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State tax nexus—the problem just won't go away

The Integrated Offshore Intentionally Defective Grantor Trust

By Mark Merric and Edward D. Brown

A new approach to structuring the defect that is the key to the advantages of the IDIT may provide taxpayers with much more flexibility. During a period when financial markets have been, to say the least, unpredictable, and in light of the uncertain status of the estate tax law under the on-again, off-again provisions of EGTRRA, such flexibility may be increasingly desirable. By using foreign trust status as the litmus test for classification as a grantor trust, taxpayers may avoid the inherent weaknesses of other techniques.

MARK MERRIC is the principal of Merric Law Firm, LLC, in Denver. He is also a CPA. An adjunct professor in the University of Denver Graduate Tax Program, Mr. Merric practices in the areas of estate planning, business transactions, international tax, and asset protection planning. EDWARD D. BROWN is a member of the Denver law firm of Engel Reiman & Lockwood pc, specializing in business transactions and planning, taxation, estate and asset protection planning. Mr. Brown, too, is also a CPA, and has previously written for The Journal.

Few estate planning tools have gained as much popularity so quickly as the intentionally defective irrevocable trust (IDIT).[1] This popularity is primarily attributable to the amount of estate tax that may be saved when the IDIT is compared with other estate tax planning tools.

The basic operation of an IDIT is generally well understood (see "The Hows and Whys of IDITs," on page 282). What is not as well known is how the potential drawback of an IDIT—the potential for a grantor having a disastrously large taxable estate—can be minimized through the use of an offshore trust and a careful application of a "toggle" switch that can turn grantor status on and off.

Although the computations below are based on the estate tax regime that existed prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, 6/7/01; EGTRRA), the concept of using the IDIT as a component of an installment sale of limited partnership interests continues to be useful. For example, it avoids having the sold assets taxed in the estate that ultimately would become taxable when the estate tax is reinstated in 2011, as it is currently slated to be. Also, the installment sale avoids the imposition of the new gift tax provisions that otherwise would apply to a completed gift in excess of $1 million to an IDIT. Therefore, the strategies discussed below are still alive and well after EGTRRA, especially given the unpredictable and temporary nature of the new tax law. Nevertheless, clients considering the strategies explored below should be advised that in the event the estate tax repeal does become permanent (as much as any law can be said to be "permanent"), they may have relinquished control over their assets unnecessarily. Then again, the attorney who is advising the client with regard to the IDIT transaction can add features to the documents to provide the needed flexibility to account for the various possible outcomes that may be mandated by the new tax laws.[2]

THE PROBLEM WITH THE BASIC TECHNIQUE

Consider a husband and wife (H&W) who create a family limited partnership (FLP) and two IDITs[3] (the "tiered IDITs") at age 55. They accelerate their applicable credit amounts through gifts of limited partnership interests, make annual *Crummey* contributions of limited partnership interests, and also complete an installment sale of limited partnership interests to the tiered IDITs. In this way, the couple effectively can reduce a $16.6 million taxable estate to zero by age 78.[4] Thus, by the time H&W reach their respective life expectancies, their taxable estates and the related estate tax due will be close to zero.

Using the same set of assumptions, the table in Exhibit 1 (on page 284) compares

the effectiveness of various other estate planning tools that reduce a taxable estate to zero, depending on the age of H&W at the start. As can be seen from the results in the Exhibit, when tiered IDITs are used in combination with gifts and an installment sale, none of the other estate planning tools in the comparison come close insofar as reducing a client's taxable estate.

While IDITs may be a very effective tool to reduce a taxable estate to zero, what happens if the husband or wife does not die at the end of the life expectancy? Using the same facts and assumptions as above, if H&W had a taxable estate of $16.6 million and both were age 55, at age 78 that amount would have been transferred to the IDITs (through gifts of FLP interests) and would have grown to approximately $45 million. Suppose this $45 million of assets generate taxable income at a mere 5%, and the clients' weighted average tax rate is 35% (federal, state, and a capital gain element). The income tax attributable to the IDITs and owed by the clients would be $787,500.

The problem is that the estate plan using the IDITs was designed to reduce H&W's assets to almost zero by the end of their life expectancy, i.e., their current age of 78. Thus, the clients do not have any assets with which to pay their $787,500 tax liability. Things could be worse—H&W might have the audacity to live until age 95. Nothing upsets an estate planner more than a client who dies early or lives longer than he or she is supposed to—that is, unless the estate planner has a flexible estate planning tool that can easily accommodate the changed circumstances.

