

**INTENTIONAL DEFECTIVE IRREVOCABLE TRUST**  
**SALE OF PRINCIPAL RESIDENCE FOR A PRIVATE ANNUITY**  
**(RULES AND RECOMMENDATIONS)**

Sale of the taxpayer's highly appreciated principal residence to an Intentionally Defective Irrevocable Grantor Trust, in exchange for a Single Premium Deferred Private Annuity Contract, for purposes of Income Tax Deferral, Estate Tax Avoidance, and Asset Protection.

**1. INTRODUCTION**

1.1 **Purpose.** This Tax, Estate, and Asset Protection Strategy (the "Strategy") is an important part of a sophisticated and advanced Estate Plan for affluent high net worth taxpayers. The purpose of this Article is to briefly describe the various legal entities, legal instruments, and rules of law, all acting collectively together to make a effective Strategy which will achieve the taxpayers objectives in his Estate Plan. Specifically, this consists of the following:

- (i) Intentionally Defective Irrevocable Grantor Trust;
- (ii) Single Premium Deferred Private Annuity Contract (the "Private Annuity"; and
- (iii) The substantial Tax, Estate, and Asset Protection Benefits available to a Taxpayer when selling the Taxpayer's highly appreciated Principal Residence ("Residence"), or other suitable highly appreciated real property (hereinafter sometimes jointly the "Property"), to the above Intentionally Defective Irrevocable Grantor Trust (the "IDIT"), in exchange for the above Deferred Private Annuity, for equivalent value (the "Private Annuity Contract").

The type of trust aforementioned is technically referred to as an "Intentionally Defective Irrevocable Grantor Trust." The reason the IDIT is referred to as intentionally defective is explained in greater detail below in paragraph 2.1.3. The substantial benefits generated by the IDIT for the Taxpayer are as follows:

- (iv) Income Tax Deferral (and possibly Income Tax Avoidance);
- (v) Estate Tax Avoidance; and
- (vi) Asset Protection

Briefly, the IDIT is a specially designed irrevocable trust to specifically hold title to the taxpayer's Residence and other types of highly appreciated real property. The IDIT is intentionally structured to qualify as a "Grantor Trust" for income tax purposes, and as a "Nongrantor Trust" for estate tax and asset protection purposes, in full compliance with all United States Federal Income Tax Laws and Estate Tax Laws (collectively the "Federal Tax Laws"). The Private Annuity is a special payment

contract whereby the taxpayer (“Annuitant”) sells their Residence to another separate legal entity, such as the IDIT (“Obligor”), in our instant case, in exchange for the Obligor’s promise to make periodic payments in fixed amounts to the Annuitant for the remainder of the Annuitant’s life. The first annuity payment may begin immediately or it may be deferred to future years, depending on the intent of the Annuitant. Hence, the Private Annuity may be “deferred,” because the Private Annuity Contract may be lawfully structured so that the first annuity payment is due at a future date. Unlike the customary installment sale/promissory note payment contract (“Note”), requiring the Payor to pay an exact monetary amount for an exact number of payments over an exact period of years (See IRC §453) to the Holder of the Note, the Private Annuity Contract obligates the Obligor to pay the Annuitant annually an exact monetary amount over an unspecified number of years to the Annuitant, for as long as the Annuitant lives. Upon the death of the Annuitant, the Private Annuity Contract terminates automatically by operation of law due to a “self canceling feature.” Hence, the termination date of the Private Annuity Contract remains unspecified because the remainder of the Annuitant’s life also remains unspecified.

- 1.2 **“Grantor Trust” versus “Nongrantor Trust”**. The income tax rules operate independently from the estate and gift tax rules for federal tax reporting purposes. The differences between these two (2) federal taxation systems are very important for our present purposes in understanding the important differences between a Grantor Trust and a Nongrantor Trust, thereby illustrating the important characteristics and usefulness of the IDIT. The IDIT utilizes the advantages of both types of trusts aforementioned in order to provide the Grantor the maximum level of Income Tax Benefits, Estate Tax Benefits, and Asset Protection Benefits. The IDIT in our instant case has the beneficial attributes of serving both as a Revocable “Grantor” Trust and an Irrevocable “Nongrantor” Trust in limited circumstances. Naturally, this assumes that the IDIT is properly structured, the appropriate Trustee is selected, and the appropriate power or powers are retained by the Grantor without the Grantor retaining “excessive control” over the IDIT. For federal income tax purposes, the IDIT will function as a Revocable Grantor’s Trust, requiring all Trust Income and all Trust Losses to be reported annually by the Grantor and not by the Trust or its Beneficiaries. Conversely, for federal estate tax purposes, the IDIT will function as an Irrevocable Nongrantor’s Trust, requiring all Trust Assets to be excluded from the Grantor’s Estate upon the Grantor’s death. It is important for the Grantor in our instant case to retain only those powers which will cause the Trust to be treated by the Internal Revenue Service (the “IRS”) as a “Grantor Trust” for income tax purposes, but not to retain those additional powers that would give the Grantor “excessive control” over the Trust, causing the Trust to be treated as a “pure” Grantor Trust for estate tax purposes. It is also important that the identity of the Trustee in our instant case to be properly selected. Thus, when an IDIT is properly structured as a Grantor Trust for income tax purposes, and as a Nongrantor Trust for estate tax purposes, the Trust Income and Trust Losses are reported on the Grantor’s personal individual income tax return on Form 1040, and not on the separate trust income tax return on Form 1041. Upon the death of the Grantor, the Trust Assets are removed from the Grantor’s Estate, and therefore the Trust Assets are not reported in the Grantor’s Estate Tax return on Form 706. Sometimes this becomes a very complicated and

