THE DILEMMA OF FINANCED NET GIFTS VERSUS SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

BY SORAYA TABIBI-AGUIRRE, ESQ.; BRIAR STAHL, ESQ.; & TIMOTHY RILEY, ESQ.

There has been significant press lately regarding the use of financed net gifts as alternatives to sales to intentionally defective grantor trusts (IDGTs).[1] This article explores the pros and cons of each.

Installment Sales to Intentionally Defective Grantor Trusts

The installment sale to an IDGT is a popular wealth-shifting tool. This commonly-used strategy often begins with the formation of the IDGT.

Step 1: Creation of an IDGT

An IDGT is an irrevocable trust, the grantor of which is treated as the "owner" for income tax purposes. This is accomplished by intentionally triggering certain sections of the Internal Revenue Code that cause all of the income from the trust to be taxed to the grantor. One way to make an irrevocable trust an IDGT is by authorizing the grantor to substitute trust assets with assets of equivalent value in the grantor's estate.

Step 2: Funding the IDGT

Before the grantor may sell assets from his estate to the IDGT on an installment-sale basis, the trust must demonstrate that it is credit worthy; otherwise, the IRS may not view the sale as "arm's-length" and may recharacterize the entire sale as a gift. A rule of thumb applicable to pre-funding an IDGT is that the grantor should make a "seed gift" to the IDGT such that the debt-to-equity ratio after the sale is nine to one (e.g., if the fair market value of the asset to be sold to the trust (after applying any applicable discounts) is $9 million, the grantor should fund the IDGT with an initial gift of $1 million). Provided the grantor has not used any or all of his lifetime gift tax exemption, he may be able to make the gift to the IDGT without paying a gift tax.

Step 3: Appraisal

Order an appraisal of the asset(s) to be sold to the IDGT.

Step 4: Sale of assets to IDGT on installment-sale basis

A purchase agreement between the grantor and the trustee of the IDGT is prepared whereby the grantor agrees to transfer the asset to the IDGT in exchange for a promissory note for the amount of the fair market value of the asset as appraised.

Step 5: Promissory note

The asset is re-titled in the name of the IDGT and the trustee, on behalf of the IDGT, issues a promissory note to the grantor. The promissory note must provide for a rate of interest of at least the applicable federal rate (AFR).[2] The note should be secured by a security agreement and financing statement (or deed of trust when dealing with real property) in order to solidify the "arms-length" nature of the sale transaction. Because the trust is an IDGT and the grantor is considered the owner of the

trust for income tax purposes, the interest income on the note will be disregarded for income tax purposes. Likewise, the grantor will not recognize any gain on the sale of the asset(s) to the trust.[3]

Problems with Installment Sales to IDGTs

The transaction outlined above may not be preferred in situations where the grantor does not have the gifting capability to support the sale. This may be the case when the grantor has previously used all of his lifetime gift tax exemption, thereby requiring the grantor to pay a large out-of-pocket gift tax. Similarly, if the asset the grantor wishes to sell to the IDGT is valued at more than 10 times the amount of the grantor's remaining gift tax exemption amount, the grantor may be required to pay a gift tax on the initial "seed gift." In these situations, practitioners often recommend that the transfer be accomplished via grantor-retained annuity trust as an alternative to the grantor paying a gift tax. However, prefunding an IDGT with a financed net gift allows a donor to shift the gift tax liability and can provide for enormous wealth-shifting and growth potential out of the grantor's estate.

What Are Net Gifts and How Are They Calculated?

A net gift is a gift in which the donee agrees to pay the gift tax liability arising from the gift as a condition to the transfer. The gift tax attributable to the gift may be "deducted from the value of the transferred property."[4] The gift tax liability on a net gift may be calculated by dividing the tentative amount of tax on the gift by one plus the tax rate.

For example: Donor makes a gift of $1 million to donee. Donee agrees, by written agreement before the transfer, to pay the gift tax liability associated with the gift. Donor has previously used all of his lifetime gift tax exemption. The current gift tax rate is 35 percent. The net gift tax liability equals (1,000,000 x 0.35) divided by (1 + 0.35), or $259,259.25. The gift tax paid by the donee on the net gift is only approximately 26 percent of the gift as opposed to 35 percent if paid by the donor. Here, the amount of tax paid to the IRS is reduced by $90,740.75 simply by the donee agreeing to pay the gift tax before the transfer and conditioning the gift on that agreement.

