

FEBRUARY 15, 2012

New Obama Budget Proposal Targets Popular Estate Planning Technique

by [Matthew Dalton](#)

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To the extent that the grantor of a trust is considered the owner of the trust for income tax purposes, the proposal would include the assets of a grantor trust in the grantor's gross estate and subject distributions to gift tax.

The proposal, included in the budget plan released February 13, would also subject the assets in a trust to the gift tax if the grantor ceased to be the owner of the trust. The proposal would apply to anyone deemed the owner of a trust who sells property to a trust in a transaction that would be subject to capital gains tax if the person were not deemed the owner. (For Treasury's green book explanation of the fiscal 2013 revenue proposals, see *Doc 2012-2947* or *2012 TNT 30-32*. For prior coverage, see *Doc 2012-2930* or *2012 TNT 30-1*.)

A grantor trust as defined in the code is not a separate taxable entity from the grantor for income tax purposes. Under current law, it is possible for a grantor to make a completed transfer to a trust for gift and estate tax purposes but remain liable for taxes on the income to the trust.

"Transferring property to a grantor trust can allow the property to grow tax free, with the grantor footing the income tax bill," said Jay A. Soled, a professor at Rutgers University. A grantor trust that is not includable in the grantor's estate is commonly called an intentionally defective grantor trust, even though its status as a grantor trust is not defective.

Grantor trusts may also be used to purchase assets from the grantor. Under current law, a sale from the grantor to the grantor trust is ignored for income tax purposes, so no gain is recognized. The transaction may be an installment sale, allowing the trust to repay the grantor over time, similar to a grantor retained annuity trust (GRAT), while future appreciation in the assets is not subject to transfer tax. "Sales to intentionally defective grantor trusts are one of the major ways people minimize their transfer tax liability," Soled said.

The proposal would not change the treatment of any trust that is includable in the grantor's gross estate under current law, such as GRATs, grantor retained income trusts, and qualified personal residence trusts.

Carol A. Harrington, a partner at McDermott Will & Emery, said she found the proposal surprising. "This proposal adds another layer to an already complex situation," she said. "It's somewhat punitive because a trust could become a grantor trust due to trust terms that do not give the grantor the kind of control that is consistent with estate or gift taxation."

For example, a beneficiary could turn a trust into a grantor trust unintentionally by appointing a successor trustee who is related to the grantor. Under the Obama proposal, the trust would be included in the grantor's gross estate, even if the trust was previously outside it.

"When coupled with the proposal to require a 10-year minimum term for a GRAT, it does significantly limit planning options," said Beth Shapiro Kaufman, a partner at Caplin & Drysdale.

Other Proposals

The administration also proposed returning the estate tax to 2009 levels, with a top rate of 45 percent and a \$3.5 million exemption level, and making permanent the portability of unused estate and gift tax exclusion between spouses.

Another proposal would extend the lien for estate taxes on closely held businesses that are deferred under section 6166. Under current law, the estate tax lien provided in section 6324(a)(1) can expire before the final deferred payment is due. According to the green book, the IRS has had difficulty collecting the tax because of business failures during the deferral period.

The budget retains proposals from the previous year that would require consistency in valuations for transfer and income tax purposes, limit the availability of valuation discounts, require a 10-year minimum term for GRATs, and place a 90-year limit on a trust's generation-skipping transfer tax exclusion.

Tax Analysts Information

Code Sections: Section 671 -- Grantors as Owners
Section 2001 -- Rate of Estate Tax
Section 2501 -- Imposition of Gift Tax

Jurisdiction: United States

Subject Areas: Trusts and estates taxation
Generation-skipping taxation
Individual income taxation

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Tax Analysts Document Number: Doc 2012-3087

Tax Analysts Electronic Citation: 2012 TNT 31-5