technical “legal tightrope” for the Grantor to properly select only those grantor retained powers causing the IDIT to be taxed as a Grantor Trust for income tax purposes, without crossing the line, and mistakenly selecting additional retained powers, giving the Grantor excessive control over the IDIT, thereby causing the IDIT to be taxed as a Grantor Trust for Estate Tax purposes. (Thus, this illustrates the general rule aforementioned that the income tax rules and the estate and gift tax rules operate independently from each other).

1.3 **Historical Overview.** Historically, the general rule was that “Grantor Trust Status” was always to be avoided when forming a Nongrantor Trust, especially when the Grantor intended to transfer an income generating asset to a Nongrantor Trust as a completed gift. The Grantor’s central objective was twofold: First, the annual income generated from the Trust Asset was to be reported annually by the Nongrantor Trust and not by the Grantor for income tax purposes, and Second, the Trust Asset was to be included as part of the estate of the Nongrantor Trust and not part of the Grantor’s Estate, upon the subsequent Grantor’s death for estate tax purposes. The accepted wisdom at the time was that it would be an expensive tax mistake if the Nongrantor Trust was classified a “Grantor Trust” for income tax purposes. Also, if “excessive control” was retained by the Grantor of the same Nongrantor Trust, the tax mistake would be even more expensive for estate tax purposes, over and above being classified as a Grantor Trust for income tax purposes. This was based on the historical premise at the time that one of the most valuable attributes of the Nongrantor Trust was its status as a separate taxpayer. It was assumed, and it was usually true, that if the Grantor paid the income tax on the trust income, the Grantor would pay an income tax at a higher income tax rate than the Nongrantor Trust or its Beneficiary, to whom the income would otherwise be taxed. Also, this income tax mistake would be compounded if the asset transferred to the Nongrantor Trust, plus all appreciation accruing on its original fair market value at time of the transfer to the Nongrantor Trust, was included in the Grantor’s Estate for estate tax purposes. Again, this adverse income tax and estate tax consequence was caused by the Grantor retaining substantial powers in the Nongrantor Trust, giving the Grantor excessive control over the Trust Assets. Two subsequent developments combined to change this view, and make the IDIT in our instant case, an extremely valuable income and estate tax planning vehicle in today’s tax planning environment.

1.3.1 **The first development** was that the federal income tax rates substantially changed over time. Historically, trusts were subject to a smaller federal income tax rate than individuals, or married persons filing separately. Compression of the federal income tax rates applicable to trusts began in 1987, and effective as of 1993, Irrevocable Trusts became subject to the top marginal federal income tax bracket (39.6%) at \$7,500 of income, by comparison with \$250,000 for individual Taxpayers. Currently, an individual taxpayer, such as a Grantor Trust, is likely to be paying a lower tax on the Grantor’s income than would the Nongrantor Trust on the same income level.

1.3.2 **The second development** was that a Nongrantor Trust was not always entirely recognized by the IRS as a separate legal entity for certain federal income tax reporting purposes [Revenue Ruling 85-13]. Thus, the “Grantor Trust Rules” (IRC §671 - §679) were used by the IRS against the Grantor to unexpectedly increase the Grantor’s individual income tax liability due to the income generated from the asset transferred to the Nongrantor Trust. This unintentional adverse income tax consequence to the Grantor was caused by the powers unintentionally retained by the Grantor of the Nongrantor Trust. However, the same “Grantor Trust Rules” previously used by the IRS against the Grantor may now be used by the Grantor against the IRS to reduce the Grantor’s individual income tax liability. Thus, the former IRS position used to “hammer” the Grantor may now be used by the Grantor to engage in certain select transactions with the Nongrantor Trust involving suitable highly appreciated real estate, in order to reduce the Grantor’s income tax liability. This Strategy has proven to be a very effective strategy for the taxpayer especially when their Residence or their other real property has greatly appreciated. For example, the Grantor may claim all of the favorable individual income tax benefits of owning the Residence and/or other Real Property, and at the same time enjoy the substantial estate tax and asset protection benefits available when using the IDIT with the Private Annuity Transaction. This special type of Non Grantor Trust has other advantages as well. It may hold S Corporation stock which permits considerable greater flexibility than the rigid Qualified Subchapter S Trust (“QSST”).

1.4 **Recap and Summary of Strategy and Benefits.** After the IDIT is properly formed, the Grantor Transfers by “sale” the Grantor’s Residence to the IDIT in exchange for a Private Annuity. The Grantor’s benefits are: (i) Grantor Retains the Individual Income Tax Benefits of Home Ownership; (ii) The Grantor’s Estate Avoids paying the Estate Tax on the Residence’s current fair market value at the time of the Grantor’s death; and (iii) The Grantor protects the Residence from the collection enforcement procedures of future potential judgment creditors.

