

## Intentionally Defective Grantor Trusts

### What Is An Intentionally Defective Grantor Trust?

A “Grantor Trust” is a trust that runs “afoul” of the rules contained in Sections 671 through 679 of the Internal Revenue Code (the “Grantor Trust Rules”). Traditionally, running afoul of Grantor Trust Rules was viewed negatively in that the Grantor (the Trustor or creator) of the trust was, for income tax purposes, the owner of the trust assets, and therefore personally responsible for all items of income (ordinary income and capital gains) attributable to the assets held in the trust. This personal responsibility existed whether the income and/or principal was distributed to the Grantor or not.

Even though the Grantor is treated as the owner of a Grantor Trust for income tax purposes, he or she is not necessarily treated as the owner for estate tax purposes. The estate tax inclusion rules are applied separately to make the latter determination.

In some cases, a beneficiary can be treated as a Grantor (and therefore, the owner, for income tax purposes) of a Grantor Trust, thus allowing the beneficiary to utilize any tax benefits (or detriments) that would otherwise be attributable to the Grantor Trust.

An “Intentionally Defective Grantor Trust” (“IDGT”) is a term used for a trust that is purposely drafted to invoke the Grantor Trust Rules.

### How Do You Make A Trust An IDGT?

An IDGT can be created in one or more of the following ways:

1. The Trustor or his or her spouse retains the power to recover the trust assets (e.g., the Trustor retains the right to reacquire property out of the trust in exchange for property of equal value);
2. The Trustor or his or her spouse can or does benefit from the trust income (e.g., the Trustor and/or a nonadverse Trustee can sprinkle income for the benefit of the Trustor’s spouse);
3. The Trustor or his or her spouse possesses a reversionary interest worth more than 5% of the value of the trust upon its creation;
4. The Trustor or his or her spouse controls to whom and when trust income and principal is to be distributed, or possesses certain administrative powers that may benefit the Trustor or his or her spouse (e.g., a nonadverse Trustee may add beneficiaries of the trust income and/or principal);
5. The Beneficiary has a power to withdraw the trust income or principal to himself or herself (e.g., a Crummey power); and/or

6. The Trustor and/or a nonadverse Trustee has the power to apply trust income to the payment of premiums for insurance on the life of the Trustor or the Trustor's spouse.

### Why Would You Want An IDGT?

An IDGT is an essential component for many estate planning techniques. For example, the most basic plan includes a revocable living trust (to avoid probate and allow for full use of the Applicable Exclusion Amount for estate tax), which is an IDGT.

Irrevocable trusts, held for the benefit of the Trustor's/Grantor's beneficiaries, can be IDGTs also. Because the Trustor/Grantor pays the income taxes incurred by the IDGT, the assets held in the IDGT can grow unreduced by such income taxes. This, in turn, increases the value of the assets available for the trust beneficiaries. In essence, the payment of taxes by a Trustor/Grantor is a gift to the trust beneficiaries that is not subject to transfer tax.

Payment by the Grantor of the income taxes will also work to reduce the assets held in the Grantor's estate, another very basic strategy for reducing estate taxes.

Certain insurance trusts, GRATs, GRUTs, charitable lead trusts, and QPRTs, all very valuable estate planning tools, are IDGTs as well. (These trusts are all discussed in other articles on this website.)

As mentioned above, the Trustor need not be the "Grantor" of an IDGT. Instead, if the beneficiaries have a right to withdraw assets from the trust, even if such right lasts for just a brief period (*i.e.*, a Crummey power to withdraw), such beneficiaries will be the "Grantors" with respect to such assets held in the IDGT, for purposes of the Grantor Trust Rules. Setting up IDGTs where the beneficiaries are the "Grantors," however, may cause creditor protection issues for the beneficiaries. The status of the law on this issue in California is not yet clear.

Also, because the Grantor is treated as the owner of the assets in an IDGT for income tax purposes, the sale of an asset by a Grantor to his IDGT will not trigger gain. Further, the interest paid by the IDGT and received by the Grantor will likewise not be subject to income tax treatment. If such an asset is sold on an installment basis (due to, for example, limited other assets in the IDGT), and the Grantor dies before all payments are made, all payments subsequent to the Grantor's death will be subject to income tax treatment, because the Grantor will no longer be treated as the owner of the IDGT, for income tax purposes. (Such income tax consequences may be mitigated by any estate taxes that are paid on the above-described right to receive payments after death.)

#### **Example:**

George forms an IDGT for the benefit of his children, Sam and Dot. During George's lifetime, the trustee has discretion to distribute trust accounting income out to Sam and Dot and the principal is to be used for their health, support, education and maintenance. After George's death, all undistributed income and principal can be distributed out to Sam and Dot. George owns real estate in La Jolla, California, worth \$1,000,000. The expected annual growth in value on this property is 4%. George's life expectancy is 20 years. At George's death, he owns

\$1,000,000 in cash, the overall transfer tax rate is 50% and the Applicable Exclusion Amount is \$1,000,000 (which, based on these facts, translates into an Applicable Credit of \$500,000). George has the following options, among others (calculations relating to the tax savings illustrated within these options are set forth in the table below):

1. George can hold on to the property and pass it to his children at death. Assuming the 4% annual growth rate, the value of the property will be \$2,191,123 ( $\$1,000,000 \times 1.04^{20}$ ) at his death. The net value of the property passing to Sam and Dot at George's death will be approximately \$2,095,562.

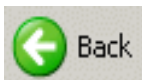
2. George can gift the property to a non-grantor trust for the benefit of his children, using up \$1,000,000 of his Applicable Exclusion Amount during life. The net value of the property passing to Sam and Dot at George's death will be approximately \$2,691,123.

3. George can sell the property to an IDGT on an installment sale, with payments of principal and interest over 15 years. Assume that George has spent all but \$300,000 of such payments prior to his death on the income tax liability from the IDGT. The net value of the property passing to Sam and Dot at George's death will be approximately \$3,341,123.

The calculations of these figures are illustrated in the table below:

As can be seen from this very simplistic example, the potential estate tax savings achieved by incorporating an IDGT into an estate plan can be substantial.

Option	1	2	3
Cash	1,000,000	1,000,000	1,300,000
Property	<u>2,191,123</u>	<u>0</u>	<u>0</u>
Total Estate	3,191,123	1,000,000	1,300,000
Tentative Tax at 50%	1,595,561	500,000	650,000
Less Applicable Credit	<u>(500,000)</u>	<u>0</u>	<u>(500,000)</u>
<b>Transfer Tax</b>	<b>1,095,561</b>	<b>500,000</b>	<b>150,000</b>
Total Estate	3,191,123	1,000,000	1,300,000
Less Transfer Tax	(1,095,561)	(500,000)	(150,000)
Property in Trust	<u>0</u>	<u>2,191,123</u>	<u>2,191,123</u>
<b>Amount Passing to Kids</b>	<b>2,095,562</b>	<b>2,691,123</b>	<b>3,341,123</b>



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