Sale to an Intentionally Defective Grantor Trust

A sale to an intentionally defective grantor trust ("IDGT") is often proposed as an alternative to a GRAT, as it is a similar technique to transfer property to beneficiaries at no, or a reduced, transfer tax cost. As with a GRAT, the success of this technique depends upon the assets that are the subject of the transaction achieving a rate of return in excess of the IRS' assumed interest rate.

Structure of the Transaction

The grantor sells property at its fair market value to the IDGT in return for an installment note. There are two keys to the transaction: (a) the trust must be structured as a grantor trust so that it will be disregarded for income tax purposes; and (b) the transaction must be recognized as a bona-fide sale for adequate and full consideration to avoid the imposition of estate and gift taxes. At the end of the note's term, any income and appreciation on the trust assets that exceed the payments required to satisfy the promissory note pass to the beneficiaries of the trust (usually the grantor's children and/or grandchildren) free of estate, gift and, if appropriately structured, GST transfer taxes.

If the trust assets appreciate at a rate that is less than the interest rate used to determine the interest payments on the promissory note, or if the assets decline in value, the grantor will receive back (as promissory note payments) the value of the original property sold to the trust, and nothing will be left to distribute to the remainder beneficiaries. Thus, if the trust assets underperform, some of the grantor's assets could be subject to double taxation: assets that are gifted to the trust to fund the note payments will be subject to gift tax upon funding the trust and subject to estate tax at the grantor's death). Assets transferred to the grantor as payment on the note are eligible for a stepped-up basis at the grantor's death.

If the trust's total return exceeds the applicable interest rate but the income generated by the trust assets is insufficient to pay the interest on the note (*i.e.*, the assets have a high growth rate, but a low income yield), the trustee can transfer trust principal back to the grantor in order to make the annual interest payment. This method of payment is common where the assets sold to the trust are highly appreciating assets with low cash flow.

Generally, any assets with appreciation potential or yield in excess of the applicable interest rate are appropriate assets to sell to an IDGT. Assets that can be valued at a discount, such as a minority interest in a closely held corporation or limited partnership interests, can produce significant savings because the face amount of the note will be based on the discounted value of the assets sold, rather than on the full value.

The trust must be designed so that the trust assets will be excluded from the grantor's gross estate for federal estate tax purposes. Accordingly, the grantor must not retain any interests in or powers over the property transferred to the trust that would cause the trust property to be includable in his or her gross estate for federal estate tax purposes.

Planning Point: To avoid inclusion of the IDGT property in the grantor's gross estate, the grantor should not be a beneficiary of the trust. Generally, state law allows a grantor's

creditors to reach a grantor's retained beneficial interests in a trust. If state law allows a grantor's creditors to reach an irrevocable trust created by the grantor to satisfy claims against the grantor, the trust is included in the grantor's gross estate. See Rev. Rul. 77-378, 1977-2 C.B. 347; Rev. Rul. 76-103, 1976-1 C.B. 293.

The grantor can be a trustee if his or her powers are appropriately limited. For example, if the grantor is acting as trustee, the grantor cannot have the power to distribute the trust property to discharge his or her legal obligations, including support obligations. If the grantor has such a power, the grantor's creditors can reach the trust property, and in that case, the trust property may be included in the grantor's gross estate. See *Estate of McTighe*, 36 T.C.M. 1655 (1977). In practice, the grantor generally is not the trustee of the grantor trust.

Planning Point: The grantor's spouse can, however, be a beneficiary of the IDGT, which, in effect, allows the grantor to obtain benefits from the transferred property. If the spouse is a beneficiary, the spouse must not transfer property to the IDGT, as doing so could have adverse estate tax consequences for the spouse. Even if the spouse is a beneficiary, the spouse can split gifts with the grantor so that gifts by the grantor to the trust are treated as having been made one-half by each of them without causing inclusion of the trust property in the spouse's gross estate. Splitting gifts also is effective for GST tax purposes, so that both the grantor and the spouse will be deemed to be the transferor of one-half of the property that the grantor gifts to the IDGT. Depending on the terms of the trust, however, the spouse's ability to split gifts to such a trust could be limited. Treas. Reg. § 25.2513-1(b)(3), (4).

The Grantor Trust. A sale to an IDGT involves the creation of an irrevocable trust that is a grantor trust for income tax purposes. A grantor trust is ignored for federal income tax purposes and, as a result, the trust's income, deductions, and credits are passed through the trust to the grantor and reported on the grantor's individual income tax return rather than to the trust as a separate entity. Although the trust is a grantor trust for federal income tax purposes, the trust is structured so that the trust assets are not includable in the grantor's gross estate for federal estate tax purposes. The basis of the assets sold to the IDGT is equal to the grantor's basis in such assets (*i.e.*, a carryover basis). Because the value of the IDGT will not be included in the grantor's gross estate, the trust assets will not receive a stepped- up basis at the grantor's death. The loss of the step-up in basis for the assets sold to the IDGT must be considered in determining the tax consequences of the sale transaction.

Planning Point: One alternative to avoid the adverse income tax consequences of selling highly appreciated assets to an IDGT and losing the step-up in basis is to pay the note in kind before the grantor's death with appreciated assets. Because the trust is a grantor trust, no gain or loss would be recognized on the payment, and the appreciated property used to pay the note would be included in the grantor's gross estate and, therefore, would get a step-up in basis at the grantor's death.

