




Presented for:

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An Intentionally Defective Irrevocable Trust (IDIT) is an irrevocable trust established by a grantor for the benefit of the grantor's family. An IDIT is "defective" only in the sense that it is a grantor trust for income tax purposes. This means that the grantor (or some other person) is the owner of the trust for tax purposes and is liable for the tax on any trust income. The trust is a grantor trust because the grantor retains one or more of the powers delineated in the grantor trust rules of the Internal Revenue Code ("Code" or "I.R.C."). In the past, the fact that a trust agreement violated the grantor trust rules was viewed negatively. Today, many drafters of trust agreements will intentionally include one of the forbidden powers to make the trust a grantor trust. In this way, the grantor can pay the trust's income tax without making a taxable gift. An increasingly popular estate planning technique is to sell a rapidly appreciating asset to an IDIT for a promissory note from the trust. The note typically bears interest at a rate issued by the IRS on a monthly basis (the "applicable federal rate"(AFR)). Due to the grantor trust status of the trust, the sale does not trigger capital gains tax. If the grantor dies while the note is outstanding, the only thing remaining in the grantor's probate estate is the promissory note. Any appreciation in the value of the asset is theoretically out of the grantor's estate for estate tax purposes. Despite the potential benefits of an IDIT sale, there are several income, gift, and estate tax issues one should consider before proceeding.



INCOME TAX *Issues...*

◆ *Making the Trust a Grantor Trust*

The grantor trust rules of the Code (Sections 671-679) 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 Section 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 has ruled that it will disregard the existence of a grantor trust for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184. As a result, any transactions between the grantor and the grantor trust should have no income tax consequences. *Id.*


There are several powers that the grantor or a third person can have that cause the grantor to be the owner of the trust. The key is to select powers that avoid inclusion of the trust assets in the grantor's estate for estate tax purposes. For example, if the grantor's spouse can receive distributions in the discretion of a "nonadverse" party (i.e., a person with no interest that would be affected by the distribution), the grantor will be considered the owner of the trust. I.R.C. § 677(a). Another such power could be the right of the grantor or a third party to acquire trust assets by substituting assets of equivalent value. I.R.C. § 675(4)(C). Note, however, that the law is not entirely settled on the circumstances of when particular powers will cause the trust to have grantor trust status. A client considering an IDIT should consult with his or her own attorney on this matter.



◆ ***Consequences of the Grantor's Death While Note Is Outstanding***

A crucial income tax issue is what happens when the grantor dies while the IDIT note remains outstanding. When a person dies, the heirs generally receive the deceased's property with a basis equal to the fair market value of the property at the time of death. I.R.C. § 1014(a). This "step-up" in basis means the heirs avoid capital gains tax on all of the appreciation occurring before the prior owner's death. The grantor trust status of a trust terminates when the grantor dies. If the 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 immediately 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 Section 1014 step-up in basis and the transaction would not produce any capital gains. Some legal commentators argue that the hypothetical sale occurs immediately prior to death. They cite an example in IRS regulations of a grantor trust that owns an interest in a tax-shelter partnership. Treas. Reg. § 1.1001-2(c), Ex. 5. Initially, the partnership produced phantom losses. Since the trust/partner was a grantor trust, the grantor could deduct the trust's share of the partnership losses. When the partnership was about to start producing 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 that 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 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. Rev. Rul. 77-402, 1977-2 C.B. 222; Madorin v. Commissioner, 84 T.C. 667 (1985). While these precedents are not exactly on point, they could bolster the argument that the death of the grantor results in taxable income for the grantor's estate. Due to the risk of IRS action, anyone considering an IDIT sale should consult with his or her own legal advisors.

The parties could avoid this argument entirely by satisfying the note prior to 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. The assets transferred back to the grantor would have a new income tax basis equal to the amount of the note remaining when satisfied. The assets would receive the step-up in basis at the grantor's death. Anyone considering an IDIT sale should discuss the risks of IRS action with their own legal advisors.

◆ ***“Turning Off” Grantor Trust Status after Satisfaction of Note***

If the trust satisfies the note prior to the grantor's death, the grantor could opt to “turn off” the grantor trust status of the trust to avoid tax on future trust income. The grantor could accomplish this simply by renouncing the powers that make the trust a grantor trust. If the powers in question belonged to another person, that person would have to renounce the powers.




