

Sale to an Intentionally Defective Grantor Trust (IDGT): A Wealth Transfer Technique

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What is an IDGT?

- **Intentionally Defective Grantor Trust (IDGT)**
 - An IDGT is simply an irrevocable trust that is complete for transfer tax purposes (gift, estate & generation skipping transfer tax (GST)), but incomplete for income tax purposes.
 - An IDGT takes advantage of differences between the income tax system and transfer tax system and can generate significant benefits in wealth transfer scenarios.

How is an IDGT created?

- **Essentially, the trust is drafted as an irrevocable trust with a provision that creates grantor trust status for income tax purposes.**
- **Grantor trust status is achieved by intentionally violating one of the grantor trust rules under IRC §§ 671-678.**
- **To be effective, both the income and principal portions of the trust must violate this provision making the grantor responsible for the payment of income taxes on trust income.**
- **At the same time, the trust must be drafted so that there is a completed gift or else the trust assets will be pulled back into the grantor's estate.**

Powers that Create an IDGT

- **Two of the more commonly used provisions that attorneys use to create an IDGT are:**
 - **Ability to reacquire the trust property by substituting other property of equivalent value, or**
 - **Giving a non-adverse party (other than the grantor) the power to add beneficiaries other than after-born children and after-adopted children.**

Powers that Create an IDGT

➤ Other trust provisions that can create an IDGT:

- The grantor or his/her spouse may benefit from the trust's discretionary distribution provisions (sprinkle provisions).
- The grantor or his/her spouse possess a reversionary interest worth more than 5% of the value of the trust at its creation.
- The grantor and/or a non-adverse trustee has the power to apply trust income to the payment of premiums for life insurance on the life of the grantor or his/her spouse.

IDGTs and Income Taxes

- **For income tax purposes, the grantor is treated as the owner of the IDGT assets and is required to pay income tax on all items of income (ordinary income and capital gains) earned by the trust.**
 - **This personal tax responsibility exists whether the trust income and/or principal is distributed to the grantor or not.**

IDGTs and Estate Taxes

- **Even though the grantor is treated as the owner of the IDGT for income tax purposes, he/she is not necessarily treated as the owner for estate tax purposes.**
 - **The estate tax inclusion rules (IRC §§ 2036-2038 or 2042) are applied separately to make the determination of whether the trust assets will be included in the grantor's estate.**
 - **An IDGT, if properly drafted so that the grantor is not given powers that are considered "retained interests," should not result in estate inclusion.**

Advantages of the IDGT

- **By paying income taxes on trust assets, the donor is essentially making additional transfers to the trust beneficiaries without paying gift tax.**
 - **Rev. Rul. 2004-64, 2004-27 I.R.B. 7 confirms this position, and additionally provides that any discretionary reimbursement of the grantor's income taxes will not have adverse gift or estate tax consequences.**
- **If the trust does not lose dollars to taxes, greater trust value and growth is possible.**
- **In turn, the grantor's payment of income taxes further decreases the grantor's taxable estate.**

Advantages of the IDGT

- **Income generated by trust assets can be used to purchase life insurance on the life of the grantor eliminating the need to gift funds to pay premiums (i.e., annual exclusions and applicable exemption amounts can be put to other use)**
- **An IDGT can be established in a state that allows perpetual trusts, thus eliminating transfer tax for subsequent generations**

Advantages of an IDGT

- **No gain or loss is recognized on assets sold to the IDGT by the grantor since the grantor is treated as the owner of the trust for income tax purposes.**
 - Reg. § 1.1001-2(c) Ex 5 & Rev. Rul. 85-13, 1985-1 CB 184
- **In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as the owner of the assets of the trust.**
 - **Issue:** The Crummey withdrawal power may potentially be treated by the IRS as if the holder is an owner of the portion of the trust represented by the withdrawal power.

Advantages of an IDGT

- **Planning opportunity:** Sale of rapidly appreciating assets to an IDGT allows transfer of substantial wealth out of the grantor's estate without significant estate, gift or GST tax.
 - Very effective **Estate Freeze Technique** with some advantages over the more common split interest trust estate freeze technique (i.e., **GRAT/GRUT**)

Note: For an in-depth discussion of GRATs and IDGTs, please consult Prudential Financial's marketing materials:

IFS A097385: Comparison GRAT vs Sale to an IDGT

IFS A097384: GRATs and Sale to IDGTs: Estate Freeze Techniques in Times of Estate Tax Uncertainty

IDGT Promissory Note Sale

- **This is a sale of income producing assets by the grantor to the IDGT in exchange for a promissory note from the trust.**
- **The note can be structured in many ways but is generally a full recourse installment note secured by the asset(s) sold.**
- **Common scenario: Interest-only note with a balloon payment at the end of the note term**
 - **Interest payments do not create taxable income to the grantor – because the trust and the grantor are regarded as one and the same for federal income tax purposes.**

