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IDGT: This trust is supposed to "fail"

Trusts come in all shapes and sizes. However, from an income tax perspective, there are basically two types: grantor trusts and nongrantor trusts. Generally, with a grantor trust all trust income is taxed directly to the grantor — the person establishing the trust — and assets in the trust may or may not be included in the grantor's estate.

In contrast, generally with a nongrantor trust, all trust income is taxed to the trust's beneficiary (or beneficiaries) or the trust itself — or some combination thereof — rather than to the grantor. In addition, the assets aren't included in the grantor's estate.

There is, however, a variation that has the best attributes of both trust types. It's purposely designed to fail the general rules, and results in income being taxed to the grantor even though the trust's assets aren't included in the grantor's estate. Appropriately enough, it's called the "intentionally defective grantor trust" (IDGT).

How the trust works

An IDGT is treated as a separate tax entity for federal estate tax purposes. However, the trust is considered to be a grantor trust for income tax purposes. If certain requirements are met, it can be a powerful vehicle for affluent individuals seeking to preserve more wealth for their heirs.

First, you establish the IDGT as a legal entity under prevailing state laws and designate the trust beneficiaries, such as your children and grandchildren. Typically, you'll transfer appreciating assets, such as securities or real estate, to the trust as "seed money." Of course, the transfers are subject to federal gift tax, but you may benefit from current favorable conditions.

Income tax implications

With a nongrantor trust, the trust itself is taxed on the income received, except for amounts that are distributed to the trust beneficiaries.

The problem is that, unlike the tax brackets for individual taxpayers, which are relatively wide, the tax brackets for trusts are extremely narrow. That means that the higher tax rates kick in at relatively low income levels compared to the individual tax brackets.

For instance, in the wake of the Tax Cuts and Jobs Act (TCJA), the current top tax rate of 37% for individuals applies when taxable income of single filers reaches $510,000, and $612,350 for joint filers. In comparison, the threshold for the 37% rate for taxing trusts and estates is a mere $12,750.

Obviously, depending on the amounts involved, a trust could easily be required to pay significantly more income tax than an individual.

Best of both worlds

By including certain "defects" in the trust document, however, the trust would be treated as a grantor trust for income tax purposes. For example, the trust may provide that the grantor has the right to exchange assets of the trust for assets with an equivalent value, or the right to add beneficiaries or make changes to the way assets would otherwise be distributed to the beneficiary.

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What's the impact of treating the trust as a grantor trust? The grantor, instead of the trust or trust beneficiaries, is taxed on the trust's income. Because the trust is drafted in a manner that retains its characterization as an irrevocable trust for estate tax purposes, however, the assets aren't included in the grantor's estate.

The reason for the dichotomy is that certain determinations for income tax and estate tax are addressed separately, which, of course, provides a planning opportunity for the right situation. By not having to pay tax on its income, the trust assets grow more rapidly than if they were encumbered by taxes. Plus, each time the grantor pays tax on the trust's income, it's as though an additional gift is being made to the trust beneficiaries. That "gift," though, isn't treated as a gift under the Internal Revenue Code.

Turn to your advisor

The IDGT is a valuable estate planning tool, but there are potential pitfalls in the process. Clearly, this isn't a do-it-yourself proposition. Rely on an experienced estate planner to handle the details. •

Selling assets to an IDGT

With an intentionally defective grantor trust (IDGT), the grantor often transfers assets to the trust through lifetime gifts. Alternatively, he or she can arrange to sell assets to the trust. In this case, there's no recognition of a capital gain, so no tax liability ensues.

The sale option often makes sense if you want to remove appreciated assets from the estate. Typically, the transaction is structured as a sale to the trust payable over several years through an installment note. In some instances, a grantor will gift assets to the trust at the outset and follow up with subsequent sales to the trust.

7 deadly estate planning sins

According to literature, the "seven deadly sins" are lust, gluttony, greed, laziness, wrath, envy and pride. Although individuals may be guilty of these from time to time, other types of "sins" can be fatal to an estate plan if you're not careful. Here are seven transgressions to avoid.

Sin #1: You don't create an estate plan. The first estate planning sin is the most basic. If you don't develop a plan featuring a will, your assets might end up being distributed according to state law, regardless of your intentions. The lack of an estate plan could lead to family conflicts and lengthy legal battles. Plus, you'll miss out on opportunities for maximizing your wealth and minimizing tax liability.

No one likes to contemplate his or her own mortality, but ignoring the need for a plan or procrastinating is asking for trouble. If you haven't started the process yet, don't delay any longer.

Sin #2: You don't understand your estate plan. Surprisingly, this is at the root of many estate planning debacles, despite the guidance of an experienced estate planning advisor.

Simply signing documents, and not knowing what you're signing, or what it means, could cause problems. This is especially true if you don't follow up with actions you're supposed to take. This doesn't mean you have to be a legal expert, but it's important to grasp the basic concepts. While you can still rely on your advisor, knowledge is power.

Sin #3: You don't update beneficiary forms. Of course, your will spells out who gets what, where, when and how. But a will is often superseded by other documents like beneficiary forms for retirement plans, annuities and life insurance policies. Therefore, like your will, you must also keep these forms up to date.

For example, despite your intentions, retirement plan assets could go to a sibling or parent — or even worse, an ex-spouse — instead of your children and/or grandchildren. Review beneficiary forms periodically and make the necessary adjustments.

Sin #4: You don't properly fund trusts. Frequently, an estate plan will include one or more trusts, including a revocable living trust. The main benefit of a living trust is that assets don't have to be probated and exposed to public inspection. It's generally recommended that such a trust be used only as a complement to a will, not as a replacement.

