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Using irrevocable trusts to transfer wealth

Families with substantial net worth may wish to explore other ways to transfer additional wealth without the imposition of a gift tax. This is where an irrevocable "grantor trust" comes into the picture.

In today's world, the pursuit of your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

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Wealthy families often desire to manage the growth or reduce the size of their estates in anticipation of potential estate taxes in the future.

What would you think if someone were to suggest that the ability to give away assets to your heirs while still paying the income taxes on income generated by those assets is a "have your cake and eat it too" scenario? You may initially think that paying income taxes on income you no longer receive is more of a "someone took my cake before I even got a bite" scenario! However, a grantor retaining the responsibility for income tax payments on transferred assets can be extremely beneficial for those families that are looking for ways to maximize wealth transfer.

Wealthy families often desire to manage the growth or reduce the size of their estates in anticipation of potential estate taxes in the future. These same families may also wish to begin passing wealth to their children and future generations during life in order to guide and coach the next generation in the stewardship and management of the family wealth.

However, the IRS limits the ability to make lifetime gifts to heirs (e.g., children, grandchildren, other family members and friends). Generally, the two main tools we have are the $15,000 annual exclusion amount (per donor, per beneficiary as of 2019, subject to a periodic inflation adjustment) and the $11.4 million per person in 2019, indexed annually for inflation. In 2019, a tax payer may give up to $15,000 to any individual ($30,000 per couple under the gift tax annual exclusion). Any gifts in excess of this amount count against the tax payer's $11.4 million lifetime gift tax exemption ($22.8 million for married couples). Note that under the Tax Cuts and Jobs Act of 2017, the $11.4 million lifetime gift tax exemption is scheduled to revert to $5 million, indexed to inflation to 2010, in 2026.

Amounts transferred to heirs above these limits are subject to a 40% gift tax.[1] These two tools provide a good starting point for a wealth transfer plan. However, families with substantial net worth may wish to explore other ways to transfer additional wealth without the imposition of a gift tax. This is where an irrevocable "grantor trust" comes into the picture.

What is a grantor trust?

When a trust is considered a grantor trust for income tax purposes, the grantor (or the settlor) of the trust is treated as the owner of the trust income and/or trust principal. This means that all items of income or deduction are reported on the grantor's personal income tax return, just as the grantor reports his or her own items of income or deduction on his or her personal income tax return.

What is the difference between a non-grantor trust and a grantor trust?

- Many irrevocable trusts are characterized as non-grantor trusts. This simply means that the trustee of the trust is responsible for filing a trust income tax return and that the trustee will use trust assets to pay any income taxes due.
- A grantor trust is a trust for which the person who created the trust (i.e., the grantor) is held responsible for reporting the income generated by the trust on his personal income tax return.
- This tax treatment is the result of provisions in the trust document that violate certain rules the IRS sets as it relates to who (the trust or the grantor) pays the taxes on income. These trusts are considered "defective" for income tax purposes.

[1] Excludes gifts to charities and spouses as well as payment to qualified institutions for education and medical expenses.

– There are many different types of trusts that are considered grantor trusts (such as revocable trusts, which are the basis for many estate plans); however, we are going to focus on those trusts that are used for the purposes of wealth transfer. These grantor trusts are drafted such that the assets are not includable in the estate of the grantor at the grantor's death and are generally irrevocable.

Why would I want to pay taxes on income that I don't receive?

Grantor trust tax treatment may be viewed as something to avoid since this may result in the grantor paying taxes on income from assets that he no longer owns. However, payment of the taxes is not considered a gift by the IRS. This allows the assets that would otherwise be removed from the trust for tax payments to instead be retained by the trust and to continue growing for the benefit of the trust beneficiaries. To take advantage of this opportunity, trust documents can be drafted such that they intentionally violate these grantor trust rules and make them defective for income tax purposes. This is where the term "intentionally defective grantor trust" comes from. For clients who are comfortable paying income taxes on transferred assets, making gifts to this type of trust can be a strategy to shift wealth to heirs in a gift tax-efficient manner.

Note: On several occasions there have been proposals that would subject assets owned in these types of trust to gift and/or estate taxes. While these proposals have not been acted upon, it is important to be aware of potential changes to the law.

An example

Let's look at a comparison of a gift to a grantor trust to a gift to a non-grantor trust:

Assumptions:
- $5,000,000 gift in 2019.
- Maximum ordinary income and capital gains tax rates in addition to the 3.8% Medicare surtax apply.
- Blended return of 4.97% based on an asset allocation of 5% cash and cash equivalents, 25% tax-free fixed income and 70% equities.[2]

Based on these assumptions, a trust treated as a grantor trust would have assets worth approximately $13.2 million after 20 years. A non-grantor trust would have assets worth only $10.4 million.

Grantor trust tax treatment may be viewed as something to avoid.

Thus, for the same initial taxable gift amount ($5 million), there is an additional $2.8 million held in the trust and excluded from the grantor's estate after 20 years. This $2.8 million essentially represents the taxes paid over the lifetime of the trust by the grantor plus the growth on those tax payments. If this were instead included in the grantor's estate, this could generate an additional $1.1 million of federal estate taxes (assuming a maximum estate tax rate of 40%).

What makes a trust a grantor trust?

