Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1995

From: Steve Leimberg's Estate Planning Newsletter
Subject: **Steve Breitstone: Lapsing 2012 Estate Planning Opportunities & Large Estates Holding Businesses and Real Estate**

"The Obama Administration's revenue proposals for fiscal year 2013 contain radical changes to the treatment of grantor trusts which would, in effect, impose an income tax on appreciated assets transferred in these leveraged estate planning transactions. Clients would be much less willing to engage in such transactions if they are subject to current income taxation – even if significant long term transfer tax savings may still be achieved. Whether or not you agree with the objectives of the proposed changes to the grantor trust rules, the current state of the law does provide some ability to mitigate transfer taxes imposed on succession planning for these business or real estate interests.

If the Administration's grantor trust proposals are enacted, there will be a need for legislation that provides transfer tax relief for these illiquid business interests. Failure to enact such legislation would fuel any perception (and the reality) that the transfer tax system has a negative impact on job creation."

Now, **Steve Breitstone** provides members with his commentary on the Obama Administration's proposal to change the grantor trust rules, as well as planning techniques clients and advisors might want to consider

implementing in the short time remaining in 2012. **LISI** will follow-up Steve's commentary with separate commentary by **Gordon Schaller** on planning techniques to consider as we countdown to the end of 2012.

Stephen M. Breitstone, of the Long Island law firm of **Meltzer, Lippe, Goldstein & Breitstone, LLP**, and a member of the New York State Bar, is a long-time contributor to many journals and publications such as the Journal of Taxation, Practical Tax Strategies, Tax Notes, the New York Law Journal and other major tax and estate planning publications. He is an adjunct professor to the NYU School of Continuing Education and a member of the advisory board of the NYU Institute on Federal Taxation. Stephen has taught courses in Partnership Taxation at Benjamin N. Cardozo, School of Law. Stephen frequently lectures on topics of interest to his high net worth real estate clientele including section 1031 "like kind" exchanges, real estate debt restructurings, capital gain maximization, "freeze" partnerships and other tax and estate planning techniques for real estate owners. Here is a link to a video by Steve on these related issues: https://vimeo.com/user12126131/largeestateplanning

Now, here is his commentary:

EXECUTIVE SUMMARY:

The Obama Administration's proposals to eliminate the current favorable treatment of grantor trusts may, if enacted, put an end to much of estate planning as we know it for the wealthier client who owns a business or actively managed real estate. These types of assets are typically illiquid. Moreover, these clients may have estates that are too large to plan for with straightforward annual exclusion gifts or even gifts of the current lifetime exemption of $5,120,000.

To plan for these clients, it is necessary to leverage the exemptions. Most leveraging transactions (such as installment sales to intentionally defective grantor trusts and grantor retained annuity trusts) depend in large part on the ability to transfer assets to a grantor trust without incurring an income tax at the time of such transfer.[1]

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radical changes to the treatment of grantor trusts which would, in effect, impose an income tax on appreciated assets transferred in these leveraged estate planning transactions. Clients would be much less willing to engage in such transactions if they are subject to current income taxation – even if significant long term transfer tax savings may still be achieved. Whether or not you agree with the objectives of the proposed changes to the grantor trust rules, the current state of the law does provide some ability to mitigate transfer taxes imposed on succession planning for these business or real estate interests.

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FACTS:

Are the grantor trust rules being abused? The grantor trust rules of IRC Sections 671-679 allow a grantor to transfer appreciated assets to a trust without recognition of gain in what would otherwise be a taxable sale. This is because the grantor is treated for income tax purpose as continuing to own the trust property. Thus, even where the transfer is to an irrevocable trust and treated as complete for estate and gift tax purposes, the transfer is disregarded for income tax purposes. This disconnect between the income tax and the transfer tax systems provides one of the most powerful drivers of larger estate planning transactions. Some have commented that this use of the grantor trust rules was never intended and is a "loophole" or "abuse"[2] – but is that really the case?

Without doubt, the grantor trust rules no longer serve their intended purpose. These rules were originally enacted when graduated income tax rates made it desirable to transfer assets to trusts so the income would be taxed at lower rates.[3] Currently, the benefit of shifting income to trusts is minimal. Since 1986 our graduated income tax rates have been compressed (with a much lower maximum rate) resulting in trusts being subject to the maximum rate when income exceeds relatively small levels.

Depending upon your perspective, the current state of the grantor trust rules is either an excellent planning opportunity or an abuse. However, it is also

difficult to controvert the fact that the grantor trust rules make it possible to mitigate (not necessarily eliminate) estate, gift and generation skipping taxes on illiquid ownership interests in businesses – including actively managed real estate.

Again, depending upon your perspective, that might not be a bad thing. Estate taxes on businesses do put a significant drag on the ability of these businesses to grow and to create jobs. If it were not for the planning that is done to minimize the transfer taxes imposed on these businesses, there would likely be a more compelling argument to provide some sort of meaningful transfer tax relief. While Congress has provided for deferral of transfer taxes on these types of interests under IRC Section 6166, those taxes must eventually be paid. It might be argued that the current grantor trust rules fill a void that needs to be filled – although perhaps some refinements are warranted.

