A Primer On Grantor Trusts

by Brandon D. Hamm and Alexander J. Wolf

When doing sophisticated estate and wealth transfer planning for a high net worth client, there may be no more effective weapon in the estate planner's arsenal than the "grantor trust." Although the use of grantor trusts by practitioners certainly involves federal estate and gift tax planning considerations, it is the grantor trust's federal income tax feature that fundamentally differentiates it from other planning options, and it is this characteristic that has led one of the nation's leading trusts and estates lawyers to state that "[g]rantor trusts are among the most powerful estate planning tools."[1]

This article is intended to provide an overview of grantor trusts, including the distinctive income tax treatment of such trusts. It also describes several of the most common ways to create a grantor trust, explains a planning technique known as a "sale to a grantor trust," and discusses the uncertainty regarding the future of this powerful tax planning option.

I. What Is A Grantor Trust?

A "grantor trust" is a trust for which the grantor of the trust (*i.e.*, the person who creates and funds the trust) is treated as the owner of the trust assets for federal income tax purposes by virtue of the inclusion of certain provisions in the trust instrument.[2] In other words, if the grantor of a trust retains (or certain other persons are granted) specific powers over or benefits in the trust, then the income of the trust is taxable to the grantor rather than to the trust, and the trust is disregarded for income tax purposes.[3] This can be true even though the trust has a separate taxpayer identification number and is regarded as a wholly separate legal entity from the grantor, and notwithstanding the fact that the grantor is not even a beneficiary of the trust.

Functionally speaking, when a trust is regarded as a grantor trust, it means that the income, deductions and tax credits that are otherwise attributable to the trust will be assigned to the grantor.[4] This is *not* to say that the income of a grantor trust will necessarily be distributed to the grantor, but rather that the income of the grantor trust will be reported on the

Brandon D. Hamm

Brandon Hamm is a Shareholder and member of Koley Jessen's Estate and Business Succession Planning Group. He graduated *magna cum laude* from Creighton University School of Law in 2005. His practice areas include estate planning, estate and trust administration, business planning and succession, and charitable giving.

Alexander J. Wolf

Alex Wolf is a Shareholder at Koley Jessen P.C., L.L.O. Alex received a BS in Business Administration from the University of Nebraska - Lincoln, with highest distinction, and a JD from the University of Minnesota, *cum laude*. Alex assists clients with estate planning, business succession planning, and organizational/tax planning for closely-held businesses, public charities and private foundations.

grantor's income tax return and the grantor is responsible for paying any associated income tax at the grantor's marginal rate even though the trust income is not distributed to the grantor from the trust.

It should be noted that it is possible for a grantor to be taxed on some, but not necessarily all, of the income of a trust.[5] Under this so-called "portion rule," a trust can be in part deemed a grantor trust, and in part not a grantor trust. Although the portion rule provides some interesting planning flexibility, for most situations it is generally desirable that a trust would be a "wholly-owned" grantor trust.

II. Use of Grantor Trusts

When working with high net worth clients on estate and wealth transfer planning, the typical planning goal is for the client to transfer as many assets as possible to others, commonly descendants, in a manner that minimizes or eliminates estate taxes that would otherwise be assessed at the time of the client's death. Irrevocable trusts are commonly used in this context. The client forms an irrevocable trust for the benefit of others, transfers assets into the trust, and then all future growth and appreciation of the trust assets occurs outside of the client's taxable estate, eventually passing to the beneficiaries of the trust on an estate tax-free basis.

The use of a grantor trust leverages what can be achieved in a wealth transfer planning effort. The planning is structured so that when the grantor makes a transfer to the trust, it is viewed as "complete" for estate and gift tax purposes, thereby removing the value of the transferred assets (and any future income/appreciation) from the reach of the estate tax, but the transfer constitutes an "incomplete" transfer for income tax purposes, such that the grantor is still deemed responsible for paying the income tax attributable to those assets. In other words, the grantor pays the income tax for the grantor trust, permitting the assets of the trust to grow and appreciate free of the "drag" of income tax. Some commentators have suggested that the income tax-free compounding of assets inside a grantor trust may provide the most effective wealth transfer planning tool available to practitioners.[6]

A simple example can illustrate the power of this feature. Assuming that a grantor trust receives interest income of $100,000 in a given calendar year, the grantor trust status would cause all such income to flow through to and be reported on the grantor's personal income tax return. There, the grantor is responsible for payment of the applicable tax from the grantor's separate assets. Assuming the grantor's combined federal and state income tax rate equals 50%,[7] the grantor would be responsible for paying an aggregate $50,000 tax bill from the grantor's personal assets on the trust's income. The trust, on the other hand, is entitled to retain the entire $100,000 of income for the beneficiaries.

