A Primer On Sales To Intentionally Defective Grantor Trusts

Mark S. Poker

A. Introduction

1. Scope

   a. This outline provides an overview of the tax treatment, structure, and use of intentionally defective grantor trusts (“IDGTs”) with a particular focus on the benefits and risks associated with implementing IDGTs. The outline also compares IDGTs to grantor retained annuity trusts (“GRATs”) and addresses the economic impact of various IDGT designs.

2. Defining An IDGT

   a. An IDGT seeks to take advantage of the differences between the estate tax inclusion rules of Internal Revenue Code (“Code”) §§2036–2042 and the grantor trust income tax rules of Code §§671–678. (Unless otherwise indicated, all section references are to the Code.) An IDGT is an irrevocable trust that effectively removes assets from the grantor’s gross estate. As a result, a sale of assets to an IDGT can freeze an individual’s estate by converting appreciating assets into a non-appreciating asset with a fixed yield. For income tax purposes, however, the trust is “defective,” and the grantor is taxed on the trust’s income. Accordingly, sales of assets between the IDGT and the grantor are not taxable. The grantor is treated for income tax purposes to have made a sale to himself or herself. Therefore, the traditional disadvantage of recognizing substantial income tax gain on a sale is eliminated.

Mark S. Poker is a partner with Michael Best & Friedrich LLP in Waukesha, WI. He is Chair of the firm’s Wealth Planning Services Practice Group and is a fellow of the American College of Trust and Estate Counsel.
B. Basics Of Installment Sales To IDGTs

1. Establishing An IDGT

   a. Grantor Trust
      i. The first step in implementing a sale to an IDGT is to create the buyer (that is, the IDGT). The IDGT is structured as a grantor trust for income tax purposes. A grantor trust can be created a number of ways, as discussed below. §§673–677. Because the IDGT is “defective” for income tax purposes, all of the trust’s income is taxed to the grantor, which produces an additional tax-free gift to the IDGT. In Revenue Ruling 2004-64, 2004-2 C.B. 7, the IRS reaffirmed that a grantor’s payment of tax on the trust income does not constitute a gift to the trust. Moreover, if the trust does not require the trustee to reimburse the grantor for the payment of income tax, the discretionary reimbursement of tax payment will not cause estate inclusion. As a grantor trust, the IDGT can hold S corporation stock. In addition, the IDGT could purchase an existing life insurance policy on the life of the grantor without subjecting the policy to taxation under the transfer for value rule. For income tax purposes, the sale of the policy should be treated as a sale to the grantor/insured, and the transfer for value exception under section 101(a)(2)(B) should apply. Typically, the IDGT is structured as a generation skipping or dynasty trust.

   b. Funding The IDGT Prior To Sale
      i. Amount Of Seed Funds
         (1) The grantor should make an initial gift to the trust of meaningful assets in advance of the sale. This “seed fund” reduces the risk that the sale will be treated as a transfer with a retained interest by the grantor under section 2036. In PLR 9535026, the IRS required a contribution of 10 percent of the installment purchase price. Some commentators have argued that a 10 percent equity funding is not required. In fact, it has been suggested that as long as the IDGT will have access to funds necessary to meet its obligations, an initial seeding should not even be required. See Hesch & Manning, Beyond the Basic Freeze: Further Uses of Deferred Payment Sales, 34 Univ. Miami Inst. Est. Pl. 1601.1 (2000). In addition, a personal guarantee by the IDGT beneficiaries assists in substantiating that the sale to the IDGT is at arm’s length. However, a beneficiary giving a guarantee may be treated as making a contribution to the IDGT, which could cause the IDGT not to be considered a grantor trust with respect to the original grantor. But see Bradford v. Commissioner, 34 T.C. 1059 (1960); Hatcher & Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, 92 J. Tax’n 152 (2000). To address this concern, the IDGT could pay an annual fee to the beneficiary in return for the guarantee.

