

Grantor Trusts on the Chopping Block

What to know and how to prepare

As of 10/4/2021

On September 13, 2021, the House Ways and Means Committee released a comprehensive draft of proposed tax increases to pay for a \$3.5T budget reconciliation package. The proposed statutory language impacts high income, high net worth individuals and corporations. Much remains to be seen in terms of what might ultimately pass and the political negotiations surrounding the larger spending bill are complex. Still, planners are seeking to understand the impact these proposals could have on clients plans. In particular, changes to intentionally defective grantor trusts (a type of “grantor trust”) threaten to flip several aspects of estate and general tax planning as we know it on its head. This piece summarizes the grantor trust proposals and what they may mean for existing and future plans and steps to consider taking before changes could be enacted.

1. What is a “grantor” trust under current law?

An intentionally defective grantor trust (“grantor trust”) is a type of irrevocable trust that contains certain provisions or powers that cause the grantor to be treated as the owner of trust assets for income tax purposes. For estate tax purposes, assets held inside of a grantor trust are outside of the grantor’s taxable estate.

Certain powers or provisions create grantor trust status. These powers are outlined in IRC §§671-679 and include the power held by the grantor to reacquire trust assets by substituting assets of equal value, the power held by a non-adverse trustee to make loans to the grantor or grantor’s spouse without adequate interest or security, and the ability by the trustee for trust income to be applied to pay premiums on a life insurance policy insuring the life of the grantor the grantor’s spouse. Irrevocable life insurance trusts (ILITs), spousal access trusts (SLATs), and grantor retained annuity trusts (GRATs) are typically drafted as grantor trusts.

2. Why is grantor trust status beneficial?

Grantor trusts offer estate planning benefits and additional flexibility. For example, because the grantor, rather than the trust, is responsible for paying income taxes on income earned by the trust, assets inside of the trust grow essentially tax-free. Additionally, because a grantor trust is disregarded for income taxes, transactions between the grantor and the grantor trust can be done without incurring additional income taxes – i.e., no gain has to be recognized on the sale of assets between a grantor and their grantor trust. This is particularly advantageous for transferring life insurance policies or other appreciated assets in or out of ILITs, as no gain is recognized on the transfer and there is no transfer-for-value when the transfer is between the trust and the grantor. Likewise, loans between a grantor/grantor trust do not generate taxable interest income, which can reduce the cost of funding premiums via loans to the trust.

3. What are the proposed changes to the grantor trust rules?

The House Ways and Means proposals add a new code section, IRC §2901. Under IRC §2901, for grantor trusts created after the date of enactment of the proposed legislation, or to that portion of a trust created before enactment that is attributable to contributions to the trust after the date of enactment:

- Property held in a grantor trust would be included in the grantor's gross estate;
- Distributions of property from a grantor trust to a trust beneficiary (other than the grantor or the grantor's spouse) would be treated as a gift from the grantor to the beneficiary when distributed;
- A termination of grantor trust status during the life of the grantor would be treated as a taxable gift from the grantor to the beneficiaries at the time of termination;
- Any transfer of property between a grantor trust and its grantor would be a recognition event for tax purposes and subject to income tax where applicable.

The proposals also include another new code section, IRC §1062, which treats sales of property between a grantor and grantor trust as the same as sales between the grantor and a third party. Therefore, IRC §1062 causes income to be recognized on sales between a grantor and grantor trusts.

Proposed IRC §§2901 and 1062 effectively ends almost all of the utility of grantor trusts for future planning and could have serious implications on existing plans.

4. What is the "enactment" date for these proposed rules?

IRC §§2901 and 1062 applies to grantor trusts created on or after the date of enactment of the legislation. Existing grantor trusts are grandfathered, but if contributions are made to existing trusts on or after enactment, there will be at least partial estate tax inclusion.

5. How do these proposals impact ILITs?

ILITs are typically drafted to qualify as grantor trusts. Although the new rules would apply only to future trusts and future transfers, many clients fund the premiums for life insurance owned in grantor ILITs on an annual basis, using annual exclusion/Crummey gifts. Gifts after enactment to grandfathered grantor trusts would be at least partially subject to estate tax if gifts are made to the trust after the date of enactment (note, some credit would be given for amounts that have already been taxed as gifts so as to avoid double taxation, however the mechanics of how that would work are not entirely clear at this time). Even if clients would find this tax consequence acceptable, accounting and tracking of separate portions of the trust would be complicated and onerous.