You may be asking yourself, "but would the grantor's payment of the $50,000 income tax on behalf of the trust be deemed a gift to the beneficiaries and subject to gift tax?" In other words, is paying the $50,000 tax liability the same as giving the trust beneficiaries a $50,000 gift? Not according to the IRS, which has ruled that a grantor does not make a gift by paying tax on income that is attributed to the grantor under the grantor trust rules.[8] Therefore, the grantor's payment of the tax each and every year on behalf of a grantor trust—while not deemed a gift for gift tax purposes—is ostensibly another "tax-free gift" from the grantor to the grantor trust's beneficiaries. In a final added benefit, each year that the grantor pays the tax liability of a grantor trust, the grantor also further diminishes the size of the grantor's own estate which will be subject to estate tax at the time of death.

III. Grantor Trust "Triggers"

The various powers, rights, or provisions that will cause a trust to be deemed a grantor trust for income tax purposes are outlined in Sections 673-677 and 679 of the Internal Revenue Code ("Code").[9] Although the presence of any of these features will lead to grantor trust status, it is important to understand which of these "triggers" are best suited to accomplish the grantor's objectives.

For example, a revocable living trust (*i.e.*, a common component of a basic estate plan) would be treated as a grantor trust for income tax purposes under Section 676 of the Code due to the grantor's ability to revoke the trust during life and re-vest the assets in the grantor's name. In this way, all "revocable trusts" are, by definition, grantor trusts. However, for that same reason, the assets of the revocable trust will be included in the grantor's estate for estate tax purposes under Section 2038 of the Code at the time of death. For a high net worth client engaged in wealth transfer planning, such estate tax inclusion would be very undesirable. Thus, in this context, estate planners generally focus on using grantor trust triggers that will result in the trust being treated as a grantor trust for income tax purposes but not cause inclusion of the trust assets in the client's estate for estate tax purposes. Some of the most common triggers favored by estate planners for this purpose are outlined below.

A. Power of Substitution

One of the most popular triggers for grantor trust status is the "power of substitution." Under Section 675 of the Code, grantor trust status is created if the grantor holds a power "in a nonfiduciary capacity. . .to reacquire the trust corpus by substituting other property of equivalent value."[10] Under this arrangement, a grantor has the right to reacquire any asset from the trust, so long as the grantor replaces it with another asset that is of equivalent value as of that date.

The power of substitution provides the grantor with tremendous flexibility to reacquire assets from the trust at a later date. For example, if the grantor should want to reacquire income-producing assets from a grantor trust for cash-flow purposes (*e.g.*, to alleviate the burden of the tax liability of such assets when held by the grantor trust), the grantor can exercise the power of substitution to take those assets out of the trust and replace them with different assets of equivalent value. Alternatively, if the grantor wants to achieve a "step-up" in the income tax basis of an asset held by a grantor trust upon the grantor's death (*i.e.*, by holding the asset in the grantor's name at death and thereby having the asset included in the grantor's estate for estate tax purposes),[11] again, the grantor simply exercises the power of substitution and swaps it with another asset of equivalent value. The "substituted" asset can include any property, potentially even a secured promissory note, so long as it is of equivalent value as of the date of substitution.

