

This Type of Trust Succeeds at “Failure”

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Depending on your situation, it may be advisable to set up a trust to fail certain tax law requirements. Actually, it is not as drastic as it sounds. An “intentionally defective trust” (known as an IDT, for short) can be a valuable estate-planning tool, especially in this current interest rate environment.

But IDTs are not for everyone or at every available opportunity. Here is a brief review of this sophisticated estate-planning technique.

How it works: Usually, you transfer assets such as cash or securities to the trust, which then pays annual income to the designated beneficiaries. By giving up all rights to the assets, you are not responsible for any federal income tax on the earnings. This can be particularly beneficial if you are in one of the top income tax brackets. (The current top bracket is 35%.) The income tax is generally paid by the trust under a graduated tax rate structure, beginning at a 15% rate.

But be aware that the income tax brackets for trusts are highly compressed. In other words, the dollar amounts for each bracket are relatively small compared with the tax brackets for individuals, so the higher tax rates are reached relatively quickly.

Bottom line: The trust could end up paying more tax than you would have been assessed in your usual individual tax bracket. In that case, you are defeating one of your own objectives.

This is where an IDT can provide some much-needed relief. Assuming the trust document is properly structured, the trust will be treated as a “grantor trust” if it permits you to retain certain rights or interests. This means that the income will be taxed to you as the grantor rather than the trust—even though you are not receiving any of the annual income.

In addition to the income tax savings, current interest rates make it conducive to establish an IDT. The resulting gift-tax liability for the remainder is based on the assumed IRS interest rate at the time the trust is created. When interest rates are on the low side—as they have been through the beginning of 2011—the gift-tax consequences are favorable to the grantor.

Note, however, that an IDT could lead to estate-tax complications. That is because your taxable estate includes assets you have transferred to trusts and individuals where you retain possession or enjoyment

of the transferred property. Essentially, you must give up complete control over the assets. Nevertheless, negative estate-tax consequences can be avoided with proper planning.

This is not a do-it-yourself proposition. Consult your Henry & Horne, LLP estate-planning adviser to determine if an IDT makes sense for your situation.

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