News Alert
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Tax Reform or No Tax Reform - The Potential Impact on Private Clients and Family Offices

Introduction

The House Ways and Means Committee recently released proposed federal tax legislation that would dramatically change income and estate tax planning. Many of the changes require immediate attention and in some cases action as it is possible that the proposals may become effective as soon as the legislation becomes law, so taxpayers may not have all of 2021 to respond. We stress that this remains proposed legislation that will undoubtedly undergo further revisions as the Act makes its way through the House and Senate.

A summary of the proposed changes affecting income and estate tax planning follows.

Grantor Trusts and other Trust Structures

The grantor trust rules were initially developed as a means to penalize an individual in a high income tax bracket from shifting income into a lower tax bracket by transferring some of their assets to a trust, and later receiving the property back in the future, thus retaining control of the property like an owner. In effect, if the grantor retains certain powers or rights with respect to the trust, the grantor trusts rules cause the grantor to be treated as the owner of the trust assets for income tax purposes. After the graduated tax brackets for trusts were compressed, causing a trust to reach the highest tax bracket once it earns approximately $12,500, grantor trusts status became desirable for estate planning purposes.

Today a grantor of a trust can use an irrevocable grantor trust to remove assets from the grantor's estate for estate tax purposes while continuing to pay the income taxes on behalf of the trust. Doing so is essentially a gift tax free transfer to the trust beneficiaries.

Examples of powers that, if retained by the grantor, should cause a trust to be treated as a grantor trust include:

- the power to control beneficial enjoyment of assets in the trust;
- the power to add or change a beneficiary of a trust;
- the power to lend trust income and principal to the grantor without adequate security;

- the power to use the income from the trust to pay life insurance premiums;
- the power to substitute assets of equal value; and
- the power to borrow trust assets.

A grantor or another person treated as the owner of the grantor trust must include for personal income tax purposes, all items of income, deductions, and credits against tax attributable to the portion of the trust for which the grantor is deemed to be the owner.

All revocable trusts are treated as grantor trusts, but there are a number of types of irrevocable trusts for estate and gift tax purposes that are treated as grantor trusts as well. An intentionally defective grantor trust ("IDGT") is an irrevocable trust that is drafted to purposely trigger grantor trust status for income tax purposes. Because the trust is irrevocable, the underlying trust assets are removed from the grantor's estate. However, the IDGT is drafted with a power to trigger grantor status, such as a power in the grantor to replace trust assets with assets of equal value. As a result, the IDGT utilizes various provisions of the tax code to make the trust tax "effective" for estate and gift tax purposes but tax "defective" for income tax purposes.

A foreign non-grantor trust ("FNGT") is a foreign trust that fails either the Control Test or the Court Test which is not revocable by the grantor and does not solely benefit the grantor or the grantor's spouse. The Control Test looks to whether a US person controls all substantial decisions of the trust and the Court Test looks to whether a US court can exercise primary supervision over the administration of the trust. FNGTs are quite often established prior to a foreign person immigrating to the United States for the benefit of non-US beneficiaries. The trust essentially shelters the assets from US estate tax after the person settles in the US and shelters the non-US source income from US income tax. However, if a foreign grantor comes to the US within 5 years of settling a FNGT, the FNGT becomes a grantor trust as to the grantor for US tax purposes (i.e., the grantor is deemed to own all of the trust assets for income tax purposes).

An irrevocable life insurance trust ("ILIT") is an irrevocable trust created to facilitate the ownership of one or more life insurance policies. The ILIT is considered the owner and beneficiary of the life insurance policies and if structured properly, the life insurance death benefit should not be subject to income tax or estate tax. ILITs are considered grantor trusts if the trust instrument provides that trust income may be applied toward the payment of premiums on policies insuring the grantor's or the grantor's spouse's life or if the trust benefits the grantor's spouse.

Finally, a grantor retained annuity trust ("GRAT") is a trust where a grantor contributes assets and retains a right to receive an annuity generally equal to the original value of the assets contributed to the trust while earning a rate of return specified by the IRS. Upon expiration of the term of the GRAT, the remaining trust assets are distributed to the grantor's beneficiaries without the imposition of gift tax if the grantor is then living. If the grantor of the GRAT dies before the trust term expires, the assets become part of the taxable estate of the grantor and the beneficiary receives nothing. A qualified personal residence trust ("QPRT") is a grantor trust that is similar to a GRAT, but a QPRT is specifically created to hold the personal residence of the grantor for a term of years.

Proposed transfer taxes on Grantor Trust -- Proposed Section 2901

Section 2901 is a proposed addition to the Internal Revenue Code which applies transfer taxes to grantor trusts.

Section 2901 has three key provisions:

1. the assets of a grantor trust are pulled into the estate of the deemed owner of the grantor trust upon the death of the deemed owner;
2. any distribution from a grantor trust to someone other than the grantor or the grantor's spouse, or for the purpose of discharging a debt of the grantor, will be treated as a taxable gift from the grantor to the person receiving the distribution; and
3. if the trust ceases to be a grantor trust during the life of the grantor, it will be treated as a gift by the grantor of all the trust assets.