When properly drafted, the power of substitution should not prevent a grantor's gift of assets to the trust from being deemed "complete" for gift tax purposes or cause the trust's assets to be included in the grantor's estate for estate tax purposes.[12] Until recently, there was some uncertainty as to whether a grantor's power of substitution over a life insurance policy on the grantor's life held by an irrevocable grantor trust would constitute an "incident of ownership" and cause inclusion of the policy's death benefit in the grantor's estate under Section 2042 of the Code. However, in 2011, the IRS ruled that a properly structured power of substitution would not cause estate tax inclusion in such circumstances.[13]

In order to ensure that a power of substitution does not pose an inclusion risk for estate tax purposes, it is important that the power be drafted carefully. For example, the trust instrument should require an independent trustee (i.e., a trustee that is not related or subordinate under Section 672(c) of the Code), acting in a fiduciary capacity, to confirm that the assets transferred into the trust under the power of substitution are of equivalent value to the assets removed from the trust.[14]

B. Income for Benefit of Grantor's Spouse

A trust will be treated as a grantor trust if the income may be distributed to or for the benefit of the grantor's spouse without the consent of any "adverse party."[15] An "adverse party" is any person who has a substantial beneficial interest in the trust that would be adversely affected by the distribution of such income to the grantor's spouse (*e.g.*, a remainder beneficiary)."[16]

It should be noted that if this trigger is the only provision relied upon to create grantor trust status, then upon the death of the grantor's spouse or in event of divorce, the grantor trust status would terminate. Therefore, even if discretionary distribution of income to the grantor's spouse is a desired feature of the trust, it is advisable to include at least one other trigger to ensure ongoing grantor trust treatment in the event of the occurrence of one of these events.

C. Power To Pay Life Insurance Premiums

A trust is deemed a grantor trust if the income of the trust is, or, in the discretion of the grantor, may be applied towards the payment of premiums for life insurance on the life of the grantor or the grantor's spouse.[17] On its face, it seems that simply granting the trustee the power to pay life insurance premiums from the income (or even just not prohibiting such) would be adequate to cause grantor trust status. However, there is some conflicting authority on this point that advises caution. For example, where a trust does not actually own a policy on the grantor's life or that of the grantor's spouse, some older cases indicate that simply granting the power to use income for life insurance premiums may not be sufficient to ensure grantor trust status.[18] In contrast, various rulings seem to indicate that providing the power to use income to pay life insurance premiums alone causes grantor trust status.[19]

What *is* clear is that any income actually used to pay premiums on life insurance policies on the life of the grantor or grantor's spouse is taxable to the grantor.[20] Even so, unlike the other common triggers discussed herein, a grantor who intends to create a wholly-owned grantor trust should not rely solely on the power to use income to pay premiums on life insurance policies, as there is a risk such structure may cause grantor trust status only with respect to the portion of trust income actually used for life insurance premium payments.

D. Power to Add Beneficiaries

Grantor trust status is also triggered if any person has a power to add new beneficiaries (other than after-born/adopted children) to the class of permissible beneficiaries of the income and principal of a trust.[21] Thus, many grantor trusts will include a provision granting a person the power to add a charitable organization as an additional beneficiary.

This power to add beneficiaries should not be held by the grantor because such a retained power will likely cause the grantor's transfer of assets to the trust to be deemed an incomplete gift, resulting in estate inclusion under either Section 2036(a)(2) or Section 2038 of the Code. The more common and recommended practice would be to instead grant this power to a party who has not contributed assets to the trust, such as the grantor's spouse. Regardless of who holds the power, that person should not be permitted to name themselves as a beneficiary of the trust to avoid inclusion of the assets in such person's estate.[22]

E. Power to Borrow Trust Assets Without Adequate Security

A trust will be considered a grantor trust if the grantor or grantor's spouse may borrow trust corpus or income from the trust without adequate interest or security.[23] However, the trust agreement must expressly grant this power, as a general lending power granted to the trustee to make loans to any person without adequate interest or security is insufficient to trigger grantor trust status.[24]

When using this trigger to achieve grantor trust status in connection with an irrevocable trust, it is recommended practice that the power be limited to granting an independent trustee (*i.e.*, a trustee that is not related or subordinate under Section 672(c) of the Code) the authority to loan trust principal or income to the grantor or grantor's spouse on a completely unsecured basis, but requiring the payment of adequate interest.[25] This helps reduce the risk that the grantor has retained a benefit in the trust that would cause estate tax inclusion.[26]

