July 2019

Trust Connection

INLET PRIVATE WEALTH & TRUST

A Monthly Report on Trust News and Information

Inlet Private Wealth & Trust takes the time to learn your financial aspirations, evaluate your personal circumstances and then provide honest, independent advice. Working together we can build a strong foundation by providing solid trustee and investment management solutions that helps protect your wealth and provide peace of mind for the future of your estate.

Inlet Private Wealth was founded and structured to best serve its clients. We believe that effective wealth management is a deeply personal process, one that must be objective, engaged and based on each client's unique goals. Clients deserve tailored solutions, and we work collaboratively with our clients to achieve their unique financial objectives.

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Installment Sales to Intentionally Defective Grantor Trusts

Estate planning with intentionally defective grantor trusts (IDGTs) is a well-established "asset freeze" technique that has numerous advantages, as described below. In this article, we will discuss the features of this technique and how it can be used for your benefit.

Overview

The intended purpose of an installment sale to an IDGT is to limit the future market value of assets that may be taxable in your estate and to transfer the "excess return" from the assets to the trust beneficiaries. This strategy begins with an initial "seed" gift to the IDGT (generally 10% of the property to be sold to the trust) followed by a subsequent sale of the property to the trust in exchange for a promissory note from the trust with interest payable to you at the Applicable Federal Rate (AFR) for the term of the promissory note.

An IDGT is an irrevocable trust most often established for the benefit of your spouse or descendants. The trust is irrevocable by design for purposes of excluding the underlying trust assets from your estate. It needs to be established with a non-interested party as trustee to avoid its accidental inclusion in your estate. Also, for you to maintain income tax liability, the trust instrument must contain one or more of the grantor trust provisions from IRC sections 671–679, making it tax "effective" for transfer tax purposes (completed gift), but tax "defective" for income tax purposes (trust income will be taxed at your level, rather than the trust level, and no gain or loss on sale).

Because the IDGT is a grantor trust, no tax is due on any gain from the sale—you are treated as having sold something to yourself. You keep the ability to maintain an income stream from the installments, or the interest payments are made to the trust to grow the value of the trust corpus for your beneficiaries. If the value of the promissory note is equivalent to the value of the property sold, there is no gift tax liability on the transfer.

For purposes of making the trust "defective," some of the most commonly used grantor trust provisions are the following:

Reacquiring trust assets. Pursuant to IRC Section 674(c), you retain the power to reacquire assets from the trust and substitute them for other assets of equivalent value. This retained interest does not prevent you from making a completed gift to the trust.

Borrowing from the trust. IRC Section 672(a) allows the trust to contain a provision giving you or other non-adverse party the power to take loans from the trust without adequate interest or security. To trigger grantor trust status, this power must be retained by you and not given solely to the trustee.

Changing the beneficiaries. Under IRC Section 674(a), the trust may give you the power of disposition, which affects the beneficial enjoyment of the trust income or principal. For example, you could retain the power to add noncharitable beneficiaries or to direct distributions to existing beneficiaries.

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It's essential that the drafter of an IDGT instrument be aware of all the exceptions to the grantor trust provisions that could have the negative consequence of either losing grantor trust status or causing the trust to be counted in your estate.

Uses

The most common goals to be achieved with this technique include:

- Restricting the future market value of high-growth assets in your estate to the value of a fixed promissory note;
- Shifting the difference between a high-growth asset's return and the promissory note interest rate (the "spread") as a nontaxable gift to the trust beneficiaries (think: heavily discounted assets or pre-IPO shares);
- Allowing you to pay the income tax on trust income that will eventually go to the trust beneficiaries.

How Does it Work?

An IDGT is created. This is an irrevocable trust where you intentionally retain one of the powers listed above. You then transfer "seed" money to the trust for payments on the note. Thereafter, you sell assets to the trust for a promissory note equal to the purchase price. The note must have a minimum interest rate equal to the AFR for the promissory note's term. There is no gain or loss on the sale to the IDGT because the sale is ignored for income tax purposes (it is a grantor trust).

Illustration

You sell $10,000,000 of closely-held assets to an IDGT when the IRS applicable federal mid-term rate (AFR) is 2.5% in exchange for a $10,000,000 promissory note amortized in equal payments over 9 years.

Promissory note terms are that principal and interest are paid ratably over the 9 years.

Assumptions: AFR of 2.5%; 6.5% annual growth on trust assets; note payment of $1,254,569 per year for 9 years.

Results: The difference between the note interest rate and the trust investment return over 9 years (the "spread") is $2,909,287. That amount is eliminated from your taxable estate and is transferred to the trust beneficiaries tax free.

There is no capital gains tax paid on the sale of the assets to the trust because it is a grantor trust.

Income and gains generated by the assets in the trust are taxable to you and become an additional tax-free transfer to the trust beneficiaries.

A 9-year balloon note with interest-only payments on the note would transfer even more (approximately $4,692,741) because the deferred repayment does not deplete the trust until the year of the balloon repayment.

Advantages for You and Your Beneficiaries

The example above illustrates some of the benefits of creating an IDGT and funding it with appreciating assets. This approach serves both as an estate-freezing technique—by giving the beneficiaries the benefit of the appreciation without incurring additional transfer taxes—and as a method for removing assets completely from your estate by putting them in an irrevocable trust.

The income taxes you pay further reduce the value of the estate, and these taxes are not considered additional gifts to the trust or its beneficiaries. In addition, if you engage in a sale of assets to the trust in exchange for a promissory note, there is no recognition of gain or loss.

Essentially, the income earned by the trust is earned free of income tax liability to anyone other than you. The benefits of tax-free

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growth only increase as time passes and the assets appreciate. Furthermore, because of the compressed tax rate schedule for trusts, you are usually in a lower tax bracket than the trust, which makes funding the IDGT with appreciating assets also suitable for income tax savings.

Another advantage comes from the fact that an IDGT is a grantor trust. This gives you the ability to control (to some extent) the beneficial enjoyment of the trust. Many forms of irrevocable trusts that do not include the grantor trust provisions require you to relinquish all rights and powers with respect to the trust and the trust assets, with no retained interest. So, despite being irrevocable by design, IDGTs offer tax benefits, as well as an added level of flexibility for you.

Making a Difference

When drafted and funded appropriately, IDGTs can be a very useful estate planning tool. They can effectively freeze the value of assets transferred to the trust, giving you maximum tax savings. And when the trust is finally distributed, the beneficiaries can enjoy the benefits of the tax-free growth of the assets.