Bar Association

A Message from the Section Chair


Ira Bloom

As this year's Section Chair, I welcome the opportunity to serve our nearly 5,000 members.

The year 2009 portends to be busy, exciting and full of significant changes.

January's Annual Meeting Program addressed the timely topic of law firm succession planning, with kudos going to James Cahill, Program Chair, and to all the panelists and speakers, including Surrogate John Cyzgier for his timely and excellent presentation on the safekeeping and turnover of wills. Our luncheon speaker, Michael Mariani, Senior Vice President, Fidelity Trust Company International, gave an informative talk on planning opportunities during these challenging and uncertain times.

A major change, initiated this year, was to shift the season for the annual out-of-state meeting. Before 2009, the meeting was held in the Fall, including the very successful meeting that was held in September of 2008 at the Broadmoor Hotel in Colorado Springs. (Wally Leinheardt, the immediate past Chair, is to be commended on that excellent program, as is the Program Chair, Ilene Cooper, who is this year's Section Treasurer.) The change to the Spring was brought about because of weather concerns, prompted by Hurricane Katrina which necessitated changing the scheduled 2005 Fall Program from New Orleans.

By now, the Spring Program at the Amelia Island Plantation will have come and gone. I'm confident that it will have met expectations: a timely and highly educational program at a wonderful and accessible location. Indeed, it is hard to imagine how the program, entitled "Estate Planning in Uncertain Times: Tax and Non-Tax Considerations," could not have been successful as it featured some of the most prominent speakers in the country, including Amy Beller, Prof. Susan Gary, Randy Harris, Carlyn McCaffrey, Prof. David Pratt, Jonathan Rikoon, Josh Rubenstein and Sandy Schlesinger. My thanks to Prof. Deborah Kearns, my colleague at Albany Law School, for serving as

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The Sale of Assets to a "GDOT"—An Essential Estate Planning Tool for Sizable Estates

By Randall H. Borkus and Richard J. Shapiro

Introduction

Consider the following scenario: an ambitious attorney has worked hard in building her estate planning practice. She has mastered "foundational" planning, including the use of credit shelter trusts and life insurance trusts for estate tax planning. The attorney has developed a nice referral network of financial advisors and CPAs, and has developed a solid reputation in her community.

Out of the blue, the attorney receives a call from a financial advisor she knows from the Rotary Club. The advisor has referred a married couple that has never done any estate planning. They come in for their appointment, looking like the "typical" client—that is, until they hand the attorney their completed intake form showing total assets of $40 million. They tell the attorney that their objectives include avoiding probate, protecting the interests of the surviving spouse, and reducing or even eliminating estate taxes.

Playing it cool, the attorney has "Mr. and Mrs. High-net worth" sign the standard retainer agreement. The attorney follows her usual procedure and prepares an estate plan featuring revocable trusts for probate avoidance and incorporating credit shelter trusts for basic estate tax planning. For high-net worth clients, however—typically those with estates in excess of $5 million—a "foundational" estate plan that does not provide adequate estate, gift tax or asset protection planning leaves the clients and their estates exposed to creditor claims, as well as punishing estate and gift tax liability. Unfortunately, without doing more than a foundational plan, the attorney will have missed a huge planning opportunity and will have failed to meet her clients' planning objectives.

In order to design a comprehensive estate plan that will address the multitude of estate and gift tax issues inherent with a sizable estate, an attorney must "crunch the numbers" to analyze cash flows and projected asset values. High-net worth clients require a sophisticated level of planning that would take an attorney who regularly practices in the high-net worth area more than a few weeks to design, execute and fund. Depending on the asset complexity, the project could take a year or more to implement.

Given the stakes involved, an attorney who finds him or herself with a high-net worth case is well served to team-up with an attorney, financial advisor, CPA or other financial professional who practices regularly in the high-net worth arena. The team approach ensures the client that they will receive the expertise required to design a sophisticated and comprehensive wealth preservation plan. Collaboration is the key to working in the high-net worth arena.

Assuming an advanced planning team is put into the place—what now? There are a number of techniques available to address the complex estate-planning needs of high-net worth clients. We will describe a frequently used advanced planning technique—the sale of assets to a particular type of irrevocable trust that we call a "GDOT."

