

Sales to Intentionally Defective Grantor Trusts (IDGT)

A sale to an Intentionally Defective Grantor Trust (“IDGT”) is a sophisticated estate planning strategy that can provide substantial benefits to wealthy individuals and families seeking to transfer assets from one generation to the next (and to future generations) while minimizing income, estate and gift tax liabilities.

This technique is **particularly effective in business succession planning for families with closely held businesses structured as partnerships or subchapter S corporations**, and is intended to accomplish the following goals:

1) transferring assets to a trust for the benefit of an individual’s (hereinafter referred to as the “grantor”) children or future generations without incurring any gift or income taxes or capital gains taxes on the sale, and

2) shifting the value of the assets sold in excess of the discounted value purchase price and any future appreciation on those assets out of the grantor’s estate for estate tax purposes. The following summarizes the transaction in more detail.

Overview of the Intentionally Defective Grantor Trust

An IDGT is an irrevocable trust typically established as a perpetual trust (a so-called “Dynasty Trust”) for the benefit of the grantor’s children and future descendants. An IDGT generally benefits the grantor’s children during their lifetimes, and is structured to benefit the grantor’s children’s descendants and future generations after their death.

From an income and estate planning perspective, **the IDGT would be purposely structured to be “defective” for income tax purposes**, but “effective” for estate tax purposes. Despite the fact that the IDGT would be a legal entity separate from the grantor, certain provisions in the IDGT agreement would provide the grantor with certain powers over the IDGT that cause it to be considered a “grantor trust” with respect to the grantor for income tax purposes, but would **not** result in the assets of the trust being included in the grantor’s estate for estate tax purposes.

Consequently, the grantor would be considered the owner of the IDGT for income tax purposes, which would result in the **grantor being taxable on the IDGT’s income**. The grantor and the IDGT would not be considered separate taxpayers for income tax purposes, but would be considered separate taxpayers for estate tax purposes. Because of the IDGT’s status as a grantor trust for income tax purposes, an IDGT can hold subchapter S corporation stock without

jeopardizing the corporation's subchapter S status, or having to make a qualified subchapter S trust, or electing small business trust election. When the IDGT later becomes a separate taxpayer from the grantor for income tax purposes, the IDGT would then make the election to be a qualified subchapter S trust or an electing small business trust.

The Powers that Create a “Defective” Grantor Trust

The following is a summary of the most common powers included in an IDGT that cause the trust to be classified as a “grantor” trust for income tax purposes, but will not result in the assets of the trust being included in the grantor's estate.

(1) The Power to Reacquire Trust Property (IRC Section 675(4)(c))

In general, the power to **reacquire trust property** by substituting property of equivalent value, when exercised in a non-fiduciary capacity by any person, without the approval of any other person acting in a fiduciary capacity, should create grantor trust status but not result in the assets of the IDGT being included in the grantor's estate. The Service has indicated that such a power does not constitute the power to revoke, amend, or alter the trust under IRC Section 2038 and therefore the trust's assets are not included in the grantor's estate (See, PLR 9548013).

The basis for this reasoning rests in the concept that even if an individual acts in a non-fiduciary capacity to reacquire trust property and substitute property of equivalent value, the trustee of the IDGT is still bound by his or her fiduciary standards to ensure that the property substituted represents full and adequate consideration for the corpus reacquired. Therefore, under such logic, the grantor of the IDGT ought to be able to act, in a non-fiduciary capacity, to reacquire the trust corpus and replace such corpus with property of equivalent value. To this end, there is some commentary that suggests the grantor may retain the right, in a non-fiduciary capacity, to sell the IDGT's assets or change the nature of the trust's assets, provided that the standards detailed above are adhered to.

(2) Power to Borrow Trust Assets **without** Adequate Interest or Security (IRC Section 675(2))

If a grantor may borrow the IDGT's assets for less than adequate interest and security or for terms that are more favorable than what would otherwise be required for such a transaction under general commercial terms, the trust will have grantor trust status.

