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Advanced Planning Case Study

Sale to an Intentionally Defective Grantor Trust

MANAGING TAXES IN ESTATE PLANNING

Many clients wish to transfer assets to their children or grandchildren during their lifetimes, but do not wish to pay the gift taxes that may result from significant gifts. Making private loans to heirs or trusts in lieu of gifts is one alternative, but only for those clients who have significant cash holdings that they can bear to relinquish during the terms of the loans. For clients with illiquid portfolios, selling assets to an Intentionally Defective Grantor Trust (IDGT) is an option for making lifetime transfers in a gift-tax-efficient manner.

An IDGT is a specially drafted irrevocable trust whose assets are considered owned by the grantor for income tax purposes, yet are not considered owned by the grantor for gift, estate, and generation skipping transfer (GST) tax purposes. Thus the IDGT is "defective" for income tax purposes and "effective" for transfer tax purposes.

While selling assets to heirs can reduce or avoid gift taxes, the sale may trigger capital gains or ordinary income taxes depending upon the type of property sold and the amount of appreciation within. Selling assets to an IDGT solves this problem, because the IDGT is considered property of the grantor for income tax purposes. As a person cannot have a transaction with oneself, a sale of assets to an IDGT is ignored for income tax purposes.*1 Yet, as an effective irrevocable trust, a properly structured sale is respected for transfer tax purposes and the IDGT's assets will not be included in the grantor's taxable estate. (However, the sale proceeds and/or promissory note received from the IDGT will be included in the grantor's estate.) Another benefit of the IDGT structure is that, while the grantor is living, the trust's income is taxed to the grantor and not to the trust. Thus the IDGT retains the full return on trust assets for the benefit of the heirs instead of merely the after-tax value. In a sense, the grantor's payments of the IDGT's income taxes are gift-tax-free transfers to the IDGT. This flow-through income taxation makes the IDGT supercharged for estate planning purposes. When the IDGT loses its "grantor trust" status (at the grantor's death or upon the occurrence of certain other events) the responsibility for the trust's income taxes will fall to the trust itself or to the beneficiaries, depending on the trust structure.

WHO MAY BENEFIT FROM A SALE TO AN IDGT?

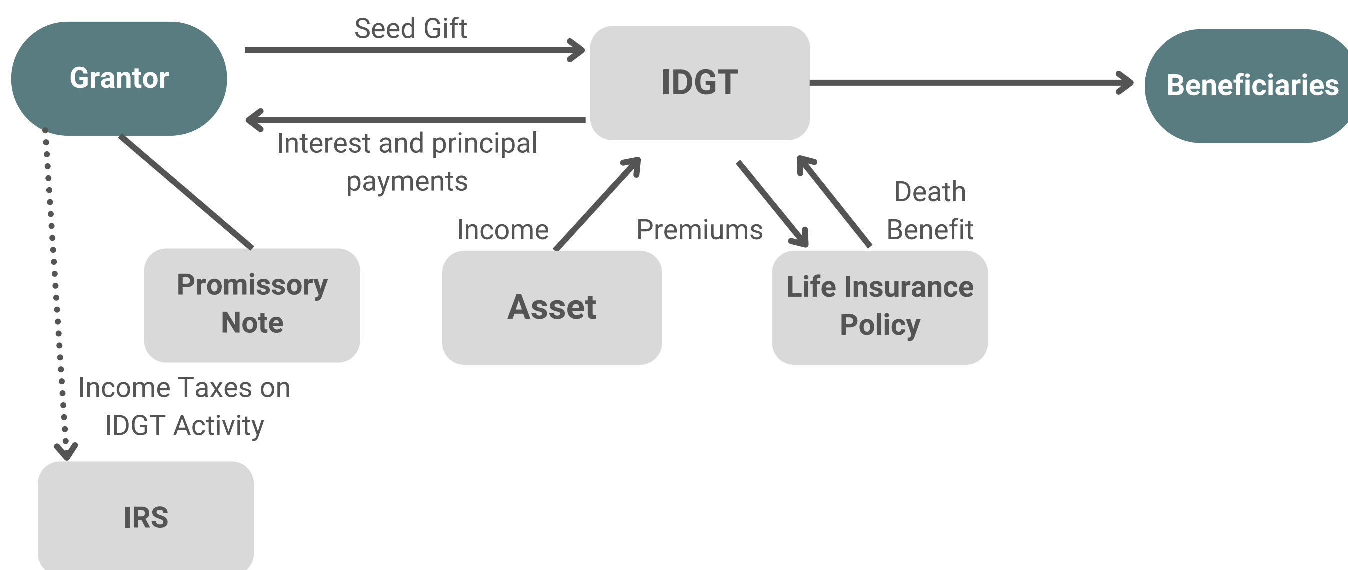
A good candidate is someone who wants to transfer significant wealth to his or her heirs, lacks the liquidity needed to make private loans, and wants to minimize income, gift, and estate taxes. The candidate will also own assets that produce consistent returns in excess of the Applicable Federal Rate (AFR), with income-producing assets preferred over purely appreciating assets. A viable candidate must also be able to withstand a reduction in his or her cash flow, as he or she will give up the asset's return and will also be responsible for paying the IDGT's income taxes.*2 If your client doesn't fit this profile, contact your Account Manager to further discuss the situation and alternatives.

WHY SELL ASSETS TO AN IDGT?

