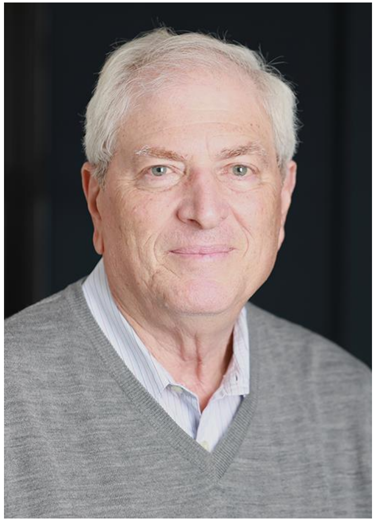
Howard Sontag

Chairman



Howard founded Sontag Advisory in 1995, a predecessor firm of Wealthspire, to introduce his personal client-centric approach to financial advisory services. The foundation of the "Sontag Model" is the belief that advisors and clients should "sit at same side of the table" and, therefore, focus on the same goals and success measures. The result is an independent, fee-only firm committed to providing independent and objective counsel.

Howard has worked with numerous families in defining and achieving multi-generational goals. He has an LL.M. in taxation from NYU Law School and is consistently focused on income and estate tax minimization.

Howard and his pioneering approach have been featured in such publications as Barron's, Investment News, Investment Advisor, Forbes.com and Financial Planning. Howard remains as committed to the business as ever, and in addition to being an advisor and managing member of the firm, is an active member of the Investment Policy Committee. He is also an active member of the community and supports numerous charities. Howard serves on the Board of Directors of the St. John's Law School Alumni Association. He is a past board member of the Urban Justice Center, a New York City based charity focused on disadvantaged populations.

Nicole R. Hart, J.D.

Senior Vice President, Trusts & Estates

Prior to joining the firm in 2014, Nicole's legal practice was focused on estate and tax planning, fiduciary trust law and non-profit law. In her current role, she draws on this experience to advise individuals and families in a variety of areas, including complex estate and tax planning, special needs and special education planning, and charitable planning. In addition, she oversees the administration of trusts when a firm principal acts as individual trustee. Nicole's approach to estate and tax planning combines technical expertise with practicality, an ability to communicate complicated concepts in an understandable way, and a passion for helping clients and their families.

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WHITEPAPER | January 2020

What is an Intentionally Defective Grantor Trust?

Nicole R. Hart, J.D.
Senior Vice President, Trusts & Estates

What is an Intentionally Defective Grantor Trust?

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Intentionally Defective Grantor Trusts ("IDGTs") are a commonly used estate planning vehicle to transfer wealth to family members during the life of the grantor. In this White Paper we will explore the four tax types relevant to IDGTs, and the mechanics of how IDGTs work. The use of the phrase "intentionally defective" is confusing, but it simply refers to an irrevocable trust where the grantor pay the trust's income tax bill during his or her life.

WHAT TAXES RELATE TO AN IDGT?

There are four types of taxes to consider: estate, gift, generation-skipping transfer (GST) and income. An IDGT allows the grantor to be the "owner" of the trust for income tax purposes, but removes the assets contributed to the trust from the grantor's estate. For a summary of the federal estate, gift and GST tax, see this cheat sheet on the topic.

HOW DOES ESTATE TAX APPLY HERE?

A typical IDGT is not subject to estate tax at the grantor's death. Upon death, any assets in an individual's name above a specified threshold amount are taxed at a set percentage rate prior to transferring to the individual's beneficiaries. The current threshold in 2020 is $11,580,000 per person; meaning that an individual may leave up to $11,580,000 in assets to any beneficiary without paying Federal estate tax. Anything above that threshold amount will be taxed at a rate of 40% in 2020.[1]

However, certain exclusions and exemptions apply. If the individual is married at her death, for example, the assets passing to her spouse may pass estate tax free under the marital deduction. In addition, if the individual designates a charity as her beneficiary, the assets may pass estate tax free via the charitable deduction.

The grantor also has to think about state estate tax. See our state estate tax cheat sheet here. The grantor may live in a state such as New York that doesn't impose a gift tax, but that imposes a state estate tax at a lower threshold than the Federal estate tax. When this is the case, it's even more impactful from an overall estate tax perspective to make a lifetime gift to an IDGT. For a New Yorker, there would be no New York gift tax cost, and you are reducing your New York estate tax bill at your eventual death.[2] To read more about New York's estate tax, visit our blog on the New York "cliff".

