

The IDGT: The Effective Defective Trust

An intentionally defective grantor trust (IDGT) is a grantor trust for income tax purposes, but a completed gift for estate and gift tax purposes. This article discusses how an IDGT is created and how to structure a sale to the trust for estate and gift-tax planning.

by Mark Stone, CPA, PFS, CFP, MST

Mark Stone, CPA, PFS, CFP, MST, is a tax manager at Margolin, Winer & Evens LLP, a certified public accounting firm with offices in New York City and Garden City, New York. His specialty includes advising high net worth individuals and closely held business owners on tax and estate planning matters. He can be reached at (516) 747-2000 or mstone@mwllp.com.

In a fervent push to repeal the estate tax, the Bush administration blamed the tax for destroying small "family-owned" farms and businesses. According to information gathered from estate tax returns filed for 1999, the Internal Revenue Service reported that very few working farmers were even subject to the estate tax, which affects only the richest two percent of Americans. With regard to family-owned businesses, 70 percent¹ fail to survive to the next generation. This high failure rate is most likely attributable to a failure to implement a management succession plan and not because of the estate tax.

The repeal did succeed in making it difficult to properly plan for the estate tax because repeal will take place only for the year 2010. In 2011, the estate tax repeal will be effectively repealed² and the rates and unified credit will generally revert to those applicable under the current law. If this sounds ludicrous, you are right! This lack of clarity in the estate tax laws amounts to an estate and financial planner's nightmare; however, one planning technique that may be effective in this uncertain environment is a sale to an intentionally defective grantor trust (IDGT).

Financial planners can offer an invaluable service to their clients by understanding how to structure the IDGT transaction and by reviewing the legal documents for potential tax traps. This article will use the example of a sale of the family business to focus on both the importance of implementing a succession plan and to illustrate the flexibility offered by the IDGT technique. In analyzing the IDGT, this article will discuss

1. How to structure the sale
2. Technical aspects of the IDGT and the related tax implications
3. A detailed case study of an IDGT transaction
4. The risks associated with this planning technique
5. A comparison of this technique with the GRAT (grantor-retained annuity trust)

A family business is usually the single largest and most illiquid asset of the client. Planning for such a business requires more than the traditional estate planning tools; it involves creating the right business structure while considering the family dynamics. To ensure the survival of a family-owned business, it is of paramount importance that a succession plan be implemented first. A properly structured IDGT sale will shift ownership of the business out of the principal's name, while allowing the owner to continue developing those members of the family who will provide the business with effective leadership and a successful infrastructure.

The Sale Technique

Structure. The sale to an IDGT is an estate freeze technique intended to reduce or eliminate the decedent's estate tax. The sale constitutes a freeze because the fair market value of the assets sold is frozen at the value on the date of sale, removing all future appreciation on such assets from the seller's estate. In structuring a sale to an IDGT, the plan must be tailored to the needs of the client. A well-crafted plan will consider the projected taxable income and cash flow of the assets being sold, as well as the cash consumption needs of the client.

The grantor will initiate the transaction by selling an asset, such as the limited partnership interest in a family limited partnership (FLP), to an IDGT (see "Funding the trust" section) in exchange for a promissory note (see "IDGT

promissory note" section). The limited partnership interest sold is usually acquired when the grantor contributes business and/or investment assets (see "S corp or LLC" section) to a newly formed FLP. Because the sale of the limited partnership interest is discounted for lack of marketability and control, the sales price will be based on a lower value than the underlying assets. This leverage is created because the limited partners cannot participate in the management of the FLP and because there is no set market for interests in a closely held family-controlled partnership. It is also important to note that the grantor will usually want to retain a significant degree of control over the FLP property. Upon formation of the partnership, the limited partnership interest will be sold based on the above mentioned technique, while the general partnership interest will be retained, allowing the grantor to retain this significant degree of control.

After the acquisition, the trust will own the FLP's limited partnership interest and will be entitled to receive a pro-rata annual distribution of cash. Based on this arrangement, the business should attempt to make distributions to the FLP. The FLP, in turn, should attempt to make distributions to the trust that will meet the trust's required debt service payments to the grantor.

