The estate law uncertainty created by a dysfunctional Congress and political posturing has resulted in a planning environment of confusion and extremes, ranging from no estate tax, to generous gift and estate exemptions, to the re-imposition of only a $1 million gift and estate exemption amount with a 55% tax rate.

This article discusses a common strategy that remains viable during 2012—using an intentionally defective grantor trust (IDGT) to achieve estate tax advantages. Indeed, as prevalent as IDGTs have been this past decade for asset transfers, they should be even more popular this year because 2012 may be the last year all the IDGT advantages exist. However, this article’s primary focus is not the transfer tax advantages of using an IDGT—those advantages are well known and documented. Rather, this article considers common pitfalls associated with using IDGTs that may be overlooked, many of which are income tax related.

Consider these case studies:
1. Harry and Wiley, husband and wife, have $10 million in marketable securities. Harry creates an IDGT for Wiley, naming her as trustee and a beneficiary along with the children. Wiley creates an IDGT for Harry, naming him as trustee and a beneficiary along with the children. They each transfer $5 million of marketable securities into the other’s trust. Assuming each trust does not give Harry or Wiley a general power of appointment, Harry and Wiley can be both the trustee and a beneficiary with their children. Thus, as long as Harry and Wiley are married and living, they can continue to benefit from the trust income and assets, yet take advantage of the $5 million exemption amount while it exists, thereby sheltering $10 million from estate tax. Or can they?

2. Harry also owns Harry’s Security Company (the Company), a $40 million business that provides consulting services and hardware. Harry’s estate lawyer has recommended converting from a C corporation to an S corporation to facilitate a stock transfer using an IDGT. Harry knows the stock can be discounted for gift tax purposes, particularly if a class of nonvoting stock is created. However, his accountant has raised several income tax issues, including the effect of nonvoting stock on the S corporation status, eligible S corporation shareholder issues, and the imposition of the built-in gains (BIG) tax. Do these income tax issues trump the estate tax advantages?
3. Harry knows that limited liability companies (LLCs) are useful planning tools because they provide asset protection and because nonvoting LLC interests can be transferred to enhance market and minority discounts, similar to transferring nonvoting stock in a corporation. Thus, Harry can transfer as much as 99% of the LLC equity but yet retain 100% control. In fact, the office building the Company rents is held in HW LLC, which is owned 50% each by Harry and Wiley. Because of these LLC advantages, Harry is considering transferring his Company stock to HW LLC, or creating a separate LLC to own the Company stock. Harry's thought is that, if he transferred all of his Company stock to an LLC, he could then transfer a nonvoting assignee interest in the LLC to his IDGT and thereby avoid having to create nonvoting Company stock. However, once again Harry's accountant has raised a number of issues pertaining to the LLC and the IDGT, including whether HW LLC, can own S Corporation stock, and whether Harry and Wiley can transfer their HW LLC, 50% interests to one IDGT. He mentions there may also be FICA taxes added to the tax cost of using an LLC.

After a brief introduction to the current estate and gift tax state of affairs and a review of IDGT mechanics, this article will address the planning pitfalls pertaining to the fact scenarios above.

### 2012—The end of the world as we know it

In the estate world, the dominant theme in 2011 was the extraordinary asset transfer opportunities available to the wealthy. One could give $5 million ($10 million for a married couple) to children or other beneficiaries in a “dynasty trust” (i.e., a trust lasting in perpetuity) and thereby protect those assets from estate tax and creditors. The dynasty trust was often created as an IDGT as described below. The assets also could be discounted to 60% or 70% of their value for transfer tax purposes. The gifts could be leveraged to allow for even greater asset transfers, through techniques that benefit from low interest rates.

In short, the stagnant economy, low interest rates, and advantageous gift and estate tax laws, combined to make 2011 a banner year for wealthy taxpayers doing estate planning. Will this optimal estate planning environment continue in 2012? Financial experts expect the stagnant economy and low interest rates to continue. Also in place is the $5 million exemption, which was increased by $120,000 for a cost of living adjustment. The Obama administration and Congress have targeted discounts on intra-family transfers and limiting dynasty trusts to 90 years, but both advantages currently remain.