THE ON-OFF SWITCH

The problem with an IDIT is turning off the grantor trust feature once it has been turned on. An IDIT is generally intentionally drafted so that it will grow to be a monstrous trust in terms of size that is designed to continue to devour a taxable estate, even if one does not exist. Most planners take the position that the trust may be drafted so that the grantor is able to release the power (or powers) that initially caused the trust to be classified as a grantor trust. This would result in the IDIT's being classified as a nongrantor trust, and under Subchapter J it would be responsible for its own taxes.

Nothing upsets an estate planner more than a client who dies early or lives longer than he or she is supposed to.

What if the reverse fact pattern occurs? The client releases the power, thus turning off the grantor trust income tax classification. Several years go by, the client's taxable estate grows too large, and it would be advantageous for the grantor trust income tax classification to be turned on. It would be the best of both worlds if an IDIT could be designed with something like a toggle switch: If the client and the trustee had the ability to control the timing of when the trust was classified as a grantor trust, they also would have more control over the dollar amount removed from the client's estate (through the payment of the income tax attributable to the IDIT). This toggle switch option would allow the client to retain enough assets for a long life but at the same time to reduce the estate to a nominal amount.

Problems With Traditional Methods

As noted above, the major concern with the IDIT is that the time may come when the grantor no longer wishes or cannot afford to pay the income tax liability generated by the income on the IDIT's assets. Typically, this concern is alleviated by granting the grantor the power to release the Power to Substitute Property of Equivalent Value (as discussed in "The Hows and Whys of IDITs"), which would turn off the grantor trust tax classification. For example, the trust instrument may contain the following language:

> The Grantor may release this Power to Substitute Property of Equivalent Value by a writing delivered to the Trustee. The release will be effective upon its receipt by the Trustee, unless the release instructs that it is to be effective upon a later date.

If the grantor releases the power, the trust is no longer classified as a grantor trust for tax purposes. If it later is advantageous from an estate planning perspective to have the trust again classified as a grantor trust, i.e., to further reduce the grantor's estate through the payment of income tax on the income attributable to the IDIT, one solution might be to give the trustee the power to regrant to the grantor the Power to Substitute Property of Equivalent Value. For example, the IDIT might contain the following language:

> In the event the Grantor releases a Power to Substitute Property of Equivalent Value, in the sole discretion of the Trustee, the Trustee may re-grant the Power to Substitute Property of Equivalent Value to the Grantor.

NOTES

1 For purposes of this article, "irrevocable trust" means a trust drafted so that transfers to the trust are completed gifts for gift tax purposes and the trust will be excluded from the grantor's estate.

2 For more on the impact of EGTRRA, see Blattmachr and Detzel, "Estate Planning Changes in the 2001 Tax Act—More Than You Can Count," 95 JTAX 74 (August 2001), and Harrington, McCaffrey, Plaine, and Schneider, "Generation-Skipping Transfer Tax Planning After the 2001 Act: Mostly Good News," 95 JTAX 143 (September 2001).

3 For generation-skipping transfer tax purposes, for designating joint lives in connection with a retirement plan, and for other client goals, most planners also will create a minor trust for the benefit of each child, a grandchild trust for each grandchild, and possibly some charitable trusts. For the sake of simplicity, only the one-FLP/two-IDITs model is discussed in this article.

4 This example includes the following additional assumptions: (1) there are seven *Crummey* beneficiaries by the time both clients reach age 78, (2) both clients have not utilized any of their applicable credit amounts and the full credit (based on pre-EGTRRA law) is accelerated through gifts of limited partnership interests to the IDITs, (3) the minority/marketability discount is 40%, (4) the federal income tax rate is 39.6%, the state income tax rate is 5%, and the capital gain tax rate is 20%, (5) the rate of return (including appreciation) is 7%, and (6) the clients' W-2 wages equal their living expenses.

Once the trustee has re-granted the Power to Substitute Property of Equivalent Value, the trustee has "toggled" the switch and turned on grantor trust status. Later, it may become desirable or necessary to repeat one or both of these steps, i.e., a release by the grantor and a re-grant by the trustee. The question that arises is how many times may the grantor and trustee work in harmony, releasing and re-granting the Power to Substitute Property of Equivalent Value, before there is an estate tax inclusion issue? Is it one time, two times, or maybe even possibly not until three times? If the grantor and trustee are viewed as working in harmony, one must consider whether their interaction would support an IRS argument that the trustee is acting solely as the grantor's agent or that there is an implied agreement that the trustee will follow the grantor's wishes.