      ii. Annual Exclusion Qualification
         (1) If the IDGT is structured as a “Crummey trust,” the contribution will qualify for the section 2503(b) gift tax annual exclusion. However, the trust status as a grantor trust could be threatened by the existence of a Crummey withdrawal clause. Specifically, section 678(a) provides that a beneficiary and not a grantor will be treated as the owner of the trust if the beneficiary has a power “exercisable solely by himself to vest corpus or the income therefrom in himself.” Relying on section 678(a), the IRS concluded in Revenue Ruling 81-6, 1981-1 C.B.
385, that a beneficiary was taxable because the beneficiary held a Crummey withdrawal power. The ruling does not address how the beneficiary was to be taxed. IRS regulations suggest that the beneficiary should be taxed on a proportionate amount of trust income (that is, the amount of income that accrues while the withdrawal right exists). Notwithstanding the foregoing, section 678(b) provides that the grantor, rather than the beneficiary, will be treated as the owner of the trust with respect to the power over income if the grantor is otherwise treated as the owner. In other words, the grantor trust provisions could be read to override a section 678 power attributable to the person holding a Crummey withdrawal right. It should be noted, however, that section 678(b) read literally only applies as to a “power over income.” A Crummey withdrawal power is generally a power to withdraw corpus. Nonetheless, the legislative history indicates that section 678(b) was intended to apply to a power over income and corpus. Despite the literal language of section 678(b) and Revenue Ruling 81-6, the IRS has privately ruled that a trust remains a grantor trust with respect to the original grantor despite the existence of Crummey withdrawal power. See PLR 200606006; PLR 200603040; PLR 200729005.

iii. GST Considerations

(1) As long as the grantor allocates his or her generation skipping tax (“GST”) exemption to lifetime gifts to the IDGT, the trust assets will be exempt from the GST tax. The GST exemption does not need to be applied to the sale to the IDGT. However, the GST tax could be implicated if there is a valuation adjustment on the property that is gifted or sold.

iv. What Assets Should Be Gifted?

(1) The grantor may choose to gift cash or marketable securities to the IDGT as the initial seed fund. This type of gift would avoid raising a valuation question and having to check the box on the gift tax return for a valuation discount. A discussion of disclosing the sale transaction on a gift tax return is provided below.

c. Sale Agreement/Note

i. Installment Note

(1) Following the gift to the IDGT, the grantor enters into an installment sale agreement with the IDGT. The IDGT can make a down payment or issue a promissory note for the full value of the property. It is recommended that the note be secured. Generally, a pledge agreement is entered into. Typically, income-producing assets that are subject to valuation discounts are purchased by the IDGT.

ii. Interest Rate/Term

(1) The note is typically structured to provide annual payments with a balloon payment at the end of the term. The interest is normally set to be equal to the section 7872 rate (referred to as the applicable federal rate or AFR) at the time of sale, which is lower than the section 7520 rate applicable to GRATs. The IRS publishes the AFR monthly. A short-term AFR can be used for a note with a term of up to three years. The mid-term AFR is used for a note over three years but not over nine years. A long-term AFR is used for a note over nine years. In reliance on section 1274(d), some planners contend that the lowest AFR in the month of the
sale or prior two months could be used. However, this approach is not risk free because a sale to an IDGT may not constitute a sale under section 1274(d). It is common for a nine-year note to be used in IDGT transactions, which would apply the mid-term rate. The note typically permits prepayment.

iii. **Self Cancelling Note**

(1) A self cancelling installment note ("SCIN") provides for the cancellation of the note if the grantor dies before the note is paid in full. Like a regular note, a SCIN can be secured. However, unlike a regular note, a SCIN is not included in the transferor’s estate. To avoid a gift on the sale, a SCIN must provide for a risk premium. The risk premium may be an increase in the sale price or a higher interest rate. See TAM 8906002. The older the transferor, the greater the risk premium. If the note is structured as a balloon payment, the risk premium must also increase. If the transferor dies during the term of the note, the unrecognized gain at the time of death will be taxable to the estate as income in respect to the decedent under section 691(a)(5); *Estate of Frame v. Commissioner*, 98 T.C. 341 (1992) aff’d in relevant part, 998 F2d 567 (8th Cir. 1993). Some planners have adopted the Tax Court’s approach in *Frame*, which held that the unrecognized gain should be reported on the decedent’s final tax return. The Tax Court in *Estate of Costanza v. Commissioner*, 81 T.C.M. 1693 (2001), rev’d, 320 F3d 595 (6th Cir. 2003), held that a SCIN was a taxable gift because it was not a bona fide transaction for full consideration. However, the Sixth Circuit reversed and remanded the case despite acknowledging that intra-family transactions are subject to careful scrutiny. The IRS argued that the parties presumed the seller would die before the note was paid because they included a self cancelling provision. The Sixth Circuit rejected this argument, ruling that it had previously been rejected by the Tax Court relying on *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980). The Sixth Circuit also noted that the fact that the transferor died within months of the transaction was not fatal since the death was unexpected.

