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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

"IDGT" Estate Tax & Business Succession Planning

An Intentionally Defective Grantor Trust ("IDGT") is established for the benefit of the Grantor's children and future descendants ("Dynasty Trust"). The technique is particularly effective in business succession planning for those with closely held business interests. It can hold Sub-S stock; when an IDGT becomes a separate taxpayer the IDGT would then need to make the election to be a qualified Sub-S trust or an electing small business trust.

The trust is designed to be "defective" for income tax purposes, but "effective" for estate tax purposes. Trust provisions that make it "defective" may include the power to reacquire trust property (IRC 675(4)(c)) in which such power does not result in estate tax inclusion (PLR 9548013; IRC 2038). Other provisions may include the power to borrow trust assets without adequate interest or security (IRC 675(2)) and or the power to use trust income for paying life insurance premiums (IRC 677(a)(3)).

An IDGT is typically used in conjunction with the sale of assets to the trust. An outright gift may be made similarly to any gift to an irrevocable trust, and income from the assets gifted is taxed to the Grantor, while the tax payment is not considered a gift. However, when considering an outright gift it is important to understand that they are subject to the three year look back rule.

An installment sale to an IDGT is a technique widely used for business succession planning, but the sale structure would be similar to that of most types of entities, such a family limited partnership or limited liability company interest. To ensure that the sale transaction to the IDGT is respected by the IRS, certain attributes of the transaction must be adhered to.

Foremost is that the IDGT must have assets that provide economic substance prior to the sale, and that the IDGT have assets worth at least 10% (the general rule) of the value of those that are being sold to it. The Grantor would need to gift an amount of "seed money" to the IDGT to provide economic substance.

To further enhance the economic benefits to the Grantor many planners will combine the strategy with an FLP and seek a discount on the sale price of the FLP interest. It is not necessary to seek a discount valuation. The economic benefits attributable to the sale result from estate tax exclusion of the asset sold, and all future asset appreciation. Since the IDGT is "defective" the transaction is tax neutral and there is ***no capital gains recognition***, and under the presumption the sale is at fair market value, there is ***no gift tax***.

The IDGT would issue the Grantor an installment note bearing interest at the AFR rate. There is flexibility in designing the note to be amortizing, level principal payment, or an interest-only with a balloon payment. The design will normally be determined by the cash flow being generated from the asset(s) sold to the IDGT. ***Interest paid on the note is not taxable to the Grantor.***

While the note payments to the Grantor are disregarded for income tax purposes, the Grantor will pay taxes on the earnings attributed to the asset(s) sold to the IDGT. Designed correctly the Grantor should be able to pay the income taxes on the IDGT assets out of the installment sale payments under the terms of the note.

In the event the Grantor were to die during the term of the installment note, the balance at the time of death will be included in the Grantor's estate – exclusive of any appreciation on the asset(s) sold. This is a significant advantage in comparison to a Grantor Retained Annuity Trust ("GRAT"). To mitigate the inclusion of all or a portion of the note being included in the Grantor's estate the note may be a "self-canceling installment note".

To further enhance the wealth transfer, the IDGT provides an excellent way to acquire significant amounts of life insurance without gift. Furthermore, the life insurance owned by the IDGT can be substantial through a traditional premium financing strategy, and used to repay the note upon the Grantor's death – which effectively further discounts the cost of repaying the note.

There appears to be no concerted effort by the IRS to challenge. If the IRS were to challenge it would probably begin with the bona fides of the overall transaction, and the issue of the "seed money" being adequate to justify a commercially viable sale; or whether the avoidance of the capital gains recognition should not be applicable to the balance of the note due at Grantor's death.