It is likely that the $5,120,000 exemption will remain until 2013, when the exemption amount falls to $1 million. Hopefully, discounts and unlimited dynasty trusts will remain too. Thus, those who wanted to act in 2011 but failed to do so still have the opportunity to transfer significant assets estate and gift tax-free during 2012.

### Why transfer assets to an IDGT

Lifetime gifts of assets, such as closely held stock, real estate, or marketable securities, from parents to children shift such assets to the next generation while minimizing estate taxes. For large gifts, an
outright transfer, although simple and straightforward, may not be the most effective transfer technique. Aside from tax considerations, outright gifts may not be in the child's best interest depending on age, financial acumen, and asset protection considerations.

One common method is a gift, or a gift and sale, of assets to an IDGT. The IDGT beneficiaries are often the children and future generations as well as the other spouse. Because the IDGT can be designed as a dynasty trust, estate tax is avoided not only at the parents' deaths but also for future generations. IDGTs also are beneficial because the trust is taxed as a "grantor trust." As a grantor trust, there is no income tax to the grantor on the sale of assets to the IDGT. The trust income also is taxed to the grantor, thereby resulting indirectly in greater tax-free gifts to the trust beneficiaries. Transfers to such a trust are said to be "effective" for estate tax purposes, but "defective" for income tax purposes. This inconsistency between the estate and income tax provisions creates the planning opportunities noted above.

How to transfer assets to an IDGT

Assets can be transferred to an IDGT by (1) a gift or by (2) a part gift and part sale. If the assets transferred are $5,120,000 million or less ($10,240,000 for a husband and wife) and the transferor has his or her full exemption available, a simple gift can be made to the IDGT. However, often the assets are both given as gifts and sold to the IDGT to leverage the amount of assets that can be transferred, preserve the exemption amount, or retain income.

In a gift and sale scenario, the gift acts as the down payment, analogous to a down payment in a third party sale. As a rule of thumb, the value of this "seed" gift should be at least 10% of the value of all assets transferred to the trust, including assets transferred by both gift and sale. When the gift is made, the transferor would use his or her lifetime gift exemption to avoid paying gift taxes.

Next, the transferor sells assets to the IDGT, such as company stock, LLC interests, or real estate, in exchange for an installment note. The note would bear interest at the applicable federal rate (AFR) required under Section 1274(d). This rate is set for the life of the loan. The incredibly low AFR rate for a nine-year note for July 2012 is 0.92%. Because the IDGT is a grantor trust for income tax purposes, the sale of the asset would not result in any taxable gain to the grantor (for income tax purposes, the grantor is considered to be selling an asset to him or herself). There also is no interest income reported by the grantor or interest deduction to the IDGT.

Consider this example of how Harry could transfer $40 million of Company's stock to an IDGT for Wiley, the children, and future generations and remove the value and its appreciation from his estate.

1. Give $5 million in stock as a gift to the IDGT.
2. Sell $35 million in stock to the IDGT. The promissory note is annual interest-only, 0.92%, with a nine-year term balloon payment. The annual interest payment would be $322,000 ($35 million principal times 0.92% AFR interest rate).
3. If the dividend on the $40 million of stock is 7% each year, the IDGT income would be $2.8 million.
4. After the payment of interest, the balance of the IDGT income may be accumulated and reinvested by the IDGT, used to pay down principal, or disbursed to the IDGT beneficiaries.

Case Study 1

In the first scenario, Harry and Wiley each created an IDGT naming the other as trustee, and as a beneficiary along with the children. They each transferred $5 million in marketable securities to the IDGT they each created. Because each IDGT will continue in perpetuity, the assets will avoid estate tax and be protected from divorce or lawsuit for the children and future generations. But after designing the trust provisions, did they fail to consider various tax and nontax issues?

