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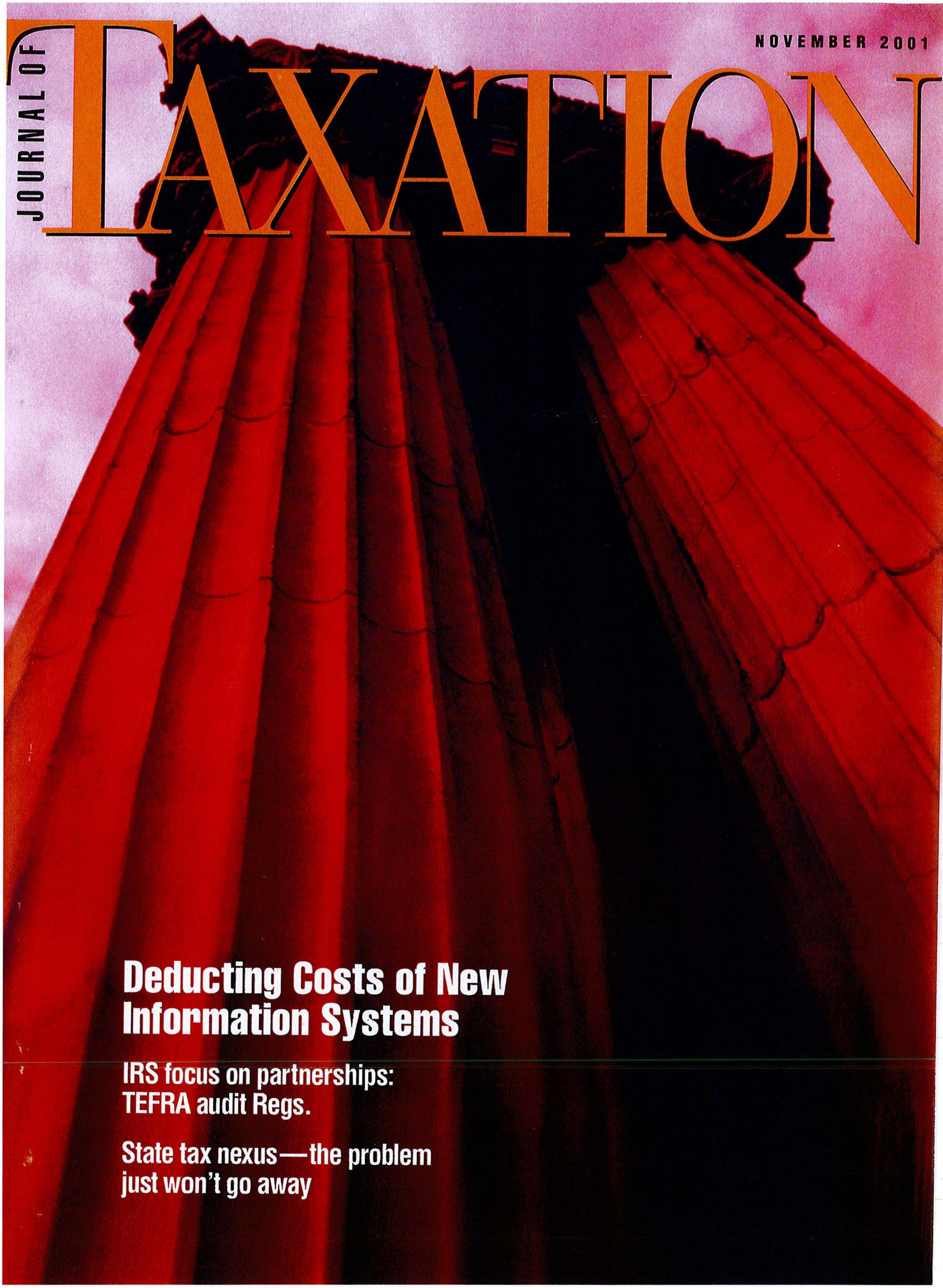

Deducting Costs of New Information Systems

IRS focus on partnerships: TEFRA audit Regs.

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

The Hows and Whys of IDITs

Before the compression of trusts' income tax rates, most practitioners designed irrevocable trusts so that they would not be subject to the grantor trust rules. Either the trust paid its own income tax or, if the income was distributed to the beneficiary (generally to the extent of distributable net income), the beneficiary paid. It was generally considered a mistake or a "defect" if the terms of the trust accidentally violated the grantor trust rules and the grantor was responsible for the tax attributable to the trust's income. The phrase "intentionally defective" denotes that the planner by design drafted the IDIT so that the grantor would be responsible for the income tax attributable to the trust.