IDGT Promissory Note Sale

- **Whatever the planning scenario, the note**
 - **Needs to be structured as an arms length bona fide sale** or the sale may be treated as a retained life estate under IRC § 2036(a)(1) or a transfer with a retained interest under IRC § 2702.
- **Undesirable Result: Where these code sections are deemed applicable by the IRS, the assets will be included in the grantor's estate.**

Bona Fide Sale

- **IDGT must have independent economic significance to avoid the perception that the sale is a transfer with a retained interest under IRC § 2036(a)(1).**
- **Common sense: Money is only loaned where there is an expectation that the debtor can repay the note. How will the trust repay the debt? Does it have a source of funds?**

Bona Fide Sale

- **Solution:** Prior to the sale, the grantor should “seed” the IDGT by gifting cash or income producing property.
 - IRS has indicated informally that “seed” assets should total at least 10% of the value of the assets being sold to the trust. Private Letter Ruling (PLR) 9535026
 - “Seeding” will require the grantor to use his/her annual exclusions and/or applicable lifetime exemption or pay gift tax on the transferred property.
 - Once the trust has been seeded and GST exemption has been allocated to cover the gift, no further GST exemption need be allocated to the IDGT.

Bona Fide Sale

- **Note should be equal to FMV of the property sold.**
 - If the IRS determines that transferred asset value exceeds the note amount, the difference will be treated as a gift.
- **Term of note: 15-20 years to avoid IRS argument of a retained equity interest rather than a true debt.**
- **Note should have an interest rate at least equal to the appropriate applicable federal rate (AFR)**
 - See *Frazee v Commissioner*, 98 T.C. 554 (1992)
 - PLRs 9535023, 9408018
 - *Krabbenhoff v. Commissioner*, 94 T.C. 887 (1990), *aff'd*. 939 F.2d 529 (8th Cir. 1991)

Structuring Note Repayment

- **Structure the note so that it is “more likely than not” that the note will be repaid prior to the grantor’s death.**
 - **Set note term shorter than grantor’s life expectancy.**
- **Why? Tax avoidance, Tax uncertainties**

Outstanding Note at Grantor's Death

- **Estate Tax Effect:** Balance of the note is included in the grantor's estate and may trigger estate taxation.
 - **Solution 1: Use a Self Canceling Installment Note (SCIN)**
 - No estate taxation, but grantor must recognize any unrealized gain if there has been a cancellation of the installment note
 - Exactly how do you value the SCIN? Can the IRS argue there is a gift?
 - **Solution 2: Use a Private Annuity**
 - No estate taxation, but what if the grantor lives longer than his/her actuarial life? – Then the purchaser must continue making annuity payments even if they are eventually more than the fair market value of the property.
 - **Solution 3: Life Insurance Sale**
 - Use a portion of the income generated by the trust assets to fund a life insurance policy on the grantor's life.
 - Use death benefit proceeds to pay off the note, or
 - To offset any estate tax costs

Outstanding Note at Grantor's Death

- **Income Tax Effect: A much debated topic**
 - Is gain triggered at the death of the grantor?
 - Or is gain recognition deferred under IRC § 453 until the debt is paid after the grantor/seller's death?
 - Is there income in respect of decedent (IRD) for the recipient of the payments after the grantor's death?
 - Does the note get a basis step-up?
- **MANY THEORIES BUT NO REAL ANSWERS**
- **Solution 1: Don't die with the note outstanding; plan for a note term that maximizes the possibility of payoff.**
- **Solution 2: Life Insurance Sale**
 - Use a portion of the income generated by the trust assets to fund a life insurance policy on the grantor's life.
 - Use death benefit proceeds to pay off the note, or
 - To offset any estate and income tax costs.

Maximizing Leverage

- **Valuation discounts may be applicable to transferred assets.**
 - **Example: family limited partnership interests**
 - **May result in lower sales price, smaller note amount, smaller interest payments, more value shifted to trust over time**

Maximizing Leverage

➤ Life Insurance

- **IDGT: Ideal vehicle to own & fund the life insurance policy**
- **Problem: Cash flow to fund premiums may be limited during period of note service**
 - **Solution 1: Split dollar funding, with exit strategy triggered after note is paid off**
 - **Solution 2: Additional seeding of the trust through**
 - **Direct gifts using annual exclusions, applicable lifetime exemption amounts**
 - **GRAT funding; IDGT is remainderman**
 - **Split-interest trust: transfer- tax savings**
 - **Solution 3: Universal life product with funding flexibility**

* Depending on the product and the state, universal life insurance is issued by The Prudential Insurance Company of America, Pruco Life Insurance Company, or Pruco Life Insurance company of New Jersey, all located in Newark, NJ.

