Intentionally Defective Grantor Trust (IDGT)

A.K.A. Grantor Trust

An Intentionally Defective Grantor Trust (IDGT) is a type of irrevocable trust used to transfer wealth out of the grantor's estate with an added benefit of the trust not legally required to pay income taxes. The "intentional defective" aspect refers to a purposeful flaw drafted in the trust which requires the grantor to continue paying income taxes on the trust's assets. This feature adds income tax efficiency to the growth of the IDGTs assets and further reduces the grantor's estate due to the income tax payments.

DESCRIPTION OF STRATEGY

The grantor establishes an IDGT and gifts assets to the trust. The assets in the trust, plus any growth in their value, are removed from the grantor's estate. Because the grantor pays the income tax for the IDGT, a) the trust assets grow inside the trust without an income tax burden, b) the grantor's assets outside of the IDGT are reduced by the amount of the income tax paid on behalf of the IDGT, and c) because the grantor is considered the owner of the IDGT for income tax purposes, any sale, loan or exchange of assets with the trust by the grantor will not trigger income tax. There is no income tax recognition as the grantor is considered to be on both sides of the transaction. Sale and loan transactions are utilized to transfer additional assets to the trust that are likely to appreciate in excess of the loan's interest rate or the seller's note. Additionally, the IDGT allows assets to be exchanged for assets of the same value which can be useful to move low basis assets to the grantor for a step-up at death. A provision can be added to the IDGT to allow the trustee, at its discretion, to reimburse the grantor for any income taxes paid on behalf of the IDGT to alleviate any hardship and not cause estate inclusion. Additionally, many IDGTs are drafted so that the grantor trust aspects can be turned off and allow the IDGTs to pay its own income tax liabilities.

KEY BENEFITS

Estate Tax Savings	The grantor removes assets and future growth from their estate, which can significantly reduce estate taxes.
GST	The grantor typically allocates GST exemption to the IDGT causing it to be free of estate taxes for multiple generations, including any value realized by the trust from sales, loans or swaps.

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KEY BENEFITS (CONTINUED)

Payment of Income Tax Saves Eventual Estate Tax

By paying the income tax on the IDGT's income, the grantor allows the trust to grow unencumbered by income taxes, essentially providing a tax-free environment to the trust/beneficiaries. The grantor's payment of the income taxes is a legal obligation and therefore not considered a gift to the trust.

Non-Recognition of Gain Upon Sale to Trust

When the grantor sells assets to the trust, no gain is immediately recognized because the same taxpayer is the buyer and seller for income tax purposes. Other transactions such as loans and exchanges of assets are also tax-free and no gains or interest income is realized.

Asset Protection

Similar to almost all irrevocable trusts, assets within the IDGT are generally protected from creditors of the grantor and beneficiaries.

RISKS/DRAWBACKS

Income Tax Liability

The grantor is responsible for the income taxes on the trust's income, which can be a substantial burden. However, trust provisions can allow the trustee to reimburse the grantor for tax payments or cause the IDGT to become its own taxpayer if the burden becomes too great.

No Step-Up in Basis At Grantor's Death

When the grantor dies, there is no step-up in basis for the assets of the trust because they are not in the grantor's estate. Thus, the grantor is trading the estate tax benefit of the trust for the foregone income tax benefit of the step up in basis.

OPPORTUNITIES TO UTILIZE

High Growth Assets

An IDGT can be particularly effective when assets that are expected to appreciate significantly over time are gifted, sold or swapped into the trust, such as family businesses, public stock, pre-IPO stock or real estate, among others.

Sale of Low Basis Assets

When a client wishes to move low basis assets outside of the estate through a sale to a trust, then an IDGT provides an opportunity to do so without immediate recognition of gain.

Asset Protection

Individuals with potential exposure to future creditor claims might use an IDGT as part of an asset protection strategy.

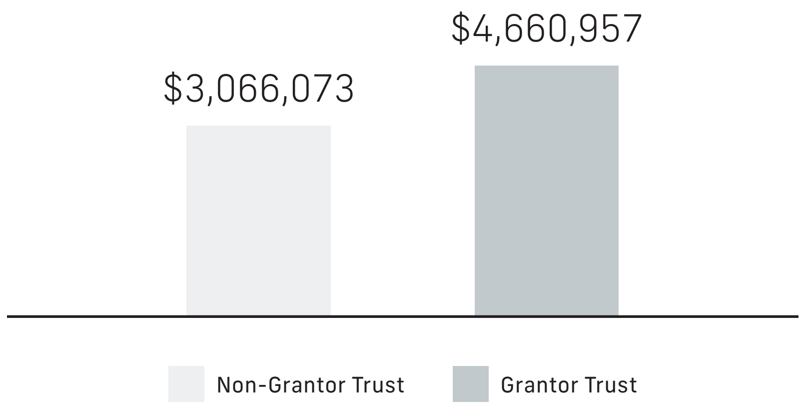
Common types of IDGTs

SLATs, ILITs, GST/Dynasty Trusts. It is important to review the provisions of these trust carefully to determine if they intend to be a grantor trust or not.

