Untaxingly Yours

Embracing Family IDIOTs

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Nearly every high net-worth (HNW) family that I have ever met has at least one family IDIOT. I do not mean the family member that acts foolishly or spends imprudently, they may have that person as well, rather I am referring to an Intentionally Defective Income Only Trusts (IDIOTs). Perhaps you have heard such trusts referred to as Grantor Type Trusts, Intentionally Defective Grantor Trusts (IDGTs), Irrevocable Life Insurance Trusts (ILITs), Dynastic Trusts, Lifetime Credit Shelter Trusts, or Spousal Lifetime Access Trusts (SLATs). All of these trusts are simply variations of the theme. For convenience, I will refer to all of these trusts as Grantor Trusts or IDIOTs. They are all irrevocable trusts that endeavor to remove assets from the taxable estate of senior generations in order to avoid future estate taxes and possibly even generation-skipping taxes (GSTs).

The statutory underpinnings of Grantor Trusts are found in Chapter 1 of the Internal Revenue Code, Subchapter J, Subpart E, 671–678. In order to gain a greater knowledge of these trusts, we will endeavor to explore the history of Subpart E, and we will look at how these rules are being applied by practitioners today to create incredible tools that all HNW individuals should consider as part of the income and estate tax planning. Although we will frequently refer to these tools as IDIOTs, it should be acknowledged that they are brilliant in avoiding estate tax inclusion while technically (and intentionally) being "defective" for income tax purposes.

Historical Background

> *Those who use the Sword are sooner or later destroyed by it.* Matthew 26:52

Not too many years ago (1963), the top marginal federal income tax rate was 91%. Numerous tax brackets are stretched out below, but above $400,000 of taxable income for a person with "Married Filing Joint" status and above $200,000 for a person filing "Single," the bracket was 91%. A common income tax planning strategy employed by tax practitioners during this period was to divide one's income across as many different taxpayers as possible. Each taxpayer would, in theory, have a fresh set of tax brackets and tax rates, and by spreading the income out between multiple family members, multiple corporations, and multiple trusts, HNW persons could shelter a portion of their income across multiple taxpayers.

Congress created the Grantor Trust provisions under Subpart E in 1954 (Code Secs. 671–678)[1] in an effort to curb these efforts in the trust area. Congress also created rules impacting controlled groups of Subchapter C corporations in the Revenue Act of 1964 (Code Secs. 1561–1563)[2] in an effort to eliminate the advantages of using multiple taxpaying corporations to hold investment assets for a small group of related taxpayers.

As regards trusts, the Grantor Trust provisions are designed to treat the creator of a trust as the owner of the trust for income tax purposes. The trust is, in essence, treated as a disregarded entity for income tax purposes. Despite the enactment of Subpart E, many skilled attorneys persisted and became adept at drafting trusts in a manner that would avoid the application of Grantor Trust provisions of Subpart E and thus the game of "Divide and Conquer" the tax brackets using multiple corporations and trusts continued, largely unabated, for 30 more years until the 1980s.

Multiple trusts began to fall out of favor after the enactment of the Tax Reform Act of 1986[3] and a series of legislative changes in the 1990s concluding with the Tax Cuts and Jobs Act of 2017. These changes ultimately reduced the top individual and fiduciary income tax brackets below 40%, compressed the number of fiduciary income tax brackets to four, effectively applied the top tax income brackets to fiduciaries once the taxable income exceeded $12,000, and enacted a "Kiddie Tax,[4]" which effectively stopped parents from splitting investment income with their minor children. With lower compressed income tax brackets, the benefit of playing "Divide and Conquer" ended. Nevertheless, the statutory framework of Subpart E (Code Secs. 671–678) remained as a part of the "Infernal" Revenue Code.

The Significance of Subpart E After 1986

The Grantor Trust provisions were originally designed to be a weapon available to the "Infernal" Revenue Service during a period of high-income tax rates and large brackets. Today, we are in a time of fairly flat tax rates and narrow brackets for HNW individuals. Parents, kids, and entities all pay fairly similar tax rates on their ordinary income. As a result, if the total income tax being paid is effectively the same dollar amount, whether it is paid by the senior generation as the junior generation, then the tax planning focus shifts from the amount paid to the actual payor. Normally, the person receiving the income also pays the tax on that same income. However, under Subpart E that is not the case, the Grantor (not the fiduciary or the beneficiaries) is the person who is legally obligated to pay the tax even if the Grantor does not receive the benefit of the income. It seems illogical, but that is the result. The Grantor pays the tax, and in many cases the income that inures is for the benefit of someone other than the Grantor.

