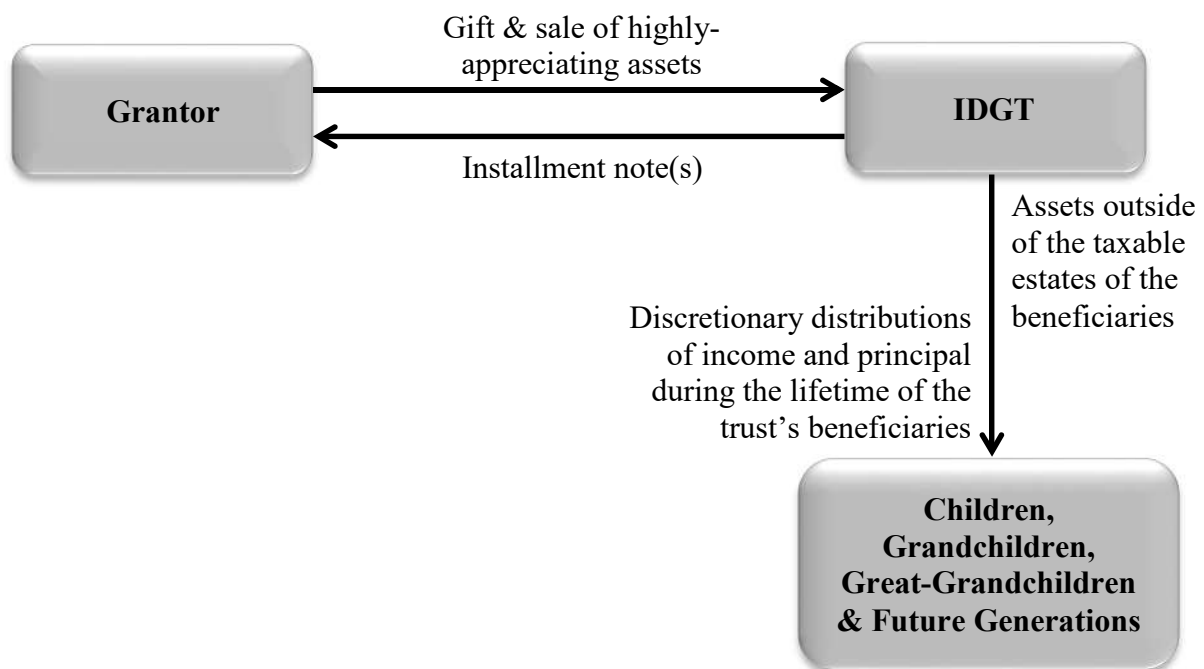


#23: IDGT Sale

Sales to an intentionally defective grantor trust (IDGT) are completed transfers for gift and estate tax purposes, but are ignored for income tax purposes. As a result, the grantor is taxed on all trust income but the transferred assets are removed from the grantor's estate. This produces important gift and income tax benefits for very large estates as explained below.

Basic Mechanics

1. Grantor creates an irrevocable trust for the benefit of his or her descendants.
2. Grantor "seeds" the trust by gifting assets having at least one-ninth the value of the assets to be sold to the trust to avoid the argument that the grantor has retained an income interest in the trust assets under IRC § 2036.
3. Grantor allocates generation-skipping transfer tax (GSTT) exemption to the trust to cover the amount of the seed money gift.
4. Grantor sells assets to the trust that are expected to increase rapidly in value and takes back an installment note.
5. The sale price is equal to the full fair market value of the property sold so that there is no taxable gift on the sale.
6. Valuation discounts may be available to reduce the selling price.
7. The interest rate on the note is set at the lowest rate allowed under the tax law (AFR).



Transfer Tax Benefits

IDGT sales produce the following transfer tax benefits. First, if the total return on the assets sold exceeds the interest rate on the note, value is transferred tax-free to the trust beneficiaries.

Example 1. Taxpayer (T) sells \$1,000,000 worth of FLP units to a nine-year IDGT at a time when the mid-term AFR applicable to the note is 1.75%. The assets grow at 10% after-tax and 12% before-tax. Assume that the trust includes a provision permitting, but not requiring, the trustee to reimburse the grantor for income tax paid on the trust income and the trustee exercises this discretion.⁷³ At the end of nine years, the value of the transferred assets has grown to \$2,357,948 in the IDGT (\$1,000,000 appreciated @ 10% for nine years). Meanwhile, the IDGT pays the grantor \$17,500 of interest each year and pays back the \$1,000,000 principal amount at the end of year nine. Assuming that the grantor reinvests the interest payments at the same 10% rate, the future value of the seller's income stream paid at the end of the nine years is \$237,641. Thus, the future value of the property transferred is \$2,357,948 and the value of the property that has come back into the grantor's estate is \$1,237,641 (\$1,000,000 principal payment + \$237,641 future value of interest stream). This makes the tax-free transfer \$1,120,307 (\$2,357,948 - \$1,237,641).