First, what happens if Harry and Wiley divorce? If Harry transferred separate property to the IDGT for Wiley, he would no longer own the property. In contrast, if the assets were accumulated during marriage, the funding of the two IDGTs would simply be a pre-funding of the asset division that otherwise would occur in a divorce. The IDGT could define the "spouse" as not specifically Harry and Wiley, but as "the person the Grantor is married to and living with" at the time a distribution is required. Harry and Wiley also could reserve the right to remove the other as the trustee provided they appointed an independent trustee. Harry and Wiley could also grant to a third party that they totally trust a limited power of appointment (see footnote 2) to redi-
rect the assets, including back to Harry and Wiley. (This could present a problem under Section 2036 as a transfer with a retained interest, unless the power is exercisable only following divorce.)

Second, what happens if either Harry or Wiley dies? For example, if Harry dies, Wiley can no longer access the income and principal from the assets she transferred to the trust for Harry (During Harry's lifetime, both she and Harry would benefit from income and principal from the trust she created. Now their children are the only beneficiaries). The trust created by Harry could purchase a life insurance policy on Harry's life to be owned by the IDGT in which Wiley is the trustee and beneficiary. The policy could be an inexpensive term policy, to cover a period of time, or a permanent policy. Either way, the death proceeds would be estate tax free, provide leverage for Harry and Wiley's portfolio, and be available for the surviving spouse.

A third issue is tax related. Because Harry and Wiley created virtually identical trusts, they would be left in the same economic position as they would have been if they had created the trusts naming themselves as life beneficiaries of their own trusts. Thus, the IRS would conclude that the "reciprocal trust doctrine" applied, and the courts would agree. The result would be that all the assets are included in Harry's and Wiley's estates. Fortunately there is a solution here as well: Each IDGT can provide the benefits Harry and Wiley desire in substantial part, but there would be key differences: In the trust created by Wiley for Harry, there would be these differences:

- Harry would have a limited power of appointment.\(^\text{10}\)
- The children would not be beneficiaries until Harry's death.
- Income would be paid to Harry automatically while he is living. (Wiley would receive discretionary payments from the trust Harry created for her.)

Case Study 2

Instead of giving marketable securities as gifts, Harry intends to transfer to his IDGT his biggest asset, the Company stock. The transfer will be a part gift and part sale, as described in the example above. The S corporation election is critical so that Company distributions can pass to the IDGT to service the debt on the sale of the stock with only a single tax at the shareholder level. Harry's accountant has raised a number of income tax issues regarding Harry's decision to elect S corporation status. These issues include: 1) the one-class-of-stock requirement; 2) eligible shareholder issues; and 3) BIG tax issues.

Voting and nonvoting stock. Harry knows that an S corporation may not have more than one class of stock.\(^\text{12}\) He intends to create nonvoting stock and then transfer nonvoting stock, representing 99% of the corporation's outstanding shares, which will enhance the minority discount. He will retain the voting stock, representing 1% of the outstanding shares and control of the Company.

The law is clear that stock that differs solely in voting rights does not violate the one-class-of-stock requirement.\(^\text{13}\) However, the S Corporation...
orporation status would be busted if there are differences in shareholder distributions or liq-
uidation proceeds. Here, Harry wants the dis-
tributions to flow pro rata to the IDGT to 
service the debt owed to him. Further, if he 
sells the Company, the estate advantages 
are achieved because 99% of the sales proceeds 
flow to the IDGT. (Within reason, Harry will 
still be able to control what he receives from 
the Company by adjusting his compensation 
and the dividends.) Thus, Harry's goals and 
the law are in sync on this issue.

Transfers to trust. Harry's accountant knows 
that an S corporation can have only certain types 
of shareholders. S corporation eligible share-
holders include only certain kinds of trusts. A 
grantor trust, such as Harry's IDGT, is eligible to 
be an S corporation shareholder. Thus, as long as 
Harry is alive, there is no issue with the S election 
and the stock being held in his IDGT.

