The DIGITS

(Defective irrevocable grantor income trust)

This is one of the oddest named new plans for estate planning, but quickly rising up the ranks as one of the preferred methods of performing an estate freeze on property that is expected to appreciate in value between now and the moment of one's eternal departure. It is generally used in conjuncture with making a sale of gift assets, with the purchase of new life insurance plan, or for exiting an existing insurance financing plan. The DIGIT is a combination of two estate planning concepts the irrevocable life insurance trust (ILIT) and the defective grantor trust.

Some background on these two planning techniques is probably needed. The irrevocable life insurance trust is aimed at two things, getting money out of the taxable estate of a U.S. citizen[1] early and providing an inheritance with as little estate tax as possible at death. Insurance proceeds are includable in the estate of a decedent if at the time of death he possessed any incidents of ownership in the life insurance policy. This includes the ability to change beneficiaries, make payments to the policy, or have the power to revoke the policy. How an irrevocable life insurance trust works (in a very basic sense) is that the client puts into a trust that he cannot revoke or amend an amount of money necessary to fund a life insurance policy. The trust holds the policy for the benefit of the beneficiaries of the trust, and pays the premium on the policies as they come due. The first benefit is that the client takes out of his estate the portion of money to fund the trust (though there may be some gift tax consequences on funding);[2] the second benefit is that the amount is not included in the gross estate.

The defective grantor trust is a little more complicated to explain (though easier to plan with) because it requires both an explanation of trust taxation, grantor trusts, and what makes them "defective". Trusts are taxed on the undistributed income they earn each year as an individual entity. They have their own tax regime under a compressed rate schedule that quickly reaches the maximum individual tax rate on income, and there is an extensive set of rules and regulations around how a trust accounts for its income taxes after reduction for distributions to beneficiaries. A trust is also included in the gross estate of a decedent for the purposes of federal estate tax if certain prohibited

---

[1] Green card holders and sometimes resident aliens are subject to Federal Estate Tax (FET) as well.
[2] Gifts are cheaper than estate taxes even though they are taxed at the same rate, because the tax cost of making a gift of $100,000 at the 55% rate is $55,000 and the cast of leaving a bequest of $100,000 is $222,222 which after taking a 55% tax of 122,222 leave $100,000. Passing an amount by gift is about 45% cheaper than by legacy at the maximum rate.

powers are retained by the decedent. So generally the trust has to be irrevocable by the settler of the trust and the settler has to avoid having any direct or indirect control over the trust after formation.

Once upon a time, when the income tax was a staggering percentage of income for higher bracket individuals, and the maximum rate of tax on trusts was not indexed to the highest individual rate and there were tax savings for the wealthy for holding income producing assets in a trust. The congress, in response, developed the grantor trust rules to include into the income of the grantor (settler) of the trust income under certain circumstances.[3] If a trust contained one of the prohibited powers then the trust was considered a "defective" grantor trust because the income was taxed to the grantor, at a higher rate than had it been taxed to the trust. Then the tax rates for trusts were amended so that the benefit to holding assets in a trust for federal income tax purposes disappeared, but the rules and the name "defective grantor trust" remains with us.

How a defective grantor trust works in the estate planning context is best explained in an example. Rich father forms a non grantor irrevocable trust for his daughter that distributes to her at his death and contributes $1,000,000 to the trust and gives daughter $12,000 in cash in the same year. Father has not made any prior taxable gifts, the $12,000 cash uses up his annual gift exclusion for the year. The million dollar gift uses up his entire credit for lifetime taxable gifts. The trust for the sake of easy numbers earns 10% a year on capital, with no expenses. The trust is taxed on the hundred thousand dollars of income each year at a rate of 35% and pays $35,000 in taxes leaving behind $65,000 to accumulate into principal. At the end of ten years the trust has accumulated about $1,877,137 for the benefit of the daughter.

But, say in this case the father is really rich and is going to pay a lot in estate taxes at death and has a lot of spare income. Then it would be in the father's interest to set up a defective grantor trust that contains a prohibited power for the grantor tax rules, but not a power that is a prohibited power under the estate tax rules such as; the power of a non-fiduciary person to reacquire the trust assets by substituting property of an equivalent value, the power of the grantor or the grantor's spouse to borrow from the trust without adequate interest or security, or the power to use trust income to pay premiums on insurance on the life of the grantor or the grantor's spouse. Then the income taxes are paid by the rich father and not the trust, and the payment of the income taxes is not treated as a taxable gift. So in the first year the trust has income of $100,000, the father pays the income tax of $35,000 and the trust corpus goes up to $110,000. After ten years the trust has a corpus of $2,593,742 and the father has removed $877,137 from his taxable estate by paying the tax and at a 55% rate and

---

[3] Sections 671-678 of the IRC contain the grantor trust rules.

has saved $482,425 in estate taxes. Which at the end of his life increase the amount of money that he leaves to his daughter.