Trust Assets

N	I	PV	FV
9 years	10%	\$1,000,000	\$2,357,948

Interest Payments

N	I	PMT	FV
9 years	10%	\$17,500	\$237,641

The tax-free transfer to the IDGT can be enhanced by transferring discounted assets.

Example 2. Assume the same facts as in Example 1 except that the transferred assets qualify for a 30% valuation discount. The interest payments are now \$12,250 per year instead of \$17,500 (FV = \$166,349) and the principal repayment amount is reduced from \$1,000,000 to \$700,000. This increases the tax-free transfer to \$1,491,599 (\$2,357,948 - (\$700,000 + \$166,349)).

N	I	PMT	FV
9 years	10%	\$12,250	\$166,349

Payment of the trust's income tax liability provides a further enhancement.

⁷³ Reimbursement clauses are often included in IDGTs to prevent cash flow problems for grantors, who are otherwise taxed on income they do not receive. Such a clause does not cause estate inclusion for the IDGT assets absent additional facts, such as (1) an understanding between the trustee and the grantor that the trustee will exercise the discretion, or (2) the grantor's power to remove the trustee (Rev. Rul. 2004-64).

Example 3. Assume the same facts as in Example 2 and also assume that the grantor pays the IDGT's income tax and there is no reimbursement provision. As a result, the IDGT assets grow at 12% instead of 10%. After nine years the value of the transferred assets is \$2,773,079 and the amount of the tax-free transfer is \$1,906,730 (\$2,773,079 - \$866,349). Note that the benefit of the grantor paying the IDGT's income tax continues after the end of the note term.

Trust Assets

N	I	PV	FV
9 years	12%	\$1,000,000	\$2,773,079

Interest Payments

N	I	PMT	FV
9 years	10%	\$12,250	\$166,349

Income Tax Benefits

As a result of grantor trust status:

1. The grantor recognizes no gain or loss on the sale;
2. The grantor is not taxed on the interest payments received from the trust;
3. The grantor recognizes no gain if installment payments are made in kind;
4. The grantor pays the trust's income tax liability; and
5. The trust is an eligible S corporation shareholder.

Disadvantages

IDGTs also have several disadvantages. First, although the IDGT receives a basis step up for any appreciation in the purchased property as of the time of the sale, there is no basis step up for any appreciation between the sale date and the grantor's date of death. However, the combined benefits of removing appreciation from the estate, taking advantage of valuation discounts and having the grantor pay the trust's income tax will ordinarily outweigh this basis disadvantage.

Second, if the sale is not properly structured, it could be treated as a gift with a retained income interest under IRC § 2036. This could happen, for example, if note payments are based on available trust income rather than on the stated terms of the note. Sections 2701 and 2702 could also apply if the note is not structured to make it bona fide debt.

Third,, payment of the trust's income tax by the grantor could cause a cash flow problem because the grantor is paying the trust's income tax without receiving the trust's income. It may be possible to avoid this problem by giving the trustee the power to turn off grantor trust status if desirable.

Finally, gain might be recognized when grantor trust status terminates. When an individual transfers assets to a grantor trust, the trust is ignored for income tax purposes and the grantor is treated as still owning the assets.⁷⁴ If grantor trust status terminates during the grantor's life, there is a deemed transfer of the trust assets from the grantor to a non-grantor trust and gain must be recognized to the extent that the consideration received exceeds the trust's basis in its assets.⁷⁵ For this purpose, consideration includes relief from liabilities (e.g., IDGT notes).⁷⁶ Thus, if trust liabilities (including the note payable) exceed the trust's basis in its assets, gain is recognized.

Commentators have argued, however, that this rule shouldn't apply to termination of grantor trust status at the death of the grantor. The argument is that under Revenue Ruling 85-13 there is no transfer of assets for income tax purposes while the trust is a grantor trust. Thus, the transfer must occur for income tax purposes when the seller dies. Although no Code section explicitly addresses the question, the traditional, well-ingrained view is that gain is not recognized by the transferor in connection with a testamentary or lifetime gift.⁷⁷ A transfer at death isn't treated as a realization event under IRC Section 1001 even if the transferred property is subject to liabilities (e.g. unpaid installment obligations).⁷⁸ Therefore, there should be no gain realized on the property in the trust. The IRS seemed to acknowledge this conclusion in CCA 200923024.

Disclosures

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⁷⁴ IRC § 671.

⁷⁵ (*Madorin v. Commissioner*, 84 TC 667 (1985); Reg. §1.1001-2(c), Example 5; Revenue Ruling 77-402).

⁷⁶ *Crane v. Commissioner*, 331 US 1 (1947).

⁷⁷ (*Campbell v. Prothro*, 209 F2d 331 (5th Cir. 1954); *International Freighting Corp.*, 135 F2d 310 (2nd Cir. 1943).

⁷⁸ Rev. Rul. 73-183; *Crane v. Commissioner*, 331 US 1 (1947).