Both inside and outside of trusts, the manner in which you own assets can make a big difference.

However, the trust must be funded with assets, meaning that legal ownership of the assets must be transferred to the trust. For example, if real estate is being transferred, the deed must be changed to reflect this. If you're transferring securities or bank accounts, you should follow the directions provided by the financial institutions. Otherwise, the assets have to be probated.

Sin #5: You don't properly title assets. Both inside and outside of trusts, the manner in which you own assets can make a big difference. For instance, if you own property as joint tenants with rights of survivorship, the assets will go directly to the other named person, such as your spouse, on your death.

Not only is titling assets critical; you should review these designations periodically, just as you should your beneficiary designations. In particular, major changes in your personal circumstances or the prevailing laws could dictate a change in the ownership method.

Sin #6: You don't coordinate different plan aspects. Typically, there are a number of moving parts to an estate plan, including a will, a power of attorney, trusts, retirement plan accounts and life insurance policies. Don't look at each one in a vacuum. Even though they have different objectives, consider them to be components that should be coordinated within the overall plan.

For instance, arrange to take distributions from investments — including securities, qualified retirement plans and traditional and Roth IRAs — in a way that preserves more wealth. Also, naming a revocable living trust as a retirement plan beneficiary could accelerate tax liability. Incorporate beneficiary designations for retirement accounts and life insurance policies into an overview.

Sin #7: You don't review the plan. It's critical to consider an estate plan as a "living" entity that must be nourished and sustained. Don't allow it to just gather dust in a safe deposit box or file cabinet.

Consider the impact of major life events like births, deaths, marriages, divorces, job switches and relocations, just to name a few. Make sure your plan continues to meet your objectives. •

The clock is running

Why now may be the time to make a Roth IRA conversion

Roth IRAs offer significant financial and estate planning benefits. If you have a substantial balance in a traditional IRA and are considering converting it to a Roth IRA, there may be no better time than now. The Tax Cuts and Jobs Act (TCJA) reduces individual income tax rates through 2025. For those making the conversion now, the TCJA both enhances the benefits of a Roth IRA and reduces the cost of converting.

Roth IRA estate planning benefits

The main difference between traditional and Roth IRAs is the timing of income taxes. With a traditional IRA, your eligible contributions are deductible but distributions of both contributions and earnings are taxable. With a Roth IRA, on the other hand, your contributions are nondeductible — that is, they're made with after-tax dollars — but qualified distributions of both contributions and earnings are tax-free.

Generally, from a tax perspective, you're better off with a Roth IRA if you expect your tax rate to be higher when it comes time to withdraw the funds. That's because you pay the tax up front, when your tax rate is lower.

From an estate planning perspective, Roth IRAs have two distinct advantages. First, unlike a traditional IRA, a Roth IRA doesn't mandate required minimum distributions (RMDs) beginning at age 70½. If your other assets are adequate to meet your living expenses, you can allow the funds in a Roth IRA to continue growing tax-free for the rest of your life, multiplying the amount available for your loved ones.

Second, your children or other beneficiaries can withdraw funds from a Roth IRA tax-free. In contrast, distributions from an inherited traditional IRA are, with certain exceptions, taxable, and, depending on the circumstance, could saddle the recipient with a sizable income tax bill.

Why now?

The TCJA's tax changes may make it an ideal time for a Roth IRA conversion. As previously discussed, Roth IRAs offer tax advantages if you expect your tax rate to be higher in the future.

The TCJA temporarily lowered individual income tax rates, which means that there's a good chance that, all else being equal, your tax rate will increase in 2026 (unless a future Congress lowers tax rates). Plus, if you're in a position to fund your future needs from sources other than your IRA, converting now, with relatively lower tax rates, is a good idea.

When you convert a traditional IRA to a Roth IRA, you pay taxes (but not penalties) on the amounts you convert, to the extent they're attributable to deductible contributions and earnings on those contributions. You'll be able to keep the funds in a Roth IRA, which avoids RMDs and allows the full balance to continue growing tax-free.

One good strategy for softening the tax blow is to do the conversion gradually between now and 2026. This allows you to spread the cost over seven years. Also, by reducing the amount converted in a given year, you minimize the chances that the income generated by the conversion itself will push you into a higher tax bracket.

Proceed with caution

If you're contemplating a Roth IRA conversion, be sure to discuss the costs, benefits and potential risks with your advisor. It's important to be cautious because, once you convert a traditional IRA to a Roth IRA, you're stuck with it. •

ESTATE PLANNING PITFALL

You haven't addressed pets in your estate plan

Is your pet like a member of the family? If so, you may want to revise your estate plan in case your pooch or feline outlives you, just like other family members. The optimal approach may be to use a so-called "pet trust."

Pet trusts have been around for decades, but they've been gaining in popularity the last few years. Minnesota recently became the last state in the union to approve these arrangements. Now, a pet trust can be established anywhere in the country.

As the name implies, a pet trust provides for the care and maintenance of one or more companion animals. Typically, the owner — called the "grantor" or "settlor" — sets up the trust and designates a trustee to hold assets for the benefit of the pet. The trustee makes payments from the trust as needed.

What's more, the trust terms may provide specific instructions regarding the care of the pet. For example, if you own a cat that prefers one brand of food or your dog enjoys romps in the park, those details may be included in the trust. You may also impose requirements for regular visits to the vet.

A pet trust can provide instructions to care for the pet if it falls ill or otherwise is incapacitated. You know your pet better than anyone, so describe the form and length of care your pet should receive.

What happens after your pet dies? The remaining funds are distributed among the beneficiaries named in the trust. So, in a manner of speaking, your grandkids and other family members will be inheriting money from your long-time pet companion.