There are nine IRS code sections that deal specifically with situations where the IRS will consider a trust as being a grantor trust for income tax purposes. Originally, these code sections were put in place to prevent individuals from shifting income to lower bracket taxpayers. However, due to the potential

[2] The return assumptions used for each asset class are as follows: 2.1% taxable interest for cash and cash equivalents; 1.8% tax free interest for tax- free fixed income; and a 2.2% dividend rate and 4.1% growth rate for equities. The returns used are estimates, are not guarantees, and actual results may vary significantly from the results shown; as can the performance of any individual security or investment.

Some attorneys may be comfortable including the ability for a trustee to reimburse the grantor for the income taxes paid but this must only be done at the discretion of the trustee.

significant wealth transfer benefits of grantor trusts, they are now a common technique used by clients with substantial wealth. While there are many different provisions that may be included in a trust document that cause a trust to be treated as a grantor trust for income tax purposes, many will also cause the assets to be taxed as part of the grantor's estate. This negates the benefits of a grantor trust for wealth transfer purposes. However, there are a few common provisions that are used that result in grantor trust treatment, while preserving the exclusion of the assets from the grantor's estate for estate tax purposes. These include the following:

- The power to add a beneficiary (this is often limited to the power to add a charitable beneficiary).
- The power to make loans to the grantor without adequate security
- The power to substitute assets of equal value (this is sometimes referred to as a "swap power").
- The power to use trust income to pay premiums on insurance on the life of the grantor or the grantor's spouse.
  - There is some debate in the legal community regarding this power due to varying interpretations of the language of the IRS code section. Some attorneys believe that a trustee simply having the ability to use income to pay premiums would trigger grantor trust status. Others feel that the trust is a grantor trust only as to the income actually used to pay premiums.

Each of these items has advantages as well as disadvantages and considerations as a means to cause a trust to be treated as a grantor trust. Your attorney's comfort level as well as your personal situation may lead you to choose one (or a combination of some of them) versus the others.

There are additional situations that may result in a trust being treated as a grantor trust, even though this may not have been the initial intent. Many of these will also result in the inclusion of the assets owned by the trust in the estate of the grantor at death, which is counter to the objectives for most wealth transfer plans.

It is mentioned that I have to report the income generated by the trust on my personal income tax return-what about losses, credits and deductions?

These flow through to the grantor as well. This would allow the grantor to continue to use these items to offset income that may be flowing through to the grantor's tax return.

What if I am generally comfortable with paying the taxes on behalf of the trust but am concerned about what might happen if there is a big taxable event (e.g., the sale of a private business)?

This is an extremely important consideration and one that may affect the type of assets and/or how much of an asset you transfer to a trust of this nature.

Some attorneys may be comfortable including the ability for a trustee to reimburse the grantor for the income taxes paid but this must only be done at the discretion of the trustee (i.e., the trust instrument may not require reimbursement). A grantor's payment of the taxes is not considered a gift to the trust for gift tax purposes only as long as the grantor does not have a right to any reimbursement under the trust terms or under state law.

However, the discretion to reimburse, in combination with other factors (such as preexisting arrangements between the trustee and the grantor and state creditor laws) may cause the assets to be included in the grantor's estate and thus needs to be carefully considered.

What if I change my mind and no longer wish to pay the taxes on behalf of the trust?

Trusts are usually drafted so that power that makes the trust a grantor trust can be released, resulting in the trust paying its own income taxes. Generally, the ability to switch from grantor trust status to non-grantor trust status is only allowed once.

Who pays the taxes after the grantor dies?

At the grantor's death, the tax status switches from a grantor trust to a non-grantor trust and the trust will begin to pay its own income taxes.

Building on the grantor trust concept

Grantor trusts are the basis for many specific planning strategies that seek to leverage the use of their gift tax exclusions and exemptions, including the following:

- Grantor Retained Annuity Trusts ("GRATs").
  - A GRAT is an irrevocable trust designed to transfer future appreciation to individuals or trusts, typically children or other family members, with little or no transfer tax cost.
- Qualified Personal Residence Trusts ("QPRTs").
  - A QPRT is an irrevocable trust designed to transfer future appreciation of a personal residence to family members in a transfer tax-efficient manner.
- Sales and loans to intentionally defective grantor trusts.
  - Transactions between the grantor and a grantor trust are typically ignored for income tax purposes. Therefore, a grantor may be able to make loans or sales to a grantor trust without the income tax consequences that may otherwise apply to the sale of an asset or to interest payments on a loan.
- Certain Charitable Lead Annuity Trusts ("CLATs").
  - This is an irrevocable trust in which annual payments are made to a charity (chosen by you) for a term of years, generally, and the remainder interest is paid to your designated beneficiaries. If this trust is structured as a grantor trust, the grantor receives a charitable deduction for income tax purposes when the trust is funded but has the ongoing responsibility of paying the taxes without any additional charitable deduction.

Grantor trusts are the basis for many specific planning strategies that seek to leverage the use of their gift tax exclusions and exemptions.

This has been a high-level overview and discussion regarding grantor trusts. While these types of trusts are commonly used as part of an overall wealth transfer plan for wealthy clients, there are numerous technical issues to address when drafting these types of trusts that may cause unintended consequences (e.g., the inclusion of the assets in the estate of the grantor). It is extremely important to work closely with your estate attorney to create a trust that satisfies your goals and objectives, results in the correct income tax treatment (i.e., grantor versus non-grantor trust treatment) and that removes the assets permanently from your estate.

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