How many times may the grantor and trustee work in harmony, releasing and re-granting the power, before there is an estate tax inclusion issue?

Implied agreement. Under Section 2036(a)(1) and Reg. 20.2036-1, an agreement that the grantor will retain control of the property for his benefit will cause the property to be included in his estate. Such an agreement may be implied by the circumstances of the transfer and the use of the transferred property.[5] To date, the existing implied agreement cases under Section 2036(a)(1) deal with the situation where the grantor is a beneficiary of a trust, but the Service may attempt to expand this implied agreement theory to include the traditional IDIT toggle-switch approach of a grant-and-release of powers.

Agency/control. Another line of cases may prove to be even more effective for the Service than the implied agreement cases under Section 2036(a)(1). The harmonious actions of the grantor and trustee also support the argument that the trustee is an agent for the grantor or is controlled by the grantor. If such an argument prevails, the trustee's powers could be attributed to the grantor, which most likely would result in an estate inclusion under Section 2036, 2038, or 2041.

For example, in two cases the courts found that the husband controlled his spouse's actions as trustee for trusts created for the benefit of their children. Therefore, the spouse's powers as trustee were attributed to the husband, with the result that the trust assets were included in the husband's estate.[6]

Particularly troublesome to the IDIT situation is *Holdeen v. Ratterree,* 166 F. Supp. 694, 2 AFTR2d 5758 (DC N.Y., 1958). While this is an income tax case[7] rather than an "agent of the grantor" estate inclusion case, it nevertheless demonstrates the factors that a court may consider significant in determining that the grantor has retained control over the trustees. In *Holdeen,* the following factors in combination supported a finding that the grantor controlled the trustees of various trusts:

- The grantor retained the right to remove and replace trustees.
- The grantor received loans at a below-market interest rate and without security.

NOTES

[5] Skinner's Estate, 197 F. Supp. 726, 8 AFTR2d 6073 (DC Pa., 1961); Estate of Barlow, 55 TC 666 (1971); Estate of McCabe, 475 F.2d 1142, 31 AFTR2d 73-1403 (Ct. Cl., 1973).

[6] Helvering v. Elias, 122 F.2d 171, 27 AFTR 821 (CA-2, 1941); Moskin v. Johnson, 115 F. Supp. 565, 44 AFTR 648 (DC N.Y., 1953), *aff'd* 217 F.2d 278, 46 AFTR 1150 (CA-2, 1954).

[7] This case was decided before enactment of the current grantor trust rules. Under current law, some of the facts of this case—such as borrowing at a below-market rate—would result in the income being taxed to the grantor without a finding by the court that the grantor controlled the trustees.

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- The trustee purchased securities for the trust from the grantor.
- The grantor directed certain security purchases on behalf of the trust.
- In certain instances, the grantor had the ability to substitute beneficiaries or accumulate income.
- The trustees were the grantor's children.

While *Holdeen* has quite a few bad facts that most planners today would avoid, it still has some troubling aspects. First, after Rev. Rul. 95-58, 1995-2 CB 191, it is quite common for the grantor to retain the power to remove and replace trustees.[8] Second, one of the most common methods to make an irrevocable trust a grantor trust is to specifically give the grantor the power to borrow at a below-market rate for less than adequate security. Third, the installment sale side of the IDIT is a sale of a security (i.e., limited partnership interests) to the IDIT. Fourth, many times a grantor will make investment recommendations that the trustees follow. Therefore, if the "bad fact" of the trustee's working in harmony with the grantor (by turning on and off the toggle switch) is added to these four factors, would a court find that the grantor controlled the trustee such that the trustee's powers should be attributed to the grantor, creating a potential for estate tax inclusion under Section 2036, 2038, or 2041?

