

NOVEMBER 2011 NEWSLETTER

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## HOW INTENTIONALLY DEFECTIVE GRANTOR TRUSTS CAN REDUCE FEDERAL ESTATE TAXES

**Before addressing this topic, Pozzuolo Rodden, P.C. is pleased to announce the following:**

**A) PHILADELPHIA MAGAZINE 2011 FIVE STAR WEALTH MANAGER, BUSINESS PLANNING**

Pozzuolo Rodden, PC is pleased to announce that Joseph R. Pozzuolo, Esquire was designated as a 2011 PHILADELPHIA FIVE STAR WEALTH MANAGER, BUSINESS PLANNING by Philadelphia Magazine. The award is featured in the November, 2011 edition of the magazine. Mr. Pozzuolo was selected after an independent survey was conducted by Philadelphia Magazine of 120,500 registered financial services professionals, high-net-worth households and subscribers of Philadelphia Magazine all of whom have an income of greater than \$190,000.

**B) UPCOMING SEMINAR: CONTINUING LEGAL/ PROFESSIONAL EDUCATION (CLE/CPE) FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS- WEDNESDAY DECEMBER 7<sup>TH</sup>**

More info here: <http://pozzuolo.com/Seminars.shtml>

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The use of an intentionally defective grantor trust (IDGT) is a clever and efficient way to transfer wealth to your children or future generations, remove assets from your estate, and reduce potential federal estate taxes. In fact, not only can you achieve favorable results with an initial seed deposit to an IDGT, but you can use additional wealth transferring techniques to enhance those results.

An IDGT is an irrevocable trust established so that you – the grantor – pay income taxes on the trust’s earnings instead of using money from the trust. A grantor will pay tax on a trust’s income and gains when the grantor retains certain powers over, or interests in, the income and/or principal of the trust. For *income* tax purposes, the IRS considers the retention of these powers and interests to be equivalent to ownership of the trust. Deductions of the trust are attributed to the grantor as well. The trust will be an IDGT if the grantor has any of the following powers and/or interests in the trust:

- A reversionary interest in the trust principal or income exceeding 5% of the value of that portion of the trust.
- A power of the grantor or a “non-adverse” party (someone who does not have a substantial beneficial interest in the trust that would be adversely affected by the grantor’s exercise or non-exercise of the power) to control the beneficial enjoyment of the trust.
- Reservation of important administrative powers to the grantor or a non-adverse party other than in a fiduciary capacity.
- Reservation of the power to revoke to the grantor or a non-adverse party.
- Reservation of the power to distribute income to, or for the benefit of, the grantor.

But having the grantor pay taxes on an irrevocable trust’s income and gain seems counterintuitive. This is why “grantor” trusts are labeled “defective”; and if you intentionally create a defective grantor trust, then you have created an intentionally defective grantor trust.

One reason a grantor would intentionally create a defective grantor trust is to remove the assets in the trust from his estate. If structured properly, IDGT’s are useful for transferring wealth because, for *estate* tax purposes, the grantor is not considered as owning the IDGT. So when income taxes are paid by the grantor rather than from the trust fund, more money is kept in the trust and will go to the beneficiaries outside of the grantor’s taxable estate. In all, the grantor will have removed from his estate the value of the trust assets, any future appreciation on those assets, and the amount of money used to pay income taxes on the earnings of the trust assets. To avoid ownership for federal estate tax purposes, the grantor can retain only certain of the powers listed above. For example, if the grantor retains an administrative power to substitute the trust corpus with property of equal value, he will be deemed the trust owner for income tax purposes but not for estate tax purposes. Other powers that will achieve this same

result for federal estate tax purposes include the power to add charitable beneficiaries and the power to borrow assets from the trust.

Another benefit of using the IDGT is asset protection. If structured properly, so that the grantor does not retain a level of control that would establish his legal or equitable ownership of the trust property, assets placed in the trust can be protected from possibility of lawsuits, creditors' claims, or ex-spouses. You can also add extra levels of protection by adding spendthrift clauses and making distributions discretionary.

Once you have established and funded an IDGT, you can take advantage of additional wealth transferring techniques to add value to the trust and further reduce your federal taxable estate, including the following:

#### I. Loan to Trust

One technique is to make a loan to the trust. The grantor lends money to the trust and charges interest equal to the current applicable federal rate (AFR). The trust then pays back the principal of the loan, plus interest equal to the AFR. The grantor does not incur any gift taxes because he made a loan to the trust. If the grantor loans the money at the right time, he can lock in a low AFR so that the funds can appreciate at a greater rate than the AFR. The trust will get to keep any amount tax free of any earnings above the AFR. The grantor has now removed the value of those appreciated earnings over the AFR from his estate free of tax. But by making a loan, the grantor also ensures his own current financial security because he will be receiving payments on the loan.

