NAEPC Journal of Estate & Tax Planning

COLLABORATE • EDUCATE • CULTIVATE

Click here to view Issue 38

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2912

Date: 01-Oct-21

From: Steve Leimberg's Estate Planning Newsletter

Subject: **Alan Gassman & Brandon Ketron: What Part of Disregarded Did You Inadvertently Disregard**

"Most tax advisors are well aware that the September 13th House Ways and Means Bill provides that the estate tax exemption amount would go to one-half of what it would otherwise be January 1st, 2022, discounting for non-business assets and entities would be unavailable after enactment, and that contributions made to irrevocable trusts that would otherwise be disregarded for income tax purposes would cause problematic results to the extent made after the date of enactment.

As a result of the above, taxpayers all over the country are considering what they should add to existing 'defective grantor trusts,' or whether they should establish new ones. In addition, those who have or are establishing irrevocable life insurance trusts are considering whether to pre-fund these trusts with cash or to pre-fund life insurance policies before the possible date of enactment in case Congress does not find a way to provide safe passage for the life insurance industry, which has historically been a sacred cow that has been milked regularly for campaign contributions."

Alan Gassman and **Brandon Ketron** provide members with commentary that examines the planning implications raised by the grantor trust provision in the Ways and Means bill.

Alan S. Gassman, J.D., LL.M., is a partner in the law firm of **Gassman, Crotty & Denicolo, P.A.**, and practices in Clearwater, Florida. He is a frequent contributor to LISI, and has published numerous articles and books in publications such as BNA Tax & Accounting, Estate Planning, Trusts and Estates, and Interactive Legal and is coauthor of Gassman and Markham on Florida and Federal Creditor Protection and several other books. His email address is agassman@gassmanpa.com. Alan is

presenting with a panel at the 46th Annual Notre Dame Tax & Estate Planning Institute on the subject of termination of charitable trusts. More information on the 46th Annual Notre Dame & Estate Planning Institute, which will be held as a virtual conference on Thursday, October 29, and Friday, October 30, can be viewed by clicking Here. Please join us! Alan is also the Executive Producer of the free newsletter known as the Thursday Report, which is sometimes published on Thursdays. To obtain your free subscription, email info@gassmanpa.com and make sure the subject of the email is "Secret Decoder Ring."

Brandon L. Ketron, CPA, JD, LL.M. is a partner at the law firm of **Gassman, Crotty & Denicolo, P.A.**, in Clearwater, Florida and practices in the areas of Estate Planning, Tax and Corporate and Business Law. Brandon is a frequent contributor to LISI and presents webinars on various topics for both clients and practitioners. Brandon attended Stetson University College of Law where he graduated cum laude, and received his LL.M. in Taxation from the University of Florida. He received his undergraduate degree at Roanoke College where he graduated cum laude with a degree in Business Administration and a concentration in both Accounting and Finance. Brandon is also a licensed CPA in the states of Florida and Virginia. His email address is brandon@gassmanpa.com.

Here is their commentary:

EXECUTIVE SUMMARY:

Most tax advisors are well aware that the September 13th House Ways and Means Bill provides that the estate tax exemption amount would go to one-half of what it would otherwise be January 1st, 2022, discounting for non-business assets and entities would be unavailable after enactment, and that contributions made to irrevocable trusts that would otherwise be disregarded for income tax purposes would cause problematic results to the extent made after the date of enactment.

As a result of the above, taxpayers all over the country are considering what they should add to existing "defective grantor trusts," or whether they should establish new ones. In addition, those who have or are establishing

irrevocable life insurance trusts are considering whether to pre-fund these trusts with cash or to pre-fund life insurance policies before the possible date of enactment in case Congress does not find a way to provide safe passage for the life insurance industry, which has historically been a sacred cow that has been milked regularly for campaign contributions.

FACTS:

On September 26th, the House Budget Committee released House Report No. 117-130 which is 501 pages of pleasurable reading on the intention behind the 881 pages of proposed legislation.

