



WRMarketplace

An AALU Washington Report

The WR Marketplace is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca S. Manicone. WR Marketplace #18-02 was written by Jonathan M. Forster, Shareholder, and Jennifer M. Smith, Associate, Greenberg Traurig.**

The AALU WR Newswire and WR Marketplace are published by the AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

Thursday, 18 January 2018

WRM 18-03

TOPIC: Decoding Tax Reform: Grantor vs. Nongrantor Trusts – Which Way Do I Go?

MARKET TREND: Post-tax reform, advisors will need to think differently about how to approach irrevocable trusts.

SYNOPSIS: H.R. 1 (“Tax Act”) has dramatically altered the tax consequences and economics of many common irrevocable trust plans given the combination of higher exemptions for gift, estate, and generation skipping transfer taxes (collectively “transfer taxes”) and changes to the taxation of individuals and trusts. Grantor trusts, which tax the trust’s income to the trust grantor, have long been a planning mainstay, since they allow greater growth in the trust and significant flexibility. Yet, the Tax Act now limits the availability of many tax deductions, possibly resulting in greater tax burdens on grantors of grantor trusts. Nongrantor trusts bear their own tax burden and receive a separate set of deductions, but they are less flexible and more quickly subject to the highest income tax rate and the net investment income tax, as the threshold for application of both is only \$12,500 (in 2018).

TAKE-AWAYS: The Tax Act brings a heightened focus on the income tax impact of legacy and life insurance planning through irrevocable trusts. Careful and customized evaluation of the tax and practical considerations when selecting between a grantor and nongrantor trust will be at a premium and will move advisors even further into holistic planning approaches that focus more on income tax issues. The use of trust-owned life insurance likely will increase in appeal as a relatively simple method to provide for investment allocation and basis management.

With its broad reach, the Tax Act has dramatically altered the tax consequences and economics of many common approaches to irrevocable trust planning. Now more than ever, a trust's tax impact can vary significantly by family depending on their specific circumstances, so understanding the differences between, and the options available for, grantor and nongrantor trusts will be crucial for legacy and life insurance planning.

THE OLD STANDBY: GRANTOR TRUSTS

Irrevocable grantor trusts have long been the mainstay of legacy and life insurance planning, given their significant flexibility and the fact that the Internal Revenue Code (**Code**) treats many common trusts, like irrevocable life insurance trusts and spousal lifetime access trust (**SLATs**), as grantor trusts. With a grantor trust, the trust income is reported by and taxed to the grantor (typically the trust creator) based on individual income (and net investment income (**NII**)) tax rates and thresholds. The grantor also receives the benefit of any related credits and deductions, subject to individual limitations.

WHAT'S CHANGED?

Given the changes made by tax reform, grantor trust status may no longer be the gold standard in legacy planning:

All About Income Tax. The tax reform legislation dramatically alters long-standing rules for individuals and trusts in determining their income taxes and available deductions. While lower tax rates apply to individuals and trusts, the Tax Act retains the individual alternative minimum tax and significantly restricts the availability of most itemized deductions, including a \$10,000 limit on the deduction for personal state and local taxes (**SALT**) (see *WRMarketplace No. 50* for more details on the changes). These changes could increase the tax burden for grantors, who must still include and pay tax on the "phantom" income from a grantor trust but will now receive fewer offsetting deductions.

Area Code Woes. Not all families may benefit from tax reform. Families in high income tax states will be particularly impacted by the restriction on the individual SALT deduction. Further, in decoupled states with estate tax exemptions lower than the federal estate tax exemption or with an inheritance tax can still face state tax exposure. Properly-structured trusts can help in both cases.

Nothing Set in Stone. Almost all Tax Act changes impacting individuals will sunset on January 1, 2026, reverting to pre-tax reform laws. Future changes in the political landscape, including the party controlling Congress and/or the Presidency, could bring about revisions even sooner. Planning proactively, rather than reactively, is the only way for families to assert any certainty over the disposition of their legacies. Irrevocable trusts remain critical in this environment, as long as active consideration is given to choosing the appropriate tax structure.

SO SHOULD I USE A NONGRANTOR TRUST?