The effect of proposed Section 2901 would be to subject the appreciation of any asset transferred to a grantor trust to estate or gift tax. It is important to note that this proposed addition to the tax code only applies to grantor trusts where the grantor is treated as a deemed owner and not where another person, such as a beneficiary, is treated as the deemed owner.

If passed in its current form, Section 2901 will apply to grantor trusts created on or after the date of enactment of the proposed legislation, as well as to any portion of a trust established before the date of enactment which is attributable to a contribution made on or after such date. As a result, the estate tax benefits of most of the grantor trusts mentioned above will be lost for such trusts that are funded after the effective date of the proposed legislation. As such, taxpayers should evaluate whether they want to implement such trusts sooner.

In addition, some grantor trusts that are already in existence may be impacted by the proposed legislation. For example, if a person already has an ILIT in place and contributes additional funds to the trust to pay insurance premiums after the proposed legislation is effective, this would cause some portion of the insurance held by the trust to be subject to estate tax. As another example, if a person established a pre-immigration FNGT with the plan to immigrate to the US within five years of doing so, they may want to delay the starting date until after the expiration of the five year period. If you have created, or were planning to create, any of the types of grantor trusts listed above or are not sure if such a trust was contemplated for you, you should seek advice as to the specific impact the proposed legislation may have on your structures.

Proposed income taxes on sales or exchanges between Grantor Trusts and the deemed owner -- Proposed Section 1062

For income tax purposes a grantor trust is essentially treated as the alter ego of the grantor. Accordingly, under current law, any sales or exchanges between a grantor trust and the grantor are disregarded for income tax purposes. The current proposal aims to ignore the disregarded nature of sales and exchanges between a grantor and a grantor trust, thus requiring gains (but not losses) to be recognized on such sales. The proposal would also increase the highest capital gain tax rate for all taxpayers (ie: transfers between individuals and grantor trusts) from the current 20% to a new 25% rate and this change would be retroactive to September 13, 2021. When net investment income tax of 3.8% is taken into account, the highest capital gain tax rate would be 28.8%.

The proposed legislation would apply to grantor trusts, other than revocable trusts, created on or after the date the Act is enacted. Existing irrevocable trusts would be grandfathered, but if a “contribution” is made to a grandfathered trust a portion of that trust would be subject to these new rules. The term “contribution” is not defined and could include not only gifts to the trust but payments made to the trust on a loan or for rent. If not addressed in the final proposed legislation, the definition of “contribution” may need to be addressed in regulations.

Proposed increased valuation and taxation of transfers of nonbusiness assets

The proposed tax legislation would also repeal the use of valuation discounts for certain nonbusiness assets. A nonbusiness asset would be any passive asset which is held for the production or collection of income but not used in the active conduct of a trade or business.

Under the proposed change, the valuation of an ownership interest in a privately-held entity for transfer tax purposes would be modified to such that

1. any nonbusiness assets owned by the entity will be disregarded in valuing the ownership interest in the entity;
2. the nonbusiness assets will be valued separately as if the transferor had transferred such assets directly to the transferee; and
3. no valuation discount will apply when valuing the nonbusiness assets

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Currently, if an individual gifts a minority interest in a private entity, the value of the gift can be valued lower than the value of the proportional amount of the entity being transferred due to discounts for a lack of marketability and control. The proposed change would repeal the use of these valuation discounts for entities that hold certain nonbusiness assets, such as marketable securities and cash. Essentially the donee would be treated as if such assets were given to him or her directly, so no discount would be available.

Reduction in the Transfer Tax Exclusion

The Tax Cuts and Jobs Act (TCJA) of 2017 temporarily doubled transfer tax exclusions to $10 million per person, adjusted for inflation (i.e., $11.7 million per person for 2021). Under the TCJA, the increased exclusion is scheduled to be reduced to $5 million, as adjusted for inflation, on January 1, 2026. The current proposal accelerates the reversion to the $5 million amount to January 1, 2022. This would essentially cut the exclusion in half as of that date.

Clients wishing to take advantage of the current $11.7 million exclusion (which is $23.4 million for married couples) should explore making gifts before the end of 2021, or allocating GST exemption to existing trusts that are not currently GST exempt before that date. However, for those clients who want to allocate the GST exemption amount to a grantor trust that is not subject to the proposed legislation, they must do so prior the date that the legislation is enacted (which is an uncertain date at this point).

Conclusion

The proposed changes to the tax code would have a significant impact on estate planning for high-net-worth individuals. Many methods traditionally used by estate planning professionals must be reconsidered should the above tax proposals be enacted. While it is feasible that the tax proposals will change before the enactment of the new tax legislation, if enacted at all, it is important to note that there is growing political momentum to pass sweeping tax legislation. It is also important to be immediately wary of how the proposed tax changes can affect your estate planning because the effective dates for the proposed changes will leave little time to plan prior to enactment.

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