ESTATE PLANNING — BENEFITS OF INTENTIONALLY DEFECTIVE GRANTOR TRUSTS (IDGTS)

For many years, estate tax planners have designed Intentionally Defective Grantor Trusts (IDGTs) to freeze the value of an asset for estate tax purposes while transferring the asset out of the estate gift-tax free. An IDGT is a complete transfer to a trust for estate and gift tax purposes, but an incomplete transfer for income tax purposes. The future value of the assets transferred is removed from the grantor's gross estate on the date of the trust's funding because the trust is irrevocable for transfer tax purposes, and the grantor has not retained any powers that would cause estate tax inclusion. An IDGT is treated as a grantor trust for income tax purposes because the grantor retains certain other powers. The most frequent power used by the grantor is the ability to substitute assets of equivalent value, which will not prevent the grantor from making a completed gift for transfer tax purposes.

Remove Future Appreciation from Taxable Estate

When funding an IDGT, the grantor should use high return assets to remove it and its future appreciation from the estate. The trust can be designed as a dynasty trust, using the grantor's GST exemption, allowing the trust assets to grow estate-tax free as long as the assets remain inside the trust. Aggressive liquid portfolios, real estate and interests in active businesses would all be viable candidates to fund the IDGT.

In addition to using lifetime exemption to gift assets, the grantor may also sell assets to the trust in exchange for a promissory note. In this instance, the grantor can seed the trust with a gift in order to validate that the trust can enter into a transaction to purchase assets. Because the transaction is between the grantor and his grantor trust, the sale is not an income taxable event. Furthermore, the sale does not necessitate the reporting of the transaction on a gift tax return.

The interest received from the promissory note is not taxable either, because the grantor is merely paying himself. The promissory note's stated interest rate must be at least the applicable federal rate (AFR), but the rate can be adjusted higher to meet the cash flow needs of the grantor. In essence, the note can be designed as a bond by the grantor, receiving interest payments for the term of the note, and receiving a balloon payment of principal at the end of the term. The note payments could also be designed to replicate the former salary or cash distributions of the business owner to assist with retirement plans. The note can be forgiven before death with any remaining lifetime exemption. Alternatively, the value of the trust can be supercharged by using life insurance to repay the note. Even though the underlying asset sold to the IDGT has been removed for estate tax purposes, the promissory note as well as the accrued interest is still in the grantor's estate until repaid or forgiven.

Power to Substitute Assets

The inclusion of swap powers is a common method for qualifying a trust as a grantor trust for income tax purposes while not jeopardizing the removal of the asset and appreciation from

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the grantor's taxable estate. A swap power allows the grantor to transfer personally owned assets into the IDGT in exchange for trust assets of equivalent value, without trustee consent. This power provides many planning opportunities. For instance, the grantor may swap high-basis assets he owns in exchange for the low-basis, highly appreciated assets inside the trust. By doing so, the grantor may accomplish one of the following: (1) He may receive a step-up in cost basis at his death for the appreciated asset brought back into his estate. (2) He may use capital loss carryforwards that he may otherwise be unable to use. (3) Trust assets with rapid appreciation may be expected to level off and replaced with new assets with higher future appreciation potential. The grantor may also consider exchanging his unrealized capital gain assets to the trust in order for the trust to use its capital loss carryforward that it may not be able to use in the future when the trust loses grantor status.

The exercise of swap powers is not a taxable gift, provided the assets exchanged have equivalent value. However, it may be prudent to report the swap on a gift tax return at zero value. By doing so, the statute of limitations begins regarding challenges to the reported values of the swap.

Non-Taxable Gifts

When the grantor pays income tax on the trust's income, it is essentially a nontaxable gift to the beneficiaries. The income taxes paid by the grantor reduces the grantor's taxable estate. Also, the trust grows income tax-free until the grantor's death, thereby increasing the appreciation that is not subject to estate tax.

Although grantor trust status may be advantageous, occasionally it may not be desirable to be a grantor trust. For example, the grantor may be concerned about his ability to pay the trust's income taxes indefinitely into the future. To resolve this dilemma, IDGTs can be drafted with a provision that "toggles off" grantor trust status when the grantor no longer wishes to pay income taxes on behalf of the trust. As a result, the grantor trust may become a flexible income tax planning vehicle in addition to an effective estate planning vehicle.

Pros and Cons of an IDGT

- An IDGT can be an effective estate-freezing technique that provides the opportunity to maintain maximum control over the use of the transferred assets.
- IDGTs should be considered for clients with large estates and appreciating assets.
- An IDGT is an irrevocable trust funded with a gift or sale during a grantor's lifetime.
- An available lifetime exemption can be used to offset gift tax upon funding.
- Assets remaining inside the trust pass to its beneficiaries estate-tax free.

- **Pros:**
  - Trust assets and their appreciation are removed from the grantor's estate.
  - Trusts can (but do not have to) be set up to pass assets only to family members.
  - Creditor protection may be available to the trust beneficiaries.
  - Trusts are established as grantor trusts allowing the grantor to continue to pay the income tax on trust assets, further reducing the grantor's taxable estate and providing a nontaxable gift to the beneficiaries (estate and income tax).

  - The grantor has the power to substitute assets of the trust, increasing flexibility in the ongoing planning.
  - The low interest rate environment may improve the ease of note repayment.

- **Cons:**
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- If a sale is made to the trust and there is an unexpected or premature death of the grantor, any unpaid or unforgiven promissory note will be included in the grantor's estate.
- If the asset sold to the trust does not perform as planned, the note repayments may be difficult to maintain.
- Future legislation may limit the intended benefits or functionality of these trusts.
- Costs to implement, costs of the ongoing tax payments, costs to value certain assets and the loss of use of the asset funding or sold to the trust require careful consideration by and financial modeling for the grantor.
- Situs of trusts requires careful consideration.
- Attorneys should not learn this planning during your client's engagement (prior experience is a must).

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