1.5 **DISCLAIMER - THIS ANALYSIS IS NOT A LEGAL OPINION. TO BE CERTAIN, THIS ANALYSIS DOES NOT PURPORT TO GIVE A “LEGAL OPINION” TO ANY PERSON OR ENTITY INVOLVING ANY GENERAL OR SPECIFIC SET OF FACTS OR CIRCUMSTANCES DESCRIBING THE IDIT, THE PRIVATE ANNUITY, AND/OR THE SALE OF THE TAXPAYER’S RESIDENCE TO AN IDIT IN EXCHANGE FOR A PRIVATE ANNUITY. THIS ANALYSIS IS INTENDED TO SERVE TO THE READER ONLY AS A “CONCEPT ANALYSIS,” ILLUSTRATING THE GENERAL PRINCIPAL INVOLVED IN A SOPHISTICATED AND ADVANCED STRATEGY FOR TAX, ESTATE, AND ASSET PROTECTION PURPOSES. NO PERSON OR ENTITY MAY RELY UPON ANY COMMENT MADE BY THE AUTHOR OF THIS ANALYSIS CONCERNING ANY PART OF THE AFOREMENTIONED STRATEGY.**

## II. ANALYSIS.

The following analysis examines this subject in four (4) parts: the First Part more fully describes the IDIT, the “pure” Grantor Trust, the “pure” Nongrantor Trust, and their respective differences; the Second Part describes the Private Annuity; the Third Part describes the Tax and Asset Protection Benefits when selling the Taxpayer’s Residence to the IDIT in exchange for the Private Annuity; and the Fourth Part describes the Grantor’s income tax reporting compliance requirements to the IRS when using the IDIT in this factual scenario.

2.1 **First Part - Trusts in General.** In its simplest form, a trust is an agreement between the Grantor and the Trustee to hold, invest, administer, and distribute the Principal and its accumulation on the Principal of the Trust for the benefit of its Beneficiaries, as provided in the Trust Agreement. It is important to note here that the Trustee Powers specified in the Trust Agreement representing the IDIT are in addition to those Trustee Powers set forth by statute per jurisdiction.

2.1.1 **Grantor Trust.** A “pure” Domestic Grantor Trust is treated by the Internal Revenue Code (“IRC”) as a Trust which is controlled by the Grantor. Thus, the Grantor is treated as the “deemed owner” of the Trust for federal income tax and estate tax purposes. Therefore, all of the trust income and trust losses are reported by the Grantor and not by the Trust, as required under IRC Sections 671 through 679 (“Grantor Trust Rules”). In addition, the Trust Assets are included in the Grantor’s estate upon the Grantor’s death, as required by IRC §2033 through §2041. Thus, the Grantor and not the Trust or its Beneficiaries report the Trust Income and Trust Losses for federal income tax purposes and the Grantor’s Estate includes the Trust Assets for federal estate tax purposes. Consequently, a “pure” Grantor Trust is not treated as a separate taxpayer, and therefore it does not require a separate federal identification number (“EIN”) for federal income tax reporting purposes (See IRC §671). Usually, the identity of the Grantor and the identity of the Trustee are the same in a “pure” Grantor Trust. However, the identity of the Grantor and the Trustee may be different in a “pure” Grantor Trust provided (1) the identity of the Trustee is deemed “subservient” to the Grantor; and (2) the Grantor (or a third party) retains sufficient control of the Trust according to one or more of the Grantor Trust Rules under IRC Sections 671 through 679, and/or IRC Sections 2033 through 2041. To be certain, a “pure” Grantor Trust is a trust whose Trust Income is taxed to the Grantor, and the Trust Assets are included in the Grantor’s Estate upon the Grantor’s death. For example, the specific retained power by the Grantor to reacquire the Trust Assets in exchange for substituting other property of equal value to the Trust is a good example of one of the above Grantor Trust Rules. Thus, this specific Grantor Trust Rule requires the Grantor and not the Trust

to report the Trust Income and Trust Losses for income tax purposes (See IRC §675(4)). In addition, another example of a retained power is when the Grantor retains the right to revoke the Trust (IRC §2038), giving the Grantor “excessive control” over the Trust, thus causing the Trust Assets to be included in the Grantor’s Estate upon the death of the Grantor for federal estate tax purposes, as required under IRC §2033 through §2041.