GIFT TAX *Issues...*

◆ *Valuation of Property Transferred*

Since the grantor will sell the assets to the IDIT for fair market value, there will usually be no taxable gift involved. The grantor and his or her advisors must be careful, however, to ensure the value of the assets sold is accurate. The IRS could argue at some later point that the assets were worth more than the sale price and that the difference amounts to a taxable gift.

One possible way to deal with an IRS revaluation of the transferred property could be some type of post-transaction adjustment clause in the sale document. Such a clause could adjust the sale price and the note to reflect the increased value. Some commentators feel, however, that the IRS could attack such a clause by applying the reasoning of the Court of Appeals in Commissioner v. Procter, 142 F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944). In Procter, the taxpayer made transfers to a trust subject to the provision that if the courts determined the transfers were taxable gifts, the transfers would be undone and treated as void. Id. at 827. The court invalidated this provision and upheld the application of the gift tax on public policy grounds. Id. The court reasoned that the provision violated public policy because it would (1) undermine the collection of the gift tax because the only effect of an attempt to enforce the tax would be to defeat the gift; (2) and render the judgments of courts meaningless because a judgment in favor of the IRS would have no effect. Id. at 827-28. The IRS could apply this same rea-




soning in attacking a valuation adjustment clause in an IDIT sale document.

Some attorneys have tried to develop clauses that would not be subject to the reasoning of the Procter case. Under one such approach, the sale document could state that the interest conveyed is a fraction of the seller's total interest in the property. The numerator would be the face value of the note and the denominator would be the total value of the property, as finally determined for gift tax purposes. In theory, any IRS adjustment to the value of the property would only increase the denominator. This would reduce the percentage of the asset actually sold, but would keep the value of the interest sold constant for gift tax purposes. There is no guarantee that this or any other attempt at a valuation readjustment clause would avoid an IRS argument based on Procter. Any person considering an IDIT sale should be aware of this issue and consult his or her own legal counsel about the best course of action under the circumstances.

◆ ***Interest Rate of Promissory Note***


Section 7872 of the Code provides that in the case of any loan that is a "gift loan" and bears a below-market interest rate, the foregone interest will be treated as transferred from the lender to the borrower and then retransferred from the borrower to the lender. I.R.C. § 7872(a)(1). A "gift loan" is a loan where the foregoing of interest is in the nature of a gift. I.R.C. § 7872(f)(3). The market interest rate is the AFR under Section 1274 of the Code for the term of the loan in question. I.R.C. § 7872(e)(1). The IRS issues the AFRs for short-term (obligations of three years or less), mid-



term (more than three years, but not over nine years), and long-term (more than nine years) loans each month. If Section 7872 applies, the lender can be treated as making a taxable gift of the amount of foregone interest and then receiving taxable income in the amount of the foregone interest. For this reason, the promissory note in an IDIT sale transaction typically will bear interest at least at the AFR. In order to achieve maximum leverage from the IDIT sale transaction, the assets transferred should usually have an expected rate of return in excess of the AFR.

◆ ***Section 2702 Issue***

Another potential gift tax issue involves Section 2702 of the Code. Under Section 2702, the value of a retained interest in a trust is valued at zero in determining the value of the interest passing to the heirs, unless the retained interest is a qualified interest. I.R.C. § 2702(a). A transfer of an interest in property in which there is one or more term interests is considered a transfer in trust. I.R.C. § 2702(c)(1). A “term interest” is a life interest or an interest for a term of years. I.R.C. § 2702(c)(3). In an IDIT transaction where the trust gave an interest-only promissory note with a balloon payment at the end of the term, Section 2702 could allow the IRS to ignore the balloon payment in calculating the value passed to the heirs. Theoretically, Section 2702 should not apply to the IDIT sale transaction because a promissory note does not constitute a beneficial interest in the trust. In a 1995 ruling, the IRS addressed a situation in which a beneficiary of a trust sold corporate stock to a trust in exchange for a promissory note from the trust. P.L.R. 95-35-026 (May 31, 1995). The IRS ruled that the promissory note was debt and not a term interest under Section 2702(c)(1).




