Estate Planning With Intentionally Defective Grantor Trusts

Do you want to minimize your taxable estate? Or pass down a family business to the next generation while reducing federal estate and gift taxes? Transactions involving an Intentionally Defective Grantor Trust ("IDGT") could be an integral part of the solution. IDGTs are a commonly used estate planning structure to transfer wealth to family members during the life of the grantor. In this paper, we will explain what IDGTs are, who they are appropriate for and some key considerations to think about before creating and funding an IDGT.

What is an Intentionally Defective Grantor Trust?

An IDGT is an irrevocable trust that is designed to take advantage of the differences between federal income tax and estate tax rules. The resulting trust is disregarded for income tax purposes, meaning the individual who establishes the trust (the "grantor") pays taxes on the income generated by the assets of the IDGT, but the trust's assets are not included in the grantor's estate for federal estate tax purposes.

Who is a Good Candidate for an IDGT?

An individual or family that meets some of the following criteria should consider implementing an IDGT as part of their estate plan.

- Anticipates having a taxable estate
- Expects that their assets will be sufficient to sustain their retirement and income needs over their lifetime
- Wants to move some of the growth portion of their assets outside of their estate in an estate and gift tax-free manner
- Has a family business that they would like to transfer to the next generation

What is the Benefit of an IDGT?

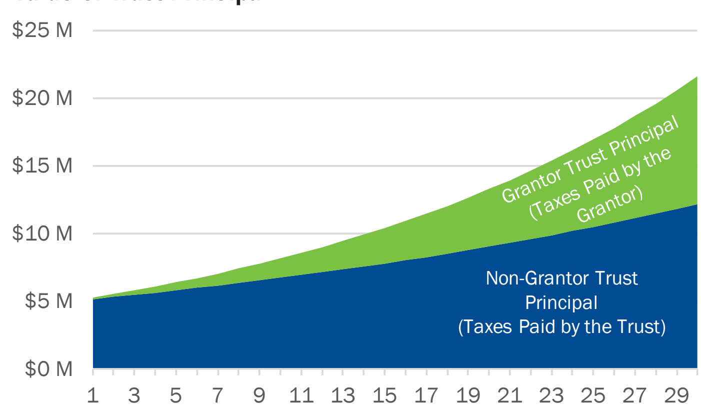
There are two primary benefits of an IDGT:

1. IDGTs enable individuals to gift or sell assets in a manner that will freeze their value at current levels, for federal estate and gift tax purposes, and shift the future appreciation to the next generation.
2. The assets within an IDGT appreciate income tax free during the grantor's lifetime.

For example, an IDGT which holds $5 million in assets and earns 5% annually over a 30-year period would grow to over $21.6 million unencumbered by taxes. Under the same conditions, a trust that needed to pay annual income taxes would grow to only $12.1 million assuming a 40% tax rate.

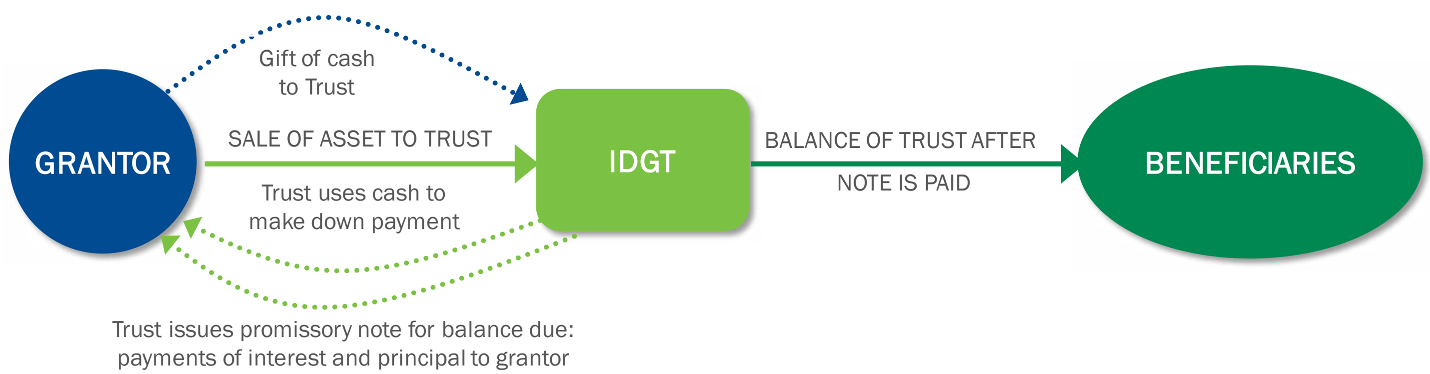
The IDGT in this example enables the trust to accrue $9.5 million more in value over 30-years by not paying income taxes (which are paid by the grantor.) This allows the grantor to transfer more than $21 million gift and estate tax free to the next generation while using only $5 million of the allotted gift-tax exemption. This is a significant estate planning win!

Value of Trust Principal



Source: Hirtle Callaghan

How Does a Typical Installment Sale to an IDGT Work?