Upon Harry's death, however, the IDGT 
ceases to be a grantor trust. It must become ei-
ther a qualified subchapter S trust (QSST) or an 
electing small business trust (ESBT). To qual-
ify as a QSST, Harry's trust must meet several 
requirements, including distributing all of its 
current income to a single beneficiary who is a 
U.S. citizen or resident. The primary disad-
antage of the QSST is that it cannot be used to 
benefit multiple beneficiaries or allow income 
to accumulate. In Harry's case, the IDGT as-
sets will be equally divided for his beneficiaries 
upon his death, but, because the assets are for-
ever protected from estate tax, the trustee may 
want to accumulate income in certain years for 
the beneficiaries. Thus, the QSST would not be 
the best choice.

Instead, Harry's IDGT would elect to be an 
ESBT. A trust qualifies as an ESBT if all of its 
beneficiaries are individuals, estates, or certain 
types of charities; if no beneficiary purchases 
an interest in the trust; and if the trustee files 
a timely ESBT election with the IRS. An ESBT 
offers the estate planning flexibility that Harry 
desires because the trust income can be accumu-
lated or it can be sprinkled among the ben-
eficiaries, i.e. the children and future genera-
tions. The main disadvantage is that the trust's 
income is taxed at the highest marginal rate, 
while a QSST's income is taxed at the lower ben-
eficiary's marginal rate, which is often lower. 
This is neutralized in a situation where the in-
dividual already is paying tax at the highest 
rate. For S corporation purposes, each benefici-
ary of an ESBT is treated as a shareholder.

Built-in gains tax issues. Harry's accountant has 
also asked about the transfer of the stock to the 
IDGT and the BIG tax. When the Company con-
verts from a C corporation to an S corporation, 
there are BIG tax issues for Harry to consider. The 
BIG tax applies to certain property or assets held 
by the Company at the time of the conversion, if 
the Company is then sold within the "recognition 
period." The recognition period traditionally is ten 
years. If the property is sold less than ten years 
after the conversion, the S corporation must pay a 
tax on the built-in gain at the time of conversion 
to an S corporation equal to 35%.

However, the transfer of the stock from 
Harry to his IDGT does not in and of itself trig-
ger the BIG tax, as the BIG tax usually applies 
only to an asset sale and not a stock sale. 
Nonetheless, it is smart planning for Harry to 
value the Company's assets at the time of its 
conversion to an S corporation. This will be 
very important if the assets are sold within the 
recognition period.

Case Study 3

Harry is considering using his existing LLC, HW 
LLC, which owns his office building, as the trans-
fer vehicle to achieve enhanced asset protection 
and valuation discounts. As a first step, the Com-
pany stock would be transferred to the LLC, and 
then a 99% LLC assignee interest would be trans-
ferred to the IDGT. However, are there restric-
tions, or at best complications, that would pre-
clude the transfer of an interest in an LLC that 
holds S corporation stock?

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Single-member LLC as shareholder in an S corporation. Case Study 2 shows that Harry can transfer his Company stock to an IDGT and retain its S corporation status. However, now Harry is considering transferring the Company first to HW LLC. If HW LLC was owned entirely by Harry, this step alone would not jeopardize the S status. The IRS has held that a single-member LLC can be an eligible shareholder of an S corporation as long as the LLC is completely owned by an eligible S corporation shareholder (e.g., an individual or a grantor trust). Thus, if HW LLC is entirely owned by Harry or by his IDGT, there would be no S election problems.

Harry wants to transfer partial ownership of HW LLC to his IDGT. However, Harry wants to transfer only a 99% assignee interest to the IDGT and retain a 1% voting interest. There is no authority on point regarding whether an S corporation owned by an LLC can retain its status if the LLC members are Harry and Harry’s IDGT. The IRS has held that an LLC owned both by a single person and that person’s IDGT, is a disregarded entity for federal income tax purposes. Thus, if a disregarded-entity LLC owned by either Harry or his IDGT can be an S corporation shareholder, and if an LLC that is owned by both Harry and his IDGT is a disregarded entity, it is reasonable to take the position that HW LLC, owned by both Harry and his IDGT, can be an eligible S corporation shareholder.