(3) The Power to Use the IDGT's Income for the Purpose of Paying Insurance Premiums (IRC Section 677(a)(3))

An IDGT may hold a broad array of **investments including life insurance on the life of the grantor**. In so doing, Section 677(a)(3) provides that a trust will be considered a grantor trust to the extent the income of the trust is applied for the benefit of the grantor, which includes the payment of insurance premiums on the grantor's life. Thus, in some planning transactions, such as where the cash flow required to service the IDGT debt to the grantor for the sale of the property to the trust is less than the total cash flow to the IDGT (i.e., there is a surplus of cash flow to the IDGT), the trustee can use any excess proceeds to purchase life insurance on the life of the grantor.

The benefit: so long as the policy is owned exclusively by the IDGT and the grantor does not retain any "incidents of ownership" with respect to the policy, the death benefit proceeds of life insurance will be paid to the IDGT **estate, gift, and income tax free**.

Outright Gifts to an IDGT

While IDGTs are typically used in conjunction with a sale of assets to the trust (see below), a client can simply make an outright gift to an IDGT using the client's gift and estate tax exemptions. A client can gift assets to an IDGT (which is set up as an irrevocable trust) and the gift works like any gift to when using a client's gift and estate tax exemptions.

The unique aspect to an IDGT is that the gift is complete for estate tax purposes but incomplete when it comes to the income taxes (from income generated from the assets gifted to the IDGT). As discussed, income produced inside an IDGT inures to the donor (and the payment of that tax is **not considered a gift**). Also, when property is not sold to the IDGT, the three year look back rule with any gift applies, and so it is important to disclose that to the client when considering an outright gift to an IDGT, or a sale as discussed next.

Structuring the Sale

As mentioned above, the installment sale to an IDGT technique can provide substantial income, estate and wealth transfer planning benefits. Because such sales are used extensively for business succession planning, the examples used in this section will focus on the sale of subchapter S corporation stock to an IDGT. As a general premise, however, the sale structure would be similar to that of most types of entities, including interests in family limited partnerships or limited liability companies.

To ensure that the sale transaction to the IDGT is respected by the IRS, certain attributes of the transaction should be respected. First, the IDGT must have assets that provide economic substance prior to the sale. The general rule of thumb is that the IDGT should have assets worth at least 10% of the value of those that are being sold to it.

When considering an installment sale transaction in which a business owner is going to sell his or her subchapter S corporation shares to an IDGT, the IDGT must have assets worth at least 10% of the purchase price value of the stock. Therefore, in a typical sale transaction, the grantor will gift a certain amount of “seed money” to the IDGT so that it would have enough economic substance to support the installment sale and payments due under a promissory note from the IDGT to the grantor upon the trust’s purchase of the stock.

When making this seed gift, it is typical for the grantor to use up a portion of the \$1,000,000 lifetime exemption to fund the IDGT. It is important to note that an individual can only gift up to \$1,000,000 during his or her lifetime without incurring any gift tax (the so-called “lifetime gift exemption”).

Example: If the grantor were to gift \$1,000,000 (the largest amount possible without incurring gift taxes) to the IDGT as the 10% seed money, the IDGT would have \$1,000,000 in assets, and could then purchase up to \$10,000,000 worth of the grantor’s stock. If the value of the stock was, in fact, \$10,000,000 (which could possibly be a discounted price), the sale would move all of the stock to the IDGT for the grantor’s children (who are the ultimate beneficiaries of the trust).