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GDOT Sales

One of the most popular strategies for high-net worth clients is the sale of assets to a grantor deemed owner trust (GDOT), also known as an intentionally defective grantor trust (IDGT). The mechanics of a GDOT are straightforward. The taxpayer creates an irrevocable trust for the benefit of his or her heirs. The trust is structured to be a grantor trust for income tax purposes by retaining one or more of the powers under Internal Revenue Code §§ 673 through 677. However, care must be taken when selecting which powers to use, because most of the powers under these sections would also cause the trust assets to be included in the grantor's estate at death under Internal Revenue Code § 2036(a)[1] and/or § 2038.[2] Many practitioners believe the safest power to use is a § 675(4) power to substitute assets of equal value. In 2005 and 2008 Private Letter Rulings,[3] the IRS ruled that retention of this power did not cause estate inclusion. Another option is found in § 675(2), which provides for the power to borrow without adequate security or interest.

Transfer Tax Benefit

After the GDOT is signed, the taxpayer sells assets to the GDOT that are expected to produce a high total return in exchange for an installment note paying the lowest interest rate permitted by law. This minimum interest rate is determined by using the applicable federal rate (AFR),[4] which is based on federal interest rates offered each month relative to the corresponding note term. The benefit of maximizing the gap between the return on the transferred assets and the interest rate paid by the trust on the installment note is that this excess represents a gift tax-free transfer from the grantor to the heirs. A critical component of the sale to a GDOT is that the value of the installment note payable to the grantor is "frozen," while it is typical that the assets sold by the taxpayer to the GDOT in exchange for the note will appreciate, often significantly. The transfer tax advantages are multiplied as the value leaving the estate (e.g., the assets sold to the GDOT) will exceed the value coming back into the estate (e.g., the amount of periodic interest payments).

> *"[N]o capital gain is recognized on the sale of assets to the GDOT."*

In the past, there was a concern that the IRS might try to challenge the tax benefits by treating the income tax payments as taxable gifts from the grantor to the GDOT. The IRS looked at the issue and eventually rejected this argument.[5]

Additionally, a GDOT provides other important income tax benefits. Pursuant to a seminal Revenue Ruling,[6] the grantor (or seller) and the trust (the GDOT) are treated as the same taxpayer. Therefore, no capital gain is recognized on the sale of assets to the GDOT. Further, interest payments received from the trust by the grantor on the note are not treated as income to the grantor because the grantor is, in effect, merely making payments to oneself.

Example: Jack and Jackie sell $1 million of non-voting LLC units to a GDOT in exchange for an installment note. Their children are beneficiaries of the GDOT. The LLC generates taxable income of $125,000 each year. Because the trust is considered "defective" for income tax purposes, Jack and Jackie will report this income on their Form 1040 and pay the income tax due.[7] Assuming a 35% tax rate, the couple is able to effectively shift an additional $43,750 to the trust each year for the benefit of their children ($125,000 x 35%), while the $125,000 continues to grow in the GDOT and outside of Jack and Jackie's estate.

Structuring the Sale

Practitioners have also been concerned that the IRS could argue that assets sold to a GDOT are subject to estate inclusion under Internal Revenue Code §§ 2036(a),[8] 2701[9] and 2702.[10] Although the IRS held in at least one Private Letter Ruling that these sections did not apply to a sale to a GDOT,[11] the ruling was conditioned on the assumption that the note retained by the seller was a *bona fide* debt. Where there was an income or equity interest retained by the grantor in the transferred assets, the IRS warned that all three sections would likely apply.

To bolster the argument that the note qualifies as a *bona fide* debt, the transaction must be structured such that the trust's debt/equity ratio is reasonable. Many commentators believe that a 10% gift, or a ratio of 9/1, provides a safe harbor.[12] Typically, a GDOT will be funded with a gift approximately equal to 10% of the value of the assets to be sold to the GDOT. This gift component is referred to as the "seed gift."