All of the above items are described in the House Report in the manner expected, with one unpleasant surprise - transactions between a grandfathered defective grantor trust and the person or persons considered to be the owners of that trust for income tax purposes will trigger capital gains tax when the “grantor” who is considered to be the owner transfers an appreciated asset or assets to the trust after the date of enactment.

The proposed law itself can be read to have this result, although it is somewhat confusing because of the use of the word “disregarded” in a way that is inconsistent with how the word is normally used in tax literature:

> SEC. 1062. CERTAIN SALES BETWEEN GRANTOR TRUST AND DEEMED OWNER.
>
> (a) IN GENERAL.—In the case of any transfer of property between a trust and the person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.
>
> (b) EXCEPTION.—Subsection (a) shall not apply to any trust that is fully revocable by the deemed owner.

(c) DEEMED OWNER.—For purposes of this section, the term ‘deemed owner’ means any person who is treated as the owner of a portion of a trust under subpart E of part 1 of subchapter J.

EFFECTIVE DATE.—The amendments made by this section shall apply—

(1) to trusts created on or after the date of the enactment of this Act, and

(2) to any portion of a trust established before the date of the enactment of this Act which is attributable to a contribution made on or after such date.

Experts who read this sentence when the bill was released assumed that this meant that disregarded trusts created before the enactment of this Act would continue to be disregarded so that assets could be sold or exchanged with the trust so long as there was no “contribution” (aka a gift) made to the trust on or after the enactment of the Act, but this was apparently not the case.[1]

The House Report clarified that the effective date was intended to cover transactions between a grantor and any grantor trust after the date of enactment, even if the trust was created before the date of enactment, specifically stating:

> The provision is generally effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date. The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for sales and other dispositions after the date of enactment.

The House Report noted in a footnote that “A technical correction may be necessary to reflect this intent.”

COMMENT:

The immediate thought with respect to this provision is that after the date of enactment assets having a fair market value exceeding their tax basis will not be good candidates for being sold to a defective grantor trust in exchange for a note or other assets. The other thing that becomes apparent is that the opposite may apply – If a grantor trust transfers an asset that it owns that is worth more than the tax basis of the asset, then income tax may be triggered as if the asset was sold to a third party.

In many situations this will not be a problem. For example, if a taxpayer has an active business corporation and the stock has a basis of $1 million and is worth $1,500,000, then a 99% non-voting member interest in the company may be worth $1 million, after discounts, and discounts will be permitted after enactment for “all business” assets.

Therefore, a sale of the 99% non-voting member interest for $1 million will trigger no income tax in the above example, and there is nothing in the legislation that appears to cause the basis of the stock to be reduced. But issues may arise with respect to other kinds of trusts that are disregarded for income tax purposes.

WHAT ABOUT GRATs AND CLATs?

For example, under present law Grantor Retained Annuity Trusts (“GRATs”) can receive appreciated assets on an income tax-free basis and will be required to make payments in cash, or in kind, back to the grantor based upon a formula which usually provides that what the grantor will receive will have a value that is approximately equal to what has been placed into the GRAT, plus a rate of return equal to the Section 7520 rate, which is presently 1%, in a series of annual payments that range from being equal to increasing by up to 20% per year.

As the result of this many existing GRATs do not have sufficient cash to meet the payment requirements, and therefore make payments in kind of investment or other assets that are valued as of the date of distribution.

Will the transfer of an appreciated asset from a GRAT to its grantor be considered to be a sale of the asset for income tax purposes, thus triggering capital gains or ordinary income due to depreciation recapture based upon its character? This appears to be what Congress is intending and what the IRS would enforce if the Act is passed as proposed.