When a trust is a "Grantor Type" trust under Subpart E, the trust is treated as a disregarded entity and the Grantor (creator of the trust) is treated as the owner of all items of income, deduction, and credits attributable to its portion of the trust. As a result, the Grantor is personally liable for the income taxes (including capital gains taxes and surtaxes that are applicable). Items attributed to a Grantor under Subpart E are not to be reported by the fiduciary on the face of Internal Revenue Service (IRS) Form 1041. Rather, such items should be shown on a separate statement attached to the fiduciary return indicating that the items will be reported directly on the personal income tax return of the Grantor.[5]

Furthermore, since the Grantor is legally obligated to pay the income tax, then the Grantor has not made a gift when it satisfies its personal legal obligation. The gift tax law does not automatically recognize an imputed gift being made to the ultimate recipient of the income.[6]

Navigating the Void Between Income Taxes and Transfer Taxes

At the outset, it is important to note that the Grantor Trust rules are located in Title 26, Chapter 1, Subchapter J, Subpart E. A careful reading of Code Secs. 671–678 restricts the application of these provisions to Chapter 1 "Normal Taxes and Surtaxes," in other words, only Income Taxes. The provisions of Subpart E do not apply to the Transfer Tax provisions of the Internal Revenue Code.[7] Congress did not make an effort to include any references in Subpart E to any of the provisions of Chapter 11—the Estate Tax, Chapter 12—the Gift Tax, Chapter 13—the Generation Skipping Transfers, Chapter 14—the Special Estate and Gift Valuation Rules; or Chapter 15—Gifts and Bequests from Expatriates. Similarly, Congress did not make any references in Chapters 11–15 to Subpart E. Some limited provisions may be contained in some transfer tax provisions, but Subpart E as a whole is not automatically linked.

Creating an effective IDIOT can be a drafting challenge. Skilled attorneys must deftly include language that will cause the income of a trust to be included in the Grantor's "Gross Income" for federal income tax purposes, without simultaneously causing the assets of the trust to be included in the Grantor's "Gross Estate" for federal estate tax purposes.

The following is a sampling of some of the more popular Subpart E provisions that drafters should consider including in IDIOTs if they wish to cause income inclusion, without risking estate inclusion:

1. The Grantor's power to borrow from the trust without adequate security [Code Sec. 675(2)];
2. The Grantor's power to substitute ("swap") assets of equivalent value with the trust [Code Sec. 675(4)(C)];
3. A Non-adverse trustee power to distribute income among Grantor's descendants [Code Sec. 674(a)]; and
4. The power to add charitable beneficiaries [Code Sec. 674(b)(4)].

None of the above have a companion or similar provision in the transfer tax realm. However, some provisions might come close. For example, the power to borrow without adequate security under Code Sec. 675(2) does not also extend to the power to borrow without adequate interest.[8] Borrowing without requiring the payment of a market interest may result in a gift being made under Code Sec. 7872. Similarly, the unrestricted right to add beneficiaries might create a General Power of Appointment under Code Sec. 2514 or 2041, which would result in estate inclusion, but the power of an independent trustee to add a charitable organization as a beneficiary appears to be sufficient.[9]

It is common for attorneys to use more than one of the above Subpart E provisions as a safeguard in assuring that the trust will be deemed to be a Grantor Type trust.

The Choice of Grantors, Fiduciaries, and Beneficiaries

The choice of not only who creates the trust but also who are the named beneficiaries may vary depending on both the clients' long-term and short-term goals. Trusts benefiting multiple generations below the clients will have GST ramifications requiring the availability of GST exemptions, which can be allocated to the trust in order to minimize or avoid the GST.

Where the clients are concerned about their own future income needs, it may not be sufficient that the language of the IDIOT allows the client to "swap" non-marketable assets such as vacation homes or personal property held by the Grantor for cash held by the fiduciary or in the alternative to borrow cash from the trust without adequate security for the loan. The fiduciary must be willing to make such deals upon those terms without risking the disapproval of current and future beneficiaries.

In order to avoid estate tax inclusion, the creator of the irrevocable trust must not also be either the trustee or a co-trustee.[10] A spouse can be a trustee so long as they are not a co-creator of the same IDIOT or the creator of a reciprocal trust.[11] Consider the typical Credit Shelter Trust (*i.e.*, "B" trust, residuary trust, or family trust) created upon the death of the first spouse to die. The post-mortem trust is clearly irrevocable. Surely, the surviving spouse may be the sole trustee of the Credit Shelter Trust without risking estate tax inclusion at the survivor's death so long as their fiduciary powers to distribute income and principal are restricted to an ascertainable standard.[12] Many practitioners remember the definition of an ascertainable standard with the acronym HEMS (health, education, maintenance, and support). These words are commonly defined in local family law courtrooms. On the other hand, the power to distribute for a person's "comfort," "welfare," "happiness," or "best interests" is not easily ascertainable. Failure to restrict the spouse's power to an ascertainable standard can result in the creation of a General Power of Appointment under Code Sec. 2041 and result in estate tax inclusion.[13]

The same holds true of irrevocable trusts created during life (our family IDIOT). Any family member, other than the person either creating the trust or funding the trust (*i.e.*, the Grantor), can be both a beneficiary and the trustee of the family IDIOT if their discretion over the power to distribute income and/or principal is limited to the HEMS standard.

Funding the Family IDIOT

As discussed above, in order to avoid estate inclusion, the person funding an irrevocable trust should not also be a beneficiary of the trust.[14] The creator of the trust should be the primary person contributing assets to contribute assets to the IDIOT.

