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## Unusual Trusts Gain Appeal In Unusual Time

### 'Intentionally Defective' Tool Can Protect Depressed Assets From Estate and Gift Taxes

BY MIKE SPECTOR AND ANNE TERGESEN

It may seem hard to come up with a financial product with a name as unattractive as an "intentionally defective grantor trust." Yet these days, in the world of estate planning, those words denote one sexy vehicle.

That's because this aggressive strategy—which can be used to move money out of taxable estates and transfer gains to heirs tax-free—is especially appealing at a time like now, when asset values have fallen sharply and interest rates are near historic lows.

Many estate planners warn that these trusts carry more risks than other accepted planning vehicles. The Internal Revenue Service hasn't blessed defective grantor trusts, and has challenged their authenticity in the past.

What's more, if your assets perform poorly in this type of trust, you could get hit with greater losses than you would suffer with some other popular wealth-transfer techniques.

Still, most defective grantor trusts have withstood IRS scrutiny, and many estate-planning lawyers report seeing increased interest in them this year, in the wake of the tumble in the real-estate and stock markets. Neil Kawashima, a partner at McDermott Will & Emery LLP, says he expects he'll increase the number of these transactions he executes this year by nearly a third. Carl Waldman, an estate-planning attorney in Westlake Village, Calif., says he has set up about 25 of these trusts in the past 12 months, versus "probably no more than six" in the prior year.

The trusts are considered "defective" because they are subject to somewhat contradictory tax treatment. They remove assets from your estate—saving your heirs estate taxes in the process—while allowing you to continue paying income taxes on those assets, effectively making another "gift" to your heirs. Another benefit: Unlike some other popular trust strategies, these can also be used as part of a broader plan to pass assets to your grandchildren.

Defective grantor trusts can be structured in many ways. Typically, the strategy involves creating a trust and then lending it money to buy one of

### Defective But Effective

Intentionally defective grantor trusts are attracting new interest.

- The trusts can allow heirs to pocket more than they would with other commonly used trusts.

- Unlike many other types of trusts, they allow you to pass assets down to your grandchildren.

- The trusts can be complex and may arouse the suspicion of the IRS.

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## Unusual Trusts Gain Appeal

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your assets—such as securities, real estate or a business interest—that you expect to appreciate significantly. In return for lending the trust money, you receive interest payments for a set number of years. The lower the interest rate, the less the trust must repay you—and the more your heirs will benefit.

The IRS publishes these rates monthly, which are locked in for the life of the loan. Once the trust repays the principal and the interest, any appreciation beyond that interest rate—also known as the "hurdle" rate—generally passes to heirs without triggering estate or gift taxes.

A defective grantor trust can yield better returns for heirs than other estate-planning vehicles. That's because it can sometimes take advantage of lower interest rates than other trusts can. Rates used for defective grantor trusts currently range between 0.83% and 3.67%, depending on the maturity date that you choose.

### 'An Extraordinary Time'

"This is an extraordinary time" to execute defective grantor trusts, says Holly Isdale, a managing director at Bessemer Trust, a New York wealth-management firm. While most investors create these trusts to last for many years, the rates today are so low that even shorter-duration loans can offer "interesting transfer opportunities," she says.

Along with other estate-planning tools, these trusts are drawing more interest as it becomes more apparent that the estate tax won't disappear in 2010, as it's scheduled to do under current law. The Obama administration favors keeping the current \$3.5 million per-person exemption level and a top rate of 45%. Many states also impose death-related taxes.

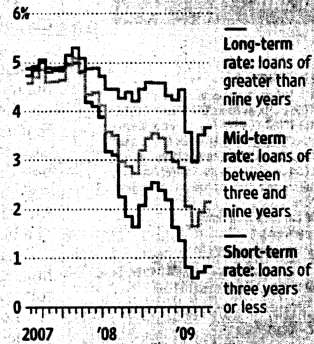
Dan Massiah and Judy Emanuele, married doctors in Riverhead, N.Y., want to protect their assets amid concerns over the potential for litigation in their high-risk profession. They plan to sell their ownership stakes in two buildings that house their practices to a defective grantor trust.

"I'm looking to get my children the most money I can, in a way that's legal and tax-exempt," says Dr. Emanuele, a 45-year-old plastic surgeon. To do so, she will start the trust by giving it some money—\$193,670—to buy the buildings. She won't owe any gift tax on that transfer, because tax-

### A Trust for Hard Times

Government-set interest rates determine how much intentionally defective grantor trusts have to pay out each month. The lower the rates—and today, they are much lower than comparable consumer rates—the less your trust will have to repay you for the assets you sell it to pass along to your heirs.

Source: Internal Revenue Service



payers get a lifetime \$1 million credit to shield their gifts.

With the \$193,670 in seed money, plus a loan for \$643,030 from the couple, the trust will buy their stake in the buildings, currently valued at about \$1.2 million. The interest rate over the loan's nine-year term: a mere 2.15%.

In another positive twist, the trust won't have to pay Drs. Massiah and Emanuele back the full \$1.2 million. Because the couple owns the real estate through a limited liability corporation, they can discount the value of the stakes they sell to the trust.

The upshot: The trust only has to pay back \$643,030, plus 2.15% interest, says Rudy Fusco, the couple's estate-planning lawyer at Leeds Morelli & Brown PC in Carle Place, N.Y.

### Trusts Can Backfire

Defective grantor trusts can backfire. Unlike some other trusts, if your assets plunge in value, the trust is still on the hook to repay your loan. And that could mean more money from your pockets.

"You've got a little more skin in the game" with a defective grantor trust, says Martin Hall, a partner at Ropes & Gray LLP in Boston. "The Achilles heel to the technique is ... the potential for more actual loss."

Another big caveat: The IRS has never specifically blessed these trusts, which draw on two separate areas of the tax code, Ms. Isdale says. That leaves them open to IRS scrutiny. Advisers recommend funding the trust up front—much like Drs. Massiah and Emanuele did—and waiting some time before making the sale.

Many advisers suggest funding one of these trusts with about 10% of the value of the assets it will

ultimately purchase. Following these steps gives the trust an air of legitimacy, positioning it as a viable entity able to buy something from your estate, advisers say.

### Discounting Assets

Like Drs. Massiah and Emanuele, many who set up these trusts take discounts on the value of relatively illiquid assets—such as a partnership or business interest—when they sell them to a defective grantor trust. But such moves have drawn scrutiny from regulators and lawmakers.

Congress has periodically threatened to close loopholes that allow discounts. Currently, a bill sponsored by Rep. Earl Pomeroy (D., N.D.) takes aim at such discounts, though it's unclear whether the measure will gain broader support.

Sharon Karmazin, the ex-wife of media mogul Mel Karmazin, ran into trouble with the IRS after setting up a defective grantor trust with discounted assets about 10 years ago. In 2002, the IRS challenged Ms. Karmazin, of North Brunswick, N.J., in part because she knocked 40% off the value of units in a family limited partnership that held securities, says her lawyer, Jerome Deener, managing partner at Deener, Hirsch & Shiranenko PC in Hackensack, N.J.

Ms. Karmazin had sold the assets, at a 40% discount, to a defective grantor trust in 1999 to benefit her two children. The IRS alleged the transaction wasn't a legitimate sale, arguing that Ms. Karmazin had made "a gift of the entire underlying amount to the trust, which produced a very significant gift tax," Mr. Deener says. Ms. Karmazin settled with the IRS in 2003 by agreeing to reduce the discount to 37% from 40%, he says.