Advisor today
NEWS AND IDEAS FOR INSURANCE AND FINANCIAL ADVISORS
October 2001 www.naifa.org www.advisortoday.com

EXPERT TO EXPERT

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Intentionally Defective Irrevocable Trusts

The new tax rates make IDITs an attractive option.

Estate planners have been using the Irrevocable Life Insurance Trust (ILIT) for many years to increase wealth and liquidity outside the taxable estate. However, transfers to ILITs are often subject to gift tax, and irrevocable trusts typically pay income tax at the highest rate.

One of the most effective techniques estate planners use to reduce income tax and provide greater leverage is the Intentionally Defective Irrevocable Trust (IDIT). An IDIT is a "defective" grantor trust for which trust income is attributed to the grantor, rather than the trust. The lower income tax rates included in the 2001 tax bill that was recently signed by President Bush make IDITs an even more attractive planning technique.

Although many ILITs are only funded with life insurance policies, clients interested in transferring other assets to an irrevocable trust should consider using an IDIT. Funding an IDIT during their lifetimes enables individuals to significantly reduce their taxable estates by paying income taxes from nontrust assets. For clients with income-producing assets, an IDIT can be an excellent planning tool. Because the trust is not diminished by income taxes, it can use the income on trust assets to purchase a life insurance policy and other assets without incurring any gift, estate or generation-skipping transfer tax (GSTT).

IDITs are irrevocable trusts that are drafted so that the grantor is the "owner" of the trust assets for income tax purposes, but not for estate tax purposes. An IDIT is a "defective" grantor trust for income tax purposes because the grantor or the grantor's spouse possesses certain powers over the trust that cause the grantor to be the owner for income tax purposes. These powers are described in certain tax code provisions known as the "grantor trust" rules (Internal Revenue Code Sections 671-678).

If the grantor trust rules apply to a trust, then the trust income, deductions and credits are carried through to the grantor's individual income tax return and income tax is paid at the grantor's individual tax rate. Payment of income taxes by the grantor allows the IDIT assets to continue growing without being diminished by income taxes. The trust income will be available to fund large insurance premiums for either single-life or survivorship policies.

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In addition, the grantor can process transactions with the trust, such as installment sales, without any adverse income tax consequences. Under Revenue Ruling 85-13, the existence of a grantor trust is disregarded for income tax purposes. As a result, transactions between the grantor and the IDIT have no income tax consequences. Gift tax issues are also avoided with an IDIT, since the "three-year look back" rule applies to gifts, not sales.

Getting started

Clients can use the following approach to effectively establish and fund an IDIT:

Step 1: The client establishes an irrevocable trust that keeps trust assets outside the taxable estate and gives the grantor (or the grantor's spouse) certain powers that cause the trust to be a grantor trust for income tax purposes. These powers can include the power of a nonfiduciary person to reacquire the trust assets by substituting property of an equivalent value. They also include the power of the grantor to reacquire trust assets by exchanging the assets for other property of equivalent value, or the power to use trust income to pay premiums on insurance on the life of the grantor or the grantor's spouse. (The last power is included in many ILITs, causing them to be grantor trusts.) To avoid estate tax inclusion, the grantor/insured should not be named as a trustee of the IDIT.

Step 2: The grantor makes an initial gift of assets to the trust. Some or all of the gift may not be subject to gift tax because of the gift tax annual exclusion and the applicable exclusion amount. The IDIT can also be used to leverage the GSTT exemption. To keep the trust exempt from GSTT, the grantor should file a gift tax return and allocate GSTT exemption to the trust for the amount of the initial gift (and for each year that a gift is made to the trust). The grantor may consider gifting cash or marketable securities to the IDIT initially, rather than closely held stock or partnership interests, to avoid having to "check the box" on the gift tax return for a valuation discount.

Step 3: After the initial gift, the grantor enters into a sales agreement with the IDIT trustee, under which the trustee agrees to purchase additional assets from the grantor,

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often at a discounted value. Ideally, the trust should buy income-producing assets, such as limited partnership interests or S-corporation stock. Valuation discounts can be taken by appraisers for a variety of reasons, including minority interests and lack of marketability. The sales agreement is generally structured as an interest-only note for a term of years, with the principal balance due at the end of the term.

The initial gift made by the grantor should total at least 10 percent of the value of the assets being sold to the trust to provide greater security for the sale. Typically, the interest rate on the note is the Applicable Federal Rate (AFR) at the time of the sale.

Step 4: The assets transferred to the IDIT appreciate and earn income each year, which accumulates inside the trust, free of gift tax and GSTT. After the trust pays interest on the note to the grantor, the remaining trust income can be used to fund a large life insurance policy.

The grantor will pay the tax due on trust income, but doing a sale or exchange of assets with the trust will not have any income tax consequences to the grantor. After the grantor's death, the trust assets will be outside the grantor's taxable estate.

An IDIT can achieve maximum leverage if the grantor outlives the term of the note. However, unlike a Grantor Retained Annuity Trust (GRAT), a grantor does not have to outlive the term of the note to obtain significant estate tax benefits. Although the unpaid balance of the note will be included in the grantor's taxable estate if he or she does not outlive the note term, the future income and appreciation of the assets sold to the trust will continue to grow outside the taxable estate. As the trust assets appreciate, the grantor can make additional "installment sales" to the trust in future years.

Putting it into practice

A hypothetical example can help illustrate the benefits of an IDIT. Matthew and Andrea Berman, both age 68, have a Family Limited Partnership (FLP) funded with real estate that earns 20 percent income annually. They have a combined estate of $10 million and are interested in reducing their estate size and funding a survivorship life insurance policy with a $5 million death benefit. However, they want to minimize gift tax on transfers to an irrevocable trust that will ultimately benefit their daughter, Sandy, and her two children.

The Bermans have decided to fund an IDIT with Sandy as the trustee. Although Matthew has already used his entire applicable exclusion amount, Andrea can currently gift up to $675,000 to an IDIT without incurring any gift tax. Andrea makes an initial gift of $400,000 cash and stock to the IDIT. Following the gift, Matthew and Andrea will sell $4 million of FLP interests to the trust in exchange for a 15-year note at 6 percent interest. The FLP interests have been discounted at 30 percent—the value of the assets sold to the trust without a valuation discount is approximately $5.7 million.

During the first year, the IDIT will earn $40,000 of income on the initial gift of $400,000, and $1.14 million of income on the limited partnership interests. After the trust pays interest on the note of $240,000 to Matthew and Andrea, the remaining income of $940,000 can be used for payment of insurance premiums, distributions to trust beneficiaries or purchase of additional assets. Since Matthew and Andrea will be recognizing the trust income on their individual income tax return, the trust's growth will be even greater than in a traditional ILIT. In the first year alone, the trust could be reduced by nearly $472,000 in income tax, if the trust had to pay the tax. Since the Bermans are paying the tax on the trust income, the trust assets will be able to appreciate at a much higher rate.

IDITs are a sophisticated planning technique that can create significant tax benefits for clients who want to fund an irrevocable trust during their lifetime. AT

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