Run the Numbers. While nongrantor trusts bear their own tax liability and are more quickly subject to the highest income tax rate and the NII tax on their undistributed income, they also receive the benefit of their separate deductions, potentially resulting in less overall taxes for the grantor and the trust than with grantor trust status. Consider this highly-simplified example:†

Example: Jack and Jill (J&J) are married and have \$650,000 of earned income in 2018. Jack is the grantor of Trust X, which has \$200,000 of investment income in 2018. J&J’s personal deductions total \$40,000, including \$10,000 in personal SALT deductions. Trust X has \$20,000 of total deductions, including \$10,000 of non-business-related SALT deductions. Note that if Trust X is a grantor trust, J&J must take its income and deductions into account on their personal tax return, so J&J’s total SALT deduction will be limited to just \$10,000 total. Compare the potential total tax liability if Trust J is a grantor versus a nongrantor trust.

	Grantor Trust	Nongrantor Trust
J&J Gross Income	\$850,000	\$650,000
J&J Deductions	(\$50,000) (\$40,000 personal + \$10,000 trust)	(\$40,000)
J&J Net Taxable Income	\$800,000	\$610,000
J&J Income Taxⁱⁱ	\$235,379	\$165,079
J&J NII Taxⁱⁱⁱ	\$7,220	\$0
J&J Total Tax	\$242,599	\$165,079
Trust Gross Income	\$0	\$200,000
Trust Deductions	\$0	(\$20,000) (incl. \$10,000 SALT deduction)
Trust Net Taxable Income	\$0	\$180,000
Trust Income Tax^{iv}	\$0	\$64,987
Trust NII Tax^v	\$0	\$6,840
Trust Total Tax	\$0	\$71,826
TOTAL J&J and Trust	\$242,599	\$236,906

The total income tax liability is less with the nongrantor trust, in part due to the availability of the additional SALT deduction. Further, the couple’s personal tax burden using a nongrantor trust is roughly \$77,000 less than with a grantor trust, an annually-occurring benefit that limits the draw on their resources over time (e.g., \$77,000 of tax over 20 years = \$1,540,000 paid by the grantor). Of course, there is no shift in the value of the tax payments to the nongrantor trust as with a grantor trust, and the assets in a nongrantor trust will grow more slowly due to the annual reduction for tax liabilities.

Whether a grantor or nongrantor trust makes sense, tax-wise, depends on numerous factors and projections unique to a family’s circumstances and goals, including the personal income of the family, the types of assets to be held by the trust, whether the family can and wants to bear the additional grantor trust tax burden, etc. Running the numbers will be a necessity, particularly if a large trust gift is contemplated to use some of the higher transfer tax exemptions. There is no “one-size fits all” solution in this post-tax reform world.

FINDING A BALANCE: TAX VS. PRACTICAL CONSIDERATIONS

As there can be practical trade-offs to using a nongrantor rather than a grantor trust, families and their advisors must carefully compare their tax and practical characteristics:

WHICH TRUST TO USE: TRADEOFF MATRIX

	Grantor Trust	vs.	Nongrantor Trust
Income & NII Taxes	<p>Grantor pays</p> <p>Taxed at individual and NII rates (joint filers (2018), 37% top rate on income over \$600,000 and 3.8% NII tax on lesser of NII or excess of modified adjusted gross income over \$250,000)</p> <p>Deductions subject to individual rules/limits</p>		<p>Trust pays</p> <p>Tax applies at top income tax rate of 37% and 3.8% NII tax on undistributed income over \$12,500 (2018)</p> <p>Available deductions subject to trust rules/limits</p>
<p>Practice Point: Nongrantor trusts hit higher tax rates sooner but reduce the personal burden to the grantor and may multiply access to deductions (e.g., both the nongrantor trust and the grantor may be eligible for the SALT deduction).</p>			
Transactions between Trust & Grantor	<p>Disregarded for income tax purposes</p>		<p>Not disregarded</p> <p>May result in income/gain recognition</p>
<p>Practice Point: Since grantor trust transactions with a grantor are disregarded, (1) no taxes result from the grantor's sale of assets to the trust, (2) transfers of a life insurance policy on the grantor's life between a grantor and the trust are not "transfers for value," and (3) interest paid by the trust to the grantor on loans (including split-dollar loans) or installment sales is not taxable income to the grantor.</p>			
Nonfiduciary Power of Substitution over Trust Assets	<p>Yes^{vi}</p>		<p>No^{vii}</p>
<p>Practice Point: A nonfiduciary substitution power provides significant flexibility. A grantor can use the power to manage the trust's investment performance (substitute assets to lock-in gains or switch to more income generation) and facilitate basis management (see below).</p>			
Complexity of Basis Step-Up for Trust Assets	<p>Less complex</p> <p>Grantor can use a nonfiduciary substitution power to substitute high basis assets for low basis trust assets</p>		<p>More complex</p> <p>Options generally involve powers of appointment to beneficiaries or others to trigger estate inclusion</p>
<p>Practice Point: A grantor trust with a nonfiduciary substitution power simplifies basis planning, as the grantor can decide, based on current economic conditions and family needs, whether to exercise the power to achieve a basis step up in the grantor's estate. The options available for</p>			

WHICH TRUST TO USE: TRADEOFF MATRIX

	Grantor Trust	vs.	Nongrantor Trust
<i>nongrantor trusts are more complex and typically require the participation of someone other than the grantor.</i>			
Spouse as Trust Beneficiary	Yes		Only with restrictions (e.g., consent of person with substantial interest in the trust (adverse party))
Practice Point: <i>Adverse party consent to spousal distributions creates added administrative complexity when trying to provide the spouse (and grantor indirectly) with access to trust assets.</i>			
Payment of Life Insurance Premiums on Grantor/Spouse	Can use income or principal		Cannot use income (current or accumulated) Unless require adverse party consent
Practice Point: <i>Nongrantor trusts require careful drafting and administration to ensure premium payments cannot and do not come from trust income, whether currently held or accumulated and added to principal.</i>			

WAIT, THERE'S MORE: OTHER TRUST MANAGEMENT OPTIONS

Having Your Cake & Eating It Too. Even if financially able, many families will not be comfortable making substantial gifts to irrevocable trusts using their increased gift and GST tax exemptions without the flexibility to later access those assets if needed. Non-reciprocal SLATs can be created by spouses to name each other as lifetime beneficiaries, allowing continued access to irrevocable trust assets. Self-settled domestic asset protection trusts or those that allow the grantor to be added later as a beneficiary or to benefit from another person's exercise of an appointment power of the trust can provide flexible access to address these concerns.

Optimizing Investment Allocation. The Tax Act incentivizes the adjustment of irrevocable trust investments toward tax-exempt and tax-deferred investments, including muni-bonds and life insurance. Generally, with life insurance, growth within the policy, policy withdrawals (up to basis in the contract) and loans,^{viii} and the payment of policy death benefits are not subject to income or NII tax.

Tools for Grantor Trusts

- **Discretionary Tax Reimbursement.** Depending on applicable state law, a grantor trust can authorize (but should not mandate) discretionary trust distributions to the grantor to reimburse him or her for the taxes paid on the trust's income. Note that, to prevent potential inclusion of the trust assets in the grantor's estate, avoid the following: (1) a mandatory reimbursement provision, (2) any implied understanding or pre-existing arrangement between a grantor and a trustee to reimburse the grantor, and (3) the inclusion of a reimbursement clause in the trust, if such a clause would subject the trust assets to the claims of a settlor's creditors under applicable state law.