Is HW LLC still a disregarded entity if it is owned by Harry and Wiley? Although it is likely that an S corporation owned by an LLC that is owned by an individual and his IDGT retains its S status, what if a second individual or entity became a member of the LLC? In that case, it is clear that the S election would be busted. The LLC would no longer be disregarded, and instead it would be treated as a partnership for tax purposes. A partnership cannot own stock of an S corporation.

In Case Study 3, the initial fact scenario was that HW LLC, was owned jointly by Harry and Wiley. Are a husband and wife treated as dual members, thus busting the S election, or are they treated as a single member because they are married? Perhaps in community property states, or if conducting a “qualified joint venture,” a married couple would be deemed a “single member.” Why take the chance, however? Both for liability protection and to ensure the LLC is a disregarded entity, Harry should create his own LLC and transfer the Company stock into the new LLC. The LLC interest would then be transferred to an IDGT for Wiley. Alternatively, Harry could transfer the stock first to Wiley (or to an LLC 100% owned by Wiley) and, after several weeks, or even better several months, Wiley could transfer the stock (or LLC interest) into an IDGT for Harry. Wiley would be the Grantor and Harry would be the Trustee and beneficiary. Harry could then again control the Company. The planning could use the two trust scenario discussed in Case Study 1.

Create nonvoting interest in HW LLC. What about Harry’s idea to transfer the voting stock to an LLC, retain a 1% membership interest (which represents the sole voting interest), and transfer a 99% assignee interest to his IDGT. Does this avoid the need to create voting and nonvoting stock, as in Case Study 2? Unfortunately, if Harry transfers only voting stock to his newly owned LLC and retains voting rights in the LLC, he would violate Section 2036(b). Included in Harry’s estate would be the entire stock through his 1% LLC interest, all of the stock is in his estate.

A grantor is any person who creates a trust, or directly or indirectly makes a transfer of property to a trust (Reg. 1.671-2(e)(1)). Section 676 provides that a person other than a “donor” is treated as owning a portion of a trust to the extent such person either (1) could vest the income or principal of the trust in himself or herself; or (2) released, in whole or in part, a power described in (1) and following the release, such person possessed certain interests or powers in the trust, e.g., a Crumey withdrawal right.

32 FICA taxes are federal payroll taxes that include Social Security and Medicare and are 15.3%. The employer and the employee each contribute half the amount.

33 Roughly $7,500 per $100,000 of income, assuming one-half the income is paid as salary ($50,000) and one-half is treated as an S corporation distribution rather than $100,000 as an LLC distribution.

24 Ltr. Rul. 200816002.
25 The closest authority is Ltr. Rul. 200102037, which is instructive but not precedent.
27 Small Business and Work Opportunity Tax Act of 2007 (Section 761(f)). A qualified joint venture is defined as a joint venture involving the conduct of a trade or business, in which (1) its only members are a husband and wife, (2) each of the spouses materially participates in the trade or business, and (3) both spouses elect to treat the business entity as disregarded for federal income tax purposes. The material participation standard is met if both husband and wife are involved in the operations of the activity on a basis that is regular, continuous, and substantial.
29 Section 2036(b). “A controlled corporation” is a corporation in which the decedent has the right to vote stock consisting of at least 20% of the total combined voting power of all classes of stock. Because Harry can vote 100% of the voting stock through his 1% LLC interest, all of the stock is in his estate.
30 A grantor is any person who creates a trust, or directly or indirectly makes a transfer of property to a trust (Reg. 1.671-2(e)(1)). Section 676 provides that a person other than a “donor” is treated as owning a portion of a trust to the extent such person either (1) could vest the income or principal of the trust in himself or herself; or (2) released, in whole or in part, a power described in (1) and following the release, such person possessed certain interests or powers in the trust, e.g., a Crumey withdrawal right.
31 FICA taxes are federal payroll taxes that include Social Security and Medicare and are 15.3%. The employer and the employee each contribute half the amount.
32 Roughly $7,500 per $100,000 of income, assuming one-half the income is paid as salary ($50,000) and one-half is treated as an S corporation distribution rather than $100,000 as an LLC distribution.
33 Harry would file IRS Form 2553 Election by a Small Business Corporation and Form 8832.
value of the Company despite the transfer of a 99% nonvoting LLC interest to the IDGT. Because Harry’s Company is a “controlled corporation,” and because Harry can vote 100% of the voting stock through his 1% LLC member interest, all of the stock would be in his estate.29 Thus, although the LLC may provide Harry with better asset protection and perhaps a greater discount of the stock value because the transfer is through a 99% assignee interest, it would not avoid the need to create voting and nonvoting stock. Only the nonvoting stock would be owned by the LLC.