Funding the trust. The transaction generally requires the creation of a new trust. The transaction should be designed to give the newly created IDGT some measure of economic substance independent of the sale. This is because the trust is acquiring a substantial asset in exchange for a promissory note. The trust should have "substance" if initially funded with assets equal to at least ten percent of the value of the property to be purchased. Typically, all or part of this initial funding can be sheltered from gift taxation though the use of the available unified credit. These concepts are discussed in further detail later in this article.

IDGT promissory note. As noted above, the grantor will sell an asset to the IDGT in exchange for a promissory note. The note either can be self-liquidated over the note's term or can require payments of interest only, with a balloon payment of principal at maturity. To provide maximum flexibility, the note should include a condition that permits the buyer the right to prepay any portion of the principal without prepayment penalty. A prepayment clause will allow the grantor to receive extra cash flow as needed, as well as the ability to accelerate the pay-down of the note.

The promissory note between the grantor and the IDGT should charge interest at the Applicable Federal Rate (AFR) under Internal Revenue Code Section 1274(d). Section 7872(f) requires that interest be charged at the AFR to avoid any gift tax issues.³ Because the promissory note can require the interest rate to be no more than the AFR, which is generally below the prevailing market rate, the IDGT can offer additional leverage to the extent that the underlying assets produce a rate greater than the AFR rate.

S corp or LLC. Many closely held businesses are transacted through either an S corporation or an LLC that is taxed as a partnership. An S corporation cannot be owned by a family partnership under Section 1361(b)(1)(B) without "blowing" the S election. But the S corporation can be owned by a grantor trust under Section 1361(c)(2)(A)(i), because the owner is still an individual for income tax purposes. There exist no limitations with respect to who may own an LLC. Rather than using a family partnership, ownership in S corps or LLCs can be sold directly to an IDGT.

If the grantor owns an S corporation, then the corporation can recapitalize the corporation with voting and nonvoting stock. Other than the right to vote, the voting and nonvoting shares are identical in terms of their rights to receive dividends and liquidating distributions. As a result of the recapitalization, the S corporation will achieve the same benefits as a family limited partnership. An LLC can achieve the same results by establishing a voting class of partners and a nonvoting class of partners.

The IDGT

How to create an IDGT. In essence, the trust is drafted as a regular entity trust with a provision that creates grantor trust status. Grantor trust status is achieved by intentionally violating one of the grantor trust rules under Sections 671–678. To be effective, both the income and principal portions of the trust must violate this provision. At the same time, the violation must be structured so there is a completed gift and the trust assets will not be "kicked back" into the grantor's gross estate.

To avoid the inclusion of the trust's assets in the grantor's estate, the provision violating the grantor trust rules must not violate one of the estate tax inclusion rules under Sections 2036–2038. The estate tax inclusion rules subject the

trust assets to estate tax when the decedent retains sufficient rights, powers or interests in the property. Several powers exist that will cause this dichotomy between the income-tax grantor provisions and the estate-tax inclusion provisions. The following discusses two of the more commonly used techniques to create the grantor status.

IDGT provisions. The retention of certain administrative powers under Section 675(4)(C) will result in grantor trust status. One such power is the ability "to reacquire the trust corpus by substituting other property of equivalent value." The power must be exercisable in a non-fiduciary capacity by the grantor or any person given that power without the approval or consent of any person in a fiduciary capacity. The trustee should not be given this power because of the presumption that a power exercisable by a trustee is exercisable in a fiduciary capacity.⁴

The second provision that creates grantor trust status is giving a non-adverse party (other than the grantor) the power to add beneficiaries or to add to a class of beneficiaries designated to enjoy the principal and income under Section 674(a). The ability to add beneficiaries can be limited to Section 501(c)(3) charitable organizations and still result in grantor trust status.⁵ However, grantor trust status is not created if the power is limited to after-born or after-adopted children.

Tax by grantor. A sale to the IDGT is not recognized for income tax purposes because the grantor and the trust are treated as the same entity. This treatment is based on the conclusion in Revenue Ruling 85-13,⁶ which was subsequently reaffirmed in PLR 9535026. The grantor in this PLR sold assets to an IDGT in exchange for a 20-year promissory note. In addition to concluding that the sale is not recognized for income tax purposes, the PLR concluded that the trust purchasing the assets would assume the respective grantor's basis in those assets transferred. Because the sale in the PLR was consummated with a note, the PLR also concluded that the interest component of the note had no income tax consequence to either the payer or the payee.

