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Exploring The Many Uses Of Grantor Trusts

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This year has brought with it applicable federal rates that are lower than many of us thought possible. The AFRs, in addition to being used to calculate the value of remainder and annuity interests, are the safe harbor provided from the Internal Revenue Service to ensure that a debt transaction will not have below-market interest. But how do these historically low AFRs help us plan for clients who want guaranteed rates of return?

Leveraging the DIGT

A simple technique for achieving this objective is the intentionally defective irrevocable grantor trust. If a trust qualifies under the tax code as a DIGT, the grantor of that trust is treated, and taxed, as the owner of the trust's assets for income tax purposes. This shifting of the income tax burden from the trust to the grantor opens many different wealth and appreciation shifting techniques.

The first technique involves the loan of funds to the DIGT. The grantor lends a sum of money to the DIGT in exchange for an interest-only promissory balloon note that charges interest at the applicable AFR. The DIGT pays interest on the loan and principal at the end of the note's term. During the note's term, the DIGT invests the loaned funds and the grantor pays the income tax due on the income generated by the DIGT's investments. If the grantor is seeking a guaranteed rate of return, the trustee can invest the funds in a no-lapse guaranteed life insurance policy.

Often when the grantor lends funds to the DIGT the loan is large enough that the income generated by the funds is enough to pay the interest due on the note and the premiums on the life insurance policy. By just using the income generated by the fund the bulk of the loaned funds is preserved and used to repay the note's principal. When this loan technique is used, both the promissory note and the life insurance premiums are usually structured to be completed in 9 years to take advantage of the mid-term AFR. By year 10 the grantor has the funds back, plus interest; and the DIGT owns a paid-up guaranteed life insurance policy.

This large-loan technique, while very effective in some situations, will not work if the grantor does not have liquid assets or if the grantor/insured is of advanced age, making the 9-pay premium too large. An alternative is to have the grantor make a smaller loan that will function as a "sinking fund" designed to be consumed over the term of the promissory note. The sinking fund allows the trustee to structure a longer premium payment schedule for the life insurance policy. But the trust will also need another means of repaying the principal on the grantor's note (an "exit strategy").

There are many different options for putting an exit strategy in place so that the DIGT can repay the grantor's loan. The simplest exit strategy is to use some of the death benefit from the life insurance policy to repay the loan. The drawback: Distributing a large portion of the death benefit to the grantor's estate is likely to run contrary to the reason for purchasing life insurance inside a DIGT.

In addition, the longer the promissory note runs, the more death benefit is required to repay the loan; in some instances the loan balance can outstrip the death benefit, making the DIGT insolvent. Should this happen, the IRS might re-characterize the initial loan as a gift to the DIGT.

Using the death benefit as an exit strategy can be avoided by applying a return of premium (ROP) rider to the policy. With ROP, the DIGT will receive, at the grantor's death, an amount equal to the purchased death benefit, plus the sum of all premiums paid into the policy. Thus, the death benefit is left inside the DIGT to satisfy the grantor's original purpose for purchasing life insurance. If a ROP is too expensive, based on the grantor's age and/or health, or if the trustee wants to structure the premium payments for a longer term (or for life) another exit strategy is available via a grantor retained annuity trust.

The GRAT Technique

When using a GRAT, the grantor transfers income-producing assets to a trust, reserving an annuity for a term of years. At the end of that term, the trust terminates and whatever assets are left inside the trust transfer to the remainder beneficiaries named in the GRAT.

The IRS says the grantor makes a gift of the value of the remainder interest at the time the GRAT is created. The IRS values the gift based on the present value of the remainder interest and calculates the present value using a growth factor called the §7520 rate (which is 120% of the mid-term AFR).

Traditionally, GRATs were used to transfer assets from parents to children with minimum gift tax exposure, but they work wonderfully as exit strategies when the DIGT is the remainder beneficiary. When the GRAT terminates, the assets remaining in the GRAT drop into the DIGT where they can be invested, used to pay premiums or used to repay the principal of the note from the DIGT to the grantor. The GRAT not only provides funds to the DIGT in a gift tax-efficient manner; it also reduces the value of the grantor's taxable estate.

Summing up

As we have seen, DIGTs are very useful for transferring assets, taking advantage of the low AFRs and purchasing life insurance with a guaranteed rate of return. In addition, DIGTs provide flexibility both in the assets in which they invest and in the manner they are funded.

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