When a Grantor of a trust relinquishes control over the assets and doesn't retain an interest in the income or principal of the trust, the assets contributed to the Trust are removed from the Grantor's estate. However, any contributions will be subject to Gift Tax.

SO HOW DOES THE GIFT TAX WORK, THEN?

In the vast majority of cases, the grantor won't have to pay a gift tax, but she will have to use part of her lifetime exemption to transfer assets to an IDGT. Any gifts made during an individual's life that exceed a certain threshold amount may be taxable to the individual at a specified rate, currently 40%. See here for an introductory summary on the estate, gift and GST tax.

Similar to the estate tax, there are certain exclusions that apply. For example, there is an exclusion for "med/ed" gifts. Where a taxable gift occurs, the individual may use the same credit available to her under the estate tax rules to avoid immediate payment of tax. However, any gifts made will be included in the taxable estate of the individual at her death.

The main advantage of making a taxable gift and using lifetime tax credits rather than waiting until death is that any growth on the assets gifted during the lifetime of the individual will not be taxed at her death. In other words, by gifting assets during life that are likely to appreciate, the individual is essentially freezing the value of the assets for transfer tax (i.e., estate or gift tax) purposes, allowing any appreciation to pass to beneficiaries transfer tax free.

HOW DOES THE GST TAX WORK, THEN? IS THE TRUST FOREVER ESTATE TAX-FREE, EVEN WHEN IT MAKES DISTRIBUTIONS TO GRANDKIDS?

Possibly. If the grantor used up his GST exemption when making the gift to the IDGT, the trust will NOT be taxed on distributions to grandkids. The trust will be exempt from GST tax because the grantor "paid a price" to get the dollars into the trust by virtue of using some or all of his GST exemption to shield the value of the gift.

Generally, assets passing through an individual's estate will be taxable at her death, then pass to her children. At the death of her children, the assets will be taxed again when they pass to her grandchildren. In order to avoid the "double taxation" that occurs when assets pass through two generations, individuals would make direct gifts to grandchildren either outright or in trust to circumvent the taxation of the estate at their children's death. To prevent this method of tax avoidance, the IRS imposed a generation skipping transfer tax, taxing any assets that pass directly or indirectly to a "skip person" (someone who is more than one generation younger than the individual) in addition to the estate tax and gift tax. Currently GST Tax, estate tax and gift tax are linked at a rate of 40% each.

Like the estate tax and gift tax, there is a threshold amount that can pass to an individual's beneficiaries without GST Tax, also tied to the estate tax amount in 2020. In other words, an individual may make direct or indirect gifts to a skip person of up to $11,580,000 in 2020 without being subject to GST Tax.

LAST BUT NOT LEAST, WHO PAYS INCOME TAX ON THE GAINS INSIDE TRUST?

The grantor. That's the whole point of an "intentionally defective" trust: the trust and the grantor are considered the same person for income tax purposes.

When a trust is not a grantor trust for income tax purposes, it means that the trust itself will be a separate income tax-paying entity, and will file its own tax return each year, paying tax at rates based on the trust income. Generally, trusts pay higher tax rates than individuals, as the threshold income levels for each tax bracket are much lower than individual tax rate threshold amounts.

When a Grantor retains certain rights to a trust, however, she will be considered the owner of the trust for income tax purposes. This means that the trust income will be taxed at the grantor's tax rate, and the grantor will benefit from any deductions available in the trust. In addition, when the grantor pays the income tax owed by the trust, she is essentially making additional tax-free gifts to the trust. By covering the trust's tax bill, she is also allowing the trust assets to appreciate faster than they would if the tax was paid directly from the trust.

When a grantor is considered an owner of the trust for income tax purposes, but has relinquished rights to the assets in the trust in a way that allows the grantor to not be considered the owner of the assets for estate tax purposes, this is called an Intentionally Defective Grantor Trust. It is "defective" because the grantor hasn't rid herself of all ownership for income tax purposes. But the defect is intentional because, in this case, we want the grantor to be the income taxpayer.