#### II. Sale of Assets to Trust

Another strategy is for the grantor to sell assets to the IDGT in exchange for a promissory note. The trust pays for the asset through installments of principal in the form of a promissory note of some length, such as 10 to 15 years plus interest. The interest on the note is set equal to the AFR, as in the loan strategy described above. This way, the assets can appreciate in the trust, and the value of the appreciation over the interest rate is removed from the grantor's estate and will go to the beneficiary tax free. In addition, the grantor will avoid any capital gains tax he may have incurred on a sale of the asset otherwise, because he is selling to the grantor trust he created, which the IRS views as his alter ego. No gain or loss is recognized.

#### III. Valuation Discounts of Family Business Interests

IDGTs are especially useful tax saving vehicles where the grantor has a family owned, privately held business and desires to transfer it to the children. In addition to all the benefits described above, the grantor can take advantage of valuation discounts of family business interests. The value of the non-controlling interest of the privately held business transferred to a family member by a IDGT can be discounted for reasons such as lack of control, lack of transferability, and lack of marketability. This allows the grantor to sell non-controlling interest of the business to the trust at a discounted value in exchange for a note of some length. Once again, the trust benefits from any difference of appreciation over the interest rate. But, the trust

also owns the interest of the family business worth its full value, while only being obligated to pay the cheaper, discounted value under the note. The grantor benefits from the fact that he has removed the full value of the business interest from his estate, while holding a note worth considerably less than the full value of the business interest. Thus, the value of his estate will be decreased.

Intentionally defective grantor trusts are effective and efficient ways to decrease the value of one's estate, thus minimizing potential estate taxes. At the same time, they are effective tools for transferring wealth to children and future generations, or turning over interest in a family business. Under the right circumstances, these wealth transferring goals can be accomplished all while maintaining current financial security to the grantor. Different types of assets and amounts of wealth can be transferred so explore your options.

Please visit our web site: [www.pozzuolo.com](http://www.pozzuolo.com)

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(CLE/CPE) FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS-  
WEDNESDAY DECEMBER 7<sup>TH</sup>**

**Joseph R. Pozzuolo, J.D., B.B.A. and Jeffrey S. Pozzuolo, J.D., M.B.A., B.S., B.A.**  
*"The Privately Held Business Symposium for the Suburban General Practitioner and CPA Including Ethics"*  
Wednesday December 7<sup>th</sup> 8am-12pm  
Penn State University, Cooperation Extension (Doylestown)  
<http://bucks.extension.psu.edu/>  
1282 Almshouse Road  
Neshaminy Manor Center  
Doylestown, PA 18901-2896

To Register or More Information: Theresa Bloom (215) 881-7402

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**Publications**

All of the following professional publications and past newsletters written by attorneys of this office are available by clicking here: <http://pozzuolo.com/PubsArticles.shtml>

**Corporate/Tax**

Design Buy-Sell Agreements For Maximum Utility

Deferred Compensation Rewards And Retains Key Employees

How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool

Protecting A Client's Business From Unfair Competition Using Restrictive Covenants

Money Purchase Pension Plan Falls Out Of Favor

Why An Employment Contract Is Mandatory

What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs

Structuring Loans From Qualified Plans - How To Handle The Strict Tax Rules

How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend

Bankruptcy - How To Prevent It And How To Cope With It Should It Happen To Your Business

How To Look, Act And Sound Like A Professional Corporation

How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations

How to Structure a Suitable Buy-Sell Agreement

## **Estate Planning**

Estate Planning For Pet Owners

The Limited Liability Company -A Sophisticated Tool For Estate Planning

Diversify Strategies For An Effective Estate Plan

Use Wills To Maximize Family Protection And Minimize Tax

Six Proven Estate Planning Techniques

Divorce Raises The Need For Performing An Estate Planning Review

Divorce and Estate Planning

Remarriage Situations Can Raise Special Estate Planning Considerations

College Funding Tool Offers Estate Planning Advantage

Drafting The Durable Power Of Attorney For Wealth Protection Purposes

Why Living Wills Advance Directives Are An Essential Part Of Estate Planning

Special Needs Trust - An Estate Planning Tool For The Disabled

Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples

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