IDITs: What advisors need to know.

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Exemption amounts are currently at an all-time high, but they won't stay there for long. Absent further action by Congress, any client with an estate worth more than $5 million ($10 million per married couple) at the end of 2025 will effectively be giving the IRS 40% of the growth in their assets when it's time to pass them to the next generation. Savvy financial advisors can help clients minimize these federal estate transfer taxes with the use of intentionally defective irrevocable trusts.

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, but under current law, 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 a client's net worth is likely to exceed the available exemption at death, and the client wishes to pass wealth down to the client's descendants or other beneficiaries (besides spouses and charities), it is appropriate to view the IRS as a "40% silent partner" in the growth of the client's assets. In other words, for every additional dollar a wealthy client earns, the IRS is standing to inherit forty cents when assets pass to the next generation.

Wealthy clients 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. This overview of IDITs is provided to assist financial advisors working to minimize their clients' federal transfer taxes. It is important to emphasize, however, that each client's situation is unique, and clients should consult with legal and tax counsel prior to engaging in an IDIT strategy.

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 clients 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 the client's death. In addition to reducing federal transfer tax exposure, an IDIT should also provide clients with increased 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 clients 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 a client's death, grantor trust status terminates and the IDIT becomes a separate taxpayer for federal income tax purposes. If the client owns an outstanding promissory note from the IDIT, there is some risk that the client's 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 IDIT typically takes a "carryover" income tax basis in any gifted asset it receives. In other words, the IDIT assumes the client's income tax basis in the gifted assets. By contrast, if a client died owning assets which were included in the client's 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 for clients to transfer high-basis assets to an IDIT or, after funding the IDIT and prior to death, for a client to swap high-basis assets, such as cash, in exchange for low-basis assets, such as a highly appreciated investment.

Gift Tax Attributes

When a client transfers assets to an IDIT, the client typically makes a taxable gift equal to the fair market value of such assets on the date of the transfer, unless the client receives assets from the IDIT with an equal value, such as a promissory note. The client is generally required to report such gift 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. Clients should obtain appraisals of 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, a client's gifts to an IDIT may qualify for the federal gift tax and/or GST tax annual exclusions, which enables the client to give up to $18,000 per year in 2024 ($36,000 per married couple) to multiple individuals without utilizing any portion of the client's 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 client's initial transfer, should not be subject to federal estate tax at the client's death. For example, if a client gives $10 million worth of assets to an IDIT and the assets grow to $50 million during the client's lifetime, the client would remove $40 million from the federal transfer tax system. Given the current 40% estate tax rate, this can result in substantial estate tax savings for clients and their families.

GST Tax Attributes

If a client makes a gift to an IDIT and allocates GST exemption (on the client's 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 the client's 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

Advisors can structure IDITs 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 a client's children, grandchildren, and other preferred beneficiaries, while a SLAT permits distributions to a client's spouse, oftentimes in addition to a client's descendants.

Conceptually, these two types of IDITs are very similar, except that SLATs provide clients with more potential access to the gifted assets by naming the non-grantor spouse as a beneficiary. As a result, many clients prefer SLATs, 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 cause inclusion of the trust assets in the clients' taxable estates (the exact result advisors are seeking to avoid). With the exemptions set to decrease in 2026, many clients will be considering 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

Advisors also can structure transfers to IDITs in a number of different ways. The two most common transfer techniques, however, are:

- Gifts, and
- Installment sales.

Both strategies are designed to remove appreciating assets from the client's taxable estate, and in many instances, clients make an initial seed gift, followed by an additional sale of assets. In both cases, the transfer should "freeze" the value of the client's assets for transfer tax purposes at their value on the date of the transfer, with any future appreciation occurring outside of the client's taxable estate.

Furthermore, with the right asset, a client can "leverage" the client's exemption through 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 client makes a gift to an IDIT, the gift consumes all or portion of the client's exemption. By contrast, when a client sells an asset 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 client has received full and adequate consideration. Promissory notes in this context should bear a market rate of interest, permit prepayments of interest and principal, and mature within

the client's life expectancy. Installment sales, compared to gifts, can be helpful when clients wish to preserve some cash flow from the transferred assets or have no exemption remaining to cover an additional transfer.

Clients also can structure transfers as an installment sale initially, but make a later taxable gift 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 advisors to be generally familiar with IDITs and when they might be useful.

In the right circumstances, advisors can add substantial value simply by recognizing that the IRS may be a 40% silent partner in the growth of family wealth, and recommending IDIT strategies designed to minimize federal transfer taxes.

About the author.

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