



Intentionally defective grantor trusts

The following information and opinions are provided courtesy of Wells Fargo Bank, N.A.

An intentionally defective grantor trust (IDGT) allows the irrevocable transfer of assets out of your gross estate in a leveraged and tax-efficient manner and may ultimately benefit your heirs.¹ Different rules deem whether trust property is part of your income tax base or whether assets are separately subject to income taxation.

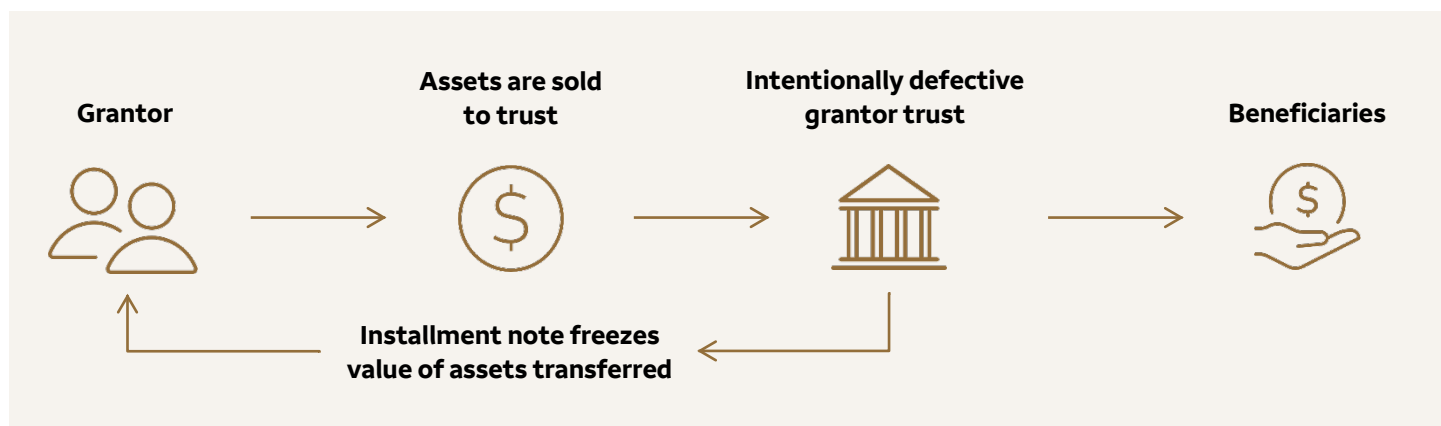
When a grantor creates an IDGT, the following outcomes generally apply:

- Asset transfers are considered completed gifts for federal gift and estate tax purposes
- Assets are not included in grantor's gross estate for federal gift and estate tax purposes²
- Asset income can be taxed to grantor instead of beneficiaries

1. Term "intentionally defective" is used because trust is specifically designed to bypass one of the grantor trust rules that Congress has enacted to prevent use of trusts to shift tax liabilities from high-income to lower-income taxpayers.

2. Federal gift and estate tax may be due if gifts are in excess of \$19,000 annual gift tax exclusion (for 2025) or gift and estate tax applicable exclusion amount has been exhausted (\$13,990,000 plus any spousal unused exclusion amount for 2025). Information sourced from [irs.gov](https://www.irs.gov); <https://www.irs.gov/newsroom/irs-releases-tax-inflation-adjustments-for-tax-year-2025>

How does an IDGT work?



An IDGT may be a potential strategy to consider for families who:

- Want to remove assets from their taxable estate
- Have sufficient cash flow to assume income tax burden of the trust
- Desire to shift appreciating assets to heirs
- Wish to promote sale of assets to family members

Once the IDGT is established, the grantor sells assets to the trust in exchange for an installment note, essentially “freezing” the value of the assets transferred as of the date of sale. Any subsequent appreciation (minus note payments to the grantor) is shifted to trust beneficiaries.

To maximize amounts transferred to beneficiaries, installment notes can be structured as interest-only based on the established IRS applicable federal rate.

Certain transaction risks may impact tax outcomes, including:

- Undervaluation of transferred property
- Below market loan structure terms
- Underperformance of trust assets
- Note delinquency or default
- Death of grantor

Potential benefits

- Property held in trust at death is not included in gross estate for federal estate tax purposes because transfer was irrevocable
- Property with appreciation potential may be suited to fund this type of trust because asset growth is also removed from gross estate
- Property of trust’s income tax liability may reduce size of grantor’s gross estate
- Property that generates losses (like certain real estate partnerships) may be used to offset income

Considerations

- Trust provisions cannot be modified and transferred assets are unavailable to grantor
- If grantor dies before promissory note is paid, the outstanding balance is included in the estate
- Trust must outperform interest rate on installment note or principal must be used to make interest payments (this may impact what remains for beneficiaries and present valuation challenges)
- Irrevocable transfer of assets not subject to “step up” in income tax basis

- Trust assets may be included in grantor’s estate or sale of trust assets may be a taxable event for income tax purposes if grantor retains certain rights:
 - Reversionary interest of five percent or more of trust property
 - Control over enjoyment of trust property
 - Certain administrative powers over trust property
 - Retains trust income

Discover more

To learn more about the benefits of an intentionally defective grantor trust, please contact your advisor.



Example*

- Mr. Jones creates irrevocable grantor trust with initial cash gift of \$1 million and files a gift tax return indicating he used \$1 million of his lifetime gift tax exemption
- Mr. Jones then sells \$5 million property to trust and, in exchange, receives a 15-year installment note bearing an interest rate of 4.53% (January 2025 IRS long-term applicable federal rate) with a balloon payment due at end of the 15-year term
- Trust asset generates return of about 8% per year and pays interest of \$226,500 annually
- At the end of 15 years, after payment of all annual interest payments and repayment of the final installment note payment (the balloon payment), the trust will have an approximate value of \$8,747,632
- The strategy will have eliminated \$8,747,632 from Mr. Jones’ taxable estate, while only utilizing \$1 million of his exemption

*Calculations are for illustration purposes and should not be considered legal, accounting, or other professional advice. Your actual benefits may vary depending on a variety of factors including timing of your gift. Information sourced from irs.gov; <https://www.irs.gov/applicable-federal-rates>

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