Not only are there estate tax inclusion issues associated with the traditional toggle switches proposed by many planners, but some estate planners have voiced concern that the Service could assert the substance-over-form doctrine and classify the IDIT as a "perpetual" grantor trust. The argument would be that the ability to switch the grantor trust powers on and off means the trust was able to become a grantor trust at any time, and as such the IDIT should be viewed as a permanent grantor trust. The IRS could contend that a trust that is able to convert to a grantor trust at any time is no different than a trust over which the grantor permanently retains powers sufficient to come within Sections 671-678. If the Service were successful in this argument, estate planners would have significant concerns about grantors living past their life expectancy.

THE OFFSHORE ALTERNATIVE

As noted above, there are two primary issues with multiple instances of a release and re-grant of the Power to Substitute Property of Equivalent Value: (1) the property may be included in the grantor's estate, or (2) the IDIT may be permanently classified as a grantor trust. The problem with both sides of the traditional toggle is that the grantor and the trustee are working in harmony: one party releases, one party re-grants. In fact, it is questionable whether the trustee would re-grant the Power to Substitute Property of Equivalent Value unless the grantor specifically asked the trustee to do so, or unless the trustee were trying to further maximize the trust funds that will be available to its beneficiaries. Therefore, the IRS may assert that the only reason the trustee's power to re-grant the Power to Substitute Property of Equivalent Value was included in the trust was for the avoidance of tax.

The IRS may assert that tax avoidance was the only reason for giving the trustee the ability to re-grant the power to substitute property.

Is there another way to provide a toggle switch without including language that appears to only have a tax motive and without giving the appearance that the grantor and the trustee are working in harmony?

Only one grantor trust section does not depend on powers held by the grantor or a non-adverse trustee.[9] Under Section 679, only three requirements need be met for a trust to be classified as a grantor trust:

1. A U.S. person transfers property.
2. The transfer is to a foreign trust.
3. There is a U.S. beneficiary.

Almost all domestic trusts are created by U.S. persons, and the domestic trusts have U.S. beneficiaries. Therefore, under Section 679, the only additional element required to create a grantor trust income tax classification is the existence of a foreign trust for tax purposes. What if either the grantor or the trustee (but not both in harmony) exercise a power that results in the trust being classified as a foreign trust? Assuming the other two requirements are also present (typically the case), the trust will be classified as a grantor trust.

Two simple methods may be used to accomplish this result. The first is to vest in the grantor the power to change the trustee to a foreign trustee.[10] Under this method, the grantor has a removal and replacement power over the trustee.[11] If the grantor removes a domestic trustee and substitutes a foreign trustee and all substantial decisions will no longer be made by U.S. persons, the trust will fail the control test[12] and will be classified as a foreign

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[8] See generally "IRS Backs Off on Inclusion Where Grantor Has Power to Replace Trustee," 83 JTAX 250 (October 1995), and the cases discussed therein.

[9] For purposes of the grantor trust rules, a non-adverse trustee (or person) is anyone (i.e., a nonbeneficiary) who does not have a substantial interest in the trust's assets. Sections 672(a) and (b).

[10] A variation would be to include a provision allowing the current trustee to appoint future trustees, which would include a foreign trustee. This approach, which vests the power to change the trust to a foreign trust solely in the trustee, may be safer (from the standpoint of the "perpetual" grantor trust argument) than having the grantor exercise a power to remove and replace trustees. See also the discussion in the text, below, regarding another method by which the trustee can change the trust's classification.

[11] With regard to a removal/replacement power, some planners prefer to follow the safe harbor of Rev. Rul. 95-58, 1995-2 CB 191, which limits the removal/replacement power to a new trustee who is not related to or subordinate to the grantor. (See also note 8, *supra*.) Other planners prefer to vest the removal/replacement power in a third person. Still others allow the existing trustee to appoint successor trustees. Regardless of which method is used, the existing domestic trustee may be easily replaced with a foreign trustee, with the result that the trust is classified as a grantor trust under Section 679.

[12] Section 7701(a)(30)(E).

trust for tax purposes. Since a U.S. person is now deemed to have transferred property to a foreign trust with U.S. beneficiaries, the trust is classified as a grantor trust under Section 679.

The second method to change the tax classification of the domestic trust to a foreign trust vests the power to make this change in the trustee. Under this method, the trustee changes the applicable law of the trust to a foreign jurisdiction.[13] The trust then fails the court test,[14] and the trust would then be classified as a foreign trust. Since all other elements are present, the trust is also classified as a grantor trust under Section 679.

Under Section 679, the only additional element required to create a grantor trust is the existence of a foreign trust for tax purposes.