For existing grantor ILITs with ongoing premiums, clients may want to consider making lump sum gifts to these trusts before the changes could go into effect. Clients currently have the ability to gift \$11.7M (\$23.4M if married). Under the proposals, this amount could be cut in half at the end of this year (estimated to be a \$6.03M exemption on 1/1/2022). Accordingly, clients may want to use exemptions to fund trusts as soon as possible before exemptions can be reduced and/or changes to grantor trust rules can go into effect.

If large gifts are not an option, after the date of enactment, loans or split dollar arrangements would likely be required to fund ongoing premiums in a grandfathered grantor trust. Under proposed IRC §1062, asset sales would trigger taxable gain, leaving cash loans as the only option. The client could consider funding the grantor trust with a smaller seed gift now to enable the trust to pay interest/economic benefit if loans or split dollar arrangements are required to fund ongoing premiums in the future.

Lastly, grantor trust powers could be toggled off prior to the enactment date by relinquishing or otherwise eliminating the power or powers that created grantor trust status (turning off grantor trust status after the enactment date should be avoided, as this would likely result in a gift). Toggling off grantor trust status could have immediate adverse income tax consequences which clients will need to discuss with their attorney and planning team.

6. What are the options for new trusts?

There may be a limited window to complete new grantor trusts and gift before changes could be enacted. For new grantor trusts before the date of enactment, clients may want to consider including the grantor's spouse as a beneficiary to preserve indirect access to trust assets.

Alternatively, for new trusts, particularly if the client is unable/unwilling to gift, the trust could be drafted to constitute a nongrantor irrevocable trust. If a nongrantor trust is used, future premium gifts should be cash gifts only. If income producing assets are gifted to a nongrantor trust, and income is inadvertently used to pay premiums, this could unintentionally trigger grantor trust status.

7. What planning considerations are there for nongrantor trusts?

A nongrantor trust is a separate tax paying entity which pays income tax at the trust level, which are compressed rate tables. Under the House Ways and Means proposals, trusts would pay ordinary income rates of 39.6% at \$13,050 of income, capital gains at a rate of 25% and the net investment income tax of 3.8%. Moreover, the proposed 3% high income surtax would apply to trusts at \$100,000 of income.

Undistributed income is taxed at these accelerated rates, while nongrantor trusts receive a deduction for discretionary distributions paid to trust beneficiaries. Therefore, distributions to beneficiaries in lower tax brackets can help to mitigate the steep income taxes nongrantor trusts would otherwise pay, and in some instances, the beneficiaries could be in a lower tax bracket than the grantor would have been under grantor trust rules. Trust accounting is highly nuanced and the trustee may be interested in life insurance for liquidity and increased income tax efficiency.

Additionally, if the client is unable to get a new trust (grantor or non-grantor) in place before changes could go into effect, a sale of a policy to a nongrantor trust could trigger a transfer-for-value without an exception. For survivorship cases, John Hancock offers an estate preservation rider free of charge which can be utilized to protect against the three year look back for policies should a client need to gift a survivorship policy to nongrantor trusts in the future.

8. How likely are these provisions to go into effect and what other steps could be taken now?

The grantor trust proposals are among the most concerning and complex. Changes to the grantor trust rules are projected to raise approximately \$7B over ten years, which is a relatively small number to offset other spending provisions. These provisions are a top priority for our industry in discussions with legislators and congressional staffers. We should have more clarity in the coming weeks, but in the meantime, encouraging clients to move forward with plans and building flexibility into plans where possible will be key.

Given the uncertainty and potential limited window of opportunity to plan, insurance professionals may want to consider:

- Reaching out to clients who have existing grantor trusts to discuss potential planning options before changes can go into effect; and
- Working with client's counsel to coordinate an action plan across the planning team.

Clients in the process of creating new trusts will want to evaluate drafting options with their attorney. Additionally, there may be an increased need to have discussions around the benefits of life insurance. When exemptions are lower or if there are concerns about estate tax inclusion, there is likely to be an increased need for liquidity to pay estate taxes for high-net-worth clients. Furthermore, irrevocable trust assets, whether in a grantor or nongrantor trust, do not receive an income tax step up in basis at death. When life insurance is owned inside of an irrevocable trust, the death benefit is received income tax-free which serves as a functional equivalent of a step-up in basis. If gifting is being contemplated, consider discussing the benefits of using gifted assets to purchase life insurance.

For more information contact Advanced Markets at 888-266-7498, option 3, AMC or option 4, Attorney

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Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration.

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