Intentionally Defective Grantor Trust

An "Intentionally Defective Grantor Trust", or IDGT,[1] is an estate planning strategy used by wealthy individuals to transfer appreciating assets to others with the least possible income tax, gift tax, and estate tax burden. The strategy employs an irrevocable trust which is carefully structured to have the following attributes:

- **Income taxable to grantor:** The income from the trust is taxable to the individual setting up the trust. Trust income is otherwise taxed either to the trust itself, or, if distributed, to the trust's beneficiaries.
- **Excluded from estate:** The assets inside the IDGT should not be included in the grantor's estate.
- **Completed gifts:** Transfers to the IDGT are considered "completed" gifts for federal[2] estate and gift tax purposes.

Parties to a Trust

- **Donor, grantor, or trustor:** The individual or individuals setting up the trust and contributing assets.
- **Trustee:** The individual or entity responsible for managing the trust.
- **Beneficiary:** The individual or individuals who receive the income and, ultimately, the trust assets.

"Intentionally Defective"

The term "intentionally defective" refers to the fact that an IDGT is structured to intentionally violate the "grantor trust" rules of the Internal Revenue Code and thus cause the trust income to be taxable to the grantor during the grantor's life. The grantor trust rules were originally designed to prevent a high-bracket taxpayer from using trusts to shift income to a lower-bracket taxpayer. An intentional "violation" occurs when the grantor or a trustee (not the grantor) who is a non-adverse party[3] retains certain powers or rights, such as:

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[1] IDGTs are also known as "Intentionally Defective Irrevocable Trusts" or IDITs.

[2] The discussion here concerns federal tax law. State or local law may differ.

[3] Generally, a "nonadverse" party is someone who is not an "adverse" party. An adverse party is someone with a significant interest in the trust who could be negatively affected by the actions (or inaction) of either the grantor or a trustee.

- The power to control beneficial enjoyment of the trust.
- Certain administrative powers, such as the power to borrow from the trust or the power to remove assets from the trust and exchange them for assets of equal value.
- The power to revoke the trust in favor of the grantor.
- The power to use trust income to purchase life insurance on the life of the grantor and/or the grantor's spouse.

Causing the trust's income to be taxable to the grantor has several significant advantages:

- Because the grantor pays the tax on trust income, the assets inside the trust effectively grow tax free.
- The federal income tax rates applicable to trusts are extremely high, compared to the tax rates applicable to individuals. In 2022, for example, a 37.0% marginal tax rate applies when taxable trust income reaches $13,450. In comparison, for an individual taxpayer using the Single filing status, the 37.0% marginal rate only applies when taxable income reaches $539,900.

Making the Transfer – And Keeping Assets Out of the Grantor's Estate

In drafting the trust provisions, it is essential that no power or authority be retained by the grantor that might cause the assets inside the trust to be brought back into his or her estate for estate tax purposes. When the grantor transfers assets into the trust, the transfer is structured as a bona fide <u>sale</u>. The fact that a sale has occurred removes the assets from the donor's estate and avoids having the transfer treated as a gift, subject to federal gift tax. The sale effectively "freezes" the value of the asset and removes any future appreciation from the donor's estate.

- **Installment note:** In exchange for the assets sold to the trust, the grantor receives an installment note of equal value from the trust. The installment note may provide for regular payments of both principal and interest, or for interest-only payments with a balloon payment at the end of a specified period of time. Substantial estate tax savings can be achieved if growth in the value of trust assets exceeds the interest paid to the grantor under the installment note.

- **“Seed” money:** Prior to the sale, a grantor will frequently transfer other assets into the trust equal to between 10% - 20% of the assets to be sold. This transfer is subject to gift tax and serves to insure that the trust has sufficient income to make the projected installment payments.

- **Valuation discounts:** In some situations, the assets to be sold to the trust may first be placed in a business structure, such as a family limited partnership or limited liability company, where valuation discounts for factors such as marketability or lack of control may apply. This can allow the grantor to increase the value of the trust for the beneficiaries.

- **Capital gains:** Because the grantor and the trust are treated, for income tax purposes, as one and the same, the grantor can sell assets to the trust without recognizing any gain on the sale.

Seek Professional Guidance

An intentionally defective grantor trust is considered by many financial professionals to be a technique that should be used only after careful consideration. Although the strategy appears to be supported by case law and IRS rulings, there is no definitive statutory basis for it. Because of the inherent complexity of an IDGT, the guidance of knowledgeable tax and legal professionals is highly recommended.