What is An Intentionally Defective Trust?

An intentionally defective grantor trust is an irrevocable trust designed to trigger the grantor trust rules, thus allowing the grantor, rather than the trust, to pay income taxes on trust income. Assets can be moved to the trust through gifts or sales, thus removing the assets and any future appreciation from the grantor's estate. Larger gifts may trigger use of your lifetime gift exclusion or the payment of gift taxes. Selling the assets to the trust and paying interest income on an installment sale are not taxable events. Since the defective trust is considered an extension of the grantor, these events are considered transactions with the grantor.

Any outside income generated by the trust is taxable to the grantor. Since the grantor is required to pay the tax on this income, it is considered a legal obligation and not a gift. Thus, all trust earnings can accumulate inside the trust for the beneficiaries' benefit.

There is no step-up in basis when the assets are transferred or sold to the trust. Thus, while the grantor uses this trust to reduce estate taxes, heirs may find themselves faced with high capital gains. However, the capital gains taxes aren't owed until the asset is actually sold. Also, if the asset is real estate, heirs may be able to perform a Section 1031 like-kind exchange to defer gains.

To use this type of trust, the trust document must be drafted to invoke the grantor trust rules. Several conditions can accomplish this.

In the right circumstances, an intentionally defective grantor trust can provide significant estate planning benefits.

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