LUKINOVICH LAGNIAPPE

July 2015 Volume III

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Lukinovich, APLC has law offices in Metairie and Baton Rouge, Louisiana. Our areas of practice include estate planning, wills and trusts, business planning, wealth preservation, probate administration and specialized fiduciary litigation.

Our mission is to devote our best skills, efforts and resources to advise our clients enthusiastically and creatively to accomplish their business, tax, family and estate planning goals and objectives, and we offer superior personalized attention with the utmost regard for privacy and confidentiality.

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Grantor Trust Strategies in Estate Planning

David Lukinovich

Over the last six (6) months or so, trusts have been featured in the local print media and on television related to the Benson case. Although there are many types of trusts, the "grantor trust" is getting the most attention with respect to the high net worth client. Our firm utilizes the grantor trust for most of its estate planning strategies for high net worth clients. Consequently, we thought it would be helpful to provide some commentary on the grantor trust.

Nearly 35 years ago, a top bracket taxpayer would consider using a taxable trust to shift income to a trust and possibly save up to 75% in taxes. Congress responded to this tax savings opportunity for wealthy individuals by implementing a complex set of tax rules that made the creator of the trust (i.e., the grantor) taxable on the income generated in the trust as if the trust did not exist for Federal income tax purposes. Although Congress made changes to the Federal income tax laws, Congress failed to make similar changes to the Federal estate and gift tax laws, which treated transfers to so-called "grantor trusts" as completed gifts for Federal estate and gift tax purposes thus enabling taxpayers to remove from their taxable estates assets placed into grantor trusts in the same way assets would be removed from estates when using taxable trusts.

Congress went after taxable trusts with a vengeance in 1986 and 1991 and compressed trust tax brackets so that by 2015, all but $12,300 of trust income is taxed at the taxpayer's highest marginal tax rate.

In 2004, IRS Revenue Ruling 2004-64 caused an explosion in the use of grantor trusts by estate planners when the IRS ruled that the grantor/settlor of a grantor trust was legally obligated to pay the taxes on the trust income that eventually would be distributed to trust beneficiaries, many of whom were several generations below the grantor/settlor.

In large estates (particularly where taxpayers have a limited number of descendants), these taxpayers' estates were growing much faster than the $14,000 per year per donor/per donee annual gift tax exclusions available to taxpayers resulting in the creation of significant taxable estates subject to the 40% Federal estate tax rate (previously 55% under prior tax law).

As a result of these favorable grantor tax rules, the low interest rate environment we have experienced for a number of years, and lower capital gains tax rates, multigenerational trusts have become increasingly popular to leverage enormous amounts of wealth down four generations (i.e., the great-grandchildren) in Louisiana and possibly perpetually in several states outside of Louisiana.

Although there are many different variations of grantor trusts, there are two basic structures generally utilized in estate planning: (1) the defective grantor trust ("DGT") and (2) the grantor retained annuity trust ("GRAT")] depending on (a) the nature of the assets being transferred; (b) the projected trajectory of the growth of such assets; (c) the taxpayer's liquidity and the timing of liquidity events; and (d) the age of the grantor and the grantor's projected life expectancy, etc. Our firm has implemented a number of short-term GRAT strategies prior to clients entering into a definitive agreement for the sale of their businesses or to create separate GRAT strategies for different portfolio stock positions as well as DGT strategies to remove (by gift or sale) significantly appreciating closely-held business interests from the grantor's estate.

However, because of the complexity of these planning strategies and the tax laws applicable to them, along with the possible volatility of assets selected and the flexibility desired by wealthy families to navigate through changing economic times and interest rates, it is imperative that clients implementing these strategies meet with their tax advisors periodically to monitor the performance of these strategies, similar to client meetings generally held with financial advisors to monitor their investment portfolio.

Conclusion

Our website lists a number of real-life case studies of how our firm has worked with clients and their estate planning advisors to implement fairly sophisticated and customized DGT and GRAT strategies in estate, gift and tax planning. Please take an opportunity to review those case studies to determine if any of them might be applicable to you. In an attempt to simplify these planning concepts; we have included the attached schedule as a basic primer on the pertinent differences between a DGT and a GRAT and hope this schedule will help you identify estate planning opportunities where these strategies may help you and your advisors accomplish your planning goals and objectives.