Contributions to irrevocable trusts generally take the form of gifts. Gifts in trust are generally gifts of "future interests" (meaning the beneficiaries do not have a current right to enjoy the gift). The primary problem with gifts of future interests is that they do not qualify for any annual gift tax exclusion that may be available under Code Sec. 2503(b). "No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts"[15] made during the calendar year. As a result, gifts of future interest will first absorb the taxpayer's applicable credit amount in effect under Code Sec. 2010(c). Amounts in excess or the applicable credit amount will result in the physical payment of gift tax.[16]

The beneficiary of a "present interest" gift, in theory, has "an unrestricted right to immediate use, possession, or enjoyment of property or the income from property."[17] Code Sec. 2503(b) grants a gift tax exclusion to a limited amount of each present interest gift gifted. The annual gift tax exclusion is limited per person (*i.e.*, donee) per calendar year. The annual exclusion was originally set at $3,000 per calendar year by the Internal Revenue Code of 1954. The amount was reset by statute at $10,000 in 1981.[18] Beginning in 1998, the annual exclusion was adjusted annually for inflation.[19] As of calendar year 2025, the annual exclusion now sits at $19,000 per person per year.[20]

Ideally, the best assets to transfer to the IDIOT will be assets that will either produce a regular cash flow, such as dividend-paying securities or even rental property, and assets that have appreciation potential. The IDIOT is an irrevocable trust intended to hold assets that will be removed from the Grantor's gross estate for federal estate tax purposes. As the value of these assets grow, the IDIOT has the potential of shielding an ever-increasing amount of family wealth.

Investment partnership interests and Subchapter S stock may be good transfer candidates. Generally, these closely held equity interests distribute cash, which is intended to cover the Federal and State income tax burdens of their owners. Since the IDIOT has no fiduciary tax burden, this available cash flow is available to reinvest or purchase additional assets from the Grantor.

"Present Interest" Annual Exclusion Gifts in Trust

One of the earliest family IDIOTs was the ILIT. Code Sec. 677(a) provides that the creator of a trust "shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, … applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse …." As a result, every ILIT that does not have an adverse party[21] as trustee will by definition be an IDIOT.

Life insurance is an unusual asset, with both positive and negative aspects. Code Sec. 101 excludes the proceeds of life insurance from the gross income of the beneficiary receiving the death benefit. However, Code Sec. 2042 includes life insurance proceeds in the gross estate of the decedent if the decedent possessed any "incidents of ownership" at the time of death over the policy. These incidents of ownership generally include the right to designate the beneficiar(ies) of the policy and the right to borrow any cash value accumulating in the policy. As a result, it can be disadvantageous to own life insurance (especially term insurance, which has no current value or accumulations) on one's own life.

An ILIT is an irrevocable trust that is designed to hold and manage the life insurance policies during the life of the insured and thus position the policy for estate tax exclusion. Despite the fact that the insured might be the creator of the ILIT, if the insured does not possess any incidents of ownership in the policies held by the trust during the three years prior to the death of the insured, then the proceeds will be excludable from the gross estate of the insured decedent. The practical problem facing attorneys and their clients is not found in the creation or the registration of the ownership of the insurance policies, but rather in the ongoing funding of future premium payments necessary to sustain the policies.

Prior to 1986, clients did not like gifting income-producing property to the ILIT to be held together with the insurance policies. Although the income-producing property could provide the funding necessary to pay future premiums, the Subpart E rules caused the trust income to be taxable to the Grantor at high income tax rates. In order to avoid the Grantor trust rules and allow the premiums to be funded with annual gifts of cash, attorneys created withdrawal powers that were exercisable at the same time that the fiduciary received the cash gifts.

The issue of whether the withdrawal powers permitted the cash additions to be deemed to be "present interests" was finally put to rest in the case of *Clifford Crummey*.[22] The U.S. Court of Appeals in the Ninth Circuit reversed the U.S. Tax Court and ruled that the existence of the rights of withdrawal (even though they were not exercised) was sufficient to permit the cash additions to the trust to be deemed to be eligible for the gift tax annual exclusion as present interest gifts. The IRS ultimately acquiesced in the decision.

Crummey powers have been used successfully for over 60 years as a means of funding not just ILITs but other IDIOTs as well. Each beneficiary of the trust can possess a *Crummey* withdrawal power and individual gifts equal to the full amount of the gift tax annual exclusion can be added to the trust for each beneficiary.

CAUTION: Where trust additions exceed $5,000 or 5% of the trust value, special care must be exercised in order to avoid other complications.[23]

Splitting Gifts with Spouses

Code Sec. 2513 creates a "fiction" within the gift tax law, which permits a gift made by one person to any person other than that person's spouse to be considered as if it had been made one-half by the donor person and one-half by the donor's spouse. This "fiction" does not treat the spouse as the actual "transferor" for gift and estate tax purposes. As a result, the IRS does not treat the election to split gifts as a transfer, which could result in estate tax inclusion as a transfer with a retained interest under Code Secs. 2035–2038.[24] This is an important distinction since, as discussed above, if the spouse was a deemed transferor of the gifted property to a trust in which the spouse is also a beneficiary, then one-half of the value of the trust (attributed to the split gift) could be includable in the gross estate of the spouse at death.