As previously indicated, the grantor will not recognize any gain on the sale. As a grantor trust, the grantor will be responsible for paying income taxes on the trust's activity. The grantor is responsible for this tax liability because of a legal obligation imposed by statute under Section 671. The grantor's payments of tax on the trust income not only will satisfy the grantor's legal obligation, but will provide another form of a "tax-free gift" to the trust's remainderman beneficiaries. This treatment presents the grantor tremendous planning opportunities, since the trust's assets will not be depleted by taxes.

To illustrate the tax planning opportunity afforded in this scenario, let us assume a taxpayer makes a one-time gift of \$1 million to a trust that earns a 9 percent taxable return and that the taxpayer is subject to a 40 percent effective tax rate. Based on these facts, the trust would earn \$90,000 of income in year one and accrue a tax of \$36,000. Upon payment of this income tax, the grantor's estate tax liability would be reduced by \$18,000 ($\$36,000 \times 50\%$) in the first year, with comparable savings available to the grantor's estate in subsequent years. This is in addition to the estate tax reduction of the initial \$1 million gift.

In some instances, the grantor may not have the desire or financial resources to pay the income taxes. If either of these conditions exist, the trust may provide the trustee of the defective trust the discretion, but not the obligation, to remit a tax reimbursement payment for any taxes paid by the grantor on income generated by the trust.

Case Study

The following case study will illustrate the effectiveness of the IDGT sale planning technique.

Pa is the founder of J & J Diamonds, LLC, a maker of fine diamond jewelry sold exclusively in upscale boutiques and department stores. J & J Diamonds is an LLC taxed as a partnership. Pa possesses 99 percent of ownership in J & J, while Ma owns the remaining 1 percent. Pa is solely responsible for the management and operation of the business.

Ma and Pa are each 60 years old and have two children. Their son, Jack, is married, 34 years of age and has been involved in the family business for the last ten years. During his tenure with the company, Jack has developed an expertise in the diamond industry and in handling the financial management of the company. Their daughter, Jill, is single, 31 years of age, and is also involved in the family business. She concentrates her efforts on the marketing of the business.

As is typical with a family-owned business, J & J Diamonds is the largest and most illiquid asset in Ma and Pa's estate. Their combined estate is valued at \$14.3 million and these assets are projected to produce taxable income of \$1 million, both of which are broken down in Table 1. The assets of the estate (except the retirement account) are conservatively projected to appreciate by five percent a year and the taxable income is projected to increase by three percent a year. J & J Diamonds distributes approximately 90 percent of the company's taxable income. Ma and Pa's effective tax rate is 40 percent and their current cash consumption needs are approximately \$330,000 a year and will increase by 2.5 percent a year.

Nature	Assets	Income
J&J Diamonds, LLC	\$7,000,000	\$700,000
Various Rental Property (Net of Mortgages)	\$2,500,000	\$200,000
Cash and Investment Portfolio*	\$2,500,000	\$100,000
Qualified Retirement Account **	\$1,500,000	
Personal Residence	\$800,000	
	\$14,300,000	\$1,000,000

* Income is statutory yield only
** Grows at 7% per year

Ma and Pa have several objectives with respect to the lifetime estate and succession plan they are contemplating. One objective they want to accomplish is to freeze the value of their estate while maintaining a steady cash flow that will meet their cash consumption needs. Second, they want the plan to be configured to allow Pa to retain full control of the business' management and operations. Finally, the plan should allow Pa to reduce his direct involvement in the day-to-day operation of the business, providing him the opportunity to determine whether Jack and Jill are capable of independently running the business upon his retirement. Based upon these facts, the issue is how to formulate a lifetime estate and succession plan that incorporates all of Ma and Pa's needs.

Suggested estate and succession planning. It is recommended that Ma and Pa form a family limited partnership funded with a 95 percent interest in J & J Diamonds⁷ among other assets specified in Table 2. In exchange for these assets, Ma and Pa will receive a 99 percent limited partnership interest (LP) and a 1 percent general partnership interest (GP). After the transfer, the value of the assets held by the FLP will be \$10,170,000. In consideration of the services Pa will continue to provide in conjunction with his continued involvement in the business, Pa will be guaranteed a payment of \$200,000 annually. As illustrated in Table 3, the FLP will generate projected income of \$715,800 and a projected cash flow of \$668,300.