Bells and Whistles

HOW ARE DISTRIBUTIONS MADE?

It's up to the grantor. When the trust is created, the grantor determines the way in which trust distributions are made. The IDGT can preserve the family wealth by limiting distributions to a standard set by the Grantor or by the discretion of a carefully selected Trustee. Access to funds by the beneficiaries can be as limited or as broad in scope as the Grantor decides. The assets owned by the IDGT are for the benefit of the beneficiaries, but are not their personal assets. The IDGT can serve as a partial substitute for a premarital agreement, preserving the trust assets as separate property to which the beneficiary has only limited access.

WHAT'S A "POT TRUST"? CAN AN IDGT BE A POT TRUST?

Yes. A pot trust (also sometimes referred to as a "sprinkle" or "spray" trust) is simply a trust for multiple beneficiaries where distributions can be made to any beneficiary at the trustee's discretion.

By way of example, let's say mom and dad have 3 kids and each kid has children of his or her own. Mom and dad may wish to create an IDGT for the benefit of all of their descendants. A typical structure would be to set up the trust as a general "pot" trust for ALL descendants during mom and dad's lives. Then, when the survivor of mom and dad die, the trust splits into 3 separate pot trusts. But this time, each pot trust is only for the child and his or her kids. The way in which the grantor decides to structure the trust will depend on his or her own unique family circumstances.

CAN AN IDGT BE A SPENDTHRIFT TRUST?

Yes. The Grantor may wish to build safeguards into the trust to protect her beneficiaries from creditors, and to allow her trustee to protect the assets from misuse by a beneficiary whose judgment has become clouded by substance abuse, improper influences, or any other issues that would jeopardize the trust assets.

CAN I TRANSFER LIFE INSURANCE POLICIES TO THE TRUST?

Yes. The trust may hold life insurance policies on the life of the Grantor, allowing the proceeds of the policy to pass safely in trust to her intended beneficiaries.

WHAT'S A SLAT? CAN AN IDGT BE A SLAT?

Yes. The Spousal Lifetime Access Trust, or "SLAT", is simply an intentionally defective grantor trust where the Grantor's spouse is a permissible beneficiary of the trust along with descendants. By including her spouse as beneficiary, the Grantor is able to transfer assets to an irrevocable IDGT but still ensure that the spouse has access to those assets should he need it during his life. While all of the aforementioned tax benefits generally apply to SLATs, careful drafting must occur to be certain the assets do not fall back into the Grantor's estate, particularly if each spouse wishes to create a SLAT for the benefit of the other spouse.

WHAT OTHER CONSIDERATIONS ARE THERE?

IDGTs are an excellent planning vehicle for the right individual. However, caution must be exercised when creating this type of trust. Things to consider before working with your estate planning attorney:

- *Will I need access to the assets I plan to put into the trust?* If the answer to this question is yes, an IDGT may not be for you. While it may be possible to access assets by swapping your individual assets for those in trust, or by borrowing funds from the trust, an IDGT is not meant to be revocable or easily accessible to the Grantor.
- *Do I expect these assets to appreciate over time?* The optimal assets for funding an IDGT will appreciate over the term of the trust, benefitting the Grantor by reducing her estate by the amount of appreciation accumulated in the trust. Where assets are not expected to appreciate, the Grantor may wish to hold the assets until her death.
- *How much control do I wish to give my beneficiaries?* The Grantor can retain significant control over the trust property even after the trust is created. The Grantor for example, may retain the ability to hire and fire the Trustee, and may change the provisions regarding when (if ever) his descendants become Trustees. The Grantor can often retain the ability to determine the trust investment policy, and may even have the final say regarding investments of trust capital. In this way, the Grantor can have continued access to the trust capital for future investment opportunities.
- *Who will be my Trustee?* Choosing the right Trustee is integral to your plan. Choosing a spouse or child can pose tax issues and requires very careful drafting of the documents.

Endnotes

1 The estate tax exemption amount was increased significantly in 2018, and is set to "sunset" in 2026. Under current law, on January 1, 2026, the estate tax exemption amount will revert back to pre-2018 levels (i.e., $5,490,000 per person, indexed for inflation).

2 However, all lifetime gifts made within 3 years of grantor's death are pulled back into the grantor's NYS taxable estate.