Unfortunately, there has been no specific guidance from the IRS or the Tax Court regarding what constitutes the perfect seed gift, leaving tax professionals to speculate what amount is reasonable to ensure that a GDOT possesses "economic substance." The only case that we have found that addressed this issue is the 2003 case of *Karmazin v. Comm'r.*[13] In *Karmazin*—which was settled before going to trial—the IRS challenged a New Jersey taxpayer's sale of assets to a GDOT that included a seed gift equal to 10% of the assets sold to the trust.[14]

The IRS initially raised numerous arguments, but in agreeing to a settlement the IRS implicitly accepted the validity of the 10% seed gift, as well as the entire structure of the asset sale to the GDOT. Ultimately, the only adjustment to the estate tax return was a reduction in the valuation discount from 42% to 37% on the assets sold to the GDOT.

What we take from *Karmazin* is that the GDOT sale works when the transaction is properly structured and maintained. As this planning strategy becomes more popular, we may expect that, as with family limited partnerships, the IRS will be successful in attacking only those GDOT/asset sale arrangements that have been improperly created and maintained.

Care Must Be Taken When Seeding the GDOT

Getting sufficient seed money into a trust is not always easy. If the sale is a large one, or the seller has used up most of his or her applicable exclusion amount,[15] the seller could have a gift tax to pay when the trust is seeded. Some practitioners believe that this problem can be solved by using beneficiary guarantees as a substitute for seed gift. In a 1995 Private Letter Ruling,[16] the IRS held that such a guarantee would suffice in the context of a private annuity sale, provided that the guarantor had sufficient personal assets to make good on the guarantee. So guarantees can work, provided everything is properly documented.

> *"Given the stakes involved, collaboration among a team of qualified professionals is essential to a successful outcome."*

Conclusion

For many high-net worth clients, the GDOT/asset sale[17] may be one of the strategies of choice for large value transfers because of the combination of transfer tax, income tax and asset protection benefits. Notwithstanding the many potential benefits, the IRS's scrutiny of advanced estate planning techniques requires that the GDOT/asset sale is carefully structured—in conjunction with all other planning techniques—to ensure that "Mr. and Mrs. High-net worth" obtain the best planning results. Given the stakes involved, collaboration among a team of qualified professionals is essential to a successful outcome.

Endnotes

1. I.R.C. § 2036(a) General rule. "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."
2. I.R.C. § 2038(a) in general. "The value of the gross estate shall include the value of all property—(1) Transfers after June 22, 1936. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death."
3. In Priv. Ltr. Rul. 200842007 (Oct. 17, 2008), the IRS stated that a grantor's exercise of a fiduciary power to substitute assets of an irrevocable trust for assets of equivalent value would not cause the trust assets to be included in the grantor's gross estate under I.R.C. § 2033, § 2036, § 2038, or § 2039. The Private Letter Ruling further held that the exercise of that power was not a taxable gift, and that no gain or loss would be recognized by the grantor or the trust on the exercise of the power. The IRS relied on Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (April 21, 2008), even though the grantor's power of substitution in that ruling was held in a nonfiduciary capacity; see also Priv. Ltr. Rul. 200603040 (Oct. 24, 2005).
4. <http://www.timevalue.com/afrindex.aspx>.
5. Rev. Rul. 2004-64.
6. Rev. Rul. 85-13, 1985-1 C.B. 184.
7. <http://www.inknowvision.com/education/articles/reporting.pdf>.
8. Priv. Ltr. Rul. 200842007 (Oct. 17, 2008), *supra* note 3.
9. I.R.C. § 2701 provides for special valuation rules in case of transfers of certain interests in corporations or partnerships.
10. I.R.C. § 2702 provides for special valuation rules in case of transfers of interests in trusts.
11. Priv. Ltr. Rul. 9535026; *see also* Hersch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 U. MIAMI INST., EST. PL., 1601.1 (2000).
12. Jerome Deener, *After Karmazin*, TRUSTS & ESTATES, 18, 25 n.4, Oct. 2006.
13. T.C. Docket No. 2127-03 (2003).
14. Deener, *supra* note 12.
15. I.R.C. § 2010. The applicable exclusion amount (formerly known as the unified credit) exempts a certain amount of gifts made during a person's lifetime from federal gift tax and exempts a certain amount of your estate from federal estate tax.
16. Priv. Ltr. Rul. 9515039 (Jan. 17, 1995); *see also* Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 91 J. TAX'N 152 (2000).
17. For additional information about asset sales to a GDOT *see* <www.inknowvision.com/education/articles/gdot.html>.

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