Does Your Grantor Trust Still Make Sense?

What is a Grantor Trust? A "Grantor Trust" is a trust where the person who created the trust (the grantor) continues to pay the income taxes on the trust's income even though the grantor does not receive any benefit from the trust. A "Non-Grantor Trust" is a separate taxpayer from the grantor and responsible for its own income taxes.

Why use Grantor Trusts? For decades estate planning attorneys have used Grantor Trusts to achieve multiple tax objectives: estate tax exclusion, income tax-free growth of the trust assets, and the continued reduction of the client's taxable estate resulting from the "tax burn" of a Grantor Trust. In a typical Grantor Trust structure, clients make a completed gift to the Grantor Trust that removes the transferred assets from their taxable estates, while they retain the income tax bill for the income and capital gains generated by the trust. This tax payment, or "tax burn," is not a gift to the trust[1].

What changed about Grantor Trusts? Fast forward to 2019 where the increased $11.4 million estate tax exemption[2] (double for married couples) requires clients and their advisors to revisit their estate planning.

Clients whose estates are below $11,400,000 or those who find their cash flow negatively affected by the Grantor Trust's income tax bill should reconsider their options.

Does it still make sense for the grantor to be paying the Grantor Trusts' income tax bill? Clients and advisors need to crunch the numbers. Changing the income tax treatment of an existing Grantor Trust does not impact the wealth transfer benefits already achieved by the trust. However, changing whether the grantor or the trust pays the income taxes may benefit the client. For example, a trust that sells an investment with a $200,000 capital gain generates a $50,000 income tax bill . As a Grantor Trust, the client pays the tax bill, and the trust keeps the entire $200,000 income tax-free. However, by "turning off" Grantor Trust status the client is no longer responsible for the income taxes, the trust pays $50,000 in income taxes, and nets $150,000 after taxes.

Considering "turning off" Grantor Trust status? A decision to "turn off" grantor trust status should not be made lightly since any missteps could cause adverse tax consequences. Clients must coordinate with their attorney and tax advisors to evaluate the overall transaction that initially created the Grantor Trust and determine, depending on the trust's technical terms, how to "turn off" Grantor Trust status. For example, changing the income tax status of a trust involved with an unrepaid installment sale could inadvertently accelerate the gain. Moreover, the trust's terms may prevent the client from toggling the off switch if, for example, the trust owns life insurance on the grantor's life or the grantor's spouse is a discretionary trust beneficiary. In both situations, decanting the assets to another trust or the parties' agreement to modify the trust terms could provide an alternative solution.

How can Porzio help you? We navigate the complex analysis required in "turning off" Grantor Trust status and collaborate with the client and other advisors to holistically meet each client's goals.

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[1] In 2004 the I.R.S. confirmed practitioners' expectation that the grantor's payment of the trust's income taxes is not an additional gift to the trust, which bolstered the use of grantor trusts as effective wealth transfer vehicles.
[2] The individual tax changes brought about by the Tax Cuts and Jobs Act, including the increased estate tax exemption, are scheduled to expire on December 31, 2025.
[3] Assume a blended federal and state income tax rate of 25%.

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