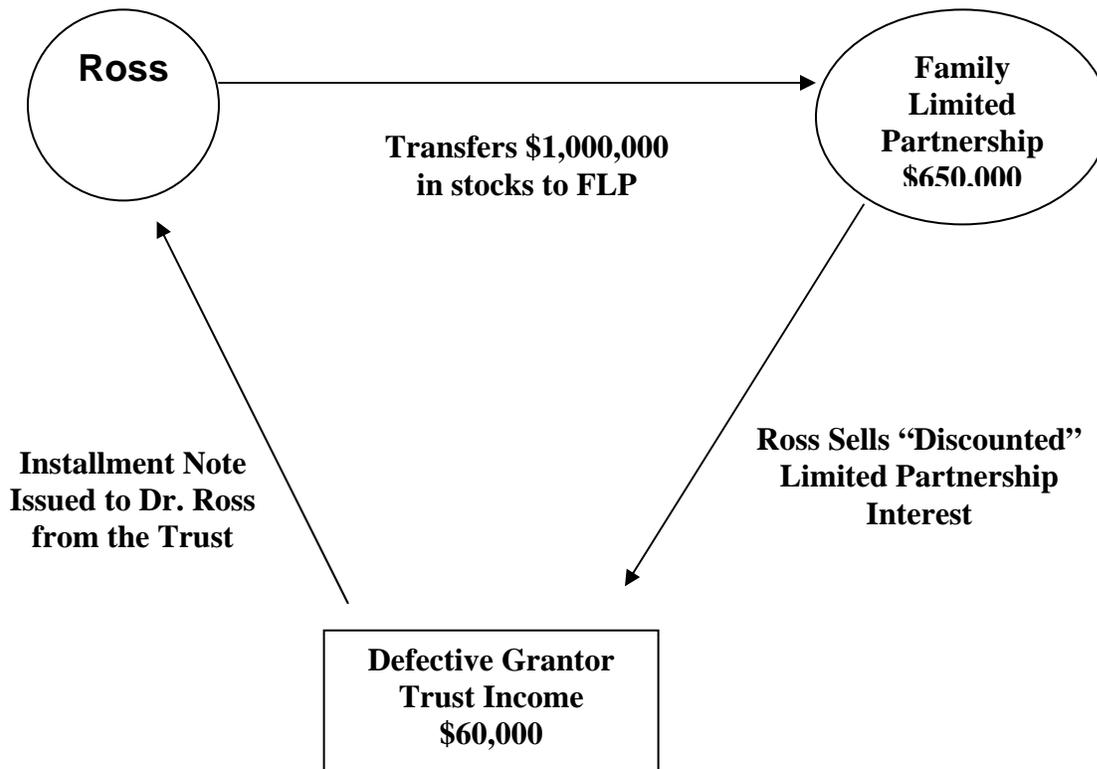
Planning Tip: Consider structuring the sale to take advantage of valuation discounts which could be applied to different classes of stock. In a subchapter S corporation, if the corporation does not already have both voting and nonvoting shares, consider recapitalizing the corporation to have both classes. For purposes of the sale, the shares to be sold would be the grantor’s nonvoting shares, and those shares will likely be subject to the greatest amount of discounts. The same concept should apply to selling limited partnership interests in a FLP to an IDGT (see below)

Discount Strategy (The use of an FLP)

Let’s combine a family limited partnership with an IDGT. Clients looking to maximize the economic benefit (paying the least amount of gift or income taxes) of an IDGT should incorporate the use of an FLP. The best way to explain the discounting strategy with an FLP and an IDGT is with an example.

Assume your client, Dr. Ross, transfers a mixed portfolio of investments (stocks, bonds, and cash) worth \$1 million to an FLP. Typical FLP discounts reduce the value of that \$1 million to about \$650,000. Then Ross creates an IDGT and sells the \$650,000 of the limited partnership interests to the IDGT in exchange for a note. If the portfolio produces a return of 6% or \$60,000, the same income measured against the depreciated value results in a return of 9.2% ($\$60,000 \div \$650,000$).

If the client sells the FLP interest to the IDGT in exchange for future payments, those future payments will be based on the lower value of the FLP interest (vs the actual value of the assets in the FLP), thereby reducing the size of the required installment note payments to the grantor. If the client chose to gift the FLP interest to the IDGT instead of selling the interest, the obvious benefit to incorporating an FLP and an IDGT is the fact that the client only uses \$650,000 of his gift tax exemption of \$1,000,000.