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WHITEPAPER | April 2020

Charitable Remainder Trusts (CRTs)

Richard Yam, J.D.
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Charitable Remainder Trusts (CRTs)

Richard Yam, J.D., Vice President, Trusts & Estates

WHAT IS A CHARITABLE REMAINDER TRUST (CRT)?

It is a trust where non-charitable beneficiaries (usually the grantor and grantor's spouse) receive payments at least annually during their lives or for a number of years, and a charity receives the trust assets remaining at the end of the trust term. A charitable trust is also referred to as a "split interest trust". This is because the beneficial interests in the trust are "split" between the initial non-charitable beneficiaries and the charitable beneficiaries that receive what remains at the end of the trust term. We will refer to the initial non-charitable beneficiaries as the "Lead Beneficiaries".

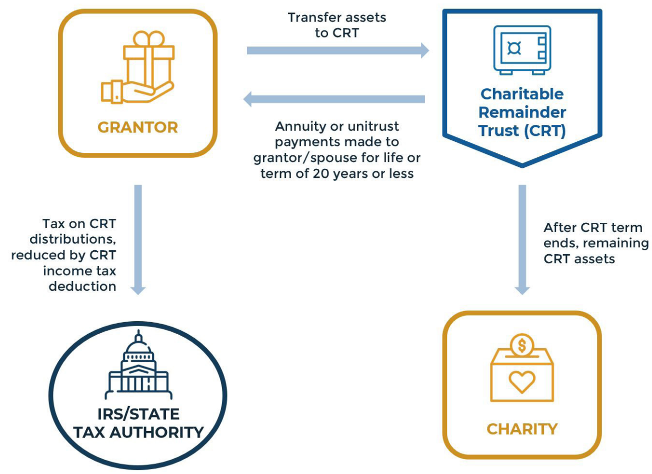
WHEN DOES IT MAKE SENSE TO HAVE A CRT?

CRTs should be considered when a charitably inclined individual wants to diversify a highly appreciated portfolio, while generating cash flow and an immediate income tax deduction. An individual may want to sell an appreciated concentrated stock position but may be deterred by the capital gains tax consequences. Transferring those assets to a CRT - and then diversifying inside the CRT - is a possible solution. Doing so will not avoid income tax (as explained below), but it will provide for income tax deferral over the life of the CRT.

HOW DOES A CRT WORK?

The grantor initially funds the CRT with highly appreciated assets. When the CRT sells the highly appreciated assets, the CRT itself is not subject to capital gains tax, thus preserving the full value of the appreciated assets to reinvest in a diversified portfolio. The capital gains taxes will be spread out and payable as the Lead Beneficiaries receive payments from the CRT. In addition, the grantor receives an immediate income tax deduction.

HOW A CRT WORKS



IS INCOME TAX IMPOSED ON THE DISTRIBUTIONS AND WHO PAYS IT?

CRTs are exempt from income tax. The CRT assumes the grantor's adjusted cost basis and holding period in the property. If the CRT sells appreciated property, neither the grantor nor the CRT will pay immediate income tax on the sales.

However, when the Lead Beneficiaries receive payments (at least annually), those payments are subject to income tax. The

Year	Trust's ordinary income (interest/ dividends)	Trust's capital gains	Distribution to Lead Beneficiaries	Amount of Distribution taxed as ordinary income	Amount Distribution taxed as capital gain	Amount of Distribution treated as non-taxable return of principal
1	$20,000	**$500,000**	$100,000	$20,000	**$80,000**	$-
2	$18,000	$-	$100,000	$18,000	**$82,000**	$-
3	$17,000	$-	$100,000	$17,000	**$83,000**	$-
4	$15,000	$-	$100,000	$15,000	**$85,000**	$-
5	$13,000	$-	$100,000	$13,000	**$87,000**	$-
6	$12,000	$-	$100,000	$12,000	**$83,000**	$5,000

following rules show how these payments are taxed, and the chart below is an illustration of these rules in effect:

- First, the payment is taxed as ordinary income to the extent of the CRT's ordinary income for that year and undistributed ordinary income from prior years.
- Second, the distribution is treated as capital gains to the extent of the CRT's capital gains for that year and undistributed capital gains from prior years.
- Third, the distribution is treated as other income to the extent of the CRT's other income for that year and undistributed other income from prior years.
- Distribution amounts in excess of the above items of income are treated as non-taxable return of principal.

