Estate Planners Cheer Death of Grantor Trust Changes

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By Jonathan Curry

Estate tax planners are breathing a collective sigh of relief at the absence of the proposed changes to grantor trusts in the latest version of the reconciliation bill, but some still eye the future with foreboding.

“When I went through the text of the bill yesterday, there was a physical manifestation of relief to see these things removed,” Keith K. Grissom of Greensfelder, Hemker & Gale PC told *Tax Notes*. “I would like to call it a win, but I can’t do that until the bill is actually signed into law.”

The House Democrats’ earlier plan to change the tax treatment of grantor trusts would have imposed gift or estate tax once a grantor trust is terminated, and treated sales between a grantor trust and its owner as taxable transactions. Together, the two provisions would have upended many traditional estate tax planning techniques.

Also, the prior version of the House bill would have accelerated the expiration of the doubled estate and gift tax exemption from its current expiration beginning in 2026 to the beginning of 2022, but that provision is absent from the bill.

Democrats also appear to have soured — for now — on several other high-profile tax proposals that would have fallen hard on wealthy taxpayers — most notably the short-lived billionaire’s tax proposed by Senate Finance Committee Chair Ron Wyden, D-Ore., as well as the repeal of the tax-free step-up in basis above a $1 million threshold that was a core feature of President Biden’s original plan. Biden’s proposal to severely curb the use of valuation discounts is also nowhere to be found in the bill.

Taking the place of those proposals is a pair of revenue raisers, one old and one new. Both the Biden administration and House Democrats had sought to expand the 3.8 percent net investment income tax to apply to trade or business income for individuals with total income in excess of $400,000, and that provision survives in the October 28 legislation. For trusts and estates, however, the newly expanded NII tax kicks in at a mere $13,050.

The bill also includes a broad-based surtax on the income of the ultrawealthy: a 5 percent tax on modified adjusted gross incomes above $10 million, which would jump to 8 percent on incomes above $25 million. For trusts and estates, the 5 percent and 8 percent taxes would kick in at just $200,000 and $500,000, respectively, with a carveout for charitable trusts.

Lesser of Two Evils

On the whole, the two provisions aimed at high-income individuals that made it into the bill are much easier for estate planners to grapple with, although they present some new considerations for planning.

Ronald D. Aucutt of Bessemer Trust said the application of the surtax at much lower thresholds for trusts and estates is still an unwelcome change, and one that is “especially awkward for a decedent’s estate, which the decedent did not ‘choose’ to create.” Estates would have to pay a significantly higher amount of income tax on the same income from investments received from decedents, he observed. A transitional rule to apply the individual rates and brackets to estates for a few years would be more palatable, he suggested.

The surtax becomes more manageable when it comes to trusts, according to Grissom, because it can be alleviated by shifting income from the trust to the beneficiary. Although very-high-income individuals may still be subject to the surtax, they’ll at least have the more generous income thresholds to work with.

Howard M. Zaritsky, a retired attorney and frequent lecturer on estate tax matters, further explained that since the surcharge calculation for trusts takes place only after the deduction for income distribution, the tax is likely to have a major impact only on large trusts that retain their income. Trusts that make current distributions to beneficiaries would be able to avoid the low trust tax thresholds, he noted.

One complication is that trust income is calculated before the section 642(c) deduction for charitable distributions is taken into account; thus, large charitable lead trusts that rely on that deduction and aren't themselves tax exempt could still take a hit, Zaritsky observed — a point he credited to Milbank LLP’s Austin Bramwell.

Grissom also said he didn’t expect that the NII tax’s application to trusts would be especially consequential because it’s already a challenge under current law for trusts to materially participate in a trade or business and thus avoid the NII tax. “We may not see a significant expansion in the number of trusts that become subject to the net investment income tax where they weren’t previously, but we are going to see a significant number of individuals who are now going to be subject to the tax where they weren’t before,” he explained.

Good Riddance

Estate planners expressed no regret over the departure of the proposed grantor trust changes.