Once the number of shares to be sold is determined (which will be a function of the value of the shares to be sold), the grantor would then sell his or her nonvoting stock to the IDGT for a price determined by an independent appraiser, taking into account all appropriate discounts. It is critically important that appraisal used be of the highest quality and strength, otherwise gift tax may be incurred.

As noted above, because the IDGT is not considered a separate taxpayer from the grantor, there is **no recognition of capital gains** on the sale. Also, since the IDGT would be purchasing the stock from the grantor at a market value determined by a qualified appraiser, there would be **no gift** being made **and no gift taxes** due on the sale.

The IDGT would **issue the grantor an installment note** and give the grantor a security interest in the stock. The note would bear interest at the IRS assumed rate (the "federal applicable rate"), and could be structured as a self-

amortizing note, a level principal payment note, or an interest-only with balloon payment note. The type of note used will largely depend on the cash flow being generated by the assets being sold to the IDGT. Because the grantor and the IDGT are not considered separate taxpayers for income tax purposes, **the grantor will not recognize income when the interest on the notes is received.**

Benefits of the Transaction

Under the terms of the installment sale transaction, the grantor would receive, through the installment payments, the discounted purchase price of the stock, plus interest at the applicable federal rate. Although these payments to the grantor are disregarded for income tax purposes, the grantor will, however, pay the taxes on the earnings attributed to the shares owned by the IDGT in the S corporation each year. **If planned correctly, the grantor will be able to pay the income taxes on the IDGT assets out of the installment sale payments being made each year under the terms of the installment note.** The IDGT would receive distributions on the nonvoting shares each year from the subchapter S corporation, which, in turn, would be used to make the installment payments to the grantor.

Observation: In the normal course of the transaction, the IDGT would remain “defective” for the entire term of the sale, which preserves the non-recognition of capital gains and interest income during the term of the note. Although technically, the provisions of the IDGT would provide the grantor with a right to terminate the IDGT’s “defective” trust status at any time, it is important to understand that if the grantor exercises this right during the term of the sale, it would have significant adverse tax consequences to the grantor (i.e., recognition of capital gains and ordinary income on the payments made to grantor by the IDGT). Thus, most individuals contemplating this transaction anticipate that the IDGT will remain “defective” at least for the time period of the note, and will not end until after the transaction has been completed.

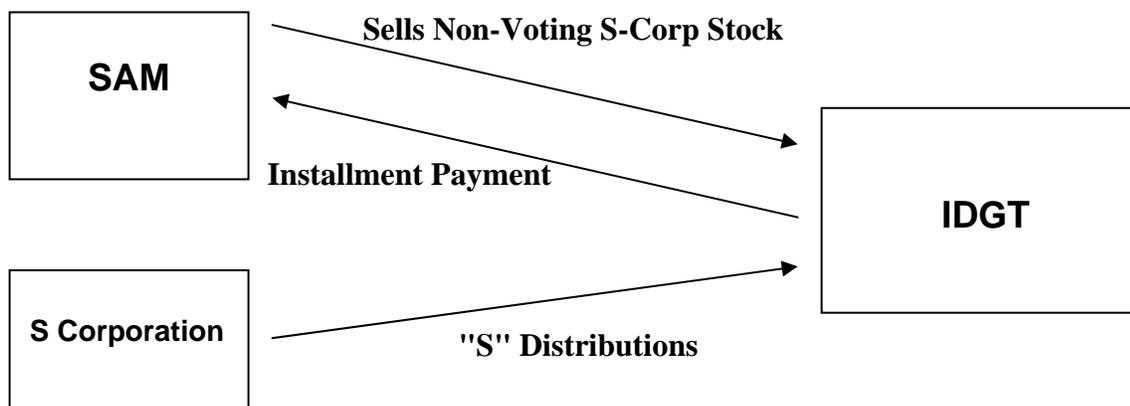
It should also be noted that if the grantor dies during the term of the sale, **the balance** (if any) of the installment note that has not been paid off at the time of his or her death **will be included in the grantor’s estate.** The actual assets held by the IDGT at the time of the grantor’s death (i.e., the subchapter S corporation stock) and any appreciation that has occurred from the date of the sale **will not be included in the grantor’s estate.** This is a significant advantage in comparison to a Grantor Retained Annuity Trust. To mitigate the inclusion of all or a portion of the installment note being included in the grantor’s estate, however, the grantor might consider using a “self-canceling installment note” (“SCIN”) or a “private annuity” in lieu of a traditional installment note to finance the sale.