As you can see from the chart below, even though $500,000 in capital gains were incurred in year 1, the tax on that gain is not immediately payable but is instead spread out over a 6-year span as the distributions are paid out.

HOW LONG CAN THE CRT LAST?

A CRT may last for the Lead Beneficiaries' joint lives or for a term of years (the term may not exceed 20 years). In addition, the actuarial value of the CRT remainder left to charity must be least 10% of the initial CRT value, determined at time of funding. This "10% test" creates a floor as to how young the Lead Beneficiaries can be. If the Lead Beneficiaries are too young, the CRT will fail the 10% test. For a lifetime CRUT, the Lead Beneficiaries must be at least in their 40s and for a lifetime CRAT, the Lead Beneficiaries need to be at least in their mid-70s. The "10% test" depends on three factors:

- The term of the CRT or for lifetime CRT's, the Lead Beneficiaries' life expectancies,
- The payment amount each year, and
- The IRC 7520 rate (defined as 120% of the federal midterm interest rate).

HOW OFTEN ARE DISTRIBUTIONS MADE?

Distributions are typically made annually or quarterly but can be weekly, monthly or semi-annually as well.

HOW ARE THE DISTRIBUTIONS AMOUNTS DETERMINED?

The IRS rules require the amount be at least 5% but no more than 50% of the trust assets. The maximum distribution amount depends on the length of the CRT term or for lifetime CRTs, the Lead Beneficiaries' life expectancies. The distribution schedule and amounts also depend on the type of CRT being used. The following tables illustrate this (all illustrations assume 3% growth and 2% income, so overall rate of return of 5%):

- *A Charitable Remainder Annuity Trust (CRAT)* pays out the same dollar amount each year, so the Lead Beneficiaries will receive the same amount no matter if the trust value increases or decreases.

CRAT @ $70,000				
Year	Beginning Principal	Growth	Income	**Distribution**
1	$1,000,000	$30,000	$20,000	**$70,000**
2	$980,000	$29,400	$19,600	**$70,000**
3	$959,000	$28,770	$19,180	**$70,000**
4	$936,950	$28,109	$18,739	**$70,000**

- *A Charitable Remainder Unitrust (CRUT)* pays out a fixed percentage of the trust value each year. The amount will be recalculated each year and the Lead Beneficiaries receive larger payments that year if the CRUT's rate of return exceeds the fixed percentage payout, and smaller payments that year if the CRUT's rate of return is less than the fixed percentage payout.

CRUT @ 7%				
Year	Beginning Principal	Growth	Income	**Distribution**
1	$1,000,000	$30,000	$20,000	**$70,000**
2	$980,000	$29,400	$19,600	**$68,600**
3	$960,400	$28,812	$19,208	**$67,228**
4	$941,192	$28,236	$18,824	**$65,883**

- *A Net Income with Makeup CRUT (NIMCRUT)* pays the Lead Beneficiaries the lesser of the net income or the fixed percentage each year. If the NIMCRUT income falls below the fixed percentage payout in certain years, payments can be made up in future years if net income exceeds the fixed percentage. A NIMCRUT may appeal to charitable individuals with illiquid assets (i.e. artwork, collectibles), and no current cash needs. While the NIMCRUT holds the illiquid assets, there will be little to no income distributed to the Lead Beneficiaries but when the illiquid asset is sold, there could be more than enough to make up for those shortfall years. Below, the $101,500 shortfall total in years 1 and 2 is made up in years 3 and 4, when net income (i.e. the gain from a sale of some of the collectibles allocated to income) exceeds the fixed percentage amount.

NIMCRUT @ 7%						
Year	Beginning Principal	Growth	Income	7% amount	**Distribution**	(Shortfall/ Makeup)
1	$1,000,000	$30,000	$20,000	$70,000	**$20,000**	($50,000)
2	$1,030,000	$31,000	$20,600	$72,100	**$20,600**	($51,500)
3	$1,061,000	$11,000	$160,000	$74,270	**$160,000**	$85,730
4	$1,072,000	$11,000	$161,000	$75,040	**$90,810**	$15,770

- *A Flip CRUT* works in certain situations where no current cash flow need exists but the occurrence of a specific definable future event would trigger a cash flow need. A Flip CRUT changes from a NIMCRUT to a normal CRUT when a specified event occurs. For example, the NIMCRUT could flip to a regular CRUT when grantor reaches a certain age (i.e. anticipated retirement age 2 years from now) or when a grantor's pension terminates (at grantor's passing). In that scenario, flipping to a normal CRUT in year 3 provides the Lead Beneficiaries with a guaranteed payment stream to offset the income loss resulting from the anticipated retirement or terminated pension.

