BRADY WARE

VIDEO TRANSCRIPT: Intentionally Defective Grantor Trusts

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Mark Kassens:

So the idea of an intentionally defective Grant or trust is to sell and gift an appreciating asset to a trust in exchange for a note. The gift has to be a part of the transfer. It doesn't have to be part of the transfer. It usually is part of the transfer in order to have enough collateral behind that note to make it a valid note it has to be a valid exchange, and it's between the grantor and the trust which is in separate legal entity.

It's 2 different taxpayers, basically because this is a grant or trust. It's disregarded for income tax purposes. State tax purposes totally different. It is a separate entity and it's out of that person's estate. So what are we doing here? We're moving appreciated asset. Right? We're putting a note back in so cash. Basically, it's cash equivalent. So the interest on the note and has to have valid stated interest. It's a legal note.

The interest on the note is being paid with the principal and the cash that's going into the trust is from that appreciate an asset. Normally, it's a small business interest. So we have an S. Corp interest. Which is allowed because it's a grant or trust or we have a partnership interest or an LLC.

So the distributions from that ask through entity going into the trust? Because it's the shareholder or member and then that that trust entity is paying principal and interest on that note to the grant. Or now these transactions one, the sale and the interest payments are tax free because you can't have an exchange between yourself. And that's really what you're doing with a grant or trust that's required for tax purposes, income tax purposes. So all of this is kind of happening by moving from the right pocket to the left pocket, as far as income taxes is concerned.

What happens then? If that pass through income is no longer kind of being passed out to the grantor. That happens when the note has been paid off. Sometimes. That's a triggering event. And there's other times that the triggering event can be a provision that the grantor gives up so but it has to cease to be a grant or trust. So what makes these things? You've touched on a couple different. Nuances. But what makes these things a grant or trust? The biggest provision that we use, and they intentionally defective grant or trust is, is they give the grant or a power to substitute.

That's part of the Grantor Trust provisions in the internal revenue code. So what that means is that the grantor has the ability to take out what they originally put in there, and to exchange it for another asset, totally unrelated asset usually but it has to be equal value. So you can substitute one asset for another asset. And perfectly fine. Not a tax taxable event. Again, it's just like the sale that happened before, and the income or the interest payments they're going back and forth.

It's to yourself. So it doesn't matter for income tax purposes not a taxable event. The power to substitute can also be turned off, which was what I was touching on with the triggering event. There's provisions in there where the grantor can say, you know what? I'm not going to substitute anymore. So I give up that right once that right is given up. It ceased to be a grand tour for us.

And like, I said as well, that other triggering event can be death of the grantor, and like any other grant or trust, once that once that happens, it's an irrevocable trust. On a normal living. Trust it. It, you know, ceases to be irrevocable. Trust cease to be a grantor trust, and it turns into just a testamentary trust, or you know it's the grantors out of it at that point they've passed away so these can also be set up to expire or the trust. Can, you know, distribute everything out when that note is paid off? But they and then the assets are distributed out to the beneficiaries.

Okay, why would you choose for these, why would you choose to keep it a grant or trust, even after the note is paid off? Yeah. So because it's a Grand Tour Trust. The income is taxed to the grantor and if that trust remains a grant or trust after that note is paid off, that income that is being passed through by that original asset. Is accumulating in the trust. It's not distributed out anymore to that grantor. Because they have no right to that income their right to the income ceased when the note was paid off. So the income is being put into the trust, adding to the trust assets.

And that income tax is being paid by the grantor. So they're not really being reimbursed anymore.
So their estate is being depleted by those income tax payments. Perfectly legal. It's their trust as it still has grantor status but that income, then, is being accumulated in the trust to be invested in other assets, or to just build up the cash value all the while that appreciating asset continues to appreciate. So it can really be a really strong way to cut move assets after the fact. Because you're paying the taxes.

It's depleting your cash reserve. The Grantor's Cash reserve and then that that trust is kind of building upon itself and growing exponentially. You know, there's some clients that really aren't looking for that result. They're just looking to transition small business or to transfer ownership of a small business.

By using a relatively small part of their lifetime exemption. Just don't forget. We might be, you know, transferring 10 million dollars of a of an asset but most of that is, is a sale. We're only using a very small part of that as a gift. So we've used a very small part of our lifetime exemption for a 10 million dollar gift just as an example. And then, if we leave the grant or status alone that 10 million dollar gift while it's already appreciated on its own. It just continues to appreciate even more, because that cash distribution from that asset is being left alone in the trust, and there to reinvest. So either way you go.

The purpose of these trust is really it's a freeze. It's an estate tax freeze because you're exchanging dollar for dollar, basically at the point of transfer but then what happens to that after is really where it grows and can really make a difference. and the exchange of the appreciating asset for the note. All that appreciation has moved out of the out of the estate. Then, on the other side of this to the extent it's a little bit better cash flow than just a straight gift, or maybe even a sensible sale.

You know, we might have a situation where you know the let's say the parent is retiring and wants to transition the business, and they don't really. They don't want to sell it to their kids but they do wanna transition the ownership plus. They might not have a lot of their lifetime exemption left, or they want to retain a lot of their lifetime exemption. This is this is a good way to do that because you use a relatively small part of that to transfer pretty large asset. Honestly.

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So the important part of this is that? If you're using a gift part of that, if it's not just A cache the old gift type, the cache you have to have evaluation of that small business for the adequate disclosure that starts the 3 year statue limitations from the filing date of the gift tax return. And then just kind of a quick, quick recap of this this to grant or trust a separate legal entity. It's irrevocable cannot be changed after the document assigned. It cannot be changed. You also need a trustee. And it can't be the grant, or you can't be the trustee of your own. Digit and then the assets are out of the trust or sorry the assets in the trust are out of the Grantors estate.

Okay? As you can see from just listening to Mark. There's a lot of wrinkles to this. There's a lot of that that applies to all the other trusts. Excuse me that we've been talking about. So please work with the trust advisor hopefully, that's mark at here at Brady ware to help you through all these intricacies, to make sure you're set up properly, and how you would like to be set up again. These videos are on our website. So please continue to check them out they're under tax. The State gives trust, and you can get to them from there.

Bruce Van Vreede:

Thanks. Mark. Appreciate the description and walk it through the some of the nuances to this. And as you can see. Not only with this one but all the other States trust videos that we've been talking about. All of those also have a lot of intricacies to them. So please make sure you're working with a trusted advisor.

Mark Kassens here at Brady ware can certainly fill that role for you. As you try to make sure these things are set up properly for you and for your situations. So thanks again for listening and watching. Please check out the other videos that are on our website and feel free to reach out to us through the contact us on our website, or you're free to email mark directly. M. Kassens, KASS. ens@bradyware.com. Thank you very much, and we'll see you for the next one.