The ability to split gifts permits an IDIOT to be created that names the spouse as a trustee and a life beneficiary. In essence, it effectively permits the clients to create a lifetime Credit Shelter Trust [otherwise referred to as a SLAT], which can receive both spouses applicable credit amounts (nearly $28,000,000 in 2025).

Leveraging "Present Interest" Annual Exclusion Gifts in Trust

Outright gifts made directly to beneficiaries are typically confined to transfers to a single generation of donees below the donor. Many parents have concerns over "fairness," which limits their gift-giving. Where a parent has two children and five grandchildren, simple math will tell us that one of the children has more of the donor's "grandchildren" than the other child. As a result, if the grandparent chooses to maximize the number of annual gifts made and gives the same amount to each child and grandchild, then one family may be getting more than the other family simply because one child has more progeny than the other. This apparent lack of fairness can be paralyzing for some grandparents and frequently results in their failure to fully exhaust their full annual exclusion gift-giving potential.

This was the exact scenario that confronted Maria Cristofani a few years ago. Maria had two children and five grandchildren. She was willing to make seven full annual exclusion gifts each year, but she did not want to treat either of her children "unfairly." In order to solve this dilemma, Maria's attorney created a single irrevocable trust (an IDIOT) to receive all seven gifts. Under the terms of the trust, each of the seven descendants was listed as either a primary or a contingent beneficiary. For example, the trust provided that at Maria's death, if both of her children were alive, the trust would be divided into two separate shares, one for each child, and both shares would be distributed outright to her children. In other words, the grandchildren would not receive anything if the children survived Maria.

If one of the children, however, predeceased Maria, then that child's share would pass (per stirpes—"by the blood") to the children of that child (here grandchildren) in equal shares. In other words, the grandchildren were contingent beneficiaries. Their potential to receive assets from the trust was contingent upon whether or not their parent died before Maria.

The IRS objected to Maria claiming seven annual exclusion gifts each year for the transfers that she made to the trust. In order to qualify for the annual exclusion, each of the beneficiaries had been notified that Maria had made a gift to the trust. This notice is sometimes called a "*Crummey*" notice. The notice advised each of the beneficiaries of the existence of the gift, and it permitted them to withdraw their portion of the gift within some period of time (30 days). The withdrawal right expired at the end of the set period. The IRS objected. The IRS could not understand why any of the contingent beneficiaries would not exercise their right of withdrawal. The IRS was unable to prove that there had been any coercion of the contingent beneficiaries. In a unanimous "reviewed" Opinion of the U.S. Tax Court, all seven gifts were permitted to qualify as present interest annual exclusion gifts.[25]

The IRS subsequently lost two other cases that were similar to *Cristofani*. In each case, the Tax Court rejected the Service's attempt to prove that there was an advance agreement that contingent remaindermen would not exercise their *Crummey* withdrawal rights, or, alternatively, that the contingent remaindermen believed they would be penalized if they exercised their rights. The Service had asked that these conclusions be inferred from the fact that no beneficiaries had exercised their rights.

The most notable loss was *L. Kohlsaat Est.*[26] In 1990, Mrs. Kohlsaat gave a commercial building (worth $155,000) to a trust that named 18 relatives (two children, one daughter-in-law, seven grandchildren, and eight great-grandchildren) as primary and contingent beneficiaries. Each beneficiary received a *Crummey* withdrawal power to remove a share of the contributed property, not to exceed $10,000, for 30 days after the gift was made. The trustee gave each beneficiary notice of the withdrawal right six days after the transfer. The primary beneficiaries were a son and daughter who each received unspecified income and corpus rights in one-half of the trust, including a special power to appoint his or her one-half share to his or her children or grandchildren. The takers in default of appointment ("contingent beneficiaries") were the son's spouse, the grandchildren, and the great-grandchildren.

Following Mrs. Kohlsaat's death, the Service, for purposes of calculating the estate tax, attempted to disallow the 16 annual exclusions claimed for the *Crummey* withdrawal powers held by contingent beneficiaries of the trust. The Service argued that the failure of any contingent beneficiary to exercise a withdrawal right was evidence either of preexisting understandings that the withdrawal powers would not be exercised or, alternatively, of the beneficiaries' belief that they would be penalized for exercising those rights.

The Tax Court ruled in favor of the estate, saying "the evidence does not establish that any understandings existed" and "we refuse to infer any understanding" concerning the exercise of the powers. The case is reminiscent of *Cristofani*, in that there is an express finding that "[n]o understandings existed between decedent, the trustees, and the contingent beneficiaries to the effect that the beneficiaries would not exercise their rights to demand [trust] distributions …."[27]

Combining the use of annual exclusion gift with the taxpayers' applicable credit amounts will permit the transfer of extremely large amounts to IDIOTs *via* gifts. However, where the IDIOT is intended to truly benefit more than one generation below the transferors, the IDIOT may be limited to the GST exemption amount.[28]