2.1.2 **Nongrantor Trust**. In contrast, a “pure” Domestic Nongrantor Trust is not classified by the IRS as a trust controlled by the Grantor, and therefore the IRS does not treat the Grantor as the “deemed owner” of the Nongrantor Trust. Thus, IRC Sections 671-679 and IRC Sections 2033 through 2041 do not apply to the Nongrantor Trust. Hence, the Trust Income and Trust Losses are reported by the Nongrantor Trust and/or its Beneficiaries, and not by the Grantor, for federal income tax purposes. In addition, the Trust Assets held by a Nongrantor Trust are not taxed in the Grantor’s Estate upon the death of the Grantor for federal estate tax purposes. Consequently, a Nongrantor Trust is treated as a separate Taxpayer and thus it requires a separate federal identification number (EIN) for federal income tax reporting purposes. Once the Nongrantor Trust is determined to be a “pure” Nongrantor Trust, the Nongrantor Trust is classified as either a “Simple Nongrantor Trust” or a “Complex Nongrantor Trust” for federal income tax purposes. In a Simple Nongrantor Trust, all income is required to be paid to the Beneficiaries currently, and no amounts are payable for charitable purposes. In a Complex Nongrantor Trust, the Trustee has the discretion whether to pay or accumulate income and/or principal of the Nongrantor Trust. Almost always, the Nongrantor Trust is irrevocable to some degree. In addition, the identity of the Grantor and the Trustee are different. Furthermore, the Trust is managed by a Trustee who must be genuinely independent from the Grantor. For example, the Trustee “should” not be a “related” or “subordinate” to the Grantor. To be certain, under no circumstances should the Trustee be “subservient” to the Grantor, whether or not related or subordinate (See IRC §672 (c) and Reg §1.672 (c) –1). In a pure Nongrantor Trust, the Grantor must not retain any powers which would violate the “Grantor Trust Rules” (IRC §671 through IRC §679, inclusive). Thus, the Trust is called a “Nongrantor Trust,” because (1) the Trustee is not presumed “subservient” to the Grantor; and (2) the Grantor lacks sufficient control to direct the Trustee’s actions in this Trust. To be certain, a “pure” Nongrantor Trust is a Trust whose trust income and trust losses are taxed to the Nongrantor Trust or its Beneficiaries, and not to the Grantor. Moreover, the Trust Principal (Trust Assets) is not taxed in the Grantor’s Estate upon the Grantor’s death.

2.1.3 **Intentionally Defective Irrevocable Trust (“IDIT”)**. Through the proper use of the Grantor’s retained powers as provided in the IDIT, this special type of trust combines the beneficial characteristics of both a Grantor Trust and a

Nongrantor Trust, in order to provide multiple benefits to the Grantor in special unique circumstances involving highly appreciated real property. The IDIT is almost identical to the above “pure” Nongrantor Trust. For example, the Grantor and Trustee are different and the Trustee should be independent of the Grantor. Furthermore, the IDIT is irrevocable. Moreover, the powers of the Trustee give wide authority for the Trustee to pay the Trust Income and/or Principal to the Beneficiaries of the IDIT. However, in our instant case there is one specific power which is retained by the Grantor in the IDIT which is not retained by the Grantor in the pure Nongrantor Trust. This specific retained power gives the Grantor the right to reacquire the Trust Estate by substituting other Property of Equal Value to the Trust. When the Grantor retains only the specific power to reacquire the Trust Assets as aforementioned, this retained power will only cause the Trust Income and Trust Losses generated from the Trust Assets to be reported annually by the Grantor for income tax purposes, but it will not cause the Trust Assets to be included in the Grantor’s estate for estate tax purposes. Thus, this illustrates again the general rule aforementioned that the federal income tax rules operate independently from the federal estate and gift tax rules, and that this fundamental difference between the federal income tax system, and the federal estate and gift tax system, may be used by the Taxpayer for their benefit or detriment. Therefore, this retained power by the Grantor intentionally renders this Nongrantor Trust a Defective Grantor Trust for federal income tax purposes, but not a Defective for federal estate tax purposes (See IRC Section 675(4)). The reason is that this specific retained power gives the Grantor a certain limited amount of control over the Nongrantor Trust to the extent that the Trust Income and Trust Losses are reportable by the Grantor for income tax purposes only. However, this retained power does not give the Grantor excessive control over the Nongrantor Trust, causing the Trust Assets to be reportable in the Grantor’s Estate upon the Grantor’s subsequent death for estate tax purposes. Since this Nongrantor Trust is defective intentionally, this explains the reason why the IDIT is referred to as a “Intentionally Defective Irrevocable Grantor Trust.”

- 2.2 **Second Part - Private Annuities in General**. In its simplest form, a Private Annuity Contract is an agreement between two parties by which one person, the Seller, transfers certain valuable property to the Buyer in exchange for the Buyers promise to make a series of periodic annuity payments for the Seller’s lifetime (the “Annuitant”). The first annuity payment may start immediately or it may start at a future date (sometimes referred to as a “Deferred Private Annuity Contract”). A Private Annuity Contract must make payments on a regular periodic basis. Private annuities are generally used by Individuals as a means of financing the sale of an asset to a related party while saving a substantial income tax and estate tax. A Private Annuity Contract is not an annuity issued by an insurance company.