iv. **Determination Of Purchase Price**

(i) An independent written appraisal of the asset being sold to the IDGT should be obtained, assuming the asset is not publicly traded. A valuation adjustment clause to minimize a gift and GST tax adjustment is typically contained in the IDGT rather than the sale agreement. A discussion of valuation adjustment clauses is provided below.

d. **Payment Of Purchase Price**

i. The IDGT’s income and appreciation accumulates inside the trust gift and GST tax-free. The grantor pays the income tax on the IDGT’s income. After the IDGT pays interest to the grantor, which is tax-free to the grantor, the remaining funds can be used to repay the note at the end of the term. The IDGT could also distribute assets in-kind to make note payments. Typically, the plan is to entirely repay the note during the grantor’s lifetime to avoid an issue of income recognition at the time of the seller’s death, as discussed below. Some planners suggest having the seller elect out of installment reporting under the rationale that the gain would be recognized in the first year (but no income recognition would occur since it is a sale to a grantor trust). Under this approach, death in a later year should not cause the recognition of income because it would be considered a non-event.
C. IDGT Tax Summary

1. Gift Tax
   a. Seed Gift
      i. It is recommended that the initial gift to the IDGT be approximately 10 percent of the value transferred to the IDGT (that is, 10 percent combined purchase price and initial gift). A conservative approach to preserve grantor trust status with respect to the original grantor would be not to include Crummey withdrawal powers. In such a case, the gift would not qualify for the annual exclusion. The initial seed gift could trigger a current gift tax if the donor has already used the donor’s $1 million lifetime exemption. Typically, the initial seed gift is with cash or other marketable assets that do not raise a valuation question.
   
   b. Sale
      i. Assuming that the purchase price reflects the fair market value of the asset being sold and there is adequate equity in the IDGT to support valuing the note at its full value, there should not be any gift with respect to the sale transaction.

   c. Payment Of Income Tax
      i. Previously, the IRS took the position that the grantor’s payment of income tax with respect to a grantor trust was a taxable gift. See PLR 9444033. However, in Revenue Ruling 2004-64, the IRS ruled that the grantor’s payment of income taxes from a grantor trust is not treated as a gift to the trust beneficiaries.

   d. Valuation Adjustment Clauses
      i. General
         (1) If the value of the transferred asset exceeds the value of the promissory note, a gift is triggered. Many planners use a defined value clause to minimize the gift tax risk. Formula clauses are commonly used in estate planning in other contexts and are expressly authorized in the Treasury Regulations. Generally, there are two types of defined value clauses. One type limits the amount that is transferred. The second type allocates the transferred amount among transferees, typically allocating the assets among taxable and non-taxable transferees by a formula. As discussed below, the decision in McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), rev’d 120 T.C. 358 (2003), addresses the second type of formula definition clause. Even if a defined value clause is used to minimize risk, an appraisal should be obtained.

      ii. Procter
         (1) In Commissioner v. Procter, 142 F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944), the Fourth Circuit did not recognize a provision in a trust requiring property transferred to the trust to be returned to the grantor if the transaction was determined to be subject to gift tax by a court. This type of provision was considered a condition subsequent, which was contrary to public policy. See also Ward v. Commissioner, 87 T.C. 78 (1986); Estate of McLendon v. Commissioner, 66 T.C.M. (CCH) 946 (1993), rev’d on other grounds, 77 F.3d 477 (5th Cir. 1995). The Fourth