Generation Skipping Tax Considerations

Although the GST Exemption Amount (under Code Sec. 2631) parallels the Applicable Credit Amount for Gift and Estate tax purposes (under Code Sec. 2010), each is applied and allocated separately. In addition, the rules relating to nontaxable gifts are different. As we discussed in the last section, present interest gifts (including *Crummey* gifts) below the annual exclusion amount are treated under Code Sec. 2503(b) and excluded from Gift Tax and therefore do not exhaust any portion of the Applicable Credit Amount for Gift and Estate tax purposes. On the other hand, Code Sec. 2642(c), which defines "nontaxable gifts," refers to gifts made under either Code Sec. 2503(b) (*i.e.*, present interest annual exclusion gifts including split gifts) or Code Sec. 2503(e) (*i.e.*, direct tuition and medical payments), but Code Sec. 2642(c) does not adopt an identical definition to Code Sec. 2503(b). As a result, *Crummey* gifts are not treated as "nontaxable gifts" under Code Sec. 2642(c). *Crummey* gifts are indirect, not direct, skips and as a result the only way that these indirect gifts will avoid GST is if a portion of the GST Exemption Amount is allocated to *Crummey* gifts.

The fact that *Crummey* gifts are not treated as "nontaxable gifts" means that the value of all transfers made to IDIOTs that are intended to benefit more than one generation (*i.e.*, Dynastic Trusts) will be capped at the GST Exemption Amount that can ultimately be allocated to the IDIOT.

Growing the IDIOT Above the GST Exemption Amount

Think of the GST Exemption Amount as being akin to flexible packing material (*i.e.*, "an expandable bubble-wrap"). If all the assets that are gifted to the IDIOT are wrapped in this expandable bubble-wrap as they enter the IDIOT, then the entire IDIOT will have a GST inclusion ratio of zero. All assets received in later years from the trust as part of a distribution or termination of the trust will therefore be taxed at a GST tax rate of zero multiplied by the GST Tax Rate of 40% (*i.e.*, zero). This is an expandable bubble-wrap, so as the value of the trust grows *via* accumulated income or as a result of capital growth, the inclusion ratio remains at zero.

We can improve the overall effectiveness of the IDIOT by limiting distributions during the lifetime of the Grantor and thus fostering its growth, in other words, by fully embracing and leveraging its Grantor Type trust status under Subpart E.

Income Tax Shifting Adds to Trust's Growth

Taxable trusts (*i.e.*, non-Grantor Trusts) are generally subject to the top fiduciary income tax rate of 37% on accumulated ordinary income in excess of $15,650 in 2025. If the taxable income consists of investment income, the top income tax rate can increase by another 3.8% under the Net Investment Income Tax (NIIT). A taxable trust's payment of fiduciary income tax removes assets from the trust and thus impairs the growth of the trust assets.

The Subpart E rules allow us to shift the responsibility for paying the income tax from the trust to the Grantor. As a result, if the trust does not reimburse the Grantor, then an IDIOT will generally grow faster than a taxable trust.

Transactions Between Grantors and IDIOTs Are Disregarded

Transactions between the Grantor and the Grantor Trust are invisible for income tax purposes. The IRS has ruled generally in Rev. Rul. 85-13 that no taxable event is deemed to occur in transactions between the Grantor and the Grantor Trust.[29]

A number of private letter rulings over the years have specifically looked at transactions involving Grantors and their IDIOTs. In LTR 9535026,[30] the Service determined that the sale of stock by the Grantor to an IDIOT for a note will generally not give rise to taxable income. Although the economic aspects of the transaction must be respected in order to avoid transfer tax for failing to pay a market rate of interest, the income tax consequences of the transaction are generally disregarded. The interest that is paid is not deductible by the payor, and the interest that is received is not gross income to the payee.

Installment Sales from Grantors to IDIOTs

Similar to a Grantor retained annuity trust (GRAT), an installment sale to an IDIOT trust may be an effective means to transfer part of the future income or appreciation from a high-income or rapidly appreciating asset with little or no gift or estate tax cost. The sale effectively "freezes" the value of the property in the Grantor's estate by exchanging the appreciating property for an installment note at a fixed rate of interest.

The family IDIOT is an important income and estate planning tool. It is capable of removing and holding assets worth several times the value of the current Applicable Credit Amount and the GST Exemption Amount.

If you sell an asset to a Grantor Type trust at fair market value, there should be no gift, and there should also be no capital gain or loss, because transactions between an income trust and its grantor are generally ignored for income tax purposes.

To "leverage" the transaction, the trust could pay for the asset in the form of an installment note, payable over several years with a market rate of interest. An installment note should not have gift tax consequences if the interest rate on the note is at least equal to the "applicable federal rate" (AFR; short term, mid-term, or long term) determined under Code Sec. 1274(d).

If the trust is a Grantor Type trust for federal income tax purposes, the "interest" payable on the note should also be disregarded. The interest payment should not create any taxable income to payee or any tax deduction for the payer, since they are deemed to be the same person. The Grantor will be taxable on the income earned from third parties inside of the trust, including the income earned by the property sold to the trust).

