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Large estate and appreciating assets? Look at an IDGT

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Using an intentionally defective grantor trust ("IDGT") might just be the estate planning tool you are looking for. An IDGT is an estate planning tool used to freeze certain assets of an individual for estate tax purposes but not for income tax purposes. For anyone looking to make sure their assets are passed down to their children and not Uncle Sam, you may want to consider this effective estate planning technique.

What is an IDGT?

An IDGT is a trust that is "defective" solely for income tax purposes. For estate tax purposes, transfers to IDGTs will be completed gifts, and the future value of the assets transferred will be removed from the grantor's gross estate on the date of the trust's funding. However, for income tax purposes, the existence of the trust is ignored, the grantor is treated as the owner of the trust and, as a result, the grantor is taxed on all of the trust's income.

How does it work?

The IDGT is formed as a grantor trust, which by nature is not includable in the grantor's estate for estate tax purposes. A grantor trust means that you, as the grantor (the person who established the trust), retain certain powers to control or direct the trust's income or assets. Assets can then be transferred into the IDGT by a few different methods. The first method is by gift. If the assets transferred are less than the 2015 gift exemption of $5.43 million for individuals ($10.86 for a husband and wife) and the transferor has his or her full exemption amount still available, a simple gift can be made to the IDGT.

However, often the assets are both given as gifts and sold to the IDGT in exchange for an installment note. The initial funding of the trust will be a taxable gift, and the grantor will use some or even all of the grantor's applicable credit amount. After the trust is funded, the grantor then sells the other assets to the trust in exchange for an installment note. The sales price must be at the fair market value of the assets transferred, and the note must bear interest at the appropriate applicable federal rate at the time of sale. This sale is nontaxable under Revenue Ruling 85-13 that holds that gain on the sale by the grantor to a grantor trust is not recognized.

Similarly, interest on the note is not taxed either. The principal and interest on the installment note will effectively result in the generation of an income stream in retirement for the grantor, as discussed below. This technique is often used to sell non-controlling interests in entities such as LLCs or FLPs to the IDGT as a means of transitioning the business owned by the family to the next generation using valuation discounts.

Let's look at an example of how this works with an FLP (family limited partnership). Assume you have a dairy farm valued at $10 million and you transfer that business to an FLP. A typical FLP valuation discount is around 35 percent, so the value of that $10 million would be reduced to

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$6.5 million. You would then create an IDGT and sell $6.5 million of limited partnership interests to the IDGT in exchange for a note. The note payments would be based on the lower value of the FLP interest (versus the actual value of the assets in the FLP), thereby reducing the size of the required installment note payments to the grantor. You have now effectively transferred $3.5 million ($10 million minus $6.5 million) of assets tax-free to your heirs.

This strategy could also work if you chose to gift a portion of the FLP interest rather than selling them. An outright gift of partnership interests totaling $8 million would only result in using $5.2 million of your total exemption amount using the same 35 percent discount as above. The remaining $2 million of partnership interests could then be sold using an installment sale, but again the value sold would only be $1.3 million using the 35 percent discount.

Many times, your cash-flow needs to live comfortably each year is determined first, taking into consideration any long-term care needs and yearly taxes that may be due on income in the IDGT. Then the number of years you will need that cash-flow stream is estimated, and the installment loan principal to generate that particular cash-flow stream is backed into. The remaining value of any unsold partnership interest can then be gifted to the IDGT.

There are many types of installment notes that could be used. The note could be structured as interest only with a balloon payment at the end, a level principal payment note or a self-amortizing note. The type used would generally depend on the cash flow generated by the assets being sold to the IDGT.

Income on the property held by the IDGT is taxed to the grantor. But why would the grantor want to pay tax on income they didn't receive? Because even though the grantor is paying the tax on the IDGT's income, the additional tax paid is not a gift for estate and gift tax purposes. This will essentially shift additional assets to the IDGT and further deplete the grantor's estate. At death, all that is included in the grantor's estate is the fair market value of the installment note. The use of the IDGT effectively froze the value of assets on the date sold, and all future appreciation is kept outside of the estate and is not subject to estate tax.

With proper planning, the grantor will be able to pay the income taxes on the IDGT assets out of the installment sale payments being made each year under the terms of the note. The payment of income taxes by the grantor on income of the trust (some of which stays in the trust) is done without gift taxes. While it might not initially seem favorable for the grantor to pay income taxes for the trust, it is a good planning tool due to the fact that paying the taxes benefits the heirs while not incurring gift taxes.

Planning concerns

The technique of a sale to an IDGT is not based on any one specific section of the Internal Revenue Code but rather on several private IRS letter and revenue rulings. It is possible, therefore, at some point in the future the IRS may try to attack the IDGT merely because it presents such a tremendous planning opportunity for the taxpayer to shift value without a transfer tax.

Also, for the IDGT to be effective, the assets must appreciate sufficiently for the estate tax savings (i.e., the freeze in value plus the payment by the grantor of income taxes attributable to trust property) to exceed the loss of step-up in tax basis. The tax effect depends on what the parties intend to do shortly after the applicable death (i.e., hold or sell the asset). **PD**

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