Nature	Ma and Pa Assets	Contribute to FLP
J&J Diamonds, LLC	\$7,000,000	\$6,650,000
Various Rental Property (Net of Mortgages)	\$2,500,000	\$2,500,000
Cash and Investment Portfolio	\$2,500,000	\$1,020,000
Qualified Retirement Account	\$1,500,000	
Personal Residence	\$800,000	
	\$14,300,000	\$10,170,000

TABLE 3

FLP—Income and Cash Flow

	Income		Cash Flow	
	Ma and Pa Income	Contribute to FLP	Contribute to FLP	
J&J Diamonds, LLC—Profits	\$500,000	\$475,000	\$427,500	
J&J Diamonds, LLC—Guaranteed Payment	\$200,000	0	0	
Rental Income	\$200,000	\$200,000	\$200,000	
Investment Yield	\$100,000	\$40,800	\$40,800	
	\$1,000,000	\$715,800	\$668,300	

Ma and Pa will create the Ma and Pa Family Trust, an irrevocable defective grantor trust. Ma and Pa will provide the trust substance with a gift of \$605,000 from their investment portfolio. This gift will be applied against their unused unified credit. The beneficiaries of the trust will be the grantor's children and grandchildren. In addition, because the grandchildren will be potential beneficiaries, Ma and Pa will want to allocate their GST (generation-skipping tax) exemption to this trust. Doing so will ensure that the trust is a 100 percent GST-exempt trust.

To consummate the transaction, Ma and Pa will sell their collective 99 percent LP interest, valued at \$6,040,980 ($\$10,170,000 \times 99\% \times 60\%$) by an independent appraiser, to the newly formed intentionally defective grantor trust. The selling price incorporates a 40 percent discount due to the lack of marketability and control associated with their interest. Because the LP interest is being sold to a non-entity for income tax purposes, Ma and Pa will recognize no gain on the sale. In exchange for their LP interest, Ma and Pa will take back a 15-year installment note at the current long-term AFR of 5.8 percent, which will result in a yearly debt service payment of \$613,893 for the newly formed IDGT.

In structuring this transaction, it is important to take into consideration not only whether the trust has enough cash flow to meet its debt obligation to Ma and Pa, but also that Ma and Pa have enough cash available to meet their cash consumption needs. As indicated in Table 4, the trust will receive \$685,817 in the first year, constituting 99 percent of the FLP interest in addition to the other gifted property. This cash inflow is enough to satisfy the required debt service payment of \$613,893.

TABLE 4

Ma and Pa Family Trust—Analysis of Trust Cash Flow

IDGT Trust Assets and Cash Flow

Year	Beginning Trust Assets*	Annual Increase in Cash Flow 3%**	Earnings on Cumulative Cash Flow 5%***	Payments on Note	Ending Principal	Annual Growth at 5%****	Ending Asset Balance
1	\$10,673,300	\$685,817	—	(\$613,893)	\$10,745,224	\$533,665	\$11,278,889
2	\$10,745,224	\$706,392	\$3,596	(\$613,893)	\$10,841,318	\$560,348	\$11,935,331
3	\$10,841,318	\$727,583	\$8,401	(\$613,893)	\$10,963,409	\$588,366	\$12,645,787
4	\$10,963,409	\$749,411	\$14,505	(\$613,893)	\$11,113,431	\$617,784	\$13,413,594
5	\$11,113,431	\$771,893	\$22,007	(\$613,893)	\$11,293,437	\$648,673	\$14,242,273
6	\$11,293,437	\$795,050	\$31,007	(\$613,893)	\$11,505,601	\$681,107	\$15,135,544
7	\$11,505,601	\$818,901	\$41,615	(\$613,893)	\$11,752,224	\$715,162	\$16,097,329
8	\$11,752,224	\$843,468	\$53,946	(\$613,893)	\$12,035,745	\$750,920	\$17,131,770
9	\$12,035,745	\$868,772	\$68,122	(\$613,893)	\$12,358,746	\$788,466	\$18,243,238
10	\$12,358,746	\$894,836	\$84,272	(\$613,893)	\$12,723,961	\$827,890	\$19,436,342
11	\$12,723,961	\$921,681	\$102,533	(\$613,893)	\$13,134,281	\$869,284	\$20,715,946
12	\$13,134,281	\$949,331	\$123,049	(\$613,893)	\$13,592,768	\$912,748	\$22,087,181
13	\$13,592,768	\$977,811	\$145,973	(\$613,893)	\$14,102,659	\$958,386	\$23,021,793
14	\$14,102,659	\$1,007,145	\$171,468	(\$613,893)	\$14,667,379	\$1,006,305	\$24,032,469
15	\$14,667,379	\$1,037,360	\$199,704	(\$613,893)	\$15,290,549	\$1,056,620	\$25,123,894

