Jerry Hesch & the Financial Danger of Maximizing Taxable Gifts in 2012

"At present, clients and their estate planning advisors are contemplating making $5,120,000 taxable gifts (or twice that amount using the split gift election) before year-end because the gift tax exemption may revert to $1,000,000[i] *starting in 2013. Before making the maximum taxable gifts for the remainder of the 2012 year, clients need to be made aware of the possibility that maximizing their taxable gifts can cause a financial hardship if the gifts are made to grantor trusts.*

Before making such gifts, clients and their advisors need to take into account the financial impact caused by the grantor having to pay the income taxes on the grantor trust's taxable income and take precautionary steps if those projections show that the income tax treatment will not leave the grantor with sufficient assets for support in their later years. This commentary is designed to show that for individuals with a life expectancy of over 20 years, making the maximum taxable gifts may not be the optimal strategy.

In evaluating whether to take advantage of the $5,120,000 gift tax exemption for the rest of the 2012 year, one needs to take into account the ages of the clients, their living expenses and the amount of their income-producing assets. The situation illustrated shows that for a couple ages 62 and 59 with $46,000,000 of investment assets, they should not make the maximum $10,240,000 in taxable gifts to a grantor trust.

Before advising a client to make the maximum tax gifts using the existing $5,120,000 exemptions available for the remainder of the 2012 year, a financial analysis needs to be undertaken, taking into account the ages of the donors, the amount of their investment assets, the character of the income generated by the investment assets owned by the grantor trust, their living and consumption expenses, the state income tax rates for their state of residence and any other factors that may impact on their financial status. Only after this analysis is performed, can the clients, with the guidance of their estate planning advisors, decide upon the level of taxable gifts to make before the end of the 2012 year."

In the face of the land-office rush to make last-minute gifts, **Jerry Hesch** reminds members of the financial analysis that needs to be undertaken before advising a client to make the maximum gifts using the $5,120,000 exemptions available for the remainder of the year.

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Here is his commentary:

EXECUTIVE SUMMARY:

At present, clients and their estate planning advisors are contemplating making $5,120,000 taxable gifts (or twice that amount using the split gift election) before year-end because the gift tax exemption may revert to $1,000,000[ii] starting in 2013. Before making the maximum taxable gifts for the remainder of the 2012 year, clients need to be made aware of the possibility that maximizing their taxable gifts can cause a financial hardship if the gifts are made to grantor trusts. Before making such gifts, clients and their advisors need to take into account the financial impact caused by the grantor having to pay the income taxes on the grantor trust's taxable income and take precautionary steps if those projections show that the income tax treatment will not leave the grantor with sufficient assets for support in their later years.

This commentary is designed to show that for individuals with a life expectancy of over 20 years, making the maximum taxable gifts may not be the optimal strategy. In evaluating whether to take advantage of the $5,120,000 gift tax exemption for the rest of the 2012 year, one needs to take into account the ages of the clients, their living expenses and the amount of their income-producing assets. The situation illustrated below shows that for a couple ages 62 and 59 with $46,000,000 of investment assets, they should not make the maximum $10,240,000 in taxable gifts to a grantor trust.

FACTS:

Although the primary objective of an outright gift in trust is to shift future income and future appreciation in value to the trust without any gift taxes, a separate wealth shifting benefit arises by the grantor's payment of the grantor trust's Federal and state income tax liabilities relating to the trust's taxable income (referred to as the "burn"). Over a long period of time, the transfer tax-free shifting of value from grantor trust status has a far greater impact than valuation discounts and the shifting of future income and future appreciation in value combined.

When there is a transfer to an irrevocable trust, and the trust is treated as a grantor trust for Federal income tax purposes, the Internal Revenue Code creates a fiction in that the individual who creates the trust (referred to as the "grantor") is deemed to own the trust's assets, and, as the deemed owner of the trust's assets, the grantor must report the trust's income on the grantor's individual income tax return even though the grantor does not receive a distribution of that income, such as when the income is accumulated or distributed to a trust beneficiary. Accordingly, the grantor must pay the income taxes on the trust's income at the grantor's individual income tax rates. The Internal Revenue Service ruled that the grantor's payment of the income taxes on the grantor trust's income is not a gift for gift tax purposes.[iii]

Suppose a grantor trust received a taxable gift of $5,000,000, with no gift taxes because the first $5,000,000 of taxable gifts is not subject to gift taxes, and the contributed asset generates $250,000 of ordinary income annually. If the combined state and Federal income tax on this income is $100,000 (a combined Federal and state effective income tax rate of 40%), the grantor is required to pay the income taxes on the trust's income.

