Estate Planning Insights

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WHY EVERY IRREVOCABLE TRUST SHOULD BE "DEFECTIVE" – PART 2

In our last quarterly newsletter (April 30, 2010), we began discussing "Intentionally Defective Irrevocable Trusts" (sometimes also known as "Intentionally Defective Grantor Trusts", or IDITs and IDGTs for short). In our previous newsletter, we reviewed some basic estate and gift tax rules. In this newsletter, we will focus more on the income tax aspects of IDITs/IDGTs and how the income tax rules can be used to accomplish the significant transfer of wealth to children and grandchildren while avoiding the payment of estate and gift taxes (or reducing the amount of these transfer taxes).

Transfer Tax Versus Income Tax. No one likes paying income taxes. However, if every decedent with a taxable estate could see the check his Executor has to write to the United States Treasury (IRS) to pay estate taxes nine months after his death, he would be mortified (pun intended). Currently (meaning, for people who die this year), there is no estate tax (death tax); however, there is still a gift tax. As previously discussed, the estate tax and gift tax are both "transfer taxes" that apply whenever a person who owns something transfers it to someone else (whether the transfer occurs during life or at death).

Unless changed by Congress, the exemption from the federal estate tax for people who die in 2011 and thereafter will be (only) $1,000,000. Further, the top estate tax rate will be going back up to 55% on January 1, 2011, with effective death tax rates ranging from 41% to 55% (most people just use 50% on the amount above $1 million for easy estimation of the tax). While the top income tax rate will be going up also, the income tax is meager compared with the estate tax. Not only is the income tax imposed at a rate lower than the estate tax rate, but the income tax only applies to *income* while the estate tax applies to *principal* (every asset you own that is being transferred when you die, valued at fair market value). There just isn't any legitimate debate regarding which is worse. Of course, the estate tax doesn't affect us while we're living–it affects our ultimate beneficiaries (usually, our children). So, we have to care about our ultimate beneficiaries to want to do something to avoid the estate tax. Thus, estate planning, or "wealth transfer planning", is a process that is designed to benefit our loved ones and not ourselves. Although many clients do not enjoy doing wealth transfer planning (because of the time, expense and complexity involved), it does make a difference in terms of who will be the major recipient of their estate when they die. Despite most clients' aversion to estate planning, they usually like their children more than they like the IRS, so they are willing to do it.

Making Lifetime Gifts. In our last newsletter, we also discussed the gift tax annual exclusion amount (currently $13,000 per donor per donee) and the $1,000,000 lifetime gift tax exemption. Further, we discussed the idea of making "smart" gifts, such as (i) tax-free gifts, (ii) taxable gifts of assets that "keep on giving" (gifts of income-producing and/or appreciating assets designed to avoid future estate taxes on post-gift earnings and appreciation), and (iii) taxable gifts that are "leveraged" in some way (i.e., gifts designed to provide "more bang for the buck"). By combining some fairly esoteric income tax rules with lifetime giving, even more wealth can be transferred to children and grandchildren free of transfer taxes.

What is "Defective" About an IDIT/IDGT? First, an IDIT (hereafter, we will just use that acronym) is an *irrevocable* trust, meaning, a trust that can't be revoked or changed after it becomes effective. With respect to transfer taxes (estate and gift taxes), the IDIT is designed so that, hopefully, the creator of the IDIT (i.e., the Grantor) has made a "completed gift" for federal gift tax purposes and has not retained any "bad" powers over the trust or its assets that will cause the IDIT assets to be included in the Grantor's estate for federal estate tax purposes when the Grantor dies. Second, the IDIT includes one or more "grantor trust powers". A grantor trust power is a power over a trust that causes the *income* earned by the trust assets to be taxed to the Grantor and not to the trust or its beneficiaries. Although estate planning attorneys call this a "defect", it is something that is done intentionally. Why would anyone do this?