*Value of 99% of FLP before discount plus the gift assets

**Based on 99% of FLP plus the gift assets

***Assumes excess cash flow (cash inflow less note payment) will produce a 5% yield

****Annual growth of initial principal only

The transaction will provide for Ma and Pa's after-tax cash consumption needs. They will receive cash of \$878,076 in the first year, consisting of a guaranteed payment of \$200,000; distributions from their five percent interest in J & J Diamonds and their one percent interest in the FLP; debt service payments from the trust; and the cash flow from the securities they retained. An itemization of these payments is provided in Table 5. Table 6 outlines Ma and Pa's tax liability with respect to their grantor trust. At the end of the first year, they will owe approximately \$400,000 of tax on the trust income of \$1 million. As indicated in Table 7, Ma and Pa will obtain a net cash inflow of \$478,076 (\$878,076 less \$400,000). They will consume \$330,000 of this amount currently, with the remainder to be used in the future when a cash shortfall is anticipated. In addition, if Ma and Pa need more cash, they may request reimbursement from the trust for taxes attributable to the trust activity. At the conclusion of the note term, the pension plan will have grown to \$4,138,547, providing additional capital for Ma and Pa's future cash consumption needs.

TABLE 5

Ma and Pa—Analysis of Cash Flow

Year	J&J Diamond Distributions and Guarantee Payment		GP Distributions		Portfolio Earnings at 3%*		Debt Service on Note		Total Cash Flow
1	\$222,500	+	\$6,683	+	\$35,000	+	\$613,893	=	\$878,076
2	\$223,175	+	\$6,883	+	\$36,050	+	\$613,893	=	\$880,002
3	\$223,870	+	\$7,090	+	\$37,132	+	\$613,893	=	\$881,985
4	\$224,586	+	\$7,303	+	\$38,245	+	\$613,893	=	\$884,028
5	\$225,324	+	\$7,522	+	\$39,393	+	\$613,893	=	\$886,132
6	\$226,084	+	\$7,747	+	\$40,575	+	\$613,893	=	\$888,299
7	\$226,866	+	\$7,980	+	\$41,792	+	\$613,893	=	\$890,531
8	\$227,672	+	\$8,219	+	\$43,046	+	\$613,893	=	\$892,830
9	\$228,502	+	\$8,466	+	\$44,337	+	\$613,893	=	\$895,199
10	\$229,357	+	\$8,720	+	\$45,667	+	\$613,893	=	\$897,638
11	\$230,238	+	\$8,981	+	\$47,037	+	\$613,893	=	\$900,150
12	\$231,145	+	\$9,251	+	\$48,448	+	\$613,893	=	\$902,738
13	\$232,080	+	\$9,528	+	\$49,902	+	\$613,893	=	\$905,403
14	\$233,042	+	\$9,814	+	\$51,399	+	\$613,893	=	\$908,148
15	\$234,033	+	\$10,109	+	\$52,941	+	\$613,893	=	\$910,976

