IDGT: This trust is supposed to "fail"

Trusts come in all shapes and sizes. However, from an income tax perspective, there are basically two types: grantor trusts and nongrantor trusts. Generally, with a grantor trust all trust income is taxed directly to the grantor — the person establishing the trust — and assets in the trust may or may not be included in the grantor's estate.

In contrast, generally with a nongrantor trust, all trust income is taxed to the trust's beneficiary (or beneficiaries) or the trust itself — or some combination thereof — rather than to the grantor. In addition, the assets aren't included in the grantor's estate.

There is, however, a variation that has the best attributes of both trust types. It's purposely designed to fail the general rules, and results in income being taxed to the grantor even though the trust's assets aren't included in the grantor's estate. Appropriately enough, it's called the "intentionally defective grantor trust" (IDGT).

How the trust works

An IDGT is treated as a separate tax entity for federal estate tax purposes. However, the trust is considered to be a grantor trust for income tax purposes. If certain requirements are met, it can be a powerful vehicle for affluent individuals seeking to preserve more wealth for their heirs.

First, you establish the IDGT as a legal entity under prevailing state laws and designate the trust beneficiaries, such as your children and grandchildren. Typically, you'll transfer appreciating assets, such as securities or real estate, to the trust as "seed money." Of course, the transfers are subject to federal gift tax, but you may benefit from current favorable conditions.

Income tax implications

With a nongrantor trust, the trust itself is taxed on the income received, except for amounts that are distributed to the trust beneficiaries. The problem is that, unlike the tax brackets for individual taxpayers, which are relatively wide, the tax brackets for trusts are extremely narrow. That means that the higher tax rates kick in at relatively low income levels compared to the individual tax brackets.

For instance, in the wake of the Tax Cuts and Jobs Act (TCJA), the current top tax rate of 37% for individuals applies when taxable income of single filers reaches $510,000, and $612,350 for joint filers. In comparison, the threshold for the 37% rate for taxing trusts and estates is a mere $12,750.

Obviously, depending on the amounts involved, a trust could easily be required to pay significantly more income tax than an individual.

Best of both worlds

By including certain "defects" in the trust document, however, the trust would be treated as a grantor trust for income tax purposes. For example, the trust may provide that the grantor has the right to exchange assets of the trust for assets with an equivalent value, or the right to add beneficiaries or make changes to the way assets would otherwise be distributed to the beneficiary.

What's the impact of treating the trust as a grantor trust? The grantor, instead of the trust or trust beneficiaries, is taxed on the trust's income. Because the trust is drafted in a manner that retains its characterization as an irrevocable trust for estate tax purposes, however, the assets aren't included in the grantor's estate.

The reason for the dichotomy is that certain determinations for income tax and estate tax are addressed separately, which, of course, provides a planning opportunity for the right situation. By not having to pay tax on its income, the trust assets grow more rapidly than if they were encumbered by taxes. Plus, each time the grantor pays tax on the trust's income, it's as though an additional gift is being made to the trust beneficiaries. That "gift," though, isn't treated as a gift under the Internal Revenue Code.

Turn to your advisor

The IDGT is a valuable estate planning tool, but there are potential pitfalls in the process. Clearly, this isn't a do-it-yourself proposition. Rely on an experienced estate planner to handle the details.

Sidebar: Selling assets to an IDGT

With an intentionally defective grantor trust (IDGT), the grantor often transfers assets to the trust through lifetime gifts. Alternatively, he or she can arrange to sell assets to the trust. In this case, there's no recognition of a capital gain, so no tax liability ensues.

The sale option often makes sense if you want to remove appreciated assets from the estate. Typically, the transaction is structured as a sale to the trust payable over several years through an installment note. In some instances, a grantor will gift assets to the trust at the outset and follow up with subsequent sales to the trust.

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