Why You Might "Fail" the Trust Rules

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Things can get turned upside down in the tax world. For instance, depending on your situation, it may make sense to fail certain tax rules for grantor trusts on purpose. You can do this by creating an intentionally defective grantor trust (known as an IDGT, for short).

In fact, an IDGT may be especially effective this year because of current interest rate levels. Let's take a look at how this sophisticated estate-planning technique works.

In the normal situation, you might transfer assets like cash or securities to a trust paying out annual income to designated beneficiaries. By giving up all rights to the assets, you are not responsible for paying federal income tax on the earnings. This can be particularly beneficial if you are in the top 35% income tax bracket. The income tax is generally paid by the trust, with a graduated tax-rate structure beginning at a 15% rate.

However, be aware that the income tax brackets for trusts are highly compressed. In other words, the dollar amounts for each bracket are relatively small when compared with the tax brackets for individuals, so the higher tax rates are triggered quickly. In the end, the trust could pay more tax than you would have been assessed as an individual.

This is where an IDGT can help you out. Assuming the trust document is properly structured, the trust will be treated as a "grantor trust" that allows you to retain certain rights or interests. This means that the income will be taxed to you as the grantor rather than to the trust—even though you are not receiving any of the annual income.

Besides the income tax savings, the current interest rate environment makes it conducive to establish an IDGT. The resulting gift-tax liability for the remainder is based on the assumed IRS interest rate at the time the trust is created. When interest rates are low, the gift-tax consequences are favorable to the grantor.

Note that an IDGT could lead to estate-tax complications. This is because your taxable estate generally includes assets you have transferred to trusts and individuals in which you have retained possession or enjoyment of the property being transferred. In effect, you must give up control over the assets to preserve the tax benefits of the trust. Thus, dire estate-tax consequences can be avoided with proper planning.

Obviously, this is not a do-it-yourself proposition. Contact your Henry & Horne, LLP professional for more information.

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