IV. "Toggling" Grantor Trust Status

Although generally beneficial for wealth transfer planning purposes, it may not always be desirable for a trust to be a grantor trust. For instance, a client may become concerned with a significant capital gains tax liability that will be incurred upon the sale of a highly appreciated asset held by a grantor trust. Thus, an important factor to a client when deciding to implement a grantor trust is often whether there is any capability to "turn off" grantor trust status if/when the client no longer wishes to pay the trust's taxes. Because of this, a grantor trust has a greater likelihood of meeting a client's objectives if it is structured with the flexibility to "turn off" and "turn back on" the grantor trust status (commonly referred to as "toggling").

The ability and degree of planning required to convert a grantor trust to a non-grantor trust depends on the specific triggers that caused grantor trust status in the first place. Some of the triggers can simply be released to terminate grantor trust status and do not involve modification of the dispositive provisions of the trust. These triggers include the grantor's release of the power of substitution, the release by the grantor's spouse or a third party of the ability to add beneficiaries, or a trustee's release of the power to loan assets to the grantor without adequate security. On the other hand, if grantor trust status was caused, for example, by a spouse's income interest in the trust, then turning off grantor trust status may prove more difficult because it involves a substantive modification of the dispositive terms of the trust. In addition, caution should be exercised in identifying who may turn off such a spousal interest to avoid any adverse estate or gift tax consequences, and, in any event, it should not be the grantor or a current or remainder beneficiary of the trust.[27]

Planning for the ability to restore grantor trust status that has been turned off provides maximum flexibility. For example, the trust instrument could provide a mechanism for the possible reinstatement of a power of substitution that has been released by the grantor.[28] However, toggling of a grantor trust, and particularly turning grantor status back on, can be a complicated area and careful planning is advised.

V. Sales to Grantor Trusts

One of the most powerful uses of a grantor trust to reduce estate tax liability of a wealthy client involves the sale of appreciating assets to an irrevocable grantor trust. The "sale to a grantor trust" technique involves two separate and distinct transactions. In the first transaction (the "Gift Transaction"), a grantor makes an initial transfer of assets to a grantor trust, with the value of the transferred assets not exceeding the grantor's remaining lifetime gift tax exemption (the current maximum being $5.45 million). The initial transfer is considered a gift for gift tax purposes, but if the gift does not exceed the grantor's remaining gift tax exemption, then the grantor will simply utilize some or all of such exemption to avoid actually paying a gift tax on the transfer.

In the second transaction (the "Sale Transaction"), the grantor sells assets to the trust in exchange for a promissory note. This sale will be ignored for income tax purposes because the Code considers the grantor to be the owner of all trust property for income tax purposes, and—because the grantor is viewed as having sold the assets to herself—no gain or loss is recognized on the Sale Transaction.[29] Likewise, the grantor will not recognize income when the grantor receives interest payments on the note. Often times, the promissory note calls for (i) repayment of the purchase price in just under a nine-year period, (ii) interest to accrue at the mid-term Applicable Federal Rate, (iii) annual payments of interest, and (iv) a balloon payment of the outstanding balance at the end of the term. The assets of the trust that are not used to repay the promissory note (and all growth and appreciation of such assets) pass to the beneficiaries of the trust (usually the grantor's descendants).[30]

The assets transferred to the trust in both the Gift Transaction and the Sale Transaction typically consist of appreciating and/or income-producing assets. By exchanging the grantor's appreciating and/or income-producing assets for a promissory note accruing a low, fixed rate of interest, the grantor is able to "freeze" the value of the grantor's estate and move all future appreciation on, and income generated by, the gifted/sold assets out of the grantor's estate for estate tax purposes.