Therefore, the IRS found that the note was not a retained interest covered by Section 2702(a).

There is the possibility, however, that the IRS could invoke Section 2702 by recharacterizing the transaction as a gift to the trust with a retained income interest. The IRS could then ignore the value of the note payments in calculating the value of the gift to the trust. The interest payments might qualify as a qualified interest. The risk of this argument might be greater if the trust has no other assets to make the note payments. In those circumstances, the trust would have to use income from the assets sold or the assets themselves to pay the note. The grantor could avoid the issue by making a “seed gift” of other assets to the trust perhaps equal to 10 percent of the value of the assets sold. Personal guarantees of the IDIT note by the trust beneficiaries might also alleviate the problem.

ESTATE TAX *Issues...*

◆ ***Grantor's Powers over Trust***

Section 2036 of the Code 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. Section 2038 includes any assets transferred in the transferor's estate if the transferor retained a power to alter, amend, revoke, or




terminate the terms of the transfer. I.R.C. § 2038(a)(1). The IDIT is an irrevocable trust. As long as the grantor retains no benefit from the trust assets or control over their disposition, the trust can be entirely outside the grantor's estate. As noted above, the drafter of an IDIT must be careful in giving the grantor powers over the trust. Any power the grantor has must be sufficient to make the trust a grantor trust without causing inclusion of the assets in the grantor's estate under Section 2036 or 2038.

◆ ***Inclusion in Estate Due to Lack of Other Assets to Pay Interest on Note***


As noted above, Section 2036 requires inclusion of transferred assets in the transferor's estate if the transferor retained any beneficial interest in the assets, including the right to income from the assets. If the trust's only assets are those transferred as a part of the sale from the grantor, the IRS could have an indirect Section 2036 argument. The IRS could attempt to recharacterize the transaction as the grantor making a gift to the trust and retaining an income interest in the gifted property. The IRS has not ruled directly on this issue, but has issued rulings that suggest that they might make such an argument. There are three potential ways to address this argument.

One potential way to avoid this argument could be to make a gift to the IDIT in addition to the property sold. Some commentators suggest this "seed" gift should be as much as 10 percent of the assets sold to the trust. In this way, the trust would have other assets besides those sold to the IDIT in the main transaction to provide income to satisfy the promissory note.



A second response could be for the IDIT beneficiaries to execute personal guarantees of the trust's promissory note. This could bolster the argument that the trust will not have to rely exclusively on the property transferred. If, however, the beneficiaries have few assets of their own, the guarantees might not help. See Estate of Mitchell v. Commissioner, 43 T.C.M. (CCH) 1034 (1982), aff'd, 734 F.2d 15 (6th Cir. 1984). Additionally, it is not clear whether the beneficiaries, as guarantors, would be grantors of the trust for income, estate, gift, or generation-skipping transfer tax purposes.

Another potential means to defeat the IRS argument could be to satisfy the note prior to the grantor's death. At the point the trust pays off the note, any retained interest the grantor has in the trust terminates. The IRS could still attempt to include the property in the grantor's estate if the grantor dies within three years of the satisfaction of the note under the "three-year rule" of Section 2035 of the Code. Under Section 2035, a decedent's taxable estate includes any property the decedent transferred (or relinquished) within three years of death if the property would have been in the estate due to Section 2036 or certain other sections of the Code had the decedent held it at death.



THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION *Act of 2010...*

The *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act* (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately.

The Act may make taxable gifts more attractive because the amount of gift or estate tax due in the future may be more. However, a sale to an IDIT can still be an attractive planning technique if the sale is for fair market value because there is theoretically no taxable gift (unless the grantor elects to make a “seed gift” to the trust, as discussed above).




