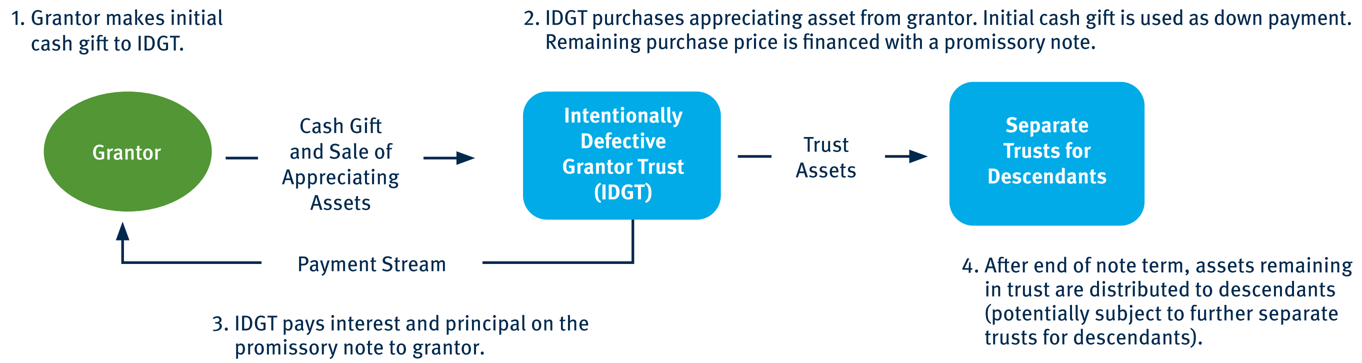
Reducing Estate Tax Exposure With an Intentionally Defective Grantor Trust (IDGT)

Wealth Planning | Estate and Tax Planning

An IDGT is a potentially powerful estate tax planning strategy that removes future appreciation on assets from one's estate. A primer on IDGTs is provided below.



Color Key	
Green	Assets subject to probate, included in taxable estate, and eligible for a step-up in cost basis.
Blue	Assets avoid probate, included in taxable estate, and not eligible for a step-up in cost basis.

Irrevocable Trust

An IDGT is an irrevocable trust to which the grantor (creator of trust) transfers appreciating assets. In many instances, the transfer of assets to an IDGT is structured as a sale. The grantor initially funds the IDGT with a cash gift. The IDGT then purchases appreciating assets from the grantor. The grantor's initial cash gift is used as a down payment for the purchase. The remaining purchase price is financed through a promissory note. In other instances, the grantor simply gifts assets to an IDGT using his or her unused federal estate and gift tax exemption ($13.99 million in 2025). As such, the grantor must file a gift tax return (Form 709), though tax is usually not owed.

Sales Characteristics

If the IDGT is funded through a sale, the sale must be structured as an "arm's-length transaction." In other words, the terms and conditions surrounding the sale must be consistent with the terms and conditions that would apply if the grantor entered into a transaction with an unrelated third party. In order to ensure the sale is structured properly, the grantor usually should obtain an appraisal of the assets transferred to the IDGT.

Initial Cash Contribution

Typically, the grantor's initial cash gift to the trust should be at least 10% of the value of the assets that will be sold to the trust. The grantor uses a portion of his or her federal estate and gift tax exemption when making this initial cash gift. As such, the grantor must file a gift tax return (Form 709), though tax is usually not owed.

Interest Rate on Promissory Note

The interest rate on the promissory note generally must be consistent with the appropriate Applicable Federal Rate (AFR) based on the duration of the note term and the period for interest compounding. The IRS publishes the AFR each month.

Income Taxes

The grantor is recognized as the owner of IDGT assets for income tax purposes. As a result, capital gains will not be recognized when the grantor sells assets to the IDGT. Additionally, interest payments received by the grantor from the IDGT are not taxable. The grantor is, however, responsible for paying income tax on income generated by the IDGT.

Save Estate Taxes on Appreciation of IDGT Assets

The grantor does not pay estate tax on the assets remaining in the trust upon his or her death. Because the grantor receives the purchase price for the assets sold to the IDGT plus interest on the note, the asset growth must outpace the interest rate on the promissory note in order to achieve estate tax savings.

Grantor's Death During Loan Term

If the grantor dies during the loan term, the balance on the promissory note is included in the grantor's estate. The grantor can structure the loan to forgive any outstanding debt at death, though this may require the interest rate to be set at a level substantially higher than the AFR.

Beneficiaries

Upon the end of the note term, trust assets are distributed to the beneficiaries named in the IDGT. As IDGTs are an effective strategy for multi-generation wealth preservation and transfer, a descendant's share is often held in a further separate trust.

Creditor Protection

IDGT assets are generally protected from creditors of the grantor and beneficiaries (including a divorcing spouse).

For more information about IDGTs, contact your local attorney and Stifel Financial Advisor.