CARLTON FIELDS

Tax Alert: Administration's Proposal Regarding Grantor Trusts

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As we mentioned in our prior tax alert, the Obama Administration's 2013 Revenue Raising Proposals contained several suggestions that, if enacted, would eliminate commonly-used estate planning techniques that have been effective in significantly reducing an individual's estate and gift taxes, and in some instances, even eliminate all gift and estate taxes. Last month we discussed the proposal to reduce the effectiveness of dynasty trusts. This month we address a proposal labeled "Coordinate Certain Income and Transfer Tax Rules Applicable To Grantor Trusts." This relatively innocuous-sounding provision would, in effect, put an end to a technique that has become the most important cornerstone of modern estate planning. And, indirectly, this proposal would eliminate the use of life insurance trusts as an estate planning technique. Grantor trusts have been particularly important to the life insurance industry because almost all life insurance trusts are, by their very terms, grantor trusts. Although no one can realistically predict if or when Congress will eventually enact any of the proposals suggested by the Obama Administration, and some practitioners doubt that the grantor trust proposal will ever be enacted, there is always a possibility that the grantor trust proposal and more likely, several of the other proposals, will become law. Interestingly, proposals that eliminate tax planning techniques have a better chance of being enacted because Congress can thus raise tax revenues without raising tax rates. As with any changes in the tax laws, the legislation would only apply to grantor trusts created after the legislation is enacted (the "Effective Date"). Therefore, all existing grantor trusts, and any grantor trusts created and funded before the Effective Date, would not be subject to this legislation. Individuals with a net worth exposed to the estate and gift taxes should consider creating a grantor trust, or making additional wealth transfers to an existing grantor trust, in order to take advantage of this and other planning opportunities that may be eliminated before the end of this year. Since Congress will address the Obama Administration's proposals after the November elections, it is possible that the use of grantor trusts for estate planning may be eliminated by the end of this year. Rather than wait to see what happens with Congress, we recommend that you consider creating a grantor trust before it is too late to use this technique. There is no downside risk in acting now to adopt a technique that one would also use in the future. As such, you should work quickly to avoid subjecting your estate planning to these proposals, which, if enacted into law, would probably take effect starting in 2013. Even more importantly, anyone considering the use of life insurance as part of their estate plan should act now! This is how a grantor trust currently works. The individual who creates a grantor trust is obligated to pay the income taxes on the grantor trust's taxable income. This payment eliminates a cost that a trust would otherwise incur, thereby increasing the accumulation of the funds in the grantor trust, but without being treated as a gift. **Example:** Assume an individual creates a grantor trust and gifts corporate bonds worth $5,000,000 that yield $200,000 (a 4% yield) of taxable interest income each year. This $5,000,000 transfer is not subject to gift taxes as the first $5,120,000 of taxable gifts made in 2012 is exempted from any gift taxes. Assuming a 40% income tax rate, the income taxes on $200,000 of interest income would be $80,000. If the trust had to pay the income taxes on its $200,000 of income, the trust would net only $120,000 after taxes. By treating the trust as a grantor trust, the individual who created the grantor trust would have to pay the $80,000 of income taxes, thus increasing the annual accumulation of funds in the trust by $80,000. Since the person who created the trust (called the "Grantor") has not made a gift by paying the $80,000 of income taxes on the grantor trust's taxable income, the extra amounts that can accumulate in the grantor trust free of all gift and estate taxes are significantly increased. Over a 25-year period, the extra $80,000 of tax-free gifts each year would total $2,000,000. But, at the end of 25 years, the funds in the grantor trust would have grown to $13,000,000 as a result of compounding if all trust income is reinvested by the trust. The reason for much of this growth is that the grantor trust accumulates all $200,000 each year instead of $120,000 each year. Under the Obama Administration proposal, the $5,000,000 initially contributed to the trust and all $8,000,000 of the growth in the grantor trust's assets would be subject to estate taxes at the proposed 45% estate tax rate for an additional estate tax cost of $5,850,000 (45% x $13,000,000). By creating a grantor trust grandfathered by the Effective Date, the potential estate tax savings in this example is $5,850,000. As you can see, one of the most effective estate planning techniques would be eliminated. Therefore, you should consider creating a grantor trust before it is too late to use this technique.

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