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Intentionally Defective Grantor Trusts (IDGTs)

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WHY DO WE CARE ABOUT IDGTs NOW?

The Tax Cuts and Jobs Act (TCJA) signed into law at the end of 2017 included an important, but temporary, modification in the gift and estate tax space – a doubling of the unified gift and estate tax lifetime exemption through December 31, 2025. In 2022 this translates to an individual having the ability to transfer $12.06 million of assets free from gift and estate tax. The word "unified" is important in the understanding of how this works and it simply means that the $12.06 million exemption applies to transfers during life (subject to "gift tax") and transfers at death (subject to "estate tax"); in other words, if an individual were to pass away in 2022 having made no gifts for purposes of the gift and estate tax, the Estate would still be eligible to exclude the first $12.06 million of assets from Estate Tax.

In terms of tools to maximize the effectiveness of lifetime gifting to reduce gift and estate tax exposure, the Intentionally Defective Grantor Trust (IDGT) is one of the more popular strategies.

THE BASICS OF IDGTs

IDGTs are in many ways an example of a "loophole" in the Internal Revenue Code. Ordinarily, when a person (grantor) transfers assets to a trust without the ability to modify, amend, or revoke the trust, this is referred to as an "irrevocable trust" and the trust will have its own filing requirements and be taxed at the trust level. If the terms of an irrevocable trust give the grantor certain powers as specified in IRC §§ 671-678, then, although the trust is still irrevocable and a completed transfer for purposes of the gift and estate tax regime, the grantor will be treated as the owner of the assets of income tax purposes. It is the inclusion of this specific language that makes the transfer of assets to the trust "defective" for income tax purposes.
Choosing which powers to use in the trust agreement to make the trust defective is an important choice in its own right. The power most commonly used in the drafting of IDGTs is the grantor retaining the "power to reacquire trust corpus by substituting property of an equivalent value" (see Regs. §1.675-1(b)(4)(iii)). This can be an extremely valuable tool if, for example, assets that were previously transferred to trust have a large unrealized gain and there are assets still within a grantor's taxable estate that are of the same value but have a high-cost basis. Since assets within a person's taxable estate at death receive a step-up in basis to fair market value at date of death, this strategy can effectively eliminate significant future capital gains.

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POTENTIAL PROS AND CONS

Pros of transfers to IDGTs include (but are not limited to):

- The value of the assets transfers is frozen for gift and estate tax purposes at the time of the gift. This means that if, for example, stock in a company increases in value a thousand-fold after the stock was transferred to the trust, none of the increased value will be subject to estate tax upon the grantor's death.

- Since the grantor is considered the owner of the trust's assets for income tax purposes, any tax payable related to the income generated from trust assets will be payable by the grantor. The payment of taxes on trust assets –referred to in the industry as "tax burn"—is itself a powerful tool to reduce one's taxable estate while allowing the assets outside of the estate to grow in value without any drag on growth that ordinarily comes from income tax payments. It's important to note that depending on the terms of the trust and/or the location of the trust (it's "situs"), the trust may be able to reimburse the grantor for the tax paid on income generated from trust assets if the benefits of the tax burn are not desired.

- The grantor of the trust can set terms of when and under what conditions the beneficiaries of the trust assets receive distributions from the trust.

- Based on current IRS guidance, a transfer of assets to an IDGT during the current period of increased unified lifetime exemption up to the exemption amount currently available to the taxpayer should be respected even if/when the lifetime exemption amount sunsets at the end of 2025. This particular issue should be examined closely upon execution of the trust, particularly in cases where a valuation discount was taken on assets transferred to the trust.

Cons of transfers to IDGTs may include (but are not limited to):

- Although the grantor will be responsible for picking up the income from the trust on his/her own income tax return, there is still a requirement to file an income tax return for the trust (for informational purposes) and issue a "grantor letter" summarizing the income generated by the trust that will be included in the grantor's personal income tax return.

- Transfers to trusts are more complex than outright gifts to beneficiaries since there are administrative responsibilities associated with managing a trust that would not exist If the assets were transferred outright.

- Irrevocable transfers are considered "irrevocable," meaning it can be difficult or impossible to modify the terms of the trust.

OTHER IMPORTANT CONSIDERATIONS

Another popular estate planning tool is selling assets to an IDGT in return for a note that pays interest at the "applicable federal rate" (AFR) as in effect at the time of sale. This strategy is essentially a bet that the assets transferred will appreciate at a rate higher than the AFR – when this works, the extent to which the appreciation realized by the trust assets exceeds the interest income on the note is growth that was shielded from gift and estate tax. This method, while popular, typically involves a mix of gifting assets and selling assets and you will want to proceed with caution under the advice of an experienced attorney.

If you would like to discuss your estate plan and if an IDGT may be advantageous to you, please contact:

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About Landmark Wealth Management

Landmark Wealth Management is a trusted, independent, registered investment advisory firm dedicated to helping clients reach their financial goals. Our firm works in a fiduciary capacity on behalf of high-net-worth individuals and families, institutions, and non-profit organizations. We focus on portfolio management, retirement planning, tax planning, and estate and generational wealth planning. Our team is credentialed in multiple areas: Certified Financial Planner (CFP), Chartered Financial Analyst (CFA), Certified Public Accountant (CPA), Certified Private Wealth Advisor (CPWA), and Certified Investment Management Analyst (CIMA). The firm is located in Amherst, New York, a suburb of Buffalo.