It is important to note that because the grantor is paying the income taxes on the IDGT assets and relieving it of that obligation, the grantor is in essence making transfers of tax-free gifts to the children and future generations equal to the income taxes paid on behalf of the IDGT. The end result is that the grantor will shift to the children (and future descendants), free of gift or estate tax, (1) the value of the stock in excess of the discounted purchase price and any future appreciation on that stock, and (2) the value of the payments of the income taxes made by the grantor that would otherwise have been paid by the IDGT, resulting in a reduction of the assets that ultimately pass to the children and future descendants.

More Examples

Example of an Outright Gift of Property or Assets to an IDGT:

Client (Sam) transfers \$1 million worth of income-producing property to an IDGT for the benefit of his children. This is an outright gift covered by Sam's \$1,000,000 gift tax exemption, so no gift tax is due.



Summary of Transaction:

The sale of the non-voting stock from Sam to the IDGT essentially "freezes" the value of the non-voting stock at its value at the time the sale. The trust can provide for Matt who is the beneficiary of the trust (via whatever language Sam inserted when creating the trust). Following Sam's death, the trust could distribute the shares to Matt or continue to hold them in trust.

Since Sam has retained all of the voting stock, he continues to control the business. No portion of the trust will be included in Sam's estate (for estate tax calculations) due to the fact that Sam sold the non-voting stock to the IDGT in exchange for an installment note/payment. The trust assets would also be excluded from Sam's estate if he used his unified credit to gift the non-voting stock to the IDGT

The trust will get funds to pay Sam the interest on the note, plus principal, from dividend distributions from the stock. Distributions from the S-Corporation are at Sam's discretion, due to the fact that he retained the voting stock. Because the IDGT is ignored for income tax purposes, Sam will not be taxed on the interest he receives from the trust but will be taxed on the dividends received by the trust. In essence, Sam is taxed on the income from the S-corporation just as if he had not created the IDGT.

Selling the Business

Eventually, when Sam sells his business, he removes all future appreciation from his estate for estate tax purposes. For example: Assume Sam's business was worth \$1,000,000 when he gifted all of his non-voting interest in the company to the IDGT. Then, assume that, when Sam sold the business 10 years later, he got \$2,000,000. All of the appreciation of the non-voting interest in the company in the IDGT effectively passed to the heirs without paying any additional estate taxes.

Typically, when an installment note is used with an IDGT in conjunction with non-voting interest of a company where there is an income stream to the grantor via an installment note, the interest on the note is less than the amount of the dividend. This creates a situation where the assets in the trust continue to grow, and will pass estate tax free to the beneficiaries.

When Sam gifts the S-corporation stock to the IDGT, he has to pay income tax on all dividends paid from the company to the IDGT. Normally, when a parent gifts something to a child (and essentially Sam was gifting the income taxes he was paying on the dividends paid to the IDGT), gift taxes are due. By gifting the S-corporation stock to the IDGT, Sam's payment of income tax is not considered a gift, thereby significantly increasing the value of the IDGT from an estate planning perspective.

Finally, using the IDGT, Sam did not have to give up control of his interest in the business due to the fact that he retained the voting interest in the business until Sam decided to sell the business to an outside buyer.