Grantor Trusts — Economic Impact Example

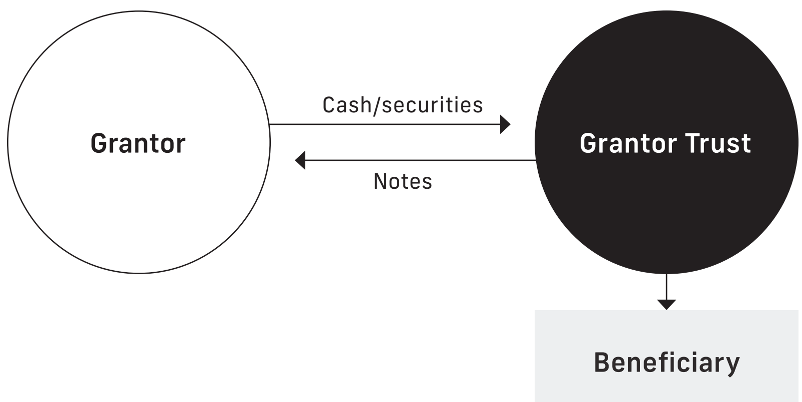
Compare the net-after tax amount of a $1M portfolio in a Grantor Trust to $1M in a Non-Grantor Trust over a period of 20 Years (Assuming a 2% yield, 6% growth, 40% ordinary tax rate, 20% capital gain tax rate; basis of $250,000 and 10% annual turnover)

- $940,000 paid in income taxes by Grantor over 20 years.



Grantor Trusts — Loan Example

- Note bears interest at AFR rate depending on it’s term.
- No interest income is recognized on the note by Grantor
- Flexibility in structuring note repayments
- Prepayment of note
- Refinance note?
- Recommended to have 10% equity over promissory note
- Volatility can create problems for note repayment



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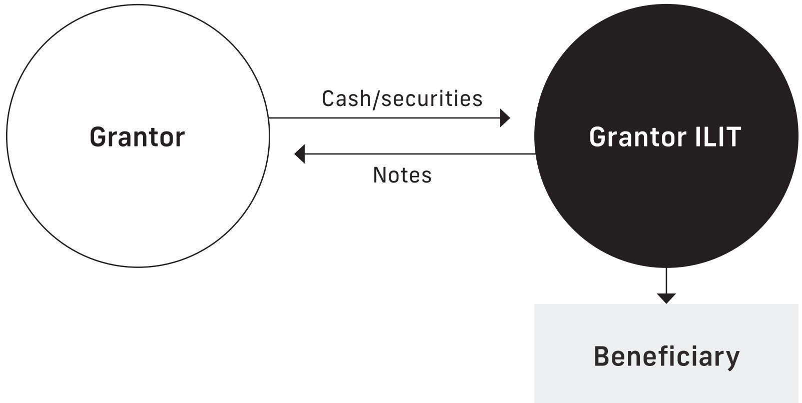
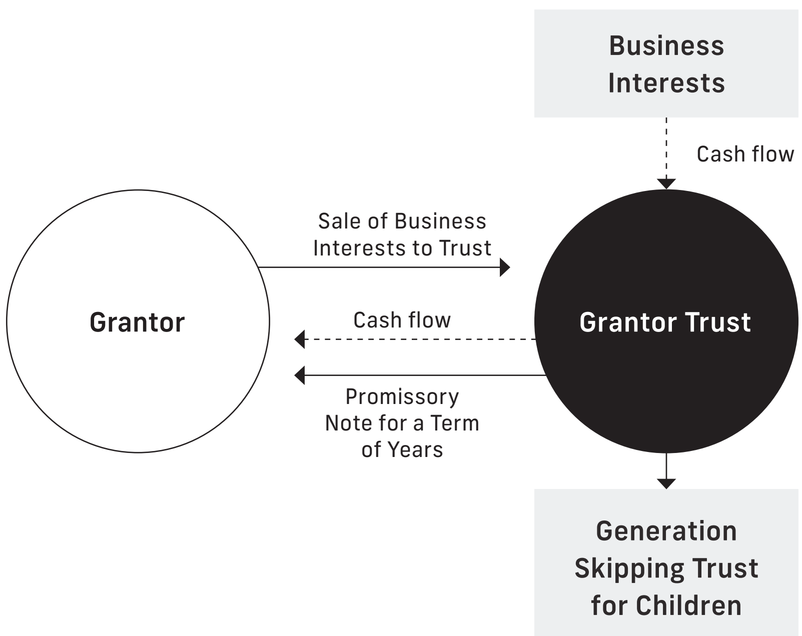
Irrevocable Life Insurance Trust (ILIT)

- Large premiums can be paid with loans to ILIT
- Crummey withdrawal provisions won't change Grantor Trust status
- Policy can be swapped to a Grantor Trust without a transfer-for-value
- Make gifts or have GRATs payout to ILIT to help pay premiums or repay note



Sale to an Intentionally Defective Grantor Trust (Example)

- Business value is $5,000,000; $3,500,000 with a 30% discount
- 8% annual cash flow from Business (or $400,000)
- Sell Business to Grantor Trust for a 9 year note at 3.5%
- Amortizes at 460,061/year or $122,500/year with interest-only



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Sale to a Intentionally Defective Grantor Trust

How a Sale to a Grantor Trust differs from a GRAT:

Positives

- Ability to transfer property into a generation skipping trust
- Flexibility in structuring note payments
- Prepayment of the note
- Cheaper interest rate than GRAT transaction
- If you die, only the note value is included in your estate (SCINS?)

Negatives

- Grantor Trust should have 10% equity over promissory note (seed gift)
- Underperformance
- Not a transaction that is specifically recognized in IRS Code
- A poor valuation of sold property could result in a gift