Obama Administration's Budget Proposals for Grantor Trusts

The Obama Administration's budget proposals would include the assets of the grantor trust in the grantor's gross estate. Transfers to a grantor trust would be considered to be incomplete gifts. Additionally, any distributions from a grantor trust would be subject to gift tax as would the assets of the trust if the grantor ceased to be the trust owner.

Where someone other than the grantor is treated as the owner of the trust property, the proposals would apply income tax to a sale by such person to the trust. The proposals would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts (GRITs); grantor retained annuity trusts (GRATs); personal residence trusts (PRTs); and qualified personal residence trusts (QPRTs). Unclear is whether, if any such trust continues as a grantor trust after its initial term, the new rules would be applicable.

According to the green book[4], the proposals would not be applicable to grantor trusts created prior to the date of enactment except to the extent that additional contributions are made thereafter. Therefore, it is possible that trusts created prior to the date of enactment will not be precluded from engaging in gift tax complete sales with the grantor subsequent to the enactment – as long as the sale does not also involve an additional gift. Nevertheless, there is a broad grant of regulatory authority that may

provide a basis to curtail this apparent grandfathering of existing trusts. It does appear that transactions completed prior to enactment date will continue to be governed under current (pre-amendment) law.

The green book sets out the following rationale behind the grantor trust proposals: "The lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences."[5]

It is, of course, difficult to predict the composition of the next Congress or what legislation it will be willing and able to enact. The current treatment of grantor trusts is widely viewed as a loophole that favors the wealthy – one that was not intended by Congress. If there is a wave of sentiment to tax the wealthy this legislation could gain some traction. It is likely that the revenue impact of such legislation would be significant.

This would force the planner to use nongrantor trusts for planning with illiquid business interests. The use of a nongrantor trust would often result in the imposition of an income tax at the time of transfer. This income tax would greatly reduce the effectiveness of, and be an impediment to, this type of planning.

One leveraging technique that will be minimally impacted by any such change would be the entity freeze under IRC section 2701. Freezes using partnerships or limited liability companies can be structured to avoid some of the income tax pitfalls of transactions with grantor trusts. At least some commentators believe a major drawback of transactions with grantor trusts may be the loss of a basis step up upon death and that the partnership freeze may avoid that problem – at least as to a retained preferred interest – especially where negative capital is present.[6]

Opportunities Remaining for 2012

It is widely known that at the end of 2012, the current lifetime exemptions from estate, gift and generation skipping taxes will, absent legislation to extend them, lapse and revert to what they would have been prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

(i.e. $1 million). Under current law, each person can give free of federal gift tax or estate tax, either during lifetime or at death, $5,120,000, or $10,240,000 for a married couple. In addition, each person can give, during life or bequeath at death, to grandchildren or great grandchildren $5,120,000 free of generation skipping transfer tax ("GSTT"). (Currently, these exemptions are adjusted for inflation.)

The focus of much planning for the remainder of this year will be on how to lock in or utilize the current levels of exemptions. However, for the high net worth client with interests in a business or real estate with values that exceed the available exemptions, there is a need to focus on leveraging these exemptions. In light of the Administration's attention to the grantor trust rules, and proposals to curtail them, there should be a push to put grantor trusts into place, perhaps funded with these exemptions. These trusts may serve as a current or perhaps even future) platform for engaging in leveraged estate planning transactions for the business or real estate owner with worth far in excess of these exemptions. The remainder of the year should be challenging because to implement the optimal planning can require considerable lead time.

As mentioned above, the proposed changes will have much less impact on one technique for leveraging exemptions. Entity freeze techniques under section 2701 should remain viable even if some version of the Administration Proposals to modify the grantor trust rules are enacted.

COMMENT:

While drawing relatively little attention, the proposed changes to the grantor trust rules may be among the proposed changes with the greatest impact on high net worth clients. For the remainder of 2012, planners will be preoccupied with gifts of lifetime exemptions. Many wealthier clients are looking to make these gifts outright. These clients should carefully consider locking in the ability to engage in larger estate planning transactions involving leveraged transfers to grantor trusts. If the Obama Administration's proposals to reign in grantor trusts are enacted, in the years to come it may become far more difficult to plan for the wealthier client holding illiquid interests in a business or real estate.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Breitstone

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CITATIONS:

[1] See generally Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984) and Revenue Ruling 85-13, 1985-1 C.B. 184.
[2] See, e.g., Cunningham, Laura and Cunningham, Noel B., Tax Reform Paul McDaniel Style: The Repeal of the Grantor Trust Rules (April 6, 2011). Cardozo Legal Studies Research Paper No. 328.
[3] See Ricks, Daniel L., I Dig It, But Congress Shouldn't Let Me: Closing the IDGT Loophole, 36 ACTEC Law Journal 641 at 644.
[4] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (February 2012).
[5] Id. at page 83.

[6] See generally, Breitstone, Income and Transfer Tax Planning for Negative Capital – The Entity Freeze Solution, Chapter 10, 70th NYU Institute on Federal Taxation (2012)