In order to ensure that a transaction is given net gift tax treatment, it is important to document the fact that the donee is paying the tax liability on the gift as a condition of the transfer. Although the referenced revenue ruling does not require the agreement to be in writing, the authors recommend that the donor and donee enter into a separate written agreement before the transfer occurs. If a grantor makes a net gift to an irrevocable trust, we strongly recommend that a written agreement be executed between the grantor and trustee on behalf of the trust.

Financed Net Gifts

Although net gifts result in less gift tax paid, one may argue that having the donee pay the gift tax instead of the donor reduces the wealth-shifting aspect of the transaction. Specifically, when the wealth-shifting plan involves assets transferred to a trust for the benefit of the donee, it may be undesirable to immediately have the trust pay out a portion of the transferred wealth to the IRS. However, if the grantor were to lend the cash to the trust necessary to pay the net gift tax in exchange for a promissory note, the trust would retain its value. A recent study performed by the Wealth Management Group at Bernstein Global Wealth Management compared the range of wealth

FINANCED NET GIFTS

continued from page 15

transferred under the standard installment sale to an IDGT strategy to the financed net gift strategy. With all other variables being equal, the financed net gift strategy out-performed the sale strategy significantly when considering the amount of wealth shifted.[5]

Drawbacks of Financed Net Gifts

Although the financed net gifts strategy presents incredible wealth-shifting opportunities, there are a few disadvantages. First and most obvious is the fact that a gift tax is paid to the IRS. However, when considering how this strategy may outperform an IDGT sale as a wealth-shifting tool, clients may be more willing to accept the gift tax component. Second, the donor may recognize capital gain on the amount by which the gift tax liability exceeds the donor's adjusted basis in the asset transferred. However, this gain can be disregarded simply by structuring the transfer such that the net gift is made to an IDGT.[6] Third, and most importantly, the three-year rule of Section 2035(b) of the Internal Revenue Code may still apply. This means that if the donor dies within the three-year period following the date of the net gift, the gift taxes paid on the gift may be included in the donor's gross estate and subject to estate tax.[7]

Comparison of Strategies: Financed Net Gifts v. Sales to IDGTs

Comparing financed net gifts with installment sales to IDGTs, we find that on a one-transaction basis the financed net gift comes out significantly ahead. This may be illustrated by the following example.

FACTS: John has an estate valued at $50 million. John's estate includes limited liability company (LLC) membership interests valued at $18 million. John wishes to transfer the interests to an IDGT for the benefit of his children. John has used all of his gift tax exemption. The current gift tax rate is 35 percent. The current AFR is 5 percent. The IDGT realizes an annual rate of return of 10 percent.

SALE STRATEGY: In order for John to properly fund the IDGT before the sale, John must make a gift of $2 million to the IDGT and pay the IRS a gift tax of $700,000. John proceeds with selling the LLC membership interest to the IDGT on an installment-sale basis. The note is structured as a nine-year interest-only note with a balloon payment at the end of the term.

SALE STRATEGY

Year	Trust Value at Start of Year	Growth	Interest and Principal Paid	Trust Value at End of Year
1	$20,000,000	$2,000,000	($900,000)	$21,100,000
2	$21,100,000	$2,110,000	($900,000)	$22,310,000
3	$22,310,000	$2,231,000	($900,000)	$23,641,000
4	$23,641,000	$2,364,100	($900,000)	$25,105,100
5	$25,105,100	$2,510,510	($900,000)	$26,715,610
6	$26,715,610	$2,671,561	($900,000)	$28,487,171
7	$28,487,171	$2,848,717	($900,000)	$30,435,888
8	$30,435,888	$3,043,589	($900,000)	$32,579,477
9	$32,579,477	$3,257,948	($18,900,000)	$16,937,425

The result is that for gift taxes of $700,000, John has successfully shifted $16,937,425 out of his estate for estate tax purposes.

