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Helping You Plan, Protect & Prosper

Sale to an Intentionally Defective Irrevocable Trust

Concept

An Intentionally Defective Irrevocable Trust (IDIT) is an irrevocable trust established by a grantor generally for the benefit of the grantor's family. An IDIT is drafted such that the trust income is taxed to someone other than the trust or the person that receives that income. Basically the grantor (or some other person) is considered the owner of the trust for income tax purposes. An IDIT can be a valuable asset shifting tool as it allows the grantor to remove or at least freeze the value of an asset in the grantor's estate through a sale of the asset to the IDIT for a promissory note. Because the federal income tax and the federal estate and gift taxes are not synchronized, the technique provides unique planning opportunities.

Situations

A sale to an IDIT may be advantageous for an individual wishing to shift appreciating property with a strong cash flow outside of the taxable estate. This is often a helpful tool for persons who have already utilized much of their lifetime and annual gift tax exemptions, as an IDIT sale may require an initial gift valued at a fraction of the overall property to be transferred. In addition, a sale to an IDIT can provide an individual with an income stream until payments under the promissory note have been satisfied.

Grantor Trust Status

The grantor trust rules, set forth within Internal Revenue Code §§ 671-678, provide that a grantor of a trust may be the owner of the trust for income tax purposes if the grantor retains certain powers over the trust. Under § 671, the owner of a trust must include the income, deductions, and credits of the trust in computing the owner's own income tax liability. The Internal Revenue Service (IRS) ruled it will disregard the existence of such a trust for income tax purposes -- the grantor and the trust are treated as the same entity for income tax purposes. As a result, any transactions between the grantor and the grantor's trust should have no income tax consequences. Thus, upon a sale to an IDIT, the grantor should not have to recognize gain in the transferred asset. In addition, interest payments to the grantor under the promissory note are not income taxable upon receipt.

There are several trust provisions which can trigger grantor trust status. The key is to select powers that avoid inclusion of the trust assets in the grantor's estate for estate tax purposes. For example, the grantor's spouse could receive distributions in the discretion of a "non-adverse" party (i.e., a person with no interest that would be affected by the distribution). Grantor trust status also may be triggered if a non-trustee, non-adverse party has the power to cause distribution of income and principal among a class of trust beneficiaries or where a non-adverse party may add beneficiaries to the trust. The discretion to expend trust income to pay premiums for life insurance on the grantor or the grantor's spouse held by a non-beneficiary trustee is another commonly used power. Further, the right of the grantor or a third party to acquire trust assets by substituting assets of equivalent value, or the power of a non-beneficiary trustee to lend trust property to the grantor without adequate security, will trigger grantor trust status. Note, however, the law is not entirely settled on the circumstances of when particular powers will cause the trust to have grantor trust status. A client considering an IDIT should consult with his or her attorney on this matter.

Logistics

The grantor will execute an irrevocable trust with the appropriate grantor trust provisions. The grantor will then make a "seed gift" to the trust in order to avoid a potential IRS argument that a subsequent sale to the trust is a gift with a retained interest. The seed gift is typically valued at 10% of total trust assets after any sale. The grantor can utilize a portion of his or her lifetime gift tax exemption amount or annual exclusion gifts to avoid gift tax. The grantor can then sell the desired property to the trust, and the trust would issue a promissory note for the purchase price. The note can be structured to require lower payments in the early years, thus reducing the cash flow requirements if the transferred property is expected to have greater cash flow in the future. The note typically bears interest at the Applicable Federal Rate (AFR) in effect when the note is executed, based on duration. These rates are issued by the IRS on a monthly basis. In months where the AFR is low, the grantor has the ability to lock in this low rate for the duration of the payout period. In the event of the grantor's death while the note remains outstanding, the note would be included in the grantor's estate. Any appreciation in the value of the asset is excluded from the grantor's estate for estate tax purposes. Despite the potential benefits of an IDIT sale, there are several issues with income, gift, and estate taxes one should consider before proceeding.

Tax Ramifications

Income Tax Issues

A crucial income tax issue potentially arises when the grantor dies while the IDIT note remains outstanding. Many commentators believe that there is no support for taxing gain at the death of a grantor with respect to which the trust is indebted at the grantor's death; however, others may disagree. When a person dies, the heirs generally receive the deceased's property with a basis equal to the fair market value of the property at the time of death. This "step-up" in basis allows the heirs to avoid capital gains tax on all of the appreciation occurring before the prior owner's death. Grantor trust status of an IDIT terminates upon the death of the grantor. If a note is outstanding, the IRS could determine that a sale of the assets for the remaining note balance is deemed to occur at death. The question is whether the theoretical sale occurs immediately before death or after death.