The result under both approaches is that solely the grantor or solely the trustee has the power to toggle the trust from nongrantor trust to grantor trust. Nevertheless, under both approaches the trustee and the grantor do not work in harmony. Hence, there is not nearly the likelihood that the IRS would be successful with an implied agreement argument.

Further, these approaches avoid one key factor in the Service's possible attacks on the traditional toggle switches. Whether the IRS is contending for inclusion of the trust property in the grantor's estate or for perpetual grantor trust status, the traditional toggles appear to have no purpose other than a tax motive: There is no business or investment purpose for the regranting and releasing of a Power to Substitute Property of Equivalent Value.[15] On the other hand, there may be one or more investment or business reasons for changing the classification of the trust from a domestic trust to a foreign trust, particularly with an integrated offshore IDIT, discussed below.

First, "integrated" estate planning combines both asset-protection planning with traditional estate planning. Over 20 nations[16] have adopted very specific asset-protection legislation that allows for the protection of a beneficiary's interest in a trust. While four states [17] also have adopted asset protection legislation, there is some question regarding how effective these statutes will be.[18] For this reason, there well may be a fiduciary purpose (i.e., to protect the trust's assets) for the trustee to change the applicable law of the trust to a foreign jurisdiction. In fact, many planners are now designing "integrated" offshore irrevocable trusts with many of the asset protection provisions found in offshore trusts.[19]

A second non-tax reason for changing the applicable law of the trust to an offshore jurisdiction, and thus justifying the classification of the IDIT as a foreign trust, is to take advantage of a foreign jurisdiction (such as the Cook Islands or Nevis) that has abolished the rule against perpetuities.[20] Here, the purpose of changing the applicable law of the trust is so that the trust may continue, and its assets would not have to vest within the period allowed under the rule. Although some states within the U.S. also have no rule against perpetuities, some planners believe that the foreign jurisdiction's laws are less likely to be repealed or revised as frequently as many U.S. laws.

Finally, another non-tax reason the trust may be classified as a foreign trust for tax purposes is the change of the trustee to a foreign investment manager/trustee. Currently, it is estimated that Swiss financial institutions hold close to 35% of all offshore assets.[21] Over time, Switzerland (as well as many other offshore jurisdictions, such as the Isle of Man, Jersey, Guernsey, Liechtenstein, Luxembourg, and the Cayman Islands) has proven that it has excellent offshore investment managers and trustees. Therefore, a third non-tax reason that supports the jurisdictional change and justifies the IDIT's being

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13 Some planners could have reservations about including a provision in the trust that gives the trustee the power to change the applicable law of the trust. The concern is that such a provision may violate the rule against perpetuities. In nine states there is good reason for such concern: Alabama, Iowa, Maine, Missouri, New York, Oklahoma, Texas, Washington, and Wyoming. While there are no cases directly on point, in these states theoretically any provision in the trust that could possibly extend the period of the trust past the period allowed under the rule against perpetuities would void the trust from inception. Therefore, a provision granting the trustees the power to change the applicable law should not be included in the IDIT. The other states, however, follow either the "wait and see" approach or the codification of that doctrine in the Uniform Statutory Rule Against Perpetuities. These states wait until the end of the period allowed under the rule against perpetuities to determine whether the rule has been violated. Therefore, a provision that allows the trustee to change the applicable law would not void the trust from inception. Rather, the trustees would be free to change the applicable law at any time prior to the expiration of the period allowed under the rule against perpetuities.

14 Section 7701(a)(30)(E)(i).

15 The authors acknowledge that the business or investment purpose test is generally applied in tax-avoidance cases or in corporate business reorganizations. Further, the authors are aware that many times a trustee will be vested with the power to grant a general power of appointment to create a non-exempt trust for generation-skipping transfer tax purposes. Nevertheless, the underlying tone of most implied-agreement, tax-avoidance, and grantor-control cases (see notes 5 and 6, *supra*) is that there is no business purpose to the action taken (or for the structure created) other than a tax motive.

16 See Engel, Lockwood, and Merric, *The Asset Protection Guide: A State of the Art Approach to Integrated Estate Planning* (CCH), Chapter 13, pages 288-289.

