

INSTALLMENT SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST

A popular estate planning transaction involves a sale, usually for an installment note, to an intentionally defective grantor trust ("IDGT"). The value of the asset is "frozen" at the value of the note received in the sale so that future appreciation in the value of the asset sold to the IDGT will be transferred to the beneficiaries of the IDGT without gift or estate tax.

The sale is not recognized for income tax purposes (i.e., there is no taxable gain) because the grantor and the trust are treated as the same entity (Rev. Rul. 85-13, 1985-1 CB 4). However, the transaction is effective for gift and estate tax purposes, and, assuming the sale is for fair market value, the value of the asset sold will not be includible in the grantor's estate at his or her death. If the grantor dies during the term of the note, the value of the note will be includible in his or her estate.

A gift should be made by the grantor to the trust prior to the sale transaction. This gift should be at least 10 percent of the value of the asset that will be sold to the trust and will help establish the trust as a viable, separate entity capable of repaying the note. The gift may be sheltered from federal gift tax by using the \$1 million gift tax applicable exclusion amount. Unless the gift can be exempted by the use of the \$13,000 annual exclusion, Tennessee gift tax will have to be paid. In effect, the gifted assets will serve as security for the note. The failure to provide sufficient coverage for the note may result in the IRS attacking the arrangement as a transfer with a retained interest under Code Sec. 2036.

The note must provide for interest to accrue on the outstanding balance of the note at the prescribed Code Sec. 1274(d) rate in effect on the date of the sale. As interest payments are made to the grantor, no recognition of income occurs for federal income tax purposes. To the extent assets subject to the installment sale outperform the interest rate, the growth will inure to the benefit of the IDGT. Because the IDGT will not have to pay federal income taxes, the likelihood of growth in excess of the Code Sec. 1274 rate is further enhanced.