THE NAUTILUS GROUP®

GUIDEPOST

Sale to an Intentionally Defective Irrevocable Trust

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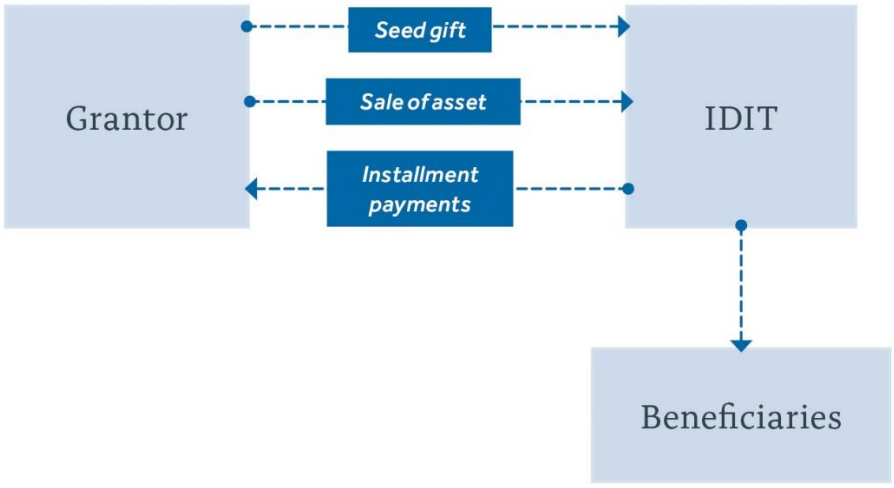
An intentionally defective irrevocable trust (IDIT) is an irrevocable trust established by an individual (the grantor) generally for the benefit of his/her family or other beneficiaries. An IDIT is typically drafted such that the trust income is taxed to the grantor, as opposed to the trust or its beneficiaries. Selling assets to an IDIT is a valuable asset shifting technique that allows the grantor to freeze the value of an asset in his/her estate through a sale of the asset to the IDIT in exchange for a promissory note. Because the federal income tax and the federal estate and gift taxes are separate, the technique provides unique planning opportunities.

A sale to an IDIT may be advantageous for an individual wishing to shift appreciating property outside of the taxable estate but who also wants retained access to income. IDITs are also used when the grantor has already utilized much of his/her lifetime and annual gift tax exclusions but wishes to engage in additional asset shifting. Because there are some risks and uncertainties, anyone considering an IDIT sale should discuss the risks with his/her own legal advisors.

Implementing a Sale to an IDIT

To utilize a sale to an IDIT to reduce estate tax exposure, the grantor would execute an irrevocable trust that includes the necessary provisions to be considered a "grantor trust" for income tax purposes. The grantor will then make a "seed gift" to the trust to avoid a potential Internal Revenue Service (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 exclusion amount (in 2023, $12.92 million) or annual gift tax exclusion (in 2023, $17,000 per donee) to avoid gift tax.

The grantor then can 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 its duration. In months where the AFR is low, the grantor can lock in this low rate for the duration of the payout period.



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. Any appreciation in the value of the asset in excess of the AFR is excluded from the grantor's estate for estate tax purposes. In the event of the grantor's death while the note remains outstanding, the note would be included in his/her estate.

Qualifying a Trust as a Grantor Trust

The grantor trust rules, set forth within Internal Revenue Code (IRC) §§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 IRC §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 IRS ruled it will disregard the existence of such a trust for income tax purposes, meaning that 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 be disregarded for income tax consequences. Thus, upon a sale to an IDIT, the grantor should not have to recognize any gain in the transferred asset. In addition, interest payments to the grantor under the promissory note are not subject to income tax upon receipt.

There are several trust provisions that 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 at 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.

Tax Considerations

Income Tax

As stated above, an IDIT is a grantor trust for income tax purposes resulting in the grantor including the income, deductions, and credits of the trust in computing his/her income tax liability.

A crucial income tax issue potentially arises when the grantor dies while the promissory note remains outstanding since the trust will no longer be considered a grantor trust. 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, other commentators disagree. When a person dies, his/her heirs generally receive his/her 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 decedent's death. Since 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 IRC §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.

This issue could be avoided 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.

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.

Gift Tax

Generally, a taxable gift of the seed amount is made to the trust. The grantor can utilize his/her lifetime exclusion amount (in 2023, $12.92 million) or annual gift tax exclusion amount (in 2023, $17,000 per donee) to offset gift tax liability. If the annual gift tax exclusion amount will be used to fund the seed gift, it will be necessary to ensure the trust includes provisions allowing the beneficiaries to withdraw such gifts to the trust to ensure gifts of the annual exclusion amount qualify as present interest gifts.

Since the grantor will sell 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 exclusions are not sufficient to cover the value of the seed gift. The grantor and his/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.

Estate Tax

IRC §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. IRC §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. As such, it will be important that the grantor retains no benefit from the trust assets or control over their disposition so that trust assets can be held entirely outside his/her estate.

Generation Skipping Transfer Tax

Generation skipping transfer (GST) tax 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 remain GST tax exempt, thereby leveraging the GST exemption.

Advantages of a Sale to an IDIT

- The current low AFR rate makes an IDIT sale an attractive asset shifting vehicle, since transferred assets only must appreciate in excess of the AFR for a sale to an IDIT to be effective.
- An IDIT sale can enable an individual with little to no remaining lifetime exclusion to reduce potential exposure to estate tax liability, since generally only the seed amount is transferred via a gift.
- GST exemption can be allocated upon initial trust funding resulting in trust assets, including ongoing appreciation, being exempt from generation skipping transfer tax.
- No taxable gain or interest income will exist upon a sale of appreciated assets to an IDIT in exchange for a promissory note.
- The grantor's payment of the trust's income tax liability annually effectively allows him/her to make additional tax-free gifts to trust beneficiaries.
- Installment payments can provide the grantor with a source of income for the duration of the note term.

Disadvantages of a Sale to an IDIT

- There is little authority through case law or IRS rulings or regulations regarding the transfer tax implications of a sale to an IDIT; therefore, this technique may create more risk than other asset shifting strategies.
- Once assets are sold to an IDIT, the grantor irrevocably loses control over trust assets.
- If the grantor dies while installment note payments remain outstanding, the balance of the note will be included in his/her taxable estate.
- There is the possibility that the IRS could invoke IRC §2702 by re-characterizing the sale transaction as a gift to the trust with a retained income interest. 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. A grantor could possibly avoid this issue by utilizing seed gifts or personal guarantees to ensure the note is respected.