There are other possible advantages of an installment sale over a GRAT:

a) If the Grantor of a GRAT should die during the term of the GRAT, the IRS has taken the position that the Grantor's retained annuity interest causes nearly the entire value of the trust to be included in the Grantor's gross estate under Code Sec. 2039. On the other hand, if the seller/Grantor in an installment sale should die before the note is repaid, only the unpaid balance of the note is included in the gross estate.

b) A GRAT is not suitable for gifts to grandchildren, because the annuity retained by the Grantor results in an Estate Tax Inclusion Period (ETIP) that prevents the application of the GST exemption. An installment sale can be used with generation-skipping trusts.

c) The payment schedule for an installment note can be more flexible than the annuity paid from a GRAT. Under the rules of Code Sec. 2702, the annuity payment from a GRAT cannot vary by more than 20% from year to year. There is no such restriction on installment sales, so the installment note could be a "balloon" note, with a large payment at the end of the note, or any other payment schedule that is desired.

d) A GRAT must be valued as though the trust terminates upon the death of the Grantor. This has the effect of reducing the value of the annuity payments and increasing the value of the remainder interests, (which is the value subject to gift tax). There is no such regulation or ruling for installment sales to trusts. This means that a properly structured installment sale, for an asset that has been properly valued, should not result in any gift tax consequence at all, while the IRS has taken the position that a GRAT will *always* result in some taxable gift.

e) The installment note can use the ordinary AFR Tables. The GRAT must use the Code Sec. 7520 rate (120% of the AFR mid-point), which is always higher. The lower interest rate allows greater leverage.

Sales of Discounted Property to IDIOTs

Additional "leverage" can be obtained by selling assets that could be valued at a discount as of the time of sale. Nonvoting stock of a closely held corporation and Limited Partnership interests of a Family Limited Partnership are frequently valued at substantial discounts.

A sale for full and adequate consideration will lock in the discounts and avoid gift and estate taxation. The value of discounted property should be documented through qualified appraisals. Consideration should be given to disclosing the sale on a timely filed gift tax return in order to avoid revaluation at death by the "Infernal" Revenue Service under Code Sec. 2036. Code Sec. 2036(a) states that a sale for less than full and adequate consideration will be treated as a gift.

The 1997 Revenue Act included significant changes to the gift tax statute of limitations. Under the law, if a transfer is adequately disclosed, on a gift tax return, then the Service will have three years in which to audit the return. If the transfer is adequately disclosed and the Service fails to audit, then the value of the transfer cannot be adjusted for either gift tax purposes or estate tax purposes.

Self-Cancelling Installment Notes with IDIOTs

A self-canceling installment note (SCIN) is an installment note that contains a provision under which the buyer's obligation to pay automatically ends in the event a specified person (usually the seller), called the "measuring" or "reference life," dies before the end of the term of the note.

An installment note is useful when a person owns a highly appreciated asset he or she would like to sell and wants to spread the recognition of and taxation on the gain over a term of years.

Installment notes with a self-canceling provision are especially useful when one family member, typically a parent or grandparent, wishes to transfer property to another family member, typically a child or grandchild, with minimal gift and estate tax consequences.

In general, the fair market value of any unpaid installment obligation on the date of death is included in the estate of the seller. However, if the note contains a properly designed self-cancellation provision, the buyer is under no obligation to make any further payments after the seller's premature death. This leaves no unpaid balance to be included in the seller's estate.

The self-canceling feature can be an effective means of transferring property to family members without estate or gift tax consequences in the event of the death of the seller-transferor before the last potential payment has been made under the terms of the installment note.

Properly nurtured, the cash flows and values generated within the IDIOT can be leveraged and used to acquire additional assets from the Grantors throughout their lifetimes.

A SCIN will avoid adverse gift and estate tax treatment only if the self-cancellation provision is properly designed. The courts have held that:

a) The cancellation provision must be bargained for as part of the consideration for the sale,
b) The purchase price must reflect this bargain either with a principal risk premium (above market sales price) or an interest rate premium (above market interest rate), and
c) The seller may not retain any control after the sale over the property being sold.

If the self-cancellation provision is not properly designed, the seller may be deemed to have a part-sale part-gift. If any of the transfer of the remainder interest (the canceled payments) is considered a gift, the entire value of the property sold, less the consideration actually paid, will be included in the decedent's gross estate.

Selecting the appropriate market rate of interest is perhaps the most difficult step in the process of designing and implementing a SCIN.

CAUTION: The cancellation of the installment note has been held to have negative income tax consequences for the estate of the decedent. In the Estate of Frane, the Circuit Court of Appeals held that the installment obligation represents Income in Respect of a Decedent (IRD), and thus even though its value may not be includable in the gross estate, the unrecognized portion of the gain on the principal will be subject to income tax at death, *without any deduction being available for the income tax attributable to the IRD.*

Private Annuity Exchanges with IDIOTs

The private annuity is a useful tool for an individual who wants to spread gain from a highly appreciated asset over his or her life expectancy.

Under a private annuity arrangement, an agreement is signed. That document requires one party (the transferor-annuitant) to transfer ownership of property to another party (the transferee-buyer). In return, the transferee-buyer makes periodic (typically monthly, quarterly, semi-annual, or annual) payments to the transferor for a specified period (usually the lifetime of the transferor or the transferor and the transferor's spouse).