Flip CRUT @ 7%				
Year	Beginning Principal	Growth	Income	**Distribution**
1	$1,000,000	$30,000	$20,000	**$20,000**
2	$1,030,000	$31,000	$20,600	**$20,600**
3	$1,061,000	$11,000	$160,000	**$74,270**
4	$1,072,000	$11,000	$161,000	**$75,040**

DO I GET A CHARITABLE DEDUCTION?

Yes, the grantor receives an immediate income tax deduction equal to the present value of the projected remainder interest that passes to the charity. The available charitable income tax deduction is limited to 60% of adjusted gross income (AGI) for the year if cash is gifted to the CRT with a public charity or donor advised fund as the charitable remainder beneficiary. However, the deduction may be limited to 30% or 20% of AGI for the year, depending on the type of property you give to the CRT (short term v. long term capital gain property) or the type of charitable organization named as remainder beneficiary (church/school/public charities/donor advised funds v. family private foundations). The good news is that you may carry over any unused charitable deduction amount from any year in which the remaining deduction surpasses these limits, up to 5 years.

ARE THERE RESTRICTIONS ON WHAT CHARITY CAN BE NAMED AS REMAINDER BENEFICIARY? CAN I CHANGE THE CHARITABLE BENEFICIARY DURING MY LIFE?

Yes, the charitable remainder beneficiary must be an organization described in Internal Revenue Code Section 170(c), such as a public charity, donor advised fund, religious organization or a private foundation. You may change the charitable beneficiary during your life, but it is best to give an independent trustee this power to avoid risk of the CRT being included in your taxable estate. For clients who think they may change the charitable beneficiary in the future, donor advised funds can be named as the charitable beneficiary, as the charities in the donor advised fund can be changed at any time without the need for an independent trustee.

CAN MY PRIVATE FOUNDATION BE THE REMAINDER BENEFICIARY?

Your private foundation can be the remainder beneficiary, but the income tax deduction will usually be less.

WHO CAN BE THE TRUSTEES?

Often, grantors will name themselves or their spouses as trustee. The grantor's other family members may also act as trustees. An independent trustee may be needed if CRT holds unmarketable or hard to value assets such as closely held stock or artwork, or if the grantor thinks he may want to change the charitable beneficiary later.

DO I HAVE TO PAY GIFT TAX WHEN I SET UP A CRT?

Generally, no. However, if someone other than grantor or his spouse receives the payments, then the grantor has made a taxable gift to that someone equal to the present value of the annuity or unitrust amounts paid to that person over the trust term, calculated when the CRT is created. The grantor may use his or her available unified credit to offset gift tax due on the amount passing to Lead Beneficiaries other than himself or his spouse. The remainder passing to the charities is always gift tax free because of the charitable deduction.

IS THE CRT INCLUDIBLE IN MY ESTATE?

Generally, by gifting assets to a CRT, a grantor removes those assets from his taxable estate. The remainder passing to the charities is not includible in the grantor's taxable estate. There is no estate tax consequence so long as the grantor and her spouse are the only Lead Beneficiaries.

However, in situations where someone else (i.e. the grantor's children) is a Lead Beneficiary, there may be an estate tax consequence. This can happen when a grantor, concerned about her premature death, sets up her CRT so that her children receive the payments after she has passed away, with the grantor reserving the right to revoke the children's payments in her Will. By reserving the right to revoke, the grantor avoids gift tax consequences, because the right to revoke causes the gift to be incomplete. However, if the grantor fails to revoke the children's payments before her passing, the entire CRT would be includible in the grantor's estate, reduced by an estate tax charitable deduction equal to the present value of the charitable remainder interest based on the fair market value of the CRT and the children's life expectancies on the date of the grantor's death.