INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

OVERVIEW

An Intentionally Defective Grantor Trust (IDGT) is a trust in which assets transferred to it are protected from estate taxes but not income taxes. The rules for a grantor trust are different for income tax and for gift and estate tax purposes. It is intentionally created to be “defective” in that the grantor, the person who sets up the trust, pays income tax on trust earnings. However, 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 when the trust is funded.

HOW THEY WORK

TRUST PARTIES

There are three main parties to a trust, although the same person can serve in each role:

- Grantor –The person who establishes and funds the trust. Also can be referred to as the settlor, donor, or trustor.
- Trustee – The legal owners of the trust's property, in charge of administering, preserving, and distributing trust assets in accordance with the trust documents.
- Beneficiary – A spouse, child, charity, or any other entity that will inherit the trust’s assets.

HOW TO MAKE A TRUST AN IDGT

A grantor trust can be made “defective” in many ways, including the following:

- Retaining the power to reacquire or recover the trust assets.
- Receiving or benefiting from the trust income, or retaining the power to do so.
- Has a reversionary interest worth more than 5% of the value of the trust upon its creation.
- Controlling to whom and when trust income and principal is to be distributed.
- Retaining the right to certain other administrative powers which may benefit the grantor and his/her spouse.

INCOME TAX

In a typical irrevocable trust, any income produced is taxed to the trust itself and not to the grantor. However, with an IDGT, the grantor retains certain powers so that the the trust, although irrevocable, is treated as a grantor trust for income tax purposes. Because of this, the grantor is taxed on all the trust’s income, even though he or she is not a beneficiary and not entitled to any trust distributions.

ESTATE TAX

Despite the fact that the IDGT is considered a grantor trust for income tax purposes, it is treated as irrevocable for estate and gift purposes. The grantor does not retain any powers that would cause estate tax inclusion, so the future value of the assets transferred is removed from the grantor's estate.

Because the grantor pays taxes on income produced within the trust, this allows the trust to receive the gross income generated by the trust's assets. Those assets to grow tax free for the beneficiaries and any future appreciation is removed from the grantor's estate. The grantor's payment of the trust's income taxes also creates a nontaxable gift to the beneficiaries which ultimately reduces the grantor's gross estate without incurring any estate or gift taxes on those payments.