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Intentionally Defective Irrevocable Trust (IDIT)

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Intentionally Defective Irrevocable Trust (IDIT)

What is it?

An intentionally defective trust is an irrevocable trust that has the following characteristics: (1) transfers of property to the trust are considered completed gifts for federal gift and estate tax purposes, (2) property in the trust will not be includable in the gross estate of the grantor (the creator of the trust) for federal gift and estate tax purposes, and (3) income from the trust will be taxed to the grantor.

The term "intentionally defective" is used because the trust is specifically designed to violate one of the grantor trust rules, resulting in characteristic (3), above. (These rules in the Internal Revenue Code were enacted to prevent the use of trusts to shift tax liabilities from high-income to lower-income taxpayers.) An intentionally defective irrevocable trust (IDIT) is a useful estate planning tool if you want to reduce your gross estate, and you want the trust income to be taxed to you rather than to the trust beneficiaries or the trust entity. (Such trusts are also commonly referred to as intentionally defective grantor trusts, or IDGTs.)

Usually, income from a trust is taxed either to the beneficiaries or to the trust itself (or to a combination of both). As a general rule, if all of the trust income is distributed to the beneficiaries, the beneficiaries will be taxed on the income, and if the trust retains the income, the trust will be taxed on the income (there are separate tax schedules for trusts).

There are times, however, when it makes financial sense for you, as the grantor of the trust, to be taxed on the trust income (even if you do not actually receive the income). This may be desirable if, for example, your income tax bracket is substantially lower than that of the trust. Or perhaps you are in a better position to pay the taxes than the beneficiaries (typically, the beneficiaries of an IDIT are children or grandchildren). Or, if the trust is funded with certain partnership interests that generate losses, you might want to use them to offset other income.

Caution: *Under certain circumstances, the IRS may hold that payment of taxes on trust income you do not receive constitutes a taxable gift to the beneficiaries' trust. You should consult a tax professional for further information.*

Caution: *The trust document must be drafted precisely to be treated as an IDIT. You should consult an experienced estate planning attorney.*

Strengths

Removes property from your gross estate

Because the trust is irrevocable, property in the trust at your death will not be includable in your gross estate for federal estate tax purposes. Rapidly appreciating property is ideally suited to fund an IDIT since any growth in value will also be removed from your gross estate.

Income from IDIT will be taxed to you as the grantor

One of the main benefits of an IDIT is that income from the trust is taxed to you as the grantor of the trust, even if you do not actually receive the income (with other kinds of trusts, this is usually a tax result to be avoided).

There may be several reasons for this strategy. You may be in a lower tax bracket than the trust entity, or in a better financial position than the beneficiaries to pay the taxes. Moreover, paying the taxes on the trust income can reduce the size of your gross estate, and, because neither the trust nor the beneficiaries of the trust will be liable for the taxes, the trust income essentially compounds tax free.

If you're funding the IDIT with property that generates losses such as certain real estate partnerships, you may want to use the losses to offset other income.

Tradeoffs

Trust is irrevocable

Because it is irrevocable, the trust can't be changed or ended except by its own terms, and you will be unable to access the property transferred to the trust.

Transfers to IDIT are taxable gifts

Transfers of property to the trust are considered taxable gifts, and federal gift and estate tax might be due if the amount of the gift is in excess of the $17,000 (in 2023) annual gift tax exclusion and your gift and estate tax applicable exclusion amount (which in 2023 is $12,920,000 plus any deceased spousal unused exclusion amount) has been exhausted.

Caution: *Any portion of your exclusion you use during your life effectively reduces the exclusion that will be available at your death.*

Tip: *You may want to transfer property to the trust (and out of your gross estate) without incurring gift tax. Perhaps, for instance, you lack the funds to pay the tax or can't otherwise afford to just give the property away. If that's the case, selling the property to the trust can avoid treatment of the transfer as a gift. You simply take an installment note from the trust in exchange for the property. Since the IDIT is a grantor trust, there are no capital gains or other income tax consequences from the sale. There is no taxable event because the IRS regards the trust and the grantor as one and the same.*

Many grantor-retained powers that would cause grantor to be taxed on trust income can also cause trust assets to be included in grantor's estate

The rules that determine whether trust property is part of your gross estate are different from the rules that determine income taxation. That is why an IDIT works. However, many of the powers that cause you as the grantor to be taxed on the trust income will also cause the property to be includable in your gross estate. Trust property will be includable in the gross estate of the grantor if (among certain other conditions):

- The grantor retains a reversionary interest of 5 percent or more of the trust property
- The grantor retains control over the enjoyment of the trust property
- The grantor retains certain administrative powers over the trust property
- The grantor retains the trust income

You will incur costs to create and maintain the trust

You'll need to pay an attorney to draft the necessary documentation and transfer property into the trust. You should also consider paying an annual fee to a professional trustee (e.g., a bank trust department) to manage the trust.

Questions & Answers

Can a defective trust be used in conjunction with an irrevocable life insurance trust?

Yes. Under Internal Revenue Code (IRC) Section 677, if the trust uses (or may use) trust income to pay life insurance premiums on the life of the grantor or the grantor's spouse, then the trust will be considered a grantor trust. The grantor may transfer income-producing property into the trust and then use the income from the trust to pay the premiums on a life insurance policy. The grantor will then be responsible for paying the tax on the trust income. If the trust is drafted properly, both the income-producing property and the life insurance proceeds will not be included in the grantor's taxable estate.

Can the grantor name himself or herself as the trustee of the IDIT?

Yes, but the grantor generally should not serve as trustee. When creating a trust, many people would like to retain some control over the assets in the trust and the disposition of those assets. The danger is that if you retain too much control over the trust, the assets in the trust will then be included in your gross estate.

Can other individuals or entities be named as the trustee of the IDIT?

Yes. In fact, many of the same powers that may be given to the grantor may also be given to what is called a nonadverse party. A nonadverse party is an individual or entity other than an adverse party. The IRC defines an adverse party as anyone who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power that he or she possesses with respect to the trust.

There are also special rules if a related or subordinate (to the grantor) party is named as the trustee. To avoid inclusion of the trust in your gross estate, you should avoid using any such parties as trustee. The IRC defines a related or subordinate party as one of the following individuals, if the individual is also a nonadverse party: the grantor's spouse (if living with the grantor); the grantor's father, mother, issue, brother, or sister; an employee of the grantor; a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant in terms of voting control; or a subordinate employee of a corporation in which the grantor is an executive.

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