In its simplest form, when the Grantor creates and funds an IDIT for his children, in addition to transferring assets to the trust in a "smart" way for federal gift tax purposes (as discussed in our last newsletter), once the assets held in the trust start earning income, if the Grantor has to pay the income taxes on that income instead of the trust (or the beneficiaries) having to pay the income taxes on that income, more wealth will end up with the beneficiaries of the trust (i.e., the children) at the end of the day. The Grantor's payment of the income taxes on the IDIT income is like a tax-free gift to the trust and its beneficiaries each year. Fortunately, the IRS has ruled that the Grantor's payment of the IDIT's income taxes is not a taxable gift, as long as the IDIT is structured properly. That is because, under the grantor trust rules, the Grantor is *required* to pay the trust's income taxes. Thus, it cannot be a gift. Since the IDIT will not be depleted in value each year by having to pay income taxes on its income, the IDIT can grow, income tax-free, for a long time (until the Grantor dies or releases the grantor trust power). Further, the Grantor's payment of the income taxes on the IDIT's income reduces the Grantor's estate for federal estate tax purposes.

IDIT Versus Roth IRA. The income tax-free growth that the IDIT experiences is *similar* to what occurs with a Roth IRA set up for a child (although not identical). An IDIT has some significant advantages over a Roth IRA, however. One advantage of the IDIT over a Roth IRA is that both the principal and income held in the child's IDIT have divorce protection. The funds in the child's IDIT were contributed by the Grantor and even the income produced by the IDIT assets is considered trust income and not personal income of the child. Therefore, the IDIT is 100% the child's separate property. In contrast, funds placed in a Roth IRA by a married person are community property. Further, even if a third party places funds in a child's Roth IRA (which would be a gift subject to the gift tax rules), although gifted assets are separate property, the earnings on gifted funds in a child's account are community property if the child is married. To repeat, all of the earnings in the child's Roth IRA during the child's marriage are community property even if the original contribution to the Roth IRA was a gift from the child's parent, leading to the entire Roth IRA becoming *commingled* for marital property purposes.

Another difference between an IDIT and a Roth IRA involves general creditor protection. If properly structured, the assets in an IDIT can be protected from creditors' claims for the child's entire life and also for the lives of the child's children after the child's death. When a child dies and his Roth IRA passes to his children, it will not have any creditor protection. Further, a Roth IRA owned by a child is includable and taxable in the child's estate when he dies, while the child's IDIT assets are designed to avoid estate taxes on the child's death. Thus, IDITs are superior to Roth IRAs from an estate tax standpoint, as well as a divorce and creditor standpoint. Finally, only a limited amount can be placed in a Roth IRA each year–the lesser of the Roth IRA owner's actual compensation for personal services that year or the applicable dollar amount for that year set by federal law (which is $5,000 for 2010). Much larger amounts can be placed in an IDIT. Of course, one disadvantage of an IDIT compared to a Roth IRA is the separate income tax reporting usually done for the IDIT. In our opinion, this disadvantage is quite small in relation to the multiple advantages the IDIT provides.

Joint IDIT or Separate IDITs? If a married couple wants to create an IDIT simply to transfer additional wealth to their children through (i) making annual exclusion gifts (or easy to value "taxable" gifts) and (ii) paying the IDIT's income taxes each year, then the married couple can create a joint IDIT. In many of these cases, one or both of the Grantors can even serve as Trustee of the IDIT, assuming all Trustee powers are carefully restricted in the trust instrument and observed by the Trustee. Of course, it's always much safer from an estate tax standpoint to appoint an *Independent* Trustee because individuals who serve as Trustee don't always follow the dictates of the trust instrument–i.e., they make mistakes which can be costly from a tax standpoint.

