Delaware Tax Institute

Income Tax Planning With Trusts After Tax Reform

December 7, 2018

By: Daniel F. Hayward, Esq.

GF&M GORDON, FOURNARIS & MAMMARELLA, P.A.

Effects of Tax Reform

- Tax reform resulted in a dramatic increase in the size of the estate, gift and GST tax exemption
  - For 2018, the amount of the exemption was $11.18 million per person ($22.36 million per married couple)
  - The increase is temporary, and will sunset after 2025 and return to $5 million per person (inflation adjusted)
- Many clients that were or could be subject to the estate tax will no longer be subject to the tax under the increased exemption amounts
  - With estate, gift and GST tax concerns not being paramount, other concerns come into play
  - Client may want to retain access to the funds
  - Income tax considerations have become more critical

Income Tax Considerations

- Preserving a step-up in basis of assets upon the client's death
- When federal capital gains taxes (20%), the surtax on net investment income (3.8%) and state income tax are taken into account, the total tax could exceed 30%, depending on the state income tax figure
- It may be tax advantageous to include some trust assets in a beneficiary's estate
  - Beneficiary has some of all of her estate tax exemption left
  - Trust has low-basis assets
  - Could be accomplished by giving beneficiary a general power of appointment

Grantor Trusts vs. Non-Grantor Trusts

- Grantor trusts
  - Delaware dynasty trusts are often structured as grantor trusts for federal income tax purposes
  - Grantor of the trust pays the income tax relating to income generated by the trust's assets
  - The trust can therefore grow income-tax free
  - The grantor's payment of the income tax is generally not viewed as an additional gift to the trust. Rev. Rul. 2004-64
  - I.R.C. §§ 671-679 govern how to the ways in a trust is deemed to be a grantor trust
    - One very popular grantor trust "trigger" is the ability for the grantor to substitute assets of equivalent value with the trust
    - A fiduciary (the Trustee, or, the Investment Adviser if the trust is a directed trust) must ensure that the substituted assets are of equivalent value. Rev. Rul. 2008-22.
    - Low-basis and high-basis assets can be swapped between the grantor and the trust based upon the grantor's current needs and the grantor's desire potentially pass certain assets to the grantor's heirs with a stepped-up basis.

Grantor Trusts vs. Non-Grantor Trusts

- Grantor trusts
  - Reimbursement provisions
    - It is possible to include a provision allowing for the grantor to be reimbursed by the trust for the income tax paid by the grantor
    - The trust instrument or local law must give a fiduciary (usually the Trustee or the Distribution Adviser) the discretion to reimburse the grantor for some or all of the income tax liability.
    - In Delaware, this power does not cause the trust assets to be subject to the claims of the grantor's creditors. 12 Del. C. § 3536(c).
    - It has become popular to add reimbursement provisions to trusts that do not already have them. How can this be accomplished?
      - Decanting/Merger
      - Modification by Consent Agreement

Grantor Trusts vs. Non-Grantor Trusts

- Grantor trusts
  - Grantor can sell assets to the trust in exchange for a promissory note
    - Can be structured so the sale is not a taxable event that cause capital gains tax to be assessed
- Non-grantor trusts
  - Trust is a separate entity from the grantor for income tax purposes and pays its own income tax liability
  - "Turning off" grantor trust status
    - Has become more appealing to grantors and, therefore, more common
    - Good drafting typically will allow for the release or relinquishment of powers that cause the trust to be a grantor trust
    - SLATs – grantor trust because grantor's spouse is a beneficiary (unless distributions must be approved by adverse parties)
      - A Trust Protector or other party can be given the non-fiduciary authority to remove spouse as a beneficiary
    - If trust has mechanism to turn off grantor trust status, can the trust be converted to a non-grantor trust?
      - Decanting/Merger
      - Modification by Consent Agreement

Grantor Trusts vs. Non-Grantor Trusts

- Non-grantor trusts
  - DING trusts
    - Have to structured in a very specific way
    - Potentially a good way to minimize tax income tax burden for the grantor while retaining a discretionary beneficial interest
    - Possible use of one or more DING trusts in connection with QSBS exemption
      - Draft trusts carefully so that beneficial interests differ

General Powers of Appointment

- Many clients are seeking to minimize capital gains tax and transfer assets with a step-up in basis.
- Planning techniques that were popular prior to tax reform, such as obtaining valuation discounts for certain assets, may not make sense for a client that is under the estate tax threshold.
- Assets that are acquired pursuant to the exercise of a power of appointment are deemed to be "acquired from the decedent" in accordance with I.R.C. §§ 1014(a),(b)(5) and (b)(9)
- An increasingly popular technique is to draft a trust and give a beneficiary who has a nontaxable estate (and a short life expectancy) a general testamentary power of appointment

General Powers of Appointment

- Drafting options
  - "Springing" GPOA
    - Give a fiduciary (typically the Trustee or the Trust Protector) the authority to give a beneficiary a general power of appointment
    - Give the fiduciary the right to convert a limited power of appointment to a general power of appointment
    - Provide for a formula GPOA that can be structured apply to assets that have appreciated in value.
  - Existing trust with no GPOA nor provision to grant a GPOA
    - Decanting
      - If an individual is a permissible distributee of principal, the trust may be decanted to a new trust that grants the beneficiary a GPOA. 12 Del. C. § 3528(a).
      - Can convert a LPOA to a GPOA
    - Modification by Consent Agreement
    - Virtual representation if beneficiary already holds a broad LPOA. 12 Del. C. § 3547(c)

Powers of Appointment – The Delaware Tax Trap

- Another way to cause assets to be includible in a beneficiary's estate is to utilize a testamentary limited power of appointment to spring the Delaware tax trap
  - I.R.C. §§ 2041(a)(3) and 2514(d)
- Under Delaware law, a powerholder can exercise a limited power of appointment in a way that will cause the power to be included in the powerholder's estate
- The powerholder can exercise the LPOA so that selected assets will be included in the beneficiary's estate (e.g., low basis assets for which you want a step-up in basis) but remain in trust and protected from creditors
  - If the assets are sold in the future, you will have reduced capital gains taxes