**A PICTURE IS WORTH
A THOUSAND WORDS** ■■■■

Sale to an IDGT

Step One: Trust Formation/Prefunding Trust



**AVOIDANCE OF IRS ARGUMENT: RETAINED INTEREST
SINCE THE TRUST HAS INDEPENDENT ECONOMIC SUBSTANCE**

Sale to an IDGT

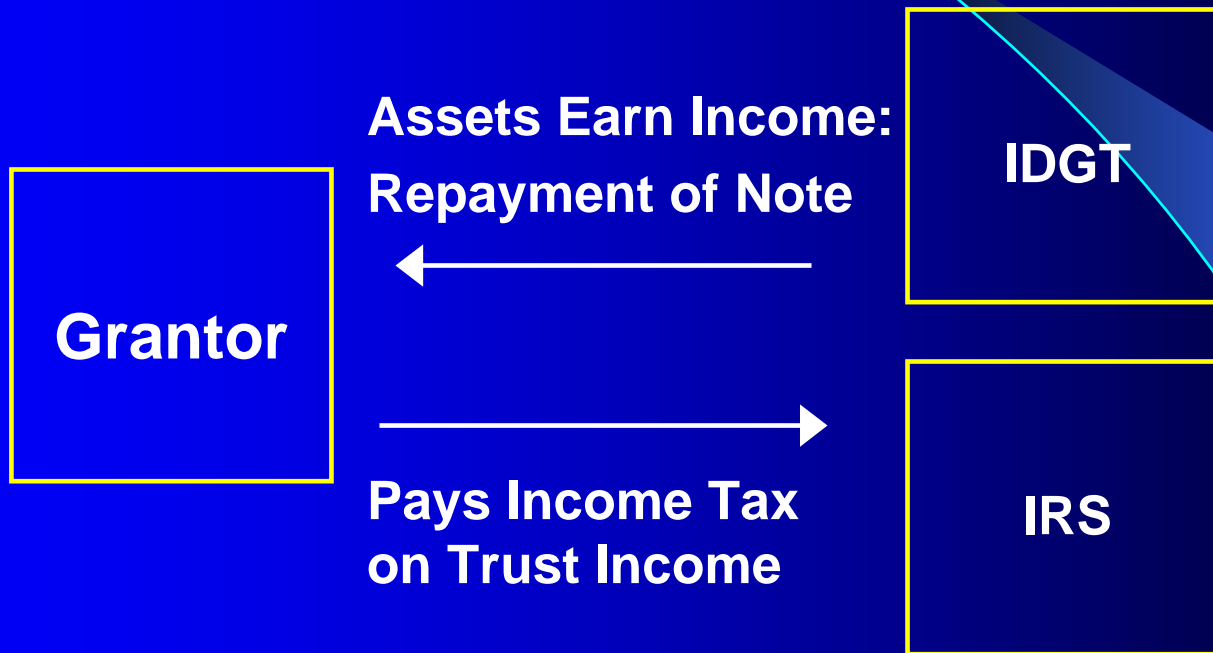
Step Two: Asset Sale



GRANTOR TRUST: NO GAIN OR LOSS RECOGNIZED ON SALE

Sale to an IDGT

Step Three: Trust income taxed to Grantor

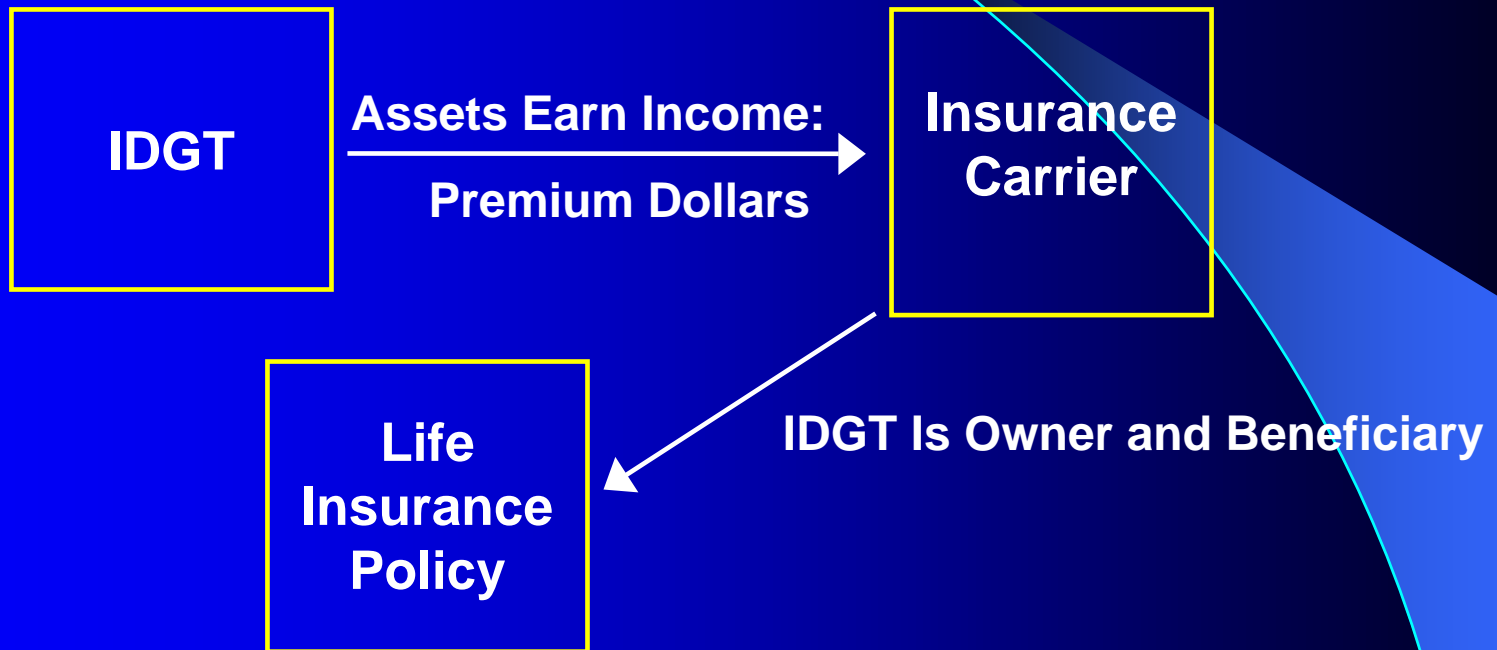


NO GIFT TO TRUST ON GRANTOR'S PAYMENT OF INCOME TAXES

GRANTOR PAYS NO TAX ON INTEREST RECEIVED ON THE NOTE

Sale to an IDGT

Step Four: Trust Purchases Life Insurance on the Grantor

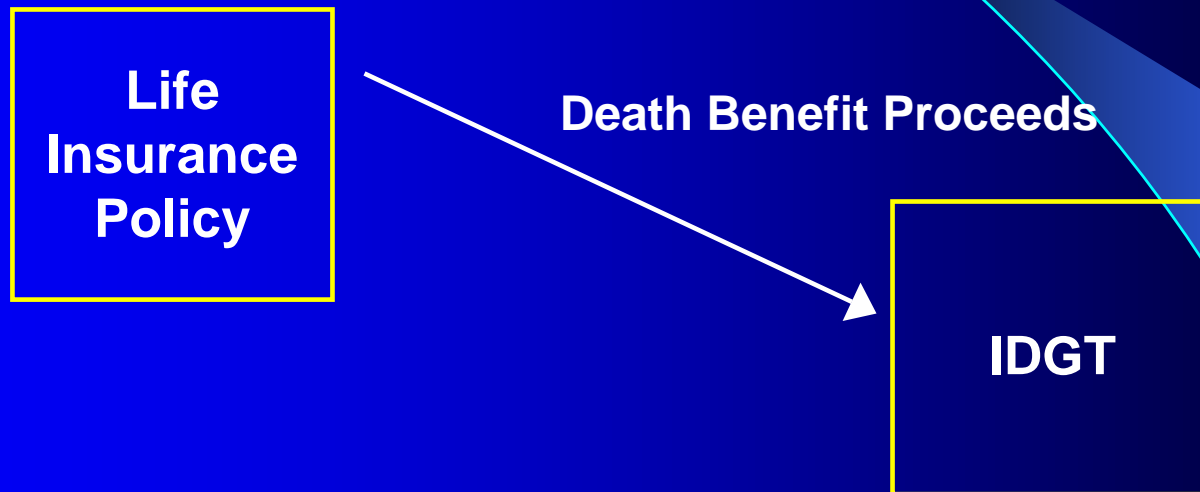


CASH VALUE IS AVAILABLE TO TRUSTEE IF NEEDED TO PAY INTEREST ON THE NOTE *

* Withdrawals and loans will reduce policy cash values and the death benefit and may have tax consequences.

Sale to an IDGT

Step Five: At Grantor's Death



DEATH BENEFIT: AVAILABLE TO PAY ESTATE/ INCOME TAXES

Conclusion

- **The sale to a grantor trust technique can be a powerful wealth transfer strategy.**
- **This platform can also serve as a most effective vehicle for funding a large life insurance policy.**
- **Like any advanced concept, this strategy contains certain tax risks.**
- **The IDGT sale is not specifically authorized under the IRC Code. There is little case law guidance on the IDGT Sale.**
- **Clients should seek the advice of their tax and legal counsel.**