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New Proposals May Limit Estate Planning Opportunities

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On February 13, 2012, the Obama Administration issued its Fiscal Year 2013 Revenue Proposals (the "Greenbook"). Although many of the revenue proposals pertaining to gift, estate and generation-skipping transfer ("GST") tax appeared as well in the 2012 Greenbook, there is a striking new proposal that, if enacted, would make many common trust arrangements far less effective.

New Proposal: Elimination of Transfer Tax Benefits of Grantor Trusts

A common trust planning technique is to establish and make taxable gifts to an irrevocable trust that is designed as a "grantor" trust for income tax purposes. The grantor pays gift tax (or uses available gift tax exemption) upon funding of the trust, but post-gift appreciation in the trust is not thereafter subject to gift or estate tax.

The income from a grantor trust is reported on the grantor's personal income tax return. Because the trust's income tax is treated as a liability of the grantor, and not of the trust, payment of income tax on behalf of the trust is not treated as a taxable gift to the trust. In addition, because the grantor and the trust are treated as the same entity for income tax purposes,

sales and loans between the grantor and the trust have fewer negative income tax effects than similar arrangements with non-grantor trusts.

The proposal, in its current form, is unclear as to how it would relate to current gift, estate and income tax laws. It appears that contributions to new or existing "grantor trusts" would still be subject to gift tax on funding, and income of the trust would still be reported on the grantor's personal income tax return. However, some portion of the trust property thereafter would be (1) included in the grantor's gross estate, if the trust is a grantor trust upon the grantor's death; (2) subject to gift tax, if distributed to one or more beneficiaries while the grantor is alive and the trust is still a grantor trust; and (3) subject to gift tax, if the grantor is alive and the trust for any reason ceases to be a grantor trust. The amount subject to estate or gift tax as described above would be reduced by the value of any taxable gift previously made to the trust by the grantor. The effect appears to be to subject to gift or estate tax all appreciation subsequent to initial funding of the trust, including (but not limited to) enrichment of the trust by allowing the grantor to pay the trust's income tax liability.

Perhaps the most troublesome aspect of this new proposal is that any estate or gift tax payable as a result of the proposed rules would be payable from the trust, and not by the grantor separately. Requiring the trust (and, therefore, the trust beneficiaries) to bear the gift or estate tax burden, and subjecting to gift or estate tax all post-funding appreciation in the trust, would make grantor trusts far less effective vehicles for gift and estate tax planning than non-grantor trusts.

The proposal would not change the treatment of trusts the assets of which are already includible in the grantor's gross estate (such as GRATs and QPRTs). However, the proposed rules would apply in certain situations

where a person other than the transferor (such as a beneficiary) is treated as a "grantor" under the grantor trust rules.

Existing grantor trusts would not be affected if there are no additional contributions to or relevant transactions with such trusts following enactment of the proposed rules. However, the proposed rules would apply to all contributions to or relevant transactions with grantor trusts (whether existing or new trusts) made after enactment of the new rules.

GRATs

One proposal, which would require a minimum term for GRATs and would technically preclude "zeroed-out" GRATs, has appeared in recent budgets and revenue proposals, and in several unsuccessful bills in Congress. See our February 24, 2011 Client Alert, "GRATs and Dynasty Trusts in the Crosshairs." It could well be that these restrictions will, sooner or later, become law. Furthermore, the Section 7520 rate (which affects the success of GRATs–a lower rate is better) is at a historic low (1.4% for February 2012). Therefore, if you are considering establishing a GRAT, especially a short-term GRAT, you should consider doing so immediately.

GST Exemption and Dynasty Trusts

Another proposal which also appeared in the 2012 Greenbook, and which appears again in the 2013 Greenbook, would affect the long-term tax efficiency of perpetual trusts, often referred to as "Dynasty Trusts." This proposal would provide that no later than the 90th anniversary of the creation of a trust, any GST exemption applied to transfers to that trust would essentially expire (with some limited exceptions). Thereafter, the trust would be treated as if no GST exemption had ever been applied. For

more detail, please see our February 24, 2011 Client Alert, "GRATs and Dynasty Trusts in the Crosshairs."

Under the current proposal, this rule would not apply to pre-existing trusts, but would apply only to trusts established after the rule is enacted. Furthermore, because the 2012 GST exemption and unified gift and estate tax exemption amounts are $5.12 million per taxpayer, now is a particularly good time to establish a Dynasty Trust. Until this proposal is passed by Congress (and barring future retroactive changes in the law), a married couple could potentially contribute up to $10.24 million (combined) to a Dynasty Trust that should be exempt from GST tax in perpetuity.

Note that the GST exemption is currently scheduled to drop to $1.36 million, and the unified gift and estate tax exemption to $1 million, in 2013, barring further changes in the law. The Obama Administration proposes setting both exemptions at $3.5 million. Either way, the ability to make large gifts free of gift and GST tax may well be curtailed in the near future.

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Of course, the foregoing proposals will not necessarily become law. However, you should consider taking advantage now of planning opportunities that may not be available in the future.