COMPARISON OF IDIT SALE TO GRANTOR RETAINED

ANNUITY *Trust...*

Another popular estate planning technique for appreciating assets is the grantor retained annuity trust (GRAT). In a GRAT, the grantor transfers assets to a trust and retains the right to a fixed annuity amount for a certain number of years. At the end of the annuity term, the remainder passes to the designated beneficiaries or remains in trust for their benefit. The present value of the remainder interest (as calculated using IRS actuarial tables and the Section 7520 interest rate issued by the IRS) is a taxable gift. By increasing the amount of the annuity payments, the grantor can perhaps zero out the anticipated remainder, resulting in little or no taxable gift. If the assets grow faster than the Section 7520 rate, there may actually be an amount left for the remainder beneficiaries. This unexpected remainder passes free of gift tax. The largest potential drawback to the GRAT is that if the grantor dies during the annuity term, a portion of the trust assets may be includable in the grantors taxable estate. The portion that would be includable is the portion of the trust corpus, valued at the grantor's death, necessary to yield the annual payout under the GRAT using the appropriate 7520 rate.

One can structure an IDIT sale to look very much like a GRAT by adjusting the term of the note to match the GRAT annuity term and the amount of the note payments to match the GRAT annuity payments. There are several factors to consider in comparing an IDIT sale



to a GRAT, including: (1) the assumed discount rate, (2) the risk of inclusion of trust assets in the grantor's estate, (3) the ability to allocate generation skipping transfer tax (GSTT) exemption, (4) the ability to "end-load" the payments from the trust, (5) the ability to totally zero out the gift tax value of the transaction, (6) the ability to adjust the payments in the event the IRS or the courts assign a higher value to the assets, (7) the risk of an IRS argument under Section 2702 of the Code, and (8) the relative tax certainty of the GRAT transaction.

◆ ***Assumed Discount Rate***

As discussed above, the IDIT note must bear interest at the AFR. By contrast, one calculates the GRAT remainder using the Section 7520 rate. The Section 7520 rate equals 120 percent of the federal midterm AFR. An IDIT note that falls into the "midterm" category (more than three but less than nine years) need only bear interest at 100 percent of the midterm AFR. A longer-term note must use the long-term AFR, but this rate is still usually lower than the Section 7520 rate.

◆ ***Risk of Inclusion of Trust in Grantor's Estate***

If the grantor of a GRAT dies during the annuity term, the portion of the trust corpus, valued at the grantor's death, necessary to yield the annual payout under the GRAT using the appropriate 7520 rate will be included in the Grantor's taxable estate. An IDIT sale transaction may involve some risk of inclusion if the grantor dies while the note is outstanding. As discussed above, proper drafting and planning may enable the grantor to avoid some of these risks of inclusion. Also, if the IDIT satisfies the note prior to the grantor's death, the risk of inclusion may lessen.



◆ ***Allocation of GSTT Exemption***


One cannot allocate GSTT exemption to a transfer during any “estate tax inclusion period” (ETIP). I.R.C. § 2642(f)(1). An ETIP is any period after the transfer during which the property would be included in the grantor’s estate for estate tax purposes if the transferor died. I.R.C. § 2642(f)(3). The annuity term of a GRAT is an ETIP, meaning the grantor cannot allocate GSTT exemption to the trust until the end of the annuity term, or the grantor’s death, whichever comes first. This means that appreciation during the annuity term does not escape the GSTT as it does the gift and estate tax. In an IDIT, there is arguably no ETIP because the IDIT theoretically avoids inclusion in the grantor’s estate.

◆ ***End-Loading Payments from Trust***

The terms of the GRAT instrument can vary the amount of the annuity payments, but no annual payment can be greater than 120 percent of the previous year’s payment. Treas. Reg. § 25.2702-3(b)(1)(ii). This effectively prevents “end-loading” the GRAT by making smaller payments in the initial years and a large lump sum in the final year. By contrast, an IDIT note can be interest only for a period of years with a balloon payment of principal at the end of the note term. This allows the parties to keep the maximum amount of appreciation in the trust during the note term.

