

IDGTs: Flexible Drafting Saves the Day When Intended Benefits Become a Burden

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By Alison Powers Herman and Karen T. Schiele. Published in the *New York Law Journal*.

Transferring assets to an intentionally defective grantor trust (IDGT) is a potentially powerful estate planning technique, allowing an individual to pass significant value to his or her intended beneficiaries transfer tax-free. Using this technique, the grantor makes a completed gift of assets to a trust for transfer tax purposes, removing the assets and any future appreciation thereon from the grantor's estate, but retains ownership of the trust for income tax purposes, continuing to pay income tax on the income earned by the trust assets.

As a result, an IDGT offers a grantor the opportunity to supercharge a gift: the payment of income tax effectively constitutes additional tax-free gifts by the grantor to the trust beneficiaries. The trust assets are not reduced by tax payments, which, when compounded over years, may significantly impact the growth of trust assets, and the tax payments further reduce the grantor's taxable base for estate tax purposes.

A grantor trust is a trust that is disregarded for income tax purposes such that any income derived from the trust's assets is treated as income of the grantor, the person who created the trust, and reported on the grantor's individual income tax return as if the grantor had received the income directly. The grantor pays the tax on the income of the trust at the grantor's individual tax rate, which is typically lower than the trust tax rate.

Grantor trust status can be triggered, and the grantor will be treated as the trust owner for income tax purposes, if the trust instrument provides to the grantor certain rights or powers over the trust assets. Grantor trust status will be triggered for any portion of a trust where the grantor retains certain reversionary interests or has the power to control beneficial enjoyment and disposition of the trust's assets, where the grantor holds certain administrative powers (including the power to purchase, exchange or dispose of trust assets for less than full consideration, the power to borrow without adequate interest or security, and the power to reacquire trust assets by substituting other property of equal value), where the grantor has the power to revoke the trust, and where the grantor or the grantor's spouse has the right to receive income. While each of these rights and powers will trigger grantor trust status, it is crucial to understand the grantor trust rules set forth in IRC §§671 through 679 so as to select the trigger that will work best to address the grantor's specific estate planning goals.

An essential component of an IDGT is that the grantor trust trigger included in the trust instrument does not result in the inclusion of the trust assets in the grantor's gross estate. For many practitioners, the grantor trust trigger of choice is the substitution power; that is, the power of the grantor, in a nonfiduciary capacity and without consent of the trustee or a third party, to reacquire trust assets by substituting assets of equivalent value.

In Revenue Ruling 2008-22, the IRS expressly stated that the substitution power will not cause the inclusion of the trust assets in the grantor's gross estate under IRC §§2036 or 2038, provided that the trustee (who may not be related or subordinate to the grantor within the meaning of IRC §672) has a fiduciary obligation to ensure that the reacquired assets and the substituted assets are, in fact, of equivalent value and provided

further that the substitution does not shift benefits among the trust beneficiaries. Also, the substitution power could be useful for future estate planning because it gives the grantor the opportunity to swap low basis assets with high basis assets without having a taxable event for income tax purposes.

While many grantors are keen to pay the income tax on the income of the trust for the benefits discussed above, it is possible for the obligation to pay taxes on income that does not benefit the grantor to become an undesirable burden. Therefore, it is useful for the trust instrument to be drafted to allow for flexibility to “turn off” grantor trust status. For example, where the trust instrument is a grantor trust because of the power to substitute assets, the trust should also give the grantor the power to release the substitution power, turning off grantor trust status.

It is also useful for the trust instrument to expressly authorize the trustee (who may not be related or subordinate to the grantor within the meaning of IRC §672) to pay the grantor such amounts as the grantor certifies as being required to discharge the grantor’s income tax liability in respect of the trust. Such discretionary authority provides the trustee flexibility to relieve the grantor’s tax burden for selected years, without turning off grantor trust status.

New York law provides comfort to a grantor with regard to reimbursement for income taxes, even when the trust instrument does not expressly give the trustee reimbursement authority. EPTL §7-1.11 permits the trustee, so long as the trust instrument does not prohibit the reimbursement, to pay the grantor from principal an amount equal to any income taxes on any part of the trust principal with which the grantor is charged.

Revenue Ruling 2004-64 considered the estate and gift tax implications of a grantor’s payment of income tax attributable to the trust and a trustee’s discretionary authority to reimburse the grantor for income tax payments. The ruling set forth that the grantor’s payment of tax is not a gift because the grantor is liable for the income tax and that the trustee’s discretionary authority to reimburse the grantor, whether granted in the trust instrument or through applicable local law, would not, by itself, cause inclusion of the trust assets in the grantor’s gross estate.

Evidence of control by the grantor, such as an understanding or pre-existing arrangement, the grantor’s power to remove the trustee and name the grantor as trustee, or local law subjecting the trust assets to the claims of the grantor’s creditors would reverse this determination.

The flexibility achieved through the discretionary authority of a trustee to reimburse a grantor for income taxes paid with respect to a grantor trust is so desirable that practitioners have recommended that trusts be modified, amended or decanted (judicially or non-judicially) to add a tax reimbursement clause to a trust without one.

However, a recent memorandum from the Office of the Chief Counsel of the IRS will likely curb such recommendations going forward. CCA 202352018, released on Dec. 29, 2023, assigns gift tax consequences to beneficiaries of a grantor trust when the trustee modifies the trust, with the beneficiaries’ consent or failure to object, to add a clause permitting the grantor to be reimbursed for income taxes with respect to the grantor trust for which the grantor is liable.

The CCA distinguishes the facts discussed in Revenue Ruling 2004-64, where the governing instrument provided the trustee with the discretionary authority to make the reimbursement and the beneficiaries had no control. In such a situation, the reimbursement would not be considered a gift by the beneficiaries of the trust.

In contrast, where the trust beneficiaries have an opportunity to object to a modification which could result in the reduction of their interest in the trust, which a reimbursement to the grantor would do, and the beneficiaries’ consent or do not object to the modification, the modification will be considered a gift from the beneficiaries for the benefit of the grantor. This conclusion is a reversal of the IRS’ prior position set forth in PLR 201647001 which viewed such a modification as purely administrative and not as a shift in the beneficial interests in the trust.

The CCA does not make mention of state statutes, such as EPTL §7-1.11, which expressly authorize the trustee to reimburse the grantor (so long as the trust instrument does not prohibit the reimbursement). Similar to when a trustee makes a reimbursement distribution pursuant to

authority expressly set forth in the trust instrument, when a trustee relies on state statute to make a reimbursement, no modification is being made and there is no opportunity for trust beneficiaries to consent or object. Therefore, there should be no gift tax consequences to the beneficiaries when a trustee reimburses the grantor for income taxes pursuant to state law.

Conclusion

IDGTs are a potentially powerful estate planning tool, offering grantors who are willing and able to pay income taxes on income that does not benefit them the ability to make transfer-tax free gifts. In light of CCA 202352018, practitioners should make special efforts to understand clients' cash needs and to ascertain whether the tax liability may be a greater burden than benefit over time. Furthermore, practitioners should consider routinely including features in grantor trust instruments allowing for flexibility, such as the ability to turn off grantor trust status entirely and the express discretionary authority of the trustee to reimburse the grantor for the income tax liability, especially in states that do not grant such authority by statute.

Alison Powers Herman and Karen T. Schiele are members of Carter Ledyard's Trusts & Estates Department.

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related professionals

Karen T. Schiele / Partner

D 212-238-8667

schiele@clm.com

Alison Powers Herman / Partner

D 212-238-8761

herman@clm.com