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Intentionally Defective Grantor Trusts

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Estate tax planners have long employed intentionally defective grantor trusts to freeze the value of an asset for estate tax purposes while transferring assets out of the estate free of gift tax. An intentionally defective grantor trust (IDGT) is a complete transfer to a trust for transfer tax purposes but an incomplete, or "defective," transfer for income tax purposes. Because the trust is irrevocable for estate and gift purposes and the grantor has not retained any powers that would cause estate tax inclusion, the future value of the assets transferred is removed from the grantor's gross estate on the date of the trust's funding.

However, because the grantor retains certain other powers, the trust, although irrevocable, is treated as a grantor trust for income tax purposes. As a result, the grantor, though not a beneficiary, is taxed on all the trust's income, even though he or she is not entitled to any trust distributions.

If structured properly, the IDGT will receive the gross income generated from the trust's income-producing assets, which will accrue to the benefit of the trust's beneficiaries. The trust also allows the grantor the opportunity to remove future appreciation from the grantor's estate while maintaining control over the assets.

POWER TO REACQUIRE ASSETS

IRC § 675(4) provides that a trust is a grantor trust for income tax purposes if any person holds a power "in a nonfiduciary capacity…to reacquire the trust corpus by substituting other property of an equivalent value." See also IRC § 675(4)(C). The retained power to substitute assets of equivalent value will not prevent the grantor from having made a completed gift for transfer tax purposes and will not trigger estate tax inclusion under section 2038.

This power to substitute assets offers the grantor the opportunity to preserve potential losses from depreciated assets, which would otherwise disappear at death. Under section 1014, the tax basis of assets transferred at death is stepped up (or down) to the fair market value at the date of death (or alternate valuation date). Since a sale to an IDGT is a disregarded event, the trust takes a carryover

basis in the assets transferred. Such a trust offers the grantor the chance to substitute the IDGT's appreciated assets for liquid assets with limited or no appreciation at a later date. Thus, if the substituted appreciated assets are later included in the grantor's gross estate, the heirs would receive a stepped-up basis for income tax purposes. If the power to substitute is not part of the IDGT instrument, the trustee could alternativelysell IDGT appreciated assets to the grantor for high-basis assets or cash. Because transactions between a grantor trust and its grantor are disregarded under Revenue Ruling 85-13, the grantor would not recognize gain on the sale.

ADDITIONAL NONTAXABLE GIFTS

Another significant advantage of a grantor trust can be that the grantor pays the income tax on the trust's income. This essentially generates a nontaxable gift to the beneficiaries, thereby reducing the grantor's gross estate without incurring estate or gift taxes. Under section 2036(a)(1), however, should a trust instrument require reimbursement of the grantor income taxes paid, all assets would be included in the gross estate. Trustee discretion is recommended to provide the grantor a cushion for the financial risk of increasing future taxes with lower cash flows.

CONCLUSION

While not for everyone, an IDGT is an effective estate-freezing tool that provides the opportunity to maintain the maximum control over the beneficial enjoyment of the transferred assets. Do not miss out on how an intentionally designed defect may benefit clients, especially those with large estates and appreciating assets.

For a detailed discussion of the issues in this area, see "The Case for an Intentionally Defective Grantor Trust," by Ora Pressey, CPA, John W. Morrisset, CPA, and Richard A. Nightingale, CPA, in the November 2008 issue (http://www.aicpa.org/pubs/taxadv/index.htm) of *The Tax Adviser*.

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