An intentionally defective irrevocable trust (IDIT) can be an effective estate planning tool. Properly used, they can enable clients to accomplish a variety of objectives. They can be particularly effective in managing transfer tax issues associated with large premium life insurance cases.

Income Taxation of Trusts – In General
It may be helpful to begin with a brief overview of trust taxation principles. A trust is a distinct legal entity that can own and manage property in the same way individuals and corporate entities can. Like their individual and corporate counterparts, trusts are subject to income tax on income realized in any given tax year. Taxable income generally consists of gross income for the year minus deductions. Gross income for a trust is broadly defined, as it is for individuals – income from whatever source derived. If an item would represent income in the hands of an individual, it will be considered income to the trust. Similarly, a trust may generally claim deductions that would otherwise be allowed to an individual, though there are certain exceptions and additions.

One additional deduction unique to trusts is the ability to deduct from income distributions of taxable income made to beneficiaries of the trust during the year. Where that occurs the beneficiaries pay tax on the income distributed to them. Generally speaking then, with trusts, whoever receives the income, pays the tax.

The Grantor Trust Rules
The general rules outlined previously do not apply to grantor trusts. Grantor trusts do not have income taxable to the trust. Rather, the trust income is taxable to the grantor as the owner of the trust for income tax purposes. The grantor trust rules were established to prevent wealthy taxpayers from reducing their income taxes by transferring income producing property into trusts over which they retained significant control, but which would be taxed at rates lower than the grantor’s. Under the grantor trust rules a person who transfers property to a trust (the grantor) is treated as the owner of the trust for income tax purposes if the grantor retains certain powers or interests in the trust or trust property. As owner of the trust the grantor is taxed on income earned by the trust (to the extent of his or her ownership interest). Those powers or interests which result in Grantor trust status are outlined in Internal Revenue Code (IRC) §§ 673 - 679. They include (but are not limited to) the following:

• Certain reversions of the trust property to the grantor (if the value of the reversion exceeds 5% of the value of the trust) ($ 673)
• Retaining certain powers to control beneficial enjoyment of the trust property or income ($ 674)
• Retaining certain administrative powers ($ 675):
  – To deal with trust funds for less than full and adequate consideration
  – To borrow without adequate interest or security
  – To exchange property of equal value
• Retaining the power to revoke the trust ($ 676)
• Trust income distributed or held for the benefit of the grantor ($ 677):
  – Income used to pay life insurance premiums on life of grantor or grantor’s spouse
  – Income used to discharge a legal obligation of the grantor

Today, the income tax brackets for trusts are compressed when compared to those for individuals. In 2014, for example, the highest marginal bracket of 39.6% is imposed on every dollar of income over $12,150. By comparison, for married taxpayers, filing jointly the 39.6% bracket does not apply until taxable income exceeds $457,600. These compressed tax brackets are one reason why it is often preferable to treat the grantor as owner and tax the income to the grantor rather than to the trust.
Estate Taxation of Trusts – In General
For purposes of federal estate taxes, one’s estate includes the value of all property interests held at the time of death – including certain interests in trusts. For estate tax reasons, grantors typically wish to avoid having the value of assets they transfer in trust included in their estate. Accordingly, grantors should avoid retaining a beneficial interest in the trust assets or retaining control over how those assets are distributed.

For example, grantors should not, in most cases, retain rights to income or other beneficial use and enjoyment of the property transferred to the trust. Grantors should generally not serve as trustee or co-trustee and they should not retain the power to revoke the trust or otherwise alter its terms. To do so would risk inclusion of the trust assets in the grantor’s taxable estate. This is, of course, why many estate planning trusts are irrevocable.

Intentionally Defective Irrevocable Trusts
With “defective” trusts the grantor is treated as the “owner” of the trust for purposes of income taxes, but not for purposes of estate taxes. In other words, the grantor has retained one or more of the powers or interests outlined in IRC §§ 673-677 or 679, but has not retained any power or interest which would cause the trust to be included in his gross estate.

Some of those powers that give us the income tax results we’re looking for would, unfortunately, also bring the assets into the estate. Therefore, the trust instrument has to be drawn carefully by professional legal counsel. A common method for establishing an IDIT is to include a provision that permits the grantor to exchange property of equal value with the trust. Another approach is to provide that trust income may be applied to the payment of life insurance premiums on the life of the grantor or the grantor’s spouse. By including such provisions and intentionally violating the grantor trust rules, we are able to create a number of favorable tax consequences:

• The effect of the grantor’s paying taxes on income earned by the trust is equivalent to the grantor making tax-free gifts to the trust.
• The trust assets can appreciate at a faster rate because its earnings are, in effect, tax-free.
• The grantor can sell assets to the trust without incurring capital gains taxes (he or she is essentially selling to him/herself for income tax purposes).

Life Insurance and Intentionally Defective Irrevocable Trusts
Typically, life insurance for estate liquidity purposes is set up in an Irrevocable Life Insurance Trust (ILIT) in which the only asset is the life insurance policy. The grantor makes annual gifts to the trust which are used by the trustee to pay life insurance premiums. The trust typically provides beneficiaries with Crummey withdrawal powers which enable the grantor to shelter some or all of the gifts with his or her annual gift exclusions.