FINANCED NET GIFTS STRATEGY: John forms an agreement with the trustee of the IDGT such that in exchange for John making a net gift of the LLC membership interest to the IDGT, the trustee will pay the gift tax liability associated with the gift. The IDGT has a gift tax liability of $4,666,666. John lends the trust $4,666,666 in exchange for a promissory note. The trustee pays the net gift tax. The note is structured as a nine-year interest-only note with a balloon payment at the end of the term.

continued on page 18

FINANCED NET GIFTS

continued from page 17

FINANCED NET GIFTS STRATEGY

Year	Trust Value at Start of Year	Growth	Interest and Principal Paid	Trust Value at End of Year
1	$18,000,000	$1,800,000	($233,333)	$19,566,667
2	$19,566,667	$1,956,667	($233,333)	$21,290,001
3	$21,290,001	$2,129,000	($233,333)	$23,085,668
4	$23,085,668	$2,308,567	($233,333)	$25,160,902
5	$25,160,902	$2,516,090	($233,333)	$27,443,659
6	$27,443,659	$2,744,366	($233,333)	$29,954,692
7	$29,954,692	$2,995,469	($233,333)	$32,716,828
8	$32,716,828	$3,271,683	($233,333)	$35,755,178
9	$35,755,178	$3,575,518	($4,899,999)	$31,430,697

In comparing the sale strategy to the financed net gifts strategy, the financed net gift strategy will likely outperform, leaving the IDGT with much greater value. However, the financed net gift strategy bears higher risk in that if John dies within three years from the date of the net gift, the $4,666,666 gift tax paid by the IDGT will be included in John's estate for estate tax purposes.

However, this is only one consideration. If a client is looking for a simple, one-time transaction, the financed net gift is definitely an attractive alternative; on the other hand, if the client's goal is to minimize taxes and he has the willingness to engage in multiple wealth-shifting transactions, the sale strategy will likely result in moving more wealth over time.

For example, assuming the same facts as above and assuming John has no need for the income stream from the note on the sale to the IDGT, $900,000 annually can be reinvested into assets which can either be the basis for a sale or can be placed into a grantor-retained annuity trust. On the other hand, with a financed net gift, John would be deprived of a significant income stream and would have less available to roll into ongoing transactions. As you can see below, if you invest the difference between the initial outlay to John for each transaction, or $2,633,333 ($18,000,000 plus $4,666,666 as a loan for gift taxes for the financed net gift; less $20,000,000 plus $700,000 for gift taxes for the sales transaction), in assets with a 7 percent rate of return after the first year, an additional $4,524,557 will result at the end of the nine-year term.

NINE-YEAR TERM

Year	Amount	Growth	End of Year Value
2	$2,633,333	$184,333	$2,817,667
3	$2,817,667	$197,237	$3,014,903
4	$3,014,903	$211,043	$3,225,947
5	$3,225,947	$225,816	$3,451,763
6	$3,451,763	$241,623	$3,693,386
7	$3,693,386	$258,537	$3,951,923
8	$3,951,923	$276,635	$4,228,558
9	$4,228,558	$295,999	$4,524,557

Without additional planning, that additional $4,524,557 may be subject to estate tax on John's death but most of us would agree that this is a good problem to have! For more information on how to make the most of your wealth-shifting opportunities, please contact us at (775) 327-3000 or (702) 222-2500. ■



SORAYA TABIBI-AGUIRRE, BRIAR STAHL AND TIMOTHY RILEY are attorneys in the private client group at Holland & Hart, LLP. Their practices focus on estate planning and wealth shifting for high net-worth individuals in the Reno, Carson City and Las Vegas areas. They can be reached at: staguirre@hollandhart.com, bkstahl@hollandhart.com or triley@hollandhart.com.

1 What's the Bottom Line?, Trusts & Estates, Dec. 1, 2008, and David A. Handler, Financed Net Gifts: No-Hassle Asset Transfers, University of Miami's 44th Annual Heckerling Institute on Estate Planning.
2 IRC Sections 1274 and 7872.
3 Rev. Rul. 85-13, 1985-1 C.B. 184.
4 Rev. Rul. 75-52, 1975-1 CB 310 (Jan. 1, 1975).
5 What's the Bottom Line?, Trusts & Estates, Dec. 1, 2008.
6 Rev. Rul. 85-13, 1985-1 C.B. 184.
7 See *Sachs Est. v. Comr.* 88 T.C. 769 (1987), aff'd on this issue, 856 F.2d 1158 (8th Cir. 1988).