- 2.2.1 In our instant case, the Taxpayer (the “Annuitant”) transfers certain valuable and highly appreciated real property to a Nongrantor Trust, who is not in the business of selling annuities. The Nongrantor Trust (the “Obligor”) agrees to make periodic payments in fixed amounts to the Annuitant for the remainder of the Annuitant’s life.
- 2.2.2 Payments received by the Annuitant pursuant to the Private Annuity Contract are composed of three elements: (i) return of capital (which is not taxable); (ii) taxable gain on the sale of the asset (ordinary gain or long term capital gain); and (iii) taxable interest accumulating thereon (ordinary gain).
- 2.2.3 The Private Annuity operates like an installment sale promissory note (“Note”), in that a Note is a special type of payment contract which requires the Obligor to pay a certain fixed amount annually over a certain fixed period of time. The Private Annuity is also a special type of payment contract but it differs from the Note in that the period of time for each annual payment is not “fixed” because the period of time is equal to the Annuitant’s life. Also, the Private Annuity Contract has certain advantages over a Note as follows: (1) the Private Annuity Contract avoids immediate 100% recapture of depreciation (applicable only upon the sale of depreciable Property); and (2) the Note makes a predetermined exact number of payments to the Annuitant, whether or not the Annuitant dies before the final payment is made, whereas the Private Annuity Contract makes payments to the Annuitant until the Annuitant’s death, then the Private Annuity Contract terminates. The unpaid balance under the Private Annuity Contract is not reportable to the Seller or to the Buyer for income tax or estate tax purposes, as opposed to the unpaid balance due under the Note.
- 2.2.4 Upon the death of the Annuitant, all payments to the Annuitant pursuant to the Private Annuity Contract cease. Also, once the payments cease on the death of the Annuitant, the Private Annuity has no further value. Thus, there is no value remaining in the Private Annuity Contract to be includable in the Annuitant’s gross estate for federal estate tax purposes. Thus, the Taxpayer’s real property sold to the Obligor has been removed from the Annuitant’s gross estate for federal estate tax purposes.
- 2.2.5 The Obligor of the Private Annuity, in exchange for the Real Property purchased, may claim a “Cost Basis” in the Private Annuity equal to the purchase price of the Real Property received. Therefore, the Obligor of the Private Annuity may thereafter resell the Property for a cash payment and not be taxed on the sales price provided it does not exceed its Basis.
- 2.2.6 In the event the Annuitant dies before receiving the Final Annuity Payment, all future Annuity payments due the Annuitant will cease, the unpaid balance will be cancelled, and the Obligor of the Private Annuity will not be taxed on the

forgiveness of the unpaid balance (sometimes referred to as “debt relief”), notwithstanding that the Obligor has been granted “debt relief,” which is usually subject to income tax. Thus, the Obligor retains the balance unpaid to the Annuitant, and the Obligor is not liable for any federal income taxes equal to the amount of the “debt relief.” Also, the Annuitant’s Estate does not include the unpaid amount remaining in the Private Annuity Contract as part of the Grantor’s Estate.

2.2.7 The total amount of the life time payments in the aggregate will be identical to the face value of the Private Annuity Contract plus interest accumulated thereon. The payments may begin immediately or they may be deferred to a future date, depending on the sole discretion of the Annuitant. The amount of each periodic payment is then calculated according to various rules and regulations specifically issued by the Internal Revenue Service (“IRS”) in order for the Private Annuity Contract to be in full compliance with the IRC, sometimes referred to as a “Safe Harbor” (IRC §7520; Actuarial Value Book of Aleph; and Rev. Ruling 2001-3 (Tables #2 and #5)).

### 2.3 **Third Part - Tax Estate, and Asset Protection Benefits.**

2.3.1 **Comparison of Income and Estate Tax Benefits Between the Pure Nongrantor Trust and IDIT.** As indicated earlier, a “pure” Non Grantor Trust reports all Trust Income and Trust Losses for income tax purposes because the Grantor does not violate the Grantor Trust Rules set forth in IRC Sections 671-679. Also, the Grantor of the “pure” Nongrantor Trust is not taxed on the Trust’s Principal for estate tax purposes when the Grantor dies because the Grantor does not violate the applicable estate tax rules per IRC Sections 2033-2041. Again, with careful tax planning, a Nongrantor Trust may be specially designed to qualify as a Grantor Trust for income tax purposes and as a Nongrantor Trust for estate tax purposes. In such an event, the Trust Income and Trust Losses are reported annually by the Grantor for income tax purposes but the Trust Assets plus all accumulation thereon, will not be included in the Grantor’s estate upon the Grantor’s death for federal estate tax purposes. The specific income and estate tax benefits to the Grantor are more fully described below:

- (a) **Income Tax Benefits.** (a) The Grantor retains the income tax benefit of the Home Exclusion per IRC §121. Thus, a married couple who sells their Home do not have to pay income tax up to \$500,000 in profit, and a single person, \$250,000 per profit; the Grantor retains the income tax benefit of the home mortgage interest deduction per IRC §163; (b) The Grantor retains the income tax benefit of the state and local real property tax deduction or personal property tax deduction per IRC §164; and (c) The Grantor retains others similar individual income tax benefits related to individual Home Ownership.

Thus, the Trust Income and Trust Losses are reported on the individual's personal income tax return on Form 1040, and not on a separate income tax return filed by the Nongrantor Trust on Form 1041. The Grantor's gain is deferred when selling the highly appreciated Property to a Nongrantor Trust in exchange for a properly structured Private Annuity. In addition, the Nongrantor Trust receives a "stepped up basis" in the Property purchased, equal to its purchase price. Thus, there is no taxable event at the time the Private Annuity Transaction is fully executed when utilizing the Nongrantor Trust. Also, the Nongrantor Trust may resell the Property previously purchased from the Grantor, and no tax will result on the gain up to the "stepped up basis" in the Property. Furthermore, the Grantor may receive the first private annuity payment immediately, or defer the same to a future date, provided Grantor is in full compliance with the IRC and other applicable federal tax laws, rules, and policies. Once the payments start, each payment is treated for income tax purposes in three parts as follows: the first part is not taxed because it is a "return of capital;" the second part is taxed at the applicable "capital gains rate;" and the third part is taxed at applicable "ordinary rates."