An IDIT can be used to accomplish more than the transfer of annual exclusion gifts and the lifetime gift tax exemption amount to children in a structure that shelters the gifted assets from divorces and creditors and future estate taxes. Thus, in many cases involving a "more sophisticated use" of an IDIT (discussed below), each spouse should create a separate IDIT. The 2-IDIT approach is absolutely necessary if S Corporation stock will be transferred to the IDIT. Further, any assets given or sold to the spouses' separate IDITs should be partitioned first (meaning, legally re-characterized as the separate property of each spouse pursuant to a written marital agreement). Finally, in cases where corporate stock of any type (S Corp or C Corp) will be held by the IDIT, the Grantor should not serve as Trustee of the IDIT.

Taking the Next Step With an IDIT. Wealthier clients go beyond merely funding an IDIT with tax-free annual exclusion gifts. They also make substantial *taxable* gifts to their IDIT, using up all or a portion of their $1,000,000 lifetime gift tax exemption amount. The reason is that they want to transfer significant wealth to their children to avoid significant estate taxes later. Of course, taxable gifts have to be reported to the IRS in a timely filed U.S. Gift Tax Return. To avoid audit risk, when making the initial taxable gifts to the IDIT (referred to as "seed capital gifts"), many wealthier clients give assets that are easy to value (e.g., cash or marketable securities). Although this is not consistent with our previous discussion in which we recommended that all *taxable* gifts be "leveraged" gifts, in this particular situation, it's part of the overall strategy and is an exception to the "rule". In this case, the long-term strategy is for the Grantor to sell substantial assets to the IDIT in exchange for a note. In order to enter into such a sale and have the sale be deemed "commercially reasonable" (so that no portion of the sale is treated as a gift), the IDIT first has to own sufficient assets so that a promissory note given by the IDIT Trustee to the Grantor will be respected by the IRS. Most estate planning attorneys believe that the IDIT must own assets worth at least ten percent (10%) of the assets which the IDIT will be purchasing from the Grantor to avoid gift tax problems. The sales transaction can also be "beefed up" for purposes of meeting the commercially reasonable goal through guarantees.

Because the IDIT is a grantor trust for federal income tax purposes, the sale of assets by the Grantor to the IDIT is not reported for federal income tax purposes. The reason is because the Grantor is, essentially, selling something to himself under the applicable income tax rules. (Remember that the income tax rules and the transfer tax rules are different, so that, even though the IDIT is a separate "person" for estate and gift tax purposes, it's not a separate "person" for income tax purposes). Further, this means that the Grantor does not recognize a capital gain on the sale of appreciated assets to the IDIT. Despite this non-reporting situation, the assets still must be sold to the IDIT at their fair market value, which should always be determined by a qualified business valuation expert (i.e., a professional appraiser).

The promissory note the IDIT gives the Grantor to purchase the assets must be structured to comply with all federal tax rules, including the "imputed interest rules". This means that the interest rate on the promissory note must be at the "Applicable Federal Rate" (or "AFR"). Further, when the IDIT makes payments on the note to the Grantor, the Grantor does not report any interest income in his federal income tax return. Instead, because of the grantor trust rules, the Grantor must pay income taxes on *all* taxable income of the IDIT. Presumably, the IDIT will have income due to its ownership of the assets initially given to the IDIT plus the assets the IDIT purchased from the Grantor. From the standpoint of making this technique work, economically, it is usually best for the assets sold to the IDIT to be assets that are "flow through" assets from a federal income tax standpoint (such as S Corporation stock or limited partnership interests in an FLP or LLC interests). That avoids a double layer of income taxes (such as occurs with a C Corporation). If someone owns C Corporation stock and wants to use this technique, the stock will usually have to be converted to S Corporation stock first.

To avoid application of the "step transaction doctrine", it is important to have a gap in time between (i) the creation and initial funding of the IDIT and (ii) the sale of assets by the Grantor to the IDIT. The IRS has been using the step transaction doctrine to challenge many taxpayers in recently reported tax cases, especially FLP cases. When the step transaction doctrine is applied, separate transactions are "collapsed" into one and evaluated as a single transaction. This often produces a very bad tax result for the taxpayer. The longer the delay between initial creation and funding of the IDIT and sale of assets to the IDIT, the better.

