

Sales to Intentionally Defective Grantor Trusts

Sales to Intentionally Defective Grantor Trusts (IDGTs) (sometimes also referred to as “intentionally defective grantor trusts”) are an effective estate planning strategy to remove assets from the estate of the senior generation while preserving an income stream from the sale. An IDGT is an irrevocable trust that removes assets from the grantor’s taxable estate. This strategy “freezes” the estate of the senior generation by converting appreciating assets into a non-appreciating asset with a fixed yield. The strategy takes advantage of the differences between the estate tax inclusion rules and the separate grantor trust income rules under the Internal Revenue Code (“Code”).

A. Description

The senior generation (grantor) creates an irrevocable IDGT that is treated as a grantor trust for income tax purposes. As a result, the grantor will be treated as owning the IDGT assets and the trust’s income will be taxed to him.

Second, the grantor sells assets (a business, real estate, marketable securities or other appreciating asset) to be removed from his estate to the IDGT. The sale is customarily structured as an installment sale. The grantor receives an interest bearing promissory note payable by the IDGT. The grantor, because he is treated as the owner of the assets of the IDGT, is not taxed on the sale (because he is considered for income tax purposes as having made a sale to himself). The usual disadvantage of gain recognition on a sale is eliminated.

The grantor is paid principal installments and interest under the note, thus preserving an income stream from the sale of the asset. The terms of repayment under the note may be tailored to the needs of the grantor. The grantor is, however, taxed on all of the IDGT’s income. The IDGT may reimburse the grantor for the income tax paid, provided the reimbursement is discretionary by an independent trustee and not required by the terms of the trust.

If the grantor outlives the term of the note, all of the assets are removed from his taxable estate. If he does not outlive the note term, the unpaid balance is included in his

estate. If appropriate, the note could be self-cancelling at the death of the grantor, to avoid inclusion of the unpaid balance in the grantor's estate.

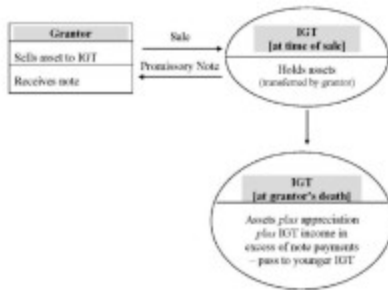
B. Advantages. There are numerous advantages of a sale to an IDGT strategy:

1. No gain is recognized by the grantor on the sale of appreciated assets to the trust
2. If the IDGT realizes more income than the payment obligations under the note, the excess income is removed from the grantor's estate (as well as the income tax paid by the grantor on the IDGT's income)
3. The assets sold to the IDGT and all future appreciation is removed from the grantor's estate
4. The income tax is paid by the grantor on trust income is not an additional gift for tax purposes
5. The grantor need not outlive the term of the promissory note to obtain estate planning benefits [unlike a grantor retained annuity trust (GRAT) where assets are included in the grantor's estate unless he outlives the GRAT term];
6. An IDGT (because it is a grantor trust) may own stock of a Subchapter "S" corporation, making the sale of Subchapter "S" stock attractive (other types of trusts may not own Subchapter "S" stock without meeting certain requirements)

C. Disadvantages. The grantor should make an initial gift of "seed" assets (cash or marketable securities) at least two months in advance of the sale, in an amount of at least ten percent (10%) of the purchase price, to establish the capability of the IDGT to make payments under the note and that it constitutes a bona fide debt.

The gift of "seed" assets to the IDGT will be a taxable gift and utilize a portion of the grantor's lifetime gift tax exemption.

D. Diagram of a Sale to an IDGT



- No gain to grantor on sale
- Grantor receives note payments tax-free
- May be reimbursed by IDGT for income taxes owed on IDGT income

Estate Tax Consequences

- At grantor's death, asset sold to IDGT not includable in his estate
- If a self-cancelling note used, nothing includable in grantor's estate