◆ ***Ability to Completely Zero Out Gift***

A popular variation of the GRAT is the so-called “zeroed-out” GRAT. Under this technique, there is no taxable gift because the grantor sets the annuity amount so high that the present value of the annuity payments equals the current value of the assets transferred. If the assets grow faster than the Section 7520 rate, there




may still be assets left in the trust at the end of the annuity term. This “unexpected” remainder passes free of gift tax. The IRS has taken the position that it is impossible to completely zero out the gift because one must account for the possibility that the grantor will die during the annuity term. Treas. Reg. § 25.2702-3(e), Ex. 5; P.L.R. 92-39-015 (June 25, 1992). However, the Tax Court has held that the IRS position on this issue is invalid if the trust must make the annuity payments to the annuitant’s estate after the annuitant’s death. *Walton v. Commissioner*, 115 T.C. 589 (2000). The court reasoned that an individual cannot make a gift to his or her own estate. The court also stated that the IRS position would effectively eliminate the term of years GRAT, a result not contemplated by Congress in Section 2702. In October 2003, the IRS finally acquiesced stating in Notice 2003-72, that it will follow the Tax Court’s decision in *Walton*, holding that Treas. Reg. § 25.2702-3(e), Ex. 5, of the Gift Tax Regulations is invalid.

In an IDIT sale transaction, the parties typically make the note amount equal the fair market value of the assets transferred. In this way, there is no gift because the trust is paying fair market value for the assets. As discussed above, however, the grantor may wish to make a “seed gift” to avoid the argument that the arrangement is really a gift with a retained interest.

◆ ***Adjustment of Transaction to Reflect Increased Value***

In some cases, the IRS or the courts could assign a higher value to assets transferred to a GRAT or IDIT. IRS regulations specifically allow a GRAT instrument to express the annuity amount as a percentage of the initial value of the assets transferred as finally



determined for gift tax purposes. Treas. Reg. § 25.2702-3(b)(1) (ii). This allows an adjustment to the annuity amount if the IRS or the courts assign a new value. As discussed above, the IRS or the courts might invalidate an adjustment clause. This could result in an unexpected taxable gift.

◆ ***Risk of Section 2702 Argument***

As discussed above, the IRS could attack an IDIT transaction by recharacterizing the transaction as a gift to a trust with a retained income interest. The IRS could then invoke Section 2702 of the Code to ignore some or all of the note payments in calculating the value of the deemed gift to the trust. By contrast, a grantor's retained annuity interest in a GRAT is a "qualified interest" under Section 2702 if the GRAT meets the requirements set out in IRS regulations. This means that the grantor can use the actuarial value of the retained interest to reduce the amount of the taxable gift to the remainder beneficiaries.

◆ ***Relative Tax Certainty of the GRAT Transaction***

The IDIT sale involves numerous tax issues the resolution of which is uncertain. There are very few court decisions and IRS rulings that deal with an IDIT sale. A GRAT, by contrast, is a fairly well established planning technique. The Code and the associated IRS regulations set out the rules for creating a GRAT. IRS rulings and court decisions have resolved many of the other issues surrounding a GRAT. A person who desires more certainty as to the tax treatment of a planning technique may be more inclined to create a GRAT instead of selling assets to an IDIT.



Conclusion...

A sale of appreciating assets to an IDIT in exchange for a promissory note can provide significant income, gift, and estate tax benefits. Despite these potential advantages, there are several tax issues that may impact the effectiveness of the IDIT sale, as discussed above. Any person considering an IDIT should consult with his or her own legal advisors before proceeding.

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Grantor

Grantor sells asset to the trust.

Because the IDIT is a grantor trust, all income received by the trust is taxed to the grantor. Additionally, no gain or loss is recognized on the sale.

The grantor may wish to make a "seed" gift to the trust.

The taxable gift is the difference between the value transferred and the value of the retained payment stream.

Note: If the grantor dies while the note remains outstanding, the note will be included in his or her estate; however, any appreciation in the value of the assets sold to the IDIT exceeding the value of the note may escape estate tax inclusion.

Grantor sells asset and
makes "seed" gift



Grantor receives installment
note payments



Intentionally Defective Irrevocable Trust (IDIT)

Trust receives assets from grantor.

Trust pays grantor installment note payments.

After the note is repaid to the grantor, trust may pay out balance to beneficiaries or stay in effect to manage distributions to them.


Balance to beneficiaries



Beneficiaries

The beneficiaries receive distributions from the trust, either outright, or according to the terms of the trust document.

An IDIT is an irrevocable trust designed so that the grantor is treated as the owner of the trust for income tax purposes, but the trust property is not includible in the grantor's gross estate for estate tax purposes.



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