Proponents of the IDIT sale concept argue that the deemed sale occurs immediately after death. As a result, the assets would receive the § 1014 step-up in basis and any subsequent transaction would not produce any capital gain. Some legal commentators argue the hypothetical sale occurs immediately prior to death, which is cited in an example in the IRS regulations regarding a grantor trust that owned an interest in a tax-shelter partnership. Because this was a grantor trust, the grantor could deduct the trust's share of the partnership

losses. Before the partnership produced any phantom income, the grantor renounced the powers that made the trust a grantor trust in an attempt to avoid recognizing the income. The example states the grantor would be deemed to have sold the partnership interests to a non-grantor trust immediately prior to the conversion of the trust from a grantor trust to a non-grantor trust. The grantor would have taxable gain to the extent that his share of the partnership liabilities exceeded the basis of the partnership interests. An IRS ruling and a Tax Court case reached the same result on almost identical facts. While these precedents are not exactly on point, they could bolster the argument that the death of the grantor results in taxable gain to the grantor's estate.

The parties could avoid this argument entirely by satisfying the note prior to the grantor's death. The trust could satisfy the note by transferring a sufficient amount of the assets back to the grantor. If the assets have appreciated in value, the trust might not have to transfer all of the assets back. The appreciation could remain in the trust. Anyone considering an IDIT sale should discuss the risks with their own legal advisors.

If the trust satisfies the note prior to the grantor's death, the grantor could opt to "toggle off" the grantor trust status of the trust to avoid tax on future trust income. The grantor could accomplish this by renouncing the powers that make the trust a grantor trust. If the powers in question belonged to another person, that person must renounce the power.

Gift Tax Issues

Since the grantor will sell the assets to the IDIT for fair market value, there usually will be no taxable gift involved (beyond the seed gift) unless the grantor's gift tax exemptions are not sufficient to cover the value of the seed gift. The grantor and his or her advisors must be careful, however, to ensure an accurate valuation of the assets sold. If the IRS were to succeed on a challenge that the assets sold were worth more than the sale price, this difference could amount to a taxable gift.

Interest Rate of Promissory Note

Internal Revenue Code § 7872 provides that in the case of any loan that is a "gift loan" and bears a below-market interest rate, the foregone interest will be treated as transferred from the lender to the borrower and then retransferred from the borrower to the lender. A "gift loan" is a loan where the foregoing of interest is in the nature of a gift. The market interest rate is the Applicable Federal Rate (AFR) under § 1274 of the Code for the term of the loan in question. The IRS issues AFRs for short-term (obligations of three years or less), mid-term (more than three years, but not over nine years), and long-term (more than nine years) loans each month. If § 7872 applies, the lender may be treated as making a taxable gift of the amount of foregone interest and then receiving taxable income in the amount of the foregone interest. For this reason, the promissory note in an IDIT sale transaction typically will bear interest at least at the AFR. In order to achieve maximum leverage from the IDIT sale transaction, the assets transferred usually should have an expected rate of return in excess of the AFR.

Section 2702 Issue

Another potential gift tax issue involves § 2702 of the Code. Under this Section, the value of a retained interest in a trust is valued at zero in determining the value of the interest passing to trust beneficiaries, unless the retained interest is a qualified interest. Theoretically, § 2702 should not apply to an IDIT sale transaction because a promissory note does not constitute a beneficial interest in the trust. In a 1995 ruling, the IRS addressed a situation in which a beneficiary of a trust sold corporate stock to a trust in exchange for a promissory note from the trust. The IRS ruled the promissory note was debt and not a term interest under § 2702(c)(1). Therefore, the IRS found that the note was not a retained interest covered by § 2702(a).

There is the possibility that the IRS could invoke § 2702 by re-characterizing the sale transaction as a gift to the trust with a retained income interest, mentioned above. The IRS could then ignore a part or all of the value of the note payments in calculating the value of the gift to the trust. The risk of this argument might be greater if the trust has no other assets other than the assets sold to the trust with which to make note payments. Therefore, the grantor could possibly avoid this issue by first making a seed gift of other assets to the trust, perhaps equal to as little as 10% of the total trust after assets are sold. Personal guarantees of the IDIT note by the trust beneficiaries might also alleviate the problem.

Estate Tax Issues

Internal Revenue Code § 2036 provides that a decedent's taxable estate includes any property transferred by the decedent in which the decedent retained a beneficial interest (including the right to income) or the right to control who owns or enjoys the use of the property. Internal Revenue Code § 2038 includes in the estate any assets transferred if the transferor retained a power to alter, amend, revoke, or terminate the terms of the transfer. The IDIT is an irrevocable trust; as long as the grantor retains no benefit from the trust assets or control over their disposition, trust assets can be held entirely outside the grantor's estate. As noted above, the drafter of an IDIT must be careful in giving the grantor powers over the trust. Any power the grantor has must be sufficient to make the trust a grantor trust without causing inclusion of the assets in the grantor's estate under § 2036 or § 2038.

As noted above, § 2036 requires inclusion of transferred assets in the transferor's estate if the transferor retained any beneficial interest in the assets, including the right to income from the assets. If the trust's only assets are those transferred as a part of the sale from the grantor, the IRS may have an indirect § 2036 argument. The IRS could attempt to re-characterize the transaction as the grantor making a gift to the trust and retaining an income interest in the gifted property. The IRS has not ruled directly on this issue, but has issued rulings that suggest they might make such an argument.

Allocation of GSTT Exemption

Generation skipping transfer tax (GSTT) exemption may be allocated to assets upon the initial transfer of the seed gift to the trust. Any growth of the property inside the trust would also receive GST protection, thereby leveraging the GSTT exemption.

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