In effect, the grantor has effectively made a gift-tax free transfer of another $100,000. And, this indirect tax-free gift continues each year that the grantor is living and paying the income taxes on the grantor trust's income. Over a long period of time, the amount of wealth that can be shifted as the principal in the trust continues to grow can deplete far more wealth than was intended at the time the grantor trust was funded.

The following example illustrates the burn caused by the grantor's payment of the Federal and state income taxes on the trust's taxable income. The illustration demonstrates that for a couple ages 62 and 59 with $46,000,000 of investment assets, over a long period of time the burn can deplete far too much from their retained investment assets and leave the grantor with little or no assets if the grantor lives too long. Given their young age from an estate planning perspective, it may be advisable that this couple not make the maximum $10,000,000 of taxable gifts during the 2012 year.

> **Example** Mr. & Mrs. Senior are ages 62 and 59. Although their joint life expectancy under Table 2000CM is 26 years, there is a 50% probability that they will both ~~at least one of them will~~ be living some 26 years from now. Given that they have access to better heath care, it is reasonable to expect that one of them will live to age 95. Therefore, any financial projection needs to illustrate the impact of the "burn" caused by grantor trust status for the next 36 years for an individual currently age 59. As residents of New York State, the impact of state income taxes needs to be taken into account. Their living expenses (other than Federal and state income taxes) need to be considered as those expenditures also deplete their estate. Their current living expenses are $600,000, and they will increase by 1% annually. Their investment assets are $$46,000,000 and generate a 5.25% rate of return (all ordinary income) over the 36-year period for the projections. They have been advised to take advantage of the maximum $5,120,000 taxable gifts that can be made before the end of the 2012 year without any gift taxes and decide to make two such gifts. But first, they contribute $13,333,333 of their investment assets to a family limited partnership. After applying a conservative 25% valuation discount, the value of their limited partnership interest is $10,000,000. They then give their discounted limited partnership interests to a grantor trust for the benefit of junior family members. Assume that the grantor trust makes no distributions and reinvests the income each year at the same 5.25% investment rate of return.

The "burn" caused by grantor trust status over a long period of time can deplete such a significant amount in later years that by the time the 36 years expire, there is nothing left in their estate. The following table illustrates the impact of the "burn" caused by the trust receiving the maximum taxable gifts over a long period of time.

Retained Investment Assets After Gifts	$32,666,667

Pre-Discounted Value of Gifts	$ 13,333,333
Investment Assets Before Gifts	**$46,000,000**
Pre-discounted Value of Gift	($13,333,333)
Living Costs over 36 years	($25,846,127)
Seniors' Earnings over 36 years	$ 45,651,254
Income Taxes on Seniors' Earnings over 36 years	($21,126,117)
Income Taxes on Trust's Earnings over 36 years	($32,851,376)
Balance in Gross Estate at end of 36 years	($1,505,700)

Year	Age of younger spouse	Add: Earnings	Less: Tax on Earnings	Less: Tax on Trust Earnings	Less: Living Costs	Remaining investment assets after gifts made
						$ 32,666,667
2,012	60	1,715,000	717,728	292,950	600,000	32,770,990
2,013	61	1,720,477	799,162	342,220	606,000	32,744,085
2,014	62	1,719,064	798,505	360,187	612,060	32,692,397
2,015	63	1,716,351	797,245	379,097	618,181	32,614,225
2,016	64	1,712,247	795,339	398,999	624,362	32,507,772
2,017	65	1,706,658	792,743	419,947	630,606	32,371,134
2,018	66	1,699,485	789,411	441,994	636,912	32,202,302
2,019	67	1,690,621	785,293	465,199	643,281	31,999,150
2,020	68	1,679,955	780,339	489,622	649,714	31,759,430
2,021	69	1,667,370	774,493	515,327	656,211	31,480,769
2,022	70	1,652,740	767,698	542,381	662,773	31,160,657
2,023	71	1,635,934	759,892	570,856	669,401	30,796,442
2,024	- 72	1,616,813	751,010	600,826	676,095	30,385,324
2,025	- 73	1,595,230	740,984	632,370	682,856	29,924,344
		1,571,028				29,410,376