17 Alaska, Delaware, Nevada, and Rhode Island.

18 Giordani and Osborne, "Stateside Asset Protection Trusts: Will They Work?," Clark Boardman Callaghan's Estate & Personal Financial Planning (November 1997); Lockwood, "Alaska, Delaware and Other U.S. Domestic Trusts as Planning Tools," 1 Asset Protection J. (Summer 1999), page 29. But see Rothschild, Rubin, and Blattmachr, "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch," 32 Vanderbilt J. Transnational L. 763-778 (May 1999).

19 Some document-generation programs even allow for the English common law concept of the "Protector." A Protector is usually an individual or entity that serves as a "check and balance" over the trustees. For example, a Protector can veto certain trustee decisions and fire and hire trustees. See 5 J. Asset Protection (Jan/Feb 2000), page 54.

20 But see note 13, *supra*, with regard to certain issues that must be addressed in certain states.

21 Hall, *Bank Sarasin: Principles of Offshore and International Investing: Private Banking in Europe*, PESI Fifth Annual Offshore Practice & Procedure Conference (9/14-15/00, Las Vegas), page III-4, citing Offshore Red Survey on offshore centers prepared by the Swiss Banking Association.

classified as a foreign trust for tax purposes may be the investment expertise of a foreign trustee.

GAIN ON OUTBOUND TRANSFERS IN TRUST

Section 679 may appear to provide the perfect toggle switch, but some practitioners are certain to raise the issue of Section 684 and what happens when the grantor dies.

A useful exception keeps the gain recognition rule of Section 684(a) from applying if the foreign trust is classified as a grantor trust.

Under Section 684(a), gain is recognized when a U.S. person transfers appreciated property to a foreign trust. Section 684(b), however, provides that the gain-recognition rule of Section 684(a) does not apply if the foreign trust is a grantor trust. As noted above, if either the grantor changes the trustee to a foreign trustee or if the trustee changes the applicable law to a foreign situs, the trust will be classified as a foreign trust. Since all of the other elements are present (i.e., U.S. grantor and U.S. beneficiaries), this foreign trust will be a grantor trust under Section 679. Thus, it appears at first blush that gain recognition under Section 684(a) is not an issue.

In order to have a grantor trust, however, there must be a living grantor. At the grantor's death, therefore, there will be a deemed transfer by the grantor to the foreign trust for tax purposes.[22] If the grantor should die when grantor trust status has been toggled "on," all of the appreciation inherent in the trust's assets will have to be recognized.

In most estates, planners would not see this as a problem. Remember, the reason grantor trust status generally will have been toggled "on" is so that the grantor could pay the income tax on the trust's assets. This usually means that the estate planner and grantor have determined that the grantor's potential taxable estate is too large, and it is advantageous to remove assets through the payment of income tax attributable to the IDIT's income. The grantor's death has just helped accomplish this goal to the *n*th degree—the income tax attributable to the grantor's death will be considered a liability of the estate, and the income tax liability will reduce the estate tax.[23]

EXAMPLE: An IDIT has investments worth $10 million. The unrealized appreciation in the IDIT's assets is $3 million. The grantor is 80 years old and has a potential taxable estate of $4 million. If the grantor dies, the estate would be responsible for all of the income tax on the $3 million of appreciation. Assuming a weighted average tax rate of 33%, the income tax due would be $1 million, which would reduce the taxable estate to $3 million. The estate tax saved due to the accelerated income tax on the assets in the offshore IDIT would be $550,000 (assuming a 55% estate tax rate on that $1 million). At the same time, the IDIT's basis in the assets would be stepped up to FMV.

In essence, the integrated offshore IDIT has clearly saved $550,000 in estate tax if the assets of the IDIT were going to be sold in the near future (i.e., because of the step-up in basis, there would be no additional appreciation). If, however, the assets were going to be held for a long period before sale, the income tax paid at the settlor's death and the estate tax savings would have

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22 Reg. 1.684-2(e).

23 Under Reg. 1.684-2(e), the transfer is deemed to occur immediately prior to grantor's death. Therefore, gain under Section 684 would be deemed to be recognized by the grantor prior to death, and the resulting income tax would be a liability of the estate.

