Increase Your Long-Term Gift, Not Your Gift Tax

You've decided it's time to transition some of your wealth out of your estate and establish an irrevocable trust for your grandchildren. You're going to fund the trust with the maximum amount of money you can without triggering the gift tax or the generation-skipping transfer tax (GST tax). You're hopeful that the trust will grow over time, and you know you have the option of making annual exclusion gifts, thereby shifting more of your wealth to your grandchildren over time without paying additional gift and GST taxes. Still, you wish it were more, but you're uncomfortable with sending Uncle Sam a check just for the privilege of sharing your wealth with your grandchildren (and perhaps their issue). You think to yourself, "If only things could be different…"

Well, things can be different, depending on the terms of the trust you create. A trust is a fairly typical estate-planning tool – perhaps a trust that will accumulate income and grow as your grandchildren age, with distributions starting at a pre-appointed time such as when they attain age 25.

A powerful tool to consider is structuring the trust so that you are required to pay the income taxes rather than the trust. By including terms in the trust that force it to be a grantor trust, you will bear the burden of the income taxes each year, allowing the trust to retain the funds that otherwise would have been used to pay taxes. This can be accomplished in several ways, but one of the most effective ways is to create an intentionally-defective grantor trust (IDGT). An IDGT is structured to be irrevocable and, more importantly, to provide you with a completed gift (thereby removing the assets contributed from your estate). However, there is a "defect" – or perhaps more than one "defect" – built into the trust which forces it to be taxed as a grantor trust. An easy way of doing this is to retain one of the "Administrative Powers" in the Internal Revenue Code §675. For example, by giving yourself the power to reacquire trust property by substituting property of an equivalent value, and having the right to exercise this power in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, the trust is now a grantor trust for tax purposes. The basic structure of the trust remains – the assets have transferred out of your estate and will be distributed based on the dispositive provisions of the instrument – but you've retained enough control that the trust is considered a grantor trust for tax purposes. Similar powers include the power to borrow funds from the trust without adequate interest or without adequate security, or the power to purchase trust property for less than adequate consideration. You can also borrow funds from the trust – even with adequate interest and security – if the loan is authorized by a related or subordinate trustee. By employing one of these techniques, as the trust accumulates its income and capital gains it's not required to pay any income taxes; that responsibility falls on you.

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It is also worth considering that structuring the trust in this way does not obligate you to pay the income taxes for the life of the trust. At any time, you can choose to relinquish the power (or powers) that you retained, thereby eliminating the grantor trust status and putting the burden of paying taxes onto the trust. In most cases, this will be an irrevocable act – you will not be able to simply turn the powers on and off at will. However, it is something to keep in mind if your estate planning needs change (or perhaps the trust simply reaches a size that you deem appropriate to allow it to stand on its own, so to speak).

As mentioned, there are several ways to force the trust to be treated as a grantor trust for tax purposes, so you'll want to discuss the options with your drafting attorney.

Knowing that you have some options, though, and can increase the impact of your gift without incurring additional gift (and possibly GST) taxes, will give you a good starting point in achieving your estate planning goals.

Families who are saddled with an outdated or ineffective trust that no longer meets their needs or fits their circumstances should strongly consider utilizing the modification statute, in addition to taking advantage of all of Delaware's other benefits available to trusts.

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