2,026	-	74		729,743	665,569	689,685	
2,027	-	75	1,544,045	717,209	700,512	696,581	28,840,119
2,028	-	76	1,514,106	703,302	737,288	703,547	28,210,087
2,029	-	77	1,481,030	687,938	775,996	710,583	27,516,599
2,030	-	78	1,444,621	671,027	816,736	717,688	26,755,770
2,031	-	79	1,404,678	652,473	859,615	724,865	25,923,495
2,032	-	80	1,360,983	632,177	904,744	732,114	25,015,443
2,033	-	81	1,313,311	610,033	952,243	739,435	24,027,043
2,034	-	82	1,261,420	585,929	1,002,236	746,830	22,953,467
2,035	-	83	1,205,057	559,749	1,054,854	754,298	21,789,624
2,036	-	84	1,143,955	531,367	1,110,233	761,841	20,530,138
2,037	-	85	1,077,832	500,653	1,168,521	769,459	19,169,338
2,038	-	86	1,006,390	467,468	1,229,868	777,154	17,701,238
2,039	-	87	929,315	431,667	1,294,436	784,925	16,119,525
2,040	-	88	846,275	393,095	1,362,394	792,775	14,417,537
2,041	-	89	756,921	351,590	1,433,920	800,702	12,588,246
2,042	-	90	660,883	306,980	1,509,200	808,709	10,624,239
2,043	-	91	557,773	259,085	1,588,433	816,796	8,517,696
2,044	-	92	447,179	207,715	1,671,826	824,964	6,260,370
2,045	-	93	328,669	152,667	1,759,597	833,214	3,843,562
2,046	-	94	201,787	93,730	1,851,976	841,546	1,258,097
2,047	-	95	66,050	30,680	1,949,204	849,962	(1,505,700)

As the assets in the grantor trust continue to grow, the taxable income earned by the grantor trust continues to increase, and the compounding of this growth results in a burn of over a million dollars a year starting when the couple reaches ages 84 and 81 (year 2034, which is some14 years before the younger spouse reaches age 95). Over the entire 36-year period the combined Federal and state income taxes paid by the grantor on the grantor trust's taxable income is $32,851,376. So, we have achieved the perfect estate plan! By the time the younger spouse~~'s death at~~ reaches age 95, there is nothing left. Of course, the spouses then ask you "What happens if both ~~one~~ of them ~~is~~ are still alive in year 2047?"

Grantor Trust

Year	Value of Gifts before discounts	Taxable Income	Balance
2,012	13,333,333	700,000	14,033,333
2,013	-	736,750	14,770,083
2,014	-	775,429	15,545,512
2,015	-	816,139	16,361,652
2,016	-	858,987	17,220,638
2,017	-	904,084	18,124,722
2,018	-	951,548	19,076,270
2,019	-	1,001,504	20,077,774
2,020	-	1,054,083	21,131,857
2,021	-	1,109,423	22,241,280
2,022	-	1,167,667	23,408,947
2,023	-	1,228,970	24,637,917
2,024	-	1,293,491	25,931,407
2,025	-	1,361,399	27,292,806
2,026	-	1,432,872	28,725,678
2,027	-	1,508,098	30,233,776
2,028	-	1,587,273	31,821,050
2,029	-	1,670,605	33,491,655
2,030	-	1,758,312	35,249,967
2,031	-	1,850,623	37,100,590
2,032	-	1,947,781	39,048,371
2,033	-	2,050,039	41,098,410
2,034	-	2,157,667	43,256,077
2,035	-	2,270,944	45,527,021
2,036	-	2,390,169	47,917,190
2,037	-	2,515,652	50,432,842
2,038	-	2,647,724	53,080,566
2,039	-	2,786,730	55,867,296
2,040	-	2,933,033	58,800,329
2,041	-	3,087,017	61,887,346
2,042	-	3,249,086	65,136,432
2,043	-	3,419,663	68,556,095

2,044	-	3,599,195	72,155,290
2,045	-	3,788,153	75,943,442
2,046	-	3,987,031	79,930,473
2,047	-	4,196,350	84,126,823

As the above table illustrates, a $10,000,000 taxable gift to a grantor trust results in $84,126,823 accumulating in the trust free of all transfer taxes!