- (b) Estate Tax Benefits. The Grantor obtains the Estate Tax Benefit because the Grantor's Estate Tax is substantially reduced or in some cases completely eliminated upon the Grantor's death for federal estate tax purposes. The reason is that the Home is not included in the Grantor's Estate upon the Grantor's death. Therefore, the proper inclusion and/or exclusion of certain Grantor's Retained Powers in the Nongrantor Trust combines the beneficial characteristics of the Grantor Trust and a Nongrantor Trust, especially when it applies to Home Ownership. The Nongrantor Trust is not taxed on the unpaid balance of the Private Annuity in the event the Grantor dies before the annuity payout fully occurs, the annuity payments cease, and the Private Annuity becomes null and void. Although there is "cancellation of debt," or sometimes referred to as "debt relief," the Nongrantor Trust is not taxed on the same.

2.3.2 **Pure Nongrantor Trust.** Asset Protection Benefits When the Transfer is Made by Gift or by Sale to a Pure Nongrantor Trust. The "transfer" of the Residence to a "Pure Nongrantor Trust" by gift or sale will provide the Grantor in most cases a certain predictable level of Asset Protection which varies depending upon whether the transfer is made by "gift" or a "sale."

- (a) *Gift.* In the event a transfer is made by gift, a gift tax shall be assessed on the Grantor based upon the full value of the Gift over the value of the Annual Exclusion (\$11,000). Assuming the Grantor fully satisfies certain criteria, the Grantor's Residence should be protected from

federal estate taxes upon the subsequent death of the Grantor, and the Residence should also be protected from the collection enforcement activities from potential future judgment creditors seeking to set aside the Gift, alleging a “fraudulent conveyance”. Some of the most important indicia forming this criteria referred to above include but are not limited to the following: (1) the Gift must be “fully completed”; (2) the Gift must not be a “fraudulent conveyance”; and (3) the Gift must be completed at least three years from the date of the Grantor’s death. If the above indicia are fully satisfied, (and other variables not mentioned herein), a transfer by gift will provide the Grantor a certain minimum level of “effective” Asset Protection. However, it becomes very problematic for the Grantor to achieve a minimum level of asset protection if any one of the above indicia is in doubt, or not satisfied.

- (b) *Sale.* In order for the Grantor to effectively achieve a greater and more predictable level of asset protection, a transfer by “sale” of the Residence in exchange for “full and adequate consideration in money or moneys worth” is the most preferred method of transfer (See IRC 2043 (a)). The Private Annuity Transaction is one of the most effective methods to execute a transfer by sale for income tax and estate tax purposes, because the IRS recognizes the exchange of the Residence for the Private Annuity as a bonafide genuine transfer for equivalent consideration provided the Taxpayer properly structures the Private Annuity in full compliance with the applicable Internal Revenue Code, Treasury Regulations, Revenue Rulings, Case Law and other applicable authority. In such an event, the Residence will not be taxed in the Grantor’s Estate upon the subsequent Grantor’s death for federal estate tax purposes. Likewise, the transfer of the Residence in exchange for the Private Annuity should not be set aside by a subsequent judgment creditor’s claim, on the basis that the transfer was a fraudulent conveyance to defraud creditors. The reason is that a transfer by Sale in exchange for “full and adequate consideration,” such as the Private Annuity does not violate IRC §2043 and is almost always a valid defense against a fraudulent conveyance allegation. Thus, the transfer by sale of the Residence to the Nongrantor Trust in exchange for a properly structured Private Annuity is preferred over a “transfer by gift” in order to ensure the maximum level of Asset Protection possible for the Grantor's Residence.

2.3.3 **Intentionally Defective Irrevocable Trust (“IDIT”).** Asset Protection Benefits When the Transfer is Made by Gift or Sale to the IDIT. The transfer by “Gift” versus the transfer by “Sale,” illustrates the asset protection benefits between two different types of transfer to the IDIT..

