A CLOSER LOOK AT INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

In our 2020 *e*.Insight, *2020 is Over – Now What?*, we discussed the importance of planning for the steps that should be taken to put your lifetime exemption to good use as soon as possible, where doing so appropriately aligns with your overall wealth planning goals.

One of the options available to individuals having utilized their lifetime exemption, as well as those reticent to do so, is a sale to an Intentionally Defective Grantor Trust ("IDGT"). While we touched on this previously, we wanted to provide more detail around this option.

INTENTIONALLY DEFECTIVE GRANTOR TRUST

With an Intentionally Defective Grantor Trust ("IDGT"), the grantor establishes a trust in which they are responsible for paying the income tax earned within the trust, better known as a grantor trust. Those with lifetime exemption remaining will want to "seed" the trust with an initial gift sufficient to provide economic substance (typically 10% of the value of assets to be sold to the trust). Those with little or no exemption remaining will want to leverage a grantor trust they have already established.

HOW A SALE TO AN IDGT WORKS

Whether using a newly created grantor trust or pre-existing one, the technique remains the same. The grantor identifies and sells appreciating assets to the trust in exchange for a promissory note. The interest rate of the promissory note should be tied to the Applicable Federal Rate ("AFR") in existence at the time of the transaction (at the time of this article, the short-term rate was 0.14% for notes less than three years; the mid-term rate was 0.52% for notes greater than three years, but less than nine; and the long-term rate for notes greater than nine years was 1.35%). If desired, the note can be interest only with a balloon payment at the end. The key is to make sure that the terms are honored and followed. It should be noted that, similar to GRATs, prior administrations have tried to limit the application of this technique by requiring the taxpayer to use a portion of their lifetime exemption at implementation; other proposals have suggested full estate inclusion of grantor trusts either at the time of the grantor's death, or the termination of grantor trust status.

POTENTIAL TAX BENEFITS

The silver lining with this planning is that for income tax purposes, the sale is viewed as occurring with one's self, and therefore there is no gain recognition or interest income to report for income tax purposes. Because the trust is viewed as owned by the grantor for income tax purposes, it is not diminished by the payment of income taxes and is able to appreciate in value tax free. Further, the payment of taxes by the grantor for any income earned by the trust is not viewed as an additional gift paid by the grantor. The grantor can transfer assets using minimal lifetime exemption and, in return, receive a steady stream of cash flow. The grantor also continues to deplete the assets in their estate by paying the income tax for the trust, thereby allowing the trust to experience tax free growth.

DELAWARE TRUST

In addition, as a further enhancement to one's planning, utilization of the proper jurisdiction could result in greater flexibility, with the possibility of providing for multiple generations. Delaware has become a favorite destination for those looking to establish a trust that will benefit multiple generations, while also allowing for greater flexibility, synergy and cohesion with one's planning. Not only does it permit the creation of a dynasty trust benefiting multiple generations, Delaware's directed trusts statute allows for the creation of multiple advisers (e.g. Investment Adviser, Distribution Adviser, Special Holdings Advisers, etc.) and a Trust Protector in order to separate the powers typically held by a single Trustee. Moreover, Delaware allows for self-settled asset protection trusts, while also providing favorable state income tax treatment for resident trusts with non-resident beneficiaries.

Trusts can be established in Delaware without the need to immediately inform the beneficiary of their rights in the trust, adding an additional level of privacy not always found in other jurisdictions when creating a trust. Delaware's court system has also been designed to specifically address the unique nature of trusts. The Delaware Court of Chancery was created with a specific focus on trust administration and distribution, with the Chancellors being appointed by the Governor to serve twelve (12) year terms. Delaware trusts also permit pre-mortem validation, as well as non-judicial settlement agreements and modifications. While Delaware continues to build on its rich history (many of these statutes were created over 20 years ago) within the estate planning spectrum, other states have also enacted statutes rivaling those of Delaware. Leveraging a jurisdiction that allows for greater flexibility within one's planning further aids in the ability to align exemption planning with an optimal trust structure.

For those seeking the preservation of generational wealth, Oxford can work with your team of advisors to determine the most appropriate jurisdiction for maximizing and aligning your planning goals.

Rev. Rul. 85-13.
Rev. Rul. 2004-64.