Can Harry and Wiley transfer their HW LLC interest to one IDGT? Assume HW LLC will not own S corporation stock because it may not be a disregarded entity; but only the office building. Harry and Wiley each intend to transfer a 49% assignee interest to an IDGT. They will each retain a 1% membership interest to retain 100% control. Should they create one IDGT or should they each have an IDGT?

The “grantor” of an IDGT is generally subject to income tax on the trust income.30 The grantor is the individual that creates the IDGT and transfers assets to it. Typically, under Sections 673 through 679, the grantor is also the owner of all the IDGT assets for income tax purposes. However, under Section 678, someone other than the grantor may be considered the owner and subject to trust income.31

If one IDGT receives Harry and Wiley’s 49% assignee interests through a gift and sale transaction, both Harry and Wiley are grantors of half the trust. Because they are married and reporting income on their joint return, there should not be income tax on the sale portion of the transaction. However, to avoid complications, Harry and Wiley should consider each transferring their interest to their own IDGT. The following plan, however, would be even better:

1. Wiley transfers her 50% interest in HW LLC, to Harry.
2. After a reasonable time (see the cases cited in footnote 28), Harry transfers a 99% assignee interest to his IDGT, naming Wiley as the beneficiary and trustee, along with the children.

The advantages of this plan include the following:

• Harry retains control of the assets as the LLC managing member.
• Wiley is trustee and a beneficiary of the IDGT assets.
• Harry can simplify the reporting because HW LLC can file as a disregarded entity.

Additionally, now the Company nonvoting stock could be transferred to the LLC without jeopardizing the S election. Harry and Wiley would either gift split or, as a separate step, Wiley could use her exemption and create her own IDGT to transfer assets to a trust for Harry and the children as in Case Study 1.

What about FICA tax issues? If HW LLC is taxed as a disregarded entity, the taxable income is subject to the Federal Insurance Contributions Act (FICA) taxes.32 On the other hand, S corporations pay FICA on W-2 wages, but not distributions. In order for HW LLC to avoid paying FICA on 100% of its income, it could elect to be taxed as an S corporation, even if it is owned 50% each by Harry and Wiley or solely by Harry and his IDGT. The income tax savings attributable to an S election can be significant.33 Harry should consider electing S status for the LLC34 unless the LLC would own nonvoting stock in the Company, which would bust the Company S election.

Conclusion

The advantages of lifetime transfers using IDGTs that can last in perpetuity are well known. It is likely that this transfer strategy will be even more prevalent over the remaining months of 2012. By 2013, it is doubtful that all the transfer advantages will survive, e.g., the $5,120,000 gift exemption, intra-family discounts on transferred assets, and low interest rates. With this in mind, in their haste to complete the transfers, practitioners and their clients need to avoid traps in the planning. The issues illustrated in the Case Studies set forth above provide a practical way to navigate through the planning minefields. ■