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UTILIZING YOUR EXEMPTION WITH IRREVOCABLE GRANTOR TRUSTS

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In our recent article "Use It or (Likely) Lose It – Federal Estate Tax Exemption Uncertainty," we described the need to utilize your federal estate tax exemption. The exemption is currently set to drop at the end of 2025, but a political change in administration this fall might accelerate that drop. This follow-up article summarizes one of the most effective ways to utilize your exemption, gifts to irrevocable grantor trusts.

The federal estate tax exemption is the amount of assets that you can pass free of tax at death. The exemption is presently $11,580,000 per person. Assets left at death in excess of the exemption, other than assets left to charities or a spouse, are taxed at a rate of 40%. The exemption is to adjust upward for inflation annually and then be reduced by 50% at the end of 2025. There is speculation that this scheduled reduction may get moved up in time following the upcoming elections.

You can take advantage of the current exemption before it drops by proactively using it to make gifts. Beyond just hedging a drop in the exemption, gifts also enable you to shield subsequent appreciation from the estate tax. For example, if you use $1,000,000 of your exemption to make a gift now and then live for another 20 years, the value of the gifted assets might grow to $3,000,000. You ultimately avoided estate tax on $3,000,000 by only utilizing $1,000,000 of your exemption.

There was initially some concern that using your exemption before the drop at the end of 2025 could result in some kind of penalty or clawback. This is no longer a concern. The IRS has released regulations indicating that there will not be a penalty.

You can utilize your exemption during life by making outright gifts to beneficiaries, but outright gifts have at least three negative consequences:

- You maintain no control over the gift. Once a beneficiary receives the gift, the beneficiary can use the gift in any manner. This is especially problematic for young beneficiaries and beneficiaries with financial maturity issues or substance abuse issues;
- The gift is available to the beneficiary's creditors. This could include exposure to spousal claims, bankruptcy estates, and lawsuits;

- The gift is within the beneficiary's estate for federal estate tax purposes. If the beneficiary is a good steward of the gift, it may appreciate significantly during the beneficiary's lifetime. This could result in estate tax being assessed on the gift at the beneficiary's death.

If you make a gift to an irrevocable trust, you can still utilize your exemption but avoid the negative consequences of an outright gift:

- You cannot maintain direct control over the irrevocable trust after the gift or you may jeopardize the estate tax benefits. However, you do have significant freedom in selecting the terms of the trust upon its initial creation. This could include stipulating how and when a beneficiary will have access to the trust assets. Examples include that distributions are only for education and medical expenses until a certain age or special distributions are to be made for first home purchases, graduations and weddings;
- The assets of an irrevocable trust are generally not available to a beneficiary's creditors; and
- Subject to certain limitations, an irrevocable trust can be structured to prevent the trust assets from being subjected to the 40% estate tax rate at the beneficiary's death.

An additional advantage of using an irrevocable trust for gifting is the ability to make the trust a grantor trust. A grantor trust is effectively disregarded from an income tax perspective and this provides two primary benefits. The first benefit is that there is generally no separate income tax return required for the trust. The trust's income gets reported directly on your personal income tax return. This avoids additional tax compliance and complexity.

The more significant benefit is that since the trust's income gets reported directly on your personal income tax return, you are responsible for the payment of any tax due on that income. It may initially seem crazy to pay tax on income that is not yours. However, it is an opportunity to shift wealth free of estate and gift tax.

If a trust generates income, someone must pay the tax due on that income. If you pay the tax, you are shrinking your estate in favor of the trust. This reduces what will be subject to estate tax at your death and maximizes what is accumulating outside of your estate. Your payment of the income tax is a gift to the trust from an economic standpoint, but it is not considered a gift under tax law.

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Irrevocable trusts that are grantor trusts for income tax purposes are sometimes referred to as "Intentionally Defective Grantor Trusts" or "IDGTs." The reference to "intentionally defective" is just describing the fact that the trust is defective from an income tax perspective, the settlor or donor remains liable for taxes due on the income generated by the trust's assets.

What if you decide at some point that you no longer want to pay the tax associated with an irrevocable grantor trust's income? An ability to terminate the grantor trust status can be included in the trust agreement. If the grantor trust status is terminated, the trust will become a non-grantor trust for income tax purposes. There are various reasons why you might want to terminate the grantor trust status. One example is that you may need to stop paying taxes on behalf of the trust to conserve cash flow for your own spending. Another is that the trust may reach a value where you no longer feel a need to shift additional wealth from yourself to the trust and its beneficiaries.

A non-grantor trust will file its own tax return. Whether a non-grantor trust pays tax on its income often depends on whether the trust distributes its income to the beneficiary. If the trust retains the income, the trust will pay tax on the income. If the trust distributes the income to the beneficiary, the trust will issue a Form K-1 to the beneficiary for the income. The beneficiary will then report the income on his or her personal income tax return and pay tax on the income at his or her personal income tax rate. Trusts reach the top income tax rate more quickly than individuals. As a result, non-grantor trusts often make distributions of income to beneficiaries to take advantage of the beneficiaries' lower income tax rate.

If you are facing a potential estate tax liability at death, making a gift to an irrevocable trust can provide a wide array of benefits. The transfer will not only utilize your estate tax exemption, but you can incorporate multi-generational estate tax planning and asset protection planning for your beneficiaries and leverage the gift further with grantor trust status. Under current law, you need to complete the gift prior to the end of 2025 to utilize your exemption before it drops. If there is a shift in political power this fall, the runway for using your exemption might shorten significantly.

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