If a couple with $46,000,000 of investment assets is left with $32,666,667 of investment assets after making two $5 million taxable gifts, it initially appears that the income and principal from their remaining assets will be more than sufficient to provide the funds needed to pay their living expenses and the income taxes on the taxable income generated by their retained assets and the taxable income of the grantor trust. Initially, the income tax on the grantor trust's taxable income (the "burn") is $292,950, and the value of their retained investment assets actually increases for the next few years.

As the assets in the grantor trust continue to grow, the burn gradually increases, and a point is reached in year 2033, when the younger spouse is age 81, where their retained assets ($24,027,043) generate taxable income ($1,313,311) that is sufficient to pay only the income taxes ($610,033) on the taxable income from their retained assets and their living expenses ($739,435). At this point, the annual burn has reached $952,243 and will continue to grow each year. Therefore, it may be practical to discontinue grantor trust status at the end of the 2033 year.

The above example assumed an investment rate of return of 5.25% so that the full depletion of their investment assets did not occur until the younger spouse reached age 95, some 36 years in the future. If the investment rate of return was 6.25%, their remaining funds would have exhausted in 32 years. And, at a 7.25% investment rate of return, their retained assets would have exhausted in 29 years.

The above example did not take into account all of the factors that need to be considered, such as when the first spouse dies, the deceased spouse's trust ceases to be a grantor trust. The purpose of the example used in this article is to sensitize the planning professional to evaluate the potential financial impact and take steps currently to prevent the burn caused by grantor trust status from depleting too much from the grantors' remaining assets.

As the above example illustrates, if this couple has more than $46,000,000 worth of investment assets, then making the maximum $10,000,000 in taxable gifts during 2012 will most likely leave them with sufficient income-producing assets if they survive well into their 90s. But, for couples at their age level with less than $46,000,000 of investment assets, maybe they should consider making taxable gifts in amounts less than the $10,000,000 maximum.

So, the next part of the analysis that the estate planning profession must perform is to evaluate what can be done to stop the burn at the appropriate point in the future.

A simple solution is to draft the grantor trust agreement so that the power creating grantor trust status expires at a time in the future when the grantor no longer wants to continue to pay the income taxes on the grantor trust's taxable income. What is important is that the estate planning advisors address the impact of the burn at the time the gifts in trust are contemplated so that the clients are informed of the financial impact of their taxable gifts and can make a reasoned decision in advance as to how to deal with the burn.

Another solution is to use a non-grantor trust so that there is no burn from the inception.

A simple way to create a grantor trust is to provide that one of the discretionary beneficiaries is the grantor's spouse and that trust income *may be* (but is not required) distributed to the grantor's spouse.[iv] In that manner, the grantor trust can make discretionary distributions to the grantor's spouse so that the distributed funds can be used to pay the income taxes caused by the burn.[v]

Discretionary tax reimbursement clauses have been addressed by the IRS in Rev. Rul. 2004-64[vi] where the IRS stated that as long as there is no understanding, express or implied, that the independent trustee would exercise the discretion to reimburse the grantor for the income taxes that the grantor is obligated to pay on the grantor trust's income, that the trustee's discretion would not alone cause the inclusion of the trust in the grantor's gross estate for Federal estate tax purposes.

The IRS then cautioned that such discretion, combined with other facts, may cause inclusion of the trust's assets in the grantor's gross estate. If such tax reimbursement distributions are never made, then there should not be any estate tax inclusion exposure. But, if discretionary tax distributions are eventually made because the grantor needs the financial support provided by such distributions, that may be sufficient to convince the trier-of-fact that other facts exist to find that there was an implied understanding that trust assets would be used for the benefit of the grantor. Since there are safer alternatives to deal with the burn, the author recommends that discretionary tax reimbursement clauses not be used.[vii]

The trustee of the trust can wait and make decisions at a future point in time when the grantor feels that the burn needs to be eliminated or reduced. One alternative is to change the investment mix of the trust's assets to change the character of the grantor trust's income from ordinary income to tax tax-free income, long-term capital gains, or "qualified dividends" if that rate preference is still available.