Various methods are used in drafting the typical IDIT to make it into a grantor trust, such as one of the following:

1. Giving the grantor the power to substitute property of equivalent value (Section 675(4)(C)).
2. Giving the grantor the specific power to borrow without adequate interest or security (Section 675(3)).

With regard to the power to substitute property, the trust might contain the following language, resulting in the trust being initially classified as a grantor trust for tax purposes:

> The Grantor is granted the power to substitute property of equal value for any trust property ("Power to Substitute Property of Equivalent Value"). This power is personal to the Grantor and may not be assigned to or exercised by someone other than the Grantor. It is the intention of the Grantor that the Trust will be a grantor trust pursuant to Code Section 675(4)(C) for as long as the Grantor retains this Power to Substitute Property of Equivalent Value.

Later, in the event the grantor no longer wishes for the IDIT to be classified as a grantor trust for tax purposes, the grantor may release the Power to Substitute Property of Equivalent Value.

With regard to allowing the grantor to borrow the trust property for less than an adequate interest rate or without security, the following language may be contained in the trust:

> The Grantor is granted the power to borrow from the trust for two points under the prime lending rate as determined by [bank] or without providing security, but not both, in exchange for the Grantor's promissory note of equal value to the amount borrowed ("Power to Borrow for Less than Adequate Interest or Without Security"). This power is personal to the Grantor and may not be assigned to or exercised by someone other than the Grantor. It is the intention of the Grantor that the Trust will be a grantor trust pursuant to Code Section 675(2) for as long as the Grantor retains this Power to Borrow for Less than Adequate Interest or Without Security. The Grantor may release this Power to Borrow for Less than Adequate Interest or Without Security 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.

Again, the IDIT initially will be classified as a grantor trust, because the grantor has the power to borrow for less than adequate interest or without security. A literal reading of the Code indicates the mere ability to borrow for less than adequate interest or without security would result in the entire trust being classified as a grantor trust. Some practitioners, however, have expressed concern that this power actually has to be exercised in order for the trust to be classified as a grantor trust. For this reason, as well as others, many practitioners generally create an IDIT with a Power to Substitute Property of Equivalent Value.

From an estate tax perspective, an IDIT provides two tax-saving planning tools, involving gifts and installment sales. First, most practitioners agree that the income tax paid by the grantor is in itself not an additional gift to the IDIT for gift tax purposes. (See Zaritsky, 858-2nd T.M. (BNA), *Grantor Trusts: Sections 671-679*, page A-19.) The grantor pays the income tax, the IDIT's assets grow income-tax free, the grantor's assets are reduced by the amount of the income tax paid, but the grantor incurs no gift tax liability for what in effect is a transfer of the amount of the income tax that the IDIT otherwise would have been obligated to pay. Thus, an IDIT provides an additional way to make gifts of property to a trust without incurring any current gift tax.

Second, rather than selling assets directly to the IDIT, a client transfers property to a limited partnership (LP). LP interests are discounted—typically, 40% to 50%—for minority status and lack of marketability. The limited partnership interests can then be sold to the IDIT using an installment sale.

Example: Sue transfers $21 million of marketable securities to a family limited partnership (FLP). Sue then sells 49% of the FLP interests (i.e., approximately $10 million worth) to the IDIT. The value of those FLP interests, assuming a combined 40% discount, would be approximately $6 million.

Sue receives an installment note from the IDIT in exchange. Here is where the magic begins: In applying Section 671, the IRS disregards a sale to a grantor trust for all income tax purposes. (See Rev. Rul. 85-13, 1985-1 CB 184; but compare *Rothstein*, 735 F.2d 704, 54 AFTR2d 84-5072 (CA-2, 1984).) Therefore, when Sue sells the FLP interests to the IDIT, no gain or loss is recognized by the client on the sale.

Instead, Sue now holds a $6 million installment note, and the IDIT holds a 49% FLP interest worth approximately $10 million. Sue has total assets, for estate tax purposes, of $16 million: $10 million representing 51% of the partnership and the $6 million installment note. In essence, Sue has reduced her taxable estate by $4 million without using any of the $10,000 annual gift tax exclusion or consuming any of her applicable credit amount. (Assume the value of Sue's 51% is not adjusted for discounts or premiums. Generally, a majority interest in a partnership would result in a control premium. In a subsequent year, Sue may make a gift of more FLP interests and relinquish control. If this occurs, Sue's remaining interest would be entitled to a minority discount.)