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About our firm:
Tempewick Wealth Management is a wealth and insurance firm with professionals specializing in estate and investment planning, business succession and wealth transfer.

TEMPEWICK WEALTH MANAGEMENT

Installment Sale to an Intentionally Defective Irrevocable Trust

What Is an Intentionally Defective Irrevocable Trust (IDIT)?

An Intentionally Defective Irrevocable Trust (IDIT) is an irrevocable trust designed with the following objectives:

1. Transfers of property to the trust are completed gifts for federal gift and estate tax purposes.

2. The income of the trust is taxed to the grantor, who is treated as the "owner" of the Trust for federal income tax purposes.

3. Trust assets will not be included in the taxable estate of the grantor or grantors.

What Is Meant by "Defective"?

A trust that intentionally violates one or more of the grantor trust rules found in IRC Sections 673–6782 is considered "defective" for federal income tax purposes. By possessing certain trust powers, the grantor or the grantor's spouse are deemed the owner of the trust.

Most commonly, the grantor retains the power in a non-fiduciary capacity to remove assets and replace them with assets of equal value.

When Is an IDIT Appropriate?

Defective trusts are particularly useful when the grantor wishes to remove an appreciating asset from the grantor's estate without making a taxable gift.

How Does an Installment Sale to an IDIT Work?

An irrevocable trust is created to remove assets from the taxable estate, and the grantor (or the grantor's spouse) is given certain powers that cause the trust to be a grantor trust for income tax purposes.

- The grantor "seeds" the trust by making a gift of assets. This gift may be subject to gift tax to the extent that it exceeds the grantor's annual exclusions and available lifetime exemption.

- After the initial gift, the trustee agrees to purchase additional income producing assets from the grantor, such as S-Corporation stock or limited partnership interests.

- In lieu of payment, the trustee gives the grantor a note promising to repay the purchase price, plus interest, over a term of years. The term of the note can be shorter than the term of the trust. The interest rate must be at least equal to the appropriate Applicable Federal Rate (AFR). The note can be structured as either a traditional loan with a portion of the principal and interest due each year, or an interest only note, with the principal repaid at the end of the term.

- Each year, the IDIT's assets are expected to grow and produce income, which accumulates inside the trust. The trust uses this income and/or liquidates the trust corpus to make payments back to the grantor, pursuant to the terms of the note.

- At the end of the trust term, the IDIT assets pass to the named beneficiaries of the trust. If the grantor dies before the note is repaid, the unpaid balance of the note will be included in the grantor's taxable estate.

"Seeding" the Trust

In order for a sale to a trust to be respected for transfer tax purposes, the trust should show the ability to make payments from a source other than the assets that are the subject of the sale to the trust. Thus, prior to the sale, the grantor often makes a gift to the trust of cash or assets worth somewhere between 10 percent and 20 percent of the value of the assets being sold.

What Are the Tax Considerations?

The grantor will not recognize any taxable gain on the initial sale of the appreciating asset to the trust since the grantor and the trust are treated as one and the same for income tax purposes.

In addition, the grantor will not be taxed on the annual interest payments made from the trust to the grantor.

The grantor will, however, be responsible for taxes on all income and capital gains of the trust as long as the trust retains its grantor status. It may be possible, with careful drafting, to write provisions into the trust that allow the grantor status to be "turned off" at a future date. Once a trust ceases to be treated as a grantor trust, the trust income will be taxable to the trust itself.

If the grantor does not survive the term of the note, the unpaid balance will be included in the grantor's estate. The capital gains tax may also apply to any gain not previously taxed.

Considerations

This strategy is based on interpretations of IRS rules. As such, significant regulatory risk exists.

- The trust must be irrevocable to avoid inclusion of assets in the grantor's estate.
- If the trust beneficiaries have Crummey withdrawal rights over the initial gift to the trust, it may be argued that the beneficiary, rather than the grantor, is owner of the assets for income tax purposes.
- The grantor should not retain a reversionary interest of more than 5 percent of the trust corpus, or the trust will be included in the grantor's estate.
- Advisors in community property states should be aware that the grantor of an IDIT may be each spouse according to his or her community interest.
- The trustee must be non-adverse to the grantor(s). A non-adverse party has no substantial interest in the trust and would not be adversely affected by the exercise or non-exercise of the power.