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THE IRREVOCABLE GRANTOR TRUST – AN OVERVIEW

A "grantor" trust is a trust that contains certain provisions set forth in the Internal Revenue Code, which defines these types of trusts. Grantor trusts are sometimes referred to as "intentionally defective irrevocable grantor trusts" or "IDIGTs." The "defective" nature of these trusts results from the fact that while the trusts are irrevocable and are treated as separate from the grantor or creator for estate tax purposes, the trusts have specific provisions that require their income to be taxed to the grantor. With a carefully drafted irrevocable grantor trust, the income is imputed to you as the creator of the trust, but the trust assets are not included in your estate for estate tax purposes. In other words, as the trust creator you must pay the income tax on all trust income, but trust assets will not be subject to estate tax at your death.

The IRS has issued rulings confirming that if the trust is structured as a grantor trust for income tax purposes, the grantor must pay the income tax from any trust income even though the beneficiaries of the trust are the grantor's children or other family members. The effect of paying the income tax is to provide a substantial economic benefit for the trust's beneficiaries, without having that benefit treated as a gift.

Grantor trusts are useful planning tools in several circumstances, particularly where you desire to transfer appreciated assets to the trust without immediately incurring income tax. Under the Internal Revenue Code, when you sell an asset you must pay income tax on the amount above your "basis" in the property. In its most simplified sense, basis is the amount you paid for an asset when you purchased it, or if you received it by gift, it is the donor's basis in the property. A typical sale of appreciated property causes imposition of income tax. However, a grantor trust is treated as your alter ego for income tax purposes. Since you cannot "sell" property to yourself, a sale to a grantor trust is ignored for income tax purposes. After the sale, the trust will have as its basis the amount it pays for the property.

Significantly, the sale must be for full fair market value – a sale for less than full market value will be treated as part sale, part gift. How does the trust obtain the ability to purchase the assets? One way to accomplish this is by you making a gift to the trust followed by the trust purchasing the assets using an interest-bearing promissory note (with terms similar to a financing transaction with a third-party lender), using the minimum interest rate established by the IRS. Another method is for able beneficiaries to guarantee the payments in a commercially reasonable manner.

Irrevocable grantor trusts are particularly useful to transfer significant limited liability company interests in family LLCs to family members without incurring substantial gift taxes and help to "freeze" the value of appreciating assets in your estate while allowing future appreciation to accrue for the benefit of your children and grandchildren.

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