The private annuity is also useful as a federal estate tax saving tool because, by design, payments end when the transferor dies and the entire value of the asset sold is immediately removed from the transferor's gross estate. In other words, there is no estate tax in the transferor's estate from the transferred property—because it belongs to the seller from the moment the private annuity document is signed.

The traditional private annuity (*i.e.*, outside of the IDIOT environment) is not frequently used in wealth transfer plans for the following reasons:

1. The purchaser may not deduct the interest portion of the payment to the seller.
2. The seller must pay ordinary income tax on the interest portion of the payment received; and the seller must pay capital gains tax on the principal portion of the payment received.

The insertion of an IDIOT as the purchaser avoids the negative income tax ramifications of the private annuity. Neither the buyer nor the seller can claim a deduction or report income on the interest portion of the annuity payment.

CAUTION: Taxpayer use of the Section 7520 IRS Tables may be restricted if the health is in jeopardy. A recent case highlights the concern. Taxpayer sold partnership interests to family member six months before his death in exchange for private annuities. At the time of the sale, the taxpayer was terminal with cancer. The taxpayer used the IRS actuarial tables to calculate the annuity payment and the value of the remainder interests. The Fifth Circuit Court of Appeals reversed the Tax Court and held that the taxpayer had a right to use the IRS Tables. Estate of Gordon McLendon v. Comm., 135 F.3d 1017 (5th Cir., 1998). The Regulations under 7520 now require that a 12-month survivability test be met of the use of the Tables.

The most significant difference between the Private Annuity and the SCIN is how each is treated for income tax purposes. The termination of the private annuity obligation at the death of the annuitant will not have negative income tax consequences for the estate of the decedent. The dissenting opinion in the *R.E. Frane Est.*, stated that the cancellation of the private annuity at death would not result in Income in Respect of a Decedent (IRD).

Death Bed Planning for IDIOTs

There are opportunities and traps that should be considered where terminally ill clients have existing IDIOTs. Ideally, if we maintain close relationships with our clients, we are aware of times when they might be of advanced age or face significant health challenges. Clearly, when a client has entered hospice care, that should be a signal that the end of life may be near and it should set off an alert to family members and their advisors that additional actions should be considered.

Assets that are held by properly structured irrevocable trusts should be excluded from the gross estate of the Grantor and should not be eligible for a step-up in basis at death. HNW clients could potentially reduce the value of their taxable estate if the existing IDIOT recognized gains on any appreciated assets held by the IDIOT during the taxpayer's lifetime. The Grantor's personal income tax on the capital gains will create a liability that will either reduce the Grantors estate during lifetime or be listed as a liability on the Grantor's U.S. Estate Tax return, thus reducing potential federal and state death taxes.

If the Grantor was unwilling to personally incur the income tax, then the Grantor should consider exchanging (swapping) assets with the IDIOT. The Grantor could exchange cash or high basis assets for the low basis assets held inside of the IDIOT. Following the principles of Rev. Rul. 85-13, discussed above, the lifetime exchange would be nontaxable. If the low basis assets were held at by the Grantor at the time of death, they would be eligible to receive a step-up in basis under Code Sec. 2014.

If, at the time of death, the Grantor possesses an installment note with an unpaid balance related to assets sold to the IDIOT, then as discussed in *Frane* death, the transaction will no longer be disregarded after death. This has two implications; first, post death the installment note will represent IRD. IRD does not get a step-up in basis at death under Code Sec. 1014(c).

Second, if the IDIOT is no longer be a deemed to be a disregarded entity, then the interest payments between the estate of the Grantor and the IDIOT will now be separate independent transactions that are no longer disregarded under Rev. Rul. 85-13. As a separate independent transaction, the includability of the income and the deductibility of the expense may be called into question. Accelerating the payoff of the installment sale or distributing an appreciated asset in exchange for the unpaid balance of the installment could avoid any mismatching and put the appreciated asset into the gross estate of the client where it will receive a step-up in basis at death.

Fully Embracing IDIOTs

The family IDIOT is an important income and estate planning tool. It is capable of removing and holding assets worth several times the value of the current Applicable Credit Amount and the GST Exemption Amount. Properly nurtured, the cash flows and values generated within the IDIOT can be leveraged and used to acquire additional assets from the Grantors throughout their lifetimes. Once inside the IDIOT, the assets can be protected from both spendthrifts and potential creditors for multiple generations.

ENDNOTES

1 Internal Revenue Code of 1954 (P.L. 83-591).

2 Revenue Act of 1964 (P.L. 88-272), effective for tax years ending after December 31, 1963.

3 The Tax Reform Act of 1984 (P.L. 98-369).

4 Code Sec. 1(g), enacted as part of the American Taxpayer Relief Act of 2012 (P.L. 112-240).

5 Reg. §1.671-4(a) [T.D. 6217, Dec. 19, 1956, amended by T.D. 7796, Nov. 23, 1981; T.D. 8633, Dec. 20, 1995; T.D. 8668, Apr. 30, 1996; T.D. 9032, Dec. 23, 2002; and T.D. 9241, Jan. 23, 2006.]

6 Rev. Rul. 2004-64, IRB 2004-27, 7 (July 6, 2004). Under the Revenue Ruling, the Grantor would only be deemed to have made a gift if the trust agreement provided for reimbursement and the Grantor waived the reimbursement.