- **Termination of Grantor Trust Status.** The trust can allow for the termination of grantor trust status if the tax burden becomes impractical for the grantor. The discretion for terminating grantor trust status should rest with the grantor, not the trustee, as the trustee's termination of the status may violate fiduciary duties owed to the beneficiaries. Accordingly, the grantor should be given the right to release any powers he or she holds that trigger grantor trust status, and upon such release, the trust agreement should require the automatic termination of any other grantor trust powers or provisions.^{ix}

Tools for Nongrantor Trusts

- **Beneficiary Distributions.** As the undistributed income of nongrantor trusts reaches the thresholds for application of the NII tax and maximum income tax rate very quickly, trustees will want to review making increased distributions to beneficiaries who are taxed in lower tax brackets or will not be subject to the NII Tax.
- **Focus on Gains and Losses.** A nongrantor trust's unused losses do not carry out to the beneficiaries until the year the trust terminates. So, during any year the trust has high capital gains, the trust can take the opportunity to divest itself of those assets that are selling at a loss, thereby reducing income subject to capital gains taxes (and the corresponding NII tax). Similarly, during any year the trust has large losses, consideration should be given to selling assets that have large built-in gains.
- **Election to Realize Gain on In-Kind Distributions.** In-kind distributions of property to beneficiaries generally do not trigger capital gain. Rather, the distribution carries out income to the beneficiaries, equal to the lesser of the trust's basis in the asset or its fair market value. Code §643(e)(3) allows an election to treat the in-kind distribution of appreciated property to a beneficiary as a sale, thereby triggering capital gain that can offset otherwise unused capital losses. The beneficiary is considered to have received a distribution of income equal to the fair market value of the property, thereby passing more income out to the beneficiary.
- **65-Day Election.** Code §663(b) allows the trustee of a complex trust (i.e., one allowed to accumulate income) to elect to treat distributions of income made within the first 65 days of a trust's tax year as being paid or credited on the last day of the prior tax year. This gives the trustee flexibility and time to analyze the prior year's tax situation and the anticipated tax issues for the upcoming year and make necessary adjustments to benefit beneficiaries.

LIFE INSURANCE SOLUTIONS

1. **Basis Management.** As life insurance provides a cash payout at the insured's passing, there is no need to worry about a basis step-up for that asset. The insurance proceeds also provide liquidity to offset any taxable gains that may result from subsequent sales of appreciated trust assets.
2. **Non-Reciprocal SLATs.** Life insurance in SLATs can ensure liquidity for the surviving spouse's benefit upon the early passing of the other spouse. For example, husband (H) and wife (W) set-up H-SLAT (benefiting W) and W-SLAT (benefiting H). W passes unexpectedly. Although W's passing terminates H's ability to indirectly access the H-SLAT assets, the death benefits received by W-SLAT can help provide sufficient benefits to support H's lifestyle, as needed.

TAKE-AWAYS

The Tax Act brings a heightened focus on the income tax impact of legacy and life insurance planning through irrevocable trusts. Careful and customized evaluation of the tax and practical considerations when selecting between a grantor and nongrantor trust will be at a premium and will move advisors even further into holistic planning approaches that focus more on income tax issues. The use of trust-owned life insurance likely will increase in appeal as a relatively simple method to provide for investment allocation and basis management.

NOTES

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

ⁱ This example is provided solely for purposes of illustration. Amount noted as deductions are assumed to be fully deductible within all current rules, restrictions, and limitations.

ⁱⁱ Per applicable income tax bracket, tax of \$161,379 plus 37% on the taxable amounts over \$600,000.

ⁱⁱⁱ 3.8% on NII of \$190,000 (\$200,000 less \$10,000 of available NII deduction).

^{iv} For the nongrantor trust under the applicable tax bracket, \$3011.50 of tax (rounded up to \$3012) + 37% of the taxable amount over \$12,500.

^v 3.8% on NII of \$180,000 (\$200,000 less \$20,000 of available NII deduction).

^{vi} The grantor or a “non-adverse” party can substitute equivalent value assets. An “adverse party” means any person having a *substantial* beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the trust power which he or she possesses. A person having a general power of appointment over the trust property has a beneficial interest in the trust. A “nonadverse party” is any person who is not an adverse party.

^{vii} Inclusion of such a power would likely trigger grantor trust status. Use of a fiduciary power would impose trust fiduciary liability on the powerholder with regard to beneficiaries.

^{viii} Assuming not a modified endowment contract (“MEC”).

^{ix} Note that, upon termination of grantor trust status during the grantor’s life, if the trust owns encumbered assets in which the debt exceeds the trust’s adjusted basis in its assets, the grantor will recognize gain on the difference.