Leveraging Assets (the use of life insurance)

The IDGT provides an excellent way to acquire significant amounts of life insurance without having to worry about taxable gifts on the premium payments. Most wealthy clients who have put off doing proper estate planning end up having their advisors tell them that they must set up an Irrevocable Life Insurance Trust (ILIT) so the death benefit can pay for the inevitable estate taxes that will be due. While it is easy for an advisor to tell a high net worth client to gift \$150,000 in premium to an ILIT, most clients are upset when they hear that they must pay gift tax on some of the premium gifted to the ILIT.

This makes the IDGT an easy sale, since the ability to discount the value of the property sold to the IDGT, combined with an interest-only installment payment, should provide the IDGT with sufficient **tax free** cash flow to allow the funding for significant amounts of life insurance. The life insurance proceeds (from the newly purchased life policy which is owned by the IDGT) can be used to repay the note upon the grantor's death which effectively discounts the cost of repaying the note. Again, an example is the best way to illustrate this concept.

Example:

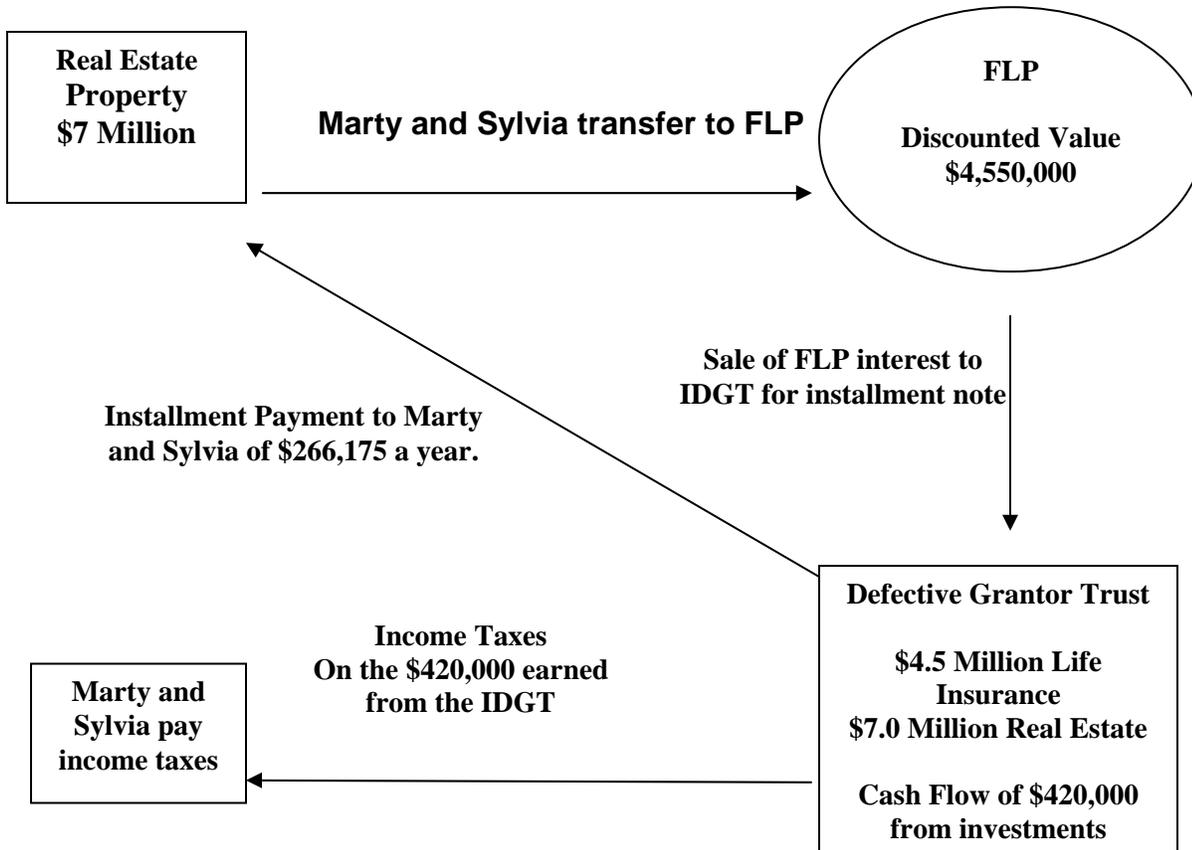
Marty and Sylvia, ages 68 and 67, have an estate valued at \$18 million and would like to acquire a \$4.5 million second-to-die survivorship life insurance policy for the benefit of their only child, Matt. Due to medical issues, however, the premium for the policy will be \$150,000 per year. While there is plenty of cash flow available to pay the premium, Marty and Sylvia are concerned over the gift taxes that would be imposed on the premium payments if they were to gift \$150,000 a year to an ILIT.