This process works very well where the gifts to the trust can be fully sheltered with annual exclusions. For clients with larger estates, however, there may not be sufficient annual exclusions available. The premiums may simply be too large, clients may already be using their annual gift tax exclusions on other gifts or there may be an insufficient number of Crummey beneficiaries.

As an alternative to the traditional unfunded ILIT, clients may want to consider funding a “defective” ILIT with income producing assets. For example, assume the grantor needs $4 million of life insurance set up in an ILIT. The required premium is $80,000 annually. The grantor has only $39,000 of available annual exclusions that can be used to offset annual gifts of premium to the trust. As an alternative to making taxable gifts every year, the grantor can consider funding the trust up front a portion of his lifetime gift tax exemption. If we assume the client makes a gift to the trust of $1 million (using a portion of his total lifetime gift tax exemption) which earns income of 6% annually, the trust’s income of $60,000, coupled with available annual gifts of up to $39,000, should be able to fully cover annual premium costs with its earnings. Additionally, this enables the grantor to allocate any remaining lifetime gift tax exemption to other transfers. By paying any income taxes on trust income, the grantor preserves his annual gift tax exclusion for use with other gifts. And remember, an IDIT’s assets are not being depleted by income taxes.

This process can be further enhanced by combining it with valuation discounts. For example, rather than making an outright gift of $1,000,000, assume the grantor makes a gift of minority interests in a family partnership. If a qualified appraiser determines that the grantor is entitled to a valuation discount of 35% for minority interest and lack of marketability, his gift of $1 million will effectively transfer assets with a pro-rata value of $1,538,462. Again, assuming a 6% current yield, the partnership interests will generate approximately $92,000 of cash flow each year without being reduced for income taxes, which are paid by the grantor. This would fully cover premium payments in our example and possibly enable the trust to purchase more life insurance on the life of the grantor.

For the wealthiest of families, premium requirements may be so large that the approach outlined above is still inadequate. Clients such as these may want to consider taking this approach one step further by enhancing it with a sale of assets to an IDIT. Here’s an example:

Let’s again assume our hypothetical client gifts $1 million to an IDIT using a portion of his lifetime gift tax exemption to offset any potential gift taxes, and that any remaining lifetime gift tax exemption has been earmarked for other transfers. After providing the trust with this “seed money,” the client then sells to the trust a minority interest in a family partnership. The pro-rata value of the assets in the partnership is approximately $15 million. The client sells this interest to the trust for its discounted fair market value of $9.75 million (assuming an allowable 35% discount for minority interest and lack of marketability).
Because the trust is a grantor trust for income tax purposes, the client does not recognize any gain on sale of the partnership interests. The trust pays for the sale with a 10-year interest-only balloon note. The initial gift of “seed money” to the trust is necessary in order to support the bona fides of any note made by the trust. The interest rate on the note would be equal to the long-term Applicable Federal Rate (AFR). It is imperative to observe all formalities of the transaction in an arms-length, businesslike fashion. Assuming the interest rate is 5%, the trust must pay the client $487,500 in interest on the note. If we assume that the trust assets ($1 million gift plus the $15 million non-discounted value of partnership assets) produce a 6% current yield, that translates to $960,000. After subtracting interest due on the note, there remains $472,500 of potential cash flow available for the purchase of life insurance. Any excess amounts can be reinvested in trust assets. Growth in value of the trust assets can be used to pay off the note at maturity.

### Sale of Family Partnership Interests to a Intentionally Defective Irrevocable Trust (IDIT)

- **Grantor**: Gifts lifetime gift tax exemption
- **IDIT**: Sale of FLP units (no gain recognized on sale)
- **Insurance Company**: IDIT (cash flow used to pay interest and premium)
- **IDIT**: Note (appreciated assets used to pay off note)

### Conclusion
Effective estate tax planning is all about leverage – transferring assets out of one’s estate while minimizing tax cost. This is generally accomplished by a combination of discounting the value of gifts made today and selecting assets that, after being gifted, have the greatest potential for future appreciation in value outside of the taxable estate. Intentionally Defective Irrevocable Trusts can be an effective vehicle for certain clients who otherwise may be confronted with significant gift taxes when funding their life insurance needs.

### Important Note:
This article points to the particular advantages an IDIT may yield when combined with valuation discounts and a sale in conjunction with a note. The ability to take valuation discounts, though firmly established and well supported in various court decisions, is complex and will almost certainly be scrutinized by the IRS. It is not entirely clear what the income tax consequences would be if the grantor died while the note is outstanding. Some have argued that because the trust is no longer a grantor trust upon death, the income associated with the sale of the assets should be recognized. Such issues serve to point out the importance of seeking the guidance of professional tax and legal advisors.

The American Taxpayer Relief Act of 2012 (ATRA) impacts the federal gift, estate and generation skipping transfer tax (together referred to as “transfer tax”) ATRA made permanent the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 exemption amounts of $5,000,000 (indexed for inflation to $5,340,000 in 2014) per person for transfer tax purposes, increased the maximum transfer tax rate to 40% and provides for portability of the estate tax exemption between spouses. Clients need to understand that tax law is always subject to interpretation and legislative change. MetLife and its affiliates do not provide tax advice and therefore clients must speak with their qualified legal and tax counsel to discuss their current estate plan and to discuss what planning options are available and appropriate.
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