Use nongrantor trusts to bypass the SALT deduction limit

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If you reside in a high-tax state (like my home state of New Jersey), you may want to consider using nongrantor trusts to soften the blow of the $10,000 federal limit on state and local tax ("SALT") deductions. The limit can significantly reduce itemized deductions if your state income and property taxes are well over $10,000. A potential strategy for avoiding the limit is to transfer interests in real estate to several nongrantor trusts, each of which enjoys its own $10,000 SALT deduction.

Grantor vs. nongrantor trusts

The main difference between a grantor and nongrantor trust is that a grantor trust is treated as your alter ego for tax purposes, while a nongrantor trust is treated as a separate entity. Traditionally, grantor trusts have been the vehicle of choice for estate planning purposes because the trust's income is passed through to you, as grantor, and reported on your tax return.

That's an advantage, because it allows the trust assets to grow tax-free, leaving more for your heirs. By paying the income tax, you essentially provide an additional, tax-free gift to your loved ones that's not limited by your gift tax exemption or annual gift tax exclusion. In addition, because the trust is an extension of you for tax purposes, you have the flexibility to sell property to the trust without triggering taxable gain.

Now that fewer families are subject to gift taxes, grantor trusts enjoy less of an advantage over nongrantor trusts. This creates an opportunity to employ nongrantor trusts to boost income tax deductions.

Nongrantor trusts in action

A nongrantor trust is a discrete legal entity, which files its own tax returns and claims its own deductions. The idea behind the strategy is to divide real estate that's subject to more than $10,000 in property taxes among several trusts, each of which has its own SALT deduction up to $10,000. Each trust must also generate sufficient income against which to offset the deduction.

Before you attempt this strategy, beware of the multiple trust rule of Internal Revenue Code Section 643(f). That section provides that, under regulations prescribed by the U.S. Treasury Department, multiple trusts may be treated as a single trust if they have "substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries" and a principal purpose of the arrangement is tax avoidance.

To preserve the benefits of multiple trusts, it's important to designate a different beneficiary for each trust.

Pass the SALT

If you're losing valuable tax deductions because of the SALT limit, consider passing those deductions on to one or more nongrantor trusts. Please consult with us before taking action, because these trusts must be structured carefully to ensure that they qualify as nongrantor trusts and don't run afoul of the multiple trust rule.

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