- (a) *Gift.* The Grantor may “gift” his/her Residence to the IDIT at its fair market value without incurring a gift tax because the gift of the Residence by the Grantor to the IDIT is incomplete. The reason the gift is incomplete is due to the specific type of powers retained by the Grantor in the IDIT. Hence, the IDIT is “gift tax neutral.” Moreover, the Grantor does not lose any income tax benefits associated with the Residence held in the Nongrantor Trust for the same reasons there is no completed gift. Assuming the Grantor’s Asset has not been effectively transferred to the Nongrantor Trust for income tax purposes, the Grantor reports all Trust Income and Trust Losses attributable to the Trust Asset. Specifically, the income tax benefits include but are not limited to IRC §121, the Home Exclusion; IRC §163, the Home Mortgage Interest Deduction; IRC §164, the State and Local Real Property or Personal Property Tax Deduction; and other similar individual income tax benefits related to home ownership. The primary disadvantage of transferring the asset by “gift” to the IDIT is that the gift is more likely to be later attacked and set aside by a potential future judgment creditor as a fraudulent conveyance, as opposed to transferring the asset by “sale.” If the fraudulent conveyance issue is not considered important to the Grantor when transferring the Grantor’s Residence to the Nongrantor Trust, then the transfer by Gift is an acceptable method of transferring the Residence.
- (b) *Sale.* The Grantor may sell the Residence to the IDIT at its fair market value without incurring an estate or gift tax because the transfer of the Residence by a properly structured lawful sale transaction is not subject to the estate or gift tax provisions of the federal tax laws (IRC §2043(a)). To be certain, the sales price for the Trust Asset should equal its fair market value. There are basically three (3) types of “sale transactions” which are generally used in this scenario to sell the Grantor’s Residence to the Nongrantor Trust. (1) The first type is the Installment Sale Promissory Note Contract (“Installment Notes”) pursuant to IRC §453. (2) The second type is the Self-Canceling Installment Note (sometimes referred to as the “SCIN”). Briefly, both types of sales transactions involve promissory notes, which requires the IDIT to make installment payments to the Grantor, until the purchase price is fully paid. However, the “SCIN” is cancelled automatically upon the Grantor’s death by operation of law, notwithstanding that there remains a balance unpaid in the SCIN; and (3) The third type of sale transaction is the Private Annuity aforementioned. As stated above, the Private Annuity is more similar to the SCIN than the Installment Note. The Private Annuity is a special payment contract whereby the IDIT promises to pay the

Grantor (“Annuitant”) a stated amount over the Grantor’s lifetime, payable monthly, quarterly, or annually pursuant to the terms of the Private Annuity Contract, in exchange for the Residence. Like the SCIN, all payments under the Private Annuity cease upon the Grantor’s death. However, the Private Annuity is more suitable to the sale of highly appreciated real estate than the SCIN, for various reasons beyond the scope of this discussion. The estate tax benefit is that the sale of the Grantor’s Residence to the Trust in exchange for the Private Annuity removes the asset from the Grantor’s estate for estate tax purposes, and thus protects the Trust Asset from the collection enforcement activities of potential future judgment creditors against the Grantor. Moreover, the IDIT is treated as a Grantor Trust for income tax purposes, thus there is no income tax applicable to the Grantor associated with the sale of the residence to the IDIT. Furthermore, the annual income tax benefits involving the Home Exclusion, Home Mortgage Interest Deduction, and Real and Personal Property Tax Deductions are retained by the Grantor and not by the Trust because the IDIT is a Grantor Trust for income tax purposes. Since the Private Annuity cancels upon the Grantor’s death, the remaining unpaid balance (if any) will not be includable in the Grantor’s gross estate for federal estate tax purposes. Also, the Nongrantor Trust is not taxed on the cancelled unpaid balance notwithstanding there is “debt relief” to the Nongrantor Trust.

2.4 **Fourth Part - Income Tax Reporting Compliance Requirements.** One of the other advantages of the IDIT is that it will give the Grantor the flexibility to choose the applicable method to file the income tax returns on behalf of the Trust. There are two basic alternatives in reference to the issue of filing income tax returns for the Trust.

**1<sup>st</sup> Alternative.** Section 6012(a)(4), IRC, requires a trust to file a federal income tax return if it has either “any taxable income” or “gross income of \$600 or over.” Because the Grantor Trust Rules attribute the Trust’s Income to its grantor, logic would dictate that income attributed to a grantor would not count toward these amounts. Thus, this Trust may not be required to file trust income tax returns on Form 1041 as a result of the grantor reporting the income.

**2<sup>nd</sup> Alternative.** The Internal Revenue Service (“IRS”) has ruled in Rev. Rul. 75-278, 1975-2 C.B. 461 that items attributable to the grantor are to be taken into account in determining whether a trust is required to file a tax return. Thus, according to the IRS, even if the IRC attributes all of a trust’s income to the grantor, the trust may be required to file a return if, before attribution, the trust has either any taxable income or gross income in excess of \$600. However, the IRS in its infinite wisdom, provides three alternatives to filing a separate income tax return for the trust.

- 2.4.1 Under the first alternative, the trustee must furnish all of the payors to the Trust with the name and social security number (“SSN”) of the grantor, as well as the address of the trust. The trustee must also obtain from the grantor a completed Form W-9. In addition, unless the grantor serves as trustee or co-trustee, the trustee must provide to the grantor a statement showing all items of income, deduction, and credits of the trust, identifying the payor of each item, setting forth the information necessary to take the items into account in computing the grantor’s taxable income, and informing the grantor that these items must be included in computing his or her taxable income and credits. Under this alternative, the trustee need not file anything with the IRS. This set of rules is found in Treasury Regs. " 1.671-4(b)(2)(i)(A); 1.671-4(b)(1); 1.671-4(b)(2)(ii)(A); and 1.671-4(b)(2)(ii)(B).
- 2.4.2 Under the second alternative, the trustee must provide each of the trust’s payors with the name, Employer Identification Number (“EIN”), and address of the trust. In addition, the trustee must file with IRS Form 1099 reporting the income or gross proceeds paid to the trust and showing the Trust as payor and the Grantor as payee. Finally, unless the grantor serves as Trustee or co-trustee, the Trustee must provide to the Grantor a statement showing all items of income, deduction and credits of the Trust, setting forth the information necessary to take the items into account in computing the Grantor’s taxable income and informing the Grantor that these items must be included in computing his or her taxable income and credits. This set of rules is found in Treasury Regs. " 1.671-4(b)(2)(I)(B); 1.671-4(b)(2)(iii)(A); and 1.671-4(b)(2)(iii)(B).
- 2.4.3 The third alternative is for the trustee to file a Form 1041, U.S. Income Tax Return for Estates and Trusts.