Selling assets to an IDGT is an effective estate freeze technique that can increase wealth and liquidity outside of the client's estate. As an irrevocable trust, a properly structured IDGT is an appropriate vehicle to hold life insurance on the grantor while keeping the death benefit proceeds out of the grantor's taxable estate. By selling assets to an irrevocable trust, the grantor minimizes the gift and GST tax liability on a significant transfer of wealth. The return on the assets received by the IDGT can also be used to pay the premiums on a life insurance policy owned inside the IDGT. By drafting the trust to be an IDGT, the grantor avoids triggering capital gains or ordinary income taxes on the asset sale. A sale to an IDGT strategy is also very effective when a client wishes to allocate his or her GST tax exemption to the IDGT and create a "dynasty trust" that remains free from transfer taxes for multiple generations.

HOW IT WORKS

The grantor will form the IDGT and make a "seed" gift of cash, marketable securities or some other asset. A seed gift is made to provide the IDGT with economic substance – allowing the later sale of assets to the trust to be respected as a legitimate arm's-length transaction for transfer tax purposes. A seed gift may be avoided if an existing IDGT holding sufficient assets is used. Many commentators recommend that the IDGT contain assets equal to at least 10% of the sale price. The grantor will then sell income-producing assets to the IDGT in exchange for a promissory note. The loan is typically structured as an interest-only term note with a balloon repayment of principal at the end of the term. The IDGT will pay interest on the promissory note, at least annually, and at a rate of interest at least equal to the AFR based on the note's term. Because the IDGT and the grantor are indistinguishable for income tax purposes, the IDGT's interest payments will not be included in the grantor's taxable income.*3 The IDGT will also purchase a life insurance policy insuring the grantor. The IDGT will receive the income generated by the assets sold to it. The IDGT will use this income to pay both the life insurance premiums and the interest payments back to the grantor. At the end of the note's term, the IDGT will repay the note's principal back to the grantor in cash or "in-kind" (with assets). Neither the sale of assets to the IDGT nor the repayment of the promissory note by the IDGT will trigger capital gain or income taxes (even if the note is repaid in-kind).



SUCCESS STORY

Issue

Jim Peacock, age 65, is the owner of an extremely successful roofing company. Jim plans to work as long as he is able before turning his business over to his children. His wife, Diane, is a school counselor who plans to retire in the next few years. Together the Peacocks' net worth is approximately $35,000,000, which is almost entirely comprised of the roofing company. Jim has a strong desire to keep the company in the family and is concerned that his estate will have to sell the business to a competitor at his death in order to pay taxes. Though they have not used any of their combined federal gift and estate tax exemption amounts, the Peacocks are facing nearly a $10,000,000 federal estate tax liability today; a liability that could increase as the business continues to rise in value and/or if estate taxes also apply at the state level. They understand the need for estate planning but do not want to incur any income or gift taxes to implement a wealth-transfer strategy.

Solution

Jim establishes an IDGT and names his children as the beneficiaries. Assets held in the IDGT will remain outside of Jim and Diane's taxable estates, but Jim will be considered the owner for income tax purposes only. Neither Jim nor Diane should be named the trustee in order to avoid the risk that the IDGT's assets are included in their estates.

Jim makes a $600,000 cash "seed gift" to the IDGT, using his lifetime gift tax exemption to avoid gift taxes. Jim then sells $6,000,000 of the roofing company's non-voting stock to the IDGT in exchange for an 8 1/2 year, interest-only, term note with a balloon repayment of principal at the end of the term.*4 The Peacocks expect the stock to yield an annual income at a 6% rate and appreciate annually at a 1% rate.

The trustee of the IDGT purchases a $10,000,000 survivorship insurance policy on Jim and Diane, structured with a 10-pay premium that will guarantee the policy for life. With a properly structured IDGT, the death benefit will not be subject to estate tax. The trustee of the IDGT expects to earn at least $360,000 per year on the roofing company stock, which the IDGT can use (with the cash seed gift) to pay interest to the Peacocks of $85,800*5 and the 10-pay insurance premium of $300,048*6 . While Jim is living, he is responsible for income taxes based on the income earned by the stock and any other assets owned by the IDGT. This leaves the trust with cash flow that is not burdened by income taxes, essentially supercharging the trust. During the ninth year, the IDGT will repay the note "in kind" by transferring the roofing company stock back to Jim. The IDGT will retain sufficient cash to pay the tenth and final insurance premium the next year. When the second of Jim and Diane die, the IDGT will receive the $10,000,000 death benefit free from estate and income taxes. The IDGT can then purchase $10,000,000 of roofing company stock from the surviving spouse's estate, providing the estate with cash needed to pay estate taxes. Both the stock retained by the estate and the stock purchased by the IDGT will then transfer to the Peacock's children, keeping the business in the family. In addition, the children will receive a basis "step-up" in the stock because the shares were held in the Peacocks' estates.

*1 See Rev. Rul. 85-13, 1985-1 C.B. 184.
*2 The reduction in the client's cash flow can be mitigated to some degree by interest and/or principal payments received from the IDGT on the promissory note (discussed in the section "How it Works").
*3 As noted above, the grantor will be responsible for taxes on the IDGT's income, at the grantor's income tax rates.
*4 As a promissory note with a term of less than 9 years, the interest rate charged must be at least equal to the mid-term AFR to avoid adverse gift tax consequences.
*5 Assuming a mid-term AFR of 1.43%.
*6 Based on Prudential PruLife SUL Protector, June 1, 2016, Male and Female aged 65, both categorized as Non-Smoker Plus, 10-year premium period. Death benefit is guaranteed on the lives of the insureds provided timely premium payments are made in a timely manner. All guarantees are subject to the claims paying ability of the issuing insurer.

Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse treatment of trust proceeds. CBS Brokerage Connections does not render tax or legal advice nor does it prepare trusts.

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