7 The author chooses to use the term "transfer taxes" as a shorthand for referring simultaneously to US Gift Tax, Estate Tax and Generation Skipping Tax.

8 Code Sec. 7872 creates a deemed gift on the part of the lender on below market interest rate loans.

9 *B. Madorin*, 84 TC 667, Dec. 42,023 (1985).

10 Code Sec. 2036(a)(1) includes property in the gross estate of the transferor if they retain the possession or enjoyment of income; Code Sec. 2036(a)(2) includes property in the gross estate of the transferor if they retain the right, either alone or in conjunction with any person, to designate who shall possess or enjoy the property or the income therefrom; and Code Sec. 2036(b) includes property in the gross estate of the transferor if they retain the right to vote shares of a controlled corporation.

11 Reciprocal trusts are beyond the scope of this current discussion, but it should be noted that where each spouse creates an irrevocable trust for the benefit of the other spouse on substantially similar terms that the IRS and the courts have been known to treat each person as if they had directly retained the powers and rights themselves thus causing inclusion under Code Sec. 2036.

12 The Treasury regulations under Code Sec. 2041 tell us that a person does not possess a General Power of Appointment if their power to enjoy income or principal are limited by an "ascertainable standard relating to health, education, support, or maintenance." Reg. §20.2041-1(c)(2). [T.D. 6296, Jun. 23, 1958, *amended by* T.D. 6582, Dec. 11, 1961].

13 *Ibid.*

14 Code Sec. 2036(a) would act to include assets in the gross estate of the transferor if they retained a life estate or the power to enjoy those assets.

15 Reg. §25.2503-3(b) [T.D. 6334, Nov. 14, 1958, *amended by* T.D. 7238, Dec. 28, 1972; T.D. 7910, Sep. 6, 1983; and T.D. 9923, Nov. 18, 2020).

16 Reg. §25.2503-3(a) [T.D. 6334, Nov. 14, 1958, *amended by* T.D. 7238, Dec. 28, 1972; T.D. 7910, Sep. 6, 1983; and T.D. 9923, Nov. 1, 2020).

17 The Economic Recovery Tax Act of 1981 (P.L. 97-34).

18 The Taxpayer Relief Act of 1997 (P.L. 105-34).

19 Rev. Rul. 2024-40, IRB 2024-45 (Nov. 4, 2024).

20 The applicable credit amount as of January 1, 2025, stands at $13,990,000. Rev. Rul. 2024-40, IRB 2024-45 (Nov. 4, 2024).

21 The term "adverse party" is defined in Code Sec. 672(a) as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." In other words, someone having an interest that potentially runs contrary to the interest of another person.

22 *D.C. Crummey*, CA-9, 68-2 USTC ¶12,541, 397 F2d 82, *aff'd and rev'd* 25 TCM 772, Dec. 28,012(M), TC Memo. 1966-144.

23 The other complications are beyond the scope of this current column. For an in depth at Crummey Power and Hanging Powers, *see* Brian T. Whitlock, *Untaxingly yours—Federal Gift Tax Returns: Managing Withdrawal Powers*, TAXES, August 2019.

24 "Regarding inclusion of the Trust corpus in Spouse's gross estate under §§2035 through 2035, although Spouse will consent under §2513 to treat the gift to Trust made by Settlor as if made one-half by Spouse, §2035(a) and §§2036 through 2038 do not apply to property interests that the decedent did not actually own and thus did not transfer. Accordingly, assuming only Settlor makes transfers to Trust, Spouse will not be the transferor of property to Trust for purposes of §2035(a), and §§2036 through 2038. *See* Rev. Rul. 82-198, 1982-2 C.B. 206; Rev. Rul. 74-556, 1974-2 C.B. 300; Rev. Rul. 54-246, 1954-1 C.B. 179." LTR 200213013 (Dec. 18, 2001).

25 *M. Cristofani Est.*, 97 TC 74, Dec. 47,491 (1991), *acquiesced* IRB 1996-29, 4 (Jul. 15, 1996).

26 73 TCM 2732, Dec. 52,031(M), TC Memo. 1997-212.

27 *L. Kohlsaat Est.*, 73 TCM 2732, Dec. 52,031(M), TC Memo. 1997-212.

28 The GST exemption amount is defined at Code Sec. 2631(c) as equal to the basic exclusion amount for Gift and Estate taxes under Code Sec. 2010(c), which is adjusted for inflation each year. For 2025, the GST exemption amount is $13,990,000. Rev. Rul. 2024-40, IRB 2024-45 (Nov. 4, 2024).

29 *See* Rev. Rul. 85-13, 1985-1 CB 184 in which the IRS rejected the conclusion reached in *H. Rothstein*, CA-2, 84-1 USTC ¶9505, 735 F2d 704. *See also*, LTR 9525032 (Mar. 22, 1995), LTR 9519029 (Feb. 10, 1995), and LTR 9345035 (Aug. 13, 1993).

30 LTR 9535026 (May 31, 1995), CCH IRS Letter Rulings Report No. 966 (09-06-95).