### **III. CONCLUSION**

The Grantor substantially benefits from intentionally structuring this Irrevocable Nongrantor Trust as a defective Irrevocable Trust, in order for it to be treated as a Grantor Trust for income tax purposes, but as a Nongrantor’s Trust for estate tax purposes. The specific benefits to the Grantor when transferring the highly appreciated Residence to the IDIT in exchange for the Deferred Private Annuity in our instant case are as follows:

- 3.1 The entire value of the Residence is removed from the taxable estate of the Grantor (“Annuitant”). When the Annuitant dies, the payments to the Annuitant cease, and the Private Annuity becomes null and void. Thus, the Residence is not taxed in the Grantor’s estate. The Residence, along with the balance of the Trust Assets will pass to its Beneficiaries free of estate and gift taxes.
- 3.2 If the Grantor transfers the Residence to the IDIT by Gift and not by Sale, this transfer by Gift will not trigger any gift tax even though the Residence may have a

substantial net worth in excess of the Annual Exclusion. The reason there is no gift tax is because the gift was never fully completed by definition because the IDIT is treated as a Grantor Trust for income tax purposes (See the “Grantor Trust Rules” per IRC §671 - §679). Thus the Trust Income and Trust Losses generated from the Residence are reported by the Grantor on IRS Form 1040 and not by the Trust on IRS Form 1041.

- 3.3 If the Grantor transfers the Residence to the IDIT by Sale and not by Gift, using the Private Annuity Transaction to consummate the sale as aforementioned, this transfer by Sale will not trigger any gift tax consequences even though the property has a substantial net worth. The reason is that the transfer was for “full and adequate consideration” (IRC §2043 (a)). The Private Annuity Transaction is treated by the IRS as a lawful arm’s length genuine bonafide transfer for consideration of equivalent value (IRC §1035).
- 3.4 The Residence will not be probated when the Grantor (Annuitant) dies. The reason is that the Residence is removed from the Grantor’s estate because it was sold in exchange for the Private Annuity of equivalent value.
- 3.5 The Residence generally will not be subject to Medicaid claims, should the Grantor (Annuitant) later require Medicaid assistance with nursing home care. The Private Annuity payment may be subject to Medicaid claims during the life of the Grantor (Annuitant), however, in most states the Residence is free from Medicaid claims.
- 3.6 The deferral of capital gains tax or ordinary income tax when using the Private Annuity Transaction produces a dramatic increase in disposable income for the Taxpayer.
- 3.7 The Beneficiaries of the Trust may advise but not dictate the Trustee’s actions concerning the disposition of the Trust Income and Trust Assets. All Trust Assets, including but not limited to the resale proceeds from the Residence, and all Accumulation on the Trust Assets, will be paid to the Grantor’s Beneficiaries. When the Grantor (Annuitant) dies, the Private Annuity terminates and only the balance of all Trust Assets remaining are distributed to the Beneficiaries, according to the Trust Agreement.
- 3.8 The IDIT may resell the Residence on a cash basis later to the ultimate buyer of the Residence, without incurring a taxable event, assuming the resale price to the ultimate buyer is less than or is equal to the IDIT’s purchase price paid by the IDIT to the Grantor. Therefore, the IDIT is not forced to make an installment sale to the ultimate buyer, in order to spread out and defer the capital gains tax. A cash sale over an installment sale is a substantial advantage because there is no guarantee the ultimate buyer will ultimately make all of the installment payments on the installment sale - promissory note.

- 3.9 The Private Annuity is the equivalent of receiving a tax-free loan from the federal government, because the capital gain tax or ordinary income tax may be deferred, benefiting the Grantor (Annuitant) for the period deferred. This assumes the interest accruing on the Private Annuity is less than the accumulation earned on the Trust Assets.
- 3.10 The formal mechanics of the Private Annuity Transaction between the Grantor (Annuitant) and the IDIT provides the additional discipline that some taxpayers may find necessary and helpful in forming and funding their own retirement plan. Moreover, the Private Annuity works equally well for single or married Grantors (Annuitants). Married couples can have the private annuity written as a joint, last to die single premium Private Annuity contract.

The final point is that the use of this strategy depends ultimately upon the facts and circumstances involving the Grantor's estate. To be certain, the benefits afforded the Grantor when adopting the use of the IDIT with the Private Annuity Transaction are substantial, and therefore this Strategy should merit serious consideration for any affluent high net worth Taxpayer with a highly appreciated personal residence and/or other suitable highly appreciated real property. If you have any questions or require additional information, please do not hesitate to contact our office.

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