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Setting up an intentionally defective grantor trust

Wealthy individuals can avoid dire estate tax consequences by shifting assets to a trust. But then the trust will likely be hit with sky-high income taxes during your lifetime.

Strategy: Set up an "intentionally defective grantor trust" (IDGT). As the name implies, the trust is designed to purposely fall under the grantor trust rules, so the income is taxed to the grantor (you), not to the trust.

If the IDGT is properly structured, you can realize income tax benefits while preserving the estate tax shelter of a trust. In other words, you can have your cake and eat it, too.

Here's the whole story: Generally, a trust is treated as a separate legal entity responsible for paying income tax on the income it receives, except for amounts that are distributed to the trust beneficiaries. The assets transferred to the trust are treated as current gifts and removed from the trust grantor's taxable estate.

This could, however, lead to income tax complications. Unlike the tax brackets for individual taxpayers, the tax brackets for trusts are extremely compressed, so the higher tax rates apply to income at a relatively low level. For instance, the top tax rate of 39.6% for trusts kicks in when 2015 taxable income exceeds $12,300. By way of comparison, the individual federal income tax threshold this year for the top 39.6% bracket is $413,200 for single filers and $464,850 for married joint filing couples.

However, with a grantor trust, the trust income continues to be taxed to the grantor (you), rather than the trust itself. This occurs when the grantor retains certain interests or ownership rights (e.g., the right to change beneficiaries).

The income received by a grantor trust is reported directly on the grantor's personal income tax return. A tax return for the trust is not required. But the assets in the grantor trust are generally still included in the grantor's taxable estate for federal estate tax purposes, which is not the preferred result.

An IDGT combines the best of both worlds. By intentionally including certain defects in the trust document, the trust is purposely set up to be a grantor trust for federal income tax purposes. Thus, the grantor (you) pays income tax on trust income at a more favorable rate than a trust would. But the trust is still drafted in a way that retains its characterization of an irrevocable trust for federal estate tax purposes. The determinations for income taxes and estates are handled separately.

Icing on the cake: Current interest rates make it especially conducive to establishing an IDGT right now. That's because the gift tax liability from setting up an IDGT (if any) is based on the assumed IRS interest rate at the time when you create the trust. When interest rates are low—as they are now—the gift tax consequences are favorable to the grantor.

Tip: This is clearly *NOT* a do-it-yourself proposition. Consult with an estate planning pro.

7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002