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EXHIBIT 1
Comparison of Estate Planning Tools at Various Ages

Technique	55	60	65
FLP with two irrevocable trusts (not IDITs)	$ 4.6M	$ 4.2M	$ 3.8M
FLP with two IDITs—gift technique (no sale)	6.8M	5.7M	4.7M
FLP with two GRATs (grantor retained annuity trusts)	9.6M	N/A*	N/A
FLP with two IDITs—installment sale technique	16.6M	12.1M	9.0M

* If a ten-year GRAT is otherwise being used, it is questionable whether one would create a GRAT for a client 60 years old. The client may die during the GRAT term, in which case the FMV of the GRAT assets would be included in the client's estate under Section 2036(a)(1). "Rolling" or "cascading" GRATs are beyond the scope of this article.

to be compared with the present value of paying the income tax at a later time. For example, if the IDIT did not sell its assets for 15 years, it may be more advantageous not to accelerate the income tax at the grantor's death. Nevertheless, generally this is not so—usually, most of the assets held by an irrevocable trust are turned over once every few years.

Another possibility—one a bit more likely to occur—is that the unrealized appreciation inside the IDIT is so great that the potential Section 684 income tax burden would be too much in terms of the desired results, leaving the grantor's remaining estate relatively too small. In this instance, the grantor or trustee has two options:

1. Do not toggle "on" the grantor trust option (i.e., the trust would remain a domestic trust for tax purposes).
2. Draft the trust so that it simultaneously becomes a domestic trust when the grantor dies.

Under the first option, if the grantor has a relatively small estate, there is probably little if any need to toggle the IDIT so that it is classified as a grantor trust.

Under the second option, some planners[24] have proposed that the trust may specifically include a provision changing the applicable law of the trust to a U.S. jurisdiction and/or appointing only a U.S. trustee concurrent with the grantor's death.[25] By changing the applicable law of the trust, the IDIT should meet the court test, and by appointing only a U.S. trustee[26] the IDIT should meet the control test. Since both tests would be met simultaneously at the grantor's death, the IDIT should be classified as a domestic trust at the same time as the grantor's death. And as noted above, gain recognition under Section 684(a) applies only to foreign trusts, not domestic trusts.

Finally, at least one author has suggested that the Section 684(a) issue arising at the grantor's death could be solved in its entirety by having the IDIT settled by an entity that does not die.[27] For example, what if a family limited partnership, rather than an individual, settles an IDIT. If state law allows the family limited partnership to continue in perpetuity, Section 684(a) does not become an issue, because the grantor never dies. Under this approach, the planner and the client have decided from inception of the offshore integrated IDIT that they do not wish to take advantage of the possible acceleration of income tax under Section 684(a) described above.

CONCLUSION

The combination of one or two IDITs (husband and wife) with a FLP is probably the single most powerful tool for reducing, over time, a client's taxable estate to zero and transferring the entire amount to the client's children. As with all estate planning tools, however, there are advantages and disadvantages. One of the greatest advantages of the IDIT is that flexibility that occurs when the trust can be toggled between grantor and nongrantor status for income tax purposes. With proper planning, the toggle switch provides a much greater ability to properly time the reduction to zero of a client's taxable estate.

The main problem with the more traditional toggle switches is that the Service may argue there is an implied agreement, or characterize the trust as a perpetual grantor trust, with the result that the corpus will be included in the grantor's federal estate.

The integrated offshore IDIT offers a new approach for turning grantor trust status on and off. The trustee and grantor are not required to work in harmony to toggle the switch. Instead, either the trustee or the grantor alone can be given the power to control the toggle switch by making the IDIT a foreign trust for tax purposes (grantor trust status on) or a domestic trust for tax purposes (grantor trust status off). Further, there may be other non-tax reasons for changing the IDIT from a domestic trust to a foreign trust, such as asset protection or to avoid the rule against perpetuities. For these reasons, an estate planner should consider the option of the integrated offshore IDIT as an alternative to the more traditional methods to create a toggle switch.

NOTES

[24] Engel, "Trusting the Act," Shore to Shore (Summer 1998), page 55.

[25] Reg. 1.684-2(e) deems the transfer by the grantor to occur immediately before the grantor's death. Therefore, it is uncertain whether this method to avoid Section 684(a) will be effective to solve the problem, because the trust is deemed to become a domestic trust concurrent with the grantor's death.

[26] The foreign trustee also may remain as a trustee of the IDIT. All substantial decisions, however, must be vested in the domestic trustee. Section 7701(a)(30)(E)(ii).

[27] Bove, "Thought-Provoking Ways of Circumventing Code Section 684, (or) Taming the Paper Tiger," 2 Asset Protection J. (No. 3, Autumn 2000), pages 11-15.