Intentionally Defective Grantor Trust

When it comes to estate tax planning, one common strategy often implemented is the transfer of assets to an Intentionally Defective Grantor Trust, or "IDGT."

When implemented correctly, this strategy can potentially mitigate gift and estate taxes in the future, while significantly increasing the value heirs receive. If used in multi-generational planning, such as combining an IDGT with the use of a Dynasty Trust, the benefits can continue to be realized long after the client has passed away. This article will review the key aspects of the strategy and who may benefit from implementation.

Structure

An IDGT is an irrevocable transfer in which the client (grantor) gifts or sells assets to a trust for the benefit of their desired beneficiaries. What makes a properly structured IDGT powerful is the difference in tax treatment—inclusion for income tax purposes, and exclusion for estate tax purposes. During the term of the trust, the grantor continues to pay the income tax liability associated with the assets, further reducing his or her estate without requiring the further utilization of lifetime exemption. The future appreciation of the asset is sheltered from further estate and gift taxes, enhancing the total benefit (inheritance) beneficiaries receive. The payment of income taxes associated with an IDGT can be viewed as one of four "gift tax-free" options to provide for beneficiaries and heirs. The other three options are 1) annual exclusion gifting, 2) payment of qualified education expenses directly to the educational institution, and 3) qualified medical payments paid directly to the health care provider.

Typically, an IDGT will be composed of one, or both, of the following components: assets which are gifted and assets which are sold to the trust. When assets are gifted, the value of the gift is subject to the grantor's available lifetime exemption amounts ($11.7 million, per person, in 2021). Any amounts in excess would be subject to gift tax liability (40% tax rate in 2021). This "freezes" the value of the asset as of the date of the gift. All future appreciation will occur outside the grantor's taxable estate with no further gift or estate tax liability.

In a sale strategy, the grantor "sells" the assets to the trust, in return for a down payment and a promissory note. What is unique about this "sale" is that under Revenue Ruling 85-13, the Internal Revenue Service ("IRS") held that these exchanges are not taxable events since the trust is not considered a separate entity under IDGT provisions. As a result, the assets do not receive a step-up in basis, and the grantor does not recognize a capital gain, at the time of the transaction. Furthermore, interest received from the note payment is not taxable income to the grantor, nor deductible by the trust.

Traditionally, sales are used in one of two scenarios:

- First, when grantors could benefit from the income stream generated from the promissory note (i.e., other sources of income and assets are not sufficient to meet the obligations of realized taxes and/or other lifestyle expense needs).
- Second, when clients have utilized their maximum allowable lifetime gift exemption and further transfers to an IDGT would incur a gift tax liability. By using a sale, the grantor can capitalize on the ability to shelter future appreciation of the asset, outside of their taxable estate.

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When structuring the promissory note for a sale, key considerations must be factored to ensure that the note is deemed bona fide and the transaction is not ultimately included in the grantor's estate. In Fidelity-Philadelphia Trust Co v. Smith (1958), the Supreme Court clearly set forth three circumstances for ensuring this.

1. **The size of the note payment must not be related to the income generated by the property in trust.**
2. **The obligation of the note must be a personal obligation of the transferee.**
3. **The required promissory note payments must not be solely the responsibility of the property sold to the IDGT.**

To achieve the first requirement, many promissory notes use the Applicable Federal Rate, or "AFR." This rate is set monthly by the IRS, based on the term of the note, and is considered the minimum required interest rate to support this test. To achieve the final two requirements, it is generally advisable for the grantor to "seed" the trust with a gift of at least 10% of the value of the assets being sold. While no formal position has been taken by the IRS as to the 10% recommendation being sufficient, many practitioners rely on commentary from the IRS in Private Letter Ruling (PLR) 9535026 for this baseline. This gift provides additional assets for which the trust can meet the obligations of the note requirements.

An alternative strategy common to structuring the sale as bona fide debt and at an "arm's length transaction," is the use of an interest rate higher than that of the AFR. Again, the goal of these strategies is to prevent the possibility of the assets being included in the grantor's estate (Internal Revenue Code ("IRC") §2036), or the entire fair market value of the sold asset being treated as a gift (IRC §2702).

Income tax impact

As stated previously, income taxes paid by the grantor are not subject to gift tax liability, as a result of Revenue Ruling 2004-64. The payment of income taxes by the grantor provides two key benefits.

1. All assets in excess of promissory note payments may remain in the trust and continue to grow exempt from future gift and estate taxes.
2. The payment of associated income tax liabilities from assets within the grantor's taxable estate further reduces the size of the grantor's estate, potentially minimizing future estate tax liability upon the passing of the grantor.

Greater transfers through discounting

When certain types of assets are transferred to IDGTs, such as interests in closely held family businesses, the ability to recognize a lower value for gift and sale purposes exists. This is achieved through the use of valuation discounts. Two key discounts available are *lack of control* and *lack of marketability*. With a lack of control discount, a reduction in recognized value is afforded through the restrictions that the business interest carries as it pertains to management decisions. With lack of marketability, additional discounts are attained due to the non-existence of a readily available market and/or restrictions on transfer of the interest. These discounts impact both gifts and sales to IDGTs, and, although dependent on facts and circumstances, have been supported as high as 50%.