COMPARISON OF DGT'S AND GRAT'S

General Rules For Defective Grantor Trust (DGT)	General Rules For Grantor Retained Annuity Trust (GRAT)
Applicable Interest Rate: An installment sale to a DGT must use the IRC applicable federal interest rates; assuming annual payments are made, the annual interest payments are as follows for the month of July, 2015: Short Term (0 to 3 years) .48% Mid Term (3 to 9 years) 1.77% Long Term (9+ years) 2.74%	**Applicable Interest Rate:** A transfer to a GRAT must use the IRC § 7520 rate in effect for the month of transfer; the § 7520 rate is 120% of the midterm AFR, which causes the interest to be a little higher than a midterm DGT. The July, 2015 § 7520 rate is 2.2%.
Multigenerational Use: A DGT can be established for the maximum Louisiana generation-skipping term, generally 4 generations. Thus, an individual can establish a trust for his existing children and their future children and grandchildren (i.e., the Settlor's great-grandchildren).	**Unavailable for Multigenerational Use:** Because the test for generation-skipping tax utilization is determined upon the expiration of the GRAT term, taxpayers generally do not use multigenerational trusts for explosive assets for fear of triggering a generation-skipping tax upon expiration of the GRAT term.
Grantor Pays the Income Taxes: All income taxes generated by the DGT are payable by the Grantor/Settlor during the term of the DGT; a provision can be added allowing the Trustee to make "discretionary" distributions to the Grantor/Settlor to assist the Grantor/Settlor in paying his income taxes attributable to income generated by the DGT. However, one of the greatest benefits of the DGT is to allow the Grantor to be saddled with income taxes that should result in non-taxable accretions to the beneficiaries of the DGT who do not have to pay the taxes.	**Grantor Pays the Income Taxes** Similar results should apply to the GRAT.

Utilization of Federal Exemption: If the value of the assets sold to the DGT decrease in value and the Settlor has made a gift of assets as seed money to the DGT, the value of the donated assets will exhaust a portion of the Settlor's lifetime estate tax applicable exclusion amount. For example, if the Grantor donates $1 million of assets to the DGT and sells to the DGT $10 million of assets, if the value of the assets sold decline in value below $10 million, the Grantor will have lost all or a portion of his $1.0 million gift tax exclusion amount.	**Utilization of Federal Exemption:** If the assets transferred to the GRAT decline in value, the GRAT will be depleted by the annuity payments made back to the Grantor and the GRAT will simply burn out with little of the Grantor's $5.43 million gift tax applicable exclusion amount being exhausted.
Risk: If discounted assets are sold to the DGT and the IRS, upon audit, successfully challenges the value of the assets sold, the difference between the sales price and the value ultimately determined (the "Undervaluation") would result in a gift tax if the Undervaluation is greater than the Grantor's available federal gift tax applicable exclusion amount and a generation-skipping transfer tax if the Undervaluation is greater than the Grantor's available generation-skipping transfer tax exemption amount (both exemption amounts are currently $5.43 million per Grantor indexed for inflation). There are valuation adjustment mechanisms which may be utilized to mitigate against valuation adjustments.	**Risk:** The GRAT document must contain an adjustment clause which increases the amount of the annuity amounts payable to the Grantor in the event of an Under-valuation; therefore, a zeroed out GRAT (i.e., where the remainder value is reduced to zero) should not result in a federal gift tax even if an Undervaluation occurs. Thus, the GRAT is a safer strategy.

Mortality Risk: Once a sale is made to a DGT, the face amount of the installment note is includible in the Grantor's estate. There is some risk that any remaining payments due to the Grantor on the installment note would be taxable as capital gains in the Grantor's estate. **Tax Basis:** There is no step-up in basis to the DGT since the sale to the DGT is disregarded for federal income tax purposes.	**Mortality Risk:** In the event that the Grantor dies during the term of the GRAT, a significant portion of the value of the assets in the GRAT could be includible in the Grantor's taxable estate for federal estate tax purposes. **Tax Basis:** There is a similar result for the GRAT.

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