And what about Charitable Lead Trusts which receive gifts and make annual payments to charity which may be in cash or in kind? Many Charitable Lead Annuity Trusts are “Grantor CLATs” considered to be owned by the contributor, so the same issues can apply – the distribution of an appreciated asset to charity may be considered to be a taxable event if the IRS considers the payment to charity to be in discharge of a financial obligation of the grantor. This issue is discussed in a number of articles, including *Charitable Giving With a Charitable Lead Annuity Trust* by Dino Giannobile from Plante Moran.[2]

And then what about capital losses that might occur if a defective grantor trust transfers an asset that has gone down in value to a grantor in exchange for a note or cash? The legislation specifically provides that IRC Section 267(b), which disallows losses on sales between related parties, will be amended to now include transactions between a grantor trust and its deemed owner.

PLANNING POINT:

As a result of the above, taxpayers who have irrevocable trusts that are disregarded for income tax purposes, including Section 678 trusts that are considered as owned by a person or persons other than the grantor should review what assets are presently in the trusts and what assets are outside of the trusts to decide whether there should be “swapping” or sales in the immediate future, before the date of enactment, to optimize tax planning and minimize potential taxable income.

For example, if a taxpayer has appreciated stock that he or she would like to have held under the trust and would like to receive back a low-interest promissory note or cash in exchange for the stock, or if the trust has appreciated stock that planners would like to have in the taxpayer's name in order to ensure a new fair market value date-of-death income tax basis if the taxpayer dies and the stepped-up basis rules remain the same, then the swapping of assets should occur before the date of enactment. Likewise, if the taxpayer is owed payments by a GRAT which has appreciated assets, he or she can receive the appreciated assets now in exchange for cash or non-appreciated assets that can be paid to the grantor to avoid the possible income tax described above.

Some taxpayers will have their grantor trusts borrow monies at arm's length from third parties or related parties to repay promissory notes owed to the grantor and be able to retain appreciated assets so as not to trigger gain.

A tax advisor's work is never done!

CONCLUSION:

The one thing that we can probably be sure of is that tax legislation resulting from a compromise between the House and Senate and refinement between now and passage will probably not be the same as what now have on the table. Nevertheless, a new law can be substantially similar to what is being formally proposed, and Congressmen should be reluctant to make things worse than what is being proposed, or to move timetables forward as opposed to backwards from an effective date

standpoint. Stay tuned, keep your seatbelts on, and remember to exit the ride to the left when it is over, keeping all hands, arms, hats, and sunglasses inside the ride until coming to a complete stop.[3]

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

Alan Gassman

Brandon Ketron

CITE AS:

LISI Estate Planning Newsletter #2912 (October 1, 2021) at http://www.leimbergservices.com. Copyright 2021 Leimberg Information Services, Inc. (**LISI**). Reproduction in Any Form or Forwarding to Any Person Prohibited - Without Express Permission. This newsletter is designed to provide accurate and authoritative information regarding the subject matter covered. It is provided with the understanding that **LISI** is not engaged in rendering legal, accounting, or other professional advice or services. If such advice is required, the services of a competent professional should be sought. Statements of fact or opinion are the responsibility of the authors and do not represent an opinion on the part of the officers or staff of **LISI**.

CITATIONS:

---

[1] While the word case commonly refers to a court decision, it may also refer to four six-packs of beer, which many of us need after reading this kind of legislation.

[2]https://www.plantemoran.com/explore-our-thinking/insight/2020/10/charitable-giving-with-a-charitable-lead-annuity-trust

[3] Until the 1980s, those purchasing admission to Disney World received tickets that admitted the Disney visitor onto rides. The very best rides required tickets, which could be purchased for additional monies if an attendee wanted to go on an any ticket ride more than once. Great

experiences in the 1970s were therefore described as “any ticket”. This is not relevant to the article but possibly of interest to Mouseketeer enthusiasts who consider tax law to be more fun than Disney World.

Click here to comment on this newsletter.

HELP US HELP OTHERS! TELL A FRIEND ABOUT OUR NEWSLETTERS. JUST CLICK HERE.

Click Here for Steve Leimberg and Bob LeClair’s **NumberCruncher** and **Quickview** Software, Books, and Other Resources