Among the assets owned by Marty and Sylvia are real estate investments valued at \$7 million, generating income of 6% or \$420,000 per year. Marty and Sylvia contribute their real estate interests to a newly formed FLP and receive a 1% general partnership interest and 99% limited partnership interests. Working with an appraiser, a 35% valuation discount was applied to the partnership interest.

Marty and Sylvia create an IDGT and **sell** their limited partnership interest to the trust in exchange for an interest only note.

Gross Value of Property \$7,000,000
 Discounted Value \$4,550,000
 Term of Payment interest only 15 years
 Income on Property 6%
 Property Growth 02%

Marty & Sylvia



Let's see how this arrangement can help fund the life insurance premiums without imposing gift taxes

Year	Installment Note	Trust Income	Interest on Note	Life Insurance Premiums	Excess Cash flow	Value of Property
1	\$4,550,000	\$420,000	\$266,175	\$150,000	\$3,825	\$7,140,000
5	4,550,000	454,621	266,175	150,000	38,446	7,728,566
10	4,550,000	501,939	266,175	150,000	85,764	8,532,961
15	4,550,000	554,181	266,175	150,000	138,006	9,421,078

This planning has allowed \$4,871,078 (which is derived by subtracting the installment note from the property value in year 15) in value to be shifted to Matt free of all taxes while creating a death benefit of \$4.5 million that will also be received totally tax free. It has also allowed Marty and Sylvia to make substantial tax-free gifts to the trust in the form of income taxes paid on the trust income.

The \$266,175 of interest paid to them annually for 15 years is not taxable, but the \$420,000 of income created inside the IDGT is taxable annually to Marty and Sylvia as grantors. Taxes on \$420,000 at the 40% rate are \$168,000 and, typically, a portion of the installment note payment of \$266,175 is used to pay that tax.

If the grantor is still alive in 15 years when the note becomes due, there are a few options. The note could be re-done, or it could pay the \$4.5 million due. Upon redoing the note, it could also be structured to start to pay down principal.

Planning Risks

The technique of a sale to a “defective” IDGT is not based on any one specific section of the Code; but rather on several IRS private letter and revenue rulings that rely on the technical underpinnings of several sections of the Code and established tax principles. At this point there is no concerted effort by the IRS to challenge this strategy, but it should be noted that the IRS has challenged certain aspects of the transaction without much success.

It is possible, therefore, that at some point in the future the IRS may try to attack the IDGT merely because it presents a tremendous opportunity for the taxpayer to shift value without a transfer tax. If the IRS were to challenge the technique, it would likely begin with the bona fides of the overall transaction (i.e., is the 10% seed money enough to justify a “commercially viable” sale, or should the non-recognition treatment afforded to the capital gains be recognized on the outstanding balance on the note if the grantor dies before the note is paid off). Any individual seeking to use this transaction should also consider that by doing so, they would forego the step-up in basis the stock would normally receive if the individual held the stock at death.