Using IDITs to reduce taxes and protect assets.

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With federal transfer tax exemption amounts currently at an all-time high, you may not be worried about estate taxes, but current law is designed to sunset at the end of 2025, reverting back to much lower exemption amounts and potentially leaving your estate subject to a much larger tax burden than expected. Using intentionally defective irrevocable trusts can help you save transfer taxes and may also provide you with increased asset protection.

In 2024, each taxpayer will have a $13.61 million exemption ($27.22 million per married couple) from federal gift and estate tax, indexed for inflation and reduced by any exemption used in prior years. Gifts during life or bequests at death that exceed a taxpayer's exemption are subject to a 40% gift or estate tax, although there are unlimited deductions for transfers to spouses or charity. There are similar rules associated with the federal generation skipping transfer (GST) tax, which applies when a transfer is made to an individual who is two or more generations below the transferor, such as a grandchild.

Exemption amounts are at an all-time high. Under current law, however, these amounts are only effective for transfers made and persons passing away through 2025. In 2026, the exemption amounts are set to decrease to $5 million per person ($10 million per married couple), indexed for inflation with a base year of 2016.

If your net worth is likely to exceed the available exemption at death, and you wish to pass wealth down to descendants or other beneficiaries (besides your spouse and charities), it is appropriate to view the IRS as a "40% silent partner" in the growth of your family's assets.

In other words, for every additional dollar you earn, the IRS is standing to inherit forty cents when your assets pass to the next generation.

Wealthy families who wish to reduce federal transfer taxes often create and fund intentionally defective irrevocable trusts, or IDITs, for the benefit of family members and other preferred beneficiaries.

While this article provides a general overview of IDITs, it is important to emphasize that each planning situation is unique. Therefore, you should consult with your tax and legal professionals prior to engaging in any estate planning strategies.

IDITs Generally

An IDIT refers to an irrevocable "grantor trust" in which the grantor (or creator) of the trust is treated as the owner of the trust assets for federal income tax purposes, but not federal estate tax purposes. This dissonance should enable persons to transfer appreciating assets to an IDIT during lifetime without income tax consequences, while also shielding the IDIT assets, plus all future appreciation, from federal transfer taxes upon death. In addition to reducing federal transfer tax exposure, an IDIT also should increase asset protection during lifetime.

IDIT Tax Attributes

A trust is deemed a grantor trust if it contains one or more features outlined in Sections 671 through 679 of the Internal Revenue Code. Common grantor trust triggers, among others, include naming a spouse as a beneficiary, allowing the grantor to serve as a trustee, and giving the grantor the right to reacquire trust property by substituting assets of equivalent value (commonly called a "swap power").

Income Tax Attributes

The creator of an IDIT is responsible for all income tax liabilities generated by the IDIT during the creator's lifetime, which are typically reported on the creator's individual federal income tax return (IRS Form 1040). The IRS does not currently view the creator's payment of income tax as an additional gift to the IDIT, which offers a tremendous wealth-shifting opportunity because it permits the assets inside the IDIT to grow income tax free. The creator of an IDIT also may sell assets to the IDIT, borrow from the IDIT, and make or receive interest payments on a promissory note with the IDIT, all without income tax consequences. This enables you to sell an appreciating asset, such as a closely held business, to an IDIT without the sale generating capital gain, and to receive interest payments on a promissory note from the IDIT without generating taxable income.

At death, grantor trust status terminates and the IDIT becomes a separate taxpayer for federal income tax purposes. If your estate owns an outstanding promissory note from the IDIT, there is some risk that the estate may have to recognize capital gain immediately on the outstanding amount, but most commentators believe that death is not a recognition event in and of itself. Instead, income tax should begin to generate on post-death note payments and other transactions.

Basis Attributes

Importantly, an intentionally defective irrevocable trust typically takes a "carryover" income tax basis in any gifted asset it receives. In other words, the IDIT assumes the transferor's income tax basis in gifted assets.

By contrast, if you owned the assets and they were included in your taxable estate, any appreciated property would receive a "step-up" in income tax basis for purposes of calculating capital gain upon a post-death sale.

All things being equal, it is better to transfer high basis assets to an IDIT or, after funding the IDIT and prior to death, to swap high-basis assets, such as cash, in exchange for low-basis assets, such as a highly appreciated investment.