Another choice for investments is to invest in assets that have the potential for appreciation in value as there is no gain to report until the assets are sold. Lastly, the trustee of the grantor trust could use some of its cash to purchase a high cash value life insurance policy as the income earned by the cash value is tax-exempt and can be accessed income tax-free by borrowing form the cash value (policy loans are not income assuming the life insurance policy is not a MEC).[viii]

The trustee of the trust can use its discretionary power to make distributions of the income-producing assets to the beneficiaries as a way of reducing the taxable income of the grantor trust. If distributions of income-producing assets are used to reduce the grantor trust's taxable income, the grantor may not want the distributions to be made directly to the individual beneficiaries as the tax, asset protection and other benefits of dynasty trusts are no longer available.

So, the question that then arises is whether the grantor trust's distributions can be made into another trust that will not be a grantor trust? The resolution of whether trust distributions can be made to another trust is determined by the language in the trust agreement, including trustee powers and the use of trust protectors, and the impact of state law.

One final word of caution is appropriate. Several advisors suggest that all that is needed to end grantor trust status for the grantor trust is to "toggle off" grantor trust status. This toggling off can be accomplished by the grantor merely taking affirmative action by releasing the power in the trust that created grantor trust status or having the trustee or trust protector cancel that power. Given that the grantor's debt obligation is cancelled by toggling off grantor trust status, the logical question to then ask is whether this cancellation gives rise to discharge of indebtedness income for Federal income tax purposes?

The narrow situation when an existing trust liability to an unrelated person is attributable to the grantor because of grantor trust status and that liability is deemed shifted to the trust when grantor trust status is terminated while the grantor is still alive is the only guidance we have as to the income tax consequences when grantor trust status is terminated.[ix] These authorities treated the liability shift as an income tax realization event, specifically as an income tax sale under Section 1001(a). These authorities all involved a liability owed to a third party and did not address a liability of the grantor.

Because these authorities take the position that the shifting of the third-party liability from the grantor to the non-grantor trust is an income tax realization event, that leads to the question whether the grantor would incur discharge of indebtedness income under § 61(a)(12) when the grantor's obligation to pay the income taxes on the trust's income is shifted to the trust upon termination of grantor trust status. This issue has never been addressed by the IRS in its Regulations, in any of its official and unofficial administrative pronouncements or in the case law, and its resolution remains unclear at this time.

The IRS takes the position that the grantor does not make a gift when the grantor pays the income taxes on the trust's income because that liability is the grantor's liability, and the IRS concludes that one cannot make a gift by paying one's own liability.[x] Because the IRS's position in Revenue Ruling 2004-64 recognizes the existence of this liability, although limited to the transfer tax consequences, it could lead one to the conclusion that when the grantor's liability is shifted to the trust, the grantor's liability is cancelled. Therefore, for income tax purposes, the grantor has to recognize discharge of indebtedness income under § 61(a)(12) of the Code.[xi]

A contrasting view is that discharge of indebtedness income should not result upon the cancellation of the grantor's obligation to pay the income taxes on the trust's taxable income. The reason for attributing items of income, deduction, and credit to the grantor under § 671 is that the grantor is deemed to be the owner of the trust property. The IRS's position of treating the grantor as the owner of the trust's assets is, therefore, consistent with and supported by the rationale in Rev. Rul. 85-13[xii].

In other words, tax liability attaches to the owner of the property. As the deemed owner of the property, the grantor's payment of income tax is in discharge of his own obligation. The income tax cannot be an obligation owed to the trust, because the trust does not exist for Federal income tax purposes. The language of Rev. Rul. 2004-64[xiii] supports this by stating that "any income tax [the grantor] pays that is attributable to Trust's income is paid in discharge of [the grantor's] own liability, imposed on [the grantor] by § 671."