If the assets owned by the IDIT appreciate in value or earn substantial income, the Grantor's estate will have avoided paying transfer taxes on all of that appreciation and income. Thus, the sophisticated IDIT strategy works best with assets that both produce a lot of income and increase substantially in value once they are no longer owned by the Grantor.

If paying the income taxes on the IDIT becomes "too painful" for the Grantor, once the IDIT has fully paid all amounts due on the promissory note given to the Grantor, the Grantor can "release" (let go of) the retained grantor trust power. After that, the IDIT will be responsible for paying its own income taxes on its earnings.

If the assets sold to the IDIT go down in value (not a good development), if the particular grantor trust power retained by the Grantor over the IDIT is the power to substitute assets of an equivalent value in a non-fiduciary capacity (a commonly used grantor trust power because, unlike some other grantor trust powers, it is considered "safe" from an estate and gift tax standpoint), the Grantor can retrieve the assets previously sold to the IDIT and substitute other assets having an equivalent value, hopefully, assets that will, in fact, appreciate in value.

Of course, the goal is for the promissory note given to the Grantor by the IDIT to be completely paid off by the time of the Grantor's death. There are some potential estate tax issues if the Grantor dies while the note is still outstanding. This is one of the reasons why many practitioners like to structure the promissory note to be completely payable in nine years or less (which also implicates the federal mid-term rate under the AFR rules).

How does the sale to an IDIT technique compare to creation of a "zeroed-out" GRAT (note: short-term GRATS may soon be disallowed)? One of the advantages of the zeroed-out GRAT technique over the sale to an IDIT is that if the GRAT assets decline in value, it doesn't cost the Grantor anything other than the GRAT transaction cost. If the GRAT assets can't beat the "hurdle rate", it just means that the GRAT didn't work. With an IDIT, if the IDIT assets decline in value, the Grantor can't get back any of his $1,000,000 lifetime gift tax exemption used to make the initial seed capital gift to the IDIT. Thus, it's important to monitor closely the value of the assets held in the IDIT while the note is still outstanding.

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Other Uses of IDITs. Sometimes the Grantor and/or the Trustee of an Irrevocable Life Insurance Trust (ILIT) has failed to do everything precisely right in funding and administering the ILIT (jeopardizing the estate and gift tax advantages an ILIT is designed to provide). The ILIT may be "beyond repair". In such a case, the Grantor might create a new ILIT that is a grantor trust for federal income tax purposes (an ILIT in the form of an IDIT). The Grantor can then fund the new ILIT with sufficient cash (through tax-free or taxable gifts, as applicable) so that the Trustee of the new ILIT can purchase the insurance policy or policies held in the old ILIT from the Trustee of the old ILIT at fair market value. Why would someone do this? One reason is to avoid the "3 year rule" that applies for federal estate tax purposes whenever an existing insurance policy is transferred gratuitously within 3 years of the insured's death. If the 3 year rule applies, the insurance proceeds are includable in the insured's estate for federal estate tax purposes (a bad result). Another reason is to avoid the "transfer for value rule", an income tax rule which, if applicable, makes the insurance proceeds taxable for federal income tax purposes when paid (also a bad result). One of the exceptions to the transfer for value rule is the transfer of an existing insurance policy to the insured. Since a grantor trust is basically ignored for federal income tax purposes, the transfer of an insurance policy insuring the insured-grantor's life to a grantor trust created by the insured is not a transfer for value. Of course, the old ILIT will end up with cash from the sale, which the Trustee must handle pursuant to the terms of the trust instrument creating the old ILIT. Usually, the Trustee has sufficient discretion to make a distribution of all of the cash to one or more of the beneficiaries of the old ILIT, resulting in termination of the old ILIT. Hopefully, the Grantor and Trustee will administer the new ILIT correctly from that point forward.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.
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