Money Matters

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Question of the Month:
When is ‘defective’ OK?

By Aaron Skloff

Q: What is an Intentionally Defective Grantor Trust (IDGT) and if it is defective can it still be a powerful vehicle to reduce or eliminate our estate taxes?

The problem – Estates larger than $3.5 million pay federal estate taxes of up to 45%. Estates larger than $675,000 pay New Jersey state estate taxes of up to 16%. That could add up to a 61% tax rate and millions of dollars of tax payments.

The Intentionally Defective Grantor Trust (IDGT) is one powerful vehicle that could eliminate estate taxes by transferring assets out of your estate. While low interest rate environments, like the one we are in are now, present certain challenges, they can enhance the benefits of IDGTs.

An IDGT is an irrevocable trust created by a person (the“grantor”), who gifts (“seeds”) assets (of at least 10% of the ultimate purchase price) to the trust, allowing the IDGT to then purchase the grantor’s assets in exchange for a promissory note with a specified term. Oftentimes, the note will require interest only payments with a balloon payment of principal at the end of the term.

The grantor avoids gift taxes upon sale to the IDGT because the grantor and the trust are the same entity for income tax purposes. Because the grantor ‘intentionally’ violates just enough of the Internal Revenue Code 671-679 control rules the assets are removed from the estate – thus the name Intentionally Defective Grantor Trust.

At the end of the term the remaining assets of the IDGT are distributed to the named beneficiary (the “remainderman”) or placed into a trust for the benefit of the beneficiary. While the grantor is responsible for all income taxes generated by the IDGT, those same income tax payments provide another “tax free gift” because they retain the maximum value of the IDGT. **Translation: the trust’s value does not decline due to tax payments.**

The earlier you establish an IDGT, the greater the potential benefit. Establishing an estate plan with the expertise of your financial advisor and estate attorney can be one of the best investments of your life.

Note. Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm based in Berkeley Heights. He can be contacted at www.skloff.com or 908-464-3060.