New Jersey Law Journal

VOL. CLXXX – NO. 6 – INDEX 466 MAY 9, 2005 ESTABLISHED 1878

ESTATE PLANNING

Intentionally Defective Grantor Trusts

A creative and effective estate planning technique, IDGTs can result in substantial federal estate tax savings

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When is it advantageous to make something intentionally defective? Although it may be a strange question, you probably will not be surprised to learn that the answer is when you want to save taxes. The concept of intentionally creating a defective entity is actually the basis for a creative and effective estate planning technique involving trusts referred to as Intentionally Defective Grantor Trusts. Estate planning with IDGTs can result in substantial federal estate tax savings by removing highly appreciated assets, or assets with the potential for substantial appreciation, out of an individual's estate with minimal income, gift or estate tax consequences.

An IDGT is a trust under which the grantor is treated as the owner of trust assets for income tax purposes, but not for gift or estate tax purposes. The trust is considered "defective" because normally the grantor would not be charged with income from a trust, which is created for the benefit of another, unless certain provisions are "intentionally" added to the trust. These provisions are designed to fail the grantor trust rules as codified in Sections 673 through 677 of the Internal Revenue Code of 1986, as amended. By intentionally violating the grantor trust rules, the trust's income is taxed to the grantor, but inclusion in the grantor's estate under certain other IRC sections such as Section 2036 (grantor's retention or possession or enjoyment or right to income over property transferred by grantor results in estate inclusion) and Section 2038 (grantor's power to revoke, alter or amend a transfer results in transfer being included in estate) is avoided.

Common provisions that are generally included in a trust to invoke defective grantor trust status include as follows: (1) the power to permit the grantor or the grantor's spouse in a nonfiduciary capacity to re-acquire trust assets by substituting assets of equivalent value which triggers IRC Section 675(4)(c); (2) granting a nonadverse trustee the discretion to make income distributions to the grantor's spouse which triggers IRC Section 677; and (3) the power of a nonadverse trustee (who is a nonadverse party) to lend money to the grantor or the grantor's spouse without regard to adequate interest or security which triggers IRC Section 675(2).

Although there is no statute that sanctions the use of IDGTs, IRS rulings and case law support the proposition that IDGTs will not be included in a grantor's estate if drafted properly. For instance, the retention of a substitution power by a grantor has been found not to cause the trust assets to be included in the grantor's estate under IRC Section 2038. *Estate of Jordahl v. Comm'r*, 65 TC 92 (1975), acq., 1977-1 CB 1. In various private letter rulings, the IRS further indicated that the substitution power will also not cause inclusion in a grantor's estate under IRC Sections 2036 or 2042. Priv. Ltr. Rul. 9247024; Priv. Ltr. Rul. 9843024. Recently, the IRS provided support for the use of IDGTs when it issued Revenue Ruling 2004-64, which clearly provides that a grantor's payment of income taxes attributed to the trust is not a gift to trust beneficiaries nor will it cause inclusion in the grantor's estate. Essentially, the Revenue Ruling allows the grantor to make additional gifts to the trust beneficiaries without having to pay a gift tax. Furthermore, the Revenue Ruling provides that under certain circumstances an independent trustee's discretionary power to reimburse the grantor for the payment of income taxes will not cause inclusion in the grantor's estate. Rev. Rul. 2004-64. Although the Revenue Ruling does not officially sanction IDGTs, it does provide some guidance on the drafting of IDGTs to avoid estate tax inclusion.

There are many advantages to creating IDGTs and having the grantor charged with the trust's income. For instance, the grantor's tax rate is likely to be lower than the compressed tax rates that are applicable to trusts and any trust losses can be used against the grantor's personal income. Moreover,

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any transactions such as sales between a grantor and an IDGT are ignored for income tax purposes. In addition, the grantor can transfer property to family members without reducing the value of the transferred property by the payment of income taxes. Also, an IDGT can hold S-Corporation stock. Perhaps most importantly, IDGTs can be used as estate freezing vehicles, allowing a grantor to transfer assets with the potential for substantial appreciation out of his estate with favorable estate, gift and generation skipping transfer tax results.

As discussed above, any transactions such as sales between a grantor and an IDGT are ignored for income tax purposes. This allows the grantor to loan money or sell property to an IDGT in exchange for a promissory note or a private annuity with no adverse income tax consequences. If the net income from and appreciation in value of the money or other property loaned or sold to the IDGT exceeds the interest payable on the loan, the value of an IDGT is enhanced. In recent years of low interest rates, this is very attractive. Further, the value of the property transferred to an IDGT may be entitled to a valuation discount for gift tax purposes. If the property being sold represents a minority interest in a closely-held business or a fractional interest in real estate, such valuation discounts can range from 20 percent to 40 percent.

Let's consider an example:

Client owns a 50 percent membership interest in a limited liability company worth $10 million. Client sells his LLC interest to his IDGT in exchange for a promissory note with a face value of $3,250,000, bearing interest at the appropriate applicable federal rate allowed under the IRC. The face value of the promissory note is based upon the appraised value of the 50 percent membership interest utilizing a lack of control and lack of marketablity discount of approximately 35 percent ($10 million x 50 percent x 65 percent). Assuming this discount is accepted by the IRS, Client will have transferred $5 million worth of property (undiscounted) to his IDGT without utilizing any of his lifetime exemption from the gift tax (which is currently $1 million). Since the IDGT in this example is treated as a grantor trust for income tax purposes, no gain or loss will be recognized on the sale of the Client's LLC interest to the IDGT in exchange for the promissory note. Further, no interest will be treated as paid on the promissory note during the term of the note and all items of income and deductions will flow through and be taxed to the grantor, rather than the trust, for income tax purposes. It is also relevant to note that in this example, the IDGT should have sufficient assets of its own to purchase the Client's LLC interest. If the IDGT does not have sufficient assets, then prior to the sale by the Client, the Client should make a gift to the IDGT of assets that can be used to make the subsequent purchase of assets. Typically, a gift equal to at least 10 percent of the value of the assets to be transferred to the IDGT is sufficient.

An IDGT is a particularly attractive estate planning tool if the IDGT is structured as a dynasty trust exempt from the federal generation-skipping transfer tax. The GST tax is a tax of approximately 47 percent imposed on the transfer of property to beneficiaries two or more generations below that of the transferor. Every individual currently is entitled to a $1.5 million exemption from the GST tax.

In New Jersey, a dynasty trust, as its name implies, can exist in perpetuity thanks to a 1999 New Jersey law which eliminated the length of time a trust could exist, known as the Rule Against Perpetuities. This legislative change now allows assets to pass in trust under New Jersey law from generation to generation free of any federal estate, gift or GST tax liability. By avoiding a transfer tax that would have occurred on each generation, the dynasty trust permits family wealth to be compounded more aggressively and more successfully. If an IDGT is structured as a dynasty trust, the grantor includes all items of income and deductions on his or her individual income tax return and the IDGT can grow income-tax free. In addition, the grantor can sell property or loan money to the IDGT (as discussed above) free of income tax consequences. ■