The value of assets transferred into the trust are often discounted for tax purposes, reflecting a discount for "lack of marketability" and/or "lack of control" inherent in the transferred assets. For example, nonvoting stock of a closely-held business is routinely discounted because it cannot readily be sold (*i.e.*,

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there is no readily-available market for stock in closely-held businesses) and because it offers the owner no control over the business (*i.e.*, because it is nonvoting). The advantage of using assets with discounted values in connection with a grantor trust is that the grantor is often able to transfer more value to the beneficiaries than is actually reflected for gift and estate tax purposes. In other words, the grantor is able to further leverage the wealth transfer capabilities of the grantor trust beyond that available through grantor trust status alone. However, it should be noted in this regard that on August 2, 2016, the IRS issued Prop. Treas. Reg. § 25.2704-1 to § 25.2704-4, which, if enacted in their current form, would limit the use of discounts in connection with the transfer of interests in closely-held family businesses.

The power of this technique can be illustrated by a simplified example. Assume that (i) a grantor wishes to sell a minority ownership position in a closely-held business to a grantor trust that he established for the benefit of his children, (ii) the business regularly achieves a 10% return on equity, (iii) the grantor's ownership interest equity position is worth $1,000,000 prior to application of any discounts, and (iii) such interest has a fair market value of $750,000 based on a qualified appraisal taking into account discounts for lack of marketability and lack of control. In such instance, the grantor could sell the ownership interest to the grantor trust in exchange for a nine-year secured promissory note with a face value of $750,000 and providing for interest at the mid-term Applicable Federal Rate (*i.e.*, 1.18% as of August 2016). After nine years, the grantor will have received $829,650 from the transaction, and the trust will have approximately $1,300,000 of assets after payment of the note.[31] The grantor will have essentially "frozen" the value of the grantor's estate for estate tax purposes and passed $1,300,000 of assets to the trust beneficiaries, and that is without taking into account the income tax benefits of the grantor trust discussed above.

VI. Uncertainty Regarding the Future

Grantor trusts have been in the bullseye of the Obama administration for several years. As in prior years, President Obama's budget proposal for fiscal year 2017 again proposed changes to the estate and gift tax treatment of grantor trusts in certain circumstances.[32] As the Treasury Department explained, with regard to any grantor trust assets that were acquired through a "sale, exchange, or comparable transaction" which was disregarded for income tax purposes, the proposal would:

- Include the value of such assets (including income, appreciation, and reinvestments) in the grantor's estate at the time of the grantor's death;
- Deem any distribution of such assets from the trust during the grantor's life to any person other than the grantor a gift subject to the gift tax; and
- Subject the value of such assets to gift tax if the grantor trust status were terminated during the grantor's life.[33]

Although practitioners need to be mindful of the possibility that these proposals could be adopted as law at some point in the future, the President's proposal was widely labeled "dead on arrival" by the media and some members of Congress. However, it still remains to be seen how the November elections might alter the chances that we see these or other changes made to the grantor trust rules.

VII. Conclusion

Grantor trusts provide practitioners with a powerful tool in the effort to reduce estate taxes for a high net worth client. The income tax features unique to this type of trust enable a client to significantly leverage their wealth transfer capabilities. This is particularly true if the "sale to a grantor trust" technique is employed. However, practitioners should exercise caution to ensure that the grantor trust trigger or triggers that are chosen do not cause inclusion in the estate of the client at the time of death. Likewise, practitioners must ensure that the client fully understands the income tax treatment of a grantor trust before implementing the trust and plan for mechanisms to mitigate or entirely "turn off" the grantor trust status if a client decides they no longer desire to be responsible for the income tax of the trust.

Endnotes

1 *See* Jonathan G. Blattmachr, Austin W. Bramwell, and Diana S.C. Zeydel, *Portability or No: The Death of the Credit-Shelter Trust?*, 118 J. TAXATION 231 (May 2013) (page 245).

2 I.R.C. § 671. It is important to note that a person other than the individual that forms and funds a trust may be deemed the "grantor" of a grantor trust under I.R.C. § 671. However, for purposes of this article, we will only make reference to situations where the individual who forms and funds the trust is referred to as the "grantor."

3 https://www.irs.gov/businesses/small-businesses-self-employed/abusive-trust-tax-evasion-schemes-questions-and-answers

4 I.R.C. § 671.

5 Treas. Reg. § 1.671-3(a)(2).

6 *See* Jonathan G. Blattmachr & Diana S. C. Zeydel, *Beneficiary Defective TrustSM Private Letter Ruling* (2009); *see also* Jonathan G. Blattmachr et al., *Selected Comparisons of Selected Estate Tax Reduction Strategies*, published in the ACTEC Proceedings in Greenbriar, West Va. (Fall 2007).