Gift Tax Attributes

When you transfer assets to an IDIT, you typically make a taxable gift equal to the fair market value of such assets on the date of the transfer, unless the IDIT exchanges with an equal value, such as a promissory note. Gifts to an IDIT must generally be reported on a federal gift tax return (IRS Form 709), which will be due on or before April 15th (or October 15th under extension) in the year following the year of the transfer. Appraisals should be obtained for any hard-to-value assets, such as real estate or closely held business interests, to support the reported fair market value and to begin the three year statute of limitations on the IRS's ability to challenge the value of the gift.

If properly structured, gifts to an IDIT may qualify for the federal gift tax and/or GST tax annual exclusions, which in 2024 allows gifts up to $18,000 per year ($36,000 per married couple) to an unlimited number of individuals without utilizing any exemption. While smaller annual exclusion gifts may not be as immediately impactful as larger gifts, these smaller gifts can still shift significant assets over time, particularly if an IDIT utilizes the funds to make new investments with substantial appreciation potential.

Estate Tax Attributes

The IDIT assets, including all appreciation after the initial transfer, should not be subject to federal estate tax at death. For example, if you give $10 million worth of assets to an IDIT and the assets grow to $50 million during your lifetime, $40 million would be removed from the federal transfer tax system. Given the current 40% estate tax rate, this can result in substantial estate tax savings.

GST Tax Attributes

When you make a gift to an IDIT and allocate GST exemption (on a gift tax return) equal to the value of the gifted assets, the IDIT should be fully exempt from GST tax. When an IDIT is exempt from GST tax, distributions can be made to grandchildren

and more remote descendants without being subject to GST tax (currently 40%). Many states permit IDITs to last for hundreds of years, or even perpetually, meaning that an IDIT can potentially benefit multiple generations without the imposition of any federal transfer tax.

IDIT Types

IDITs can be structured in a number of different ways, but the two most common alternatives are:

- An IDIT for the benefit of descendants or other preferred beneficiaries only (a "descendants' trust"); or
- A spousal lifetime access trust (a "SLAT").

A descendants' trust only permits distributions to children, grandchildren, and other preferred beneficiaries, while a SLAT permits distributions to a spouse, oftentimes in addition to descendants.

Conceptually, these two types of IDITs are very similar, except that SLATs provide more potential access to the gifted assets by naming the non-grantor spouse as a beneficiary. As a result, SLATs are often preferred, and spouses will often create two SLATs, one for the benefit of each spouse. Importantly, though, the SLATs must be structured differently to avoid the "reciprocal trust doctrine," which could subject the assets in both SLATs to estate tax (the exact result sought to be avoided).

With the exemptions set to decrease in 2026, many spouses will consider non-reciprocal SLATs in 2024 and 2025 as a means to reduce federal transfer taxes, while also preserving some access to gifted assets.

IDIT Techniques

Transfers to IDITs also can be structured in a number of different ways, however, the two most common transfer techniques are:

- Gifts, and
- Installment sales.

Both strategies are designed to remove appreciating assets from the federal transfer tax system, and in many instances, an initial seed gift is made, followed by an additional sale of assets. In both cases, the transfer should "freeze" the value of an asset for transfer tax purposes at its value on the date of the transfer, with any future appreciation avoiding estate tax.

Furthermore, with the right asset, exemptions can be "leveraged" through certain valuation discounts. For example, the fair market value of a closely held business interest may include discounts for a lack of marketability and lack of control, which can often range from 20% to 40% of net asset liquidation value.

As discussed above, when a gift is made to an IDIT, the gift consumes all or a portion of your remaining exemption. By contrast, when an asset is sold to an IDIT in exchange for a promissory note with a face amount equal to the fair market value of such asset, this should not be a gift because the IDIT should be providing full and adequate consideration for the asset it received. Promissory notes in this context should bear a market rate of interest, permit prepayments of interest and principal, and mature within the holder's life expectancy.

Installment sales, compared to gifts, can be helpful when a person wishes to preserve

some cash flow from the transferred assets or has no exemption remaining to cover an additional transfer. A transfer also can be structured as an installment sale initially, but a taxable gift can be made at a later date by cancelling all or a portion of the note. This strategy could be particularly appealing with the uncertainty surrounding the exemption levels heading into the next election cycle and 2026.

Conclusion

While it would be impossible to cover all aspects of IDIT planning within the space allotted, it is important for wealthy families to be generally familiar with IDITs and when they might be useful. In the right circumstances, IDITs can remove the IRS as a 40% silent partner in the growth of family assets.

About the author.

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