Terms of the Sale. After creating the trust, the grantor sells assets to the trust at their fair market value in return for a promissory note that bears interest at the interest rate sanctioned by the Code.

(1) **The Interest Rate**. The interest rate on the note is determined by reference to IRC § 7872(f)(2)(A). This Section states that the AFR for a term loan is the AFR

in effect under IRC § 1274(d) for the period represented by the loan, compounded semi-annually. The AFR changes monthly and varies depending upon the term of the note. The short term rate applies for terms of three years or less, the mid-term rate applies to terms greater than three years and nine years or less, and the long-term rate applies to terms greater than nine years.

(2) **<u>The Note</u>**. The promissory note will bear interest at the interest rate determined by reference to the applicable federal rate ("AFR") under IRC § 7872(f)(2)(A). Ideally, the note will be structured as a balloon note, where repayment of the principal is deferred until the end of the note term. Therefore, the trust will make only annual interest payments to the grantor. By using a balloon note, a larger percentage of the assets remains in the trust during the note term, thereby allowing the greatest compounding of appreciation inside the trust.

> **<u>Planning Point</u>:** The term of the promissory note can be for any length. Generally, the longer the term, the larger the required interest payment because the AFR will be higher. Because the death of the grantor during the note term only will result in the unpaid balance of the note being included in the grantor's estate (as opposed to the full value of the note), the grantor's survival of the term is not necessary to achieve transfer tax savings. In general, the length of the term will depend on interest rates at the time of the transaction (*e.g.*, if the AFR is low, the grantor may want to lock in this rate by using a longer term; alternatively, if the AFR is high, the grantor may want to use a shorter term and then enter into another sale transaction when rates are more favorable).

> **<u>Planning Point</u>:** The sale should be documented in the same way in which a sale to an unrelated party would be. Thus, there should be a sales contract, an assignment, a promissory note, an appraisal of the property, if necessary, and a security document, if applicable.

> **<u>EXAMPLE</u>:** Grantor, age 50, transfers $500,000 to an irrevocable grantor trust. The income and principal of the trust are to be paid, in the trustee's discretion, for his daughter's health, education, support and maintenance. At his daughter's death, the trust assets will be held in the trust for the benefit of his grandchildren. Grantor files a gift tax return to report the $500,000 gift to the trust (which is sheltered from tax by his applicable exclusion amount) and allocates GST exemption to the transfer. After funding the trust, Grantor sells $5,000,000 worth of assets to the trust in exchange for a 5-year, $5,000,000 promissory note. The promissory note is structured so that interest is paid annually at the mid-term AFR of 4.65%, and a balloon payment of principal is due at the end of the 5-year note.

> As discussed, the initial funding of the trust with $500,000 results in a taxable gift. Nevertheless, if Grantor's applicable exclusion amount is available, the initial transfer can be sheltered from gift tax. No gain or loss is recognized on the sale of $5,000,000 of assets to the trust, and the annual interest payments of $232,500 ($5,000,000 x 4.65%) will not be taxable as income to Grantor. Assuming a 15% annual growth rate, at the end of the note term, the trust will pay Grantor a balloon payment of $5,000,000, which also will not be taxable income to Grantor. After the payment of the note, $3,489,183 will be left in the trust and will pass to the trust beneficiaries free of gift, estate and GST taxes.

If the assets were sold to an existing trust, however, Grantor would avoid the $500,000 gift.

Tax Consequences of a Sale to an Intentionally Defective Grantor Trust

Gift Tax. A promissory note bearing interest at the AFR is deemed to have a fair market value equal to its face amount. Therefore, the sale of assets to the IDGT in return for a promissory note will not be a gift as long as the promissory note equals the value of the property transferred and bears interest at the AFR. An accurate appraisal is essential to support the fair market value claimed in the transaction.

Estate Tax. If the grantor dies before the note is fully paid, then the balance due on the note will be included in the grantor's gross estate. Post-sale appreciation on the trust assets, however, will not be subject to estate tax.

Income Tax. As discussed above, the trust is designed to be a grantor trust for income tax purposes. This means that transactions between the grantor and the trust have no income tax consequences (because the grantor is treated for income tax purposes as if he or she still owns the trust assets). The transaction has the following income tax ramifications:

- The grantor will not recognize gain or loss on the sale of assets to the trust in return for the promissory note. As the sale is ignored for income tax purposes, the income tax basis of the assets sold to the trust will not change as a result of the sale;
- The grantor is not taxed on interest payments he or she receives from the trust on the promissory note; and
- Because the grantor is treated for income tax purposes as if he or she still owns the trust assets, the grantor will report, for income tax purposes, all items of income, deduction and credit generated by the trust on his or her individual income tax return. Such items will not be taxable to the trust as a separate entity. Thus, if interest or dividends are received or capital gains are recognized in the trust, the grantor continues to be taxed on such items as though he or she had never sold the assets to the trust. The net effect of this income tax treatment is that the grantor is effectively able to make a tax-free gift to the beneficiaries of the trust, as the grantor's payment of income taxes reduces his or her estate without any transfer tax consequences while enhancing the assets that ultimately pass to the remainder beneficiaries by leaving the trust assets intact.