7 Fifty percent (50%) estimated rate is an approximate number based on combined 39.6% federal income tax rate, 3.8% net investment income tax and 6.84% Nebraska income tax rate.

8 Rev. Rul. 2004-64, 2004-2 CB 7.

9 Note that, pursuant to I.R.C. § 678, a beneficiary of a trust may be deemed to be the grantor of a trust under I.R.C. § 671. However, for purposes of this article, the focus is on the provisions which cause the creator/funder of the trust to be considered the grantor for income tax purposes.

10 *See* I.R.C. § 675(4)(C).

11 *See* § 1014 (the tax basis of assets transferred at death is "stepped up" or down to its fair market value at the date of grantor's death (or alternate valuation date)).

12 Notably, it has been held that a power to substitute assets does not constitute a power to alter beneficial enjoyment of an asset under I.R.C. § 2036(a), a retained economic benefit to the grantor under I.R.C. § 2038(a), nor is it a retained incident of ownership under I.R.C. § 2042, *See Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1972), acq. 1977-1 C.B. 1; Rev.Rul. 2008-22, 2008-1 C.B. 796; and Rev. Rul. 2011-28, 2011-49 IRB 830, 12/01/2011.

13 *See* Rev. Rul. 2011-28, 2011-49 IRB 830, 12/01/2011.

14 *See* Rev.Rul. 2008-22; Rev. Rul. 2011-28.

15 I.R.C. § Section 677(a)(1).

16 I.R.C. § 672(a).

17 *See* I.R.C. § 677(a)(3).

18 *Corning v. Comm'r*, 104 F.2d 329, 333 (6th Cir. 1939); *Moore v. Comm'r*, 39 B.T.A. 808 (1939), acq. 1939-2 C.B. 25.

19 I.R.S. Field Att'y Advice Mem. 20062701F (July 7, 2006); Priv. Ltr. Rul. 88-52-003 (August 31, 1988).

20 *See Iversen v. Comm'r*, 3 T.C. 756 (1944); *Weil v. Comm'r*, 3 T.C. 579 (1944).

21 I.R.C. § 674(a) and (b).

22 I.R.C. § 2041.

23 I.R.C. § 675(2).

24 *See* Treas. Reg. § 1.675-1(b)(2).

25 *See* Stephen R. Akers, Jonathan G. Blattmachr and F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 Real Property, Trust and Estate Law Journal, Vol. 44, No. 2, Summer 2009.

26 *Id.*

27 Allowing the grantor to exercise such power would likely cause estate tax inclusion and granting such power to the beneficiaries could be seen as a power of appointment that causes negative gift or estate tax consequences.

28 The power to reinstate should be held by someone other than the grantor, otherwise the grantor's release of the power may be disregarded. *See* Treas. Reg. § 1.675-1(a); *see also* Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, in A.L.I.-A.B.A. COURSE OF STUDY: PLANNING TECHNIQUES FOR LARGE ESTATES 1539, 1556 (2007) (explaining that even if the original party who had the power to reinstate the power to add beneficiaries, he or she would be treated as never having relinquished the authority to add beneficiaries in the first place).

29 *See* I.R.C. § 671 and Rev. Rul. 85-13, 1985-1 C.B. 184.

30 To ensure that assets transferred to the irrevocable trust are not included in the grantor's estate for estate tax purposes, it is important that certain "best practices" be utilized, the specifics of which are beyond the scope of this article.

31 This assumes (i) loan repayment of the original $750,000 principal balance, plus $79,650 in interest payments, (ii) growth on the original $1M equity amount at a 10% annual rate, and (iii) that the trust has sufficient cash flow to make annual interest payments.

32 Office of Management and Budget, *Budget of the U.S. Government Fiscal Year 2017*, 154 (Feb. 9 2016).

33 Department of the Treasury, *General Explanations of The Administration's Fiscal Year 2017 Revenue Proposals*, February 2016.

See next page for rest of agenda and registration form