Now for the third piece of the puzzle - the estate freeze. The main thought behind this beautiful piece of tax engineering is to prevent the estate of a business owner from getting larger while keeping the business going. It is done many different ways; preferred stock arrangements, family limited partnerships, and, of course, in the case of trusts- installment sales. Suppose in this case the rich father has a taxable estate of $20,000,000 and most of his net worth is tied up in a business he owns, called Fathers LLC. Suppose the father is planning on being alive for another ten years, at least, and expects that his business if it keeps growing will be worth $40,000,000 when he dies. That twenty million will cost his beneficiaries $11,000,000 in estate taxes when he dies.[4]

An installment sale to a trust works like this: the father first puts $2,222,222 in cash in a trust for daughter. Then the trustee of the trust buys the bulk of the value of the Father LLC from the father on an installment sale for twenty million with interest at the stated Adjusted Federal Rate (AFR) published by the IRS each month.[5] If Father LLC is producing enough income to pay the note each year, then when father dies all that he posses at death is the value of the note which is worth $20,000,000 or less depending on principal payments, and all the appreciation of the business is captured in the trust for the benefit of the daughter, which passes along $11,000,000 dollars to the daughter pretty much tax free.[6]

The DIGIT combines all these different estate planning techniques into one overall estate planning device. It is generally formed in the following way. First the client forms the DIGIT which is a trust designed by estate planning professionals to avoid estate inclusion and to fail the grantor trust rules in such a way under one of the inclusion rules so that income in the trust is taxed to the grantor. Second, the grantor pays in seed money equal to 1/9th of the total value of the assets transferred to the trust. Third, the grantor then enters into an installment sale with the DIGIT trustee who agrees to purchase income producing assets from the grantor in exchange for an installment note.[7] There should not be any capital gains on the sale of the asset since the grantor is still treated as owning the income for tax purposes. The professionals structuring the transaction should be an effort

[4] When it comes to the estate tax, success can be expensive.

[5] Generally if Father continues to run the business then the LLC is divided into separate interests, a control interest of 1% that has management of the company, and a non-controlling interest that is transferred to the trust worth 99% of the business. There is also a discount for the lack of control, and perhaps marketability depending on the type of business.

[6] This kind of planning can go seriously wrong if the property that is being transferred is a real estate that has serious depreciation and non-recourse mortgages. There are some instances in dealing with real estate developers, and the transfer of investment property where the increase of basis at death is worth more than the estate taxes imposed.

[7] The trust needs to be in a legal jurisdiction where such a purchase is considered a valid investment of the trust assets so that the trustee does not violate any “prudent investor” rules.

to structure the transfer of business assets in such a way as to get a market valuation discount on the sale of the assets. Forth, the assets transferred to the DIGIT should be income producing assets such that they are able to pay the note as it comes due. The income on the assets will be taxed to the grantor of the trust. The interest on the note will not be taxable because essentially from a tax point of view the grantor is paying that money to himself, but there is no deduction for the interest either. Fifth, the DIGIT should use any residual money to purchase an insurance policy on the life of the grantor, or accumulate money for the payment of the principal of the note.

The actual calculations of the financial effects of this form of DIGIT are complex. For it to work there has to be certain factors in place;

1. There has to be enough cash flow from the investment to pay the interest on the note.
2. The grantor must retain enough assets to pay the taxes as they come due on the income of the assets in the trust, minus the distributions from the trust to the grantor.
3. The property must appreciate over the life of the trust, or not depreciate enough that the note becomes more valuable than the property in the trust or the estate tax consequences flip.

Conclusion

The DIGIT works best obviously for wealthy people, who expect appreciation in their assets. The most advantage from an estate planning point of view is if the grantor of the trust outlives the payment of the note but there are advantages from the estate freeze from the very start. The ability to use excess income over interest payments to fund insurance policies that allow for a tax free appreciation of value is a beneficial bonus. The ability to take an appraisal discount for transferred property is also a consideration.