*Investment yield on the \$875,000 Ma and Pa retained

TABLE 6

Ma and Pa—Analysis of Income Tax Owed

Year	J&J Diamond Taxable Income and Guarantee Payment		GP Taxable Income		Portfolio Earnings		Trust Income*		Total Income		Tax at 40%
1	\$225,000	+	\$7,158	+	\$35,000	+	\$732,842	=	\$1,000,000	-	(\$400,000)
2	\$225,750	+	\$7,373	+	\$36,050	+	\$758,423	=	\$1,027,596	-	(\$411,038)
3	\$226,523	+	\$7,594	+	\$37,132	+	\$785,873	=	\$1,057,121	-	(\$422,848)
4	\$227,318	+	\$7,822	+	\$38,245	+	\$815,302	=	\$1,088,687	-	(\$435,475)
5	\$228,138	+	\$8,056	+	\$39,393	+	\$846,827	=	\$1,122,414	-	(\$448,965)
6	\$228,982	+	\$8,298	+	\$40,575	+	\$880,572	=	\$1,158,426	-	(\$463,370)
7	\$229,851	+	\$8,547	+	\$41,792	+	\$916,667	=	\$1,196,857	-	(\$478,743)
8	\$230,747	+	\$8,803	+	\$43,046	+	\$955,249	=	\$1,237,845	-	(\$495,138)
9	\$231,669	+	\$9,068	+	\$44,337	+	\$996,465	=	\$1,281,538	-	(\$512,615)
10	\$232,619	+	\$9,340	+	\$45,667	+	\$1,040,465	=	\$1,328,091	-	(\$531,236)
11	\$233,598	+	\$9,620	+	\$47,037	+	\$1,087,411	=	\$1,377,666	-	(\$551,066)
12	\$234,606	+	\$9,908	+	\$48,448	+	\$1,137,474	=	\$1,430,436	-	(\$572,174)
13	\$235,644	+	\$10,206	+	\$49,902	+	\$1,190,831	=	\$1,486,582	-	(\$594,633)
14	\$236,713	+	\$10,512	+	\$51,399	+	\$1,247,671	=	\$1,546,295	-	(\$618,518)
15	\$237,815	+	\$10,827	+	\$52,941	+	\$1,308,193	=	\$1,609,776	-	(\$643,910)

*Includes 3% of the LLP taxable income (Table 3), the taxable yield on the portfolio held in the trust, and income earned by the trust on cumulative cash flow (Table 4)

TABLE 7

Ma and Pa—Analysis of Income Tax Owed

Year	Total Cash Flow (Table 5)		Tax at 40% (Table 6)	=	After-Tax Cash Flow	+	Cumulative Cash Flow Not Consumed*
1	\$878,076	-	(\$400,000)	=	\$478,076	+	\$148,076
2	\$880,002	-	(\$411,038)	=	\$468,963	+	\$282,492
3	\$881,985	-	(\$422,848)	=	\$459,137	+	\$401,985
4	\$884,028	-	(\$435,475)	=	\$448,553	+	\$505,214
5	\$886,132	-	(\$448,965)	=	\$437,167	+	\$590,752
6	\$888,299	-	(\$463,370)	=	\$424,929	+	\$657,085
7	\$890,531	-	(\$478,743)	=	\$411,789	+	\$702,602
8	\$892,830	-	(\$495,138)	=	\$397,692	+	\$725,593
9	\$895,199	-	(\$512,615)	=	\$382,583	+	\$724,243
10	\$897,638	-	(\$531,236)	=	\$366,401	+	\$696,626
11	\$900,150	-	(\$551,066)	=	\$349,084	+	\$640,697
12	\$902,738	-	(\$572,174)	=	\$330,563	+	\$554,289
13	\$905,403	-	(\$594,633)	=	\$310,770	+	\$435,103
14	\$908,148	-	(\$618,518)	=	\$289,630	+	\$280,702
15	\$910,976	-	(\$643,910)	=	\$267,066	+	\$88,504

*The cumulative cashflow not consumed is computed by taking the after-tax cashflow less \$30,000 (at a 2.5% yearly increase), which is the client's cash consumption needs. The cumulative cashflow not consumed is expected to generate a 2.5% yearly return.

As a result of this plan, Ma and Pa effectively transferred \$10,673,300 of assets to the next generation without significantly increasing their own taxable estate. These assets are conservatively projected to grow to \$25,123,894 (Table 4) over the 15-year term, allowing the trust to accumulate additional wealth for the benefit of the children and grandchildren with no gift tax implications. In addition, Ma and Pa will retain the GP interest of the FLP and a five percent interest in J & J Diamonds, allowing them to monitor the succession of the company. As with any estate plan, it is important that Ma and Pa continue to monitor their estate and succession plan by reviewing their wills to ensure their remaining assets are properly divided between Jack and Jill (and any grandchildren) in accordance with their wishes.

Tax-Related Risks

Because the IDGT promissory note sale is a relatively new technique that incorporates several disparate legal principles, the concept presents several potential tax-related risks. As indicated by one noted tax commentator, a roadmap does not even exist with respect to the structure of the promissory note.⁸

In structuring the transaction, the practitioner should pay special attention to three particular risks. These are (1) the proper treatment of the grantor's legal obligation to pay income taxes on the trust obligation, (2) the potential adverse effects of Section 2036(a)(1) and (3) the correct income tax treatment upon the death of the grantor.