Depending on the size of the interest transferred, these discounts can substantially impact how much a grantor can transfer into the IDGT. For example, a client owns a business valued at $50MM, and has their entire 2021 lifetime gift exemption available ($11.7MM). If they choose to gift their maximum allowable amount to an IDGT, without discounts, they will have shifted approximately 23% of their business to the trust ($11.7MM/$50MM). If a qualified valuation expert is retained and completes a valuation and discount study on the assets, and based on appropriate lack of control and lack of marketability restrictions the interest being transferred obtains a 33% combined discount, the grantor is now able to transfer approximately 35% of their business ($17.46MM) for the same gift of $11.7MM. This approximately $5.8MM difference between the fair market value and the discounted value of the transferred interest, and its subsequent future appreciation, is free of current and future gift and estate taxes.

The same holds true for sales to IDGTs. Assuming the gift in the above example is now a sale, and the client is taking a promissory note for the exchange, with discounts they are able to sell approximately 35% of their business to the IDGT, in return for a promissory note equal to approximately 23% of the business. This difference in the fair market value of the interest transferred to the trust and the principal amount the grantor receives in the note, provides value to both the grantor, and the trust. The grantor retains a smaller note, thus reducing possible estate inclusion value, should they pass away prior to the term of the note. The trust benefits from a smaller required note payment allowing a greater amount of the trust to continue to grow estate and gift tax free.

Assets includable in estate

When assets are gifted to an IDGT they are no longer part of the grantor's estate. Depending on the terms of the trust, beneficiaries may begin receiving immediate distributions of their interest, or the assets could be retained in trust, and ultimately distributed to them at a future date.

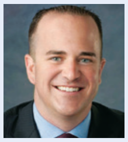
With a sale to an IDGT, the promissory note is a note receivable on the balance sheet of the grantor. As note principal is paid down, the value included in their estate is reduced. Should the grantor die before the complete payment of the note, any remaining balance will be includable in the estate for estate tax purposes. While this may not sound optimal, the amount included will likely be significantly lower than the value of the asset inside the IDGT, which is sheltered from estate taxes.

Tax basis considerations

In the case of assets which are gifted to an IDGT, IRC §1015 states that the property will receive a carryover basis. More specifically, basis is equal to the grantor's basis in the asset, adjusted for any gift tax paid or any loss unrealized to date (i.e. the lower of the grantor's cost basis, or current fair market value on the date of the gift). Thus, generally, the basis of the asset transferred to the trust is the same as the basis which the owner had prior to the transfer. Traditionally, it is not advisable to gift assets into an IDGT that either currently have a capital loss associated with them or that would trigger a gift tax.

In the case of assets sold to an IDGT, Revenue Ruling 85-13 states that, at time of sale, and while the trust is a grantor trust, the basis is to remain the same as the grantor's basis as a result of the sale being disregarded for income tax purposes. Unfortunately, some uncertainty persists as it relates to a basis step up, or down, under IRC §1014, when the grantor passes. One argument is that upon cessation of grantor trust status, there is a step up in basis and a potential recognition of gain (Regulation §1.1001 2(c), Example (5)). The counter argument is that no gain should be recognized as a result of death, as death is not considered a recognition event. Unfortunately, since 2015, the IRS has ceased providing guidance on their position as it pertains to gain recognition, and a step up in basis.

Due to the varying schools of thought, and the potentially significant difference in outcomes, should basis be stepped up and/or a gain recognized on a portion of the transaction, it is strongly advised that you speak with your tax and/or legal advisors to ensure possible outcomes are understood and potential impacts as they pertain to your specific situation are reviewed.



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Proposed tax legislation and its impact on IDGTs

On September 13, 2021, the House Ways and Means committee released their version of proposed legislation. This draft included a provision requiring recognition of capital gains for sales to an IDGT occurring after the date of enactment of the legislation. In addition, the Ways and Means draft included an acceleration of an already scheduled reduction in the estate & gift tax exemption currently at $11.7 million. Their proposal reduces the exemption to $5,000,000, indexed for inflation (anticipated to be $6.03MM, in 2022). This reduction, if passed, would take effect on January 1, 2022, and would have substantial impact on the amount one is able to transfer to their desired beneficiaries gift tax-free. These changes could have a profound negative impact on the use of IDGTs moving forward.

While final legislation has not been drafted, nor voted on, as of the date of this article, should either of the above provisions be enacted on or before January 1, 2022, there is no more optimal time than now to consider implementing an IDGT strategy.

Conclusion

While there is uncertainty in the future of tax treatment on the unrealized gain of assets transferred to an IDGT, a window of opportunity exists currently where a properly structured IDGT strategy could provide significant value to you and your estate planning goals and objectives. As with any transfer vehicle, proper structure, asset selection, note terms (if applicable), and other considerations should be closely tailored to your specific needs and objectives. If you believe this strategy may benefit your estate objectives, please reach out to your BMO Wealth Management team to schedule a conversation about this strategy.

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