It is only after grantor trust status terminates that the non-grantor trust springs into life as a separate entity for Federal income tax purposes. The grantor is deemed to relinquish ownership of the trust assets at that time. The trust, as owner of the assets must pay the resulting income tax liability. This transfer appears analogous to an individual who transfers income producing property by gift. While the individual owns the property, he reports the income from it, and thus pays the income tax on the income produced.

Once the individual transfers the property to another person, he no longer reports its income, and thus has no corresponding obligation to pay the income taxes associated with the property. He does not, however, recognize any discharge of indebtedness income on the actual transfer of an income-producing asset by gift. Likewise, one should be treated similarly if there is a deemed transfer of an income-producing asset when grantor trust status is terminated.

Given the uncertainty of the income tax consequences when grantor trust status is toggled off, it is best not to rely upon the toggling off alternative and use any of the alternatives suggested above. The most practical of the alternatives is to perform a financial projection, decide at the time the grantor trust agreement is drafted when grantor trust status should end and have the power that creates grantor trust status automatically expire by the trust terms.

COMMENT:

As the above illustrations point out, before advising a client to make the maximum tax gifts using the existing $5,120,000 exemptions available for the remainder of the 2012 year, a financial analysis needs to be undertaken, taking into account the ages of the donors, the amount of their investment assets, the character of the income generated by the investment assets owned by the grantor trust, their living and consumption expenses, the state income tax rates for their state of residence and any other factors that may impact on their financial status. Only after this analysis is performed, can the clients, with the guidance of their estate planning advisors, decide upon the level of taxable gifts to make before the end of the 2012 year.

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

Jerry Hesch

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LISI Estate Planning Newsletter #2035 (December 5, 2012) at http://www.leimbergservices.com

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[i] Even if the estate tax exemption is continued at an amount up to $5,000,000, there is a good possibility that the gift and estate tax exemptions will not be unified and that the gift tax exemption will be only $1,000,000.

[ii] Even if the estate tax exemption is continued at an amount up to $5,000,000, there is a good possibility that the gift and estate tax exemptions will not be unified and that the gift tax exemption will be only $1,000,000.

[iii] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[iv] If the trust provides that it is for the benefit of the settlor's spouse in addition to the settlor's descendants, the trust is automatically treated as a grantor trust under § 677(a)(1). A trust for the benefit of a spouse will continue as a grantor trust only as long as the settlor's spouse is living.

[v] Using a spousal limited access trust (a "SLAT") allows the trust to make distributions to the beneficiary spouse to pay the income taxes created by the burn as the spouses file joint income tax returns. But, as noted in Rev. Rul. 2004-64, 2004-2 C.B. 7, the IRS will view such distributions as an implied retention of a § 2036(a) retained right to enjoyment. Caution: If both spouses make taxable gifts to separate grantor trusts, the trusts must be drafted in a way to avoid the reciprocal trust doctrine. With two separate trusts, once one of the spouses dies, the trust created by the deceased grantor will no longer be a grantor trust, and that will eliminate the burn with respect to one of the trusts. But, if both spouses continue to live well into their 90s, the burn will continue to be a factor

[vi] If tax reimbursement distributions are mandatory, the IRS held that the grantor has retained a right to have the trust property expended in discharge of the grantor's legal obligation and that estate tax inclusion under § 2036(a)(1) is required.

[vii] In several states, such as New York, discretionary tax reimbursement powers are read into the trustee's powers unless specifically addressed in the trust agreement.

[viii] Since the life insurance policy will be owned by a trust that is not included in the grantor's gross estate. Since the objective is to shelter the income earned by the cash value from income taxation, the insured need not be on the life of the grantor, but can be on the life a beneficiary. When high cash value life insurance policies are needed, and there will be large premium payments, the trustee should consider the use of private placement life insurance ("PPLI") products.

[ix] Treas. Reg. § 1.1001-2(c) Example 5; Rev. Rul. 77-402, 1977-2 C.B. 222 and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[x] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[xi] The IRS's statement in C.C.A. 2009-23-024 (Dec. 31, 2008) that conversion of a non-grantor trust to a grantor trust is not a transfer for income tax purposes of the property held by the non-grantor trust to the owner of the grantor trust that requires the recognition of gain to the owner is questionable.

[xii] 1985-1 C.B. 184.

[xiii] 2004-2 C.B. 7.