Taxes. The grantor is legally obligated to report the trust's income on his or her personal tax return. The IRS has expressed concern that the grantor's obligation to pay taxes on the trust activity is a tax-free gift. The IRS originally indicated that a taxable gift would occur if there was not a mandatory tax reimbursement clause in a trust document. The IRS subsequently recanted its position, noting that they were reconsidering the gift tax consequences.⁹ There has been no further guidance on this issue.

When drafting an IDGT, it is also important to structure the reimbursement provision such that it does not violate the estate-tax inclusion rules. It is clear that a mandatory reimbursement clause or a discretionary power of reimbursement held by an unrelated non-subordinate person will not cause inclusion in the grantor's estate as a retention to the right of income.¹⁰

A retained interest—2036(a)(1). If the transaction is structured as a bona fide sale in exchange for a promissory note, then the decedent will not be treated as retaining any interest in the property under Section 2036(a)(1).¹¹ If Section 2036(a)(1) is triggered, then the sale will be disregarded and the trust assets will be included in the grantor's estate. A properly structured sale will generally avoid this treatment if

1. The size of the note payments to the seller is not to be based on the actual income of the assets sold to the trust
2. The assets sold to the trust are not to be the sole source of the debt repayment
3. The liability incurred is to be a personal obligation of the transferee/purchaser

In essence, these tests¹² will avoid having the assets sold to the trust constitute the sole source of payment for the note, and avoid the IRS's claim that this is a sham transaction. Making sure the trust has other assets outside the transaction can satisfy these tests. The IRS has indicated informally that other assets equal to or exceeding ten percent of the purchase price will give the trust economic significance.¹³ In lieu of funding the trust with ten percent of the purchase price, a smaller gift can be made if one or more of the beneficiaries of the IDGT issues a guarantee. Extra caution must be exercised if the trust is funded with less than ten percent of the purchased property or if guarantees are used.

Death. Upon the death of the grantor, the promissory note becomes part of the decedent's gross estate. There exists some ambiguity about the proper income tax treatment of the unpaid portion of the promissory note. It is clear that the IDGT loses its grantor trust status at the seller's death. One area of disagreement focuses on whether the deemed transfer of assets from the individual as a grantor trust to an entity trust will cause a sale. If a sale does occur, a timing issue arises concerning whether the sale occurs the instant before death or the instant after death. Three points of view exist regarding this issue.

One view contends that the transfer to the trust occurs the instant before death. Gain recognition is required in this scenario because the grantor will be treated as having transferred all the IDGT assets to the new trust at the grantor's basis in exchange for being relieved of any liabilities that were considered the grantor by way of the IDGT.¹⁴ If the sale does not qualify for installment treatment (for example, if the sale involves marketable securities), the gain would be reported on the seller's final return; otherwise the gain would be recognized under the installment reporting method.¹⁵

Another view contends that the transfer occurs as a result of the seller's death. Consequently, the seller of the property is not the decedent, but the decedent's estate. Under this approach, even though there exists a realization event, there is no gain because the newly acquired basis will generally equal the amount realized on the deemed sale that occurs at death.¹⁶

A third possibility assumes that death does not possess any income tax ramifications since the sale was consummated at a time when Revenue Ruling 85-13 applied. Based on this assumption, the assets in the IDGT are treated as passing from the seller at death to the IDGT without a sale. Gain would not be avoided, but instead would be deferred until the trust sells the respective assets.¹⁷

To avoid confronting the incongruity, the IDGT could satisfy the note before death by transferring back to the grantor the very same property originally sold to the trust. Under this approach, the satisfaction of the note will be ignored for income tax purposes under Revenue Ruling 85-13. The grantor assumes the risk of bringing the assets back into the decedent's estate too early. On the flip side, the trust assets used to prepay the note will receive a step-up in basis.

Or a GRAT?

The three most commonly used estate planning techniques to sell assets are GRATs (grantor-retained annuity trusts), SCINS (self-canceling installment notes) and private annuities. In comparing these various techniques, the IDGT is conceptually most similar to the GRAT. A GRAT is created by transferring assets to an irrevocable trust in which the grantor retains the right to an annuity for the term of the trust. For transfer tax purposes, the remainder interest is