The problem that the changes were attempting to solve is real, Zaritsky acknowledged. “The concept of an installment sale to an [intentionally defective grantor trust] is not inherently abusive, but like most tax planning techniques, avarice . . . has caused many to push the envelope off the desktop entirely,” he said.

But Zaritsky likened the earlier proposed grantor trust changes to taking a “meat cleaver to a problem that could better be solved with a scalpel.”

Looming Specters

Several practitioners cautioned that even if the reconciliation bill is ultimately signed and turned into law in its current form, that doesn't mean estate planners are out of the woods yet.

Grissom suggested that since Treasury has already contemplated cracking down on valuation discounts via the section 2704 proposed regulations (REG-163113-02) and Congress has come close to doing so in law, that suggests the discounts are increasingly a target for Democrats. "I wouldn't be surprised to see a challenge to those valuation discounts again sometime in the near future," he said.

Aucutt similarly noted that those valuation discount regulations could be revived, although even that would be "a lot less aggressive than the discount provisions of the House Ways and Means bill," assuming Treasury stays within its statutory authority. But any attempt to crack down on valuation discounts would still likely generate an uproar from family businesses, just as in 2016, he said.

Practitioners were split on whether the Biden administration might take unilateral administrative action to fulfill its policy wishes on grantor trusts if it can't get its way through legislation.

James F. Hogan of Andersen Tax LLC said that while the administration has regulatory authority to challenge tax planning techniques it deems abusive, sales and gifts to grantor trusts have been used for decades as a way to shift value to younger generations, and when done under terms allowed by the tax code, those techniques shouldn't be viewed as abusive.

"I believe that if there is going to be a change, it must be a change to the statute," Hogan said.

Aucutt also minimized the prospects of an administrative attack on grantor trusts. "Whatever it is that is bugging lawmakers about grantor trusts, I don't see much that regulations could do," he said.

But other estate planners suggested that Treasury does have regulatory options it could avail itself of, if it chooses.

A more precise alternative to the grantor trust proposal, Zaritsky said, would be to require bona fide sales for bona fide debt instruments through guardrails—for example, deeming an installment note to constitute bona fide debt only when the purchasing trust has presale assets equal to a minimum of 20 percent of the value of the asset being purchased.

"A 20 percent equity would mean that the donor would have to make actual gifts to the trust, and that the trustee would have to put those assets at risk," Zaritsky said.

Coupled with that, the IRS could state that a 20 percent equity requirement can't be satisfied by loan guarantees from a trust's beneficiaries or the grantor's family members. Although there is nothing "inherently unreasonable" about loan guarantees, they're almost never called upon by the lender, Zaritsky said. "Thus, treating them as illusory for this purpose, or at least until called upon, would not be unreasonable," he said.

At an October 21 panel of the Notre Dame Tax & Estate Planning Institute, Turney P. Berry of

Wyatt, Tarrant & Combs LLP suggested that the IRS and Treasury could shake up tax planning with grantor trusts by revoking Rev. Rul. 85-13, 1985-1 C.B. 184.

“They could just revoke it today and say, ‘You people think about what it means.’ And we’d all think about what that means, but we wouldn’t be very happy about it,” Berry said. “You don’t need congressional legislation to do that, either; just stand up, be an American, and revoke the ruling.”

Another indirect way of dealing with grantor trust excesses, like the tax planning with grantor-retained annuity trusts that has frequently drawn the ire of Democrats in Congress, would be to take a stricter approach with interest rates. That could look like setting an applicable federal rate that floats between a 5 percent floor and a 10 percent ceiling. “That way, when you have superlow rates because the Fed is desperately trying to get us out of a recession, we don’t go that low because it skews results,” Berry explained.

Ultimately, Zaritsky advised against focusing too much on what the future might bring. “The bigger question may be how sanguine we should be. In my view, never very sanguine, but never too terrified either,” he said.

“After all,” Zaritsky added, “it is only money, and someone else’s at that.”

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