While transactions involving IDGTs, commonly known as installment sales to an IDGT, are quite complicated, the mechanics can be broken down in five distinct steps:

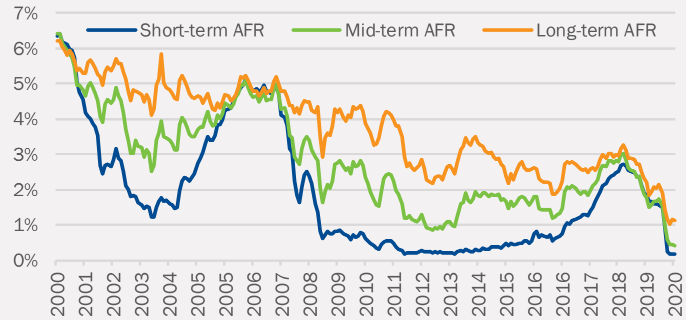
1. The grantor establishes an irrevocable trust for his/her beneficiaries.
2. The grantor transfers an initial "seed" gift to the IDGT (generally 10% of the asset to be sold to the trust). In practice, the seeded capital is typically cash or otherwise fairly liquid assets.

3. The grantor sells an asset for its current fair market value to the IDGT. Since the IDGT is disregarded for Federal income tax purposes, the initial sale transaction between the grantor and the trust has no Federal income tax consequences. The IDGT gives the grantor a promissory note in exchange for the assets with minimum interest set at the Applicable Federal Rate ("AFR") based on the terms of the note.
4. The grantor receives annual payments over a fixed term based on the loan terms.
5. At the end of the note term, the IDGT pays off the principal using accumulated cash or a portion of the assets. The remaining trust assets are held in trust for the grantor's beneficiaries. [1]

APPLICABLE FEDERAL RATE ("AFR")

The AFR is the minimum interest rate individuals can use for loans between related parties determined by the IRS to avoid gift-tax issues. There are three different types of AFRs: short-term for notes with maturities of three years or less; mid-term for maturities between three and nine years; and long-term for notes with maturities greater than nine years. All three rates are near or at historic lows as demonstrated in the chart to the right.

Applicable Federal Rate



Source: Hirtle Callaghan. Bloomberg.

What are the Best Assets to Transfer to an IDGT?

The best assets to transfer into an IDGT are those with the most potential for appreciation over time. These assets may include marketable securities, hedge funds, private equity investments, real estate and business interests. In addition, closely-held business interests (partnerships, LLCs, S Corporations) are great candidates for an IDGT because lack of control and lack of marketability discounts can be used for valuation purposes. Cash may be transferred to an IDGT if the IDGT is going to invest the cash to produce a return in excess of the AFR.

How Does the IDGT Compare to a GRAT?

Grantor Retained Annuity Trusts ("GRATs") are similar to IDGTs as an estate planning strategy. [2] However, there are some critical differences which impact why you may choose one strategy over the other. Individuals tend to employ GRATs when the grantor has used all of his/unified credit and does not want to pay any gift tax. However, GRATs are not as effective for transferring assets to grandchildren or younger members of the family because the allocation of the Generation Skipping Trust ("GST") tax exemption cannot be made until after the GRAT term is completed and the GRAT's success is calculated. IDGTs may be more appropriate when the grantor's life expectancy is unknown because they do not contain a survivorship requirement (i.e. that the grantor does not have to outlive the term of the promissory note).[3]

	IDGT	GRAT
Interest Rate	AFR - 100% of the appropriate AFR (depending on the term of the note)	Section 7520 Rate - 120% of the Federal midterm rate
Generation Skipping Trust	Yes	No
Survivorship Requirement	No	Yes
Payment Term	Flexible	Require estimated distributions of principal back to the grantor during the trust's term

[1] The assets owned by the IDGT at the time of the grantor's death will not get a step up in basis.
[2] For more information on GRATs, read Hirtle Callaghan's article "Making Lemonade Out of Lemons: The Grantor Annuity Trust."
[3] However, if the grantor dies during the term of the promissory note, the grantor trust of the IDGT will terminate and the grantor or grantor's estate may have to recognize a gain attributable to the initial asset sale.

AN IDGT IN PRACTICE

The owner of a $20 million business wants to minimize his estate taxes. His business currently distributes between $1.5 million and $2 million each year.

The owner could gift about 25% of the company to family members or an irrevocable trust, eliminating that portion of the business value and its subsequent growth from his estate, but he would still be stuck with the other 75%.

OR, the owner could sell the business to an IDGT, in exchange for a 20-year promissory note from the trust that agrees to make interest-only payments of 2% per year for the next 20 years, followed by a balloon payment of the principal at the end of the 20-year term. At this interest rate, the trust will only need to make interest payments of $400,000 per year, which is easily covered by the available cash from the business' profit distributions.

Immediately after the transaction, the owner's net worth and estate tax exposure have not changed. He's simply traded his family business worth $20 million for a $20 million promissory note. Because he sold the business to an IDGT (which is disregarded for income tax purposes), there are no capital gains taxes due on the initial sale transaction, and the cost basis of the business simply carries over into the trust.

However, going forward, the owner's balance sheet will grow by its simple 2% yield, while the business is already producing almost four times that amount of cash flow, plus the potential for the business to appreciate further. For instance, if at the end of the first year, the business appreciated to $21 million, plus distributed $1.5 million to its owner, and then paid out $400,000 in interest, its value would be up to $22.1 million.

Concluding Thoughts

As the AFR hovers around a record low, IDGTs are a highly effective and valuable structure to transfer wealth from one generation to the next. However, IDGTs are not for everyone. The suitability of an IDGT requires the thoughtful consideration of a wide range of tax and non-tax factors. At Hirtle Callaghan, we have helped create countless IDGTs on behalf of our family clients over the past 30 years. We have the experience and the team in place to work with you and your other advisors to determine if an IDGT make sense for you.

For more information, please reach out to your Investment Officer or Portfolio Manager.

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